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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**23 January 2008, London**
Project:	**Liabilities and Equity**
Subject:	**Cover note: staff draft of the discussion paper *Financial Instruments with Characteristics of Equity* (Agenda paper 5)**

Background

1. In December 2007, the Board discussed the strategy for proceeding in the Liabilities and Equity project.

2. At that meeting, the Board decided that the IASB discussion paper should contain an IASB Invitation to Comment and the FASB Preliminary Views document *Financial Instruments with Characteristics of Equity*. The Board agreed that the goal is to issue the discussion paper in the first quarter of 2008.

3. Also at that meeting, representatives from the FASB led an education session on the FASB PV document. Board members had the opportunity to ask questions about the three approaches contained in that document.

FIWG meeting held on 17 January 2008

4. On 17 January 2008, the staff (and some IASB Board members) met publicly with members of Financial Instruments Working Group (FIWG) to discuss the draft IASB Invitation to Comment.

5. FIWG members were asked if the draft Invitation to Comment is as understandable and as complete as necessary given its purpose. FIWG members also were asked for comments and suggestions on the proposed questions for respondents that are included in the Invitation to Comment. The purpose of the FIWG meeting was <u>not</u> to debate the issues in the Invitation to Comment or the FASB PV document.

Objectives of this Board meeting

6. The objectives of this Board meeting are as follows:

   (a) to discuss the content of the staff draft of the IASB Invitation to Comment (That document is distributed as Agenda Paper 5A.)

   (b) to discuss the questions for respondents included in the IASB Invitation to Comment (For Board members' convenience, those questions are reproduced in Appendix 1 of this agenda paper. Also, the questions included in the FASB PV document are reproduced in Appendix 2 of this agenda paper.)

   (c) to provide to the Board an oral summary of the FIWG discussions

Content of the IASB Invitation to Comment

7. The Board asked the staff to prepare an analysis of the differences between IFRS requirements (IAS 32) and the three approaches discussed in the FASB PV document.

8. That analysis is included in paragraphs 39-73 of the Invitation to Comment. Additionally, the table in Appendix A of that document sets out how 25 instruments are classified under IAS 32 and would be classified under the three approaches in the FASB PV document.

9. ***Questions for the Board***

   (a) **Do Board members agree with the staff's analysis?**

   (b) **Is further analysis required? If so, what additional analysis do Board members think is necessary, and why?**

10. In addition to the aforementioned analysis, the Invitation to Comment includes the following information:

   (a) a brief summary of the relevant IFRS requirements related to distinguishing between liabilities and equity instruments (paragraphs 7-10 of the Invitation to Comment)

   (b) a summary of problems that arise from the application of the those requirements (paragraphs 11-30 of the Invitation to Comment)

   (c) a brief summary of the three approaches in the FASB PV document (paragraphs 31-38 of the Invitation to Comment)

11. ***Question for the Board***

    Is the content of the Invitation to Comment appropriate? If not, what information should be added or removed and why?

Proposed questions for respondents

12. Appendix B of the Invitation to Comment (reproduced as Appendix 1 of this agenda paper) includes questions for respondents that are <u>in addition to</u> those asked in the FASB PV document.

13. ***Questions for the Board***

Are the proposed questions appropriate? If not, what questions should be added or removed and why? How do any suggested changes interact with the questions included in the FASB PV document?

APPENDIX 1

<u>In addition to</u> the questions asked in the FASB Preliminary Views document, the staff thinks that the following questions should be asked in the IASB Invitation to Comment:

1. Do you agree that there a need for the IASB to comprehensively address the accounting for financial instruments with characteristics of equity? Why or why not?

   a) What aspects of existing IFRS accounting for such instruments could be improved or simplified and how pervasive are these issues?

   b) How important is it that the IASB develops a common, high quality standard used in both US and IFRS jurisdictions in the short to medium term?

2. Are the three approaches expressed in the FASB Preliminary Views document a suitable starting point for a project to improve and simplify IAS 32, and to create convergence between IFRS with US GAAP? If not, why not?

   a) Do you believe that the three approaches would be feasible to implement? If not, what aspects do you believe could be difficult to apply, and why?

   b) Are there any other alternative approaches to improve and simplify IAS 32 that you would recommend? What would be the benefit of those alternatives to users of financial statements?

3. How would you address the interaction between this project and the IASB's other projects on the conceptual framework, financial instruments and financial statement presentation? Are certain projects precedential?

4. Is the scope of the project as set out in paragraph 15 of the FASB Preliminary Views appropriate in all jurisdictions? If not, why not? What other scope would you recommend and why?

5. Are the principles behind the basic ownership instrument appropriate to all types of entities and in all jurisdictions? If not, which types of instruments or jurisdictions are they not appropriate in, and why? What would you recommend?

APPENDIX 2

The following questions are included in the FASB Preliminary Views document:

Questions on the Basic Ownership Approach

1. Do you believe that the basic ownership approach would represent an improvement in financial reporting? Are the underlying principles clear and appropriate? Do you agree that the approach would significantly simplify the accounting for instruments within the scope of this Preliminary Views and provide minimal structuring opportunities?

Perpetual Instruments

2. Under current practice, perpetual instruments are classified as equity. Under the basic ownership approach (and the REO approach, which is described in Appendix B) certain perpetual instruments, such as preferred shares, would be classified as liabilities. What potential operational concerns, if any, does this classification present?

3. The Board has not yet concluded how liability instruments without settlement requirements should be measured. What potential operational concerns, if any, do the potential measurement requirements in paragraph 34 present? The Board is interested in additional suggestions about subsequent measurement requirements for perpetual instruments that are classified as liabilities.

Redeemable Basic Ownership Instruments

4. Basic ownership instruments with redemption requirements may be classified as equity if they meet the criteria in paragraph 20. Are the criteria in paragraph 20 operational? For example, can compliance with criterion (a) be determined?

Separation

5. A basic ownership instrument with a required dividend payment would be separated into liability and equity components. That classification is based on the Board's understanding of two facts. First, the dividend is an obligation that the entity has little or no discretion to avoid. Second, the dividend right does not transfer with the stock after a specified ex-

dividend date, so it is not necessarily a transaction with a current owner. Has the Board properly interpreted the facts? Especially, is the dividend an obligation that the entity has little or no discretion to avoid? Does separating the instrument provide useful information?

Substance

6. Paragraph 44 would require an issuer to classify an instrument based on its substance. To do so, an issuer must consider factors that are stated in the contract and other factors that are not stated terms of the instrument. That proposed requirement is important under the ownership-settlement approach, which is described in Appendix A. However, the Board is unaware of any unstated factors that could affect an instrument‘s classification under the basic ownership approach. Is the substance principle necessary under the basic ownership approach? Are there factors or circumstances other than the stated terms of the instrument that could change an instrument‘s classification or measurement under the basic ownership approach? Additionally, do you believe that the basic ownership approach generally results in classification that is consistent with the economic substance of the instrument?

Linkage

7. Under what circumstances, if any, would the linkage principle in paragraph 41 not result in classification that reflects the economics of the transaction?

Measurement

8. Under current accounting, many derivatives are measured at fair value with changes in value reported in net income. The basic ownership approach would increase the population of instruments subject to those requirements. Do you agree with that result? If not, why should the change in value of certain derivatives be excluded from current-period income?

Presentation Issues

9. *Statement of financial position*. Basic ownership instruments with redemption requirements would be reported separately from perpetual basic ownership instruments.

The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity. Are additional separate display requirements necessary for the liability section of the statement of financial position in order to provide more information about an entity's potential cash requirements? For example, should liabilities required to be settled with equity instruments be reported separately from those required to be settled with cash?

10. *Income statement*. The Board has not reached tentative conclusions about how to display the effects on net income that are related to the change in the instrument's fair value. Should the amount be disaggregated and separately displayed? If so, the Board would be interested in suggestions about how to disaggregate and display the amount. For example, some constituents have suggested that interest expense should be displayed separately from the unrealized gains and losses.

Earnings per Share (EPS)

11. The Board has not discussed the implications of the basic ownership approach for the EPS calculation in detail; however, it acknowledges that the approach will have a significant effect on the computation. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?

Questions on the Ownership-Settlement Approach

1. Do you believe the ownership-settlement approach would represent an improvement in financial reporting? Do you prefer this approach over the basic ownership approach? If so, please explain why you believe the benefits of the approach justify its complexity.

2. Are there ways to simplify the approach? Please explain.

Substance

3. Paragraph A40 describes how the substance principle would be applied to indirect ownership instruments. Similar to the basic ownership approach, an issuer must consider factors that are stated in the contract and other factors that are not stated in the terms of the instrument. Is this principle sufficiently clear to be operational?

Presentation Issues

4. *Statement of financial position*. Equity instruments with redemption requirements would be reported separately from perpetual equity instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity. What additional, separate display requirements, if any, are necessary for the liability section of the statement of financial position in order to provide more information about an entity's potential cash requirements? For example, should liabilities required to be settled with equity instruments be reported separately from those required to be settled with cash?

Separation

5. Are the proposed requirements for separation and measurement of separated instruments operational? Does the separation result in decision-useful information?

Earnings per Share

6. The Board has not discussed the implications of the ownership-settlement approach for the EPS calculation in detail. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?

Settlement, Conversion, Expiration, or Modification

7. Are the requirements described in paragraphs A35–A38 operational? Do they provide meaningful results for users of financial statements?

Questions on the REO Approach

1. Do you believe that the REO approach would represent an improvement in financial reporting? What would be the conceptual basis for distinguishing between assets, liabilities, and equity? Would the costs incurred to implement this approach exceed the benefits? Please explain.

Separation and Measurement

2. Do the separation and measurement requirements provide meaningful results for the users of financial statements?

Earnings per Share

3. The Board has not discussed the implications of the REO approach for the EPS calculation in detail; however, it acknowledges that the approach will have a significant effect on the calculation. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?

Other Alternatives

1. Some other approaches the Board has considered but rejected are described in Appendix E. Is there a variation of any of the approaches described in this Preliminary Views or an alternative approach that the Board should consider? How would the approach classify and measure instruments? Why would the variation or alternative approach be superior to any of the approaches the Board has already developed?