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International
Accounting Standards
Board

Financial Instruments with Characteristics of Equity

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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 IASB and the FASB issued the Memorandum of Understanding, *A Roadmap for Convergence between IFRSs and US GAAP*

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- 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 which presents the FASB’s preliminary views.
 - 6 The IASB did not deliberate any of the issues in the FASB PV document, and it has no preliminary views on the three possible approaches. In February 2008 the IASB published a discussion paper that contained an IASB Invitation to Comment and the FASB PV document. The discussion paper was open for comment until 5 September 2008.
 - 7 In July 2008, the IASB moved the project from its research agenda to its active agenda.
 - 8 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.

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, and
 - b. Converge IFRS and US GAAP in this area

Next steps

- 10 The boards will continue to develop a classification model.
- 12 During 2010, the IASB and FASB will continue to develop those principles. The boards tentatively plan to publish an exposure draft in the second quarter of 2010.

13 **Scope**

Instruments currently accounted for under IFRS 2 and Accounting Standards Codification Topic 718 are not within the scope of this project.

Classification

Equity Instruments

The following types of instruments should be equity in their entirety:

1. Perpetual instruments (instruments not required to be redeemed unless the entity decides to or is forced to liquidate its assets and settle claims against the entity) issued by entities without specified limits to their lives. (That includes both ordinary and preferred shares.)
2. A nominally perpetual instrument issued by an entity with a specified limit on its life or that must be liquidated at the option of an instrument holder. (That means an instrument that would otherwise be equity will not become a liability merely because it is issued by an entity that is not or may not be able to continue to exist indefinitely.)
3. Mandatorily redeemable and puttable instruments that meet either of the following criteria:
 - i. The instrument's terms require, or permit the holder or issuer to require, redemption to allow an existing group of shareholders, partners, or other participants to maintain control of the entity when one of them chooses to withdraw.
 - ii. The holder must own the instrument in order to engage in transactions with the entity or otherwise participate in the activities of the entity, and the instrument's terms require, or permit the holder or issuer to require, redemption when the holder ceases to engage in transactions or otherwise participate.
4. Contracts that require or may require an entity to issue a specified number of its own perpetual equity instruments in exchange for a specified price (for example, call options, forward contracts to issue shares, rights issues, and purchase warrants) should be classified as equity. For this purpose, the specified number must be either fixed or vary only so that the counterparty will receive a specified percentage of total shares that were outstanding on the issuance date for a specified price. The specified price must be fixed in the reporting entity's currency unless the domestic currency of the shareholder that holds the derivative

- (or functional currency if the shareholder is a reporting entity or a unit of a reporting entity) is different from the currency in which the issuing entity issues equity instruments to domestic shareholders. In that case, the price may be specified in the currency of the shareholder instead of in the currency of the issuer.
5. Instruments that require an entity to issue a specified number of its own perpetual equity instruments for no further compensation should be classified as equity (for example, prepaid forward contracts to issue shares).
 6. The entity's ability to issue its own perpetual equity instruments to settle share-settled instruments classified as equity should be assessed at the date that each instrument is issued and at each reporting date thereafter. If, at any time, the entity does not have enough authorized shares to settle a share-settled instrument classified as equity, that instrument should be reclassified as a liability and left there for the remainder of its life.
 7. Preferred shares required to be converted into a specified number of common shares on a specified date or on the occurrence of an event that is certain to occur should be classified as equity.
 8. A contract that requires an entity to issue for a specified price (or for no future consideration) a specified number of puttable or mandatorily redeemable instruments that will be equity in their entirety when issued. Examples are a forward contract to issue mandatorily redeemable equity instruments and an identical forward contract that has been prepaid.
 9. A contract that requires the entity to issue for a specified price (or for no future consideration) a specified number of derivatives that will require the entity to issue a specified number of instruments that will be equity in their entirety when issued. Examples are a forward contract to issue a written call option on the entity's own shares and an identical forward contract that has been prepaid.
 10. Preferred shares that are required to be converted into a specified number of perpetual equity instruments.
 11. Preferred shares that are required to be converted into a specified number of puttable or mandatorily redeemable instruments that will be equity in their entirety when issued.

Convertible Debt

A bond (or other debt instrument) should be separated into a liability component and an equity component if it is convertible at the option of the holder into a specified number of instruments that will be equity in their entirety when issued.

All other convertible debt instruments should be classified as liabilities in their entirety.

Puttable Shares

Puttable shares that are not classified as equity in their entirety should be separated into liability and equity components. The liability component, which represents a written put option, should be accounted for as a freestanding written put option.

Presentation of Freestanding Written Put Options and Forward Repurchase Contracts

A freestanding written put option should be presented net as a liability in its entirety.

Contracts that require an entity to repurchase its own shares on a specified date or on the occurrence of an event that is certain to occur should be separated into a liability representing the amount to be paid (measured according to standards for similar freestanding instruments) and an offsetting debit to equity (grossed up).

All Other Instruments

All instruments that are not classified as either equity in their entirety or separated into liability and equity components are classified as liabilities or assets.

Subsidiary Instruments in Consolidated Financial Statements

Equity classification in a subsidiary's financial statements should carry forward into consolidated financial statements unless the nature of the instrument changes in consolidation because of arrangements between the instrument holder and another member of the consolidated group. If the nature of the instrument changes in consolidation, classification should be reconsidered in the consolidated financial statements.

Measurement

Transaction Costs

An entity should expense as incurred all transaction costs or fees arising from the issuance of equity or separated equity hybrid instruments.

Initial Measurement of a Freestanding Equity Instrument

An entity should initially measure a freestanding equity instrument at its transaction price. The term *transaction price* does not include transaction costs or fees.

Initial Measurement of the Components of a Separated Equity Hybrid Instrument

An entity should initially measure components of a separated equity hybrid instrument as follows. The liability or asset component should be measured at fair value as if it were a freestanding liability or asset. The remainder of the transaction price for the hybrid instrument as a whole should be allocated to the equity component.

Subsequent Measurement of a Freestanding Equity Instrument and an Equity Hybrid Instrument

An entity should not remeasure a freestanding equity instrument or equity component of a hybrid instrument that it cannot be required to redeem.

At each reporting date, an entity would remeasure at current redemption value an equity instrument or a separated equity component of a hybrid instrument that has a redemption requirement. The current redemption value is the amount that would have resulted from applying the redemption formula as if redemption were required at the measurement date. Changes in current redemption value would be recorded as a transfer between retained earnings and the redeemable equity instrument or component.

An entity should remeasure the liability or asset component of a separated hybrid instrument on the basis of the requirements of U.S. generally accepted accounting principles (GAAP) that would apply if it were a freestanding instrument. Those measurement requirements are subject to change based on future deliberations in the Board's project on accounting for financial instruments.

Freestanding Liabilities and Assets

Freestanding liabilities and assets would be measured using principles developed in the Board's project on accounting for financial instruments.

Contact information

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