Project **Financial instruments with characteristics of equity**

Topic **Classification of a subsidiary's equity instruments in consolidation**

Introduction

1. The principles described in Agenda Paper 5A/FASB memo 80 focus on the classification in the issuer's financial statements. At this meeting, we will ask the boards to decide how a subsidiary's equity instruments should be classified in the consolidated financial statements.

2. We have identified three ways in which the boards can address this issue:

   (a) **Alternative 1**—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) **Alternative 2**—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) **Alternative 3**—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

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equity instrument that has redemption requirements. If the nature of the instrument changes in consolidation, classification should be reconsidered in the consolidated financial statements.

Analysis of Alternative 1

3. One of the principles agreed to in October 2009 is that equity instruments are always subordinated to liabilities. (A *subordinated interest*, as we are using the term in this project, must wait to receive assets until higher priority interests are satisfied.) In the absence of any specific contractual arrangements to the contrary, a subsidiary's creditors are first in line to receive a share of the subsidiary's assets. The parent and the holders of noncontrolling interests are next in line. Then, creditors of the parent have rights to any assets that have been distributed to the parent. Viewed from that perspective, the parent company's creditors are subordinated to the subsidiary's creditors and noncontrolling shareholders. Therefore, under Alternative 1, all interests in all subsidiaries would be classified as liabilities in consolidated financial statements.

4. That can be demonstrated using the following example in which we assume that a parent company needs assets to make payments on its own loan payable to a bank. (That lender is the parent's only creditor in this example.) The parent itself does not have sufficient assets to make that payment, but it has a subsidiary. The subsidiary has *exactly enough assets* to satisfy its own (the subsidiary's) creditors with enough left over for the parent to make its loan payments. The parent owns 90 percent of the subsidiary's outstanding perpetual ordinary (common) shares, which are eliminated in consolidated financial statements. A third party owns the remaining 10 percent of the outstanding common shares. Those shares are reported in the consolidated financial statements as noncontrolling interests.

5. To provide assets to the parent company, the subsidiary declares a cash dividend on its ordinary shares so that the parent can use that cash to make its loan payments. All shares are eligible for that dividend, including the noncontrolling interest. Therefore, the holders of the noncontrolling shares are entitled to receive 10 percent of the total dividend and the parent is entitled to only 90 percent. The parent receives only 90 percent of the cash it needs to make its loan

payment. Therefore, the lender's interest is not completely satisfied because the holder of the noncontrolling interest in the subsidiary has a right to receive its share of the subsidiary's cash before the parent's creditor receives its share.

6. Thus, the interest of the parent's creditor (which would be reported in consolidated financial statements as a liability) is subordinated to the interest of the subsidiary's third party shareholder. That means that if classification of the subsidiary's common shares were reconsidered in consolidation using the subordination principle, those shares would be classified as a liability.

7. We do not think classification of noncontrolling interests as liabilities faithfully represents the nature of the instruments. Therefore, we recommend that the boards reject Alternative 1.

Description of Alternative 2

8. Alternative 2 would provide classification results that are consistent with the current classification for noncontrolling interests under Subtopic 810-65 (originally issued as FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*) of the Accounting Standards Codification and IAS 27, *Consolidated and Separate Financial Statements*.

9. Alternative 2 also provides the same results for most instruments as does IAS 32, *Financial Instruments: Presentation,* but there is one significant difference. Under IAS 32, the following two types of instruments classified as equity by a subsidiary are classified as liabilities in consolidated financial statements:

   (a) Puttable instruments that qualify as equity of the subsidiary as a result of the 'puttables amendment' (paragraphs 16(a)-16(d) of IAS 32)

   (b) Instruments that impose an obligation on liquidation (for example, shares issued by a limited-life entity or partnership instruments that are required to be put upon liquidation).

   Under Alternative 2, those instruments would retain equity classification in consolidated financial statements.

Puttable instruments and instruments that impose an obligation on liquidation

10. Instruments in the scope of the *Amendments to IAS 32,* Financial Instruments: Presentation*, and IAS 1*, Presentation of Financial Statements—Puttable Financial Instruments *and* Obligations Arising on Liquidation (the puttables amendment) are classified as equity in the separate financial statements of the subsidiary if all of the relevant requirements in paragraphs 16(a)-16(d) of IAS 32 are met. The IASB concluded that the instruments would be liabilities of the consolidated entity because they are not the most residual interest in the consolidated financial statements.

11. Many constituents disagree with this result. Those constituents argue that the IASB's limited-scope amendment does not improve financial reporting because the instruments are still classified as liabilities in the consolidated financial statements. Alternative 2 would resolve this issue.

Limited-life entities

12. Alternative 2 would require shares issued by a limited-life subsidiary to be classified as equity in the consolidated financial statements. This is different from current IFRS literature that requires shares issued by a limited-life subsidiary to be classified as liabilities in consolidated financial statements.

13. As originally written, FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, (now included in Subtopic 480-10) would have required shares issued by a limited-life entity to be classified as a liability in consolidated financial statements. However, many constituents expressed concerns about the implications of that requirement. Specifically, the requirement would have eliminated most, if not all, of the equity of most U.S. partnerships and real estate holding companies. After further consideration, the FASB decided to indefinitely defer the requirement to classify particular noncontrolling interests as liabilities in the consolidated financial statements until it could consider the issue in this project. Alternative 2 would resolve the issue that the FASB encountered with Statement 150.

14. We believe Alternative 2, which retains the subsidiary's classification in consolidated financial statements, more faithfully represents the substance of the

noncontrolling interests even though they are interests in only a portion of the consolidated entity. It could be argued that the result is based on legal form, and that is true. However, in this situation, the legal form makes a substantive economic difference, which is often the reason subsidiaries are formed to undertake activities that the parent itself could probably have undertaken.

15. We acknowledge that our recommendation could provide an opportunity for unscrupulous entities to create short-lived subsidiaries to disguise debt instruments as equity. For example, an entity could fill a short-lived subsidiary's balance sheet with interest-bearing instruments that create net income for that subsidiary that is equal to the interest payments the parent would have made if the *shares* had been debt. If the boards choose this alternative, we recommend that they deal with that issue in a very straightforward way by providing examples of structures that would be inconsistent with the principles and the boards' intent.

Analysis of Alternative 3

16. Alternative 3 is a compromise between Alternatives 1 and 2. Under this alternative, an entity would generally carry over the consolidation from subsidiary financial statements into consolidated financial statements unless (a) the nature of the instrument changes in consolidation or (b) the instrument is issued by a limited life entity or is an equity instrument that has redemption requirements. Instruments issued by a limited life entity or equity instruments that have redemption features would be classified as liabilities in the consolidated financial statements. Some may support this approach because it would limit structuring opportunities.

Share-settled Instruments Classified as Equity

17. Approach 4.2 would allow a limited number of share-settled instruments, for example, rights issues and forward contracts to issue shares, to be classified as equity. Those instruments would maintain equity classification under Alterative 1. However, the classification may change under Alternatives 2 and 3 if the nature of the instrument changes in consolidation; for example, if the subsidiary issues a forward contract to issue shares and the parent agrees to buy the shares back immediately.

Appendix 1

18. Appendix 1 provides a list of equity instruments and illustrates how they would be classified in the consolidated financial statements under the three alternatives described in this paper.

Question for the board

Question 1

Which of the following alternatives for classifying instruments of subsidiaries in consolidated financial statements do the boards believe is most appropriate?

1. Always reconsider classifications in consolidation as if the consolidated group were a single legal entity
2. Use the same classification in consolidation financial statements as in the subsidiary's financial statements unless another member of the consolidated group has obligations related to those instruments that would have changed the classification
3. Use the same classification in consolidation financial statements as in the subsidiary's financial statements unless (a) another member of the consolidated group has obligations related to those instruments that would have changed the classification or (b) the instrument has redemption requirements or the subsidiary is a limited life entity.

Appendix 1

Instrument	Classification at Subsidiary Level	Alternative 1	Alternative 2	Alternative 3
Ordinary share issued by a subsidiary	Equity	Liability	Equity	Equity
Share issued by subsidiary that is redeemable at the option of the issuer	Equity	Liability	Equity	Equity
Ordinary share with a required dividend	Liability and Equity	Liability	Liability and Equity	Liability and Equity
Ordinary share issued by a limited-life subsidiary	Equity	Liability	Equity	Liability
Ownership instrument issued by a subsidiary that gives the holder the right to request redemption, but in which the issuer can refuse redemption	Equity	Liability	Equity	Equity
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	Liability	Equity	Liability
General partnership instrument 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	Liability	Equity	Liability