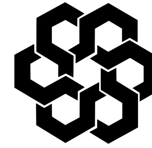

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International Accounting Standards Board

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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: **March 2009, London**

Project: **Financial Instruments with Characteristics of Equity**

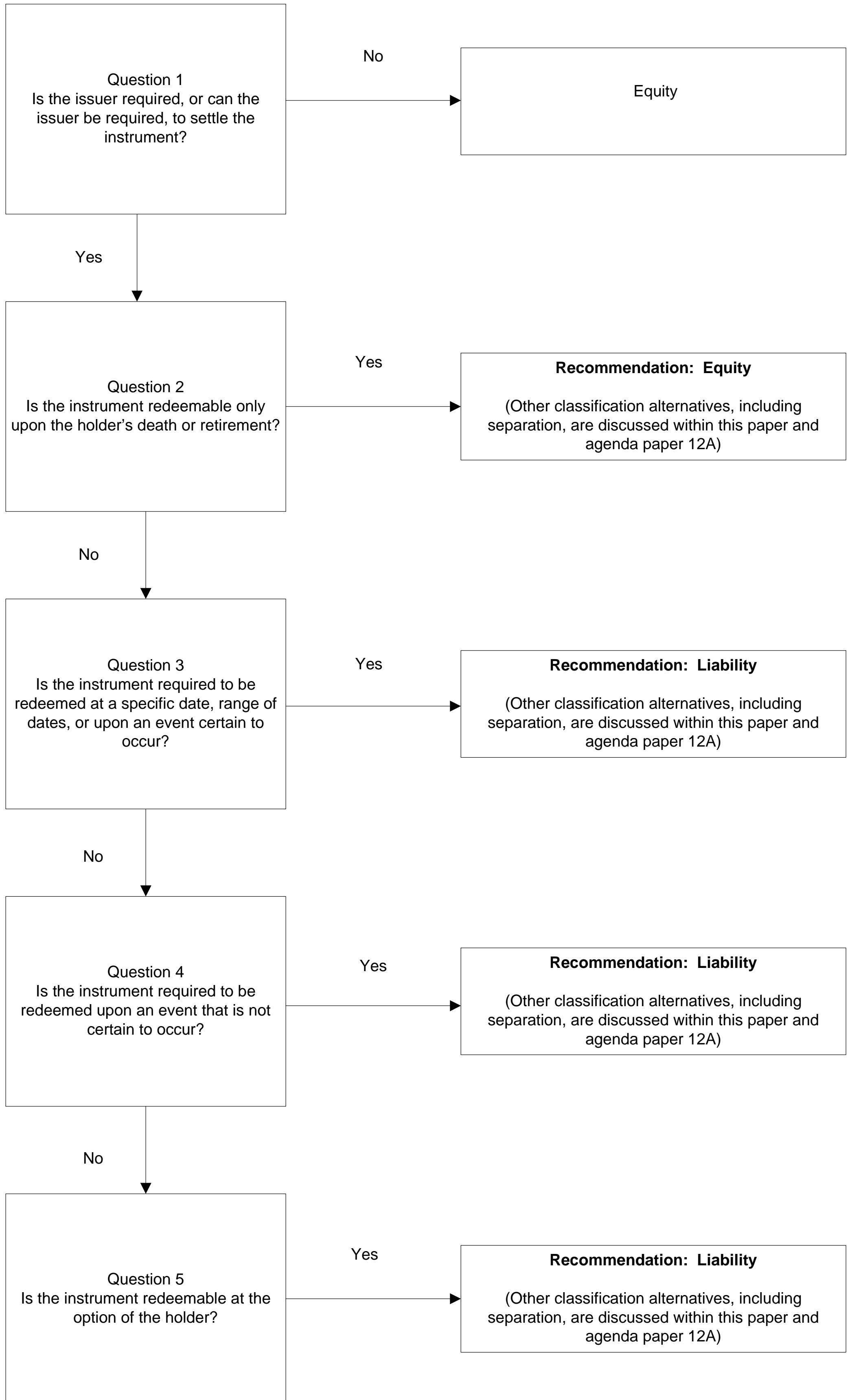
Subject: **Developing a Classification Model (Agenda Paper 12)**

INTRODUCTION

1. At the January meetings, the Boards directed us to develop and analyze an approach that would divide redeemable instruments into two categories:
   a.) Instruments that are redeemable upon the occurrence of an event that is certain to occur (such as death or retirement)
   b.) All other redeemable instruments.
2. This paper describes and analyzes this approach.

SUMMARY OF THE APPROACH

3. The following flowchart illustrates the approach and our classification recommendations.


Question 1
Is the issuer required, or can the issuer be required, to settle the instrument?
No
Equity
Yes
Question 2
Is the instrument redeemable only upon the holder's death or retirement?
Yes
Recommendation: Equity
(Other classification alternatives, including separation, are discussed within this paper and agenda paper 12A)
No
Question 3
Is the instrument required to be redeemed at a specific date, range of dates, or upon an event certain to occur?
Yes
Recommendation: Liability
(Other classification alternatives, including separation, are discussed within this paper and agenda paper 12A)
No
Question 4
Is the instrument required to be redeemed upon an event that is not certain to occur?
Yes
Recommendation: Liability
(Other classification alternatives, including separation, are discussed within this paper and agenda paper 12A)
No
Question 5
Is the instrument redeemable at the option of the holder?
Yes
Recommendation: Liability
(Other classification alternatives, including separation, are discussed within this paper and agenda paper 12A)

4. The remainder of this Paper discusses each of the questions in the flowchart and the rationale for our classification recommendations.

QUESTION 1: IS THE ISSUER REQUIRED, OR CAN THE ISSUER BE REQUIRED, TO SETTLE THE INSTRUMENT?

5. The Boards have tentatively decided that all perpetual instruments should be classified as equity. As we have defined the term *perpetual*, a *perpetual instrument* lacks a contractual settlement requirement and entitles the holder to a portion of the net assets of the entity in liquidation. Since ownership instruments that are redeemable at the option of the issuer (sometimes labeled "callable") have no settlement requirement, they meet our definition of perpetual instruments and, thus, would be classified as equity. That is consistent with current IFRS and U.S. GAAP requirements.

6. The Boards could decide to separate callable ownership instruments into an asset component (a purchased call option) and an equity component (a perpetual instrument). Separating the instrument would result in presenting a callable share as common stock and a purchased call option. However, separating this instrument adds complexity that we think is unnecessary. Moreover, many of the disadvantages of separation that we presented in Agenda Paper 11B for the January Board meetings would be equally applicable to separating instruments.

QUESTION 2: IS THE INSTRUMENT REDEEMABLE ONLY UPON THE HOLDER'S DEATH OR RETIERMENT?

7. We think instruments that are redeemable at the option of the holder (or are required to be redeemed) upon the holder's retirement or death should be classified as equity.

8. Many nonpublic closely held entities issue only ownership instruments that are redeemable upon the holders' death or retirement. Similarly, many partnership interests are automatically redeemed when a partner dies or retires. In these cases, the redemption features are included to maintain control of closely held businesses or to extend and restrict membership privileges.

9. Those redemption features are different from other redemption features, which often are added to an instrument to "sweeten the deal" for investors. That is, other redemption features are a benefit to the instrument holder because it provides a type of guarantee or insurance that the holder will be able to sell the instrument. The redemption feature might provide the holder with guaranteed liquidity (for example, if there is not an active market for the instrument) or a guaranteed amount of cash (for example, if the redemption price is fixed).

Separating Instruments That Are Redeemable upon Death or Retirement

10. We do not think that instruments that are redeemable at the option of the holder (or are required to be redeemed) upon the holder's retirement or death should be separated into equity and non-equity components. These instruments have one actual outcome.

11. Determining the fair value of the derivative (the written put option or forward purchase contract) that is embedded in an equity instrument can be difficult unless there is a quoted price for similar options. Also, because the value of the derivative is "derived" from the price and price volatility of the underlying equity instrument, the entity must determine those values first. That would be especially difficult for cooperatives, partnerships, and private companies that do not issue similar non-redeemable instruments (that is, the entities only issue redeemable instruments). Therefore, we think separating this type of instrument may not be operational.

QUESTION 3: IS THE INSTRUMENT REQUIRED TO BE REDEEMED AT A SPECIFIC DATE, RANGE OF DATES, OR UPON AN EVENT THAT IS CERTAIN TO OCCUR?

12. Instruments that are required to be redeemed on a specific date, within a range of dates, or upon an event that is certain to occur (other than death or retirement) have one actual outcome. The issuer is unconditionally obligated to deliver cash or other financial assets to the holder. Therefore, we believe this type of instrument should be classified as a liability.

Separating Ownership Instruments That Are Required to Be Redeemed at a Specific Date, Range of Dates, or upon an Event That Is Certain to Occur

13. We do not think that instruments that are required to be redeemed should be separated into equity and non-equity components. The instruments have one actual outcome – the instrument is required to be redeemed. Separating instruments with one outcome would present a single instrument as if it could have multiple outcomes, which is not a faithful representation of the instrument.

QUESTION 4: IS THE INSTRUMENT REQUIRED TO BE REDEEMED UPON AN EVENT THAT IS NOT CERTAIN TO OCCUR?

14. An instrument that is required to be redeemed upon an event that is not certain to occur is difficult to classify because it has characteristics of both a liability and an equity instrument. That is because this type of instrument has two possible alternative outcomes. One outcome is equity-like and the other is debt-like. Some examples of this type of instrument are as follows:

    a.) An ownership instrument that is required to be to redeemed if the issuer does not meet its debt covenants.

    b.) An ownership instrument that is required to be redeemed if there is a change in control of the issuer.

15. The instruments described above have two alternative outcomes. The instruments can either be redeemed (a liability outcome) or remain outstanding (an equity outcome). The instrument in paragraph 14(a) will be required to be redeemed if the issuer does not meet its debt covenants or will remain outstanding if the issuing entity meets all of its debt covenants. The instrument in paragraph 14(b) will be redeemed if a change in control occurs or will remain outstanding if a change in control does not occur.

16. In analyzing the classification of this type of instrument, we identified and considered the following three alternatives:

    a.) Alternative 1—Classify the instrument as equity.

b.) Alternative 2—Classify the instrument as a liability.

c.) Alternative 3—Separate the instrument into liability and equity components.

17. We do not recommend Alternative 1 because it is inconsistent with the Boards' decision to classify all perpetual instruments as equity. An instrument that is required to be redeemed upon an event that is uncertain to occur has settlement requirements. The issuer does not have an unconditional right to avoid delivering cash (or another financial asset) to the instrument holder.

18. We do not recommend Alternative 3. Although the instrument has two alternative outcomes, only one will occur. The instrument will either be redeemed **or** remain outstanding. Both cannot occur for the same instrument. Therefore, consistent with our rationale in paragraph 13, we do not believe instruments with one ultimate outcome should be separated into liability and equity components. Moreover, we believe this alternative would add complexity to the Boards' classification model because redeemable instruments would be classified three different ways:

    a.) Instruments that are redeemable (i) at the option of the holder (or are required to be redeemed) upon the death or retirement of the holder or (ii) at the option of the issuer would be classified as equity.

    b.) Instruments that are required to be redeemed on a specific date, range of dates, or upon an event that is certain to occur (other than the holder's death or retirement) would be classified as liabilities.

    c.) All other instruments that are required to be redeemed would be separated into liability and equity components.

19. We recommend Alternative 2 because it is consistent with the Boards' tentative decision to classify perpetual instruments as equity. Also, this alternative will avoid the complexities associated with Alternative 1 or Alternative 3.

20. Alterative 2 provides the same classification results for an instrument that is required to be redeemed upon an event that is **uncertain** to occur as an instrument that is required to be redeemed upon an event that is **certain** to occur (other than death or retirement). Both would be classified as liabilities. If the Boards choose to classify those two types of instruments differently, they will have to provide guidance on

issues such as (a) whether, and if so, when the terms of the instrument should be reassessed to determine if uncertain events have become certain (and, thus, the instrument should be reclassified) and (b) how any gains or losses resulting from that reclassification should be reported. We think issue (b) would be especially complex if the Boards choose Alternative 3.

QUESTION 5: IS THE INSTRUMENT REDEEMABLE AT THE OPTION OF THE HOLDER?

21. Similar to the instruments described in the preceding section, instruments that are redeemable at the option of the holder have two possible alternative outcomes. Some examples are as follows:

    a.) An ownership instrument that gives the holder the option to redeem it any time after January 1, 2010.

    b.) An ownership instrument that gives the holder the option to redeem it if the issuer does not meet its debt covenants.

22. All of the instruments described above have two alternative outcomes. The instruments can either be redeemed (a liability outcome) or remain outstanding (an equity outcome). The instrument in paragraphs 21(a) will remain outstanding if the holder chooses not to redeem the instrument. The instrument in paragraph 21(b) will remain outstanding if either the issuing entity meets all of its debt covenants or if the issuing entity does not meet those covenants but the holder chooses not to redeem the instrument. However, in both examples the instruments have only one ultimate outcome. The instrument will either be redeemed **or** remain outstanding. Both can not occur for the same instrument.

23. We think the analysis of these instruments is the same as the instruments in the preceding section because both groups have two possible outcomes – but only one ultimate outcome. Therefore, the same alternatives described in paragraph 16 also are available for instruments that are redeemable at the option of the holder.

24. We think that instruments that are redeemable at the option of the holder should be classified as liabilities for the reasons described in paragraphs 17–20.

25. Agenda Paper 12A describes how our recommended approach would be applied to particular types of entities and includes questions for the Boards.