Project	**Financial instruments with characteristics of equity**
Topic	**Classifying share-settled instruments as equity**

Introduction

1. One of the purposes of this paper is to comply with the Boards' request for information about the issues raised by their decision in October to pursue Approach 4.1, which would classify some instruments settled by delivering shares as equity. The other purpose of this paper is to compare classification of share-settled instruments under Approach 4.1 with classification under IAS 32, *Financial Instruments: Presentation*, and the ownership-settlement approach, both of which are similar in some ways. At this meeting we will ask the Boards to affirm their decision to pursue classification of share-settled instruments as equity.

2. There are three major classes of issues raised by classifying some share-settled instruments as equity and one other class that might be considered minor. The three major classes are as follows:
   (a) Determining when shares are being used as currency
   (b) The substance of the share-based settlement and the effects of implicit settlement requirements
   (c) Distinguishing between instruments subject to standards for share-based payments and the instruments to be subject to requirements developed in this project.

3. The first two of those three are considered at a high level in this paper, but we have not come up with any innovative ways to address them. The Boards will need to consider detailed rules at a later meeting. The third is analyzed in a separate paper for the December meeting.

4. The potentially minor class involves reporting in consolidated financial statements of instruments issued by subsidiaries that are settled by delivering shares of the parent or other subsidiaries. We have not yet analyzed that class of issues, but we expect that a discussion at a future meeting will be necessary.

5. Another set of issues arises if the Boards decide to bifurcate convertible debt, which otherwise would be a liability as a whole under the definitions suggested by the staff in this project. This paper lists some of those issues but does not include a detailed analysis.

Determining When Shares Are Being Used as Currency

6. After further consideration of comments at the October meeting, we have realized that determining when shares are being used as currency is more difficult than we had thought. We had suggested the following criterion:

   A claim required to be settled by issuing equity instruments would be equity **unless** it has any of the following characteristics:

   (a) Either party has a cash settlement option. (Issuing and acquiring shares is not critical to the transaction.)

   (b) It requires net settlement in shares or either party has a net settlement option. (That implies an immediate gain or loss is the objective and becoming an owner is incidental.)

   (c) The contract exposes either party to risks of changes in value other than those resulting from share price changes, time value of money.

7. We had hoped that by stating this criterion in the negative, we could avoid some of the issues related to “fixed-for-fixed” exchanges (which is shorthand for the IAS 32 requirement) or “ownership returns” (which is shorthand for the comparable

requirement in the ownership-settlement approach). That is, we thought that instead of describing the characteristics that instruments must have to be equity, we could describe the characteristics it must not have.

8. Unfortunately, point 6(c) as stated would permit instruments settled with variable numbers of shares or variable amounts of cash to be equity. That does not seem to be consistent with the basic idea that instruments that involve shares used as currency should not be equity.

9. To fix that problem, the Boards would need to add something similar to the following additional point (which is stated in the negative to be consistent with the other criterion):[1]

   A claim required to be settled by issuing equity instruments would be equity **unless** it has any of the following characteristics:

   (d) The *intrinsic value* of the contract [equivalent alternative: the *value of the settlement* if it were to occur at the classification date] to the counterparty does not change with changes in the price of the shares to be delivered.

10. Points (c) and (d) are roughly equivalent to saying that the exchange must be a fixed amount of cash for a fixed number of shares.

11. The term *intrinsic value* or *value of settlement* must be used because values of options include time value (or volatility value), which changes differently from the share prices, and because values of forwards change based on forward prices instead of current spot prices.

12. That raises all of the boundary issues inherent in IAS 32 (fixed-for-fixed) and the ownership-settlement approach. Some of the boundary issues are:

    (a) How closely must the changes in intrinsic value track the changes in share prices or, alternatively, how fixed is fixed? (Anti-dilution provisions are

[1] The Boards may want to consider revising the criterion to be stated positively instead of negatively. However, there are other reasons not to do so which will be explained at a future meeting.

one example of changes that do not track the share price but seem innocuous.)

(b) How should instruments with floors, caps, or similar features that cause the value to change with changes in share prices in some but not all circumstances? (Intrinsic values of options do not change if the options are out of the money, which is a floor. The IASB staff has received questions about other such provisions.)

(c) Should Bermudan options—options under which the exercise price changes over time or depends on the current share price—be viewed as a series of options each with a fixed strike price in which the exercise of one option cause the others to expire unexercised?

Substance of Share-Settlement Provisions and Implicit Settlement Provisions

13. IAS 32 requires that financial instruments be classified based on the substance of the contract. That standard also states that settlement alternatives that are not genuine do not affect classification, which amounts to the same thing. IAS 32 does not go into detail about substance or genuineness.

14. Subtopic 815-40, Contracts in an Entity's Own Equity (more specifically, the requirements that were originally issued as EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock"), which governs classification of share-settled instruments in the United States, includes provisions to assure that share-settlement provisions have substance. Although these requirements are very specific to securities laws in the United States and we do not necessarily recommend that the Boards include all these requirements, we have included them in this paper as an easy way to illustrate the issues that have arisen with share-settled instruments.

15. Essentially, Subtopic 815-40 does not permit share settlement to be considered substantive unless the entity has the ability at all times during the life of a contract to issue enough shares to fulfill its share settlement requirements under all outstanding

contracts. The following are the eight specific requirements that an entity and a contract must meet for purposes of classification:

(a) *The contract permits the entity to settle in unregistered shares.*

Net-cash settlement is assumed to be required if the entity is required to deliver registered shares but does not have the ability to do so.

Exception: Share delivery is assumed to have substance if a contract involves the delivery of registered shares, the entity holds sufficient registered shares, and there are no further requirements.

Exception: The entity may not be able to deliver unregistered shares, even if the contract permits the entity to deliver unregistered shares, if a failed registration statement has occurred within the last six months. That is a legal determination.

Issue: Fair value of unregistered shares may be less than registered shares, which would invoke a penalty provision. If a settlement alternative includes a penalty that makes that alternative uneconomic, that alternative should be disregarded in classifying the contract. A discount from the value of registered shares that is a reasonable estimate of the difference in fair values is not considered a penalty.

(b) *The company has sufficient authorized and unissued shares available to settle the contract after considering all other commitments that may require the issuance of stock during the maximum period the derivative contract could remain outstanding.*

If shareholders must approve an increase in authorized shares, the entity would consider only the shares that are already authorized and unissued.

The issuer must evaluate whether it has enough authorized and unissued shares to deliver the maximum amount of shares it can be required to deliver under all outstanding contracts. That assessment may change at any time, which would require a classification change.

(c) *The contract explicitly limits the number of shares to be delivered in a share settlement.*

If the number of shares that could be required to be delivered to satisfy a net-share settlement requirement is indeterminate, an entity would be unable to conclude that it has sufficient available authorized and unissued shares. If so, cash settlement is assumed.

(d) *There are no required cash payments (registration rights penalties) to the counterparty in the event the company fails to fulfill SEC filing requirements.*

The ability to make timely SEC filings is considered outside the control of the entity. A contract that requires net-cash settlement would be classified as an asset or a liability if the entity fails to make timely filings with the SEC.

(e) *There are no cash settled "top-off" or "make-whole" provisions. That is, the issuer does not have to deliver additional shares if the holder cannot realize a specified amount of cash by selling the shares it receives.*

(f) *The contract requires net-cash settlement only in specific circumstances in which shareholders also would receive cash in exchange for their shares.*

Equity classifications would not be precluded if net-cash settlement can only be required if the holders of the related shares also would receive cash.

For example, if a contract requires net-cash settlement upon a change in control, the contract generally is classified as an asset or a liability. However, if a change-in-control provision requires the same form of consideration for the counterparty as holders of the underlying shares, equity classification would not be precluded.

(g) *There are no provisions in the contract that indicate that the holder has rights that rank higher than those of a holder of the stock underlying the contract.*

A contract cannot be classified as equity if the counterparty's claim in bankruptcy would receive higher priority than the claims of the holders of the stock underlying the contract.

Legal advisors' comments to the EITF about U.S. law governing priority in bankruptcy were as follows:

(a) Generally, a net-share settled derivative that an entity can settle in shares even upon termination could be net-share settled in bankruptcy.

(b) If the contract is not net-share settled, the claim of the counterparty in bankruptcy or liquidation would not have priority over the stockholders.

(c) In federal bankruptcy proceedings, a debtor cannot be compelled to affirm an existing contract that would require it to pay cash to acquire its shares.

(h) *The issuer cannot be required to post collateral at any time or for any reason.*

16. In deliberating the ownership-settlement approach, the FASB decided to replace the rules-based requirements described above with a substance principle. That principle would have required an entity to identify cash settlement alternatives that were not explicit in the terms of an instrument and consider them for classification purposes (unless they were deemed remote). In assessing an unstated cash settlement feature for a share-settled instrument, an entity would have been required to evaluate whether it would be able to deliver shares upon settlement. The assessment would have considered all facts and circumstances that could occur over the life of the instrument.

17. If the substance principle that the FASB developed is applied to Approach 4.1, many share-settled instruments would be classified as liabilities. That is because there is always a possibility that an entity may be unable to deliver shares as required under the contract, which would result in a cash-settlement outcome and liability classification. That result is inconsistent with the Boards' intent when deciding to pursue Approach 4.1.

Additional Issues Raised by a Requirement to Bifurcate Convertible Debt

18. Under the proposed definition of a *financial liability* in Approach 4.1, convertible debt would be a liability in its entirety because the holder has a cash settlement option. At least one Board member has expressed a preference for requiring convertible debt to be bifurcated into debt and equity components.

19. One reason for requiring bifurcation is to require that interest expense comparable to a freestanding debt instrument be reported. However, this project is unlikely to

achieve that objective for all convertible debt. If the number of shares to be received upon conversion is variable, no part of the instrument would be equity and, therefore, it would not be bifurcated by the requirements of this project. That means that an entity seeking to avoid bifurcation could insert a requirement that results in variability in the number of shares.

20. For the following other reasons, requiring bifurcation of convertible debt instead of classifying it as a liability in its entirety seems to run counter to the objectives in this project:

    (a) Conversion of convertible debt is not an exchange of a fixed amount of a financial asset for a fixed number of shares for at least three reasons:

        (i) Although the principal amount is fixed, its value is not

        (ii) To the issuer, the bond is not a financial asset

        (iii) The entity giving up the bond principal is also giving up its right to receive interest, the value of which varies according to market interest rates and the undiscounted amount of which changes after each interest payment is made.

    (b) It may raise more issues than it resolves. Some questions about convertible debt that the IASB staff has received involve how to account for bonds with the following characteristics:

        (i) The principal amounts are denominated in foreign currencies.

        (ii) The bonds are issued by a subsidiary and convertible into its parent's shares, especially when the two entities have different functional currencies.

        (iii) The provisions allow or require the holder to convert upon a change in control and adjust the number of shares to compensate for the time value lost by converting earlier than the holder would otherwise have done.

        (iv) There are changes in the number of shares to be received to compensate for dilution or anti-dilution because of specified events such as stock splits, stock dividends, reverse splits, rights issuances, or share issuances.

21. Because no convertible debt is really an exchange of a fixed amount of a financial asset for a fixed number of shares, it may be very difficult to describe which convertible debt instruments should be bifurcated and why.

Different Ways to View Convertible Debt

22. In the past, most people have viewed convertible debt instrument as having an equity component similar to a freestanding call option. However, the equity component does not have a value comparable to a freestanding option. The value of the equity component is determined by valuing a hypothetical debt component first and subtracting that amount from the total value of the bond. It is classified as equity because it is viewed as similar to a physically settled written call option

23. There are at least two possible explanations for the fact that the non-bond component of a convertible bond does not have a value comparable to a freestanding call option. First, it is more complicated than the usual call option if it is actually a written call option. It has a variable strike price equal to the fair value of the convertible bond (principal plus the coupon rate of interest). In fact, the strike price not only is variable, it depends on the value of the bond as a whole, which is a complicated and circular notion.

24. Second, the derivative component of convertible debt could be described as an equity return swap with a floor. The swap exchanges a debt return (an interest rate for hypothetical non-convertible bond that bears market interest less the actual coupon rate on the bond) for an equity-like return (the value of the related shares less the value of the debt, which goes up and down with as the difference between the share price and the price of the hypothetical bond changes). There is a floor on the equity return, that is, it cannot be less than the stated coupon rate on the bond.

25. We are not surprised if those two descriptions seem a little confusing. A convertible bond actually is a more complicated instrument because the equity remainder actually is not very similar to a freestanding call option. A freestanding call option is very simple by comparison.

26. Viewed in either of those two ways, the derivative component of the convertible debt would not qualify to be classified as equity under the principles we have suggested.

Comparison to IAS 32 and Ownership-Settlement Approach

27. In general, the differences between Approach 4.1, IAS 32, and the ownership-settlement approach are as follows:

    (a) The fixed-for-fixed requirement in IAS 32 applies to both cash-settled instruments for which the entity receives its own shares and share-settled instruments for which the entity issues its shares. Under Approach 4.1 and the ownership-settlement approach, no cash-settled derivatives would be classified as equity.

    (b) Both IAS 32 and Approach 4.1 would only allow physically settled derivatives to be classified as equity. The ownership-settlement approach would allow some net-share settled derivatives to be classified as equity.

    (c) Under IAS 32, a puttable share can be classified as either a liability or as equity depending on the terms of the put. A puttable share is not separated under IAS 32. Under Approach 4.1, some puttable shares would be classified as equity and others would be separated into liability and equity components. The classification of a puttable share under the ownership-settlement approach is not clear. Some puttable shares would be separated into components and others would be classified as equity in their entirety. We are not sure if a puttable share could ever be classified as a liability in its entirety under that approach.

(d) Debt that is convertible into a fixed number of shares would be separated under IAS 32 and the ownership-settlement approach. Debt that is convertible into a variable number of shares would be classified as a liability under both the ownership-settlement approach and IAS 32. However, those instruments may be subject to bifurcation into two liabilities under Topic 815, Derivatives and Hedging (originally, issued as FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*) and IAS 39. No convertible debt instruments would be separated under Approach 4.1.

28. Appendix A contains a list of instruments and their classification under Approach 4.1, the ownership-settlement approach, and IAS 32.

Summary

29. The issues discussed in this paper are significant and likely to be time consuming. The other papers for this meeting discuss additional issues. If we are to complete this project and issue a final IASB standard and FASB Accounting Standards Update before June 30, 2011, we will need to issue an Exposure Draft by June 30, 2010 at the latest. Working backward from that deadline and allowing time for drafting, balloting, and dealing with “sweeps issues,” the last meeting before beginning drafting would be the March joint meeting. Please carefully consider whether that is feasible. If you share the staff’s significant doubts about whether we can resolve these issues satisfactorily by that time, please inform us now so that we can try to develop a (less ambitious) Plan B.

Questions for the Boards

Questions
Q1. After considering the issues and the amount of time it will take to resolve them, do you still want to proceed with Approach 4.1? That is, do you believe that all of the issues can be resolved in time to issue a final standard by June 30, 2011? Q2. If you decide to proceed with Approach 4.1, do you have specific concerns about the criteria (in paragraphs 6 and 9) for determining when shares are used as currency or any suggestions for improving those criteria? Q3. Do you want to further consider whether convertible debt should be separated into liability and equity components? If so, what further information/analysis do you need to make that decision?

Appendix A

	Instrument	Approach 4.1	Ownership-Settlement Approach	Current IFRS
1	Common share	**Equity**	**Equity**	**Equity**
2	Perpetual preferred share	**Equity**	**Equity**	**Equity**
3	Share issued by a limited life entity	**Equity**	**Equity**	**Liability or Equity**[2]
4	General partnership interest Classification assumes that (a) the general partner takes an active role in the management of the partnership, (b) the instrument must be redeemed if the general partner retires from the partnership, and (c) the partnership does not liquidate upon the partner's redemption	**Equity**	**Equity (assumes it meets the definition of a BOI)** **Liability if the instrument is redeemed something other than FV or book value and is not the most residual instrument.**	**Liability or Equity**[2]

[2] IAS 32 classifies instruments that are required to be redeemed and that are redeemable at the option of the holder as financial liabilities unless they have particular features and meet particular conditions.

	Instrument	Approach 4.1	Ownership-Settlement Approach	Current IFRS
5	Limited partnership interest Classification assumes that (a) the limited partner does not participate in the management of the partnership, but, rather, only has a financial interest in the partnership, (b) the instrument is redeemable at the option of the partner, and (c) the partnership does not liquidate upon the partner's redemption	**Liability and Equity**	**Equity (assumes it meets the definition of a BOI)** **Liability and Equity if the instrument is redeemed at something other than FV or book value and is not the most residual instrument.**	**Liability or Equity**[2]

	Instrument	Approach 4.1	Ownership-Settlement Approach	Current IFRS
6	Limited liability partnership instrument Classification assumes that (a) the limited liability partner takes an active role in the management of the partnership, (b) the instrument must be redeemed if the partner retires from the partnership, and (c) the partnership does not liquidate upon the partner's redemption	**Equity**	**Equity** **(assumes it meets the definition of a BOI)** **Liability if the instrument is redeemed something other than FV or book value and is not the most residual instrument.**	**Liability or Equity[2]**
7	Ownership instrument that is redeemable at the option of the holder (other than upon retirement or death)	**Liability and Equity**	**Liability or Equity**	**Liability or Equity[2]**
8	Ownership instrument that is required to be redeemed if an uncertain event occurs	**Liability and Equity**	**Liability or Equity**	**Liability or Equity[2]**

	Instrument	Approach 4.1	Ownership-Settlement Approach	Current IFRS
9	Ordinary share with a required dividend	**Liability and Equity**	**Liability and Equity**	**Liability and Equity**
10	Ordinary share with a substantive registration rights penalty[3]	**Liability and Equity**	**Liability and Equity**	**Liability and Equity**
11	Preferred share convertible into variable number of ordinary shares at the option of the holder	**Liability and Equity**	**Liability**	**Liability**
12	Preferred share that is required to be converted into a variable number of ordinary shares on a specific date or event that is certain to occur (other than death or retirement)	**Liability**	**Liability**	**Liability**
13	Instrument issued by a cooperative that gives the holder the right to request redemption, but the cooperative can refuse that request	**Equity**	**Equity**	**Equity**

[3] A promise to remit consideration to an investor if an instrument held by that investor is (a) not registered for public trading by a specified date or (b) not listed on a stock exchange by a specified date.

	Instrument	Approach 4.1	Ownership-Settlement Approach	Current IFRS
14	Instrument issued by a cooperative that must be redeemed upon the holder's death, retirement, or decreased participation	**Equity**	**Liability or Equity depending on the redemption terms**	**Liability or Equity**[2]
15	Instrument that *converts* mandatorily on a specific date or event that is certain to occur (other than death or retirement) into a variable number of share instruments with a fixed monetary amount (for example, share-settled debt)	**Liability**	**Liability**	**Liability**
16(a)	Physically (gross) settled written call option	**Equity**	**Equity**	**Equity**[4]
16(b)	Net-share-settled written call option	**Liability**	**Equity**	**Liability**

[4] Classification as equity assumes that the instrument will be settled only by the issuer exchanging a fixed amount of cash for a fixed number of its own equity instruments.

	Instrument	Approach 4.1	Ownership-Settlement Approach	Current IFRS
16(c)	Physically (gross) settled employee stock option	**Equity**	**Equity**	**Equity**
16(d)	Physically (gross) settled instruments that give the holder the right to acquire a fixed number of the entity's own equity instruments at a fixed price (a rights issue) denominated in a currency that is not the entity's functional currency (example assumes that the options were offered pro-rata to all existing shareholders)	**Equity**	**Equity**	**Equity**[5]
17	Net-cash-settled written call option and cash SAR	**Liability**	**Liability**	**Liability**
18(a)	Net-cash- or net-share-settled forward purchase contract at a fixed price	**Liability or Asset**	**Liability or Asset**	**Liability or Asset**
18(b)	Physically settled forward purchase contract	**Liability or Asset**	**Liability or Asset**	**Gross liability and contra-equity**

[5] Classification is based on the IASB's recent amendment to IAS 32.

	Instrument	Approach 4.1	Ownership-Settlement Approach	Current IFRS
19	Prepaid forward purchase contract for a fixed number of shares	**Asset**	**Asset**	**Contra-equity**[6]
20(a)	Net-cash- or net-share-settled written put option	**Liability**	**Liability**	**Liability**
20(b)	Physically settled written put option	**Liability**	**Liability**	**Gross liability and contra-equity**
21	Prepaid written put option for a fixed number of shares	**Asset**	**Asset**	**Contra-equity**[6]
22	Convertible debt for fixed number of shares	**Liability**	**Liability and Equity**	**Equity and Liability**
23	Share redeemable at the option of the issuer (callable share)	**Equity**	**Equity**	**Equity**
24(a)	Preferred share convertible into a fixed number of ordinary shares at the option of the holder	**Equity**	**Liability and Equity (if puttable at a fixed price** **Equity (if puttable at fair value)**	**Equity**[7]

[6] Classification as contra-equity assumes that the issuer has prepaid a fixed amount of cash and that the instrument will be settled by the issuer receiving a fixed number of its own equity instruments.
[7] Classification as equity assumes that the preferred share includes no other contractual obligations.

	Instrument	Approach 4.1	Ownership-Settlement Approach	Current IFRS
24(b)	Preferred share required to be converted into a fixed number of ordinary shares	**Equity**	**Equity**	**Equity**[8]
25	Preferred share puttable, callable, and convertible	**Liability and Equity**	**Liability and Equity**	**Liability**
26	Note receivable settled with cash or a variable number of shares[8]	**Asset**	**Asset**	**Asset**
27	Debt indexed to shares (for example, convertible debt for which the entire conversion value is settled in cash)	**Liability**	**Liability**	**Liability**

[8]The example assumes the counterparty can choose the form of settlement. That fact is relevant to current U.S. GAAP classification only.