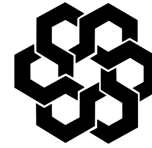

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
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 12A)**

INTRODUCTION

1. Agenda Paper 12 describes an approach for identifying equity instruments. The staff's recommendation in that paper is summarized below:

Redemption terms	Staff recommendation
Instruments that the issuer cannot be required to settle. (This includes instruments that are redeemable at the option of the **issuer** [sometimes labeled "callable" instruments])	Equity
Instruments that are redeemable at the option of the holder (or are required to be redeemed) only upon the holder's retirement or death	Equity
All other redeemable ownership instruments	Liability

2. This paper provides further analysis of the application of this approach. We describe how it would be applied to particular types of entities such as cooperatives, partnerships, limited-life entities, and other types of entities that issue only redeemable ownership instruments.

DISCUSSION OF PARTICULAR TYPES OF ENTITIES

Cooperatives

3. Many cooperatives issue perpetual instruments. That is because although the members can request redemption, the entity has the unconditional right to refuse to redeem the instruments or redemption is unconditionally prohibited (for example, by local law, regulation, or the entity's governing charter). In those cases, the instrument does not have a settlement requirement. If the instrument also entitles the holder to a portion of the entity's net assets in liquidation, it would be classified as equity.

4. However, other cooperatives issue instruments that are not perpetual. Members may be required to redeem their instruments when they cease to participate in the cooperative or die. Similarly, a cooperative may require members to hold ownership instruments in proportion to their participation. Therefore, members are required to redeem some of their ownership instruments if their participation in the entity with the cooperative decreases. In other words, the redemption features extend and restrict membership privileges in the cooperative.

5. We believe that instruments with the redemption features described in paragraph 4 are akin to instruments that are required to be redeemed upon the holder's retirement or death and, thus, would be classified as equity under the approach in Agenda Paper 12.

Partnerships

6. Many partnerships allow the partners to withdraw from the partnership at any time and, upon withdrawal, the retired partner's interests are required to be redeemed. Moreover, if a partner dies, his partnership interest is required to be redeemed. Those types of partnership interests would be classified as equity under our recommended approach.

7. However, some partnerships (for example, real estate holding companies) are limited-life entities and are discussed in the next section.

Limited-Life Entities

8. Liquidation of a limited-life entity is certain to occur and is outside the control of the entity. Upon liquidation, all ownership instruments are redeemed. In many cases, liquidation will occur on a specific date. Therefore, all instruments issued by limited-life entities would be classified as liabilities under our recommended approach.

9. Some limited-life entities are required to liquidate based on an event that is certain to occur, rather than on a specific date. For example, some partnerships must liquidate upon any partner's withdrawal. In other words, all partnership interests will be redeemed when one partner retires or dies. Therefore, a partnership interest is redeemable upon an event that is certain to occur **other than** the **holder's** retirement or death. Such partnership interests would be classified as liabilities under our approach.

10. However, some Board members may think that instruments issued by limited-life entities should be classified as equity because those instruments are "perpetual to the entity." That is, the instrument does not have a settlement requirement as long as the entity exists. The Boards may think that classifying such instruments as equity is a natural extension of their tentative decision that all perpetual instruments should be classified as equity. If so, we will explore that idea further. (However, we realize that classifying such ownership instruments as equity will raise consolidation issues if a subsidiary is a limited-life entity and the parent entity is not. That topic will be discussed at a later date.)

Other Entities That Issue Only Ownership Instruments That Are Redeemable at the Option of the Holder (or Are Required to Be Redeemed)

11. In addition to those entities discussed above, other entities issue only ownership instruments that are redeemable at the option of the holder (or are required to be redeemed). For example, many **closely-held private companies** issue only instruments that are required to be redeemed upon death or retirement. The

redemption feature is included in the instrument to maintain control of the entity. Such instruments would be classified as equity under our approach.

12. However, there are other types of entities that issue only ownership instruments that are redeemable (either mandatorily or at the option of the holder) upon dates or events other than the holder's retirement or death. For example, many development banks[1] issue ownership instruments that are redeemable any time at the option of the holder. Other entities might issue only ownership instruments that are redeemable (either mandatorily or at the option of the holder) upon a change in control of the entity, an initial public offering (or failure to make such an offering), or a change in tax regulation. These instruments would be classified as liabilities under our recommended approach. Therefore, some entities would have no equity. At this point, we are not sure how many entities would have that result.

13. If Board members are concerned that some entities may not have any equity, we have identified three alternative ways to resolve that issue:

    a.) Separate some or all redeemable instruments into liability and equity components.

    b.) Identify specific types of redeemable instruments that should be classified as equity (for example, those that are redeemable at fair value or an approximation of fair value).

    c.) Classify as equity a redeemable instrument if it is the entity's most subordinate ownership instrument.

[1] A development bank is a financial institution that provides financing for national development. Development banks oftentimes are multilateral; that is, they are formed by a group of countries, consisting of both donor and borrowing nations. Examples of multilateral development banks are the World Bank, the African Development Bank, and the Asian Development Bank.

Separate Some or All Redeemable Instruments

14. We discussed separation in Agenda Paper 12 and recommended that all redeemable instruments be classified as liabilities or equity in their entirety. We continue to support that recommendation for the reasons discussed in that Agenda Paper. However, we acknowledge that separation may be considered a practical solution that will result in most entities having at least some amount of equity.

15. If the Boards are going to consider separation as an alternative, we would recommend that all redeemable instruments with alternative outcomes be separated. That is, all instruments that are redeemable at the option of the holder, all instruments that are required to be redeemed upon an event that is not certain to occur, and all callable shares should be separated. A requirement to separate some, but not all redeemable instruments with alternative outcomes will almost certainly result in more complex separation rules.

16. In Agenda Paper 11B, for the January Board meetings we discussed practical difficulties associated with separating redeemable instruments. Perhaps the most significant difficulty that we identified is related to determining the fair value of a derivative that is embedded in an equity instrument. We concluded that valuing the embedded derivative would be very difficult unless there is a quoted price for similar options. Because the value of the derivative is “derived” form the price and the price volatility of the underlying instrument, the entity must determine those values first. We argued that it would be especially difficult to cooperatives, partnerships, and private companies that do not issuer similar non-redeemable instruments (that is, the only issue redeemable instruments). Our recommended approach described in Agenda Paper 12 partially resolves this issue because many cooperatives, partnerships, and private companies issue instruments that are redeemable upon the holder’s death or retirement and, thus, would be classified as equity. However, we are concerned that other types of entities may have similar problems if their instruments are required to be separated.

17. For example, many development banks allow members to put their interests back to the bank at any time, and, thus, the interests would not be classified as equity under our recommended approach. The instrument also has two alternative outcomes; therefore, based on our views in paragraph 15, we believe this instrument would be separated. In many cases, the redeemable instruments do not have fixed redemption dates or redemption amounts (the redemption value is not known until a member exercises his option to redeem). Some of the banks do not expect the instruments ever to be redeemed. In fact, many of the instruments have never been redeemed. Therefore, we think it will be difficult (and perhaps impossible) for particular entities to value the embedded derivatives.

Identify Particular Redeemable Instruments That Should Be Classified As Equity

18. The Boards may want to identify other particular redeemable instruments that should be classified as equity. For example, the Boards could discuss whether an instrument that is redeemable at fair value (or an approximation thereof) should be classified as equity.[2] One reason might be because such instruments' characteristics are similar to ordinary shares in that the instruments give the holder a residual interest in the net assets of the entity. That is, the holders are just getting "their fair share" of the entity's net assets. Another reason is that the value of the derivative liability (the written put) will be minimal. Therefore, for practical reasons, some might argue that the entire instrument should be classified as equity.

Classify a Redeemable Instrument As Equity If It Is the Most Subordinate Ownership Instrument

19. The Boards could decide that an entity's most subordinate ownership instrument should be classified as equity – regardless of whether it is perpetual or redeemable. As a result, all entities would have equity.

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[2] This would be similar to the approach that the IASB took in the Exposure Draft, *Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation*. The IASB did not take that approach in the final amendments, *Puttable Financial Instruments and Obligations Arising on Liquidation*.

20. Some entities may issue perpetual ownership instruments that have a preference in liquidation (for example, perpetual preferred shares) **and** redeemable ownership instruments that are more subordinate (for example, an ordinary share that is redeemable at the option of the holder upon a change in control). Under our recommended approach, the perpetual preferred shares would be classified as equity and the redeemable ordinary shares would be classified as a liability even though they are the most subordinate instrument. Some may find this result troubling. Including an additional subordination criterion for equity classification would resolve this issue.

21. However, many respondents to the FASB's Preliminary Views and the IASB's Discussion Paper, *Financial Instruments with Characteristics of Equity,* stated that it is difficult for some entities to identify the **most** subordinate instrument. That is, it may be difficult to determine if two classes of instruments are equally subordinated or if one class has priority over the other.

22. **Question 1 for the Boards:** Does the Board agree that instruments that are redeemable at the option of the issuer ("callable" instruments) are perpetual?

23. **Question 2 for the Boards:** Does the Board agree that instruments that are redeemable at the option of the holder or required to be redeemed only upon the holder's retirement or death should be classified as equity?

24. **Question 3 for the Boards:** Other than those that are redeemable upon the holder's death or retirement, does the Board want to classify as equity any other redeemable ownership instruments? If so, which ones and what would be the underlying principle?