Project	**Financial instruments with characteristics of equity**
Topic	**Summary of External Review Comments**

Introduction

1. Seven external reviewers were provided with a copy of the preballot draft of the boards' exposure draft, *Financial Instruments with Characteristics of Equity*. We received over 600 written comments on the standard and implementation sections of the document (the basis for conclusions was not distributed to the reviewers), and two of the external reviewers did not provide their comments in writing.

2. The purpose of this memo is to describe what we consider to be the most significant comments that we received on the preballot draft. For some, but not nearly all, of the significant comments of reviewers, we have suggested some possible quick fixes. However, as noted in FASB memo 95/IASB Agenda Paper (AP) 2A, we are recommending that the boards discontinue any further work on this approach.

3. We are concerned that board members may underestimate the comments received by reading this paper. The volume and depth of detail in the comments was significant, and we found it extremely difficult to communicate that in a summary. If the boards decide to move forward with the approach in the preballot draft, many lesser issues not discussed in this paper also will have to be considered.

4. At the very least, we think an exposure draft in this project should accomplish three things:

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

(a) Clearly articulate the proposed requirements

(b) Ensure that the issues that are addressed in current US GAAP and IFRS are considered in the proposed requirements.

(c) Consider known practice issues in US GAAP and IFRS.

5. In general, external reviewers do not think the document as currently drafted meets those three objectives. We agree with their assessment. This paper is organized as follows:

   (a) Staff's general observations

   (b) The most significant and pervasive issues:

      (i) Lack of principles

      (ii) Inconsistent or illogical results

      (iii) Failure of the specified-for-specified criterion to achieve its objective

      (iv) Structuring opportunities provided by separating convertible debt

      (v) Too many unanswered questions in the requirements to remeasure redeemable equity instruments and components.

   (c) Board decisions that need additional explanation

   (d) Additional issues that should be addressed.

Staff's general observations

6. We have made a few broad observations about the reviewers' comments:

   (a) The requirements described in the exposure draft are broadly similar to current US GAAP and IFRS and therefore provide the same classification results in many cases. Because the preballot draft would not change the classification of many instruments, the reviewers found it difficult to read the proposals without considering the current accounting requirements and

the language used to describe those requirements. In some cases, the current requirements are significantly more detailed than the proposals. Without drastically changing the classification approach in the preballot draft, we think it probably will be difficult to get constituents to view the approach as "new" and not consider the "baggage" that is associated with current US and IFRS requirements.

(b) The level of detail of current liability/equity literature under US GAAP is different than under IFRS. In the US, there is a lot of literature that addresses specific narrow issues that was developed to answer implementation questions and prevent structuring opportunities as they arose in practice. In most cases, it is very detailed. As a result, many of the US reviewers seemed to focus on ensuring that all of the issues that are currently addressed under US GAAP are explicitly addressed in the exposure draft. For example, most reviewers noted that the proposed requirements attempt to address the requirements in Subtopic 815-40, Derivatives and Hedging—Contracts in Entity's Own Equity, (formerly issued as EITF 07-05 and 00-19) in two sentences. Reviewers suggested that the boards adequately address how each of the instruments described in Subtopic 815-40 are evaluated under the new proposals. If the proposals do not address particular issues that are addressed in current literature, we think that (i) constituents will undoubtedly continue to use the current requirements to "fill the gaps" and (ii) the boards will likely receive requests to address these issues after final guidance is issued.

(c) IAS 32 *Financial Instruments: Presentation* does not have (i) the same level of detail as U.S. GAAP and (ii) as many interpretations. Some of the reviewers expressed concern that the lack of application and interpretational guidance has resulted in inconsistent application. For example, some told us that the "fixed-for-fixed" principle in IAS 32 is not consistently applied. Other reviewers noted that the preballot draft contained even less guidance than IAS 32 in some cases; eg, the proposals do not explicitly address contingent settlement provisions whereas IAS 32 does. As a result, the

reviewers expressed concern that the proposals would not address existing practice problems.

(d) Several reviewers questioned whether the proposals would result in an improvement to current US GAAP and IFRS. One of the FASB's objectives in this project is to eliminate more than 60 pieces of current US accounting literature because that literature is inconsistent, subject to structuring, and difficult to understand and apply. Some reviewers questioned whether the boards' preballot draft would achieve that objective. For example, reviewers questioned whether it was the boards' intention or whether it was appropriate to eliminate existing requirements for induced conversion accounting. Others are concerned that eliminating the current requirements for beneficial conversion features would allow for structuring opportunities. Finally, others were disappointed that the document did not address some outstanding questions about IAS 32 that the IFRIC decided not to address.

The most significant and pervasive issues

Issue #1—Lack of principles

7. As an overall comment, the reviewers said that the document does not contain a clear and consistent underlying principle, which made it difficult to understand. The reviewers noted that the proposals discuss several notions for distinguishing equity from non-equity but do not provide enough information about how those notions should be applied (eg, which notion is primary) or how they interrelate. For example, the proposals discuss:

(a) the nature of the instrument's claim (how and when the instrument would be settled);

(b) whether the instrument represents the "foundation of an entity's capital structure" or are the "first claims at risk"; and

(c) whether the instrument is a "fundamental equity instrument".

8. The lack of a clear and consistent principle made it difficult (and, in some cases, impossible) for the reviewers to determine how an instrument should be classified if the proposals do not specifically describe that instrument. Reviewers also expressed concern that the lack of a clear and consistent principle could lead to increased complexity and practice issues.

Staff Analysis and Potential Solutions

9. Admittedly, the principles in the preballot draft present the aggregation of individual conclusions about the classification of particular instruments. The following discussion assumes that we will not change any of the results that were intended in the preballot draft. That is, the classifications would remain the same; only the way the classification is achieved would change.

10. At a minimum, we believe the boards need to settle on a description that involves a single principle with exceptions. We acknowledge that we have not been successful in explaining the requirements in a clear and concise manner without exceptions. One way to deal with this issue is to begin with the following principle and make exceptions for particular share-settled instruments, mandatorily redeemable and puttable instruments and instruments that are issued by limited life entities, which the boards decided should be classified as equity.

    Classification principle: An instrument is classified as equity if it gives the holder the right to force the entity to settle only if the issuer (a) chooses to distribute all of its assets or (b) is required by an event (such as bankruptcy) to distribute all of its assets.

11. That principle would result in classifying all instruments that require settlement prior to liquidation as liabilities regardless of whether they are settled in shares or cash. Exceptions would be made for some puttable and mandatorily redeemable instruments and for those share-settled instruments that are viewed as not using shares as currency.

12. An alternative would be a principle based on settlement with cash or other assets. That also would require an exception for some puttable and mandatorily

redeemable instruments and for some share-settled instruments. Unlike the first alternative, the exception would go in the opposite direction; share-settled instruments would be equity except for those that use shares as currency. That is more similar to existing U.S. GAAP than the first principle suggested, but since it appears that most types of share-settled instruments are intended to be liabilities, the exceptions to the principle would be more numerous. However, some may prefer it because employee stock options not viewed as using shares as currency (if there are any such instruments) would not be in the list of exceptions.

13. Neither principle would resolve the issues of settlements that may be in cash or in shares, including the entity's ability to settle in shares (ie, does the entity have enough shares authorized), who has the choice over how the instrument is settled and similar issues.

14. Reviewers also had difficultly determining which instruments should be separated. The board identified a separation principle, which is clear and operational. That principle is as follows:

Separation principle: An instrument is separated into two components if both of the following occur:

(a) the instrument requires a payment and that payment does not meet the criteria for equity classification (the liability component); and

(b) after the payment is made, an equity instrument remains outstanding (equity component).

15. However, in addition to the instruments described in that principle, the boards decided that some puttable shares and convertible debt should be separated. Reviewers found themselves searching for an underlying principle explaining why those instruments are separated. They wanted to draw analogies to justify separating other instruments that they believe are similar. The requirements in the preballot draft allowed for no principle for separating those instruments (a least no principle consistent with the other principles in the document); therefore, we believe it would be clearer to describe them as exceptions.

Issue #2—Inconsistent or illogical results

16. A prepaid forward purchase contract is classified as an asset under the preballot draft while a forward contract that is not prepaid is classified as a gross liability and contra-equity. Also, a freestanding purchased call option is an asset under the preballot draft; however, if a purchased call option is embedded in a share, the whole instrument is classified as equity. Many questioned why that is appropriate and opined that it would provide structuring opportunities. We acknowledge that some of those outcomes are the same under current IFRS (ie, whether a prepaid forward purchase contract or a purchased call is classified as an asset or contra-equity depends on whether the instrument meets the fixed-for-fixed principle). Under current US GAAP, a prepaid forward purchase contract and a purchased call option are generally classified as contra-equity.

Staff Analysis and Potential Solution

17. The easiest solution to this issue is to report forward contracts net instead of gross on the statement of financial position.

Issue #3—Failure of the specified-for-specified criterion to achieve its objective

18. In general, most reviewers noted that the "specified-for-specified" criterion is very similar to the "fixed-for-fixed" criteria in IAS 32, which has been an ongoing practice issue. The reviewers urged the boards to further clarify the requirements and provide specific examples demonstrating its application; otherwise, diversity in practice would exist. (We believe that a sufficiently clear description of the requirements should not need examples to demonstrate application.)

19. Several reviewers stated that they were not sure whether the boards intended to narrow or broaden the "fixed-for-fixed" criterion in IAS 32, which we found troublesome. Most reviewers noted that very few, if any, derivatives will meet the specified-for-specified criterion described in the draft document. As a result, almost all derivatives would be classified as non-equity. Most derivatives would fail based on one or more of the following reasons:

(a) Many common anti-dilution provisions and other adjustments do not meet the "specified *number*" condition. Few, if any, such provisions adjust the number of shares for *all* types of changes in the number of shares to maintain a fixed percentage of shares outstanding, as the specified-for-specified criterion would require. Most or all have specified triggering events that do not cover all possible reasons for changes in shares outstanding.

(b) The "specified *price*" condition related to functional currency is too prohibitive. For example, the currency in which the reporting entity issues instruments to domestic shareholders can be different from both (i) the issuer's functional currency and (ii) the holder's functional currency. Such an instrument would fail the specified-for-specified criterion. Additionally, the reviewers expressed concern about whether it was possible to identify the domestic or functional currency of every instrument holder and asked what would happen if the original instrument holder sells the instrument to someone else.

(c) Some rights issues that are currently classified as equity under the IASB's recent amendments to IAS 32 would not qualify for equity classification under the proposals because those rights issues are denominated in a currency **other than** the issuer's functional currency and the holder's functional currency. (As discussed further below, the amendments to IAS 32 allow for a fixed amount of **any** currency.)

(d) Most derivatives have contingent settlement features that are triggered in particular circumstances, and those features would prohibit equity classification under the proposals. Many reviewers noted that most instruments have a cash settlement feature that is triggered by the issuer's bankruptcy, which would result in liability classification under the boards' proposals.

Staff Analysis and Potential Solutions

Anti-dilution provisions

20. We believe the boards intended to allow instruments with anti-dilution provisions to be classified as equity; however, the requirements in the preballot draft involve maintaining a fixed percentage of shares outstanding. Few, if any, anti-dilution provisions work that way. Many reviewers pointed out that existing US GAAP addresses that issue with a reasonable degree of success and expressed concern that the preballot draft would not do it as well. Reviewers also noted that practitioners have asked for more guidance to address specific anti-dilution provisions (eg, adjustments for special dividends or adjustments that exceed a specified amount) under IAS 32.

21. US GAAP defines standard antidilution provisions as follows:

> Standard antidilution provisions are 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.

22. Equity restructuring is further defined as follows:

> A nonreciprocal transaction between an entity and its shareholders that causes the per-share value of the shares underlying an option or similar award to change, such as a stock dividend, stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend.

23. The easiest solution to this issue is to carry forward the existing US GAAP definitions above.

"Specified price" and rights issues

24. The comments in subparagraphs 19(b) and 19(c) should be discussed together. The foreign currency requirement in the specified-for-specified criterion was included primarily to ensure that rights issues are classified as equity. However, as noted in subparagraphs 19(b) and 19(c), reviewers said that the terminology used in the proposed requirements did not appear to achieve that goal.

25. The reviewers suggested the following two solutions to this issue, which we believe could be a practical quick fix to the issue:

   (a) Use wording similar to the amendment to IAS 32, *Classification of Rights Issues*. One way to do this would be to use the following sentence:

   For this purpose, rights, options or warrants to acquire a specified number of the entity's own shares for a specified amount of any currency are classified as equity if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments.

   OR

   (b) Use the following wording:

   For this purpose, rights, options, or warrants to acquire a specified number of the entity's own shares for a specified amount of any currency are classified as equity if the exercise price is denominated in the currency of a market in which the entity's equity securities trade.

Contingent Settlement Features

26. In the preballot draft, any instrument with a contingent settlement provision that could require cash settlement would be classified as a liability. Both US GAAP and IFRS have requirements for contingent settlement features.

27. Under IFRS, an instrument is classified as a liability if settlement is based on uncertain future events outside the control of both the issuer and the holder unless:

   (a) the contingent settlement provision is *not genuine*[1]

   (b) settlement in a way that would make the instrument a financial liability can

[1] Paragraph AG28 of IAS 32 describes the term *not genuine* as extremely rare, highly abnormal and very unlikely to occur. As a result, a contract that requires settlement in cash or a variable number of the entity's own shares only on the occurrence of an event that is genuine is an equity instrument. Similarly, settlement in a fixed number of an entity's own shares may be contractually precluded in circumstances that are outside control of the entity, but if those circumstances have no genuine possibility of occurring, the instrument is classified as equity.

be required only in the event of the liquidation of the issuer; or

(c) the instrument is redeemable and is classified as equity in its entirety.

28. Questions have arisen in practice about the notion of control; for example, how does one determine whether an event is within control of the issuer and/or holder. IAS 32 does not address that issue. The issue will more than likely arise again if not addressed.

29. At least two pieces of US GAAP related to financial instruments base classification on control. Under Topic 718 (originally issued at Statement 123(R)) a contingent liability would not be recorded until the occurrence of the event is probable. That would result in not reporting the obligation as a liability until just before it becomes payable, which would probably not be favored by users.

30. Subtopic 815-40 (originally issued as EITF 00-19), provides detailed requirements to determine whether delivery of shares is within the control of the company. Those detailed requirements could probably be incorporated into the preballot draft.

Issue #4—Structuring opportunities provided by separating convertible debt

31. Under the proposed requirements, the debt component would be measured as if it is a freestanding (vanilla) debt instrument. Any non-equity derivatives (eg, any embedded puts or calls) would be included in the equity component. At least one possible structuring opportunity has been identified. In general, it would allow almost any derivative-like feature to go in equity as long as it was embedded in a convertible debt instrument. The example was provided to the staff confidentially. If board members are interested in seeing the example, please contact the staff.

Staff Analysis and Potential Solutions

32. There are two ways to resolve this issue. The first is to **not** to establish a requirement in this project to separate any convertible debt instruments. Instead, classify them as liabilities in their entirety and subsequently measure them under

the proposed requirements in the boards' financial instruments projects. For the FASB, the instrument would be measured at fair value through net income. For the IASB, the instrument would be bifurcated into a host and an embedded derivative (the conversion feature) or designated under the fair value option.

33. The second alternative is to put all embedded features except for the conversion option into the liability component and initially measure the liability component at the fair value of a similar liability without the conversion option. That is consistent with the requirements in IAS 32. Subsequently, the liability component would continue to be measured at fair value through net income under the FASB's financial instrument proposals. For the IASB, the instrument would be assessed to see if the embedded non-equity derivatives (eg, the call, put or prepayment option) are closely related to the host (see paragraph AG30(g) of IAS 39 *Financial Instruments: Recognition and Measurement*). If the embedded derivatives **are** closely related to the host, the entire liability would be measured at amortized cost. If they are **not** closely related to the host, the liability would be separated into a host and an embedded derivative. In either case, the entity may be able to designate the liability under the fair value option.

34. A couple of issues arise under the second alternative. First, we think the boards' objective in separating convertible debt was to show interest expense. If the liability component is subsequently measured at fair value under the FASB's accounting for financial instruments project (or under the IASB's fair value option project), interest expense will not be reported unless the boards want to require disaggregation in the income statement of changes in fair value into interest and other changes. The boards briefly discussed disaggregation in the income statement in this project and concluded that it is not in the scope of this project. Under the IASB's proposals, interest expense would be reported (either in the statement of comprehensive income or in the notes) if the liability is at amortized cost.

35. The second alternative also has the potential to create structuring opportunities. Once the boards allow particular convertible debt instruments to be separated,

some entities will try hard to ensure that their instrument is separated so that they can report the conversion option in equity and prevent gains and losses from being reported in net income. Therefore, an airtight description of the types of convertible debt instruments to be separated will be critical.

36. The proposed requirements in the preballot draft would require instruments that are convertible into a specified number of shares to be separated into liability and equity components. External reviewers noted that this requirement could encompass a lot of convertible debt instruments and wondered whether that was the boards' intention. For example, some convertible debt instruments have variability in the interest or principal payments. Other convertible debt instruments have principal payments that are indexed to things other than shares, for example, gold. We are not certain what types of convertible debt instruments the boards' intended to separate.

Issue #5—Too many unanswered questions in the requirements to remeasure redeemable equity instruments and components

37. There is a requirement in current U.S. GAAP to measure redeemable equity instruments at current redemption that is similar if not identical to the one in the preballot draft. Reviewers stated that there are problems in implementing that requirement because of complexities in the redemption requirements. For example, if an instrument is redeemable in 7 years for one amount if X happens and in 10 years for a different amount if Y happens, how do you decide which amount to use when remeasuring the current redemption value?

38. Similarly, for puttable financial instruments classified as equity, current IFRS requires an entity to disclose the expected cash outflow on redemption or repurchase (see IAS 1 *Presentation of Financial Statements*, paragraph 136A(c)). Some constituents have told us that the disclosure is very difficult and, in some cases impossible, to prepare because there is significant uncertainty about (a) the amount at which the instruments will be redeemed (eg, if they are redeemable at fair value) and (b) the date of redemption (eg, if they are redeemable at any time).

Staff Analysis and Potential Solutions

39. We do not have a quick solution for this issue.

Board decisions that need additional explanation

40. **More precise guidance is needed on which puttable or mandatorily redeemable instruments would be classified as equity in their entirety.** The reviewers said that, as written, the proposals are too broad and raise too many questions. For example:

    (a) Additional discussion is needed on terms such as "maintain control of the entity", "engage in transactions with the issuer" and "actively participate in the activities of the issuer." Reviewers were unable to determine whether instruments such as puttable interests in some cooperatives, mutual funds or other types of investment companies would qualify for equity classification.

    (b) Additional guidance is needed to describe the characteristics of the redeemable instruments that would be classified as equity under the proposals. The reviewers were concerned that without additional explanation, the proposals would be inconsistently applied or structuring opportunities would arise. For example, can an instrument be classified as equity in its entirety if the redemption amount is linked to a variable such as gold? Or, can a redeemable instrument be classified as equity in its entirety if only some of the entity's issued instruments are redeemable (and other issued instruments are perpetual)? Or, what if most parties must hold a redeemable instrument in order to transact with the issuer but other parties can transact with the issuer without holding such an instrument?

41. We have not yet attempted to rewrite the requirements for equity classification of puttable and redeemable instruments, but based on the nature of the reviewers' comments, we believe that rewriting the requirements more precisely is possible. They were written too broadly, and we now have a better understanding of the specific points that need to be addressed.

42. **Further explanation is needed about how liability and equity components of a separated instrument should be initially measured.** Some reviewers recommended that the proposals need to address how an entity would measure the components of an instrument with multiple liability and equity features. For example, consider a puttable convertible preferred shares—should the measurement of liability component (the put option) be measured as a put on a convertible preferred share or as a put on a non-convertible preferred share? Also, some reviewers questioned how to deal with a situation in which the fair value of the liability component exceeds the proceeds of the entire instrument (in other words, the equity component would have a negative value). US reviewers noted that this situation is common in practice and current accounting requirements do not address the issue.

43. This issue would seem to require more research and we may need to request more information. (Maybe we could post a semiformal staff request for information on the boards' websites, which is a technique that has been used by the FASB staff a few times in the past). Although it seems unbelievable that an embedded conversion option could have a negative value, we have been assured that the situation occurs. That is extremely troubling because it is nearly impossible to understand how an entity would have to accept less for a convertible instrument than for an otherwise similar nonconvertible instrument. Unless the issuers and their advisors are foolish (which is highly doubtful), the supposedly comparable nonconvertible instruments are not actually comparable, or there are other embedded options that favour the issuer instead of the holder and overwhelm the value of the conversion option. We were unable to get enough information to figure that out, and what we heard was anecdotal and not detailed.

Additional issues that should be addressed

44. **Contingent settlement features**. Many instruments have settlement requirements that are contingent on the occurrence (or non-occurrence) of particular events. Most of those features would cause the instrument to be classified as a liability

under the proposed requirements in the preballot draft. However, some reviewers suggested that not all contingencies should have that effect (eg, what if the issuer has some control over the triggering event or the triggering event is only liquidation?).

45. **Modification accounting for equity instruments and equity components**. At least one reviewer noted that there currently is no authoritative literature that addresses how to determine whether to account for a change to an equity instrument as settlement of the old instrument and issuance of a new instrument or modification of the old instrument.

46. **How to determine whether an entity will have enough shares to settle its share-settled instruments.** If an entity has several share-settled instruments and does not have enough authorized shares to settle all of them, which instruments should be classified as equity (if any)? Also, what happens when an instrument will be settled in a variable number of shares? The issuer has no idea how many shares will be necessary to settle the instrument so it cannot determine whether it will have enough shares to settle other instruments. U.S. GAAP currently specifies how to make this assessment, but neither IAS 32 nor the preballot draft does.

47. **Earnings per share calculation.** Many reviewers believe that the impact of the proposed guidance in the preballot draft on the earnings per share calculation should be addressed in a future draft.

Other points

48. In addition to the points discussed above, the reviewers raised other items, which we may be able to address through drafting but will still require additional thought. Those items related to issues such as:

    (a) The proposed definitions of some defined terms are not the same as existing literature or in practice (eg, puttable share).

    (b) Some of the words used in the proposals are not commonly understood (eg,

perpetual ordinary share). Similarly, the proposals discuss "required dividends" and the reviewers said that the term needs to be explained because it is not always clear in practice whether a dividend is required (eg, the terms of the instrument require a dividend to be paid but the shareholders can vote to waive that requirement). Or, in some jurisdictions, the entity may be required on an annual basis to pay a fixed percentage of the net income to the instrument holders (eg, real estate investment trusts (REITs) in the US)—is that payment a "required" dividend?

(c) Some obligations are created by law or regulation rather than by the contractual terms of the instrument (eg, in some jurisdictions, mandatory dividends or redemption requirements are statutory). It is unclear whether the proposals would apply to features that are outside of the contractual terms of the instrument.

(d) The examples in the table at the end of the preballot draft did not provide enough information to determine why a particular conclusion was reached.