Project **Financial Instruments with Characteristics of Equity**

Topic **Classification Approach 4.1**

Introduction

1. Under Approach 4, *all* share-settled instruments would be classified as liabilities regardless of their terms. Some board members have stated that they will not vote for an approach that would require liability classification for employee stock options and particular rights issues. Some board members also have stated that they are uncomfortable with classifying as a liability a preferred share that is mandatorily convertible into a common share.

2. This paper describes a new proposal (Approach 4.1) for distinguishing between liability and equity instruments. Approach 4.1 would not change the boards' previous classification decisions for cash-settled instruments. Under Approach 4.1, share-settled instruments would be subject to a separate classification principle, which would result in equity classification for a few instruments that require the entity to issue its own shares.

3. Approach 4.1 was discussed in general terms at the September 17, 2009, IASB meeting and the FASB September 30, 2009, education session. At the October joint meeting, we will ask the boards if they want to continue to develop Approach 4.1.

Short Summary of Approach 4.1

4. A claim required to be settled by paying cash or other assets would be a liability unless it has both of the following characteristics:

    (a) Its claim status is lower than all liability claims; and

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(b) The required payments occur for one of the following reasons:

(1) The entity issuing the instrument chooses to distribute all its assets or is required by an event such as bankruptcy to distribute all its assets.

(2) The issuer chooses to pay a dividend or repurchase shares.

(3) The terms of the instrument require, or permit the holder or issuer to require, retirement of that instrument to allow an existing group of shareholders, partners, or other participants to maintain control of the entity when one of them chooses to withdraw.

(4) The terms of the instrument require, or permit the holder of issuer to require, retirement of that instrument when the holder has ceased to engage in transactions with the entity or otherwise participate in the activities of the entity.

5. Instruments with both an equity settlement feature and a liability settlement feature are separated into components.

6. A claim required to be settled by issuing equity instruments would be equity **unless** it has any of the following characteristics:

(a) Either party has a cash settlement option. (Issuing and acquiring shares is not critical to the transaction.)

(b) It requires net settlement in shares or either party has a net settlement option. (That implies an immediate gain or loss is the objective and becoming an owner is incidental.)

(c) The contract exposes either party to risks of changes in value other than those resulting from share price changes, time value of money, counterparty performance risk, and possibly foreign currency (if the counterparty is a foreign owner before the transaction).[1]

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[1] This does not include the pro rate notion, but it may prove to be necessary.

Objectives of Approach 4.1

7. The provisions listed in paragraph 4 are the same as the provisions in Approach 4. Approach 4.1 does not change the board's previous decisions related to puttable and mandatorily redeemable instruments. That is, the puttable or mandatorily redeemable instrument would be classified as equity if it is redeemable upon death or retirement, or upon the holder ceasing to participate in the activities of an entity. All other puttable or mandatorily redeemable instruments would be separated or classified as liabilities in their entirety.

8. The objective of the provisions listed in paragraph 6 is to classify as equity instruments in which the primary reason for issuance is for the counterparty to become an owner, in which case the entity is not using its shares as currency. Rights issues, written call options, forwards to issue shares, stock purchase warrants, and similar things would be classified as equity *if* the result of the transaction is for the entity to issue shares and for the counterparty to acquire shares. Claims under which an entity receives its own shares, for example, a forward purchase contract or a written put option, would be subject to the cash-settled provisions (unless the entity is required to settle by issuing its shares instead of delivering cash).

9. All convertible debt instruments have a cash settlement option. Therefore, all convertible debt instruments would be classified as liabilities under Approach 4.1.

Other Implications of Approach 4.1

Employee Stock Options

10. A gross physically settled employee stock option that is currently treated as equity for its entire life would be classified as equity under Approach 4.1 once that instrument is vested. Before vesting, an employee stock option is a contract to exchange a stock option for employee services, which clearly does not meet the definition of a financial instrument and therefore would not be within the scope of this project. Once vested, however, a gross physically settled employee stock option is a contract to exchange shares for cash, which is a financial

instrument according to the definition. That instrument would be considered an equity instrument unless it has some provisions that change the amount of shares based on factors other than those listed in paragraph 6(c).

11. Net-cash- and net-share-settled employee stock options would be classified as liabilities under Approach 4.1. Because they are net settled, those instruments do not meet the conditions in paragraph 6 of this memorandum.

Rights Issues

12. IAS 32 includes a provision that classifies an instrument as equity if it requires an exchange of cash for shares and both sides of the exchange are fixed at inception (a fixed number of shares for a fixed amount of cash.) At its September 17, 2009, meeting, the IASB decided to expand that provision to classify as equity some types of rights issues even if the amount of cash to be received is not fixed. The instruments affected are those issued pro rata to existing shareholders to give them the right to acquire a fixed number of the entity's own equity instruments at a price fixed in a foreign currency. Instruments that will receive equity classification under the IASB's recent amendment will maintain that classification under Approach 4.1 as long as the instruments are gross physically settled.

Preferred Shares That Are Mandatorily Convertible into Common Shares

13. Preferred shares that are mandatorily convertible into common shares would be classified as liabilities under Approach 4. Several board members believe the instrument should be classified as equity because the issuer has a legal form ownership instrument outstanding at all times. Prior to conversion, the issuer has a preferred share outstanding, and subsequent to conversion, the issuer has an ordinary share outstanding. Approach 4.1 would require a preferred share that is mandatorily convertible into common shares to be classified as equity.

Potential Questions and Issues That May Arise under Approach 4.1

14. Allowing some derivatives to be classified as equity raises additional questions and issues the boards may want to consider. Many of these questions were

identified by FASB members at the September 30, 2009, education session. Most of the concerns focused on structuring opportunities.

Unstated Cash Settlement Features

15. Under Approach 4.1, gross physically settled derivatives may qualify for equity classification while net-share- or net-cash-settled instruments would not. Because the form of settlement determines the classification of particular instruments, structuring opportunities will occur. For example, an entity may issue a physically settled written call option and qualify for equity classification. Once the instrument is settled, the issuer could later repurchase the shares for cash. We do not think the boards will ever be able to develop linkage criteria that would eliminate this structuring opportunity.

16. As currently written, Approach 4.1 also would allow an entity to avoid liability classification by writing a gross physically settled written call option and not having sufficient authorized and unissued shares available to satisfy the contract. If the holder exercises the option, and the issuer does not have shares to issue, the issuer's only alternative will be to pay the holder cash. If the issuer had written the derivative to be cash settled, it would have been classified as a liability. This leads to the following two questions:
    (a) Does every share-settled instrument have an unstated cash settlement requirement?
    (b) Is so, should the unstated cash settlement feature affect classification?

17. Under current U.S. GAAP, in order for a derivative to obtain equity classification, the issuer must evaluate whether a sufficient number of authorized and unissued shares exists at the classification (and reassessment) date. There are many practice issues surrounding that requirement. For example, many issuers have asked how instruments should be ordered before applying the requirements. In other words, if the entity has issued several share-settled instruments and does not have enough authorized shares to settle them all, which are not equity?

18. Instead of carrying forward rules-based requirements with known practice issues, the FASB tried to deal with unstated cash settlement features in a principles based manner in the Preliminary Views on financial instruments with characteristics of equity. The FASB developed a principle that required an issuer to consider all substantive stated and unstated terms when determining an instrument's classification. The FASB decided that factors that have more than a remote chance of affecting the instrument's outcome in a more than minimal way should be considered in determining classification. Because remote is an extremely low threshold, the requirement in the Preliminary Views would have resulted in every share-settled instrument having a substantive cash settlement feature and being classified as a liability. That classification is not consistent with the intent of Approach 4.1.

19. Under Approach 4, the issue of unstated cash settlement features never arises because the "currency" (cash or shares) used for settlement does not matter in classification.

Information about Dilution in the Statement of Financial Position

20. At least one FASB member is concerned that Approach 4.1 would not appropriately capture information about dilution caused by particular instruments. Under Approach 4.1, a gross physically settled option's dilution is not reported over the life of the option as it is in Approach 4, nor is the effect ever reported in comprehensive income. Some potential follow-up questions related to Approach 4.1 may include the following:

    (1) Should an issuer report shares at fair value at issuance date if the shares are issued because of exercise, conversion, or settlement of an equity instrument?

    (2) If so, how should the issuer account for the difference between the book value of the equity instrument and the fair value of the shares issued?

Definition of a Liability in the Framework

21. It would be difficult, if not impossible, to develop a definition of a liability in the conceptual framework that is consistent with Approach 4.1. That is because

Approach 4.1 would require some share-settled instruments to be classified as liabilities and some share-settled instruments to be classified as equity. Our initial thought is to keep the definition of a liability similar to what is in the current framework. That is, a liability requires a transfer of cash or assets. Any share-settled instruments classified as a liability would be an exception to the conceptual framework definition. Likewise, any cash-settled instrument classified as equity would be an exception.

Physically Settled Forward Contracts to Purchase Shares and Written Put Options

22. Physically settled forward contracts to repurchase an entity's own shares and written put options would be classified as liabilities or assets under Approach 4.1 because the entity is receiving (not issuing) its own shares. Those instruments would be subsequently measured at fair value through net income. Two IASB board members have expressed the following different views on the accounting for those instruments:

    (a) **Classify the instruments as equity in their entirety**—At least one board member would prefer to classify physically settled forward purchase contracts and written put options as equity. That board member does not believe changes in an entity's share price should be reflected in the income statement.

    (b) **Present the instrument "gross"—**The present value of the forward repurchase price or option exercise price would be reported as a liability with an offsetting debit reported as contra-equity. The liability component would be subsequently accreted to the amount to be paid at settlement.

    View (b) is consistent with current accounting for physically settled forward purchase contracts and written put options under IAS 32. Topic 480 of the Accounting Standards Codification, originally issued as Statement 150, has the same requirements for forward purchase contracts. The board member who espoused View (b) believes gross presentation will prevent structuring opportunities.

23. Both boards have previously considered the view presented in paragraph 22(b) and rejected it. The boards reasoned that a physically settled forward purchase contract and a physically settled written put option are derivatives and should be accounted for similar to all other derivatives—a net liability or asset measured at fair value through net income. The IASB has asked us to discuss this issue again at a later date regardless of whether the boards decide to pursue Approach 4.1 or Approach 4.

Appendix 1

24. Appendix 1 illustrates the classification results under Approach 4, Approach 4.1, current U.S. GAAP, and current IFRS. The classification differences between Approach 4 and Approach 4.1 are shaded.

Question for the Boards

Question 1
Are the boards interested in pursuing Approach 4.1?

Appendix 1

	Instrument	Approach 4.1	Approach 4	Current IFRS	Current U.S. GAAP[2]
1	Common share	**Equity**	**Equity**	**Equity**	**Equity**
2	Perpetual preferred share	**Equity**	**Equity**	**Equity**	**Equity**
3	Share issued by a limited life entity	**Equity**	**Equity**	**Liability or Equity[3]**	**Equity**
4	General partnership interest Classification assumes that (a) the general partner takes an active role in the management of the partnership, (b) the instrument must be redeemed if the general partner retires from the partnership, and (c) the partnership does not liquidate upon the partner's redemption	**Equity**	**Equity**	**Liability or Equity[2]**	**Equity**

[2]Current U.S. GAAP includes the requirements of Topic 480, originally issued as Statement 150, before the deferral under Section 480-10-65, originally issued as FSP FAS 150-3. Instruments denoted by a * indicate those that might have been subject to an indefinite deferral for certain nonpublic entities.

[3] IAS 32 classifies instruments that are required to be redeemed and that are redeemable at the option of the holder as financial liabilities, unless they have particular features and meet particular conditions.

	Instrument	Approach 4.1	Approach 4	Current IFRS	Current U.S. GAAP[2]
5	Limited partnership interest Classification assumes that (a) the limited partner does not participate in the management of the partnership, but, rather, only has a financial interest in the partnership, (b) the instrument is redeemable at the option of the partner, and (c) the partnership does not liquidate upon the partner's redemption	**Liability and Equity**	**Liability and Equity**	**Liability or Equity[2]**	**Equity**
6	Limited liability partnership instrument Classification assumes that (a) the limited liability partner takes an active role in the management of the partnership, (b) the instrument must be redeemed if the partner retires from the partnership, and (c) the partnership does not liquidate upon the partner's redemption	**Equity**	**Equity**	**Liability or Equity[2]**	**Liability***

	Instrument	Approach 4.1	Approach 4	Current IFRS	Current U.S. GAAP[2]
7	Ownership instrument that is redeemable at the option of the holder (other than upon retirement or death)	**Liability and Equity**	**Liability and Equity**	**Liability or Equity[2]**	**Equity** **(Temporary equity for public companies)**
8	Ownership instrument that is required to be redeemed if an uncertain event occurs	**Liability and Equity**	**Liability and Equity**	**Liability or Equity[2]**	**Liability***
9	Ordinary share with a required dividend	**Liability and Equity**	**Liability and Equity**	**Liability and Equity**	**Equity**
10	Ordinary share with a substantive registration rights penalty[4]	**Liability and Equity**	**Liability and Equity**	**Liability and Equity**	**Liability and Equity**
11	Preferred share convertible into variable number of ordinary shares at the option of the holder	**Liability and Equity**	**Liability and Equity**	**Liability**	**Equity**
12	Preferred share that is required to be converted into a variable number of ordinary shares on a specific date or event that is certain to occur (other than death or retirement)	**Liability**	**Liability**	**Liability**	**Equity**

[4]A promise to remit consideration to an investor if an instrument held by that investor is (a) not registered for public trading by a specified date or (b) not listed on a stock exchange by a specified date.

	Instrument	Approach 4.1	Approach 4	Current IFRS	Current U.S. GAAP[2]
13	Instrument issued by a cooperative that gives the holder the right to request redemption, but the cooperative can refuse that request	**Equity**	**Equity**	**Equity**	**Equity**
14	Instrument issued by a cooperative that must be redeemed upon the holder's death, retirement, or decreased participation	**Equity**	**Equity**	**Liability or Equity[2]**	**Liability***
15	Instrument that *converts* mandatorily on a specific date or event that is certain to occur (other than death or retirement) into a variable number of share instruments with a fixed monetary amount (for example, share-settled debt)	**Liability**	**Liability**	**Liability**	**Liability**
16(a)	Physically (gross) settled written call option	**Equity**	**Liability**	**Equity[5]**	**Equity**
16(b)	Net-share-settled written call option	**Liability**	**Liability**	**Liability**	**Equity**

[5] Classification as equity assumes that the instrument will be settled only by the issuer exchanging a fixed amount of cash for a fixed number of its own equity instruments.

	Instrument	Approach 4.1	Approach 4	Current IFRS	Current U.S. GAAP[2]
16(c)	Physically (gross) settled employee stock option	**Equity**	**Liability**	**Equity**	**Equity**
16(d)	Physically (gross) settled instruments that gives the holder the rights to acquire a fixed number of the entity's own equity instruments at a fixed price (a rights issue) denominated in a currency that is not the entity's functional currency	**Equity**	**Liability**	**Equity**[6]	**Liability**
17	Net-cash-settled written call option and cash SAR	**Liability**	**Liability**	**Liability**	**Liability**
18(a)	Net-cash- or net-share-settled forward purchase contract at a fixed price	**Liability or Asset**	**Liability or Asset**	**Liability or Asset**	**Liability or Asset**
18(b)	Physically settled forward purchase contract	**Liability or Asset**	**Liability or Asset**	**Gross liability and contra-equity**	**Gross liability and contra-equity**
19	Prepaid forward purchase contract for a fixed number of shares	**Asset**	**Asset**	**Contra-equity**[7]	**Generally, contra-equity**
20(a)	Net-cash- or net-share-settled written put option	**Liability**	**Liability**	**Liability**	**Liability**

[6] Classification is based on the IASB's recent amendment to IAS 32.
[7] Classification as contra-equity assumes that the issuer has prepaid a fixed amount of cash and that the instrument will be settled by the issuer receiving a fixed number of its own equity instruments.

	Instrument	Approach 4.1	Approach 4	Current IFRS	Current U.S. GAAP[2]
20(b)	Physically settled written put option	**Liability**	**Liability**	**Gross liability and contra-equity**	**Liability**
21	Prepaid written put option for a fixed number of shares	**Asset**	**Asset**	**Contra-equity[6]**	**Generally, contra-equity**
22	Convertible debt for fixed number of shares	**Liability**	**Liability**	**Equity and Liability**	**Liability[8]**
23	Share redeemable at the option of the issuer (callable share)	**Equity**	**Equity**	**Equity**	**Equity**
24(a)	Preferred share convertible into a fixed number of ordinary shares at the option of the holder	**Equity**	**Liability and Equity**	**Equity[9]**	**Equity**
24(b)	Preferred share required to be converted into a fixed number of ordinary shares	**Equity**	**Liability**	**Equity[8]**	**Equity**
25	Preferred share puttable, callable, and convertible	**Liability and Equity**	**Liability and Equity**	**Liability**	**Equity** **(Temporary equity for public companies)**

[8] Classification assumes the instrument is not within the scope of Subtopic 470-20, originally issued as FSP APB 14-1.

[9] Classification as equity assumes that the preferred share includes no other contractual obligations.

	Instrument	Approach 4.1	Approach 4	Current IFRS	Current U.S. GAAP[2]
26	Note receivable settled with cash or a variable number of shares[10]	**Asset**	**Asset**	**Asset**	**Asset (if cash settled)** **Contra-equity (if share settled)**
27	Debt indexed to shares (for example, convertible debt for which the entire conversion value is settled in cash)	**Liability**	**Liability**	**Liability**	**Liability (with a separated embedded derivative)**

[10]The example assumes the counterparty can choose the form of settlement. That fact is relevant to current U.S. GAAP classification only.