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International Accounting Standards Board

INFORMATION FOR OBSERVERS

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Project: **Liabilities and Equity**

Subject: **Illustrations (Agenda Paper 4H)**

INTRODUCTION

1. This paper provides a series of examples to illustrate the discussions from the preceding topic papers.

2. The paper is organized into four categories of instruments; Common Stock, Preferred Stock, Options and Forwards, Hybrids. The first section of this paper gives a brief overview of a basic instrument in each category and how the three models would classify such an instrument. The paper then addresses each category of instruments in turn seeing how the basic instrument can be varied and the impact of those variations to the classification.

3. This paper is not intended to be exhaustive. A more extensive reference section can be found at the back of the FASB models.

OVERVIEW OF BASIC INSTRUMENTS BY CATEGORY

4. Common stock. The basic instrument is an ordinary share, perpetual, fully subordinated on liquidation, with full participation in profits or losses of the entity.

5. Preferred stock. The basic instrument is perpetual, discretionary non-cumulative fixed coupon, with preference to common stock on liquidation.

6. Hybrid instruments. The basic instrument is a zero coupon convertible bond, issued at a discount to notional, maturing at notional amount in five years or converting to a fixed number of ordinary shares.

7. Options and forwards. The basic instrument is a written call option that must be settled with a fixed number of the underlying shares.

Table 1 – summary of classification of basic instrument.

	Ownership	**Ownership-settlement**	**REO**
Common Stock	Equity	Equity	Equity
Preferred	Equity	Equity	Liability
Convertible	Liability	Split – eq & liab	Split – eq & liab
Written call option	Liability	Equity	Split – eq & asset

8. The ordinary shares have a claim to a proportional share in the net assets of the entity and have no preference on liquidation. The shares meet the criteria to be an ownership instrument and are equity under every model.

9. The preference shares do not participate in the performance of the entity and are preferential on liquidation, therefore they are not an ownership instrument. However as there is no settlement obligation they are classified as equity under ownership and ownership-settlement. The absence of an obligation is

not sufficient for equity classification under REO and as there is no ownership interest (either direct or indirect) the instrument is a liability.

10. As the convertible bond does not provide a proportional claim to the net assets of the entity and is preferential on liquidation therefore does not meet the criteria to be an ownership instrument. The instrument does have a settlement feature, being the maturity date of the bond or the conversion date and therefore is not a perpetual instrument. As such the instrument is a liability under the ownership model.

11. Ownership-settlement and REO both consider the different potential outcomes. Conversion into the ordinary shares represents an equity outcome, if the bond does not convert then it is straight debt which is a non-equity outcome. Therefore the convertible bond qualifies for split accounting under both models.

12. The option contract does not represent an existing ownership instrument and has a settlement outcome; therefore under ownership the instrument is not equity. The instrument does meet the criteria of an indirect ownership instrument under both REO and ownership-settlement, ie the value of the instrument moves directly with the fair value of the underlying common stock (which itself is an ownership instrument) and the instrument is settled with common stock. Ownership-settlement classifies the entire instrument as equity. Under REO the exchange contract represents two payoffs, cash receipt and issuance of shares, therefore the REO model splits the instrument into the two exchange components and recognizes an asset (probability weighted cash receipt) and equity (fractional share).

COMMON STOCK

13. The ordinary share is classified as equity under all three models due to it representing an ownership instrument.

14. The ordinary share would be recognized at the issue price in equity and would not be subsequently remeasured.

Puttable at fair value

15. The basic ordinary share - but the holder has the option to put the share back to the entity at any time to be redeemed at the proportional share of the fair value of the entity.

16. This put feature creates an obligation, however as the put is at fair value the instrument still has a proportional share in the performance of the entity. Therefore the share is equity in its entirety under all three models.

Puttable at par (or other than fair value)

17. The basic ordinary share with a put feature, but the redemption value of the share is the par value.

18. The ability to put the share at par means the instrument has a guaranteed share of the net assets, and therefore does not meet the criteria to be an ownership instrument.

19. The instrument is not perpetual and is not an ownership interest therefore under the ownership model the instrument is not equity.

20. Both REO and ownership-settlement recognize the two possible outcomes from this instrument, exercise of the put (which creates an instrument that doe not participate proportionally) or non-exercise of the put (which leaves a perpetual ownership instrument). As such both models split the instrument into liability and equity components.

21. The mechanism for splitting the instrument is different under REO and Ownership-settlement. Under the ownership-settlement model the full redemption amount is discounted back from the expected settlement date, this assumes a 100% probability of a liability outcome; in practice this means that the most of the instrument would be recorded as liability. Under REO the probability of redemption is considered in the calculation, and therefore the liability component will be more reflective of separating out the FV of the embedded put option.

22. Subsequent measurement:

    a. Under ownership the entire instrument is liability and would therefore be subject to IAS 39 measurement requirements.

    b. Under ownership-settlement the liability component would be subject to IAS 39 measurement requirements. The equity component would not be remeasured. And the split between components would not be reassessed.

    c. Under REO the entire instrument would be remeasured to fair value at each reporting date. The movement in the fair value would be taken to the income statement. And the split between the components would be reassessed.

23. Substantive features. There are many instances when the put feature may be regarded as non-substantive, for instance if there were legal or regulatory restrictions on the amount of capital that could be redeemed. In such a situation the put feature of any instruments in excess of that maximum amount would be non-substantive and would therefore be disregarded for classification purposes. The instrument would be classified as a non-redeemable ordinary share.

24. The above discussion is for a share redeemable at par, but the analysis and treatment would be the same for any share redeemable at other than fair value.

Puttable at book value

25. In situations where there is no active market, or shares can only be sold back to the issuing entity, shares puttable at book value or a formula intended to represent fair value are treated as though they were redeemable at fair value. In those situations shares redeemable at book value would be equity under all three models as they represent an ownership instrument.

26. In situations where there is an active market or where shares can be traded outside of the entity, then book value or a formula intended to represent fair value are no longer considered to be a proxy for fair value. In these situations such instruments would be treated consistently with the discussion above for redeemable at par.

Callable

27. The basic ordinary share with an issuer's option to call the share back to the entity at any time.

28. There is obviously a settlement term within this instrument; therefore it is not perpetual. However, because the issuer can avoid that settlement it does not impact the classification of the instrument.

29. The call is at the control of the issuer, therefore the redemption amount is irrelevant (ie whether the shares are callable at fair value or at par).

Table 2: summary of common stock

	Ownership	**Ownership-settlement**	**REO**
Basic ordinary share	Equity	Equity	Equity
Puttable at fair value	Equity	Equity	Equity
Puttable at par	Liability	Split – eq & liab	Split – eq & liab
Puttable at book value (subject to certain criteria)	Equity	Equity	Equity
Callable	Equity	Equity	Equity

PREFERRED STOCK

30. Preferred stock. The basic instrument is perpetual, non-cumulative fixed coupon, with preference to common stock on liquidation.

31. The instrument does not participate in the performance of the entity and the instrument is preferential on liquidation, therefore it does not meet the criteria

to be an ownership instrument. However, due to the absence of a settlement obligation both ownership and ownership-settlement classify the instrument as equity.

32. Under REO unless there are some ownership characteristics the instrument will not be classified as equity.

Preferential Dividend only

33. Preferred stock in some jurisdictions is fully participatory and has no priority in claim on liquidation. The only element of preference is in the non-discretionary payment of a fixed coupon dividend throughout the life of the entity and/or instrument.

34. Under all three models such an instrument would be regarded as an ownership instrument due to its proportional claim and no priority on liquidation, therefore the host instrument would be equity.

35. However, under all three models the non-discretionary dividend stream represents an obligation and as such must be separated out of the host instrument and carried as liability on the balance sheet. In practice the discounted value of the perpetual dividend stream would represent most, if not all, of the instrument's initial transaction price. Therefore essentially the entire instrument would be classified as liability - although in theory the host instrument is equity.

Convertible preferred stock

36. Preferred stock that includes an option for the holder to convert the preferred shares into a fixed number of common shares, at anytime after 5 years at the request of the holder or the issuer.

37. The conversion feature means the instrument is no longer perpetual as it has a settlement outcome (conversion). Also, the preference share does not represent an ownership instrument because it does not have a claim to a proportional share of the net assets and it is preferential to the ordinary shares on liquidation. Therefore under ownership the instrument is a liability.

38. Under ownership-settlement the instrument as the conversion is not mandatory there are multiple outcomes, but both outcomes are equity, conversion into ordinary shares represents an indirect ownership instrument, non-conversion represents a perpetual preference share. Therefore the instrument is equity. If the instrument converted into a variable number of shares it would be a liability.

39. Under REO the inclusion of the conversion feature introduces an equity outcome, conversion of the preferred stock to common stock (which represents an ownership instrument). Therefore the model would split the instrument into the preferred stock (which under REO is not equity) and the probability weighted conversion into common stock.

Table 3: summary of preferred stock

	Ownership	**Ownership-settlement**	**REO**
Basic preference share	Equity	Equity	Liability
Non-discretionary preferential dividends only	Liability separated from equity host.	Liability separated from equity host.	Liability separated from equity host.
Convertible preferred stock	Liability	Equity	Split – eq & liab

HYBRID INSTRUMENTS

40. None of the instruments in this category would be classified as equity under the ownership model; they do not represent ownership instruments in the entity and are not perpetual. The instruments would be recorded at transaction price as liabilities and would be accounted for under the guidance of IAS 39. As such the ownership model will not be discussed further within this section.

Basic instrument

41. The basic instrument is a zero coupon convertible bond, issued at a discount to notional and maturing in five years at notional amount or converting into a fixed number of ordinary shares.

42. Both ownership-settlement and REO recognize the two potential outcomes of this instrument; the conversion option represents an indirect ownership instrument and non-conversion represents straight debt. Therefore both approaches split the instruments into components.

Mandatorily converting instrument that converts into a fixed number of shares

43. Note issued for Cu 10 that receives interest and that converts to 1 share in 5 years.

44. Under the ownership-settlement model the instrument is an indirect-ownership instrument. The fair value of the instrument is dependent on the fair value of the underlying shares, and will be settled with the shares from which it derives its value. Therefore the instrument is equity in its entirety.

45. Under REO the instrument has a single equity component with a payoff that is directly related to the reporting entity's share price. Therefore the instrument is equity in its entirety.

Debt convertible into a variable number of shares (mandatorily convertible or not)

46. Zero coupon convertible bond, issued at a discount to notional, maturing in five years at the nominal amount of the bond or common stock worth the nominal amount of the bond.

47. Analysis under both REO and ownership-settlement is consistent. Settlement with a variable amount of shares means that the conversion feature does not meet the definition of an equity instrument and therefore the instrument is a liability in its entirety.

48. Substantive terms. A fixed number of shares represents an equity outcome under ownership-settlement and REO and a variable number of shares represent a non-equity outcome. However, if the variation in the number of shares is purely on the occurrence of a change in ownership, or a change in the capital structure of the entity, such terms are likely to be included to preserve the existing terms of the convertible debt. Such variations may sometimes be disregarded for classification purposes.

Table 4: summary of hybrid instruments

	Ownership	**Ownership-settlement**	**REO**
Basic convertible debt	Liability	Split eq & liab	Split eq & liab
Debt mandatorily convertible into fixed no. of shares	Liability	Equity	Equity
Debt convertible into variable no. of shares	Liability	Liability	Liability

OPTIONS AND FORWARDS

49. None of the instruments in this category would be classified as equity under the ownership model; they do not represent ownership instruments in the entity and are not perpetual. The instruments would be recorded at transaction price as either assets or liabilities, most would qualify as derivatives (with the exception of the prepaid forward) and would be carried at fair value under the guidance of IAS 39. The ownership model will not be discussed further within this section.

Basic share settled share option

50. The basic instrument is a written call option that must be settled with the underlying shares.

51. As the instrument derives its value from the underlying common stock and is settled with that common stock the instrument represents an indirect ownership instrument which would be classified as equity in its entirety.

52. Under REO the instrument has a payoff outcome that is based on the exchange of assets for the issuance of shares. The instrument is separated into an equity component (issuance of shares) and an asset component (receipt of asset).

53. Measurement:

    a. Under ownership-settlement the instrument is equity, initially measured at transaction price and not subsequently remeasured.

    b. Under REO the instrument is split into an asset (being the probability weighted cash to be received) and equity (being the fractional share) the total of the components equals the transaction price. The entire instrument is subsequently measured at fair value, and the split between components is reassessed at each reporting date.

Cash settled written call option

54. Identical to the above instrument but can be settled net in cash or with the issuance of shares.

55. The analysis under REO is unaffected by the change in terms; the instrument is split as discussed in paragraph 52 and 53c.

56. Under ownership-settlement the requirement of an indirect ownership instrument is that the instrument must be settled with the ownership instrument from which it derives its value, ie a share option must be settled with those shares. The change in terms of the instrument to allow cash settlement means the instrument is no longer an equity instrument and must be classified as a liability in its entirety.

Purchased put option, share settled

57. An instrument in which the reporting entity has the right to issue to the counterparty a specified quantity of its own shares at a fixed price.

58. The analysis and treatment of this instrument is consistent with the written call option detailed above.

Purchased call option, share settled.

59. An instrument in which the reporting entity has the right to repurchase a specified quantity of its own shares from the counterparty at a fixed price.

60. Under ownership-settlement this instrument does not represent an indirect ownership instrument as the value of the instrument is not directly related to the fair value of the underlying instrument. The value inversely reflects the movements in the fair value of the underlying ownership instrument. As such the instrument would be classified as non-equity.

61. Under REO an indirect ownership instrument can follow either directly or inversely the fair value of the ownership instrument of the entity, therefore under REO this instrument does represent an indirect ownership instrument. As the instrument has a payoff outcome that is based on the exchange of assets for the repurchase of shares the instrument is separated into an equity component (repurchase of shares) and a liability component (payment of cash).

Share settled forward contract

62. Contract for no initial consideration to issue 1 share to the counterparty in 2 years time for Cu 10.

63. The contract is an indirect ownership instrument, the value of the contract varies directly with the value of the underlying ordinary shares, and the contract will be settled with those ordinary shares. Therefore, under ownership-settlement the contract would be classified as equity in its entirety, and under REO the contract would be split into its exchange components.

64. If the forward contract were cash settled the instrument would not meet the definition of an indirect ownership instrument under ownership-settlement and would be classified as a liability. The cash settlement feature would not change the analysis under REO.

65. If the forward contract were for a variable number of shares the fair value of the contract would no longer be indexed to the fair value of the shares and therefore the instrument would be non-equity under both ownership-settlement and REO.

Table 5: summary of options and forwards

	Ownership	**Ownership-settlement**	**REO**
Basic share settled written call option	Liability	Equity	Split eq & asset
Cash settled written call option	Liability	Liability	Split eq & asset
Purchased put option	Asset	Equity	Split eq & asset
Purchased call option	Asset	Asset	Split contra eq & liab
Share settled forward contract	Liability	Equity	Split eq & asset