Project **Financial instruments with characteristics of equity**
Topic **Measurement of Equity Instruments and Separated Hybrid Instruments**

Overview

1. We recommend the following measurement requirements for freestanding equity instruments and equity hybrids (instruments that are separated into an equity component and a liability or asset component):

Transaction costs

(a) Transaction costs or fees incurred to issue freestanding equity instruments and equity hybrids should be expensed immediately. The term *transaction price* as used in this paper does not include transactions costs or fees.

Initial measurement of freestanding equity instruments

(b) Freestanding equity instruments should be initially measured at their transaction prices.

Separation of equity hybrids

(c) Separated components of an equity hybrid should be measured as follows. First, the liability or asset component should be measured at the fair value as if it were a freestanding liability or asset. Second, the remainder of the transaction price for the hybrid instrument should be allocated to the equity component.

Subsequent measurement

(d) Equity instruments and separated components that the entity cannot be required to redeem should not be remeasured.

(e) At each reporting date, equity instruments and separated equity components with redemption requirements should be remeasured at current redemption value. Changes in current redemption value should be recorded as a transfer between retained earnings and the redeemable equity instruments or components.

(f) The liability or asset component of a separated instrument should be subsequently remeasured as if it were a freestanding instrument.

2. The reasoning for our recommendations and other alternatives we considered are described below.

Transaction Costs

3. An entity typically incurs various costs when it issues an equity or liability instrument. Those costs might include registration and other regulatory fees or amounts paid to legal, accounting, and other professional advisors.

Existing Requirements

4. APB Opinion No. 21, *Interest on Receivables and Payables*, states that issuance costs are recorded as a deferred charge. This can be interpreted to mean either recognition of an asset or contra-account, both of which would be subject to amortisation. We understand that constituents generally record a contra-liability for debt issuance costs.

5. Under IFRS, the accounting requirements for transaction costs depend on the classification of the instrument and its subsequent measurement attribute. Paragraph 37 of IAS 32, *Financial Instruments: Presentation*, states that transaction costs related to an equity transaction are accounted for as a deduction from equity to the extent they are incremental costs directly attributable to the equity transaction. In other words, transaction costs related to equity instruments are never recognised in profit or loss.

6. Paragraph 39 of IAS 32 discusses transaction costs that relate to the issuance of a financial instrument that is separated into equity and liability components. Such costs are allocated to the liability and equity components in proportion to the allocation of the proceeds.

7. IAS 39, *Financial Instruments: Recognition and Measurement*, provides the accounting requirements for transaction costs associated with liability and asset instruments.

Equity Instruments

8. We considered four alternatives for accounting for transaction costs related to an equity transaction:

   (a) Alternative 1—As a deferred asset and amortised

   (b) Alternative 2—As contra-equity and amortised

   (c) Alternative 3—Netted against the transaction price upon initial recognition

   (d) Alternative 4—Expensed immediately.

9. Alternatives 2 and 3 have the same results at initial recognition. However, they are different on Day 2. Under Alternative 2, those costs would be amortised as an expense over a particular period. Under Alternative 3, the costs would remain netted against the transaction price in equity.

10. We rejected Alternative 1 because transaction costs do not meet the definition of an asset (there is no future economic benefit).

11. We rejected Alternative 2 because equity instruments generally do not have a contractual life; therefore, it would be difficult and necessarily arbitrary to select a period over which to amortise the costs. We rejected Alternative 3 because transaction costs associated with equity instruments would never be recorded in the income statement.

12. In developing the Preliminary Views, *Financial Instruments with Characteristics of Equity*, the FASB decided that transaction costs should be expensed immediately (Alternative 4). The Board concluded transaction costs are a period cost and provide no future economic benefit. We continue to support that decision.

13. Moreover, IFRS 3, *Business Combinations*, and FASB Statement No. 141 (revised 2007), *Business Combinations,* require the acquirer to account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received. Our recommendation is consistent with this principle.

Hybrid Instruments

14. Hybrid instruments raise an issue that freestanding equity instruments do not because they have liability (or asset) components. Current accounting for transaction costs related to freestanding liability and asset instruments differ depending on how the instrument will be subsequently measured. If a financial liability will be carried at cost-based amounts (with amortizations, accretions, accruals, and impairments), the transaction costs are reported as a reduction of the initial carrying amount and accreted into profit and loss. The requirement for assets is similar except that the transaction costs result in an increase to the initial carrying amount.

15. We have identified two alternatives for accounting for transaction costs related to the issuance of a hybrid instrument that is separated:

    (a) Alternative a—Expense the transaction costs immediately.

    (b) Alternative b—Allocate the costs to equity and liability (or asset) components. Expense the portion of the costs related to the equity components (to be consistent with the staff recommendation on costs related to freestanding equity instruments). Treat the portion related to the liability or asset component as it would be treated if that component were a freestanding instrument.

16. Alternative (a) would be simpler, more straightforward, and consistent with the notion that transaction prices (and fair values) do not include transaction costs. However, it would not be consistent with the current treatment of transaction costs on some freestanding financial assets and liabilities.

17. Alternative (b) would require allocating the transaction costs to the equity and liability (or asset) components. The most straight-forward allocation method would be in proportion to the allocation of issuance proceeds or transaction price of the equity hybrid.[1] The transaction costs allocated to the equity component would be expensed consistent with the staff recommendation for freestanding equity instruments. The transaction costs allocated to the liability (or asset) component would be treated in accordance with the measurement requirements for liability (or asset) instruments (e.g., IAS 39, Opinion 21, or FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*).

18. Alternatives (a) and (b) would have the same results in some cases. For example, a previous Board decision in this project would require separation of instruments that are puttable on a fixed date. Under alternative (a), all of the transaction costs associated with that hybrid instrument would be expensed immediately. Under alternative (b), the transaction costs would be allocated between the equity component and the liability component (the put option). The costs allocated to the equity component would be expensed immediately. The put option would be measured at fair value through profit or loss as all derivatives are; the transaction costs would be expensed.[2]

19. There will be a difference between the alternatives if the liability component is not measured at fair value through profit or loss. In that case, transaction costs allocated to the liability component will not be expensed immediately.

20. The Boards may want to comprehensively address transaction costs related to liability and asset instruments in their project on the recognition and measurement

[1] See paragraph 33 for a discussion of how to allocate the transaction price to the two components.
[2]Designation as a cash flow hedge would require that the gains or losses be reported in other comprehensive income, but transaction costs would still be expensed.

of financial instruments. If so, alternative (b) would maintain the status quo until that reconsideration is completed.

Question for the Board

Question 1
How should transaction costs related to equity instruments and equity hybrids be accounted for?

Initial Measurement

21. We identified three potential alternatives for initial measurement of an entity's own equity instruments–fair value, transaction price, and current market trading price.

Fair Value

22. It is inherently difficult for an entity to measure its own equity instruments at fair value as currently defined because ownership instruments are unique to the issuer. Liability instruments represent contracted payments that a third party with the same credit risk could undertake to provide without changing the level of risk to the holder. There may be no market for a particular liability instrument but at least in theory, a market transaction is possible if the creditor agrees to it. The same cannot be said for an entity's own equity instruments. Not even in theory can a third party step into the position of an issuer of ownership interests and maintain the same potential for risks and returns to the holder.

23. When the IASB discussed the fair value of one's own equity in January 2009 (in a meeting on the fair value measurement project), the Board acknowledged the theoretical difficulty and identified a practical solution. The fair value to the holder of an equity instrument should be used as a proxy for the fair value to the issuer.

24. The FASB has no explicit guidance on determining fair values of one's own equity instruments. Footnote 4 of FASB Statement No. 157, *Fair Value Measurements*, states that "the definition of fair value focuses on assets and liabilities because they are a primary subject of accounting measurement. However, the definition of fair value also should be applied to instruments measured at fair value that are classified in stockholders' equity." However, Statement 157 provides no further guidance on how to deal with the problems discussed in paragraph 22 of this paper. Therefore, if the Boards decide fair value is the appropriate initial measurement attribute, the FASB will have to provide guidance on how to determine fair value.

25. Even if the Boards can agree on what fair value means in the context of an equity instrument, initially measuring equity instruments at fair value could create Day 1 gains or losses if the transaction price and the fair value of a particular instrument differ. It would be difficult to explain why an entity should recognize a gain on issuance of its own shares in an arm's-length market transaction.

26. Describing the measurement attribute as fair value and then providing a practical expedient like the IASB did in the fair value measurement project seems to "pollute" the definition of fair value and would likely to lead to confusion and inappropriate application of the expedient to other items by analogy. We strongly recommend against setting that precedent.

Transaction Price

27. Measurement of newly issued equity instruments at the transaction price is a long-standing practice and avoids the potential difficulties of fair value measurement. The transaction price of an equity instrument is the fair value of the consideration received for issuing the instrument. If an equity instrument is issued because of the exercise of an option or other derivative, the transaction price includes both the exercise price and the fair value of the option.

28. It should be noted that even if the transaction price of an equity instrument issued under the terms of an option includes the fair value of that option, the total may

not equal the amount at which the instrument could have been issued in a market transaction on that same day. Of course, the intrinsic value of the option plus the exercise price of that option will always equal the trading price of the shares on the exercise date. However, the fair value of the option would include some time value if it were exercised at any time other than the expiration date. Therefore, the exercise price plus the fair value of the option would exceed the trading price of the share on that date.

Current market trading price

29. A third alternative might be to use the current market issuance price (or trading price) of a newly issued equity instrument even if it is not actually issued at that price. That would avoid the difficulty of determining fair value to the issuer and also would avoid reporting shares issued pursuant to options at amounts greater than the trading price on the issuance dates.

30. The downside of using the current market trading price would be for entities issuing shares for which there are no price quotes. For those entities, current trading price would be no more difficult to estimate than fair value. In fact, the current market trading price would be the same thing under the IASB's practical expedient of using the holder's price.

31. The actual transaction price would normally be easier to determine than either the fair value or the current market trading price.

Question for the Board

Question 2
How should freestanding equity instruments be measured on the issuance date?

SEPARATION OF EQUITY HYBRIDS

32. At the May 2009 meetings, the Boards tentatively agreed that instruments with more than one possible outcome, one of which would require equity classification if it were the only outcome and one of which would require liability classification if it were the only outcome, would be separated. Examples of instruments that would require separation are an ownership instrument with at required dividend, an ownership instrument that is required to be redeemed upon an uncertain event, and some types of ownership instruments that are redeemable at the option of the holder.

33. We identified the following alternatives for initially measuring the components:

    (a) **Liability First—**First, measure the liability or asset component. Then, allocate the rest of the transaction price to the equity component.

    (b) **Equity First**—First, measure the equity component. Then, allocate the rest of the transaction price to the liability or asset component.

    (c) **Most Easily Determinable First**—First, measure the component with the most easily determinable value. Then allocate the rest of the transaction price to the other component.

    (d) **Simultaneous**—First, determine the value of each component independently. Then, adjust the components on a pro rata basis so that the sum of the components equals the transaction price.

34. Alternative (a) was the method described in the FASB Preliminary Views (and IASB Discussion Paper). It is the simplest and most practical approach because it avoids the difficulties in directly measuring the fair value of equity instruments or components described in paragraph 22 of this paper. It also avoids recognizing gains or losses on Day 2 for liability instruments subsequently measured at fair

value that could arise under the other methods solely because the measurement at Day 1 was not fair value.

35. All of the other alternatives involve direct measurement of the equity component. If that allocation is to be based on fair value, the difficulties discussed in paragraph 22 will arise. Those theoretical difficulties with determining fair value of equity instruments might be avoided by using a measure other than fair value to do the allocations under alternatives (b), (c), or (d). However, that would require specification of a new measure and all the related problems and questions that could arise. Also, it would create gains from remeasurements of instruments that are required to be subsequently measured at fair value.

Question for the Board

Question 3
How should instruments that are separated into equity and liability (or asset) components be initially measured?

SUBSEQUENT MEASUREMENT

Instruments and components that the entity cannot be required to redeem prior to liquidation

36. As a general rule, there is no reason to remeasure equity instruments and equity components that the entity cannot be required to redeem.[3] Amounts received by holders of equity instruments (such as dividends) are considered **distributions** of net income rather than **determinants** of net income. Examples of equity instruments that would not be remeasured include perpetual ordinary shares,

[3] The reason for the phrase *as a general rule* is that in a few cases outside the ordinary course of business, such as a business combination, bankruptcy, or recapitalization, remeasurement may be determined to be appropriate. This discussion is not intended to eliminate that possibility.

perpetual preferred shares, and shares that are redeemable at the option of the issuer.

Question for the Board

Question 4
Should equity instruments and components that the entity cannot be required to redeem prior to liquidation be remeasured? If so, which ones, what measurement attribute should be used, and why?

Equity Instruments with Redemption Requirements

37. At the March and May 2009 meetings, the Boards tentatively decided that some ownership instruments with redemption requirements should be classified as equity (those redeemable only on death, retirement, or otherwise ceasing to participate in the activities of the issuer).

38. Remeasuring equity instruments with redemption requirements at each reporting period would provide users with information about the liquidity needs of the entity, specifically, the magnitude of a reporting entity's possible cash (or other asset) outflows. The FASB Preliminary Views (and the IASB Discussion Paper) would have required that redeemable equity instruments be measured at their current redemption value.

39. Current redemption value is a defined term. Every class of redeemable instruments has some kind of formula for determining the redemption value. It may be as simple as a fixed amount or it may be related to fair values or book values. The current redemption value, as we have defined the term, means the amount that would result from applying the redemption formula as if redemption was required at the measurement date. In other words, this is the amount that would have resulted from the redemption formula if the entity had known in advance that redemption would occur on the reporting date and had time to arrange its affairs in the same way it expects to arrange them when it actually

redeems the instruments. In no case would a discount be applied to the current result of the redemption formula unless the formula itself involves a discount.

40. Some may argue that current redemption value is not representative of the issuer's obligation because the uncertainty around the timing and amounts of the redemption would not be reflected. For example, if all shares are required to be redeemed upon death or retirement of the holders, redemption value on the reporting date may not be a relevant measure because it is very unlikely that all the holders would die or retire at the reporting date. We acknowledge that the current redemption value might be more useful in some cases if it were discounted. However, there is no effect on profit and loss, which is often the purpose of discounting, and the reporting entity also would be required to disclose the facts and circumstances surrounding possible redemptions in the notes to the financial statements.

41. Some may think information about an instrument's current redemption amount should be disclosed in the notes to the financial statements instead of presented on the face of the financial statements. We believe this information is extremely important to users and will be easier to find if it is presented in the statement of financial position.

Question for the Board

Question 5
Should equity instruments and components with redemption requirements be subsequently measured at current redemption value with changes reported as transfers to or from retained earnings? If not, what does the Board suggest and why?

Liability and Asset Components of a Separated Instrument

42. We think the liability or asset component of a separated instrument should be subsequently remeasured as if it were a freestanding instrument. This

recommendation is consistent with the requirements in the FASB Preliminary Views. Measurement of liability and asset instruments is further discussed in agenda paper 9B for the June Board meeting.

Question for the Board

Question 6
Should liability and asset components of a separated instrument be remeasured as if the component were a freestanding instrument?