Project	**Financial instruments with characteristics of equity**
Topic	**Approach 4.2—Classification of instruments an entity will settle by issuing its own shares**

Introduction

1. This paper describes Approach 4.2 to distinguishing between instruments classified as assets or liabilities and instruments classified as equity.

Approach 4.2

2. Approach 4.2 would have the same classification requirements as Approaches 4.0 and 4.1 for instruments that the entity can be required to settle with cash or other assets (which are described in this paper as cash-settled instruments). In addition, some types of puttable instruments would be bifurcated into equity and liability components in the same way as under Approaches 4.0 and 4.1. (Appendix A to this paper describes the boards' previous decisions about cash-settled instruments.)

3. Approach 4.2 would require classification as equity for three fairly narrow classes of instruments that an entity is required to settle (and has the ability to settle) by issuing its own shares. The approach would require all other instruments that require or permit an entity to issue its own shares to be classified as liabilities. The result of Approach 4.2 would be to classify as equity more instruments than Approach 4.0 and fewer instruments than Approach 4.1.

4. The terms *specified number of its own shares* and *specified price,* which are used in the descriptions of the instruments to be classified as equity, are similar to the terms (but not the same as) *fixed number* and *fixed price,* which are used in IAS 32. Those terms are defined in paragraph 8 of this memo.

5. Approach 4.2 would require an entity to have the ability to settle by issuing its own shares to classify a share-settled instrument as equity (see paragraph 9 of this memo).

6. The requirements of Approach 4.2 would result in classifying convertible debt instruments as liabilities in their entirety. They would not be bifurcated for classification purposes. However, convertible debt instruments have features that qualify as embedded derivatives and those embedded derivatives, if issued separately, would not meet any of the criteria for equity classification in Approach 4.2. Therefore, the instruments might be required to be bifurcated under the requirements of other standards.

Three Types of Share-Settled Instruments to Be Classified as Equity

7. Approach 4.2 would require the following types of instruments to be classified as equity. In all three cases, the phrase *require the entity to issue* is intended to mean that there is no other settlement option. It is not intended to exclude instruments that the entity may never be required to settle if the holder does not exercise its option.

   (a) Short-term instruments that have both of the following two characteristics:

      i. They are issued as part of the process of issuing new stock to the public or to existing shareholders

      ii. They require the entity to issue a specified number of its own shares in exchange for a specified price in cash or other assets.

   This description is intended to include (a) rights issues and (b) 'regular-way' forward contracts to issue shares (which are about three days in length in the United States, but are probably longer in other places). We do not know how long rights issues are normally outstanding before expiration, but we plan to attempt to determine the customary maximum length of time and include that (plus a few extra days just to be safe) in the requirement instead of relying on the less specific adjective *short -term*.

(b) Instruments that have both of the following two characteristics:

i. They are either (a) issued at the same time new shares are issued to the same buyers as those new shares or (b) issued to existing shareholders in proportion to their percentage of ownership of outstanding shares

ii. They require the entity to issue a specified number of its own shares in exchange for a specified price in cash or other assets.

This description is intended to include stock purchase warrants issued solely for the purpose of raising additional capital. We are not aware of any customary term of expiration on these instruments, but if one can be identified, we would recommend adding a maximum term.

(c) Instruments that require the entity to settle them by issuing a *specified number of its own shares* and that have the following characteristics:

i. The original instruments would qualify as equity if they did not have the conversion requirement

ii. The original instruments do not have cumulative dividends or similar requirements that must be paid in cash upon conversion

iii. The original instruments do not have cumulative dividends or similar requirements that are included in the formula for determining the number of shares to be issued and that create the appearance of approximating a principal and interest payment using shares as a currency.

This description is intended to include preferred shares convertible to ordinary (common) shares and non-voting ordinary shares convertible to voting ordinary (common) shares. The description is intended to exclude instruments with associated dividend requirements that would appear to be more similar to debt than equity whether those requirements were settled in cash. The conversion requirement may be unconditional (that is, it is guaranteed to happen either at or before a specified time or on the occurrence of an event that is certain to occur), at the option of the holder, or conditioned on the occurrence of an event such as change of control that may or may not occur. The shares that include the conversion obligation must have characteristics that would qualify as equity in their entirety if the conversion obligation did not exist, and the shares to be issued upon conversion must qualify as equity in their entirety after they are issued. This type of instrument would not be limited to short term.

Specified number of shares of its own shares and specified price

8. The terms *specified number of its own shares* and *specified price* are used with the following meanings.

   Specified number of its own shares: The entity's own shares that it is required to issue must be cash-settled instruments that will qualify as equity in their entirety once issued. (Paragraph 2 and Appendix A of this paper describe those instruments.) The specified number must either be fixed or vary only to ensure that the counterparty will receive a specified percentage of total shares that were outstanding on the issuance date for a fixed price. That could be described as an anti-dilution provision (if the total number of outstanding shares increases because of other transactions) or the anti-concentration provision (if the total number of shares outstanding decreases).

   Specified price: The specified price must be fixed in the reporting entity's currency unless the domestic currency of the existing shareholders (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 shares to domestic shareholders. In that case, the issuing entity may accept some or all of the foreign currency exchange risk without violating the specified price provision.

The entity's ability to issue shares

9. The entity's ability to settle by issuing its own shares would be determined at the date an instrument is issued. If, at any time during the life of that instrument, the entity cannot demonstrate conclusively that it will have the ability to issue enough shares to meet the settlement requirements of outstanding instruments that are classified as equity, those instruments would be reclassified to liabilities and would remain in that classification until settled.

Staff Analysis and Recommendation

10. Approach 4.2 would limit implementation difficulties in the following ways.

    (a) It would limit equity classification to narrow classes of instruments and describe the intended results of those limitations.

    (b) The nature of the instruments to be classified as equity limits concerns about the entity's ability to issue shares because the instruments are more clearly associated with capital-raising activities than some of the instruments included in equity under current standards or some other approaches the boards have considered.

    (c) It would not permit any portion of convertible debt to be classified as equity, which would eliminate fixed-for-fixed questions and any other classification issues related to convertible debt.

    (d) It would answer the outstanding questions about anti-dilution provisions.

    (e) It would retain the provisions related to foreign currency denominated rights issues.

11. Approach 4.2 would result in classifying as equity the share-settled instruments about which board members have expressed concerns. It would not classify as equity longer-term options or forwards and more complicated instruments that seem more likely to be issued for speculative purposes than for capital raising purposes.

12. We cannot assert with full confidence that Approach 4.2 is totally immune from manipulation. In particular, as indicated by the description of the class of instruments discussed in subparagraph 7(c), there appears to be a possibility that those instruments could be convertible debt disguised as equity. The explicit provisions in subparagraphs 7(c)(ii) and 7(c)(iii) are intended to reduce that possibility. In addition, the lack of an implicit floor on the value of the settlement (which is provided by the cash option in a convertible debt) also would work to reduce that possibility.

13. We are not aware of aspects of Approach 4.2 that need further development except for the points about expiration dates identified in subparagraphs 7(a) and 7(b).

14. We recommend that the boards accept Approach 4.2 as described in this paper.

15. Appendix B contains a list of instruments and their classification under Approach 4.2, current U.S. GAAP, and IAS 32.

Questions for the boards

Questions
1. Should the short-term options and forwards described in paragraph 7(a) be classified as equity? 2. Should the purchase warrants described in paragraph 7(b) be classified as equity? 3. Should the convertible instruments described in paragraph 7(c) be classified as equity? 4. Are there other specific types of share-settled instruments that should be classified as equity? If so, what are they?

Appendix A

A1. The boards' previous decisions related to cash-settled instruments are as follows.

A2. 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

(b) The required payments occur for one of 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 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.

A3. Instruments with both an equity settlement feature and a liability settlement feature are separated into components.

Appendix B

	Instrument	Approach 4.2	Current IFRS	Current U.S. GAAP[1]
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**[2]	**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**[2]	**Equity**

[1]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.
[2] 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 4.2	Current IFRS	Current U.S. GAAP[1]
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 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 and (b) the instrument must be redeemed if the partner retires from the partnership	**Equity**	**Liability or Equity[2]**	**Liability***
7	Ownership instrument that is redeemable at the option of the holder (other than upon retirement or death)	**Liability and Equity**	**Liability or Equity[2]**	**Equity** **(Temporary equity for public companies)**

	Instrument	Approach 4.2	Current IFRS	Current U.S. GAAP[1]
8	Ownership instrument that is required to be redeemed if an uncertain event occurs	**Liability and Equity**	**Liability or Equity[2]**	**Equity**
9	Ordinary share with a required dividend	**Liability and Equity**	**Liability and Equity**	**Equity**
10	Ordinary share with a substantive registration rights penalty[3]	**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 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 on an event that is certain to occur (other than death or retirement)	**Liability**	**Liability**	**Equity**

[3]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 4.2	Current IFRS	Current U.S. GAAP[1]
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[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**
16(a)	Physically (gross) settled written call option	**Equity if meet criteria in paragraph 7 of this paper , otherwise liability**	**Equity[4]**	**Equity**

[4] 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 4.2	Current IFRS	Current U.S. GAAP[1]
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 if meet criteria in paragraph 7 of this paper , otherwise liability**	**Equity**[5]	**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**
18(b)	Physically settled forward purchase contract	**Liability or gross liability and contra-equity (to be discussed at a later date)**	**Gross liability and contra-equity**	**Gross liability and contra-equity**

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

	Instrument	Approach 4.2	Current IFRS	Current U.S. GAAP[1]
19	Prepaid forward purchase contract for a fixed number of shares	**Asset**	**Contra-equity**[6]	**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 (to be discussed at a later date)**	**Gross liability and contra-equity**	**Liability**
21	Prepaid written put option for a fixed number of shares	**Asset**	**Contra-equity**[6]	**Generally, contra-equity**
22	Convertible debt for fixed number of shares	**Liability**	**Equity and Liability**	**Liability**[7]
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**[8]	**Equity**

[6] 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.
[7] 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.
[8] Classification as equity assumes that the preferred share includes no other contractual obligations.

	Instrument	Approach 4.2	Current IFRS	Current U.S. GAAP[1]
24(b)	Preferred share required to be converted into a fixed number of ordinary shares	**Equity**	**Equity[8]**	**Equity**
25	Preferred share puttable, callable, and convertible	**Liability and Equity**	**Liability**	**Equity** **(Temporary equity for public companies)**
26	Note receivable settled with cash or a variable number of shares[9]	**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 (with a separated embedded derivative)**

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