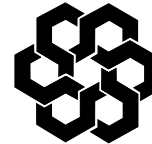

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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**January 2009, London**
Project:	**Financial Instruments with Characteristics of Equity**
Subject:	**Alternative 2—Separating Redeemable Instruments (Agenda Paper 11B)**

Note: This paper uses the term *redeemable instruments* as a convenient way to describe instruments that are puttable (redeemable at the option of the holder) or mandatorily redeemable and that would clearly be equity if not for those features. This term does not include equity instruments that are callable (redeemable at the option of the issuer).

BACKGROUND

1. Some Board members have suggested that redeemable instruments should be separated into an equity component (for example, a share) and a non-equity component (a derivative).

2. During the project that resulted in the amendments to IAS 32, *Financial Instruments: Presentation*, the IASB considered whether all puttable instruments should be separated into a written put option component and an equity component. However, the IASB decided not to pursue that approach because conducting further research into that approach would duplicate efforts of this longer-term project.

3. This paper addresses a broader set of instruments than the amendments to IAS 32 because we are considering **all** redeemable instruments, whereas the amendments addressed particular puttable instruments and particular other instruments with obligations arising only on liquidation. As mentioned above, a puttable instrument could be separated into a perpetual instrument and a written put option. Similarly, a mandatorily redeemable instrument could be separated into a perpetual instrument and a forward purchase contract.

4. This agenda paper:

    a. discusses some of the advantages and disadvantages related to separating redeemable instruments

    b. provides our recommendation.

5. This paper does not address other types of instruments that the Boards may want to consider separating (for example, a share with a required dividend or a preferred share convertible into common shares). Those instruments will be discussed at a later date.

6. Furthermore, this paper does not address instruments that have more than one non-equity component (for example, debt with a conversion option) because they do not raise liability-equity classification issues.

Current Requirements for Redeemable Instruments

7. IAS 32 does not require separation of redeemable instruments. Redeemable instruments meet the definition of a financial liability, and, consequently, most are classified in their entirety as liabilities. However, instruments that meet all of the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of IAS 32 are exceptions. They are classified as equity.

8. U.S. GAAP also does not require separation of redeemable instruments. Currently effective standards require puttable instruments and some mandatorily redeemable

instruments to be classified as equity.[1] Other mandatorily redeemable instruments are classified as liabilities. FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity,* would have required the following types of instruments issued by all reporting entities to be classified as liabilities:

a. mandatorily redeemable instruments

b. instruments that obligate the issuer to repurchase its own equity instruments for cash or other assets

c. instruments that the issuer must or can settle by issuing a variable number of its own equity shares that have specified other characteristics.

9. However, shortly after the issuance of Statement 150, the FASB learned that many non-public closely held entities issue only instruments that are redeemable upon the holder's death or retirement. That meant that those entities would have no equity instruments under Statement 150. FASB Staff Position (FSP) FAS 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150,* indefinitely defers the effective date for mandatorily redeemable instruments of nonpublic entities.[2]

User Input

10. Users who participated at the FASB public roundtable meetings in September 2008 to discuss the FASB Preliminary Views, *Financial Instruments with Characteristics of Equity,* stated that they would prefer a classification approach that minimizes separation.

[1]The SEC requires public companies to classify some redeemable equity instruments as "temporary equity".

[2]FSP FAS 150-3 also indefinitely deferred the requirements for certain mandatorily redeemable noncontrolling interests. Paragraph 9 of Statement 150 requires that "a mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity." This would allow some mandatorily redeemable noncontrolling interests to be classified as equity at the subsidiary level, but also would require them to be classified as a liability at the consolidated level. We will bring this issue to the Boards when we discuss whether a subsidiary's equity instruments should be classified as equity at the consolidated level.

11. Also, users that we spoke to during the comment period on the IASB discussion paper, *Financial Instruments with Characteristics of Equity,* generally supported a simple and clear classification approach. Overall, they supported the basic ownership approach, which classifies redeemable instruments in their entirety as equity or non-equity.

ADVANTAGES OF SEPARATING REDEEMABLE INSTRUMENTS

12. There are two potential advantages of separating redeemable instruments. One is technical and the other is practical.

13. First is the technical issue. Separation of redeemable instruments would result in presenting a single instrument with a redemption feature in the same way as a similar instrument (common stock) issued along with a separate redemption option (forward purchase contract or put option). Some current U.S. GAAP and IFRS requirements are designed to achieve that result without separating instruments.

14. Statement 150 requires physically settled forward purchase contracts (settled by exchanging a fixed number of shares for cash) to be recognised at gross amounts. The gross amounts recognise the shares to be repurchased and the gross (discounted) amount of cash to be delivered under the contract price. Under Statement 150 gross accounting, the underlying shares are treated as though they have been repurchased from the counterparty at the *inception* of the contract, rather than at the contract's settlement date. The end result is that forward purchase contracts are treated like mandatorily redeemable shares. IAS 32 has similar requirements for physically settled forward purchase contracts and written put options.

15. In November, each Board decided that all derivatives on an issuer's own equity instruments should be classified as liabilities or assets. Therefore, the gross accounting described in the preceding paragraph would no longer exist.

16. Second is the practical issue. The Boards have already tentatively decided that all perpetual instruments should be classified as equity, and it may prove to be difficult to develop a single principle under which all perpetual instruments **and** some

specified types of redeemable instruments would be classified as equity. (Refer to Agenda Paper 11A for a discussion of another possible way to achieve the desired results.)

17. At the November Board meetings, the Boards preliminarily expressed a view that some redeemable instruments should be classified as equity. Identifying specific criteria for determining which redeemable instruments should be classified as equity will be difficult. As mentioned in paragraph 2 of this agenda paper, the IASB recently issued an amendment to IAS 32 and IAS 1, *Puttable Financial Instruments and Obligations Arising on Liquidation,* that requires some instruments that meet the definition of a financial liability to be classified as equity. The Board and staff spent years developing and issuing the detailed requirements (rules). If the Boards decide to separate redeemable instruments, they can avoid developing and deliberating such requirements.

18. Unfortunately, there are significant disadvantages and challenges associated with separating some kinds of redeemable instruments, especially those issued by cooperatives and private companies. Because those are some of the specific instruments that persuaded at least some Board members that some redeemable instruments should be classified as equity, the practical advantage of separation may not be as significant as it seems.

DISADVANTAGES OF SEPARATING REDEEMABLE INSTRUMENTS

Separating an instrument that has only one actual outcome

19. Redeemable instruments have only one actual outcome. Puttable instruments have two alternative outcomes, only one of which can occur. (They will either be put **or** remain outstanding. Both cannot occur for the same instrument.) Mandatorily redeemable instruments are required to be redeemed. Again, there will be only one outcome (assuming the two parties actually perform as agreed). [3]

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[3] To illustrate the contrast, the following is an example of an instrument with two independent outcomes, which is NOT addressed in this paper. Some U.S. companies have issued perpetual shares with provisions that require the issuer to pay the holders a specified amount if the shares are not registered for public

20. Separating a redeemable instrument into an equity and non-equity component would present a single instrument as if it could have multiple outcomes, which is not a faithful representation. Separation also raises some practical challenges, which are described in the next section of this paper.

Practical difficulties associated with separating redeemable instruments

Measurement

21. As previously noted, in November, each Board decided that all derivatives on an issuer's own equity instruments should be classified as liabilities or assets. To be consistent with that decision, all such instruments would be measured at fair value through profit or loss in accordance with IAS 39, *Financial Instruments: Recognition and Measurement,* or FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

22. Determining the fair value of a derivative (a put or forward) that is embedded in an equity instrument can be difficult unless there is a quoted price for similar options. Because the value of the derivative is "derived" from the price and price volatility of the underlying instrument, the entity must determine those values first. That would be especially difficult for cooperatives and private companies that do not issue similar non-redeemable instruments (that is, they only issue redeemable instruments). Many of those redeemable instruments do not have fixed redemption dates and many do not have fixed redemption amounts. Some entities do not expect the instruments to be redeemed for a long time. In fact, some entities have told us that none of their redeemable instruments have ever been redeemed. Those factors will make measuring the embedded derivative difficult. (We acknowledge that these measurement difficulties will exist if the Boards decide to classify those types of redeemable instruments in their entirety as liabilities measured at fair value through profit and loss.)

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trading by a specified date. Those instruments have two separate independent outcomes. Whether or not a payment is required, the instrument will remain outstanding. Obviously, one of those outcomes is uncertain, but the two are independent, which is the key characteristic. (The EITF previously reached a consensus that the apparently single instrument is two separate instruments for reporting purposes.)

23. Unlike U.S. GAAP, paragraph 47(a) of IAS 39 provides an exception for the subsequent measurement of derivative liabilities that are linked to and must be settled by delivery of an unquoted equity instrument. If the fair value of that derivative cannot be reliably measured, it shall be subsequently measured at cost. While that guidance may simplify the **subsequent** measurement of derivatives issued by particular entities, it does not address the complexities that we have described for initial measurement.

24. If an instrument is redeemable at its fair value (or an approximation thereof), the embedded derivative may have value because it enhances liquidity in the absence of an active market for the underlying instruments. However, that value generally would be expected to be minimal. In that case, the majority of the value of the redeemable instrument would be attributable to the equity component. As a result, some people have suggested that there is very limited benefit in separating an instrument that is redeemable at the fair value. In such cases, the instrument could be classified as equity in its entirety as a practical expedient even if the general principle were to classify only perpetual instruments as equity.

25. In contrast, if an instrument is redeemable at an amount other than fair value (or a reasonable approximation), the derivative might have a significant value. That certainly would be the case if the instrument were redeemable at a fixed amount and the fair value of the underlying instrument was substantially lower than the redemption amount. As a result, a significant portion of the value of the redeemable instrument would be attributable to the liability component.

26. That raises the question about whether an instrument redeemable at fair value should be treated differently from an instrument redeemable at another amount. The IASB Exposure Draft, *Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation,* proposed an exception to the definition of a financial liability only for instruments puttable at fair value. Constituents told the IASB that the scope of the ED did not work because it did not capture the complete population of instruments that represent the residual interest in the entity, and, thus, should be

classified as equity. Moreover, many comment letters queried whether fair value meant (a) the fair value of the **instrument**, (b) the fair value of the **net assets of the entity**, or (c) the fair value of the **entity**. During their redeliberations, the IASB decided that the scope of the final amendments to IAS 32 should be broader than instruments puttable at fair value.

Settlement, conversion, expiry, and modification of the instrument

27. Requiring separation of redeemable instruments would require detailed guidance for settlement, conversion, expiry and modification of instruments. The FASB attempted to develop requirements for separated instruments and those requirements are described in paragraphs A30-A33 of the FASB PV.

28. We think that the requirements in the FASB PV are unworkable and would need to be reconsidered if the Boards decide to separate redeemable instruments. Moreover, any such requirements that we can envision would be complex. If the derivative is measured at fair value and the equity component is not remeasured, it is highly unlikely that the carrying amount of the components at settlement will equal the cash (or other assets) transferred. The difference probably would need to be allocated between the liability and equity component, and the Boards would have to develop detailed requirements for that allocation.

Recent amendments to IAS 32

29. Some IASB Board members have noted that the recent amendments to IAS 32 required some entities to change the classification of particular redeemable instruments, and that it would be inappropriate if this project required those entities to change again. If the Boards decide to require separation of redeemable instruments, **all** entities would be required to change how they classify redeemable instruments.

30. Moreover, if the Boards decide that redeemable instruments should be separated, it is possible that a significant portion of the value of the instrument would be reported as a liability (a derivative) and measured at fair value through profit and loss. Measuring redeemable instruments through income was one of the primary concerns

that constituents raised about the classification requirements under Statement 150 and IAS 32. Separating these instruments will not resolve the issues that the Boards were trying to address with the FSP on Statement 150 and the amendments to IAS 32.

Mandatorily redeemable versus puttable instruments

31. Some Board members may think that puttable instruments should be separated into components but mandatorily redeemable instruments should not. That is because puttable instruments have two alternative outcomes—the instrument may be put back to the issuer or it may remain outstanding—while mandatorily redeemable instruments do not have alternative outcomes; the instrument will be redeemed.

32. A requirement to separate some but not all redeemable instruments will almost certainly result in more complex separation rules.

Staff Recommendation

33. We think that redeemable instruments should be classified as equity or liabilities in their entirety.

34. As discussed in paragraphs 19-20, a redeemable instrument has a single actual outcome. Classifying a redeemable instrument in its entirety faithfully represents that fact.

35. The redemption feature (the put or the forward) does not have its own separate cash flows. The holder cannot settle (extinguish) or sell it separately from the underlying instrument. Therefore, we do not think that separating the instrument and accounting for the components as if they are freestanding instruments reflects the economic reality of the transaction.

36. Moreover, most users of financial statements have told us that separating redeemable instruments does not provide better information. They stressed that they prefer a simple and clear distinction between equity and non-equity instruments.

37. Furthermore, based on the Boards' decision in November, convertible debt would be classified in its entirety as a liability and, as a result, the current practice problems under IFRS related to its separation will be resolved. Some of the practice problems relate to the "joint-ness" of the components (for example, measuring the liability component without taking into account the equity component). As discussed above, if the Boards decide to separate redeemable instruments, we think similar practical difficulties will arise. We think it would be unfortunate if the Boards resolved the practice problems and complexity related to convertible debt but introduced those same problems and complexity for redeemable instruments.

38. Finally, we acknowledge that some Board members believe that a puttable instrument is economically similar to a perpetual instrument and a standalone written put option and should be classified as such. We think that separating the puttable share is not the only way to account for those things similarly. Alternatively, in particular circumstances, the Boards could decide to **link** the perpetual instrument and the standalone written put; thus, accounting for those two instruments the same way as a puttable share. The FASB PV includes a linkage principle and we will bring that issue to the Boards at a future meeting.

Question for the Boards: Do the Boards agree that puttable and mandatorily redeemable instruments should not be separated?