Project	**Financial instruments with characteristics of equity**
Topic	**Initial Discussion of the Modified IAS 32 Approach**

Introduction

1. At the January meeting, the boards directed the staff to analyze a possible amendment to IAS 32, *Financial Instruments: Presentation*. We will refer to this approach as the Modified IAS 32 Approach. The purpose of this paper is to confirm our understanding about the major features of what the boards expected when they decided to pursue the Modified IAS 32 Approach. Specifically, this paper discusses changes to the fixed-for-fixed provision, another provision related to puttable shares, and accounting for convertible debt.

Key Features of the Modified IAS 32 Approach

2. The following are the two most significant differences we see between the Modified IAS 32 Approach and the existing requirements of IAS 32:

   (a) It would use *specified price* and *specified number of shares* instead of *fixed amount of financial assets* and *fixed number of shares* to determine whether puttable equity instruments and options (including warrants and rights issues) and forward contracts on equity instruments are classified as equity.

   (b) It would classify as equity an instrument that must be redeemed only if the issuing entity liquidates or the holder ceases to participate in the activities of the entity because of death, retirement, or withdrawal from membership. In this circumstance, the instrument does not have to meet the *specified-for-specified* requirement.

3. Appendixes 1 and 2 present two possible ways to revise the definitions of financial assets, financial liabilities, and equity in IAS 32 to incorporate those changes described in paragraph 2. The definition in Appendix 1 does not fundamentally change the current IAS 32 format, which describes a financial asset and a financial liability and then defines equity as a residual. The definition in Appendix 2 represents a more significant change to the format in IAS 32 but has the same results as Appendix 1. Appendix 3 provides descriptions of types of instruments and their classification instead of definitions.

4. Appendix 4 includes a table showing the instruments that have been used as examples in previous papers. This version of the Appendix shows the classification under the Modified IAS 32 Approach, current IFRS, and current U.S. GAAP.

A Question on the Fixed-for-Fixed Requirement

5. Under the current requirements in IAS 32, an instrument qualifies for equity classification if there is *exchange* of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. That applies regardless of the direction of the exchange, which means that the issuer could *issue* or *receive* its own shares. Under the 4-series approaches (4.0, 4.1, and 4.2), the requirement would have applied only in one direction—when the entity issued its own shares. We are not sure whether the boards intended to apply the specified requirement in both directions as IAS 32 does or in only one direction as the 4-series approaches would have.

6. The practical effects of that difference (ignoring the change from fixed-for-fixed requirements to specified-for-specified requirements) are as follows:[1]

   (a) Under IAS 32, an entity's right to receive a fixed number of its own shares (for example, a prepaid forward repurchase contract) would be classified as contra-equity. Under the 4-series approaches, that right would be an asset.

   (b) Under IAS 32, a forward contract to repurchase a fixed number of an entity's own shares for a fixed amount of cash would be in equity. However, there is an additional requirement to bifurcate the put option and report it as if it were a note payable (in liabilities) and shares receivable (contra-equity). Under the 4-series approaches, that contract would be an asset or liability depending on the share price, but the boards were considering adding a requirement to bifurcate that liability in the same way IAS 32 would have.

   (c) Under IAS 32, a written put option that may require the entity to repurchase a fixed number of its own shares for a fixed price should be an equity instrument. However, there is an additional requirement to bifurcate the put option and report it as if it were a note payable (in liabilities) and shares receivable (contra-equity). Under the 4-series approaches, that contract would be a net liability, but the boards were considering adding a requirement to bifurcate that liability in the same way IAS 32 would have.

7. The bifurcation requirement discussed in paragraphs 6(b) and 6(c) applies not only to instruments classified as equity under the fixed-for-fixed requirement, but also to similar types of instruments classified as liabilities because the exchange is not a fixed-for-fixed requirement. Consequently, if the boards decide to retain that requirement for written put options and forward repurchase contracts, our question about whether to apply the specified-for-specified requirements in one or both directions only matters for the types of contracts described in paragraph 6(a).

[1] This represents the FASB-based staff's understanding of IAS 32's requirements. Because of the tight deadline for this paper, we have not had an opportunity to confirm it with the IASB staff members who work with IAS 32. If we have misunderstood, we will correct that misunderstanding in future papers.

Convertible Debt

8. IAS 32 describes convertible debt as a compound financial instrument. Paragraph 29 states that "an entity recognizes separately the components of a financial instrument that (a) creates a financial liability of the entity and (b) grants an option to the holder of the instrument to convert it into an equity instrument of the entity."

9. Paragraph 32 of IAS 32 states:

> …the issuer of a bond convertible into ordinary shares first determines the carrying amount of the liability component by measuring the fair value of a similar liability (including any embedded non-equity derivative features) that does not have an associated equity component. The carrying amount of the equity instrument…is then determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole.

10. Convertible debt might be viewed in more than one way, but most seem to view it as described in IAS 32—a note payable with an embedded call option on shares. Under the procedure described in IAS 32, the equity component would be a written call option with a strike price equal to the fair value of the debt component, which of course, is not fixed. The fixed-for-fixed exchange in IAS 32 does not literally apply to convertible debt because although it may require delivery of a fixed number of equity instruments (or a specified number), the other side of the exchange does not involve a fixed amount of cash or other financial assets. In fact, the exchange does not involve receipt of assets at all. It involves extinguishment of a specified financial liability.

11. If the bifurcation were tied closely to a fixed-for-fixed principle or a specified-for-specified principle, it would be too easy to circumvent. An entity that does not want to bifurcate its convertible debt could include some variability in the number of shares to be issued to fail the specified-for-specified requirement. Fortunately, the relevant paragraphs of IAS 32 quoted above do not explicitly rely on the fixed-for-fixed principle. As you can see from the key quotes above, there is no mention of a fixed-for-fixed principle (although an example in paragraph 29 uses the word fixed a couple of times).

12. Thus, if the boards believe convertible debt should always be bifurcated, paragraphs 29–32 of IAS 32 should be left as is or perhaps strengthened to make clearer that the bifurcation criteria applies to all convertible debt that actually involves the physical delivery of shares.

Questions for the Boards
1. Have we understood the boards' instructions? That is, do the definitions in Appendix 1 and Appendix 2 and the descriptions in Appendix 3 account for the instruments the way the boards expected? 2. Should the "specified-for-specified principle" apply to instruments under which the issuer receives its own shares? 3. Should all physically settled convertible debt be separated into a liability component and an equity component? 4. Which of the two definitions in this paper do the boards want to use?

Next Steps

13. At a future meeting we will ask the boards if they want to consider any of the following questions listed below. This list reflects the questions that we have been able to identify to date, however more may arise as we continue to develop the approach.

(a) How should a subsidiary's equity instruments be classified in the consolidated financial statements?

(b) Should written put options and forward contracts to repurchase the issuer's own shares be reported gross or net?

(c) Should puttable shares that are not classified as equity in their entirety and shares that are required to be redeemed upon an uncertain event be separated into liability and equity components?

(d) Should economic compulsion issues be addressed?

(e) Are linkage requirements necessary?

(f) Should the scope of IAS 32 be retained for U.S. GAAP purposes?

(g) Are additional requirements in the statement of stockholders equity that would provide information about dilution of derivatives that are classified as equity necessary?

14. It is important to note that the IAS 32 was originally developed by the IASC. The IASB developed a revised standard as part of an improvements project. The current basis for conclusions provides a basis for the changes that were made to the original version of IAS 32. For aspects of the standard that were not changed, there is no basis. Both boards will have to consider whether or not they want to develop a more comprehensive basis for the standard or just describe any further changes that are made to the standard.

Appendix 1—Definition 1

Definition	Explanation of Changes and Comments
A *financial asset* is ~~any asset that is~~:	
(a) cash;	
(b) an equity instrument of another entity	
(c) a contractual right:	
(i) to receive cash or another financial asset from another entity; or	
(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favorable to the entity; or	
(d) a contract that will or may be settled in the entity's own equity instruments and is:	
(i) a derivative that will or may be settled other than by the exchange of ~~a fixed~~ a specified amount of cash or another financial asset for a ~~fixed~~ specified number of the entity's own equity instruments. 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	We changed the order of (d)(i) and (d)(ii) to define the term *specified* before referring to it. As currently written, a derivative that requires a payment of a specified amount of cash to receive a specified amount of the issuer's own shares is classified as contra-equity. We are not sure if that is the boards' intention.

may be specified in the currency of the shareholder instead of the currency of the issuer; or ~~For this purpose the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 16A and 16B, 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 and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.~~ (ii) a non-derivative for which the entity ~~is or may be obligated~~ has a right to receive ~~a variable~~ an other than specified number of the entity's own equity instruments.~~;or~~	An asset is a right, not an obligation.
A *financial liability* is a contract ~~any liability~~ that ~~is~~: (a) will be settled by paying cash or other assets and in which the required payments occur for reasons other than the following: ~~a contractual obligation~~: (i) the entity issuing the instrument chooses to distribute all of its assets or is required by an event such as bankruptcy to distribute all of its assets ~~to deliver cash or another financial asset to another entity; or~~ (ii) the issuer chooses to pay a dividend or repurchase shares. ~~to exchange financial assets or financial liabilities with another entity under conditions that are potentially~~	This adds the redemption features of the 4-series approaches but excludes the requirement that the claim status of the instrument must be higher than all equity claims. We are not sure that requirement is necessary anymore.

~~unfavorable to the entity; or~~

(iii) 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.

(iv) the terms of the instrument require, or permit the holder or 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.

(b) will or may be settled in the entity's own equity instruments and is~~a contract that will or may be settled in the entity's own equity instruments and is~~:

(i) a derivative that will or may be settled other than by the exchange of a ~~fixed~~ specified amount of cash or another financial asset for a ~~fixed~~ specified number of the entity's own equity instruments. 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 existing 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 issuing entity may accept some or

all of the risk of changes in foreign currency exchange rates between the two currencies without violating the specified price provision; or ~~For this purpose the entity's own equity instruments do not include puttable financial instruments that are classified as equity in accordance with paragraphs 16A and 16B, 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 and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.~~ (ii) a non-derivative for which the entity is or may be obligated to deliver an other than specified ~~a variable~~ number of the entity's own equity instruments.~~; or~~ ~~As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all of the features and meets the conditions of paragraphs 16A and 16B or paragraphs 16C and 16D.~~	
An *equity instrument* is legal evidence of ~~any contract that evidences~~ a residual interest in the assets of an entity after deducting all of its liabilities or an obligation to issue the entity's own equity instruments excepted as described in paragraph (b)(i) of the definition of a financial liability.	Ownership interests in entities are not contracts, at least in some jurisdictions (for example, the U.S.).

Appendix 2—Definitions using a simpler format

Definition	Explanation of Changes and Comments
An *equity instrument* is a claim that: (a) Will be settled *only* by paying cash or other assets for the following reasons: (i) The entity issuing the instrument chooses to distribute all of its assets or is required by an event such as bankruptcy to distribute all of its assets. (ii) The issuer chooses to pay a dividend or repurchase shares. (iii) 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. (iv) The terms of the instrument require, or permit the holder or 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; or (b) A derivative that will or may be settled by the exchange of a specified amount of cash or another financial asset for a specified number of the entity's own equity instruments. 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	We used the term *claim* instead of financial instrument because IAS 32 scopes in instruments that do not meet the definition of a financial instrument.

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 the currency of the issuer.	
A *financial liability* is a claim against an entity other than those specifically defined as equity that the entity will settle by delivering financial assets, its own financial liability or its own equity instrument other than those specifically defined as equity.	
A *financial asset* is: (a) Cash; (b) An equity instrument of another entity; (c) A contractual right of an entity other than those specifically defined as equity to receive a financial instrument, its own financial liability, or its own equity instrument.	

Appendix 3—Descriptions instead of definitions

***Instruments that will or may require the entity to pay cash, deliver financial assets, or issue a financial liability without receiving anything in return*[2]**

Instruments that the entity can be required to settle *only* for the following reasons are equity.

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

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

(c) 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.

(d) The terms of the instrument require, or permit the holder or 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.

All others are financial liabilities.

Instruments that can* only *require the entity to issue its own non-derivative equity instruments without receiving anything in return

An instrument is equity if the entity issues a specified number of non-derivative equity instruments for no compensation.

All others are financial liabilities.

Instruments that can* only *require the entity to issue its own equity instruments in exchange for cash, financial assets, or financial liabilities

An instrument is equity [or contra-equity] if the entity issues or receives a specified number of equity instruments in exchange for a specified price in cash, financial assets, or financial liabilities.

All others are financial liabilities if they are net credits or financial assets if they are net debits.

Instruments that can require the entity to pay cash or issue a financial liability in exchange for its own non-derivative equity instruments.

[We are not sure how the boards' what to classify this type of instrument.]

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[2] Of course, the settlement obligation is extinguished, which some might view as receiving the entity's own liability or equity instrument in return.

Appendix 4

	Instrument	Modified IFRS 32	Current IFRS	Current U.S. GAAP[3]
1	Common share	**Equity**	**Equity**	**Equity**
2	Perpetual preferred share	**Equity**	**Equity**	**Equity**
3	Share issued by a subsidiary that is a limited life entity	**Equity**	**Liability or Equity**[4]	**Equity**
4	General partnership interest Classification assumes that (a) the general partner takes an active role in the management of the partnership and (b) the instrument must be redeemed if the general partner retires from the partnership	**Equity**	**Liability or Equity**[4]	**Equity**

[3]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.

[4] 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	Modified IFRS 32	Current IFRS	Current U.S. GAAP[3]
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 and (b) the instrument is redeemable at the option of the partner	**Liability or separated into liability and equity components—yet to be determined**	**Liability or Equity[4]**	**Equity**
6	Limited liability partnership instrument Classification assumes that (a) the limited liability partner takes an active role in the management of the partnership and (b) the instrument must be redeemed if the partner retires from the partnership	**Equity**	**Liability or Equity[4]**	**Liability***

	Instrument	Modified IFRS 32	Current IFRS	Current U.S. GAAP[3]
7	Ownership instrument that is redeemable at the option of the holder (other than upon retirement or death)	**Liability or separated into liability and equity components—yet to be determined**	**Liability or Equity[4]**	**Equity** **(Temporary equity for public companies)**
8	Ownership instrument that is required to be redeemed if an uncertain event occurs	**Liability or separated into liability and equity components—yet to be determined**	**Liability or Equity[4]**	**Equity**
9	Ordinary share with a required dividend	**Liability and Equity**	**Liability and Equity**	**Equity**
10	Ordinary share with a substantive registration rights penalty[5]	**Liability and Equity**	**Liability and Equity**	**Liability and Equity**
11	Preferred share convertible into a variable number of ordinary shares at the option of the holder	**Liability or separated into liability and equity components—yet to be determined**	**Liability**	**Equity**

[5] 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	Modified IFRS 32	Current IFRS	Current U.S. GAAP[3]
12	Preferred share that is required to be converted into a variable number of ordinary shares on a specific date or on an event that is certain to occur (other than death or retirement)	**Liability**	**Liability**	**Equity**
13	Instrument issued by a cooperative that gives the holder the right to request redemption, but in which the cooperative can refuse that request	**Equity**	**Equity**	**Equity**
14	Instrument issued by a cooperative that must be redeemed upon the holder's death, retirement, or decreased participation	**Equity**	**Liability or Equity[4]**	**Liability***

	Instrument	Modified IFRS 32	Current IFRS	Current U.S. GAAP[3]
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**
16(a)	Physically (gross) settled written call option	**Equity**	**Equity**[6]	**Equity**

[6] 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	Modified IFRS 32	Current IFRS	Current U.S. GAAP[3]
16(b)	Net-share-settled written call option	**Liability**	**Liability**	**Equity**
16(c)	Physically (gross) settled option 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 (example assumes that the options were offered pro-rata to all existing shareholders).	**Equity**	**Equity**[7]	**Liability**
17	Net-cash-settled written call option and cash SAR	**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**

[7] Classification is based on the IASB's recent amendment to IAS 32.

	Instrument	Modified IFRS 32	Current IFRS	Current U.S. GAAP[3]
18(b)	Physically settled forward purchase contract	**Liability or Gross liability and contra-equity—yet to be determined**	**Gross liability and contra-equity**	**Gross liability and contra-equity**
19	Prepaid forward purchase contract for a fixed number of shares	**Contra-equity**	**Contra-equity[8]**	**Generally, contra-equity**
20(a)	Net-cash- or net-share-settled written put option	**Liability**	**Liability**	**Liability**
20(b)	Physically settled written put option	**Liability or Gross liability and contra-equity—yet to be determined**	**Gross liability and contra-equity**	**Liability**
21	Prepaid written put option for a fixed number of shares	**Contra-equity**	**Contra-equity[8]**	**Generally, contra-equity**
22	Convertible debt for fixed number of shares	**Liability or separated into liability and equity components—yet to be determined**	**Equity and Liability**	**Liability[9]**

[8] Classification as equity assumes that the issuer has a prepaid fixed amount of cash and that the instrument will be settled by the issuer receiving a fixed number of its own equity instruments.
[9] Classification assumes the instrument (a) may not be settled in cash upon conversion (including partial cash settlement) and (b) does not have a beneficial conversion feature.

	Instrument	Modified IFRS 32	Current IFRS	Current U.S. GAAP[3]
23	Share redeemable at the option of the issuer (callable share)	**Equity**	**Equity**	**Equity**
24(a)	Preferred share convertible into a fixed number of ordinary shares at the option of the holder	**Equity**	**Equity**[10]	**Equity**
24(b)	Preferred share required to be converted into a fixed number of ordinary shares	**Equity**	**Equity**[10]	**Equity**
25	Preferred share puttable, callable, and convertible	**Liability or separated into liability and equity components—yet to be determined**	**Liability**	**Equity** **(Temporary equity for public companies)**
26	Note receivable settled with cash or a variable number of shares[11]	**Asset**	**Asset**	**Asset (if cash settled)** **Contra-equity (if share settled)**

[10] Classification as equity assumes that the preferred share includes no other contractual obligations.
[11] The example assumes the counterparty can choose the form of settlement. That fact is relevant to current U.S. GAAP classification only.

	Instrument	Modified IFRS 32	Current IFRS	Current U.S. GAAP[3]
27	Debt indexed to shares (for example, convertible debt for which the entire conversion value is settled in cash)	**Liability**	**Liability**	**Liability (with a separated embedded derivative)**