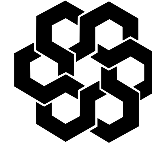

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International Accounting Standards Board

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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: **November 2008, London**

Project: **Financial Instruments with Characteristics of Equity**

Subject: **Developing a Classification Model (Agenda Paper 9)**

INTRODUCTION

1. At the joint FASB/IASB meeting, the Boards decided to begin future deliberations using the principles underlying the perpetual and basic ownership approaches.

2. This memo is divided into two parts. The first part discusses the following three basic classification issues that we think the Boards might be able resolve at this meeting:

   a. Should perpetual basic ownership instruments be classified as equity?

   b. Should other perpetual instruments be classified as equity?

   c. Should derivatives held or issued by an entity be classified as equity if the underlying is the entity's own equity instruments?

3. The second part of the memo raises the following classification issues that seem likely to require further analysis and consideration at future meetings:

a. Which hybrid instruments[1] should be separated into equity and non-equity components?

b. How should redeemable ownership instruments be reported?

c. Should instruments that are classified as equity in the financial statements of a subsidiary retain that classification in the consolidated financial statements?

d. How do the Boards want to address income statement presentation (especially disaggregation of gains and losses on derivatives and hybrid instruments)?

4. The reason for raising those four issues without enough analysis for the Boards to make decisions is that we need to know what points need to be analyzed. The FASB spent many meetings discussing similar issues and, therefore, large stacks of analysis memorandums are available. Rather than overwhelm the Boards with potentially uninteresting data, we want to ask for guidance on how to proceed with further analysis.

PART 1—ISSUES TO BE RESOLVED AT THIS MEETING

SHOULD PERPETUAL BASIC OWNERSHIP INSTRUMENTS BE CLASSIFIED AS EQUITY?

5. A basic ownership instrument has both of the following characteristics: (a) the holder has a claim to a share of the assets of the entity that would have no priority over any other claims if the issuer were to liquidate on the date the classification decision is being made and (b) the holder is entitled to a percentage of the assets of the entity that remain after all higher priority claims have been satisfied. The holder's share depends on its share of the total claims with the lowest priority and has no upper or lower limit except for the amount of net assets available.

6. For the purposes of this discussion, we are focusing on perpetual basic ownership instruments (for example, a share of stock with the lowest priority claim of all other instruments the entity has issued). We acknowledge that some redeemable

[1] In this memo, *hybrid instrument* has the same meaning as *compound financial instrument*, which is defined in the IFRS glossary as "a financial instrument that, from the issuer's perspective, contains both a liability and an equity element."

instruments meet the definition of a basic ownership instrument in the FASB Preliminary Views (PV) and the IASB Discussion Paper (DP) on financial instruments with characteristics of equity. Redeemable instruments are addressed in a later section of this paper.

7. We believe that perpetual basic ownership instruments represent ownership instruments in the entity and should be classified as equity. Holders of basic ownership instruments bear the ultimate risks and are entitled to the ultimate rewards inherent in an entity and its activities. The basic ownership instruments are the most subordinated interests in the entity.

8. **Question 1: Should perpetual basic ownership instruments be classified as equity?**

SHOULD PERPETUAL INSTRUMENTS WITH A PREFERENCE IN LIQUIDATION BE CLASSIFIED AS EQUITY?

9. Several times prior to issuance of the PV, the FASB debated whether perpetual instruments with a preference to dividends or in liquidation (preferred shares) should be classified as equity. On at least two occasions the FASB decided that if an instrument has no contractual settlement requirements and entitles the holder to a share of the issuer's net assets in liquidation, it should be classified as equity. However, shortly before issuing the PV, the FASB decided to classify perpetual preferred shares as liabilities because the Board was unable to resolve issues of economic compulsion (related to instruments with increasing dividend rates).

10. We believe that instruments that lack a settlement requirement should be classified as equity. Advantages of classifying preferred shares as equity are as follows:

    a. It would address concerns of the majority of respondents to the PV and DP who objected to classifying preferred shares as liabilities. Most respondents stated that preferred shares should not be classified as liabilities because they do not impose an obligation to deliver cash or other assets. Also, some respondents suggested that classifying preferred shares

as liabilities could have a significant effect on financial ratios and would require significant amendments to debt covenants, which would result in incremental costs.

b. If preferred shares are classified as liabilities, the Boards will have to decide how to measure instruments without settlement requirements (or at least to allocate a portion of retained earnings to those classified as liabilities). Classifying preferred shares as equity would eliminate the need to address that issue.

11. One potential disadvantage of classifying preferred shares as equity involves increasing dividend rates or similar features that become so punitive that future settlement is a high probability, even without a contractual settlement requirement. Several Board members have already made it clear that they believe it is necessary to establish a principle requiring liability classification in those situations. Based on past experience, we believe it will be very difficult to determine exactly when the probability of settlement becomes high enough to justify liability classification.

12. **Question 2: Should perpetual instruments with a preference in liquidation be classified as equity?**

SHOULD DERIVATIVES ON AN ISSUER'S OWN EQUITY INSTRUMENTS BE CLASSIFIED AS EQUITY?

13. To date, the Boards have focused on two alternatives for classifying derivatives on an issuer's own equity instruments:

a. Alternative 1—Classify indirect ownership instruments settled with equity instruments as equity (or contra-equity).

b. Alternative 2—Classify all equity derivatives as assets or liabilities.

Classify Indirect Ownership Instruments Settled with Equity Instruments as Equity

14. The PV describes an indirect ownership instrument as a derivative whose fair value changes in the same direction as (not in the opposite direction to) the fair value of the basic ownership instrument. An indirect ownership instrument is classified as equity only if it is ultimately settled (that is, net-share settled or gross physically settled) with a basic ownership instrument. (As noted in paragraph 47 of DP, the requirements related to derivatives in IAS 32 are different. IAS 32 classifies as equity both delivery and receipt contracts that are gross physically settled if they meet the "fixed for fixed" principle. IAS 32 also requires an entity to recognize a liability for any obligation to deliver a financial asset arising as a result of a forward purchase contract or a written put option.)

15. Some view indirect ownership instruments settled with the issuer's equity instruments as "nascent equity." The holder has a return similar to the return of an equity instrument and will (or has the option to) eventually hold an equity instrument. Moreover, the issuer does not have an obligation to deliver cash or another financial instrument to the holder of the indirect ownership instrument.

16. Classifying indirect ownership instruments as equity would be an exception to underlying principles of both the basic ownership and perpetual approaches. In addition, it raises a number of difficult questions. If a derivative has multiple underlyings but always changes in the same direction (though not by the same amount or percentage) as the underlying equity instrument, is it equity? How would settlement alternatives—net in cash or shares as compared to gross physical share settlement—affect classification and why?

Classify All Derivatives as Assets or Liabilities

17. This alternative would require all derivatives to be classified as liabilities or assets and is consistent with the two approaches that the Boards agreed to use as a starting point for deliberations. Indirect ownership instruments, even simple ones such as written call options, do not represent ownership interests until the options are exercised and the holders receive equity instruments.

18. We believe that all derivatives should be classified as liabilities or assets. An instrument's form of settlement should not determine classification. We also believe that instruments with identical economic payoffs (for example, a net-share written call option and net-cash-settled written call option) should be classified the same way.

19. We acknowledge that classifying all derivatives as liabilities or assets will require the Boards to consider whether employee stock options accounted for under Statement 123(R) or IFRS 2 should be within the scope of this project. Unless Board members have already made up their minds that they do not want to open the employee stock option issue, the staff will address it at a future meeting.

20. **Question 3: Should derivatives on an issuer's own equity instruments be classified as liabilities and assets?**

PART 2—ISSUES THAT NEED FURTHER CONSIDERATION

WHICH HYBRID INSTRUMENTS SHOULD BE SEPARATED?

21. A hybrid instrument is an instrument that has both equity and non-equity features. The basic ownership approach as written in the PV requires an instrument to be separated into an equity component and a non-equity component if it requires a payment and, after the payment is made, an equity instrument remains outstanding.

22. Some Board members have suggested that the following additional instruments should be separated:

    a. Some or all puttable instruments

    b. A bond that grants an option to the holder to convert it into a fixed number of equity instruments

23. Regardless of which instruments are to be separated, the method of separation and measurement of the parts will need to be addressed. We will prepare an analysis of possible separation methods for discussion at a future meeting. The planned discussion at this meeting is about which instruments should be separated.

24. **Question 4: Have we identified the instruments that should be considered for separation? If not, what others should we include in the list?**

HOW SHOULD REDEEMABLE OWNERSHP INSTRUMENTS BE REPORTED?

25. The Board could decide that some, or all, redeemable ownership instruments (instruments that would be equity if not for the redemption feature) should be separated into components (for example, puttable instruments). However, if those instruments are not separated, the question is how they should be classified.

26. We have identified three alternatives:

    a. Alternative 1—Classify all redeemable ownership instruments as equity.

    b. Alternative 2—Classify all redeemable ownership instruments as assets or liabilities.

    c. Alternative 3—Classify some specific types of redeemable ownership instruments as equity.

Classify All Redeemable Ownership Instruments as Equity

27. The Boards could decide to classify all redeemable instruments as equity. However, that alternative is not consistent with the principles underlying the basic ownership approach or the perpetual approach.

Classify All Redeemable Ownership Instruments as Assets or Liabilities

28. The Boards could decide that no redeemable instruments should be classified as equity. However, that alternative is not consistent with the Boards' preliminary views on redeemable instruments. The basic ownership approach would classify particular redeemable instruments as equity if they are appropriately subordinated. Additionally, some Board members have expressed a desire to retain the IAS 32 classification of puttable instruments and obligations arising on liquidation. Moreover, entities that only issue redeemable instruments (for example, some

cooperative and private entities) would have no equity and certainly would raise objections that are hard to dismiss.

Classify Some Specific Types of Redeemable Ownership Instruments as Equity

29. Unless the Board directs otherwise, we will analyze the following issues for discussion at a future meeting:

    a. Can an entity have redeemable and non-redeemable instruments both classified as equity?

    b. Can an instrument that is redeemable at an amount other than fair value (such as at a fixed amount) be classified as equity?

30. We also will consider whether the types of entities that issue redeemable instruments are so fundamentally different from other entities that they require a separate set of classification principles.

31. We believe this is a reasonable starting point for the Boards' future deliberations. It is consistent with much of the feedback that the Boards received during the project that resulted in the recent amendment to IAS 32 and IAS 1, from the comment letters to the PV and the DP and at the FASB public roundtable meetings in September 2008.

32. **Question 6: Should some redeemable instruments be classified as equity? If so, what are your initial views about which ones?**

SHOULD INSTRUMENTS ISSUED BY A SUBSIDIARY BE CLASSIFIED THE SAME WAY IN THE CONSOLIDATED FINANCIAL STATEMENTS AS IN THE SUBSIDIARY'S SEPARATE FINANCIAL STATEMENTS?

33. We have identified two alternatives for determining how instruments issued by a subsidiary should be classified in the consolidated financial statements of the group:

    a. Alternative 1—Carry over classifications from subsidiary financial statements into the consolidated financial statements unless the nature of

the instrument changes in consolidation because of arrangements between the instrument holder and another member of the consolidated group

b. Alternative 2—Always reconsider classifications of instruments issued by a subsidiary in the consolidated financial statements, regardless of how the instruments are classified by the subsidiary

Carry over Classifications from Subsidiary Financial Statements into Consolidated Financial Statements

34. This alternative generally is consistent with the basic ownership approach and IAS 32 (except for some puttable instruments and instruments that impose an obligation on liquidation). Many respondents to the PV and the DP disagreed with this alternative.

35. This alternative could allow entities to report additional equity for the consolidated group by establishing subsidiaries to issue equity instruments that would not meet the definition of equity if they had been issued by the parent.

Always Reconsider Classifications of Instruments Issued by a Subsidiary in the Consolidated Financial Statements

36. This approach is consistent with the recent amendment to IAS 32 and IAS 1 for puttable instruments and instruments that impose an obligation on liquidation. Instruments within the scope of that amendment are classified as equity in the separate financial statements of the subsidiary if all of the relevant requirements are met, but would not be equity of the consolidated group because they are not the residual interest in the consolidated financial statements. Therefore, those instruments would be classified as financial liabilities in the consolidated financial statements of the group.

Question 7: Have we identified the appropriate alternatives? If so, what are your initial views? If not, what other alternatives should we analyze?

INCOME STATEMENT PRESENTATION ISSUES

37. The PV does not address any income statement presentation issues that arise from measuring financial instruments at fair value. We acknowledge that some Board members believe that presentation issues are fundamental to this project and must be addressed. However, income statement presentation issues are not unique to this project. Similar presentation issues arise when the fair value option is applied and will arise in the Boards' project on reducing complexity in reporting financial instruments.

38. The staff has performed extensive research on this topic, including the following:

    a. In March 2006, the staff issued a questionnaire to users (primarily buy-side equity analysts, sell-side equity analysts, and rating agencies) that asked what types of information about financial instruments measured at fair value would be relevant to their analysis. The staff received responses to the questionnaire from 47 individuals covering 34 organizations. The staff also spent a considerable amount of time meeting with those organizations to discuss their responses. The staff discussed that research with the IASB in June 2006. In 2007, the FASB staff held meetings with selected users to confirm their understanding of the original feedback and determine any additional informational needs.

    b. The PV and the DP asked constituents to comment on whether the change in an instrument's fair value should be disaggregated and, if so, how that amount should be disaggregated and displayed.

    c. In September and October 2008, the staff interviewed eight users (primarily equity and credit analysts) to obtain their views on how changes in fair value should be disaggregated and displayed.

39. Based on the input received, users would like additional disaggregated information about changes in fair value. Users suggested varying types and levels of disaggregation of changes in the fair value of liabilities. However, almost all the

users who participated in the research would like to see interest expense for non-derivative instruments and changes in value of derivatives related to an entity's share price separately displayed.

40. Some users also suggested separate presentation for the change in an instrument's fair value related to the reporting entity's own credit risk. Toward that end, paragraph 10 of IFRS 7 states that "if the entity has designated a financial liability as at fair value through profit or loss in accordance with paragraph 9 of IAS 39, it shall disclose (a) the amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to the changes in credit risk of that liability…." Statement 159 requires similar disclosure if an entity has elected the fair value option. [Portions of this paragraph have been omitted from the observer note.]

41. Disaggregation of changes in fair value is a complex topic that could easily be a separate major project. However, the Boards can address the issues described in paragraph 39 relatively easily. We recommend that the Boards consider requiring issuers to separately display (a) interest expense for all non-derivative instruments classified as liabilities and (b) changes in the fair value of derivatives on the entity's own equity instruments. Those recommendations would address a majority of the users' concerns and will significantly improve the current presentation requirements. We acknowledge that there are aspects of these recommendations that require further analysis (for example, how to present changes in the fair value of a derivative that has multiple underlyings, one of which is the entity's own equity instruments).

42. Any requirements beyond what we recommend would introduce complexity and may decrease the usefulness and comparability of the information provided. For example, if the Boards choose to separately display more than one component of the change in fair value for non-derivative instruments, determining the order in which those components are determined significantly affects the resulting amounts presented because the components are interrelated.

43. **Question 8: Should separate presentation be required of (a) interest expense for all non-derivative instruments classified as liabilities and (b) changes in the fair value of equity derivatives classified as liabilities?**