Project **Financial instruments with characteristics of equity**

Topic **Measurement of Liability and Asset Instruments**

Overview

1. This memo describes how instruments classified as liability (or assets) under the Boards' classification approach would be measured using current measurement requirements in IFRS and U.S. GAAP.

2. **SPECIAL NOTE: The questions for the two Boards will be different because the underlying IFRS and U.S. GAAP standards are different. IASB members will be asked to address the questions in the IFRS section (questions 1 and 2 in this paper) and FASB members will be asked to address the questions in the U.S. GAAP section (questions 3, 4 and 5 in this paper). Both Boards will be asked to address question 6 on transaction costs in the last section of the paper.**

3. The issues addressed in this paper will be or have been discussed by both Boards separately in their current projects on recognition and measurement of financial instruments (FI-RM). Obviously, it is not necessary to deal with these issues in both this project and the FI-RM project. However, measurement issues are very important for transparently reporting the cost to the entity of issuing instruments that have some but not all equity characteristics and are classified as liabilities (for example, debt instruments convertible to equity). Therefore, we are providing this paper at this time to make sure the Boards are aware of how cross-cutting issues in the FI-RM project affect this project.

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

IFRS

4. IAS 39, *Financial Instruments: Recognition and Measurement,* provides measurement requirement for most financial asset and liabilities. The applicable measurement requirements in that standard are summarized as follows:

   (a) Financial assets and liabilities are initially measured at fair value. If the instrument is subsequently measured at fair value through profit or loss, transaction costs are recognised in profit or loss immediately. If the instrument is subsequently remeasured using a measurement attribute other than fair value, transaction costs are included in the carrying amount of financial assets or financial liabilities and generally amortized over the life of the instrument.

   (b) Financial assets are subsequently measured at fair value except for:

      (i) Loans, receivables, and held-to-maturity investments, which are measured at amortized cost using the effective interest rate method.

      (ii) Investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments are measured at cost.

      (iii) Financial assets that are designated as hedged items, which are subject to the requirements described in paragraphs 89-102 of IAS 39.

   (c) Financial liabilities are subsequently measured at amortized cost using the effective interest rate except for:

      (i) Derivatives and other trading liabilities, which are generally measured at fair value. A derivative instrument that is linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured is measured at cost.

(ii) Financial liabilities that arise when a transfer of financial assets does not qualify for derecognition or when the continuing involvement approach applies. Paragraphs 29 and 31 of IAS 39 describe the measurement requirements for those instruments.

(iii) Financial guarantee contracts, which are measured at the higher of (a) the amount determined in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets,* and (b) the amount initially recognized less, when appropriate, cumulative amortization recognized in accordance with IAS 18, *Revenue*.

(iv) Commitments to provide a loan at a below market interest rate. After initial recognition, the instrument is measured at the higher of (a) the amount determined under IAS 37 or the amount recognized less, when appropriate, cumulative amortization recognized in accordance with IAS 18.

(v) Financial liabilities that are designated as hedged items, which are subject to the requirements described in paragraphs 89-102 of IAS 39.

(d) An issuer may elect to fair value a financial asset or liability if particular criteria are met.

Derivatives

5. Financial instruments that meet the definition of equity instruments in IAS 32, *Financial Instruments: Presentation,* are currently excluded from the scope of IAS 39,[1] and, therefore, derivatives classified in equity are not accounted for at fair value as are most other derivatives. The Board's decision in this project to classify equity derivatives (those with an entity's own equity instruments as underlyings) as assets and liabilities would automatically eliminate that exception and subject equity derivatives to the requirements of IAS 39. Consequently, most

[1] Paragraph 2(d) of IAS 39 describes that exception.

equity derivatives will be measured at fair value with changes recorded in profit and loss.

6. The only equity derivatives that would not be measured at fair value through profit and loss would be those that qualify and are designated as cash flow hedging instruments and options and forwards that have non-traded equity instruments as their underlyings. Two types of equity derivatives that deserve special mention are employee stock options and forward contracts and options that require an entity to repurchase its own shares.

Employee Stock Options

7. Employee stock options are currently subject to a special exception in paragraph 2(i) of IAS 39. Therefore, changing the equity classification requirements in IAS 32 would not automatically mean that employee stock options would be accounted for like other derivatives. The Board will need to consider whether or not to eliminate that exception. We will prepare an analysis of the surrounding issues to be addressed at a future meeting.

Physically Settled Forward Contracts and Written Put Options

8. Under paragraph 23 of IAS 32, contracts that oblige an entity to repurchase its own equity instruments (physically settled written put options and forward purchase contracts) are recorded "gross" (or "broad"). The present value of the forward repurchase price or option exercise price is reported as a liability with an offsetting debit reported as contra-equity. Subsequently, those instruments generally are measured at amortized cost in accordance with IAS 39.

9. If the exception in paragraph 2(d) of IAS 32 is eliminated (as is currently the plan), physically written put options and forward purchase contracts on an entity's own shares will be derivatives as defined in IAS 39. Therefore, if the related shares have quoted prices, the options and forwards would be reported net rather than broad and at fair value rather than at amortized cost. If the underlying shares

do not have quoted prices, the options and forwards would be reported at cost. We do not recommend making an exception for instruments that would be measured at fair value, but the Board may want to continue the existing treatment (report broad and amortize) for those that would not be reported at fair value because lack of quoted prices for the underlying shares.

Question for the IASB

Question 1
Should physically settled forward contracts and written put options on an entity's own equity instruments be accounted for under the IAS 39 requirements for derivatives (at cost if there are no quoted prices for the underlying shares and fair value for others)? Should such contracts be reported broad and amortized (the current requirement) if there are no price quotes for the underlying shares?

Embedded Equity Derivatives in Instruments Classified as Liabilities or Assets

10. Instruments that are classified as liabilities or assets under the Boards' classification approach must be further analyzed under IAS 39 for embedded derivatives. IAS 39 requires that an embedded derivative be separated from the "host" contract and accounted for as a freestanding derivative if certain criteria are met. Convertible debt is an example.

11. Separating convertible debt[2] will result in a derivative liability component (a written call), which would be measured at fair value, and a debt component, which would be measured at amortized cost. We believe that separating an instrument into two liability components would add complexity to the proposed standard (or actually perpetuate and exacerbate complexities that already exist but are not currently prevalent). For example, which of the two liability components should be measured first? An issuer may come up with very different amounts depending

[2] The issuer may elect the fair value option for convertible debt.

on which component is measured first. We recommend classifying convertible debt as a liability in its entirety and measuring it at fair value because we believe it will be simpler despite the issues that may arise in determining fair value.

12. If the Board does not support that recommendation, it would be important to separate the instrument and account for it under current IFRS requirements for derivatives so that the cost to the entity (as measured by changes in the fair value of the embedded derivative) is reflected in profit and loss. We do not think it is appropriate to classify convertible debt as a liability in its entirety and measure it at amortized cost because that would result in unrealistically low rates of interest expense (possibly zero or even negative).

Question for the IASB

Question 2
Should convertible debt be measured at fair value with changes recorded in profit and loss? If not, how should the instrument be accounted for and why?

U.S. GAAP

13. There are approximately 60 pieces of U.S. GAAP literature that address accounting for instruments in the scope of the FASB's Preliminary Views, *Financial Instruments with Characteristics of Equity.* Upon completion of this project, most of the 60 pieces of literature will be significantly amended or eliminated. As a result, some instruments may not have measurement guidance under current U.S. GAAP. In paragraph 18, we identify some types of instruments that the FASB may want to consider providing measurement guidance for within this project.

Derivatives

14. All derivatives would be subject to the measurement requirements in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Derivatives will be measured at fair value with changes recorded in profit and loss except for those that qualify and are designated as cash flow hedging instruments.

Employee Stock Options

15. Employee stock options are currently subject to a special exception from derivative accounting (paragraph 11(b) of Statement 133). Therefore, changing the equity classification requirements in U.S. GAAP would not automatically mean that employee stock options would be accounted for like other derivatives. For several reasons, it is not completely clear what would happen if the Board were to decide not to adopt special provisions for employee stock options. We will prepare an analysis of the surrounding issues to be addressed at a future meeting.

Physically Settled Forward Repurchase Contracts on an Entity's Own Shares

16. FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity,* requires that forward contracts that require an entity to repurchase its own shares be reported broad; that is, as a liability for the fair value of the shares on the contract date offset by a debit to contra-equity. Because Statement 150 will be superseded by this project, that requirement will be eliminated. The Preliminary Views would have required that physically settled forward repurchase contracts be accounted for net and subject to the fair value measurement requirement in Statement 133.

Question for the FASB

Question 3
Should physically settled forward repurchase contracts be accounted for net and subject to the fair value measurement requirement in Statement 133?

Embedded Derivatives

17. Statement 133 would require convertible debt to either be (a) separated into a debt and equity component, or (b) measured at fair value through the fair value option. Separating convertible debt will result in a derivative liability component (a written call), which would be measured at fair value, and a debt component, which would be measured at amortized cost. We believe that separating an instrument into two liability components would add complexity to the planned standard (or actually perpetuate and exacerbate complexities that already exist but are not currently prevalent). For example, which of the two liability components should be measured first? An issuer may come up with very different amounts depending on which component is measured first. We recommend classifying convertible debt as a liability in its entirety and measuring it at fair value because we believe it will be simpler despite the issues that may arise in determining fair value.

Question for the FASB

Question 4
Should convertible debt be measured at fair value with changes recorded in profit and loss?

Additional U.S. GAAP Measurement Requirements

18. Once this project is complete, there will be several instruments for which there are no measurement requirements within U.S. GAAP. Some examples are:

    (a) Financial instruments that are indexed to an entity's own stock and require physical settlement with an instrument that is not readily convertible to cash (for example, nontraded equity securities). Examples include physically settled written call options, warrants, and forward purchase contracts. Current classification and measurement requirements are in EITF Issue 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," and Statement 150, which will be eliminated.

    (b) Financial instruments that would be equity except they are required to be redeemed on a specific date or upon an event that is certain to occur (for example, many mandatorily redeemable common or preferred shares). Current classification and measurement requirements are described in Statement 150.

    (c) Instruments that would meet the definition of a derivative in Statement 133 except that they are net settled with shares instead of cash and the shares are not readily convertible to cash.[3] This type of instrument is typically issued by private companies.

19. We think the FASB should consider including some broad measurement principles for liability and asset instruments within the proposed Statement to ensure each instrument in the scope of this project has measurement requirements under U.S. GAAP. However, if the FI-RM project results in establishing general requirements that would include the instruments discussed here, no specific action would be necessary in this project.

---

[3] This differs from instruments described in paragraph 18(a) in that the underlying is not the entity's own shares, for example, an otherwise ordinary interest rate swap settled in shares instead of cash.

20. The FASB Preliminary Views would require all instruments to be initially measured at transaction price unless initial measurement is specified in other U.S. GAAP. (Transaction price does not include transaction costs, which would be expensed immediately.) The FASB considered using fair value as an initial measurement attribute, but did not like the possibility of recognizing Day 1 gains and losses.

21. Initially measuring instruments in paragraph 18 at fair value would be consistent with current U.S. GAAP requirements. Currently Issue 00-19 and Statement 150 require instruments in paragraph 18 of this paper to be initially measured at fair value. This recommendation also is consistent with the initial measurement requirement in IAS 39.

22. We acknowledge that our recommendation to initially measure liability and assets at fair value may be viewed as inconsistent with our recommendation in agenda paper 9A for the June board meeting, which is to initially measure equity instruments at transaction price. As noted in that paper, we believe it would be difficult to measure equity instruments at fair value because an exit price notion does not seem to apply to ownership instruments issued by an entity.

23. We recommend that instruments for which there would be no subsequent measurement requirements should be measured as follows:

    (a) Instruments with a fixed maturity dates and settlement amounts that are fixed or that change only because of variable interest rates should be accreted (or amortized).

    (b) Instruments that have varying or uncertain settlement amounts should be measured at fair value.

24. The proposed principles are intended to be at least generally consistent with subsequent measurement requirements in current U.S. GAAP. If the Boards' current FI-RM project results in a different measurement requirement before deliberations in this project are completed, there would be no need to establish separate requirements in this project. However, the scope and timing of that

project are uncertain. Therefore, we are proposing the principles in the preceding paragraph as a temporary fix if one is needed.

Question for the FASB

Question 5
Should this project provide additional measurement requirements to "fill holes" in current U.S. GAAP? If so, what measurement attributes does the Board want to use?

Transaction Costs

25. The FASB Preliminary Views addressed the accounting for issuance costs for freestanding instruments (equity, liabilities, and assets) that would be initially measured under the requirements of that document. The Preliminary Views requires transaction costs or fees to be charged to income immediately.

26. Agenda paper 9A for the June board meeting addresses the accounting for issuance costs of equity instruments. This paper does not address the accounting for issuance costs for liability and assets because the Board plans to address that issue in its current project on recognition and measurement of financial instruments. However, given the short timeline in that project, we are not sure that the Boards and staff will have the opportunity to address the issue. Currently, IFRS and U.S. GAAP are not convergent on the accounting for transaction costs for liability and asset instruments.

Question for the FASB and the IASB

Question 6
Do the Boards want to address the accounting for transaction costs for liabilities and assets within the financial instruments with characteristics of equity project?