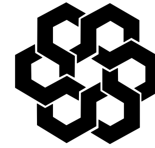

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International Accounting Standards Board

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:	**14 October 2008, London**
Project:	**Financial instruments with characteristics of equity**
Subject:	**Comment letter analysis (Agenda Paper 2A)**

INTRODUCTION

1. The comment period for the IASB discussion paper *Financial Instruments with Characteristics of Equity* ended on 5 September 2008.

2. As of 19 September, the board received 115 comment letters. During the comment period, the staff discussed the three approaches in the discussion paper with the IASB's Analyst Representative Group (ARG) and other users of financial statements. Those comments also are included in this analysis. [A portion of this paragraph has been omitted from the Observer Note.]

3. The objective of this paper is to provide board members with an overview of the main issues raised by respondents. The staff plans to provide more detailed analysis of the responses to the some of questions in the discussion paper as the relevant issues are addressed at subsequent meetings.

4. This paper does not provide a quantitative review of the comments received or attribute comments to individual respondents. The staff has given equal consideration to all comment letters received. This paper also does not contain

staff views or recommendations. Those will be presented to the boards at subsequent meetings.

5. The comment period for the FASB Preliminary Views document *Financial Instruments with Characteristics of Equity* ended on 30 May 2008. The staff's analysis of those comment letters is included as Appendix B to this paper.

SUMMARY OF SIGNIFICANT COMMENTS AND ISSUES

6. Respondents generally supported the boards' efforts to develop a converged and improved standard on the distinction between equity and non-equity instruments.

7. However, most respondents stated that the boards should complete their joint project on the conceptual framework before deliberating a standards-level project on this topic.

8. Moreover, the majority of respondents did not support using the three approaches described in the FASB PV document as a starting point for improving and simplifying IAS 32 *Financial Instruments: Presentation*. Respondents raised the following issues:

   (a) IAS 32 is not fundamentally flawed and provides a better starting point for the boards' future deliberations

   (b) Criticisms of the basic ownership approach (the FASB's preferred approach) include:

      i. Perpetual ownership instruments that are not basic ownership instruments are classified as liabilities

      ii. The definition of a *basic ownership instrument* depends on an instrument's priority in liquidation (rather than on a going concern basis)

      iii. Basic ownership instruments of a subsidiary generally are classified as equity in the consolidated financial statements of the group

      iv. The basic ownership approach classifies some instruments differently than the IASB's recently issued amendment to IAS 32 and IAS 1 *Puttable Financial Instruments and Obligations Arising on Liquidation*

and IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*

(c) The scope of the FASB PV document is too narrow and focuses on instruments issued by for-profit entities in the United States

DETAILED DISCUSSION OF THE SIGNIFICANT COMMENTS AND ISSUES

Interaction with the Boards' Joint Project on the Conceptual Framework

9. Most respondents expressed concern about the interaction between this project and the boards' joint project on the conceptual framework.

Definition of elements (phase B)

10. Many respondents stated that the boards should defer this project until they have completed their joint review of the conceptual framework. Those respondents supported developing robust principles in the conceptual framework project to distinguish equity and non-equity instruments, such that any subsequent standard essentially is implementation guidance.

11. However, a few respondents urged the boards not to treat the outstanding conceptual framework deliberations as a "show stopper" to the resolution of these important standards-level issues.

The "proprietary view" versus the "entity view" (phase A)

12. Moreover, many respondents observed that the approach in this project for distinguishing equity from non-equity instruments should be consistent with the boards' decision in the conceptual framework project that financial reporting should be prepared from the perspective of the entity ("entity perspective") rather than the perspective of its owners or a particular class of owners ("proprietary perspective").

13. Many of those respondents expressed the view that the basic ownership approach is inconsistent with the entity perspective. However, those respondents generally did not provide an explanation for that view other than stating that the basic ownership approach is consistent with the proprietary perspective because only the most residual claims are classified as equity.

IAS 32 as a Starting Point for Future Deliberations

14. Many respondents noted that convergence is important and they generally supported the boards' efforts to develop an improved common standard for financial instruments with characteristics of equity. However, although most respondents agreed that US GAAP requirements are complex, fragmented, and difficult to apply, those respondents stated that IFRS requirements are not fundamentally flawed.

15. Although they acknowledged the criticisms outlined in the IASB discussion paper, many respondents think that IAS 32 generally is working well in practice. Those respondents think most of the problems could be addressed by amending particular aspects of IAS 32 (for example, to address issues related to economic compulsion) or providing additional application guidance (for example, on the "fixed for fixed" principle). Thus, many respondents suggested that the boards use IAS 32 as a starting point for future deliberations (or that the FASB adopt IAS 32 without modifications).

16. However, one user respondent noted the principles in IAS 32 are more akin to a "bolt-on set of principles" that focus on an accounting outcome, rather than being a conceptually coherent set of principles. That respondent stated that IAS 32 can result in inconsistent accounting for instruments with similar economic characteristics (for example, a derivative's form of settlement can dictate classification). In addition, other users with whom the staff spoke noted that the current distinction between equity and non-equity instruments in IAS 32 is very difficult to understand. Those users generally supported pursuing a simpler approach.

Criticisms of the Basic Ownership Approach

17. The majority of respondents did not support the basic ownership approach. The issues raised in response to the IASB discussion paper were very similar (and, in some cases, identical) to the responses to the FASB PV document.

18. However, as noted above, some users support the basic ownership approach because that approach draws a clear and understandable "line" between equity and non-equity instruments.

Perpetual ownership instruments

19. Under the basic ownership approach, perpetual instruments that are not basic ownership instruments would be classified as liabilities. Shares with preference in liquidation would be liabilities regardless of whether they are perpetual, callable, puttable or mandatorily redeemable.

20. The majority of respondents objected to classifying perpetual ownership instruments (e.g., perpetual preferred shares) as liabilities. Most of those respondents relied on the current definition of a liability to support their view, noting that perpetual instruments do not impose an obligation to deliver cash or assets. Furthermore, some respondents expressed the view that it seemed counterintuitive to classify some perpetual instruments as liabilities while some redeemable instruments meet the definition of a basic ownership instrument and would be classified as equity.

21. Although the FASB PV document did not conclude on how to re-measure perpetual instruments that are classified as liabilities, paragraph 34 of the FASB PV document describes some possible measurement requirements. Respondents generally opposed re-measuring perpetual instruments at fair value with changes reported in net income. Some respondents noted that changes in the value of an entity's own shares should not be reported in earnings because it would distort an entity's financial performance by mixing market changes of the entity's own shares with its operating results. Other respondents pointed out that it will be difficult to measure perpetual instruments that are not actively traded and, thus, re-measuring such instruments at fair value will increase the subjectivity of earnings.

Definition of a basic ownership instrument

22. 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 of net assets has no upper or lower limit except for the amount of net assets available.

23. Some respondents expressed the view that classifying an instrument as a liability or equity on the basis of an instrument's priority in liquidation is inconsistent with the fundamental principle that financial statements portray the financial position of an issuer as a going concern. Those respondents noted that an instrument may have priority in the event of liquidation but may have characteristics and risks similar to the most subordinate class of common shares absent liquidation. (The respondents did not explain whether such instruments would have similar characteristics and risks if the entity has limited liquidity – but is not in liquidation.)

Classification of a subsidiary's basic ownership instruments in consolidated financial statements

24. Under the basic ownership approach, basic ownership instruments of a subsidiary 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. Some respondents asserted that that provision seems inconsistent with the underlying principle of the basic ownership approach. For example, non-controlling interests in a subsidiary would be classified as equity of the consolidated entity even though their claims to net assets are limited to a portion of the consolidated entity.

25. Moreover, some respondents pointed out that the FASB's decision is inconsistent with the IASB's decision in the recently issued amendment to IAS 32 and IAS 1. The IASB decided that puttable instruments (and instruments with an obligation arising only on liquidation) issued by a subsidiary never shall be classified as equity in the consolidated financial statements. That is because such instruments do not represent the residual interest in the consolidated financial statements.

Puttable financial instruments and obligations arising on liquidation

26. Basic ownership instruments with redemption requirements will be classified as equity if they meet certain requirements (refer to paragraph 20 in the FASB PV). Some respondents suggested those criteria are neither clear nor operational.

27. Moreover, some respondents noted that the basic ownership approach classifies some redeemable instruments differently than the IASB's recently issued amendment to IAS 32 and IAS 1. While the underlying principles are similar, in

certain circumstances the two approaches will provide different classification results. For example:

(a) In order to be classified as equity under the IASB amendment, a puttable instrument must be in the most subordinated class of instruments and all of the instruments in that class must have identical features (i.e., the instruments must all be puttable). In contrast, under the basic ownership approach, two types of basic ownership instruments (i.e., redeemable and non-redeemable) could be classified as equity if they are equally the most subordinated.

(b) The basic ownership approach would classify as liabilities all instruments that are redeemable at a fixed price. In contrast, the IASB amendment might 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.

IFRIC 2

28. Some respondents noted that the basic ownership approach classifies some instruments differently than IFRIC 2. IFRIC 2 states that a redemption requirement does not prevent shares (that other would be equity) from being equity if either (a) the entity has an unconditional right to refuse redemption or (b) if redemption is unconditionally prohibited by local law, regulation, or the entity's governing charter.

29. Almost all of the cooperative respondents that currently apply IFRIC 2 stated that they prefer those requirements to the requirements in the basic ownership approach. They encouraged the boards to consider incorporating IFRIC 2 into any model that they develop.

30. As noted in paragraph 22 of this paper, a basic ownership instrument has two characteristics and cooperatives expressed concern about the second. That characteristic states that the holder must be entitled to a percentage of net assets after all higher priority claims have been satisfied. The holder's share of net assets has no upper or lower limit expect for the amount of net assets available.

31. Many cooperative instruments will not meet that requirement. In some jurisdictions, there is an upper limit (usually the nominal value of the share) to the member's rights to the net assets in liquidation. Therefore, those instruments would be classified as liabilities under the basic ownership approach even though they are subordinate to all other classes of instruments and expose the holders to a loss of 100% (or more) of their investment.

Scope

32. Paragraph 15 of the FASB PV outlines the scope of that document as follows:
    (a) Basic ownership instruments (whether or not they are ownership instruments in legal form)
    (b) Other instruments that are ownership interests in legal form
    (c) Any other contract that is settled with basic ownership instruments or whose fair value is determined by prices of basic ownership instruments.
33. The majority of respondents opposed the scope of the FASB PV document. Those respondents stated that the scope is too narrow. Instead, those respondents generally supported a scope similar to IAS 32 (i.e., a scope that includes all or almost all financial instruments).
34. Moreover, many respondents noted that it is inappropriate to refer to the legal form of ownership interests in a standard with global application because there are considerable jurisdictional differences in legal terminology and requirements. Therefore, classification of identical or similar instruments may be inconsistent depending upon the jurisdiction in which they are issued. Moreover, some respondents stated that references to "ownership interests in legal form" might be difficult to interpret and apply but did not provide further explanation of those difficulties.

Other Comments

35. Respondents also commented on the following topics:
    (a) Under the basic ownership approach all derivatives will be classified as liabilities and measured at fair value with changes recognized in profit or loss. Responses on that issue were mixed.

(b) Many respondents noted that the ownership-settlement approach does not have a single, robust principle but is similar to IAS 32 in terms of the number and types of instruments classified as equity. Therefore, there are not sufficient benefits to pursuing that approach.

(c) Nearly all of the respondents stated that the REO approach is too complex to understand and apply. Those respondents noted that the boards should not pursue that approach.

(d) Some respondents encouraged the boards to consider other approaches (or particular features of other approaches), such as the loss absorption approach. One respondent suggested an alternative approach. Under that approach, 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). Possible alternative approaches are discussed further in Agenda Paper 11.

APPENDIX A – SUMMARY ANALYSIS OF RESPONSES

[Appendix A has been omitted from the Observer Note.]

APPENDIX B: FASB Comment Letter Analysis

1. As of August 1, 2008, the Board received comment letters from 65 respondents as summarized below.

Respondent Profile

Number and Type of Respondents (by Occupation/Role)	
Type of Respondent	**Number**
Public Accounting	
Big Four accounting firm	4
Other accounting firm	2
Total Public Accounting	6
Preparer	
Cooperative	13
Financial Institution	7
Technology	2
Other	2
Total Preparer	24
User	
Rating agency	1
Total User	1
Academic	
American Accounting Assoc.	2
Other	1
Total Academic	3
Professional Organization	
Cooperative	10
CPA Society	8
Private Company / Venture	2
Standard Setter	2
Other	3
Total Professional Org	25
Subtotal	**59**
Other	6
Total Other	6
Total Respondents	**65**

SIGNIFICANT ISSUES

2. The majority of the respondents do not support the basic ownership approach. Significant issues raised by those respondents include:

a. The classification as liabilities of all perpetual instruments that are not basic ownership instruments (measurement was also cited as a potential issue)

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

c. Reporting changes in fair values of many types of liabilities in net income

d. Certain puttable financial instruments and obligations arising on liquidation (for example, certain partnership arrangements) that are currently classified as equity would be liabilities under the basic ownership approach

e. Many instruments classified as equity by cooperatives 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.

Preferred Shares

3. Perpetual instruments other than basic ownership instruments are classified as liabilities under the basic ownership approach. That means that shares with a preference in liquidation would be liabilities whether they are perpetual, callable, puttable, or mandatorily redeemable. The basis for conclusions explains that those instruments are classified as liabilities because they reduce the assets available for distribution to holders of basic ownership instruments. The Board also noted that classifying those perpetual instruments as liabilities reduced structuring opportunities. A few respondents (for example, Fitch CL #4 and TIC CL #61) supported the Board's decision.

4. However, the majority of respondents objected to classifying preferred shares as liabilities. Most respondents relied on the current definition of a liability to support their opposing view, noting that preferred shares do not impose an obligation to deliver cash or other assets. Other respondents (who apparently disagreed with the basic principle or did not understand it) found that treatment inconsistent with classification of certain mandatorily redeemable instruments as equity. Other respondents expressed the following concerns:

   a. ISDA (CL #49) noted that entities that are predominantly capitalized using preferred shares would have very little equity, which would create "significant implications".

   b. The Accounting Standards Board of Japan (CL #19) noted that the Japanese Companies Act requires that perpetual financial instruments be classified as equity. Therefore, any change to the population of

instruments reported in equity would require a change in the law in Japan and possibly other countries with a similar Act.

c. UBS (CL #26), Nortel Networks (CL #32), and New York State Society of CPAs (CL #28) stated that the proposed classification could have significant effect on financial ratios and will require significant amendments to debt covenants, which would result in incremental costs.

5. Although the Board did not decide how to remeasure perpetual instruments that are classified as liabilities, paragraph 34 of the PV described some possible measurement requirements. The respondents who commented on those measurement requirements generally opposed remeasuring the instruments at fair value with changes reported in income. Some respondents pointed out that remeasuring an instrument that does not trade on an active market would be difficult, lead to more Level 3 measurements, and create complexity in the financial reporting.

Classification of a Subsidiary's Basic Ownership Instruments in Consolidated Financial Statements

6. Under the basic ownership approach, basic ownership instruments of a subsidiary or 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.[1] Many respondents asserted that that 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. Some respondents also suggested that the Board's decision 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.

Changes in Fair Value

7. The majority of respondents objected to reporting changes in fair value arising from changes in an entity's share price in net income. Some respondents agreed that it may be appropriate to measure some instruments (with the exception of

[1] All three of the approaches described in the Preliminary Views have that same provision.

stock based compensation) at fair value. TIC (CL # 61) suggested that increasing the number of instruments measured at fair value would increase complexity and would require nonpublic companies to incur higher valuation costs. Other respondents suggested separating interest expense from unrealized gains and losses in the income statement.

Puttable Financial Instruments and Obligations Arising on Liquidation

8. 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. While the underlying principles in the IAS 32 amendment and the basic ownership approach are similar, in certain circumstances the two approaches will provide different classification results. The most significant differences with regards to puttable shares are as follows:
   a. In order to be classified as equity under the IAS 32 amendment, a puttable ownership instrument must be in the most subordinated class of instruments. Moreover, all of the instruments in that most subordinated class 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 the most subordinated, for example, redeemable and non-redeemable 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. That condition would exist if all or nearly all of the entity's profits are expected 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. This requirement does not extend to the classification of non-controlling interests in consolidated financial statements. In contrast, the basic ownership approach would maintain the equity classification in the consolidated financial statements unless the characteristics of the instrument changes at the consolidated level.

Other Comments

9. Respondents also commented on the following issues:

    a. **Scope**—Some respondents believe the scope of the project should be expanded to include all financial instruments or all items on the credit-side of the balance sheet. Others expressed concerns that Statement 123(R) would be amended.

    b. **Partnerships**—Some respondents pointed out that none of the examples in the Preliminary Views involve partnership structures. They also suggested the basic ownership approach would be difficult to apply to partnerships with complex distribution structures.

    c. **Redeemable basic ownership instruments**—Basic ownership instruments with redemption requirements may be classified as equity if they meet certain criteria (see paragraph 20 in the PV). Some respondents suggested those criteria are not clear or operational.

COOPERATIVES

10. Approximately one third of the respondents were cooperatives. The majority of those cooperatives expressed a preference for IFRIC 2. IFRIC 2 states that a redemption requirement does not prevent shares (that otherwise would be equity) from being equity if either (a) the entity has an unconditional right to refuse redemption or (b) if redemption is unconditionally prohibited by local law, regulation, or the entity's governing charter. The cooperatives also encouraged the Board to consider incorporating certain features of the Loss Absorption Approach in any model that is developed. Two changes suggested were to classify all perpetual instruments as equity and remove references to upper limits on distributions from the definition of a basic ownership instrument. That second suggestion is discussed further in the following paragraphs.

Definition of a Basic Ownership Instrument—Upper Limit on Participation of Assets

11. A basic ownership instrument has two characteristics: (a) it is the most subordinated claim and (b) it entitles the holder to a percentage of net assets after all higher priority claims have been satisfied. The holder's share of net assets has no upper or lower limit except for the amount of net assets available.

12. Most U.S. cooperative shares have the first characteristic; however, not all will have the second. In some cases there is an upper limit to a member's rights to the net assets, which is usually the nominal value of the share. 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 value.

Therefore, those shares would be liabilities under the basic ownership approach even though they are the most subordinated, entitle the holder to a percentage of net assets, and expose the holders to loss of 100% of their investments.

13. Another issue that arises in the upper limit requirement in the definition of a basic ownership instrument is the classification of former member's shares that have been submitted for redemption, but not yet approved by the Board. In some cases, (as described in CL # 23 and 38) the Board may restrict the redemption amount to the last stated redemption value of the share, effectively creating an upper limit. This would require all of the former member shares that have not yet been redeemed to be reclassified as liabilities.