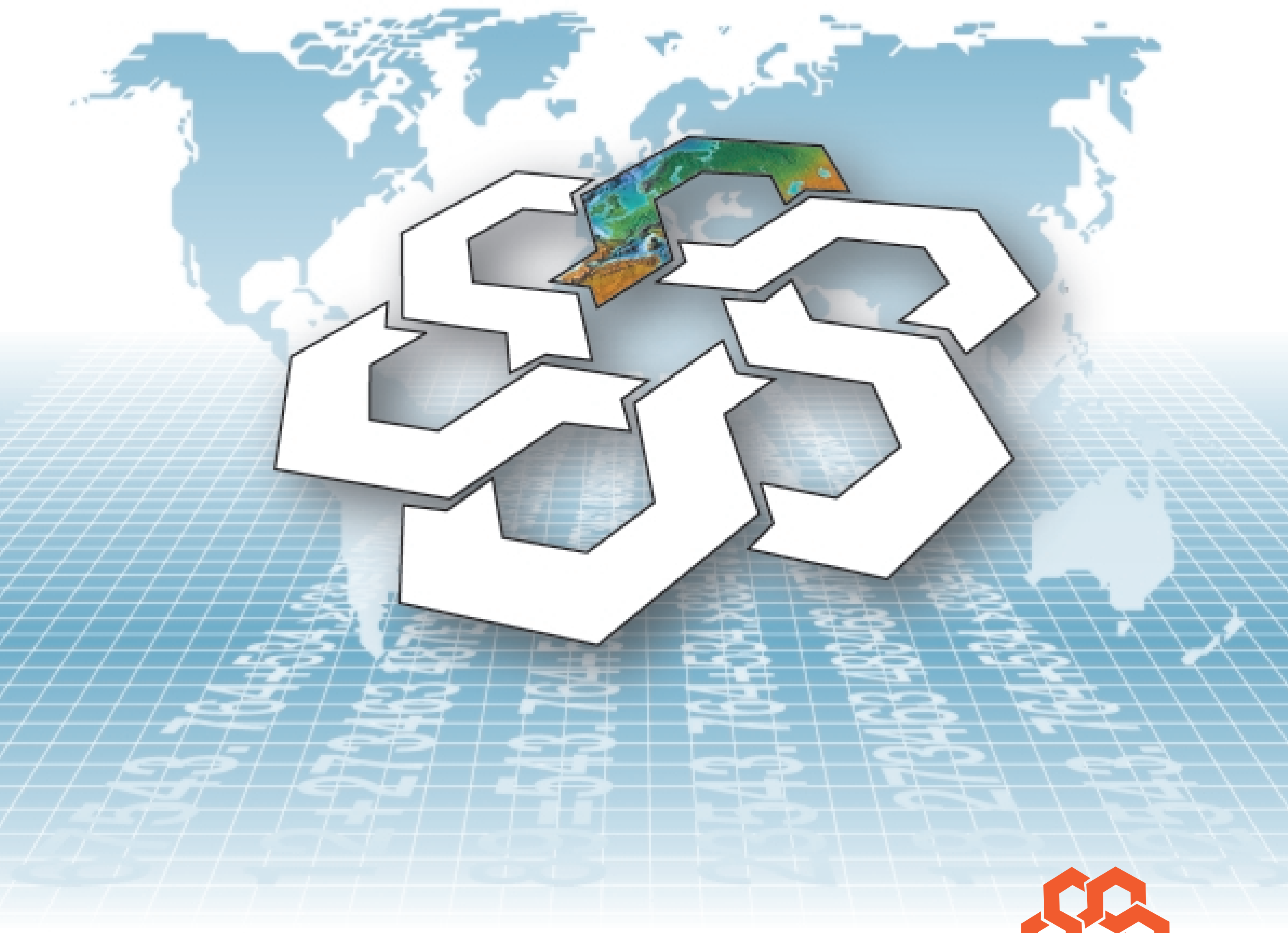
February 2008

DISCUSSION PAPER

Financial Instruments with Characteristics of Equity

Invitation to Comment

Comments to be submitted by 5 September 2008



International
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Discussion Paper

Financial Instruments with Characteristics of Equity

Invitation to Comment

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INVITATION TO COMMENT

Introduction

1 In November 2007 the US Financial Accounting Standards Board (FASB) published a Preliminary Views document *Financial Instruments with Characteristics of Equity*. That document considers the distinction between liability and asset instruments and equity instruments.

2 The International Accounting Standards Board (IASB) did not participate in the development of the FASB document and has not deliberated any of its conclusions. The FASB document represents the views of the FASB only and describes issues in the context of US generally accepted accounting principles (GAAP), unless explicitly stated otherwise.

3 In February 2006 the IASB and the FASB published a Memorandum of Understanding (MoU) *A Roadmap for Convergence between IFRSs and US GAAP–2006 to 2008*, affirming their commitment to convergence. One of the goals for 2008 set out in the MoU is 'to have issued one or more due process documents relating to a proposed standard' on the distinction between liabilities and equity.

4 This discussion paper, which comprises an Invitation to Comment and the FASB Preliminary Views document, fulfils that commitment.

5 The Invitation to Comment includes background information relevant to International Financial Reporting Standards (IFRSs). It also includes questions for respondents that are in addition to those asked in the FASB document.

6 In January 2008 the European Financial Reporting Advisory Group (EFRAG) published a discussion paper *Distinguishing between Liabilities and Equity*[*] on behalf of the Pro-active Accounting Activities in Europe (PAAinE). That paper describes the loss absorption approach. As noted in paragraph E11 of the FASB Preliminary Views document, the loss absorption approach classifies instruments or components of instruments as equity if the instrument's claim on net assets is reduced if the entity incurs a loss.[†]

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* http://www.efrag.org/files/ProjectDocuments/PAAinE%20-%20Equity%20-%20Liability/DP%20PAAinE%20Equity-Liabilities.pdf

† When releasing a document for public consultation, the IASB's policy is to alert readers to alternative proposals. The IASB has not discussed these alternative proposals and thus reference does not signal the IASB's endorsement. Rather, the reference is meant to facilitate consideration of the alternatives by interested parties.

7 The liabilities and equity project is on the IASB's research agenda. Following the publication of this discussion paper, the IASB will consider a proposal to add the project to its active agenda. If the project is added, the IASB intends to undertake it jointly with the FASB. The responses to this discussion paper will be considered in that project as the boards develop a common standard.

Invitation to comment

8 The IASB invites comments on all matters in the discussion paper. Appendix B of the Invitation to Comment contains questions for respondents that are in addition to those asked in the FASB document. The IASB requests comments in response to both sets of questions. Comments are most helpful if they:

(a) comment on the questions as stated.

(b) indicate the specific paragraph or paragraphs to which the comments relate.

(c) contain a clear rationale.

(d) describe any alternative the IASB should consider.

9 Respondents need not comment on all of the questions and are encouraged to comment on any additional issues.

10 The IASB will consider all comments received in writing by **5 September 2008**.

Summary of relevant IFRS requirements

11 IAS 32 *Financial Instruments: Presentation* sets out the relevant guidance for distinguishing between liability and asset instruments and equity instruments.[*] In this discussion paper, liability instruments and asset instruments are referred to as 'non-equity instruments'.

12 IAS 32 defines a financial liability as a contractual liability that has particular characteristics. A financial liability may be an obligation to deliver a financial asset to another entity (or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity). Alternatively, a financial liability

* IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* applies the principles in IAS 32 to financial instruments issued to members of co-operative entities that evidence the members' ownership of the entity.

may be a contract that will or may be settled in the entity's own equity instruments. That contract may be a non-derivative contract that will or may be settled in a variable number of the entity's own equity instruments or a derivative contract that will or may be settled other than by the exchange of a fixed amount of cash (or another financial asset) for a fixed number of the entity's own equity instruments.

13 IAS 32 defines an equity instrument as any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. Whether a financial instrument (or part of a financial instrument) is classified as an equity instrument depends on the definition of a financial asset and a financial liability.

14 A contract that will be settled in the entity's own equity instruments and is for the delivery or receipt of a fixed amount of cash for the delivery or receipt of a fixed number of equity instruments does not meet the definition of a financial asset or of a financial liability. Therefore, it is classified as an equity instrument under IAS 32. In this discussion paper, this is referred to as the 'fixed for fixed' principle.

Criticisms of IAS 32

15 In general, there are two broad classes of criticisms of the distinction set out in IAS 32 between equity instruments and non-equity instruments:

(a) how the principles in IAS 32 should be applied and

(b) whether application of those principles results in an appropriate distinction between equity instruments and non-equity instruments.

How the principles in IAS 32 should be applied

16 The principle in IAS 32 is straightforward: if a financial instrument (or part of that instrument) does not meet the definition in IAS 32 of a financial asset or a financial liability, it is classified as an equity instrument. In other words, only those financial instruments (or parts of those instruments) that evidence a residual interest in the assets of an entity after deducting all of the entity's liabilities are classified as equity.

17 However, the application of that principle can be problematic and some have asked how it should be applied in specific situations.* For example, questions have arisen related to the following topics:

(a) determining whether a contractual obligation exists

(b) applying the 'fixed for fixed' principle

(c) determining whether a contingent settlement provision exists.

Existence of a contractual obligation

18 A contractual financial obligation exists when an entity does not have an unconditional right to avoid delivering cash (or another financial asset) to another party. That may be difficult to determine because the instrument holder may have multiple relationships with the entity. The instrument holder could be an owner, a manager and an investor in the entity and make decisions in each of those roles. Therefore, whether an entity has an unconditional right to avoid delivering a financial asset to another party may be difficult to ascertain.

Application of the 'fixed for fixed' principle

19 A contract to exchange a financial asset for an entity's own equity instruments is classified as equity only if both the amount of financial assets and the number of equity instruments are fixed. If either the amount of financial assets or the number of equity instruments is not fixed, a financial liability exists.

20 This raises the question of what 'fixed' means. For example, if the amount is fixed but in a currency other than the functional currency of the issuing entity, then the amount is not fixed for the purpose of classifying the financial instrument.

Contingent settlement provisions

21 A financial instrument may require the entity to deliver cash or another financial asset (or otherwise settle the financial instrument in such a way that it would be a financial liability) in the event of the occurrence or non-occurrence of uncertain future events that are beyond the control of both the issuer and the holder of the instrument, such as a change in a stock market index or interest rate. This is known as a contingent settlement provision.

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* Some of these issues have been addressed by the International Financial Reporting Interpretations Committee (IFRIC).

22 Unless the contingent settlement provision is 'not genuine', arises only on liquidation of the issuer or arises in a puttable instrument classified as equity, the financial instrument is classified as a financial liability. The application of the 'not genuine' criterion requires judgement in order to determine how likely (or unlikely) it is that the future event will occur.

Whether application of the principles in IAS 32 results in an appropriate distinction between equity instruments and non-equity instruments

23 The existence of a contractual obligation to deliver a financial asset overrides any other characteristics of the financial instrument for the purposes of classification. Some argue that this results in inappropriate classification of some financial instruments, for example:

(a) if the redemption of an instrument is almost certain, but no contractual obligation exists.

(b) if an entity has no equity instruments because all of the financial instruments issued by the entity are classified as financial liabilities.

(c) if the financial instruments are derivatives that are settled with the issuer's own equity instruments.

Redemption of an instrument is almost certain, but no contractual obligation exists

24 A financial instrument that includes no contractual obligation to deliver a financial asset is classified as an equity instrument. An example is a perpetual instrument with discretionary periodic payments to the holder.

25 However, the dividend amount paid to holders of such an instrument might increase over time and become so large that the entity in effect is forced by the economic circumstances of the transaction to buy back the instrument. Such an instrument includes no contractual obligation. However, with near certainty, the issuer will redeem the instrument.

26 Compare this with an instrument that includes a non-financial obligation that must be settled if, and only if, the entity fails to redeem the instrument. An example is a financial instrument that requires the issuing entity to deliver a fixed amount of wheat if it does not redeem the instrument by a stated date. The value of the non-financial obligation (in this example, the obligation to deliver a fixed amount of

wheat) may substantially exceed the value of the cash redemption. As with the previous example, the entity will almost certainly redeem the instrument (to avoid settling the non-financial obligation). However, this instrument, unlike the previous example, is considered to include an indirect contractual obligation to deliver cash or another financial asset and is classified as a financial liability in accordance with IAS 32.

27 Some argue that the instruments in these two examples are economically similar and should be classified consistently.

An entity has no equity instruments because all of the financial instruments issued by the entity are classified as financial liabilities

28 Some entities issue only instruments that contain a contractual obligation. For example, some types of entities issue only financial instruments that are redeemable at the option of the holder. Unless such instruments contain particular features and meet particular conditions, they are classified as financial liabilities in accordance with IAS 32. As a result, the entity may not have any instruments that are classified as equity.

29 Some believe the situation in the preceding paragraph results in information that is not relevant or understandable.

Derivative financial instruments that are settled with the issuer's own equity instruments

30 The definitions of a financial asset and financial liability in IAS 32 are inconsistent with the definitions of an asset and liability in the IASB's *Framework for the Preparation and Presentation of Financial Statements*. As a result, some derivative financial instruments that are settled with the issuer's own equity instruments would be classified in accordance with the *Framework*'s guidance differently from their classification in accordance with IAS 32.

31 For example, some financial instruments that are settled with the issuer's own equity instruments meet the definition of a financial liability in IAS 32 (paragraphs 19 and 20 above). However, such instruments do not always meet the definition of a liability in the *Framework*. That is because the instrument may not result in the sacrifice of an asset (eg cash); rather it involves the delivery of the entity's own equity instruments. For example, a written call option for a variable number of the issuer's ordinary shares would meet the definition of a financial liability in IAS 32 but would not meet the definition of a liability in the *Framework*.

32 Another example of the differences between IAS 32 and the *Framework* is some purchased options that are settled with the issuer's own equity instruments. Such instruments meet the definition of an asset in the *Framework* because they have the potential to contribute to the entity's cash inflows. However, some of those instruments do not meet the definition of a financial asset in IAS 32 (and are classified as equity) because they meet the 'fixed for fixed' principle.

33 The requirements in IAS 32 for such financial instruments are difficult to apply and some believe that they produce results that are inconsistent with the economic facts of the transactions.

34 Furthermore, IAS 32 requires a liability to be recognised for the future delivery of financial assets (eg cash) to settle a 'fixed for fixed' contract that is classified as equity. Such a contract could be unconditional (eg a forward purchase contract) or conditional (eg a written put option). Such instruments are, in effect, accounted for as though they have been executed. This accounting is inconsistent with the accounting for derivative contracts in IAS 39 *Financial Instruments: Recognition and Measurement*.

Approaches in the FASB Preliminary Views document

35 The FASB document describes three approaches for distinguishing equity instruments from non-equity instruments—basic ownership, ownership-settlement and reassessed expected outcomes (REO). The FASB has reached a preliminary view that the basic ownership approach is the appropriate approach for determining which instruments should be classified as equity. The IASB has not deliberated any of the three approaches, or any other approaches, to distinguishing equity instruments and non-equity instruments.

36 All three approaches use the definition of a *basic ownership instrument*. The characteristics of such an instrument are:

(a) the holder has a claim to a share of the assets of the entity that is subordinate to all other claims if the issuer were to liquidate on the date the classification decision is being made, and

(b) the holder is entitled to a percentage of the assets of the entity that remain after all higher priority claims have been satisfied.

Some instruments that are redeemable (mandatorily or at the option of the holder) meet the definition of a basic ownership instrument.

37 A basic ownership instrument would be classified as equity under all three approaches.

38 Under the basic ownership approach, only basic ownership instruments would be classified as equity.

39 The ownership-settlement approach would also classify as equity other perpetual instruments and some derivative instruments that are indexed to and settled with the entity's basic ownership instruments. Moreover, the ownership-settlement approach would classify a component of an instrument as equity if the instrument has multiple outcomes and one or more of those outcomes provides a return to the holder that has the same general profile as the return to the holder of a basic ownership instrument.

40 In addition to basic ownership instruments, the REO approach would also classify as equity or 'contra-equity'* those instruments or components of instruments whose fair value changes in the same direction as or opposite direction to the fair value of a basic ownership instrument.

41 The main body of the FASB document describes the basic ownership approach in detail. Appendix A describes the ownership-settlement approach. Appendix B describes the REO approach. The discussions of the three approaches also address related issues such as measurement, separation, linkage, substance and settlement. Appendix C includes a comparison of the three approaches.

42 Appendix E of the FASB document briefly discusses three other approaches—the claims approach, the mezzanine approach and the loss absorption approach. However, none of those approaches is fully developed in the document.

IAS 32 and the FASB document: different approaches to defining equity

43 The definition of an equity instrument in IAS 32 cannot stand alone; it depends entirely on the definitions of a financial asset and a financial liability. In other words, IAS 32 defines an *equity instrument* as a financial instrument that is **not** a financial asset or financial liability.

* Contra-equity offsets equity. In other words, it is a debit balance in equity.

44 In contrast, all three approaches in the FASB document use the definition of a *basic ownership instrument*. That definition (described in paragraph 36 above) can stand alone. It does not rely on the definitions of a financial asset and a financial liability.

Possible implications for IFRSs of the three approaches in the FASB document

Numbers and types of instruments classified as equity

45 Table 2 in Appendix C of the FASB document sets out how 25 instruments are classified under US GAAP and would be classified under each of the three approaches. A table based on Table 2 is at Appendix A of this Invitation to Comment with an additional column for classification in accordance with IAS 32. Appendix A demonstrates that the ownership-settlement approach is the most similar to IAS 32 in terms of the number and types of instruments that would be classified as equity.

46 Significantly fewer instruments would be classified as equity under the basic ownership approach than under IAS 32. For example:

(a) perpetual instruments (other than basic ownership instruments) classified as equity in accordance with IAS 32 would be classified as liabilities under the basic ownership approach.

(b) if an entity issues two classes of shares that are not equal in priority, only the class with the lower priority would be a basic ownership instrument even if both classes are labelled as 'ordinary shares.' In contrast, IAS 32 classifies all classes as equity as long as there is no contractual obligation to deliver a financial asset.

(c) no derivative financial instruments would be classified as equity under the basic ownership approach;[*] some are so classified in accordance with IAS 32. As noted in the FASB document, if the basic ownership approach were applied to share-based payment awards, those awards would be classified as liabilities.

[*] However, Appendix C of the FASB document states that a warrant to purchase a basic ownership interest for one cent when the fair value of the basic ownership instrument is substantially higher than one cent is equity because the warrant is a basic ownership instrument in substance.

47 Classifications under the ownership-settlement approach would be broadly consistent with the classifications in IAS 32. However, under the ownership-settlement approach:

(a) more instruments would be separated into components. Therefore, more components of instruments would be classified as equity. For example, a financial instrument that is redeemable at the option of the holder and does not have the characteristics of a basic ownership instrument in its entirety (eg an ordinary share that is redeemable at a fixed price) would be separated into an obligation component (ie a liability to reflect the redemption feature) and a basic ownership component (ie equity). In accordance with IAS 32, such an instrument would be a liability in its entirety unless it contained particular features and met particular conditions and, therefore, was classified as an equity instrument in its entirety.

(b) fewer derivative instruments would be classified as equity. The ownership-settlement approach classifies only those instruments whose fair value changes in the same direction as (not in the opposite direction to) the fair value of the basic ownership instrument and are ultimately settled with a basic ownership instrument. Under the ownership-settlement approach, a written call option on the entity's own basic ownership instruments would be classified as an equity instrument but a written put option would be classified as a liability. IAS 32 classifies as equity both delivery and receipt contracts that are physically settled if they meet the 'fixed for fixed' principle (although an entity may also be required to recognise a liability for any obligation to deliver a financial asset arising as a result of a forward purchase contract or written put option).

48 The REO approach would classify many more instruments, and components of instruments, as equity than does IAS 32. Any instrument or component of an instrument whose fair value changes in the same direction as or the opposite direction to the fair value of a basic ownership instrument is classified as equity or 'contra-equity'. However, some instruments that IAS 32 classifies as equity would be classified as liabilities under the REO approach—for example, all perpetual instruments other than basic ownership instruments.

Remeasurement of the instrument and the related effect on profit or loss

49 As noted above, the basic ownership approach would classify fewer instruments as equity than does IAS 32. This would result in more instruments being remeasured at fair value (for example, derivatives), with gains and losses being recognised in profit or loss. The FASB document does not address how changes in fair value would be presented in the statement of comprehensive income. Moreover, the FASB document does not contain a preliminary view on how perpetual instruments that are not basic ownership instruments should be remeasured.

50 The ownership-settlement approach would result in more derivative instruments being classified as non-equity instruments. Once again, that would result in more instruments being remeasured at fair value with changes being recognised in profit or loss than is required by IFRSs.

51 Many instruments would be separated into components under the REO approach. Each component of a separated instrument, including the equity component, would be remeasured using fair value techniques and gains and losses from remeasurement would be recognised in profit or loss. This would be a significant change to IFRSs.

Separation, linkage and substance of instruments

52 All of the approaches in the FASB document would introduce new concepts to IFRSs or provide additional guidance on existing concepts: for example, separation, linkage and substance.

Separation of instruments and measurement of components

53 A financial instrument may be structured so that it contains both an equity component and a non-equity component. The instrument is neither entirely a liability or an asset nor entirely equity. In general terms, the components reflect alternative or multiple outcomes of the instrument. For example, a convertible bond has alternative outcomes—the issuer may be required to repay the instrument holder in cash, which is a liability of the issuer, or may be required to deliver its own equity instruments.

54 IAS 32 requires the issuer of a non-derivative financial instrument to evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component (eg some convertible bonds). Such components are be classified separately as financial liabilities, financial assets or equity instruments.

55 The basic ownership approach would require separation of financial instruments into equity and non-equity components in fewer situations than is required by IAS 32. That is because significantly fewer instruments would be classified as equity instruments under the basic ownership approach. In order for an instrument to require separation into components under the basic ownership approach, the issuing entity must be able to extinguish the liability component while the equity component remains outstanding. Initial measurement of the components under the basic ownership approach would be similar to IAS 32. The liability component would be measured at the fair value of a comparable liability with no equity component (assuming a 100 per cent probability of a liability outcome) and the equity component would be measured as the residual between the liability component and the transaction amount.

56 The ownership-settlement approach would require more instruments to be separated into components than does IAS 32. The ownership-settlement approach would require any instrument with non-equity and equity outcomes to be separated into two components (an equity component and non-equity component). For example, a basic ownership instrument that is puttable at the option of the holder for a fixed price would be separated into liability and equity components. However, if the instrument were puttable at fair value, the instrument would be classified as equity in its entirety because both outcomes would be regarded as equity outcomes. Under IAS 32, puttable instruments are classified as equity or non-equity instruments in their entirety. Initial measurement of the components under the ownership-settlement approach is similar to that required by IAS 32 (described above in paragraph 55).

57 The REO approach would require the largest number of financial instruments to be separated into two components. Like the ownership-settlement approach, the REO approach would require instruments with non-equity and equity outcomes to be separated into two components (an equity component and a non-equity component). The REO approach requires the use of contingent claims modelling techniques (option pricing models) to measure the components at their relative fair values. The fair values incorporate the probability of each of the outcomes. Moreover, contracts linked to basic ownership instruments would be separated into their exchange components and accounted for gross (eg a written call option on a basic ownership instrument would be recognised as an asset and equity instrument).

Linkage of two or more instruments

58 Linkage requirements dictate when to classify and measure two or more free-standing financial instruments as if they were a single combined instrument. Linkage requirements eliminate the opportunity to choose between alternative accounting results by altering the structure of an arrangement.

59 IAS 32 does not include any linkage principles. Instead, it contains rules to ensure that, in specific situations, two free-standing instruments are classified and measured in the same way as a single instrument with similar characteristics. For example, a liability is recognised for any contract that may require an entity to purchase its own shares except for those puttable instruments that have particular features and meet particular conditions that are required to be classified as equity.

60 The linkage criteria in the basic ownership approach and the ownership-settlement approach are consistent. Two or more instruments would be linked if:

(a) they are part of the same arrangement, either contractually or implicitly, and

(b) accounting for the instruments individually would result in amounts of net income or equity that are different from the amounts that would result from accounting for a comparable single instrument.

However, because of the larger population of instruments classified as equity, linkage is more heavily relied upon in the ownership-settlement approach.

61 The REO approach requires no linkage for *classification purposes* because it subjects all instruments to scrutiny for the purposes of separation and separates anything with an ownership return. One of the primary objectives of the approach is to create an arbitrage-free model of classification. As such, the approach classifies economically similar instruments consistently without the need for linkage criteria. However, to achieve this objective, the approach is complex in other ways, such as the requirement for derivative instruments to be separated into their exchange components.

62 The REO approach may require linkage to achieve *consistent measurements*. For example, if an entity issued fixed rate debt and a share option, it could achieve an economic outcome very similar to that of convertible debt, but the measurements would be different. The fixed rate debt as a

free-standing instrument would be subsequently measured by accreting interest on the transaction price. The debt component separated from the convertible debt would be measured at fair value (as are all components under the REO approach). Consequently, the REO approach requires the debt and the option to be linked for measurement purposes and then separated.

Substance of the instrument's terms

63 Sometimes the substance of an instrument is not represented by its stated terms. In those cases, the stated terms should not affect its classification.

64 IAS 32 uses a similar principle with respect to any contingent settlement provisions of an instrument. A financial instrument may require the entity to deliver a financial asset (or otherwise settle the instrument in such a way that it would be a financial liability) in the event of the occurrence or non-occurrence of uncertain future events that are outside the control of both the issuer and the holder of the instrument. This is known as a contingent settlement provision. If the contingent settlement provision is 'not genuine' it must be ignored for the purposes of classification. A contingent settlement provision is 'not genuine' if the reporting entity deems its occurrence to be extremely rare, highly abnormal and very unlikely to occur.

65 The substance principle in the FASB document is relevant to all terms, not just to contingent settlement provisions. The FASB document states that terms that have only a remote chance of affecting the instrument's outcome in more than a minimal way are not substantive and should be ignored for the purposes of classification.

66 Furthermore, the substance principle in the FASB document applies to terms that are not stated in the contract—for example, a forward contract that is stated to be share-settled also has an unstated cash settlement feature that would be considered substantive if there were more than a remote chance that the entity would default in delivering shares to settle the contract.

67 The substance principle is important under the ownership-settlement approach because classification of instruments relies on the form of settlement.

68 The substance principle is less relevant under the basic ownership and REO approaches. Under the basic ownership approach, there are few (if any) unstated facts that could affect the instrument's classification. Assessing substantive terms under the REO approach is not necessary because the probability of the instrument's outcome is incorporated in its measurement.

Reassessment of classification

69 IAS 32 does not require classification to be reassessed unless the terms and conditions of the instrument have changed, except for some puttable instruments and instruments that impose an obligation only on liquidation of the entity.[*] Equally, IAS 32 does not provide guidance on how reclassifications from equity to liability or vice versa should be recorded, except for reclassification of some puttable instruments and some instruments that impose on the entity an obligation to deliver to another party a pro rata share of net assets of the entity only on liquidation.

70 Under the basic ownership and ownership-settlement approaches, the FASB document would require reassessment at each reporting date to check that the existing classification is appropriate. This could result in instruments being reclassified more frequently than under IAS 32.

71 Guidance on how to perform such reclassifications, and when such reclassifications would occur, is contained in the FASB document. Under the basic ownership and ownership-settlement approaches, no gain or loss would be recognised on reclassification even if reclassification results in remeasurement of the instrument. Instead, an entity would recognise in equity any difference in value upon reclassification.

72 Under the REO approach, reassessment is less relevant because the probability of an instrument's outcome is incorporated in its measurement.

Settlement, conversion, expiry and modification of the instrument

73 IAS 32 provides some guidance on how to account for the repurchase of a convertible instrument and the amendment of the terms of a convertible instrument to induce early conversion. Otherwise, that standard does not provide guidance on how equity instruments are derecognised, except for guidance on the reclassification of some puttable instruments and some instruments that impose on the entity an obligation to deliver to another party a pro rata share of net assets of the entity only on liquidation.

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* IFRIC 2 provides guidance on transfers between financial liabilities and equity. Those transfers occur when the number of shares or the amount of paid-in capital subject to a redemption prohibition change.

74 The FASB document contains detailed guidance on when and how instruments are derecognised under each approach.

75 For the ownership-settlement approach, the guidance is extensive and complex; this complexity is dictated by the approach. The basic ownership approach is less complex because fewer and simpler instruments are classified as equity. Lastly, the REO approach is simple because most instruments would be measured at fair value and the probability of each outcome would be considered in the valuation of the instrument; in other words, the approach in effect derecognises each outcome automatically.

Basic ownership instrument issued by subsidiaries

76 IAS 32 provides some guidance on how to classify non-controlling interests and refers to the guidance in IAS 1 *Presentation of Financial Statements* and IAS 27 *Consolidated and Separate Financial Statements*. IAS 32 requires an entity to consider all the terms and conditions agreed between members of the group and the instrument holders in assessing whether the consolidated group has an obligation that would result in liability classification of the instrument. In effect, the instrument would retain equity classification unless something else within the group affects the substance of that instrument. However, as an exception, some puttable instruments and some instruments that impose an obligation only on liquidation of the entity meet the definition of a financial liability but are required to be classified as equity in the entity's separate financial statements. That exception does not extend to the consolidated financial statements of the group.

77 Guidance within the three FASB approaches is consistent with the principle in IAS 32. Classification is determined at the subsidiary level and that classification is maintained in the consolidated financial statements unless the instrument's characteristics are different in the context of the consolidated financial statements. However, what constitutes an equity instrument in the first place is different.

Appendix A
Comparison of existing and proposed approaches

A1 The table is based on Table 2 (Classification Examples) in Appendix C of the FASB Preliminary Views document and adds the classification of the 25 instruments using IAS 32 (as amended in February 2008). It also includes an additional item (instrument 26).

A2 The FASB document uses the term 'common share' whereas IFRSs use the term 'ordinary share'. Those two terms are intended to be synonymous.

	Instrument	Current US GAAP[9]	Basic Ownership	Ownership-Settlement	REO	Current IFRSs IAS 32
Legal Ownership Instruments						
1	Common share[10]	Equity	Equity	Equity	Equity	Equity
2	Perpetual preferred share	Equity	Liability	Equity	Liability	Equity
3	General partnership interest	Equity	Equity	Equity	Equity	Equity
Mandatorily Redeemable Instruments						
4	Common share mandatorily redeemable or puttable at fair value or a formulaic amount designed to approximate fair value	Mandatorily redeemable—Liability* Puttable—Equity (temporary equity for public companies)	Equity	Equity	Equity	Liability or equity[(a)]

continued...

9 Current US GAAP includes the requirements of Statement 150 before the deferral under FSP FAS 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150.* Instruments denoted by a * indicate those that might have been subject to an indefinite deferral for certain nonpublic entities.

10 This table was prepared under the assumption that common stock fits the definition of a basic ownership interest. That would not necessarily be the case in all situations. For example, an entity might issue two classes of stock, both of which are called common, but one could have a higher priority in liquidation. If so, only the lowest priority class would be a basic ownership interest.

(a) (IASB footnote): IAS 32 classifies mandatorily redeemable and puttable instruments as financial liabilities unless they have particular features and meet particular conditions.

...continued

	Instrument	Current US GAAP[9]	Basic Ownership	Ownership-Settlement	REO	Current IFRSs
						IAS 32
Mandatorily Redeemable Instruments						
5	Share mandatorily redeemable at a fixed price	Liability	Liability	Liability	Liability	Liability or equity[(b)]
6	Preferred share mandatorily redeemable or puttable regardless of the way the amount is determined and form of settlement (cash or shares)	Mandatorily redeemable—Liability* Puttable—Equity (temporary equity for public companies)	Liability	Liability	Liability	Liability
7	Instrument that "converts" mandatorily into a variable number of basic ownership instruments with a fixed monetary amount (for example, share-settled debt)	Liability	Liability	Liability	Liability	Liability
Freestanding Options and Forward Contracts						
8	Written call option, warrant, share-settled stock appreciation right (SAR), and employee stock option settled with shares	Equity	Liability	Equity	Equity and asset	Equity[(c)]
9	Net-cash-settled written call option and cash SAR	Liability	Liability	Liability	Liability and asset	Liability

continued...

(b) (IASB footnote): IAS 32 classifies mandatorily redeemable and puttable instruments as financial liabilities unless they have particular features and meet particular conditions.

(c) (IASB footnote): Classification as equity assumes that the instrument will be settled only by the issuer exchanging a fixed amount of cash for a fixed number of its own equity instruments.

...continued

	Instrument	Current US GAAP[9]	Basic Ownership	Ownership-Settlement	REO	Current IFRSs
						IAS 32
Freestanding Options and Forward Contracts						
10	Warrant to purchase a basic ownership instrument for one cent when assuming the fair value of the basic ownership instrument is substantially higher than one cent	Equity	Equity	Equity	Equity	Equity
11	Written call option with a substantive registration rights penalty[(d)]	Equity and a contingent liability (recognized and measured under FASB Statement No.5, *Accounting for Contingencies*)	Liability	Equity and liability	Equity and asset (A liability component, representing the registration rights penalty, is netted against the asset component in the written call option.)	Equity[(e)] and liability
12	Physically, net-cash-settled or net-share-settled forward purchase contract at a fixed price	Liability or asset	Liability or asset	Liability or asset	Contra-equity and liability	Liability or asset

continued...

(d) (IASB footnote): *A registration rights penalty* is defined in the FASB document as a promise to remit consideration to an investor if an instrument held by that investor is (1) not registered for public trading by a specified date or (2) not listed on a stock exchange by a specified date.

(e) (IASB footnote): Classification of the written call option as equity assumes that the instrument will be settled only by the issuer exchanging a fixed amount of cash for a fixed number of its own equity instruments.

...continued

	Instrument	Current US GAAP[9]	Basic Ownership	Ownership-Settlement	REO	Current IFRSs
						IAS 32
Freestanding Options and Forward Contracts						
13	Prepaid forward purchase contract for a fixed number of shares (or a note receivable for a fixed number of shares)	Generally, contra-equity	Asset	Asset	Contra-equity	Contra-equity[(f)]
14	Physically, net-cash-settled or net-share-settled written put option	Liability	Liability	Liability	Contra-equity and liability	Liability
15	Prepaid written put option	Generally, contra-equity	Asset	Asset	Contra-equity and asset	Contra-equity[(f)]
Instruments with Embedded Options						
16	Share puttable at a fixed price	Equity	Liability	Equity and liability	Equity and liability	Liability or equity[(g)]
17	Share puttable at fair value	Equity	Equity	Equity	Equity	Liability or equity[(g)]
18	Convertible debt for fixed number of shares	Liability	Liability	Equity and liability	Equity and liability	Equity and liability
19	Callable common share (fixed price)	Equity	Equity	Equity	Equity and liability	Equity
20	Callable preferred share (fixed price)	Equity	Liability	Equity	Equity and liability	Equity

continued...

(f) (IASB footnote): Classification as contra-equity assumes that the issuer has prepaid a fixed amount of cash and the instrument will be settled by the issuer receiving a fixed number of its own equity instruments.

(g) (IASB footnote): IAS 32 classifies mandatorily redeemable and puttable instruments as financial liabilities unless they have particular features and meet particular conditions.

...continued

	Instrument	Current US GAAP[9]	Basic Ownership	Ownership-Settlement	REO	Current IFRSs IAS 32
Instruments with Embedded Options						
21	Preferred share convertible into a fixed number of basic ownership instruments	Equity	Liability	Equity	Equity and liability	Equity[(h)]
22	Preferred share puttable, callable, and convertible	Equity	Liability	Equity and liability	Equity and liability	Liability
Other Instruments with Settlement Amounts Determined by Share Prices						
23	Note receivable settled with cash or a variable number of shares[11]	Asset (if cash settled) Contra-equity (if share settled)	Asset	Asset	Asset	Asset
24	Debt indexed to shares (for example, convertible debt for which the entire conversion value is settled in cash)	Liability (with a separated embedded derivative)	Liability	Liability	Equity	Liability
25	Variable share forward sales contract issued in conjunction (separately) with common share that is puttable at a fixed price[12]	Equity	Liability	Equity and liability	Equity and liability (or asset)	Liabilities[(i)]

continued...

(h) (IASB footnote): Classification as equity assumes that the preferred share includes no other contractual obligations.

11 The example assumes the counterparty can choose the form of settlement. This fact is relevant to the current US GAAP classification only.

12 This example assumes the instruments meet the linkage criteria and are combined and accounted for as one freestanding instrument.

(i) (IASB footnote): These instruments would be accounted for as two separate instruments in accordance with IAS 32. Classification of the puttable share as a liability assumes that it does not have all the features or meet the conditions to be classified as equity.

...continued

	Instrument	Current US GAAP[9]	Basic Ownership	Ownership-Settlement	REO	Current IFRSs
						IAS 32
Additional Instrument						
26	Common share puttable at fair value This share is in a class of instruments that do not have identical features. For example, some are puttable at fair value, others are callable (at the same or at different strike prices) and yet others are neither puttable nor callable.	Equity (temporary equity for public companies)	Equity	Equity	Equity and liability	Liability[(j)]

(j) (IASB footnote): IAS 32 classifies puttable instruments as financial liabilities unless they have particular features and meet particular conditions. One of the requirements for equity classification is that all of the puttable instruments in the class have identical features.

Appendix B
Additional questions for respondents

B1 Are the three approaches expressed in the FASB Preliminary Views document a suitable starting point for a project to improve and simplify IAS 32? If not, why?

(a) Do you believe that the three approaches would be feasible to implement? If not, what aspects do you believe could be difficult to apply, and why?

(b) Are there alternative approaches to improve and simplify IAS 32 that you would recommend? What are those approaches and what would be the benefit of those alternatives to users of financial statements?

B2 Is the scope of the project as set out in paragraph 15 of the FASB Preliminary Views document appropriate? If not, why? What other scope would you recommend and why?

B3 Are the principles behind the basic ownership instrument inappropriate to any types of entities or in any jurisdictions? If so, to which types of entities or in which jurisdictions are they inappropriate, and why?

B4 Are the other principles set out in the FASB Preliminary Views document inappropriate to any types of entities or in any jurisdictions? (Those principles include separation, linkage and substance.) If so, to which types of entities or in which jurisdictions are they inappropriate, and why?

B5 Please provide comments on any other matters raised by the discussion paper.