Project	**Financial instruments with characteristics of equity**
Topic	**Developing a classification model**

Subordination

1. In some ways, subordination is the quintessential characteristic of equity. In other words, equity is the financial foundation on which the entity's capital structure is built. The first capital raised is usually equity because it is the seed capital that permits raising other capital. That is the reason (or at least a very important reason) that the FASB chose in the PV to base the definition of equity in the basic ownership approach on subordination. However, many have asked why should only the most subordinated class of instruments be considered equity?

2. Limiting equity to the most subordinated class of instruments would result in the fewest instruments in the equity category. That would result in including the greatest possible amount of information about costs of capital in comprehensive income because all other instruments would be classified as non-equity (thus distributions to holders and the effect of remeasuring the instruments would be recognized in profit and loss). At least some users have indicated that is a desirable outcome. Simplicity and ease of implementation might also be considered benefits of strictly limiting instruments to be included in equity.

3. However, limiting equity to the most subordinated class of instruments would mean that some entities' perpetual instruments would not be classified as equity because those instruments are senior (superior in rights to receive distributions) to

redeemable instruments. For example, some cooperatives have said that they have that sort of capital structure.[1]

4. If equity is really the financial foundation of an entity, subordination would seem to be a necessary condition for an instrument to be classified as equity. That leads to one general principle of subordination:

   (a) Equity instruments are always subordinated to all liability instruments but may be senior to other classes of equity.

Settlement Requirement or Lack Thereof

5. The lack of a settlement requirement is also a classic characteristic of equity for entities in corporate form. That would necessarily not be inconsistent with the subordination principles discussed previously. It is difficult to envision how an instrument with no settlement requirement could have rights to receive distributions that are senior to a class of liabilities with settlement requirements.

6. That discussion leads to the following general principle of settlement requirements:

   (b) An instrument is equity if the issuer cannot be required to settle it unless the issuer winds up its operations and distributes all of its remaining assets. That is a sufficient but not necessary condition for equity classification.

7. There are at least two possible forms of settlement requirements, and the form may affect the substance of the instrument. One form of settlement requirement is more liability-like; the creditor has the right to require performance by the debtor and failure to perform is an event of default, which gives the creditor other rights such as the right to ask a court to enforce the right to payment. Another form of settlement requirement is more equity-like; the investor has the right to receive distributions of assets to the extent assets are available. The investor cannot sue to enforce performance (unless the entity has committed fraud or broken other laws).

[1] A holder of such an instrument probably would have to accept a limit on the amount of assets it could receive to be granted that seniority. That is the case with “conventional” preferred shares (whether or not the common shares are redeemable).

8. If the form of settlement requirements was always clear and it was always possible to identify when the form and substance were aligned, the form could be the subject of a separate principle. Unfortunately, it is not always easy to distinguish between those two different settlement requirements, and different jurisdictions may view apparently similar instruments differently.

9. One possible principle for identifying some equity-like settlement requirements relates to the reasons for the settlement (redemption). Some entities require ownership of an instrument for the holder to take part in management or other activities of the entity or to conduct business with the entity. In those cases, the terms of the instrument may require its redemption when the holder no longer engages in the activities that required ownership of the instrument. That type of settlement requirement supports the use of the instrument as a means of establishing a barrier to doing business with the entity or of maintaining control of an entity within a small group. It is not a classic liability characteristic.

10. In contrast, other settlement requirements are much more liability-like. For example, a requirement to settle for a fixed amount on a fixed date is a classic liability feature. Settlement requirements triggered by events beyond the control of the issuer are also liability-like (as in insurance, warranties, derivatives, and others with similar settlement features).

11. Some instruments have both liability-like and equity-like features (a hybrid instrument). This occurs when a settlement requirement is combined with a perpetual instrument. A hybrid instrument may have two or more separate outcomes (all may occur) or two or more alternative outcomes (only one will occur).

12. An ordinary share with a required dividend is an example of a hybrid instrument with two separate outcomes.[2] The issuer must pay cash if particular events occur (liability outcome) but the perpetual instrument remains outstanding (equity outcome). In other words, the instrument has equity characteristics, and at particular times, it also requires the issuer to transfer cash.

13. Other instruments have more than one possible outcome, one of which is liability-like and the other which is equity-like. Some examples are:

    (a) An ownership instrument that is required to be settled upon specified events that are not certain to occur

    (b) An ownership instrument that gives the holder the option to require the issuer to settle the instrument.

14. The instruments described above consist of both a derivative (a written put option or a forward purchase contract) and perpetual instrument and have two possible outcomes. The instrument could remain outstanding in perpetuity **or** the issuer could be required to settle it. The issuer could be required to settle the instrument if the holder so chooses or an uncertain event triggers the settlement. However, only one of those outcomes will occur. A simple and direct way of dealing with hybrid instruments with two or more separate or possible outcomes is to require them to be separated.

15. That discussion leads to three more general principles of settlement requirements:

    (c) A settlement requirement that becomes effective when the holder has died, retired, resigned, or otherwise ceased to take an interest in the activities of the entity does not cause an instrument to be classified as a liability if the holder was required to hold the instrument in order to transact with the entity or otherwise engage in the activities of the entity.

    (d) A settlement requirement for any other reason indicates that an instrument is a liability or part equity and part liability.

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[2] Another common example is an ordinary share with a registration rights penalty. A registration right penalty is a promise to remit consideration to an investor if an instrument held by the investor is (a) not registered for public trading by a specified date or (b) not listed on a stock exchange by a specific date.

(e) An instrument shall be separated into liability and equity components if the instrument has two separate or alternative outcomes, one of which would require equity classification if it was the only outcome and one of which would require liability classification if it was the only outcome.

Claims to Percentages of Remaining Assets

16. A claim to a percentage of the assets that remain after all other claims against the issuer have been satisfied is commonly considered a characteristic of "pure form" equity instruments. However, some entities issue instruments with fixed or partially fixed claims that must be satisfied only if the entity winds up its operations and distributes all remaining assets. Others issue instruments with claims similar to a percentage of the remaining assets (for example, profit-sharing arrangements) but that are settled prior to other claims.[3]

17. An ownership instrument with a redemption feature would be a stronger candidate for equity in its entirety if its redemption amount varies according to a formula that is designed to calculate or approximate a percentage of remaining assets. If the redemption requirement in such an instrument was required to be separated from the ownership instrument and measured at its estimated fair value, the result would be that a large majority of the value would be in equity. The Boards might choose as a practical expedient to exempt such instruments from any separation requirements.

18. The following is the general principle of claims to percentages of remaining assets:

(f) Claims to percentages of remaining assets are neither necessary nor sufficient to identify an equity instrument, but they may help to classify otherwise borderline instruments.

[3] If an instrument truly represents a subordinated percentage of the residual claim, the terms of that instrument or other instruments will require tests to make sure the entity still has sufficient assets to settle senior claims after the more subordinated claims have been settled. Otherwise, senior creditors may be able to sue to recover assets distributed to more subordinated claimants.

Recap of the General Principles and Development of Decision Rules

19. The following is a recap of the general principles discussed in previous paragraphs:

(a) Equity instruments are always subordinated to all liability instruments but may be senior to other classes of equity.

(b) An instrument is equity if the issuer cannot be required to settle it unless the issuer winds up its operations and distributes all of its remaining assets. (That is a sufficient but not necessary condition for equity classification.)

(c) A settlement requirement that becomes effective when the holder has died, retired, resigned, or otherwise ceased to take an interest in the activities of the entity does not cause an instrument to be classified as a liability if the holder was required to hold the instrument in order to transact with the entity or otherwise engage in the activities of the entity.

(d) Settlement requirements other than those described in item (c) indicate that an instrument is a liability or a liability-equity hybrid instrument (part equity and part liability).

(e) An instrument shall be separated into liability and equity components if the instrument has two separate or alternative outcomes, 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.

(f) Claims to percentages of remaining assets are neither necessary nor sufficient to identify an equity instrument. However, they may help to classify otherwise borderline instruments.

20. Those general principles cannot be distilled into a single rule, but they can form the basis for a set of decision rules to implement the principles as follows:

(a) An entity must classify as equity retained earnings and capital contributed without the contributor receiving a claim against the entity in exchange even if that entity has issued no equity instruments.

(b) An issuer must classify an instrument as a liability if the instrument has a fixed settlement date or must be settled on the occurrence of an event that is certain to occur, excluding those described in item (i. and ii.) below.

(c) An issuer would classify the following other instruments as equity:

(i) Instruments that the issuer cannot be required to settle prior to winding up its operations and distributing all of its assets (regardless of the amount of the claim)

(ii) Instruments that the holder is required to own in order to do business with or otherwise actively engage in activities of the issuer and that are redeemable only if the holder dies, retires, resigns, or otherwise ceases to actively engage in the activities of the issuer. (This would include holdings the amounts of which vary based on volume of business transacted by the holder.)

(d) An instrument shall be separated into liability and equity components if the instrument has two separate or alternative outcomes, 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.

Issues for Further Consideration

21. This approach would require different classification results for an instrument that is required to be redeemed upon an event that is **uncertain** to occur and an instrument that is required to be redeemed upon an event that is **certain** to occur (other than death or retirement). *Oxford's Dictionary* defines *certain* as "[something] that you can rely on to happen or to be true" and "having no doubts." In other words, we think an event would have to be 100 percent likely to occur for it to be considered certain. Since most events will probably not meet that threshold, instruments that are required to be redeemed upon events other than death, retirement, or on a particular date (or during a range of dates) will be separated.

22. If the Boards agree with our proposed approach, 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.

23. The approach as drafted does not consider how classification is affected by consolidation. We will address that issue at a future meeting if the Boards decide to pursue this approach.

24. Agenda Paper 2B includes a decision tree that illustrates the approach and a table that describes how particular types of instruments would be classified.

Questions for the Boards

Question 1
Does the Board agree with the general principles described in paragraphs 19(a) –19(f)?

Question 2
Does the Board agree with the decision rules described in paragraphs 20(a)–20(d)?