IASB/FASB October 2010 Joint Board Meeting

IASB Agenda reference	**13**
FASB Agenda reference	**96**

Staff Paper

Project	**Financial Instruments with Characteristics of Equity**
Topic	**Targeted Improvements Approach**

Introduction

1. Both boards have individually discussed how to move forward with the project in light of external review comments received on the preballot draft of the proposed FASB Accounting Standards Update, *Equity (Topic 505)*: *Financial Instruments with Characteristics of Equity* (Exposure Draft). As a result of those discussions, three of the five alternatives on how to proceed with the project (see FASB Memorandum 94/IASB Agenda Paper AP 2) were either viewed with a degree of scepticism or rejected as a path forward.

2. The five alternatives that were presented to the individual boards in August and September are as follows:

   (a) **Alternative (a)**—Adopt a narrow view of equity similar to the basic ownership approach in the Preliminary Views: *Financial Instruments with Characteristics of Equity* or Approach 4.0.

   (b) **Alternative (b)**—Amend IAS 32, *Financial Instruments: Presentation,* to address specific practice issues (fixed-for-fixed derivatives, convertible debt, and puttable instruments) and adopt the amended version in the United States.

   (c) **Alternative (c)—**Make targeted improvements to U.S. GAAP and IFRS related to convertible debt, puttable shares, and redeemable shares that

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Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update.* Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

would classify those instruments similarly under either set of standards. (Drafting would be as similar as possible with differences to conform to the differing contexts for each set of standards.)

(d) **Alternative (d)**—Defer work on this project until some of the other projects on the boards' agendas are completed.

(e) **Alternative (e)**—Continue working on the approach in the Exposure Draft.

3. While none of the views were formally voted on by the FASB, the IASB tentatively decided to discuss alternatives (b) and (c) jointly with the FASB effectively eliminating alternatives (a), (d), and (e).

4. The staff notes that alternatives (b) and (c) are not different from an IASB perspective. The targeted improvements suggested in alternative (c) are the same improvements as those suggested for IAS 32. However, the differences in the approaches are a concern for the FASB because it will need to decide whether adoption of IAS 32 in the United States is operationally feasible or if the targeted improvements converge the standards to a point that overall adoption of IFRS in the future will be easier. That difference in decision primarily rests on the amount of detailed guidance provided under U.S. GAAP that is simply not contained in IAS 32 and the fact that the IASB has made it clear that it does not want to incorporate that guidance into any future standard.

Purpose

5. The purpose of this discussion is to determine if the boards want to proceed (a) with a targeted improvements approach to IFRS and U.S. GAAP that will culminate in the FASB adopting IAS 32 or (b) with a targeted improvements approach to IFRS and U.S. GAAP that will closely align the different standards without the FASB adopting IAS 32.

6. Additionally, the staff will review for the boards why the other alternatives listed in paragraph 2 were eliminated.

Targeted Improvements

7. The discussion that follows in this section is largely adapted from the discussion provided to the boards individually as part of FASB Memorandum 94/IASB Agenda Paper AP 2. Some portions, especially paragraphs 9, 12, and 13 have been updated to reflect new information obtained from regulators and subject experts.

Staff Analysis

8. The staff suggests that the boards amend existing literature to replace the requirements for the following troublesome areas for which practice problems exist and that are resolvable in the near term:

   (a) fixed-for fixed interpretation issues

   (b) convertible debt

   (c) redeemable and puttable instruments.

9. Reporting in these areas causes problems under both sets of standards. Admittedly in the United States, these issues are much more prevalent for smaller entities (e.g. market capitalization of 75 million or less) for a variety of reasons including, but not limited to, the fact that when those entities issue hybrid instruments they often have to add "sweeteners" to attract investors. Consequently, the instruments issued become more complex.

10. When EITF Issue No. 07-5, "Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock," (now included in Topic 815) was originally issued, it was intended to address many of the concerns for items (a) – (c) in paragraph 8. However, the staff has discussed those issues with regulators and subject matter experts and learned that significant problems still exist in all of the identified areas.

Fixed-for-fixed interpretation issues

11. The interpretation of the fixed-for-fixed requirement continues to be an issue. The IASB's staff has received a number of questions about convertible debt denominated in foreign currencies and what constitutes a fixed number of shares (e.g. variability related to antidilution provisions and conversion rates that change over time). The IASB and IFRIC have said that those questions would be addressed in this project.

12. For the FASB, EITF Issue 07-5 has not adequately addressed what is meant by "inputs to the fair value of a fixed-for-fixed forward or option on equity shares[1] " when trying to determine if an instrument (or embedded feature) is indexed to an entity's own stock. The analysis seems to be so complex that a number of small issuers (and a few larger ones) have had to restate previously issued financial statements because of errors in application. For example, it was brought to our attention that some entities failed to apply the requirements of EITF Issue 07-5 and instead looked to the guidance in EITF Issue 00-19 "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" because they were either not aware of (a) the sequencing of the literature or (b) the existence of EITF Issue.

13. Additionally we were made aware of the fact that in some instances U.S. GAAP does not provide guidance for some instruments. For example, this situation would arise for a free-standing warrant that does not meet the definition of a derivative and is not indexed to its own stock.

Convertible Debt

14. Convertible debt is reported differently under IFRS and U.S. GAAP. U.S. GAAP requires that the conversion option in convertible debt[2] be analyzed as if it were a freestanding instrument to determine whether it would qualify for equity classification. If the conversion option would be classified as equity if it were

[1] Quoted text is taken paragraph 815-40-15-7D of the Codification (formerly EITF Issue 07-5).
[2] For purposes of this discussion, the term *convertible debt* is used to apply to instruments that require the conversion option to be settled by issuing the full amount of shares, rather than net shares or cash.

separated from the debt host, the instrument would not be separated but would be classified as a liability in its entirety. Many convertible debt instruments in the United States are structured to qualify for reporting as a single liability with interest expense recognized at the coupon rate (adjusted for any premium or discount on issuance). Of course, that interest expense is less (sometimes much less) than the interest that the entities would have paid for nonconvertible debt.[3]

15. IAS 32 requires that compound instruments (specifically, convertible debt) be separated if the two settlement alternatives are fixed. The conversion option is analyzed as an exchange of shares for an amount of cash equal to the principal amount of the convertible debt instrument. If the principal amount and the number of shares are fixed, the convertible debt is separated. Constituents have said that many (or at least some) convertible debt instruments accounted for under IAS 32 are separated into an equity and liability component. In that case, interest is reported at a rate similar or identical to the rate for a freestanding nonconvertible debt instrument.

16. U.S. reporting entities tend to avoid separation of convertible debt and the consequences for interest expense. IFRS requires reporting entities to separate all convertible debt whether the bifurcated derivative is equity or not. As discussed in Appendix A, one of the potential solutions could be more clearly identifying which embedded derivatives in convertible debt instruments should be classified as equity. In IFRS, this might be accomplished by requiring that to be classified as equity after bifurcation, the share-settlement provision must be a fixed number except for standard anti-dilution provisions. Given that IFRS generally includes less detail, an equivalent to EITF Issue 07-5 may not be necessary, but under U.S. GAAP, an improved (and hopefully simplified) version seems likely to be necessary.

[3] U.S. GAAP requires some forms of convertible debt to be separated into liability and equity components. Examples include convertible debt instruments that contain a beneficial conversion feature and convertible debt instruments that permit cash settlement upon conversion.

Mandatorily Redeemable and Puttable Instruments

17. The problems of entities that issue only redeemable or puttable instruments are similar under each of set of standards. Topic 480, Distinguishing Liabilities from Equity, requires classification of all mandatorily redeemable instruments as liabilities. When that requirement was originally issued (as FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*), constituents were alarmed that many entities (e.g. closely held corporations and some partnerships) would no longer have any instruments classified as equity. In response to those concerns, the FASB indefinitely deferred the effective date of those specific provisions for the entities and instruments most directly affected. Part of the reason for this project was to resolve the issues that led to the indefinite deferral.

18. IAS 32 includes an exception that allows classification of some puttable and mandatorily redeemable instruments as equity even though the instruments would otherwise meet the definition of a liability. *Amendments to IAS 32*, Financial Instruments-Presentation *and IAS 1* Presentation of Financial Statements-Puttanle Financial Instruments *and* Obligations on Liquidation (puttables amendment), which was issued in February 2008, established that exception. The puttables amendment has been criticized for (a) being rules-based and difficult to apply and (b) not including other similar instruments. The IASB hoped to replace the current requirement as a result of this project.

Concerns Regarding Adoption of IAS 32

19. Knowledgeable people with whom we discussed the possibility of adopting IAS 32 in the United States have expressed significant concerns. These concerns are based on the questions that the IASB and its staff have received, the international accounting firms' published guidance on how to apply IAS 32, and on discussions with U.S. constituents. Even if targeted improvements are made, IAS 32 may not be effective in the United States. IAS 32 does not explicitly address many of the issues that existing U.S. GAAP addresses and that U.S. constituents expect to be

addressed. As a result, it could be very difficult to apply consistently and the FASB and SEC will undoubtedly receive the same questions that have been addressed in the past.

20. Conversely, concerns have been expressed by IASB board members about (a) the sequencing of events related to the project if one of the proposed options are chosen and (b) the implications of making the targeted improvements without the FASB ever intending to adopt IAS 32.

21. First, if the FASB intends to adopt IAS 32, there are members of the IASB that have expressed concern that if the adoption of IAS 32 does not occur prior to making targeted amendments, the detailed guidance provided in U.S. GAAP will inevitably make its way into practice and there is a risk that IAS 32 will become a "rules-based" standard. Second, if the targeted improvements are made without any intention of the FASB adopting IAS 32, then the boards will not reach a fully converged standard.

22. The staff recognizes the concerns that both boards have about the options that have been presented. However, the staff believes that the areas suggested for targeted improvements are known problem areas that should be addressed in the near term. Addressing those issues now will bring IFRS and U.S. GAAP closer to convergence in areas that we are certain are divergent. The staff believes that the issue of IAS 32 adoption in the United States should not preclude the boards from deciding to move forward with improvements.

Question 1

1. Do you agree that the areas recommended for targeted improvements are appropriate? If not, why not?

Question 2

2. If the appropriate way forward is to address the areas recommended in this paper, are FASB members willing to commit to adopt IAS 32 as improved? If not, is the IASB willing to proceed with the targeted improvements?

Question 3
3. If the boards decided to proceed with the targeted improvements, should the deliberations be joint or separate?

Rejected Views

23. The staff discussed five alternatives with the boards individually and determined that three of the five alternatives were not feasible to move the project forward. The discussion that follows is, in part, a recap of the issues discussed with the boards in previous meetings.

Staff Analysis

Alternative (a)—Narrow View of Equity

24. Under Alternative (a), all share-settled instruments would be classified as liabilities (except employee stock options, which the boards have affirmatively decided to exclude from the scope of this project).

25. A narrow view of equity approach would require liability classification for all rights issues and other forms of derivatives and convertible instruments. Furthermore, the approach would classify preferred shares that are mandatorily convertible into common shares as liabilities. Many constituents and members of both boards would likely oppose the results of such an approach and therefore the staff has rejected this approach.

Alternative (d)—Defer Work

26. The project clearly meets the agenda criteria of each board and would not be discontinued based on its technical merits. Furthermore, the staff conducted discussions with regulators and subject experts and determined this area of accounting is still one of concern that needs to be addressed. Consequently, any decision to drop or defer work on the project would be based on the relative urgency of this project as compared to other projects on the boards' agendas.

Alternative (e)—Continue with Exposure Draft

27. As previously documented, the staff has significant concerns with continuing to develop the approach described in the recent Exposure Draft as is evidenced by the numerous comments received by external reviewers. The requirements in the Exposure Draft are intended to classify most (if not almost all) instruments in the same way in which they are currently classified in IFRS and U.S. GAAP. However, the words are radically different from either set of current standards, which raises a high risk of confusion and unintended consequences.

28. Furthermore, many U.S. external reviewers expressed concern that the Exposure Draft did not address many issues about share-settled instruments that the FASB and the EITF have resolved (slowly) over the last several years. A new standard that does not address those issues will almost certainly raise all of the same questions again, at least in the United States. Incorporating the detailed requirements in Subtopic 815-40, Derivatives and Hedging—Contracts in Entity's Own Equity,[4] might prevent those questions from arising again, but IAS 39, *Financial Instruments: Recognition and Measurement*, is much less specific, and at its July meeting, the IASB expressed no interest in adding that type of complexity.

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[4] The requirements referred to here were originally issued as EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," (now included in Topic 815) or EITF Issue No. 07-5, "Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock" (now included in Topic 815).

Appendix A – Targeted Improvement Details

Targeted Improvements Specifics

1. The staff has included this appendix to give the boards an idea of what the targeted improvements might entail. The appendix is intended to be an overview of what the fixes for each of the areas may look like and is not intended to be a completely analyzed approach.

Fixed-for-fixed interpretation issues

2. The implications of the issues and potential solutions surrounding EITF Issue 07-5 for the IASB are not clear at this point. However, adopting the term *standard anti-dilution provisions* that is defined in U.S. GAAP,[5] adjusted for differences in standard provisions from jurisdiction to jurisdiction, might resolve some of the IASB's problems with share-based derivatives.

3. Also, we tend to view the bifurcated *derivative* as if it were a real stock option, (i.e. a swap of cash payments for shares), when it actually is a defined way of settling an outstanding debt instrument. Thus, the fixed-for-fixed provision may not need to be applied to the potential cash settlement of convertible debt.

Convertible Debt

4. The ideal outcome for both boards would be to answer the questions and resolve problems that each one faces by adopting a single set of requirements. One possibility would be to require separation of convertible debt if that debt is convertible into a number of shares that is fixed except for the effects of standard anti-dilution provisions and if the cash settlement alternative is fixed in any currency. That possibility may answer many, if not all, of the questions that the IASB has received.

5. However, under that approach, an entity would be able to avoid separation easily (and thereby avoid additional interest expense) by varying the share count other than by a standard anti-dilution provision or by varying the cash settlement for

[5] Section 815-40-20 defines *standard anti-dilution provisions* as those that result in adjustments to the conversion ratio in the event of an equity restructuring transaction that are designed to maintain the value of the conversion option.

reasons other than foreign currency denomination. To resolve that concern (which may be mostly a U.S. issue), all convertible debt instruments could be bifurcated and only those that qualify as described in the previous paragraph would have an equity component. Convertible debt without an equity component would be treated as two liabilities (at least one of which would be measured at fair value) or recombined if the instrument is measured at fair value in its entirety. The boards would need to decide how to report the changes in fair value. For example, would a portion be considered interest expense?

Mandatorily Redeemable and Puttable Instruments

6. The Exposure Draft described a more principles-based requirement for the classification of redeemable instruments. That requirement is not perfect, but it was less criticized by reviewers than the other aspects of the Exposure Draft. The primary concern of the reviewers was the clarity of some of the terms. For example, to make the Exposure Draft requirement workable, the boards would need to clarify the term *participation*, but that seems to be achievable. Another concern is the very different contexts in which the two boards would apply that provision. For example, terms such as *puttable* and *mandatorily redeemable* are defined differently in IFRS and U.S. GAAP. Additionally, SEC literature dictates the classification of redeemable instruments as temporary equity in particular circumstances for public companies. However, notwithstanding those issues, we believe both sets of standards could be improved with a single new requirement.