

**FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY  
COMMENT LETTER SUMMARY**

1. As of August 1, 2008, the Board received comment letters from 65 respondents as summarized below.

**Respondent Profile**

<b>Number and Type of Respondents (by Occupation/Role)</b>	
<b>Type of Respondent</b>	<b>Number</b>
<b>Public Accounting</b>	
Big Four accounting firm	4
Other accounting firm	2
Total Public Accounting	6
<b>Preparer</b>	
Cooperative	13
Financial Institution	7
Technology	2
Other	2
Total Preparer	24
<b>User</b>	
Rating agency	1
Total User	1
<b>Academic</b>	
American Accounting Assoc.	2
Other	1
Total Academic	3
<b>Professional Organization</b>	
Cooperative	10
CPA Society	8
Private Company / Venture	2
Standard Setter	2
Other	3
Total Professional Org	25
<b>Subtotal</b>	
	<b>59</b>
<b>Other</b>	
	6
Total Other	6
<b>Total Respondents</b>	
	<b>65</b>

## **SIGNIFICANT ISSUES**

2. The majority of the respondents do not support the basic ownership approach.

Significant issues raised by those respondents include:

- a. The classification as liabilities of all perpetual instruments that are not basic ownership instruments (measurement was also cited as a potential issue)
- b. The classification as equity in consolidated financial statements of basic ownership instruments of a subsidiary
- c. Reporting changes in fair values of many types of liabilities in net income
- d. Certain puttable financial instruments and obligations arising on liquidation (for example, certain partnership arrangements) that are currently classified as equity would be liabilities under the basic ownership approach
- e. Many instruments classified as equity by cooperatives would be classified as liabilities under the basic ownership approach because they have fixed redemption prices or upper limits on the amounts the holders would receive in liquidation.

### **Preferred Shares**

3. Perpetual instruments other than basic ownership instruments are classified as liabilities under the basic ownership approach. That means that shares with a preference in liquidation would be liabilities whether they are perpetual, callable, puttable, or mandatorily redeemable. The basis for conclusions explains that those instruments are classified as liabilities because they reduce the assets available for distribution to holders of basic ownership instruments. The Board also noted that classifying those perpetual instruments as liabilities reduced structuring opportunities. A few respondents (for example, Fitch CL #4 and TIC CL #61) supported the Board's decision.

4. However, the majority of respondents objected to classifying preferred shares as liabilities. Most respondents relied on the current definition of a liability to support their opposing view, noting that preferred shares do not impose an obligation to deliver cash or other assets. Other respondents (who apparently disagreed with the basic principle or did not understand it) found that treatment inconsistent with classification of certain mandatorily redeemable instruments as equity. Other respondents expressed the following concerns:

- a. ISDA (CL #49) noted that entities that are predominantly capitalized using preferred shares would have very little equity, which would create “significant implications”.
  - b. The Accounting Standards Board of Japan (CL #19) noted that the Japanese Companies Act requires that perpetual financial instruments be classified as equity. Therefore, any change to the population of instruments reported in equity would require a change in the law in Japan and possibly other countries with a similar Act.
  - c. UBS (CL #26), Nortel Networks (CL #32), and New York State Society of CPAs (CL #28) stated that the proposed classification could have significant effect on financial ratios and will require significant amendments to debt covenants, which would result in incremental costs.
5. Although the Board did not decide how to remeasure perpetual instruments that are classified as liabilities, paragraph 34 of the PV described some possible measurement requirements. The respondents who commented on those measurement requirements generally opposed remeasuring the instruments at fair value with changes reported in income. Some respondents pointed out that remeasuring an instrument that does not trade on an active market would be difficult, lead to more Level 3 measurements, and create complexity in the financial reporting.

### **Classification of a Subsidiary’s Basic Ownership Instruments in Consolidated Financial Statements**

6. Under the basic ownership approach, basic ownership instruments of a subsidiary or consolidated variable interest entity would be classified as equity in the consolidated financial statements unless the parent has entered into an arrangement with holders that would cause those instruments’ characteristics to change upon consolidation.<sup>1</sup> Many respondents asserted that that provision seems to be inconsistent with the underlying principle of the basic ownership approach. For example, noncontrolling interests in a subsidiary would be considered equity of the consolidated entity even though their claims to assets are limited to only a portion of the consolidated entity. Some respondents also suggested that the Board’s decision could create structuring opportunities by allowing entities to create additional equity by establishing

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<sup>1</sup> All three of the approaches described in the Preliminary Views have that same provision.

subsidiaries to issue residual interests that would not meet the definition of equity if issued by the parent entity.

### **Changes in Fair Value**

7. The majority of respondents objected to reporting changes in fair value arising from changes in an entity's share price in net income. Some respondents agreed that it may be appropriate to measure some instruments (with the exception of stock based compensation) at fair value. TIC (CL # 61) suggested that increasing the number of instruments measured at fair value would increase complexity and would require nonpublic companies to incur higher valuation costs. Other respondents suggested separating interest expense from unrealized gains and losses in the income statement.

### **Puttable Financial Instruments and Obligations Arising on Liquidation**

8. In February 2008, the IASB amended IAS 32 to require equity classification for certain types of financial instruments that meet the definition of a financial liability but represent the residual interests in the net assets of the entity. While the underlying principles in the IAS 32 amendment and the basic ownership approach are similar, in certain circumstances the two approaches will provide different classification results. The most significant differences with regards to puttable shares are as follows:
  - a. In order to be classified as equity under the IAS 32 amendment, a puttable ownership instrument must be in the most subordinated class of instruments. Moreover, all of the instruments in that most subordinated class must have identical features (i.e., they must all be puttable and the method used to calculate the redemption price is the same). In contrast, under the basic ownership approach, two types of basic ownership instruments could be classified as equity if they are equally the most subordinated, for example, redeemable and non-redeemable common shares.
  - b. All shares puttable at a fixed price are liabilities under the basic ownership approach. In contrast, the IAS 32 amendment would classify instruments that are puttable at a fixed price as equity if the total expected cash flows over the life of the instrument are based substantially on the performance of the entity. That condition would exist if all or nearly all of the entity's profits are expected to be distributed and the holder's receipts are a share of those profits. Fixed entry and exit prices would not cause an instrument to fail that test if the prices are relatively small compared to the

distributions. (The IASB tends to refer to these instruments as fixed-in, fixed-out.)

- c. Under IAS 32, puttable instruments classified as equity in the financial statements of a subsidiary are classified as liabilities in the consolidated financial statements of the parent. This requirement does not extend to the classification of non-controlling interests in consolidated financial statements. In contrast, the basic ownership approach would maintain the equity classification in the consolidated financial statements unless the characteristics of the instrument changes at the consolidated level.

## Other Comments

9. Respondents also commented on the following issues:

- a. **Scope**—Some respondents believe the scope of the project should be expanded to include all financial instruments or all items on the credit-side of the balance sheet. Others expressed concerns that Statement 123(R) would be amended.
- b. **Partnerships**—Some respondents pointed out that none of the examples in the Preliminary Views involve partnership structures. They also suggested the basic ownership approach would be difficult to apply to partnerships with complex distribution structures.
- c. **Redeemable basic ownership instruments**—Basic ownership instruments with redemption requirements may be classified as equity if they meet certain criteria (see paragraph 20 in the PV). Some respondents suggested those criteria are not clear or operational.

## COOPERATIVES

10. Approximately one third of the respondents were cooperatives. The majority of those cooperatives expressed a preference for IFRIC 2. IFRIC 2 states that a redemption requirement does not prevent shares (that otherwise would be equity) from being equity if either (a) the entity has an unconditional right to refuse redemption or (b) if redemption is unconditionally prohibited by local law, regulation, or the entity's governing charter. The cooperatives also encouraged the Board to consider incorporating certain features of the Loss Absorption Approach in any model that is developed. Two changes suggested were to classify all perpetual instruments as equity and remove references to upper limits on distributions from the definition of a basic ownership instrument. That second suggestion is discussed further in the following paragraphs.

## **Definition of a Basic Ownership Instrument—Upper Limit on Participation of Assets**

11. A basic ownership instrument has two characteristics: (a) it is the most subordinated claim and (b) it entitles the holder to a percentage of net assets after all higher priority claims have been satisfied. The holder's share of net assets has no upper or lower limit except for the amount of net assets available.
12. Most U.S. cooperative shares have the first characteristic; however, not all will have the second. In some cases there is an upper limit to a member's rights to the net assets, which is usually the nominal value of the share. Many international cooperatives are required to abide by certain laws or rules that forbid them to redeem shares (either before or at liquidation) above their nominal value. Therefore, those shares would be liabilities under the basic ownership approach even though they are the most subordinated, entitle the holder to a percentage of net assets, and expose the holders to loss of 100% of their investments.
13. Another issue that arises in the upper limit requirement in the definition of a basic ownership instrument is the classification of former member's shares that have been submitted for redemption, but not yet approved by the Board. In some cases, (as described in CL # 23 and 38) the Board may restrict the redemption amount to the last stated redemption value of the share, effectively creating an upper limit. This would require all of the former member shares that have not yet been redeemed to be reclassified as liabilities.