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International
Accounting Standards
Board

Financial Instruments with Characteristics of Equity

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Project Updates are provided for the information and convenience of constituents who wish to follow the IASB's deliberations. All conclusions reported are tentative and may be changed at future IASB meetings. Decisions become final only after completion of a formal ballot to issue an International Financial Reporting Standard, Interpretation, or Exposure Draft.

Introduction

This project report is structured as follows:

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Background

- 1 IAS 32 *Financial Instruments: Presentation* provides the relevant guidance for distinguishing between equity instruments and other financial instruments (non-equity instruments).
- 2 There are criticisms of the requirements in IAS 32. Specifically, there are concerns about how the principles in IAS 32 should be applied and whether the application of those principles results in an appropriate distinction between equity and non-equity instruments.

- 3 In February 2006, the Board and the FASB issued the Memorandum of Understanding, *A Roadmap for Convergence between IFRSs and US GAAP 2006– 2008* (MoU). One of the goals for 2008 is ‘to have issued one or more due process documents relating to a proposed standard’ on the distinctions between liabilities and equity.
- 4 The IASB and the FASB are conducting this project under a modified joint approach. The FASB led the project during the initial research stage.
- 5 On 30 November 2007, the FASB issued a Preliminary Views (PV) document, *Financial Instruments with Characteristics of Equity*, which describes three approaches for distinguishing between equity and non-equity instruments and presents the FASB’s preliminary views.
- 6 The IASB did not deliberate any of the issues in the FASB PV document and has no preliminary views on the possible approaches. In February 2008 the IASB published a discussion paper which contained an IASB Invitation to Comment and the FASB PV document.
- 7 In July 2008, the IASB moved the project from its research agenda to its active agenda.
- 8 In October 2008, the IASB and FASB began deliberations and are working together towards developing and publishing an Exposure Draft.

Objective

- 9 The objective of this project is to improve and simplify the financial reporting requirements for financial instruments with characteristics of equity. Specifically, this project is intended to:
 - a. Develop a better distinction between equity and non-equity instruments
 - b. Converge IFRS and US GAAP in this area

Next steps

- 10 On 28 February 2008 the IASB published a discussion paper *Financial Instruments with Characteristics of Equity*. The discussion paper was open for comment until 5 September 2008.

- 11 In October 2008 the IASB discussed the comment letters received. At the joint IASB/FASB meeting in October, the boards discussed which approach for identifying equity instruments provides the best starting point for future deliberations. The boards decided to begin future deliberations using the principles underlying the perpetual and basic ownership approaches.
- 12 In the fourth quarter of 2008 and during 2009, the IASB and FASB will continue to develop those principles.

Project history: Tentative decisions to date

- 13 The Board discussed this project at several of its meetings. Below is the summary of each meeting.

IASB April 2006

The Board held an education session on the FASB's Liabilities and Equity project. The session was led by the FASB project team and discussed the conclusions reached to date by the FASB. No decisions were made.

IASB FASB October 2006

The FASB staff summarised the current status of the FASB's liabilities and equity project. The staff presented three possible approaches for distinguishing between financial liabilities and equity instruments. No decisions were made.

IASB January 2007

The Board discussed the process it will follow to enable it to meet its MOU commitment to issue a discussion paper on liabilities and equity. In addition, the Board discussed the project's interaction with the Conceptual Framework project. The Board also discussed implementation issues related to IAS 32 *Financial Instruments: Presentation*, as well as views on what 'equity' is. No decisions were made.

IASB March 2007

The Board held an education session to enhance understanding of the FASB approaches for distinguishing between liabilities and equity and to identify possible issues and questions that the Board may want to include in the IASB discussion paper. No decisions were made.

IASB December 2007

The Board discussed its strategy for proceeding in the Liabilities and Equity project. The Board agreed that the IASB discussion paper should contain an IASB Invitation to Comment and the FASB PV. The Invitation to Comment will include background information relevant to IFRSs, the main differences between the approaches discussed in the FASB document and IFRS requirements and any necessary additional questions for constituents. The Board agreed that its goal is to publish the discussion paper in the first quarter of 2008.

Also at this meeting, representatives from the FASB held an education session on the FASB document. No decisions were made at the education session.

IASB January 2008

In January 2008, the Financial Instruments Working Group (FIWG) reviewed a draft of the IASB Invitation to Comment.

At this meeting, the Board discussed that draft and the main points raised by the FIWG. The Board asked the staff to prepare a ballot draft of the discussion paper. The Board confirmed that it expects to publish the paper in the first quarter of 2008.

IASB February 2008

At this meeting, the Board decided that the discussion paper should alert readers to another discussion paper *Distinguishing between Liabilities and Equity* published in January 2008 by the European Financial Reporting Advisory Group (EFRAG) on behalf of the Pro-active Accounting Activities in Europe (PAAinE).

IASB FASB April 2008

At this joint meeting, the IASB and FASB generally agreed that the liabilities and equity project is a high-priority project but progress depends on whether the boards make an early decision on which approach to pursue.

The boards noted that during the comment period, the IASB needs to begin to develop a view on the approaches in the FASB PV document.

IASB July 2008

Independently of the IASB and the FASB, task forces from the European Financial Reporting Advisory Group's PAAinE (Proactive Accounting Activities in Europe) initiative and the German Accounting Standards Board developed an approach for distinguishing between liabilities and equity. At this meeting, representatives from both task forces updated the IASB about their approach. No decisions were made.

Also at this meeting, the Board decided to add this project to its active agenda. The project was on the Board's research agenda.

IASB September 2008

Representatives from the European Association of Co-operative Banks led an education session to discuss the financial instruments issued by European co-operatives. They discussed the characteristics of those instruments, the current accounting for them and how entities might account for them under the approaches described in the FASB PV.

No decisions were made.

IASB October 2008

The Board published the discussion paper *Financial Instruments with Characteristics of Equity* in February 2008. The comment period ended in September 2008. At this meeting the Board considered an analysis of the comment letters received.

The Board also discussed which approach for identifying equity instruments provides the best starting point for future deliberations. No decisions were made.

IASB FASB October 2008

The boards decided to begin future deliberations using the principles underlying the perpetual and basic ownership approaches. Under the perpetual approach, an instrument would be classified as equity if it:

- lacks a settlement requirement and
- entitles the holder to a share of the entity's net assets in liquidation.

Under the basic ownership approach, an instrument would be classified as equity if it:

- is the most subordinated claim and
- entitles the holder to a share of the entity's net assets.

The boards acknowledged that they may decide to make exceptions to the basic principles as they continue to develop an approach to identify equity instruments.

IASB November 2008

The Board continued to develop the approach for identifying equity instruments and made the following tentative decisions:

- All perpetual instruments (including perpetual basic ownership instruments) should be classified as equity.
- Derivatives on an issuer's own equity instruments should be classified as non-equity. (The Board will discuss at a future meeting whether derivative instruments within the scope of IFRS 2 *Share-based Payment* would be subject to that classification principle.)

The Board also had a preliminary discussion of other issues including:

- which hybrid instruments should be separated;

- the classification of puttable and mandatorily redeemable instruments; and
- whether instruments issued by a subsidiary should be classified in the consolidated financial statements the same way as in the subsidiary's separate financial statements.

The Board did not make any decisions on these issues.

IASB January 2009

The Board discussed the classification of puttable and mandatorily redeemable instruments. The Board directed the staff to analyse further an approach that would identify different types of such instruments and consider whether those types should be classified differently.

The Board also discussed the conceptual definitions of a liability and equity. The Board directed the staff to develop an approach that separates the objectives of:

- determining what things qualify for potential recognition (a conceptual definition) and
- determining how those things should be classified (a standards-level principle or principles).

IASB March 2009

The Board continued to discuss an approach for determining whether a financial instrument should be classified as equity.

The Board decided tentatively that the following instruments should be classified as equity:

- An ownership instrument that is redeemable at the option of the issuer
- An ownership instrument that is puttable or mandatorily redeemable only upon the holder's retirement or death. (The term *retirement* is used broadly to include events such as termination,

resignation or ceasing to be a member in a co-operative or partnership.)

The Board decided tentatively that an ownership instrument that is mandatorily redeemable on a specific date, a range of dates or an event that is certain to occur (other than retirement or death) should be classified as a liability.

The Board directed the staff to analyse further whether the following instruments should be separated into equity and liability components:

- an ownership instrument that is mandatorily redeemable upon an event that is uncertain to occur
- an ownership instrument that is puttable upon an event other than retirement or death.

The Board also directed the staff to analyse further how a limited life entity would classify its ownership instruments.

Contact information

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