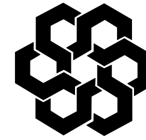

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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **24 January 2007, London**

Project: **Liability and Equity**

Subject: **Overview of IAS 32 (Agenda paper 12B)**

BACKGROUND

1. The distinction between equity and liability has significant consequences for most entities, including balance sheet ratios, the determination of profit and loss and earnings per share. In some jurisdictions there may also be tax implications. Hence the extent of debate (and disagreement) about where that line should be drawn.

2. It is generally accepted that the dividing line between equity and liability should be conceptual rather than based on a set of (possibly inconsistent) rules. Issues, including the tension between legal form and economic substance, as well as the overlapping nature of many "hybrid" financial instruments, make drawing a conceptually based line challenging.

3. This paper sets out to illustrate these difficulties by considering the model in IAS32 and discussing a number of application issues that model has created. This paper also highlights the significant challenge we face in the L/E project given the wide diversity of opinion regarding what "equity" is.

CONTENTS OF THIS PAPER

4. This agenda paper summarises the current liability/equity (L/E) classification requirements under IAS 32 *Financial Instruments: Presentation* and highlights a number of application issues that have arisen.

5. This paper also illustrates the difference of opinion that exists among constituents and others regarding what is "equity". (Also see paragraph BC21 of IAS 32.)

6. This paper has two sections,

   - the first section provides a summary of IAS 32, as it relates to liability/equity;

   - the second section raises some of the application and discussion issues resulting from IAS 32;

7. This paper does not attempt to propose solutions to the issues raised, neither does it introduce the FASB models developed. The aim of this paper is to set the scene for Board sessions as proposed in paper 12a. Rather than provide the paper as background information to a future session the staff wanted to present the paper in order to identify any missing issues or concerns that board members would want included in the discussion.

SUMMARY OF THE IAS 32 MODEL

8. IAS 32 looks first to the definition of a liability when classifying whether a financial instrument is a liability or equity. The underlying principle is that if the instrument embodies a contractual obligation to deliver cash or another financial asset to another entity (or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity) the instrument is a liability.

9. The definition goes on to say that any contract settled in the entity's own equity instruments, (i) for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments in exchange for a fixed or indexed amount (variable shares for fixed amount) or (ii) that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments, also represents a liability

(fixed shares for variable amount). In summary, if a contract is for the exchange of a fixed amount of cash for a fixed number of shares the contract is classified as equity, however if either element shows variance then the contract is classified as liability. Some view the classification of any share settled contract as a liability to be contradictory to the existing conceptual framework; this point is discussed further in paragraphs 45 to 47**.**

10. In developing a clear distinction between two categories it is preferable to have just one defining characteristic. The more characteristics that are admitted the more combinations of characteristics are possible and, therefore, more categories of instruments will result.

11. As noted above IAS 32 relies on one defining characteristic, if the instrument embodies an obligation[1] it is a liability. If no obligation exists then it is equity. However, there are exceptions to that principle in IAS 32 and subsequently an overlay of rules; these exceptions and resulting rules are designed to allow application of the principle, prevent abuse and address some of the apparent counter-intuitive results that occur. Some of these rules (for example, relating to contracts that will or may be settled in the entity's own equity instruments) have been touched on above - and more of which are laid out below. The need for these exceptions and rules highlights the divergence of opinion that exists with regards to what is equity.

12. The IAS 32 model could be described as a 'settlement' model - however there is a body of thinking that equity should be defined by its ownership characteristics. It is the conflict between these two views that has led to many of the exceptions to the underlying principle in IAS 32, as discussed below.

Contractual Obligation

13. The critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of the issuer to deliver cash or another financial asset to the other party. Only if the entity has an unconditional right to

[1] To deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.

avoid delivering cash or another financial asset to settle a contractual obligation would the instrument be considered to be equity.

14. In some situations the terms and conditions of a contract may not explicitly establish a contractual obligation, but an indirect contractual obligation may exist.

15. The key word to note is "contractual". For instance, market expectation that an entity will redeem an instrument or make distributions does not result in liability classification. Similarly, if rational financial behaviour would predict redemption but there is no contractual obligation to redeem, then the instrument is equity.

Settlement with own shares

16. Settlement in own shares does not necessarily mean an instrument is equity. Only if a fixed number of an entity's own equity instruments will be exchanged for a fixed amount of cash or another financial asset, will the instrument be considered to represent a residual interest in the entity and be classified in part or in whole as equity.

17. In the event that the issuer can choose the mode of settlement (ie whether the instrument is settled in equity instruments or cash) then unless all settlement options are equity in nature the instrument will be a liability.

Contingent settlement and settlement options

18. Some instruments have contingent settlement provisions that are triggered by the occurrence or non-occurrence of uncertain future events that are beyond the control of both the issuer and the holder of the instrument. As the issuer can not unconditionally avoid settlement of the obligation (due to the fact that they can not control the trigger event) such instruments are classified as liabilities.

19. In situations where the contingent settlement provision is "not genuine" or when the contingent settlement is only in the event of liquidation, then the contingent settlement provision does not impact the classification as equity.

Compound instruments

20. If an instrument has separately identifiable equity and liability elements then it should be split into those elements and accounted for as two separate instruments.

21. A compound instrument is split by firstly identifying the liability component, which is measured at the fair value of a similar liability that does not include the equity feature. The equity component is measured as the difference between the transaction price for the instrument as a whole and the liability component.

Treatment of outstanding derivative contracts to be settled in shares.

22. Under IAS 32 forward purchase contracts and written put options on an issuer's own equity instruments that require physical settlement in exchange for cash are required to be treated as though the future transactions have already occurred. For a forward contract this would result in the recognition of a liability on day one at the present value of the settlement amount, and a reduction to equity of the same amount. The liability would accrete to the settlement amount via the income statement to the settlement date, then on settlement the entry would be to extinguish the liability and record the cash receipt. Hence the shares would be effectively terminated on day one.

Consolidated group vs separate stand alone entity

23. The classification of an instrument may differ between the stand alone entity and the consolidated group accounts. An instrument would be classified as equity in the stand alone entity accounts if it embodies no contractual obligation to deliver cash etc. But at a group level the existence of a written put option over those instruments issued by another group entity may mean that the group as a whole has an obligation to repurchase those shares in the future. Therefore, the instrument must be reclassified as a financial liability in the consolidated accounts.

APPLICATION AND DISCUSSION ISSUES ARISING UNDER IAS 32

24. The preceding paragraphs summarise the existing guidance on the classification of liability and equity as set out in IAS 32. But many of these principles and rules have created implementation issues. This section analyses some of those

implementation issues and also highlights some of the more contentious discussions that have been prompted by IAS 32. Frequently these issues illustrate the diverse opinions held as to what "equity" is.

Contractual Obligation – economic compulsion

25. As discussed above, the obligation to deliver cash or another financial instrument must be contractual (either explicit or implicit) in nature for that instrument to be classified as a liability. Economic compulsion does not create a liability.

26. An equity instrument with an embedded written put that is unlikely to be exercised would be a liability. If the put were exercised the writer would have no way of avoiding delivery of cash. But an instrument with a redemption feature that is controllable by the issuer is equity. This holds even though it may be known that the issuer has no other "economic" option but to redeem that instrument. Some argue that this result is counterintuitive. In the first situation (which is a liability), there is limited probability of an economic outflow occurring. In the second situation (which is not a liability), the probability of redemption is high.

27. One example that some maintain demonstrates economic compulsion is an instrument with a step-up clause on the coupons and a call option. If the step-up clause kicks in it will be economically preferable for the entity to exercise the call option and redeem the instrument than pay the increased coupon. The call option is under the control of the issuer. Economic compulsion to redeem does not create any contractual obligation and therefore the instrument is classified as equity under IAS 32.

28. In contrast, an instrument that may be settled either in cash (or another financial asset) or in a fixed number of shares, is deemed to give rise to an indirect contractual obligation and is classified as a liability, the holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option (IAS32.20(b)). This is an example of an indirect contractual obligation, but many struggle to see the difference in the obligation created by this example and economic compulsion as discussed above. One difference is that this contract contractually requires settlement in some form whereas the instrument discussed in paragraph 27 does not.

29. The above result (that an instrument with a high probability of settlement would be equity, whilst an instrument unlikely ever to settle would be a liability) is counter-intuitive to many peoples' ideas of what equity represents. But, it is consistent with IAS 32's underlying principle that the existence of a contractual obligation is the defining characteristic between equity and liability.

Contractual obligations - puttables

30. One issue, that has resulted in the publication of an ED, is an instrument redeemable by the holder at fair value. An obligation for the issuer exists and therefore the instrument meets the definition of a liability. An entity in which all of the shares or equity interests are redeemable may have no equity. IAS 32 sets out disclosures to communicate this situation to users of the financial statements.

31. As with the previous issue this issue demonstrates the diversity of approaches (and opinions) to the L/E line. Should the existence of a contractual obligation to deliver cash or another financial asset (the 'settlement') be the dictating principle, or should other 'ownership' factors take precedence?

What is meant by discretion?

32. A contractual obligation exists when the entity cannot avoid making a payment. Whether an entity does or does not have discretion quite often depends on individuals who have multiple relationships in and with the organisation. The same individuals could be owners, managers and investors in the entity, and those individuals make decisions in each of their roles. Therefore what represents discretion of the entity may be difficult to ascertain.

33. This becomes more important when considering puttables. If the put is at the discretion of the entity the instrument would be classified as equity. However, if the entity is controlled by the investors who would be exercising that put, then are those investors acting in their interest as investor or are they acting as the entity? Equally, if you change the situation to a family owned business, redemption of existing shares and reduction of the capital base is under the control of the shareholders jointly, but if it's an owner managed business essentially the shareholders are one person, who also manages the business, and can unilaterally call for redemption of the share capital.

34. Again this issue highlights the reluctance to accept the presence of a contractual obligation as the defining characteristic of the L/E line.

Settlement in own shares – impact of the fixed for fixed rule

35. As discussed in paragraph 9 and further in paragraphs 16 and 17, a contract to exchange cash for shares is classified as equity only if it is for the exchange of a fixed amount of cash (or another financial asset) for a fixed number of shares. Any variability in either of these components renders the contract a liability.

36. There have been a number of IFRIC submissions around this area, especially around the topic of foreign currency denominated instruments, and whether a fixed amount of currency, other than the functional currency of the entity, represents a fixed or variable amount of cash. The staff analysis (and subsequent Board discussions) showed that a fixed amount of currency, other than the functional currency of the entity, represents a variable amount of cash and therefore any instruments which include the delivery or exchange an entity's own equity instruments but which are denominated in a currency other than the functional currency of the entity, would not be equity. Additionally, this issue can be further complicated when considering which currency is the functional currency within a group situation.

37. The idea of fixed for fixed was to prevent the use of shares as a currency to settle obligations, but the precise rules cause many implementation issues. Additionally some argue that they do not result in the faithful representation of the instruments being classified. The issue as to whether or not a contract settled with shares that is classified as a liability actually conflicts with the existing conceptual framework is discussed in paragraphs 45 to 47.

Contingent settlement provisions

38. As discussed, a contingent settlement provision within an instrument could create an obligation and result in the instrument being classified as a liability (unless the contingent settlement is "not genuine" or only arises on liquidation of the issuer).

39. When a contingent settlement provision should be regarded as "not genuine" is an area of contention. An example, which is financial services specific but which

illustrates the point nicely, is a contingent settlement triggered by any change in the regulatory classification of the instrument. In many jurisdictions changes in regulatory practice grandfather existing instruments, which means instruments in existence prior to the change in rules will retain their original classification. Therefore it is highly unlikely the contingent settlement will ever be triggered, but in theory it could be, and including the provision in the instrument may change its classification even though it doesn't substantively alter the instrument.

Consolidation

40. There are a number of application issues regarding the interaction of IAS 32 with IAS 27. For example, puts held by minority interests and calls over majority holdings.

41. Puts and forwards held by minority interests are topics that have been addressed by the IFRIC. The question regarded the appropriate accounting when a parent entity has entered into a forward to acquire the shares held by the minority interest in a subsidiary, or alternatively when the minority interest holds a put to sell those shares to the parent entity.

42. Equally, sometimes a minority shareholder would have a contract with the majority shareholder that gives it the right to purchase the shares held by the majority shareholder. This would result in the minority acquiring control of the entity. The accounting for that call (whether it should be equity and, if not, whether it is as a derivative under IAS 39) has been questioned by some constituents.

Treatment of outstanding derivative contracts to be settled in shares.

43. The one dissenting opinion to IAS 32 was around this topic. The dissent considers the treatment of forward purchase contracts and written put options, and the fact that such unsettled derivative contracts are essentially accounted for as though they have already been executed. The accounting for these contracts results in combining the separate forward contract and the written put option with outstanding shares to create a synthetic liability. Recognising such a liability is inconsistent with our conceptual framework as there is no present obligation for such an amount.

44. In both of these situations the shares that are the subject of the contract are still outstanding, have the same rights as any other shares and the dissenting opinion argues that they should be accounted for as outstanding. Equally, the forward and option contract meet the definition of a derivative and the dissent argues that they should be accounted for as derivatives.

Settlement in own shares –and the interaction with the conceptual framework

45. A more conceptual issue arising from the fixed for fixed rule is that an entity may be required to classify a contract as a financial liability that does not meet the definition of a liability per the conceptual framework.

46. The conceptual framework definition defines a liability as *a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying an economic benefit.* Many people reason that settlement of an obligation with own issued equity instruments does not represent an outflow of resources embodying an economic benefit. Therefore classifying instruments settled with a variable number of shares as liability arguably contradicts our conceptual framework.

47. The reasoning behind the fixed for fixed rule was to prevent the use of shares as a currency to settle an outstanding obligation, and subsequently classify that obligation as equity. The standard also reasons that a contract that could be settled with a variable number of shares does not represent a residual interest in the entity. Again this issue illustrates the tension that exists between a settlement notion and an ownership notion when identifying the dividing line between equity and liability.

LESSONS LEARNT FROM IAS 32.

48. The issues encountered by the implementation of IAS 32 fall into three general categories:

- Implementation issues created by the specific rules within the standard. These issues tend to arise when instruments do not neatly fall into the rules as written. In many situations these rules create situations where people feel the strict

application of the rule leads to classification that does not faithfully represent the underlying instrument.

- Implementation issues created by counter-intuitive results. Simply speaking, the answer provided by the standard conflicts with the popular perception of how an instrument should be 'faithfully represented'. A good example of such an issue is the treatment of puttable instruments.

- Conceptual conflicts. This class of issue would include the debate over the classification of some share settled contracts as liabilities. It would also include the discussion around whether an executory contract should be treated as executed, as discussed with regards to option and forward contracts on own equity instruments.

49. The first category could be minimised in future standards by focussing on the principles and avoiding exceptions (which create the need for detailed rules).

50. The remaining two categories of issues generally arise due to conflicts between different ideas of what equity is. They also represent that conflict between the desire for a simple underlying principle to the distinction between equity and liability and the complex reality of the multiple defining characteristics of the two groups of instruments. And finally they illustrate the significant challenges faced by the L/E project in arriving at a conceptually based line that distinguishes between equity and other items.

51. Question for the board:

    - **Are there any issues absent from the above discussion that should be considered in the joint project?**