Project **Financial instruments with characteristics of equity**

Topic **Moving Forward**

Introduction

1. Both boards have individually discussed a high-level summary of the external review comments received on the preballot of the proposed FASB Accounting Standards Update, *Equity (Topic 505)*: *Financial Instruments with Characteristics of Equity* (exposure draft). FASB Memorandum 95/IASB Agenda Paper (AP) 2A provide an expanded summary of the more significant issues.

2. As discussed in AP2A/Memorandum 95, we have significant concerns about continuing to develop the approach described in the recent preballot exposure draft. The requirements in the preballot 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.

3. Furthermore, many of the U.S. external reviewers expressed concern that the preballot 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

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.

Hedging—Contracts in Entity's Own Equity,[1] 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.

4. The issue is relatively simple: do the incremental benefits of implementing a new standard similar to the requirements in the preballot exposure draft justify the cost to constituents and the risk of undesirable unintended consequences? The staff's answer to that question would be no. This paper identifies alternatives for the boards to consider.

Potential Ways to Proceed in This Project

5. We have identified the following alternatives for the boards to consider:

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

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

[1] 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).

(e) **Alternative (e)**—Continue working on the approach in the preballot exposure draft.

This paper concentrates on Alternative (c), which has not been discussed previously in any detail.

Alternatives (a) and (b) have been described and discussed in detail at past meetings. The staff can provide a more detailed recap of those discussions for board members who are interested.

Alternative (d) is not discussed further. This project clearly meets the agenda criteria of each board and would not be discontinued based on its technical merits. Consequently, any decision to drop or defer the project would be based on the relative urgency of this project as compared to other projects on the boards' agendas.

Alternative (e) is discussed in a separate memo for this meeting.

Staff Analysis

Alternative (a)—Narrow View of Equity

6. 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). That would eliminate the need for detailed and relatively complex requirements related to share-settled instruments, which means that the most significant practical advantage is that a narrow approach would be far simpler to write and to implement. Additionally, a narrow approach would reduce opportunities to structure very similar transactions or arrangements differently to achieve a different financial reporting result. It could be very similar to Approach 4.0, which is based on subordination, or it could be based on settlement requirements (for example, only perpetual instruments in equity).

7. However, a narrow approach would require liability classification for all rights issues and other forms of derivatives and convertible instruments. Additionally, preferred shares that are mandatorily convertible into common shares would be classified as liabilities. Those results most likely would be opposed by many constituents as well as many members of both boards.

Alternative (b)—Amend IAS 32 and Adopt in the U.S.

8. At the July board meeting, a member of the IASB suggested alternative (b). The most significant advantage is that unlike the requirements in the preballot exposure draft, IAS 32 has been tested in practice, and at least some of the "bugs" have been worked out. However, 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, we do not think IAS 32 is really viable in the United States. For one thing, IAS 32 does not explicitly address many of the issues that existing U.S. GAAP addresses. Furthermore, significant portions of the standard would be very difficult to apply consistently. The FASB and the SEC will undoubtedly receive the same questions that have made the IASB want to change IAS 32 and more.

Alternative (c)—Targeted Improvements

9. Under Alternative (c), the boards would amend existing literature to replace the requirements for the following troublesome instruments for which practice problems exist and that are resolvable in the near term:

   (a) convertible debt

   (b) redeemable and puttable instruments.

10. Reporting those instruments causes problems under both sets of standards. The problems of entities that issue only redeemable or puttable instruments are similar under each of set of standards. Reviewers of the preballot exposure draft criticized the proposal in that document because the meanings of some terms were

not clear (such as the term *participate*, which was used to describe being involved in the activities of an entity). Some reviewers provided examples of some of the distinctions that would need to be made, and it appears that the concerns could be satisfactorily addressed.

11. The problems with convertible debt are not the same under IFRS and U.S. GAAP, but they could be solved by more clearly identifying which convertible debt instruments should be bifurcated. That probably could 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. The term *standard anti-dilution provisions* is defined in U.S. GAAP[2] but could be adjusted, if needed, for differences in standard provisions from jurisdiction to jurisdiction. Although we tend to view the bifurcated "derivative" as if it were a real stock option, that is, a swap of cash payments for shares, it actually is a defined way of settling an outstanding debt instrument. Thus, the fixed-for-fixed provision need not be applied to the potential cash settlement of convertible debt.

12. The other significant problem area is the IASB's fixed-for-fixed requirement for share based derivatives. The questions about how to apply the requirement under IAS 32 generally do not arise under U.S. GAAP, either because the guidance is different or because the issues were addressed by the FASB or the EITF. For that reason, it is not listed as a candidate in paragraph 9. However, adopting the term *standard anti-dilution provisions* adjusted, for differences in standard provisions from jurisdiction to jurisdiction might resolve some of the IASB's problems with share-based derivatives.

13. We recommend that the boards consider each of those improvements independently with the goal of making near-term improvements to the most divergent areas of the literature.

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[2] 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.

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[3] 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 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.[4]

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. However, the IASB and its staff have received a number of questions about convertible debt denominated in foreign currencies and about what constitutes a fixed number of shares (for example, variability related to anti-dilution provisions and conversion rates that change over time). The IASB and IFRIC have said that those questions would be addressed in this project.

17. It appears that U.S. reporting entities tend to avoid separation of convertible debt and the consequences for interest expense. Under IFRS, reporting entities seem to

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[3] 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.

[4] 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.

want to separate the conversion option and report it in equity. It is not clear why the motivations are different, and possibly, we have misunderstood. However, the fact remains that the two standards are quite different, and there are significant questions or issues about each one.

18. 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 would answer many, if not all, of the questions that the IASB has received.

19. 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 varying the cash settlement for 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 paragraph 18 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?

20. Because the boards would be making changes in different contexts, the results may not be exactly the same, but we believe the results would be an improvement over existing accounting.

Mandatorily Redeemable and Puttable Instruments

21. Topic 480, Distinguishing Liabilities from Equity, requires all mandatorily redeemable instruments to be classified as liabilities. When that requirement was issued (as FASB Statement No. 150, *Accounting for Certain Financial*

Instruments with Characteristics of both Liabilities and Equity), constituents were alarmed that many entities (for example, 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.

22. IAS 32 includes an exception that allows some puttable and mandatorily redeemable instruments to be classified as equity even though they would otherwise meet the definition of a liability. That exception was established by the amendment issued in February 2008 (puttables amendment). The puttables amendment has been criticized for being rules-based and difficult to apply as well as for not going far enough. The IASB hoped to replace the current requirement as a result of this project.

23. The preballot 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 preballot exposure draft. The primary concern of the reviewers was the clarity of some of the terms. For example, to make the preballot exposure draft provision 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.

Question 1
Which of the following alternatives do you support? a. Narrow view of equity b. Amend IAS 32 and adopt in the United States c. Targeted improvements (related to convertible debt and puttable and redeemable shares d. Defer further work e. Continue working on the approach that was discussed in the preballot exposure draft.