IASB/FASB Meeting March, 11 2010
FASB Education Session March 10, 2010

IASB agenda reference	**2B**
FASB memo reference	**91**

Project	**Financial instruments with characteristics of equity**
Topic	**Economic Compulsion**

Introduction

The attached paper was issued for the January meeting but not discussed due to lack of time. No changes have been made.

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IASB/FASB Meeting January 2010

IASB agenda reference	**5D**
FASB memo reference	**83**

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Project **Financial Instruments with Characteristics of Equity**

Topic **Economic Compulsion**

Introduction

1. This memorandum discusses whether an instrument without an explicit settlement provision that would make it a liability should ever be classified as a liability if the issuer feels compelled to settle or redeem because not doing so imposes significant negative economic consequences.

Economic Compulsion Compared to Constructive Obligations

2. This memorandum uses the term *economic compulsion* to refer only to outstanding financial instruments that would otherwise be classified as equity because they have no settlement requirement but that the issuer feels compelled to settle because not doing so imposes significant negative economic consequences.

3. *Economic compulsion* does not refer to obligations that may exist even though they are not explicitly contractual, statutory, or regulatory. Those have been referred to as *constructive obligations,* implied contracts, or obligations arising from promissory estoppel. This memorandum does not address obligations unrelated to existing financial instruments because if a constructive obligation of that type existed, it would create a liability and would not affect classification of an existing instrument. Thus, it is irrelevant for this project.

Instruments Highly Likely to Be Redeemed Because of Economic Compulsion

4. The most commonly cited example of an instrument that may be redeemed because of economic compulsion is callable increasing rate preferred stock. The stated dividend rate on preferred stock may increase to an above market rate on a specific date. The dividend is payable only if declared, but it must be declared before a dividend on common stock can be declared or before the preferred stock can be retired. If the issuer believes it will ever want to pay dividends on common stock or to retire the preferred stock, that issuer will feel compelled to redeem the instrument before the cumulative undeclared dividends become too large.

5. Although increasing rate preferred stock is the only example that has been discussed so far, an entity may feel economically compelled to redeem an instrument any time an instrument's terms are significantly more onerous than the terms a replacement instrument would carry under current market conditions. Some examples include the following:

   (a) A perpetual preferred stock with a stated dividend rate of 10 percent is callable at a fixed price in 3 years. If prior to the call date, market rates for a similar instrument are only 5 percent, the entity would be highly likely to call the instrument and replace it, if necessary, with a lower rate instrument.

   (b) A perpetual preferred stock with a stated dividend rate of 10 percent that is publically traded. If the market rates for a similar instrument are only 5 percent, the entity would be highly likely to buy its own share back on the open market and replace it, if necessary, with a lower rate instrument.

   (c) A perpetual instrument with a variable dividend rate of LIBOR plus 5 percent is callable at a fixed price. If the entity's credit rating improves so much that the spread above LIBOR for a similar instrument is only 2 percent, the probability of the entity calling the instrument would be extremely high.

   (d) The terms of a preferred stock provide the issuer with a choice after year 10 of either (1) redeeming the security by paying cash equal to the face amount plus any dividends in arrears or (2) paying damages in cash equal to 90 percent of the face amount plus any dividends in arrears over a 1 year period and leaving the security outstanding. Although the entity is not required to redeem the instrument, Alternative 2 is highly likely to be considered uneconomic because the security would remain outstanding even after 90 percent of the liquidation value was paid.

6. Based on the Boards' decisions to date, the instruments described in each of the examples would currently be classified as equity or have an equity component under Approach 4.2, even though the instrument is highly likely to be settled. We have identified three alternatives for the Boards to consider:

   (a) **Alternative 1**—Develop an economic compulsion principle

   (b) **Alternative 2**—Do not address economic compulsion

   (c) **Alternative 3**—Identify and address specific instruments.

Alternative 1—Develop an Economic Compulsion Principle

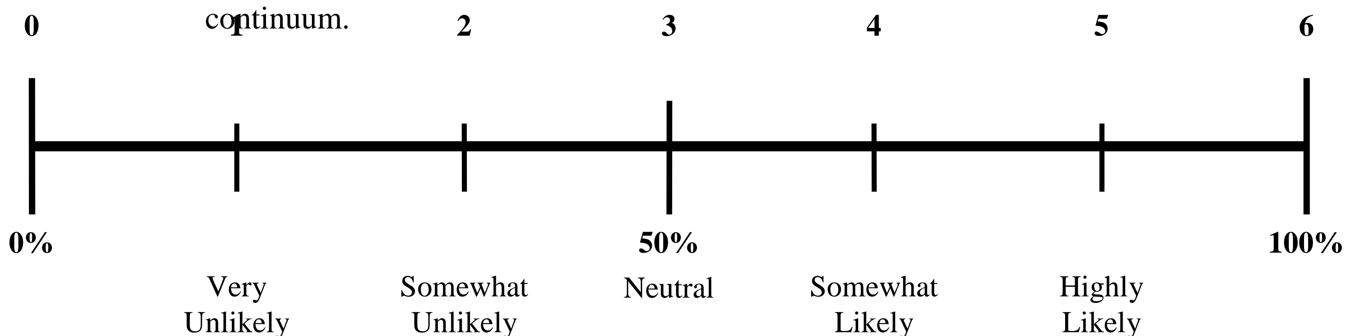
7. The following is a draft of a principle that would require entities making equity-liability classification decisions to consider economic compulsion.

   When classifying an instrument, an entity shall consider future redemptions that are not required by contract, statute, or regulation but that are highly likely because the entity has the ability to retire the instrument and a significant incentive to do so to avoid negative economic consequences.

8. That draft principle refers not just to an incentive to settle but to an ability to settle as well. If the market for such instruments is illiquid and the instruments have no call provision, the issuer may not be able to redeem them regardless of the negative consequences of not doing so.

Incentive Threshold

9. In deciding on the appropriate threshold for the principle, we considered *likely* and *somewhat likely*. To illustrate the thresholds, we have provided the following continuum.



10. *Highly likely* seems to be the most appropriate threshold for identifying and preventing blatant structuring opportunities. Using a lower probability threshold (such as *very unlikely* or *somewhat unlikely*) could greatly increase the number of nonredeemable instruments classified as liabilities. Since inferring an unstated settlement obligation is potentially troublesome from a conceptual standpoint,[1] it seems best to limit the application of such a principle.

11. The Boards could choose to present just the principle as described above without any further clarification. The principle alone may be sufficient, but a list of circumstances in which the issuer may have the ability or incentive to settle might limit questions and improve the chances for consistent application. Identifying some factors for consideration in determining economic compulsion may alleviate some questions.

Examples of Ability or Incentive to Settle

12. In determining whether an issuer is economically compelled to settle or choose a certain settlement alternative, the following may be considered when assessing the entity's ability to settle:

    (a) The absence or existence of call options
    (b) Market trading or lack thereof
    (c) The demonstrated ability to coerce or induce counterparties to settle (in the absence of call options or market trading) (past practice of settlement).

13. In determining whether an issuer is economically compelled to settle or choose a certain settlement alternative, the following may be considered when assessing the entity's incentive:

    (a) Multiple settlement alternatives with differing monetary amounts
    (b) Terms of the instrument (for example, increasing rate or fixed rate)

[1] For example, economic compulsion might be applied to an apparently uneconomic lease with a cash penalty for cancellation. It also might be applied to absolutely necessary future maintenance or upgrades of equipment. Those do not seem to create liabilities, so why should economic compulsion create a liability out of an equity instrument? The reason seems to be solely abuse prevention, and, as such, the application of such a principle should be as limited as possible.

(c) Significant changes in market conditions.

14. The above lists are not complete, and include only the most obvious circumstances. An issuer would apply its own judgment to decide if it has the incentive and ability to redeem an otherwise nonredeemable instrument.

Reassessment of Classification Due to Economic Compulsion

15. If an economic compulsion principle is adopted, we believe the presence or absence of economic compulsion should be reconsidered at each reporting period. For example, if market dividend rates on preferred stock increase, the increased rate on an increasing rate stock, which was considered well above market when the stock was issued, may no longer be above market. In that case, the instrument should be reclassified to equity since the entity is no longer economically compelled to redeem it.

Alternative 2: Do Not Address Economic Compulsion

16. The Boards may choose not to address the classification of instruments in which an issuer is economically compelled to settle or chose a certain settlement alternative at this stage of the project. Under this alternative, increasing rate preferred shares would continue to be classified as equity.

Alternative 3: Identify and Address Only Specific Instruments

17. Another alternative is to identify specific instruments for which probable settlement should be treated as if it was a requirement; for example, an increasing rate preferred share. Those specific instruments would be required to be classified as liabilities and would be considered an exception to the Boards' underlying classification principles. The Boards could address only increasing rate preferred stock, which is the instrument that has been identified as a significant issue.

Staff Analysis and Recommendation

18. Several Board members have expressed concerns about classifying an increasing rate preferred share as equity. Both Alternatives 1 and 3 would resolve that issue. The challenge in developing a principle is choosing the appropriate threshold in which an entity should recognize a liability. If the Boards set the threshold too low, they run the risk of classifying instruments that lack settlement requirements as liabilities. That result would be difficult to justify from a conceptual standpoint. If the threshold is set too high, it is possible that an instrument with a significant actual obligation would not be classified as a liability.

19. Some may argue that using a rather vague anti-abuse principle with uncertain application in circumstances other than increasing rate preferred stock (Alternative 1) may create more problems and questions than it solves. As the examples in paragraph 5 demonstrate, market changes could cause conclusions about economic compulsion to change from period to period, which would change classifications from period to period. In addition, the inevitable questions about how negative the economic consequences of not redeeming must be to require liability classification would be minimized.

20. Alternative 3 would resolve the concern described in paragraph 19. Those who support Alternative 1 would argue that addressing only specific situations (Alternative 3) could leave the door open for other structuring opportunities in the future. Additionally, under Alternative 3, the Boards may be forced to periodically update a list of detailed rules for when economic compulsion affects classification and when it does not. Some may view that as a disadvantage.

21. We support Alternative 2 for the reasons described in the preceding paragraphs. We acknowledge that this alternative will result in classifying as equity increasing rate preferred shares, which some may view as inappropriate; however, we are concerned that Alternatives 1 and 3 would cause bigger problems than they would resolve.

Question for the Boards

Question
1. Which of the alternatives do the Boards support?
Alternative 1—Develop an economic compulsion principle
Alternative 2—Do not address economic compulsion
Alternative 3—Identify and address specific instruments