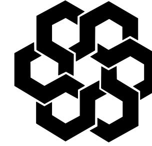

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
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: **16 October 2008, London**

Project: **Financial instruments with characteristics of equity**

Subject: **Selecting an approach (Agenda Paper 11)**

INTRODUCTION

1. To complete this project by 2011, the project plan discussed by the IASB and the FASB (the boards) in June requires a decision in October regarding which approach the boards want to pursue.

2. At the October IASB board meeting and the October 8 FASB education session, the staff will ask the boards to discuss which approach provides the best starting point for future deliberations. The staff will not ask the boards to make a decision at those separate meetings. However, the staff anticipates that the boards will be able to tentatively reject some of the approaches and focus on the approaches that they believe should be considered for further development.

3. At the October joint meeting, the staff will ask the boards to decide which approach, if any, they want to use as a starting point for future deliberations.

SUMMARY OF THE APPROACHES

4. This section briefly summarizes the approaches that the boards may want to consider as a starting point for future deliberations. The approaches are discussed in more detail later in the paper.

5. The FASB Preliminary Views, *Financial Instruments with Characteristics of Equity,* presents three approaches:

   a. **Basic ownership approach:** An instrument would be classified as equity if it (1) is the most subordinated claim and (2) entitles the holder to a share of the entity's net assets. The holders of this class of instruments are viewed as the owners of the entity.

   b. **Ownership-settlement approach:** An entity would classify instruments based on the nature of their return and their settlement requirements (or lack thereof). Instruments that lack settlement requirements or that represent (or upon settlement will represent) the most residual claims are classified as equity. The following three types of instruments would be classified as equity:

      (1) Basic ownership instruments
      (2) Other perpetual instruments
      (3) Indirect ownership instruments settled by issuing related basic ownership instruments.

   c. **Reassessed expected outcomes (REO) approach:** All basic ownership instruments are classified as equity. Additionally, instruments (and components of instruments) whose fair value changes in the same direction as, or the opposite direction to, the fair value of a basic ownership instrument are classified as equity or contra-equity.

6. Interested parties have suggested five alternative approaches:

   a. **Loss absorption approach**: Participation in losses is the decisive factor for distinguishing equity from liabilities. Capital is classified as equity if the amount of its claim on the entity's net assets is reduced if the entity incurs a loss.

b. **Perpetual approach**: An instrument is classified as equity if it (1) lacks a settlement requirement and (2) entitles the holder to a share of the entity's net assets in liquidation.

c. **Participation approach**:[1] An instrument (or component) is classified as equity if it would participate without an upward limit in the proceeds of a disposal of the reporting entity (or a business within that entity).

d. **IAS 32 (without modification)**: This approach would require the FASB to adopt IAS 32, *Financial Instruments: Presentation,* (including IFRIC 2, *Members' Shares in Co-operative Entities and Similar Instruments*) without any modifications. Generally, IAS 32 would classify an instrument as equity if (1) it includes no contractual obligation to deliver cash or another financial asset (or to exchange financial assets or financial liabilities under conditions that are potentially unfavourable) or (2) it will be settled by delivering a fixed number of the issuer's own equity instruments or by exchanging a fixed number of the issuer's own equity instruments for a fixed amount of cash (or another financial asset).

e. **Modified IAS 32**: This approach would require the boards to develop a converged standard based on IAS 32. Amendments would be made to the standard to address criticisms identified by constituents.

STEP 1—REDUCING THE NUMBER OF ALTERNATIVES

7. The staff thinks that some of the approaches in the preceding section should not be developed further. Therefore, it recommends that the boards vote against pursuing the following six approaches: the REO approach, the loss absorption approach, the participation approach, the ownership-settlement approach, the IAS 32 approach, and the modified IAS 32 approach. However, at some point, the staff may recommend

[1]The FASB staff previously referred to this as the "broad view of equity" approach.

that the boards consider incorporating some features of the approaches into the selected approach.

REO Approach

8. Paragraph B21 of the FASB Preliminary Views (PV) summarizes why the FASB rejected the REO approach. Specifically, it is difficult (or perhaps impossible) to envision how the REO approach could be reconciled with the current or future conceptual definitions of assets, liabilities, and equity. Additionally, the REO approach requires more instruments to be separated and measured at fair value than current accounting requirements. Most respondents to the IASB discussion paper and the FASB PV did not support pursuing the approach.

Loss Absorption Approach

9. In July, some of the authors of the EFRAG Discussion Paper, *Distinguishing between Liabilities and Equity,* led an education session for the IASB on the loss absorption approach. A similar education session was held during the joint IASB/FASB Board meeting in April 2007. Additionally, an education session was held at the IASB Financial Instruments Working Group (FIWG) meeting in April 2007.

10. During those sessions, the boards raised some concerns about the loss absorption approach, which are summarized below:

    a. The underlying principle of the approach is not fully developed and may not be operational. Under the loss absorption approach, an instrument is equity if it is available to absorb losses without creating a default on the part of the entity. However, the authors of the paper observe that "losses" could refer to economic losses (a decrease in value of the entity) or to accounting losses. The loss absorption approach tentatively defines losses as accounting losses but as noted in paragraph 4.41 of the Discussion Paper, the authors acknowledge that they "have not yet concluded on the operationalisation" of that decision.

    b. The approach is susceptible to structuring opportunities. It classifies an instrument based on contractual terms. That may be problematic if the stated

terms do not reflect the substance of the instrument. For example, some instruments only absorb losses up to a certain amount or losses that exceed a certain amount. As long as there is a continuum of loss-absorbing capital (e.g., one instrument absorbs losses up to 100M CU and another instrument absorbs losses that exceed 100M CU), all instruments on the loss absorbing continuum would be classified as equity—even if it is likely that a particular instruments will never absorb losses (i.e., because losses are not expected to exceed a certain amount). The topic of loss-absorbing instruments is described in paragraphs 4.28-4.30 and illustrated in IE9 of the Discussion Paper.

c. The staff thinks this approach classifies some puttable instruments differently than the recent amendment to IAS 32 and IAS 1, *Puttable Financial Instruments and Obligations Arising on Liquidation*. For example, the amendment would classify as equity some instruments that are puttable at a fixed amount. In contrast, the loss absorption approach would appear to classify all such instruments as liabilities. As a result, the boards would have to reconsider many of the issues that were addressed during the deliberation of the amendment.

11. The staff thinks many of the concerns with the loss absorption approach will take a considerable amount of time to address. The approach does not address some contentious issues including measurement, display in the statements of financial position and comprehensive income, and classification in consolidated group financial statements of instruments issued by subsidiaries. If the boards decide to pursue this approach, the staff doubts this project will be completed by 2011.

Participation Approach

12. The participation approach would allow more instruments to be classified as equity than current IFRS and U.S. GAAP requirements. Examples of instruments that would be classified as equity under this approach include perpetual ordinary shares, some perpetual preference shares, some mandatorily redeemable shares, and all derivatives on an entity's ordinary shares (including those that are cash settled). Convertible debt and puttable instruments would be split into an equity component

and a liability component. Equity instruments would be initially measured at fair value and not subsequently remeasured.

13. This approach requires significant disclosures about the instruments that are classified as equity including (a) the instruments' terms and conditions (e.g., voting rights, liquidation preference, and dividend rights) and (b) cash flow obligations (e.g., amounts payable for written put options and forward share purchase contracts).

14. The staff does not support pursuing the participation approach. Some of our concerns are summarized below:

    a. The underlying principle of the approach is not fully developed and may not be operational. The authors of the approach did not define the term "participation". The staff thinks an instrument could be considered participating if it (1) increases in value or (2) entitles the holder to cash. One of the primary authors of this approach asserts that all derivatives on an entity's own shares (cash and share settled) would be classified as equity but it is unclear whether that is consistent with the underlying principle, if participation means the holder is entitled to cash. For example, a holder of a call option on an entity's ordinary share generally is not entitled to any proceeds from the disposal of the entity. Rather, the holder first must exercise the call option and become a holder of an ordinary share. In other words, the participation right is attached to the ordinary share, not the call option. Moreover, it is unclear why the underlying principle would result in equity classification for purchased options.

    b. The approach seems to result in inconsistent classification in some cases. For example, a written put option on an entity's own shares would be classified as equity but a puttable share would be separated into liability and equity components. It is unclear why the put option embedded in a share would be classified as a liability component but the standalone-written-put option would be classified as equity.

c. It is difficult (or perhaps impossible) to envision how the participation approach could be reconciled with the current or future conceptual definitions of assets, liabilities, and equity. For example, derivative instruments that require the entity to deliver cash (e.g., a written put option or a forward purchase contract) would be classified as equity.

15. The approach does not address some contentious issues including measurement of instruments classified as liabilities, display in the statements of financial position and comprehensive income, linkage, reassessment of classification, and classification in consolidated group financial statements of instruments issued by subsidiaries. If the boards decide to pursue this approach, the staff doubts this project will be completed by 2011.

Ownership-Settlement Approach

16. The staff does not support pursuing the ownership-settlement approach because it is incredibly complex. Although the approach often results in the same classification as existing IFRS and U.S. GAAP requirements, the process an entity must go through to make the decision is more complex. Moreover, under the ownership-settlement approach, most instruments must be separated. That increased separation results in hypothetical measurements of the non-equity components. The requirements in the FASB PV for reporting settlements, conversions, expirations, and modifications of separated instruments are unworkable. Moreover, the approach focuses on an instrument’s form of settlement (i.e., cash versus share) in determining classification. As a result, instruments with identical economic profiles (payoffs) may be classified differently. Most accountants will not be able to internalize the requirements.

17. The staff thinks that the boards should begin their deliberations with a simple, straight-forward principle. It is inevitable that the approach selected by the boards will be revised and refined during their deliberations. Therefore, we think it would be preferable and logical to build on or to modify a simple principle rather than add complexity to or try to simplify an already complex principle. The staff has only identified one possible way to make the ownership-settlement approach less

complex—that is, to classify all indirect ownership instruments (i.e., certain derivatives) as liabilities. However, classifying indirect ownership instruments as equity is a significant aspect of the ownership-settlement approach and generally is very appealing to those who support the approach.

18. Moreover, the ownership-settlement approach and IAS 32 are similar in terms of the number and types of instruments that would be classified as equity. Therefore, the staff thinks that there may be insufficient benefits for the IASB to pursue the ownership-settlement approach.

IAS 32 (without Modification)

19. Many respondents to the FASB PV and the IASB discussion paper suggested the FASB adopt the requirements in IAS 32 instead of developing a new approach.

20. The principle in IAS 32 is straightforward. However, as outlined in the IASB Invitation to Comment, *Financial Instruments with Characteristics of Equity,* (paragraphs 15-34 of that document), the requirements in IAS 32 often are criticized. As a result, the IASB has been urged to simplify and improve those requirements. The criticisms generally fall into two broad classes:

    a. How the principles in IAS 32 should be applied

    b. Whether the application of those principles results in an appropriate distinction between equity instruments and non-equity instrument

21. The IASB's Invitation to Comment (included as Appendix A to this paper) describes the criticisms of IAS 32 in more detail and compares that approach to the approaches described in the FASB PV. The IASB recently responded to some of those criticisms by amending IAS 32 to address issues related to puttable instruments and instruments that contain an obligation only on liquidation. Moreover, the IFRIC has addressed other issues (for example, IFRIC 2).

22. During the comment period, IASB board and staff members discussed the project with financial statement users (e.g., buy and sell side analysis). In general, users

noted that the current distinction between liabilities and equity described in IAS 32 is difficult to understand and strongly supported improved guidance.

23. At this stage, the staff does not recommend that the FASB adopt IAS 32 because of the criticisms and application issues described in the IASB's Invitation to Comment. The staff also is concerned that if the FASB adopts IAS 32, the boards, IFRIC, and the EITF will continue to receive requests to clarify and interpret the requirements. The staff thinks that addressing specific implementation and application issues on a piece-meal basis will result in rules-based requirements that will be difficult to understand and apply. However, the staff can envision two scenarios in which it might recommend that the FASB adopt IAS 32.

24. First, as noted in the project plan, if the boards are not able to agree on an underlying principle by the end of 2008 the staff highly doubts this project can be completed by 2011. If that happens, the staff likely will recommend that the FASB adopt IAS 32 (without any modifications) to converge the accounting requirements in this area.

25. Second, as noted in the previous section, the ownership-settlement approach provides classification results that are very similar to IAS 32. If the boards decide to pursue the ownership-settlement approach, the staff likely would recommend that the FASB adopt IAS 32 instead of implementing a more complex accounting approach that would result in marginal changes to current IFRS requirements.

Modified IAS 32

26. Many respondents to the IASB discussion paper suggested modifying or improving the principles in IAS 32. Respondents suggested that the boards conduct a comprehensive review of the standard to identify possible areas for improvement. Some respondents suggested that the boards address the following issues (many of these criticisms are the same as or similar to those described in the IASB's Invitation to Comment):

    a. The underlying principle—Many respondents suggested IAS 32's underlying principle is not appropriate for all industries because it results in liability

classification for many partnership interests and cooperative shares issued in Europe. They further noted that the recently issued limited-scope amendment to IAS 32 did not resolve all the classification issues.

b. The "fixed-for-fixed" principle—To be classified as equity under IAS 32, a derivative must involve the exchange of a fixed number of shares for a fixed amount of cash (or other financial asset). Respondents noted difficulties in interpreting and applying this principle. For example, respondents suggested the boards further clarify how to account for foreign currency denominated convertible bonds in the issuer's financial statements and upon consolidation.[2] Some respondents suggested the "fixed-for-fixed" principle should be eliminated.

c. Reassessment of classification—IAS 32 generally does not require classification to be reassessed unless the terms and conditions of the instrument have changed.[3] Additionally, the standard does not address whether an issuer should report a gain or a loss upon reclassification if the reclassification requires a change in the way the instrument is measured. Many respondents suggested that this additional guidance is necessary.

d. Existence of a contractual obligation—Under IAS 32, a financial instrument that includes no contractual obligation to deliver a financial asset or a variable number of the entity's own shares is classified as equity. Some respondents suggested this allows structuring opportunities.

e. Linkage—Some respondents noted that IAS 32 lacks linkage guidance. Providing guidance would result in more consistent classification of freestanding and compound instruments.

[2] The IFRIC addressed some aspects of this issue in April 2005.

[3] The amendments to IAS 32 and IAS 1 issued in February 2008 provide such guidance for some puttable instruments and some instruments that impose an obligation only on liquidation. In addition, IFRIC 2 provides guidance on transfers between financial liabilities and equity. Those transfers occur when the number of shares or the amount of paid-in capital subject to a redemption prohibition change.

27. The staff is concerned that modifying the existing literature will result in more rules-based exceptions to IAS 32. That is not consistent with the boards' objective to develop improved and principles based-guidance.

28. **Question 1:** Do the boards agree with the staff's recommendation that (a) REO, (b) loss absorption, (c) participation (d) ownership-settlement, (e) IAS 32 (without modification), and (f) modified IAS 32 should not be used as a starting point in this project? If not, how would board members like to proceed with the approaches?

STEP 2—SELECTING AN APPROACH

29. The remainder of this paper focuses on and compares the two approaches the staff believes the boards should consider: the perpetual approach and the basic ownership approach. The staff recommends the perpetual approach.

30. Under the perpetual approach, an instrument is classified as equity if it (a) lacks a settlement requirement and (b) entitles the holder to a share of the entity's net assets in liquidation. Common shares, shares with a preference in liquidation, and callable shares are examples of perpetual instruments. Instruments that obligate the issuer to deliver assets, provide services, or issue financial instruments would be classified as liabilities. Examples of instruments that would be classified as liabilities include forward contracts, options, and convertible debt.

31. The perpetual approach may be viewed as similar to a modification to the underlying principle in IAS 32. Similar to IAS 32, instruments that do not have a contractual obligation to deliver cash or assets would be classified as equity under the perpetual approach. However, the perpetual approach would eliminate the "fixed-for-fixed" principle, which seems to cause many of the current application issues. Moreover, this approach would define equity directly and the boards' future deliberations would be based on the principle described in paragraph 6(b) as the starting point (not the principles and requirements in IAS 32).

32. The chart on the following page compares (a) the underlying classification principles of the two approaches, (b) potential exceptions to the classification principles that the boards may want to consider, (c) advantages and disadvantages of the approaches, and (d) suggested definitions for a liability under the two approaches that might be explored in the joint conceptual framework project. Some of the items in the chart are described further in the remainder of this paper.

	Perpetual Approach (staff recommendation)	Basic Ownership Approach
Underlying principle	An instrument is classified as equity if it (1) lacks a settlement requirement and (2) entitles the holder to a share of the entity's net assets in liquidation.	An instrument is classified as equity if it (1) is the most subordinated claim and (2) entitles the holder to a percentage of the entity's net assets.
Advantages	• Simple underlying principle • Could resolve many criticisms of the basic ownership approach, such as the classification of perpetual instruments that do not meet the definition of basic ownership instruments • Definition of a liability is most consistent with the current thinking in the joint conceptual framework project	• Simple underlying principle • Reduces or eliminates the need to address economic compulsion issues because only basic ownership instruments are classified as equity
Disadvantages	• May need to address economic compulsion issues (e.g., related to certain dividend payments) • Exceptions to the principle are likely	• Need to decide how to measure perpetual instruments classified as liabilities • Would require the definition of a liability to include instruments that lack settlement requirements • Exceptions to the principle are likely
Possible definition of a liability[4]	A liability is a present obligation to sacrifice assets, the probability-weighted outcome of which will be an outflow of economic value	A liability is a claim, the probability-weighted outcome of which would reduce the assets available for distribution to each holder of basic ownership instruments

[4] The definitions presented would be consistent with each approach. They are only suggestions for possible definitions. The staff does not intend on discussing the merits of the definitions at the October board meetings.

Underlying Principle

33. Both the basic ownership approach and the perpetual approach have simple principles. Under both approaches, all derivatives on an issuer's shares and hybrid instruments would be classified as liabilities. However, there are two fundamental differences between the two approaches. Those differences are the classification of (a) perpetual instruments with a preference in liquidation (preferred shares) and (b) redeemable instruments (mandatorily or at the option of the holder). Those differences and related consequences are described in the next section.

Perpetual Instruments with a Preference in Liquidation (Preferred Shares)

34. Under the basic ownership approach, perpetual instruments that are not basic ownership instruments are classified as liabilities. The majority of respondents to the IASB discussion paper and the FASB PV objected to classifying preferred shares as liabilities. Those respondents noted that preferred shares cannot be liabilities because they do not impose an obligation to deliver cash or other assets. Additionally, some respondents suggested that classifying preferred shares as liabilities could have a significant effect on financial ratios and will require significant amendments to debt covenants, which would result in incremental costs. Other respondents cited measurement of preferred shares as a potential issue. The perpetual approach would resolve those issues because an instrument with no settlement requirements would be classified as equity. However, classifying all perpetual instruments as equity raises issues of economic compulsion (that is, redemption of the instrument is more than likely or almost certain but no contractual obligation exists).

Economic Compulsion

35. In developing the basic ownership approach, the FASB decided to classify perpetual instruments that are not basic ownership instruments as liabilities when the Board was unable to resolve issues of economic compulsion. For example, some entities issue perpetual preferred stock with a cumulative dividend that increases over time (this instrument is typically referred to as an "increasing rate preferred share"). The dividend rate may eventually become so high that it becomes highly probable that the entity will repurchase the instrument if it has the net assets available. The dividend is payable only if declared, but it must be declared before a dividend on common stock can be declared or before the preferred stock can be retired.

36. Classifying all perpetual instruments with a preference in liquidation as liabilities resolved this classification issue, but created a measurement issue. If the boards decide to pursue the basic ownership approach, they will have to decide how to measure perpetual instruments classified as liabilities. The FASB did not address this issue in the PV. On the other hand, if the boards decide to pursue the perpetual approach, they may have to consider whether a high probability of settlement without a contractual requirement to do so should result in liability classification.

Redeemable Instruments (Possible Exceptions to the Underlying Principle)

37. Instruments that are mandatorily redeemable or puttable at an amount designed to approximate the holder's percentage of net assets (fair value or book value, depending on the type of entity) would be classified as equity under the basic ownership approach. The perpetual approach would not classify any mandatorily redeemable or puttable instruments as equity. If the boards decide to pursue the perpetual approach they will have to consider whether an exception to the underlying principle (or a separate principle) is necessary for entities that have issued no perpetual instruments.

38. In February 2008, the IASB amended IAS 32 to require equity classification for certain types of financial instruments that meet the definition of a financial liability but represent the residual interests in the net assets of the entity. Neither

the basic ownership approach nor the perpetual approach would produce the same classification results as that amendment. The underlying principles in the IAS 32 amendment are similar to those underlying the basic ownership approach, but the classification results are different in some cases. The most significant differences with regards to puttable shares are as follows:

a. To be classified as equity under the IAS 32 amendment, a class of puttable ownership instruments must be the most subordinated instruments the entity has issued and all of the most subordinated instruments must have identical features (i.e., they must all be puttable and the method used to calculate the redemption price is the same). In contrast, under the basic ownership approach, two types of basic ownership instruments could be classified as equity if they are equally subordinated, for example, redeemable and non-redeemable (voting and nonvoting) common shares.

b. All shares puttable at a fixed price are liabilities under the basic ownership approach. In contrast, the IAS 32 amendment would classify instruments that are puttable at a fixed price as equity if the total expected cash flows over the life of the instrument are based substantially on the performance of the entity.[5] That condition would exist if all or nearly all of the entity's profits are expected[6] to be distributed and the holder's receipts are a share of those profits. Fixed entry and exit prices would not cause an instrument to fail that test if the prices are relatively small compared to the distributions. (The IASB tends to refer to these instruments as "fixed-in, fixed-out".)

c. Under IAS 32, puttable instruments classified as equity in the financial statements of a subsidiary are classified as liabilities in the consolidated financial statements of the parent. That is because the IASB decided the amendment is an exception to the principles otherwise applied in IAS 32 and that the exception should not be extended to the group's consolidated financial statements. In contrast, the basic ownership approach would maintain the

[5] This assumes that the puttable instrument has all of the features and meets the conditions in paragraphs 16A and 16B of the amendment.

[6] A requirement to distribute the profit as dividends would not meet this test. An instrument with that feature would be a liability.

equity classification in the consolidated financial statements unless the characteristics of the instrument changes at the consolidated level.

39. If the boards decide to pursue the basic ownership approach or the perpetual approach, they will have to consider whether the requirements described in the IAS 32 amendments should be included in approaches as an exception to the underlying classification principle.

Definition of a Liability

40. The basic ownership approach, the perpetual approach, IAS 32, and current U.S. GAAP are inconsistent with the existing definitions of asset, liability, and equity in the IASB's *Framework* and FASB Concepts Statement No. 6, *Elements of Financial Statements*. The boards are reconsidering those definitions in their joint conceptual framework project.

41. Suggestions of possible definitions of liabilities under the basic ownership and perpetual approaches are included in the table after paragraph 32. The staff believes that the definition of a liability under the perpetual approach is more consistent with the work performed to date in the conceptual framework project.

Staff Recommendation

42. The staff recommends the boards pursue the perpetual approach. The principle is simple and would resolve the following three significant criticisms of the basic ownership approach. Those concerns related to:

    a. The classification as liabilities of perpetual instruments that are not basic ownership instruments

    b. The classification of basic ownership instruments of a subsidiary as equity in consolidated financial statements

    c. Many perpetual instruments currently classified as equity by cooperatives (e.g., in accordance with IFRIC 2) that would be classified as liabilities under the basic ownership approach because they have fixed redemption prices or upper limits on the amounts the holders would receive in liquidation.

Classifying as equity all instruments that lack a settlement requirement clearly resolves issue (a). The remaining two issues are described below.

Classification in Consolidated Group Financial Statements of Instruments Issued by Subsidiaries

43. Under the basic ownership approach, basic ownership instruments of a subsidiary or a consolidated variable interest entity would be classified as equity in the consolidated financial statements unless the parent has entered into an arrangement with holders that would cause those instruments' characteristics to change upon consolidation (consolidation provision).

44. Many respondents to the IASB discussion paper and the FASB PV asserted that the consolidation provision seems to be inconsistent with the underlying principle of the basic ownership approach. For example, noncontrolling interests in a subsidiary would be considered equity of the consolidated entity even though their claims to assets are limited to only a portion of the consolidated entity. Furthermore, some respondents also suggested that the consolidation provision could create structuring opportunities by allowing entities to create additional equity by establishing subsidiaries to issue residual interests that would not meet the definition of equity if issued by the parent entity.

45. The staff considered the consequences of applying the consolidation provision to the perpetual approach. That is, a perpetual instrument classified as equity in the subsidiary's financial statements also would be classified as equity in the consolidated financial statements as long as the parent has not entered into an arrangement with the holders to settle (redeem) the instrument.

46. The staff thinks that the boards will need to reconsider whether the consolidation principle is appropriate under either approach. However, it thinks that the consolidation provision as currently described in the FASB PV is generally consistent with the underlying principle of the perpetual approach. The staff agrees with respondents in that it seems inconsistent with the underlying principle of the basic ownership approach.

Definition of a Basic Ownership Instrument—No Upper Limit on the Claim to the Entity's Remaining Net Assets

47. The boards received many comment letters from cooperative entities stating that perpetual instruments currently classified as equity would be classified as liabilities under the basic ownership approach. That is because in order to meet the definition of a basic ownership instrument, the holder's claim to a percentage of net assets in liquidation must have no upper limit or lower limit except for the amount of net assets available (paragraph 18(b) of the FASB PV). Some U.S. cooperatives do not meet that criterion. In some cases there is an upper limit to a member's rights to net assets, which is usually the nominal value of the share. Similarly, many international cooperatives are required to abide by certain laws or rules that forbid them to redeem shares (either before or at liquidation) above their nominal amount. Therefore, those shares would be liabilities under the basic ownership approach even though they are the most subordinated, entitle the holder to a portion (although it is limited) of net assets, and expose the holders to a loss of 100 percent (or, in some cases, more) of their investment. If the boards pursue the basic ownership approach, they would have to decide whether the upper limit on participation in net assets criterion is necessary.

48. The staff thinks the perpetual approach could resolve this issue. Under the perpetual approach, an instrument is equity if it does not require settlement and entitles the holder to a fixed or variable portion if the issuer's net assets in liquidation.

49. If the boards decide to pursue the perpetual approach, the staff will further refine the principle and discuss it with the boards in December.

Final Note

50. The staff thinks the perpetual approach will work well for public corporations. However, notwithstanding the discussion in paragraphs 47-49, the approach may not work as well for other types of entities (e.g., cooperatives and private companies) because the nature of their equity may be different. Cooperatives are owned and controlled by their members. A member of a cooperative invests in the entity to obtain goods or services at a lower price. In contrast, a shareholder invests in a public corporation with the hopes that the value of the stock will increase and that it can be sold for a profit. Some closely held private companies are owned and run by their founders. Often call options and mandatory redemption features are added to private company shares to ensure the owners can maintain control of the business. The staff will consider whether a single set of classification and measurement principles should be applied to all types of entities or if there are some types of businesses that may require a separate set of principles.

51. **Question 2:** Do the boards agree with the staff's recommendation that the perpetual approach should be used as a starting point for future deliberations? If not, which approach should be used?

APPENDIX A – IASB Invitation to Comment

The Invitation to Comment is available on the IASB website:

http://www.iasb.org/Current+Projects/IASB+Projects/Liabilities+and+Equity/Discussion+Paper+and+Comment+Letters/Discussion+Paper+and+Comment+Letters.htm