Financial Accounting Standards Board

INFORMATION FOR OBSERVERS
IASB BOARD MEETING: 25 APRIL 2006
AGENDA PAPER 3A

Liabilities and Equity

Project Update and Upcoming Steps

IASB April 25, 2006 Meeting

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

Disclaimer

The views expressed in this presentation are our own and do not represent positions of the Financial Accounting Standards Board.

Positions of the Board are arrived at only after extensive due process and deliberations.

Presentation Summary

- Project Objectives
- Brief History of Project
- Ownership-Settlement Approach
- Other Possible Approaches
- Upcoming Steps

Project Objectives

- To develop a comprehensive standard of accounting and reporting for financial instruments with characteristics of equity, liabilities, or both, and assets.

- To further converge with accounting standards developed by the IASB by conducting the project under a modified joint approach.

A Brief History of the Liabilities and Equity Project

Discussion Memorandum, *Distinguishing between Liability and Equity Instruments and Accounting for Instruments with Characteristics of Both*	1990
Resumed deliberations	1997
Exposure Drafts of Standards and Concepts	2000
Comments, Field Visits, Roundtable	2001
Redeliberations began with how to separate convertibles	2002
Statement 150 – Limited scope, focus on liabilities	2003
Phase 2 deliberations began	Q4 2003

A Brief History of the Liabilities and Equity Project—Phase 2

- 2004: Presented REO to IASB
- 2005: Presented Milestone Draft to IASB
  - Ownership-settlement approach for single-component instruments
- Now: Ownership-settlement approach for all instruments

Ownership-Settlement Approach

- **Scope**: Financial (and certain non-financial) instruments that have characteristics of liabilities, assets, and equity.
- Refer to the chart of principles for the ownership-settlement approach (Attachment A) as we next discuss each principle.

Principle 1—Linkage

- Instruments should be linked if they are part of the same arrangement and accounting for the individual instruments differs from accounting for them as if they were a single instrument with the same or similar outcomes.

Principle 1—Linkage

- Instruments are part of the same arrangement if either is met:
  - Interdependency exists between the instruments; or
  - The instruments have interacting payoff structures and are entered into at or near the same time with the same or related counterparty or an agent acting on behalf of a counterparty.

Principle 2—Classification: Substantive Features

- An entity should classify an instrument, a linked group of instruments, or a separated component of an instrument in the same manner as another instrument with the same or similar outcome(s).
  - All substantive settlement features (both stated and unstated) should be considered.
  - All nonsubstantive features should be ignored.

Principle 2—Classification: Substantive Features

- A substantive feature has:
  - More than a remote likelihood of affecting an instrument's outcome (reasonably possible)
  - More than a minimal effect as compared to other features within an instrument.

Principle 3—Classification: Equity Instruments

- **Perpetual instruments** embody no settlement obligation and entitle the holder to a portion of the issuer's net assets in liquidation—they may or may not be direct ownership instruments.
- Perpetual instruments do not embody obligations for the issuer and, therefore, do not meet the necessary characteristics of a liability.

Principle 3—Classification: Equity Instruments

- **Direct ownership instruments** have two characteristics:
  - Proportionate claims to net assets without limits
  - Subordination in a hypothetical liquidation.
- Those are distinguishing characteristics of an ownership relationship regardless of whether there is a settlement requirement.

Principle 3—Classification: Equity Instruments

- **Indirect ownership instruments** have three characteristics:
  - Have settlement requirements (not perpetual)
  - Indexed to, and in the same direction as, direct ownership instruments
  - No contingent exercise provisions based on an external market or index.
- Those instruments establish relationships that are similar to that of an owner, and, if resulting in ownership (share settlement), are equity instruments.

Principle 4—Classification: Separation of Components

- An instrument is separated into equity and nonequity components if it:
  - Embodies an obligation
  - Has both equity and nonequity outcomes with differing counterparty payoffs.
- Equity outcomes are based on the three types of equity instruments.

Principle 5—Classification: Other Instruments

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

Principle 6—Initial Measurement: Single Instruments

- Instruments classified as equity or nonequity in their entirety are initially measured at the transaction price (generally it is fair value for liabilities and assets).
- Issuance costs for all debt and equity instruments would be recognized as expenses when incurred.

Principle 7—Initial Measurement: Separated Components

- The transaction price is divided between the equity and nonequity components.
- First the entity must determine the fair value of the nonequity component by constructing a hypothetical instrument with terms that would produce the same or a similar outcome.
- The difference between the transaction price and the nonequity component is allocated to equity.

Principle 7—Initial Measurement: Separated Components

- The following should be considered when constructing the hypothetical instrument:
  - The expected amount and timing.
  - A fixed settlement amount (a floor) is considered 100% likely to be paid.
  - If the amount or timing varies or is uncertain, a probability-weighted method should be used.
  - If the nonequity component is accreted, the expected settlement date is calculated first.

Principle 8—Separate Reporting Within Equity

- Equity instruments that may be settled with cash or other assets should be reported under a separate heading than all other equity instruments.
  - Examples: Callable shares, puttable shares, and mandatorily redeemable shares.

Principle 9—Subsequent Measurement: Equity Instruments

- Equity instruments that may be settled with cash or assets are subsequently remeasured at current settlement value:
  - The current result of the redemption formula applied as it would be on the redemption date.
- All other equity instruments are not remeasured unless required by other GAAP.

Principle 10—Subsequent Measurement: Nonequity Instruments

- Nonequity instruments or components with:
  - Varying payoffs are measured at fair value
  - Fixed settlement amounts are accreted.
- Reallocation of components is only required if one of the following occurs:
  - The forecasted expected date lapses and the nonequity component is outstanding
  - Early settlement or modification occurs.

Principle 11—Reassessment of Classification

- At each reporting date an instrument should be reassessed to ensure proper classification:
  - All substantive features (stated and unstated) should be considered.
  - No gain or loss is recorded upon reclassification unless it results in a debt extinguishment or modification.

Principle 12—Classification in Consolidated Financial Statements

- The classification of an instrument of a consolidated subsidiary should be evaluated at the consolidated financial statement level to ensure proper classification at the consolidated level.

Principle 13—Extinguishment Accounting

- Extinguishment accounting includes settlement:
  - Per contractual terms
  - At an amount outside contractual terms
  - By conversion into equity instruments
  - By modification of an instrument.

Principle 13—Extinguishment Accounting

- If the liability component of a separated instrument is extinguished or modified, it is accounted for as if both components of the instrument have been replaced with a new instrument with new terms.
- If the extinguishment amount differs from the liability carrying amount at extinguishment, a gain or loss is recorded after reallocation to the liability and equity components.

Application of Principles: Example–Zero Coupon Convertible Debt Containing Various Put and Call Features

(Refer to page 10 of principles)

Example 1: Facts

Face Amount	$1,000		Convertible into shares anytime
Proceeds (yield = 2%)	$742		Callable at and anytime after year 5 for 2% accreted yield amount
Issue Date	11/1/2000		Puttable at year 3 for $788, 5 for $820, and 10 for $905 (2% accreted amounts)
Maturity Date	11/1/2015		
Conversion Ratio (in shares)	8.33		Puttable anytime upon a change in control at the 2% accreted amount
Share Price 11/1/2000	$71.25		Initially expected settlement date is year 5

Comparison of Approach to IAS Literature
(including proposed amendments)

Principle	IAS Literature
Linkage	None, but the work done for IFRIC is similar to the linkage requirements.
Substantive	Stricter—must be genuine (extremely rare, highly abnormal, and very unlikely to occur).
Classification	Similar but equity classification is stricter—shares puttable at fair value are equity only if all shares are that way, mandatorily redeemable at fair value not included(?), net share settled instruments are not equity.
Separation	More limited—must create a financial liability of the entity and (b) grant an option to the holder to convert it into an equity instrument of the entity.

Comparison of Approach to IAS Literature
(including proposed amendments)

Principle	IAS Literature
Measurement of Single Instruments	Initial measurement is the same except issuance costs are not expensed. Subsequent measurement is similar except the FASB approach uses fair value instead of bifurcation (IAS 39).
Measurement of Separated Instruments	Similar except IAS measurement is more complex and unclear. (Examples: settlement dates, interaction between multiple embedded components, and determining appropriate discount rate.)

Comparison of Approach to IAS Literature
(including proposed amendments)

Principle	IAS Literature
Separate Reporting and Remeasurement Within Equity	No requirement.
Reassessment	Unclear.
Consolidated Financial Statements	Changes at the consolidated entity level (puttable at fair value).
Extinguishment Accounting	Similar.

Other Possible Approaches

The Board will develop and compare the ownership-settlement approach to other possible approaches:

- **Dilution Approach**–Liability or asset is recognized if shareholders will sacrifice or receive economic benefits (similar to a narrow view of equity).
- **Reassessed Expected Outcomes**–Probabilistic modeling technique used to predict the possible outcomes with subsequent reallocation.

The Board will decide its preferred approach.

Timing and Next Steps

- After choosing an approach, the FASB will discuss:
  - Earnings per share
  - Substantive and nonsubstantive features for instruments that may embody constructive obligations.
- Preliminary Views to be issued in the second quarter of 2007.
- The liabilities and equity project will then be a joint project with the IASB.