
Project	Financial Instruments with Characteristics of Equity
Topic	High-level summary of external review comments

Objective

1. In April, we distributed a draft of the Exposure Draft, *Financial Instruments with Characteristics of Equity*, to a small group of external reviewers. The external review comment period ended on Friday, May 7. This paper provides a very high level description of what we consider to be the most significant comments. We will provide a more comprehensive analysis at a later date. This meeting is for informational purposes only and, therefore, there are not any questions for the Board. The FASB discussed this paper at a public board meeting on May 11, 2010.

Overall Approach

2. Reviewers had the following comments about the overall approach:
 - (a) **The approach lacks principles.** As a result, reviewers found it difficult to determine how an instrument that is not specifically described in the document would be classified.
 - (b) **The approach provides inconsistent results.** A prepaid forward purchase contract is classified as an asset while one that is not prepaid is classified as a liability and contra-equity. Additionally, a freestanding purchased call option is an asset, yet if the instrument is embedded in a share it would be classified as equity. Some questioned whether this treatment would result in structuring opportunities.

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.

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Cash Settled Instruments

3. Most reviewers think that additional implementation is necessary in order to apply the cash-settled criterion. Some commented that additional explanation for terms such as “actively participate,” “maintain control” and “engage in transactions” is necessary. Some reviewers believe the following issues should be considered further:
 - (a) Are there structuring opportunities with the embedded put options? For example, can the embedded put be indexed to anything, such as gold?
 - (b) Will this principle work for investment companies, mutual funds and real estate investment trusts (REITs)?

Specified-for-Specified Criterion

4. Reviewers had the following significant comments on the specified-for-specified criterion:
 - (a) **Criterion does not resolve existing practice problems with IAS 32 *Financial Instruments: Presentation*.** The specified-for-specified criterion is very similar to the fixed-for-fixed criterion in IAS 32. Most reviewers noted that the fixed-for-fixed criterion is an ongoing practice issue in IFRS. Some reviewers questioned whether the criterion in the draft actually resolved the practice problems. Other reviewers questioned whether the new specified-for-specified criterion is narrower or broader than the current fixed-for-fixed criterion.
 - (b) **Criterion does not adequately address the instrument described in Subtopic 815-40, Contracts in the Entity’s Own Equity, (originally issued as EITF 00-19 Accounting for Derivatives Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock and EITF 07-5 Determining Whether an Instrument (or an Embedded Feature) Is Indexed to an Entity’s Own Stock.)** It is

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not clear how the instruments addressed in those EITF issues would be classified under the proposed requirements. The approach does not adequately address how instruments should be sequenced in determining if an entity has enough authorized shares.

- (c) **The criterion as written may not achieve the boards' objectives of classifying some derivatives as equity.** At least one respondent believes that very few, if any, derivatives will meet the specified for specified criterion. Most instruments have clauses that require the instruments to be settled in assets upon bankruptcy. Standard anti-dilution clauses in instruments issued in the U.S. do not meet the criterion either. Most contingent settlement features would fail the specified-for-specified criterion. Some questioned whether that is appropriate and if some contingent settlement features should be ignored for classification purposes.
- (d) **The criterion as written would not classify rights issues as equity.** The rights issues that are classified as equity under IAS 32 are denominated in currencies other than the issuing entity's functional currency. The instruments are not necessarily denominated in the holder's functional currency as described in the boards' approach.
- (e) **The requirement to identify the domestic or functional currency of the shareholder may not be operational.**

Separation Criteria

- 5. Reviewers had the following significant comments on the specified-for-specified criterion:
 - (a) **The measurement requirement for a separated convertible debt instrument creates significant structuring opportunities.**

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- (b) **Some instruments may have negative equity components when separated.** At least one respondent questioned how the initial measurement principle would be applied in that situation.

Remeasuring Equity Instruments at Current Redemption Value

6. Some reviewers are concerned that measuring equity instruments or components at current redemption value may not be operational. Although current U.S. GAAP requires particular instruments to be measured using an attribute that is very similar to current redemption value, practice problems exist. Similarly, for puttable financial instruments classified as equity, current IFRS requires an entity to disclose the expected cash outflow on redemption or repurchase of that class of financial instrument. Constituents have told us they have difficulty applying that requirement as well. One reviewer asked the following question about current redemption value: If an instrument is redeemable at 7yrs if X happens and 10 years if Y happens, how do you know what date to use when determining the current redemption value?

Related Literature

7. Some reviewers questioned whether particular pieces of U.S. GAAP literature can be eliminated without leaving significant holes in U.S. GAAP. There is a lot of detailed literature in the U.S. that addresses various aspects of accounting for financial instruments within the scope of this project. Much of that literature addresses specific and narrow issues and was developed to answer implementation questions and prevent structuring opportunities as they arose in practice. For example, reviewers questioned whether the following pieces of literature can be eliminated:
- (a) D-42, *The Effect on the Calculation of Earnings per Share for the Redemption or Induced Conversion of Preferred Stock*, and D-98, *Classification and Measurement of Redeemable Shares*

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- (b) Subtopic 815-40, Contracts in the Entity's Own Equity, (originally issued as EITF 00-19 Accounting for Derivatives Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock and EITF 07-5 Determining Whether an Instrument (or an Embedded Feature) Is Indexed to an Entity's Own Stock.)
- (c) Requirements for induced conversion and modification accounting.