IASB/FASB Meeting February 2010

IASB agenda reference	**15**
FASB memo reference	**85**

Project	**Financial instruments with characteristics of equity**
Topic	**Broad classification questions**

Introduction

1. After further consideration, we have decided that the paper that would have been discussed at the February 2, 2010, joint board meeting did not represent the best way to go forward with this project. Consequently, we do not plan to discuss that paper, and we ask that you please discard it.

2. At this meeting, we will ask the boards to address how particular instruments should be classified. We have prepared what is intended to be a comprehensive list of the as-yet-unanswered questions that a standard produced in this project should answer. It is critical that we get answers to these questions if we are to meet the timetable set out in the boards' technical plans. It is barely possible that we will still be able to meet the deadline without answers to all questions at this meeting, but only if we get specific instructions about what additional information the boards need to make a decision at the next meeting.

3. Once the boards have answered these questions, our next step will be to draft a possible standard that produces the desired classifications. Our goal in drafting will be to make the possible standard as simple and as clear as possible and to format it as a principle or set of principles with a minimum number of exceptions.

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Once the draft is completed, we will discuss it with the boards to determine whether it would be appropriate to issue it as an Exposure Draft.

4. Nearly all of the questions in the paper have been analysed and discussed in prior meetings. We previously issued a paper related to Question 6, but it was never discussed by the IASB. Therefore, we have reissued that paper (Agenda Paper 15A/FASB Memo 86) for this meeting. We also have issued Agenda Paper 15B/FASB Memo 87 to explain issues related to accounting for freestanding written put options and puttable shares, but the questions related to that issue are discussed in that separate paper. Agenda Paper 15C/FASB Memo 88 address the issues surrounding convertible debt.

Previous Decisions

5. The key decisions made by the boards in previous meetings (which we do not believe you want to change despite rejecting the previously considered approaches) are as follows:

   (a) Instruments currently accounted for under IFRS 2, *Share-based Payment*, and Topic 718 of the *FASB Accounting Standards Codifcation*™(originally issued as Statement 123 (R), *Share-Based Payment)*, are not within the scope of this project.

   (b) Perpetual instruments (instruments not required to be redeemed unless the entity decides to or is forced to liquidate its assets and settle claims against the entity) issued by entities without specified limits to their lives will be classified as equity in their entirety. (That includes both ordinary and preferred shares.)

   (c) The following mandatorily redeemable and puttable instruments (which would have been equity under any of the approaches in the 4 series) will be classified as equity in their entirety:

      (i) Instruments with terms that require, or permit the holder or issuer to require, redemption to allow an existing group of shareholders, partners,

or other participants to maintain control of the entity when one of them chooses to withdraw

(ii) Instruments that the holder must own in order to engage in transactions with the entity or otherwise participate in the activities of the entity and whose terms require, or permit the holder or issuer to require, redemption when the holder ceases to engage in transactions or otherwise participate.

(d) All other mandatorily redeemable instruments (instruments that an entity is required to redeem on a certain date or on the occurrence of an event that is certain to occur) will be classified as liabilities.

(e) Contracts that require or may require an entity to issue a specified number of its own perpetual equity instruments in exchange for a specified price (for example, options, forwards, rights issues, and purchase warrants) will be classified as equity. (For this purpose, the specified number must be either fixed or vary only so that the counterparty will receive a specified percentage of total shares that were outstanding on the issuance date for a specified price. The specified price must be fixed in the reporting entity's currency unless the domestic currency of the shareholder that holds the derivative (or functional currency if the shareholder is a reporting entity or a unit of a reporting entity) is different from the currency in which the issuing entity issues equity instruments to domestic shareholders. In that case, the price may be specified in the currency of the shareholder instead of in the currency of the issuer.

(f) Instruments that require an entity to issue a specified number of its own perpetual equity instruments for no further compensation will be classified as equity (for example, prepaid forward contracts to issue shares).

(g) The entity's ability to issue its own perpetual equity instruments to settle share-settled instruments classified as equity will be assessed at the date that each instrument is issued and at each reporting date thereafter. If, at any time, the entity does not have enough shares to settle a share-settled instrument classified as equity, that instrument will be reclassified as a liability and left there for the remainder of its life.

(h) Preferred shares required to be converted into a specified number of common shares on a specified date or on the occurrence of an event that is certain to occur will be classified as equity.

(i) Contracts that require an entity to repurchase its own shares on a specified date or on the occurrence of an event that is certain to occur will be separated into a liability representing the amount to be paid (measured according to standards for similar freestanding instruments) and an offsetting debit to equity (grossed up).

Question for the Boards
1. Do you continue to support the decisions described in paragraph 5?

6. One previous decision is not included in the list in paragraph 5 because it may need to be changed. The boards decided that a puttable share not classified as equity in its entirety would be bifurcated into a put option and an equity share. We will ask the boards to reconsider that decision because it is inextricably related to two other issues that the boards will consider at this meeting. Those issues are (a) whether the specified-for-specified exchange requirement for equity classification should be applied to repurchase contracts such as written put options and (b) whether written put options should be grossed up as forward repurchase contracts are. The relationship between those three issues and the implications of the various combinations of decisions are discussed in Agenda Paper 15B/FASB Memo 87.

7. The remainder of this paper consists of five separate sections with questions related to the following matters:

(a) Perpetual instruments issued by limited-life entities

(b) Contracts that require specified-for-specified issuances of equity instruments

(c) Contracts that require the entity to issue a specified number of equity instruments in exchange for no future compensation

(d) Convertible preferred shares

(e) Classification of subsidiary instruments in consolidated financial statements.

Instruments issued by limited-life entities

8. The boards have not decided whether nominally perpetual instruments issued by entities with specified limits on their lives or that can be liquidated at the option of the instrument holders (limited-life entities) should be classified as equity in the separate financial statements of those entities. The criteria in IAS 32, *Financial Instruments: Presentation*, are detailed in paragraphs 16C and 16D, the text of which is included in Appendix A to this paper. Paragraphs 16E and 16F, which also are included in Appendix A, discuss reclassification of the instruments described in paragraphs 16C and 16D in response to changes in its essential features. (Paragraphs 16E and 16F also apply to puttable instruments, but that issue is discussed in a separate paper. The question below relates only to limited-life entities.)

9. We have identified the following alternatives:

   (a) Retain the criteria in paragraphs 16C–16F of IAS 32 (in Appendix A)

   (b) Classify all perpetual instruments as equity in the financial statements of the issuer even if the issuer's life has a specified limit

   (c) Do not classify any instruments issued by limited-life entities as equity.

Question for the Boards
2. Which of the alternatives do you support?

Contracts that require specified-for-specified issuances of equity instruments

10. The boards have not considered whether the requirement to classify as equity instruments that require an entity to issue a specified number of equity instruments for a specified price applies to equity instruments other than perpetual equity

instruments. The fixed-for-fixed requirement in IAS 32 does not apply to puttable instruments even if they are classified as equity in their entirety. It also does not apply to derivative instruments classified as equity. No puttable shares are bifurcated under IAS 32, but some may be bifurcated by the possible standard being developed in this project.

11. The reason for not applying the fixed-for-fixed requirement in IAS 32 to exchanges of instruments other than perpetual equity instruments seems to have been to avoid possible abuses. We were not involved in those discussions, so we would appreciate if an IASB member who was involved in the puttables amendment to IAS 32 would explain at this meeting that reasoning to help current board members make a decision.

12. We have identified the following alternatives. Apply the specified-for-specified requirement to:

    (a) Perpetual equity instruments

    (b) Puttable and mandatorily redeemable equity instruments as described in paragraph 5(c)

    (c) Derivatives classified as equity

    (d) Puttable instruments that when issued would be bifurcated into an equity instrument and a derivative.

Question for the Boards

3. Should contracts that require issuance of a specified number of the following instruments for a specified price be classified as equity?

    a. Puttable and mandatorily redeemable equity instruments as described in paragraph 5(c)
    b. Derivatives classified as equity
    c. Puttable instruments that when issued would be bifurcated.

Contracts that require the entity to issue a specified number of equity instruments in exchange for no future compensation

13. This issue is similar to the issue regarding fixed-for-fixed exchanges (Question 3). IAS 32 classifies as equity contracts that require the entity to issue a fixed number of equity instruments (shares issuable), but the requirement does not apply to puttable and mandatorily redeemable instruments even if they are classified as equity or to derivatives classified as equity. The alternatives are the same as in Question 3.

Question for the Boards

4. Should contracts that require issuance of a specified number of the following instruments in exchange for no further consideration be classified as equity?

   a. Puttable and mandatorily redeemable equity instruments as described in paragraph 5c)
   b. Derivatives classified as equity
   c. Puttable instruments that when issued would be bifurcated.

Convertible preferred shares

14. The boards decided that mandatorily convertible preferred shares would be classified as equity, but we are not sure how broad that decision was intended to be; therefore, we need clarification.

Question for the Boards

5. Which of the following types of mandatorily convertible preferred shares should be classified as equity?

   a. Those convertible into a specified number of perpetual equity instruments?
   b. Those convertible into other than a specified number of perpetual equity instruments?
   c. Those convertible into a specified number of puttable or mandatorily redeemable equity instruments?
   d. Those convertible into other than a specified number of puttable or mandatorily redeemable equity instruments?
   e. Those convertible into a specified number of puttable equity instruments that will be bifurcated?

f. Those convertible into other than a specified number of puttable equity instruments that will be bifurcated?

Classification of subsidiary instruments in consolidated financial statements

15. Agenda Paper 15A/FASB Memo 86 discusses classification in consolidated financial statements of instruments issued by subsidiaries. The alternatives are:

    (a) Always reconsider classifications of instruments issued by a subsidiary in the consolidated financial statements as if the consolidated group was a legal entity that had issued an instrument with the same characteristics.

    (b) Carry over the classification from subsidiary financial statements into consolidated financial statements unless the nature of the instrument changes in consolidation because of arrangements between the instrument holder and another member of the consolidated group. If the nature of the instrument changes in consolidation, classification should be reconsidered in the consolidated financial statements.

    (c) Carry over the classification from subsidiary financial statements into consolidated financial statements unless (1) the nature of the instrument changes in consolidation because of arrangements between the instrument holder and another member of the consolidated group or (2) the instrument is issued by a limited-life entity or is an equity instrument that has redemption requirements. If the nature of the instrument changes in consolidation, classification should be reconsidered in the consolidated financial statements.

Question for the Boards
6. Which alternative do you support?

Appendix A—Paragraphs 16C-16F of IAS 32

Instruments, or components of instruments, that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation

16C Some financial instruments include a contractual obligation for the issuing entity to deliver to another entity a pro rata share of its net assets only on liquidation. The obligation arises because liquidation either is certain to occur and outside the control of the entity (for example, a limited life entity) or is uncertain to occur but is at the option of the instrument holder. As an exception to the definition of a financial liability, an instrument that includes such an obligation is classified as an equity instrument if it has all the following features:

(a) It entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation. The entity's net assets are those assets that remain after deducting all other claims on its assets. A pro rata share is determined by:

  (i) dividing the net assets of the entity on liquidation into units of equal amount; and

  (ii) multiplying that amount by the number of the units held by the financial instrument holder.

(b) The instrument is in the class of instruments that is subordinate to all other classes of instruments. To be in such a class the instrument:

  (i) has no priority over other claims to the assets of the entity on liquidation, and

  (ii) does not need to be converted into another instrument before it is in the class of instruments that is subordinate to all other classes of instruments.

(c) All financial instruments in the class of instruments that is subordinate to all other classes of instruments must have an identical contractual obligation for the issuing entity to deliver a pro rata share of its net assets on liquidation.

16D For an instrument to be classified as an equity instrument, in addition to the instrument having all the above features, the issuer must have no other financial instrument or contract that has:

(a) total cash flows based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity (excluding any effects of such instrument or contract) and

(b) the effect of substantially restricting or fixing the residual return to the instrument holders.

For the purposes of applying this condition, the entity shall not consider nonfinancial contracts with a holder of an instrument described in paragraph 16C that have contractual terms and conditions that are similar to the contractual terms and conditions of an

equivalent contract that might occur between a noninstrument holder and the issuing entity. If the entity cannot determine that this condition is met, it shall not classify the instrument as an equity instrument.

Reclassification of puttable instruments and instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation

16E An entity shall classify a financial instrument as an equity instrument in accordance with paragraphs 16A and 16B or paragraphs 16C and 16D from the date when the instrument has all the features and meets the conditions set out in those paragraphs. An entity shall reclassify a financial instrument from the date when the instrument ceases to have all the features or meet all the conditions set out in those paragraphs. For example, if an entity redeems all its issued non-puttable instruments and any puttable instruments that remain outstanding have all the features and meet all the conditions in paragraphs 16A and 16B, the entity shall reclassify the puttable instruments as equity instruments from the date when it redeems the non-puttable instruments.

16F An entity shall account as follows for the reclassification of an instrument in accordance with paragraph 16E:

> (a) It shall reclassify an equity instrument as a financial liability from the date when the instrument ceases to have all the features or meet the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D. The financial liability shall be measured at the instrument's fair value at the date of reclassification. The entity shall recognise in equity any difference between the carrying value of the equity instrument and the fair value of the financial liability at the date of reclassification.
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> (b) It shall reclassify a financial liability as equity from the date when the instrument has all the features and meets the conditions set out in paragraphs 16A and 16B or paragraphs 16C and 16D. An equity instrument shall be measured at the carrying value of the financial liability at the date of reclassification.

Appendix B

	Fair Value Beginning of the Year	Issuances	Repurchases/ Expirations	Changes in Fair Value	Fair Value End of Year
Non-Redeemable Capital					
Common Stock					
Preferred Stock					
Written Call Options					
Subtotal					
Contingently Redeemable Capital					
Preferred Stock					
Convertible Debt					
Subtotal					
Redeemable Capital					
Preferred Stock					
Long Term Debt					
Subtotal					
Total Capitalization (at fair value)					