Financial Accounting Standards Board

Liabilities and Equity
Project Update and Upcoming Steps

FASB/IASB Joint Meeting
October 23, 2006

These notes are based on the staff papers prepared for the IASB and FASB. Paragraph numbers correspond to paragraph numbers used in the joint IASB-FASB 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
- Ownership-Settlement Approach
- Ownership Approach
- Reassessed Expected Outcomes Approach (REO)
- Key Differences and Examples
- 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.

Project Plan

- The Board is developing the following alternative approaches:
  - Ownership-Settlement
  - Ownership (narrower view of equity)
  - REO
- The Board will then choose a preferred approach and present all three approaches in a Preliminary Views.

Ownership-Settlement Approach

Ownership-Settlement Approach

- **Scope**: Financial (and certain nonfinancial) instruments that have characteristics of liabilities, assets, and equity (same for all approaches).

- Refer to the "Chart of Principles for the Ownership-Settlement Approach" and the application information (Attachment 3).

Ownership-Settlement Approach

- **Linkage**—Instruments that are part of the same arrangement are linked if the accounting for the instruments individually differs from accounting for them as a single instrument.

- **Substantive features**—An instrument is classified in the same manner as another instrument with the same or similar outcomes by identifying substantive (non-remote) features (reassessment required).

Summary of Classification

- Equity
  - (P) Perpetual and Direct Ownership with No Settlement Requirement
  - (D) Direct Ownership with Settlement Requirement
  - (I1) Indirect Ownership Settled with the Indexed Direct Ownership Instrument.
- Non-Equity
  - (I2) Indirect Ownership Not Settled with the Indexed Instrument
  - (O) All Other Instruments.

Classification under the Ownership-Settlement Approach

- An instrument is separated into equity and nonequity components if it:
  - Embodies an obligation
  - Has both equity and nonequity outcomes with differing counterparty payoffs at the outcome date.
- All other instruments that are not equity instruments or are not separated are classified as assets or liabilities.

Measurement of Single Instruments under the Ownership-Settlement Approach

Initial Measurement

- <u>All Instruments</u>
  - Transaction price disregarding issuance costs.

Subsequent Measurement

- <u>Equity</u>
  - (P) None
  - (D) Settlement Value
    - By applying the redemption formula at the reporting date in the same manner it would be applied at the redemption date
  - (I1) None.
- <u>Non-Equity</u>
  - (I2) Fair Value
  - (O) Fair Value Unless Otherwise Required by Other GAAP
    - Mandatorily redeemable shares with fixed redemptions and other debt instruments are accreted at present value using the expected settlement date.

Measurement of Separated Instruments under the Ownership-Settlement Approach

- The nonequity component to be separated is measured at its fair value.
  - Present value of amount to be paid under a 100 percent debt outcome using the expected settlement date.
- The remainder is allocated to equity.
- Fair value option is not available in lieu of separation.
- Debt extinguishment, modification, or conversion results in reallocation and possible gain or loss (similar to IAS 32).
  - Conversion at the expected settlement date would not result in a gain or loss unless modified.

Ownership Approach

Ownership Approach

- The Board developed the ownership approach (a narrower view of equity) based on the ownership-settlement approach.
- Refer to the draft version of the “Chart of Principles for the Ownership Approach” (Attachment 3).
- The key differences between the two approaches are described next.
- The objective is to identify the owners of an entity (equity instruments) and the instruments that will or may affect the net assets available to those owners (how owners may be diluted).
- Another objective is to reduce complexity.

Ownership Approach—Key Differences

- All indirect ownership instruments are classified as liabilities or assets.
  - Examples include options and forwards.
  - The Board reasoned that the holders of these instruments are not owners and that the instruments may dilute the claims of existing shareholders upon settlement; therefore, this approach focuses less on possible outcomes and more on possible dilution.

Ownership Approach—Key Differences

- Substantive features and linkage issues still arise but are less prevalent because many instruments are liabilities or assets in their entirety recorded at fair value.
  - Linkage examples include puttable stock versus a share and a separately issued written put option.
  - Substantive examples include stock with a minimal registration rights penalty or a remote put option.

Ownership Approach—Key Differences

- Separation would be limited: an equity instrument that also embodies a distinct nonequity obligation and will result in the retention of the ownership interest after the obligation is settled is reported as both equity and nonequity instruments.
  - Examples are stock with required dividend payments, stock with a substantive registration rights penalty, and a net-cash settled puttable share/make whole provision.

Ownership Approach—Key Differences

- Extinguishment would be less complex because many instruments are subsequently measured at fair value.
- The Board noted that because many instruments are reported at fair value, separate display for gains and losses may be required but the Board deferred these decisions until the Exposure Draft stage and to other pending projects.

Reassessed Expected Outcomes Approach (REO)

REO Approach

- The Board is in the process of developing the REO approach and will complete the approach in November. Therefore, the principles described are tentative.
- Refer to the draft version of the "Chart of Principles for the Reassessed Expected Outcomes Approach" (Attachment 3).
- REO is a probabilistic measurement approach that uses contingent claims modeling techniques to determine the probability of an equity or a nonequity payoff (or payoffs) at the outcome date.

REO Approach—Key Differences

- Indirect ownership instruments are classified as equity or contra-equity regardless of settlement features.
  - Examples include options and forwards.
  - Indirect ownership instruments would include those with payoffs inversely related to the share price.
- The present value of a nonequity outcome would not be calculated assuming 100 percent probability of its outcome because the outcome is uncertain.

REO Approach—Key Differences

- Options and forward contracts (exchange contracts) would be separated into their exchange components (grossed up) if they represent, or are based on issuing or repurchasing the reporting entity's ownership instruments unless the exchange components both represent equity payoffs.
  - An option to issue shares at fair value would be equity in its entirety.
  - An option at a fixed price would be separated into (1) the right or obligation to receive or pay cash upon exercise and (2) the issuance or repurchase of shares (based on the probability of exercise).

REO Approach—Key Differences

- Separated components are remeasured and reallocated between nonequity and equity. The nonequity component is remeasured based on the current probability of the payoff’s occurrence, which includes determining the expected timing of the outcome if it would vary. The measurement is calculated by inputting the current share price and remaining maturity period in the same model used at inception.

REO Approach—Key Differences

- Interest is recorded based on the nonequity balance at beginning of the reporting period times the appropriate conventional borrowing/lending rate.
- Remeasurement of the nonequity component results in an allocation to equity.

REO—Open Items

- The following issues will be addressed next (in November):
  - Measurement attribute (fair value versus historical transaction price)
  - Linkage/Display—Recording an asset versus a contra-liability (for example, a stock option)
  - Interest expense computation
  - Display within the equity section for instruments that may require cash settlement
  - Conceptual considerations
  - EPS computation (to be addressed later in the project when the approaches are compared).

Key Differences: Examples Illustrating Accounting for Certain Instruments

	Ownership Settlement Approach	Ownership Approach	REO at Transaction Price	REO at Fair Value
Convertible Debt and Puttable Stock	Separate Liability (Financial) and Residual Equity (liability not probability-weighted)	Liability (Financial) Fair Valued	Separate Liability (Financial) and Residual Equity (liability probability-weighted considering current share price)	Separate Liability (Financial) and Equity (liability probability-weighted considering all variables)
Shares Redeemable at Fair Value	Equity (separate display)	Equity (separate display)	Equity (display?)	Equity (display?)
Written Call, Physically Settled	Equity	Liability (Derivative)	Separate Asset and Residual Equity (asset probability-weighted considering current share price)	Separate Asset and Equity (probability-weighted considering all variables)
Written Put, Physically Settled	Liability (Derivative)	Liability (Derivative)	Separate Liability (Financial) and Residual Contra-Equity (liability probability-weighted considering current share price)	Separate Liability (Financial) and Contra-Equity (probability-weighted considering all variables)

Accounting for Convertible Debt (into a Fixed Number of Shares) under the Ownership-Settlement Approach

- Classification:
  - Separated into liability and equity components based on identification of both payoffs.
- Initial Measurement:
  - Nonequity component measured at fair value using expected settlement date and 100 percent probability of outcome
  - Residual is equity.
- Subsequent Measurement:
  - Nonequity component accreted
  - Equity component remains unchanged.

Accounting for Convertible Debt (into a Fixed Number of Shares) under the Ownership Approach

- Classification:
  - Liability in its entirety.
- Initial Measurement:
  - Initially measured at transaction price (disregard issuance costs).
- Subsequent Measurement:
  - Subsequently measured at fair value
  - Changes in fair value recorded in income.

Accounting for Convertible Debt (into a Fixed Number of Shares) under the REO Approach (at Transaction Price)

- Classification:
  - Separated into liability and equity components based on identification of both payoffs.
- Initial Measurement:
  - Components are initially measured at fair value considering the probability of each outcome and expected settlement date
- Subsequent Measurement:
  - Nonequity component is remeasured based on probability of occurrence by adjusting the current share price and remaining term
  - Remeasurement of nonequity component results in allocation to equity by forcing back to the transaction price (considering interest).

Accounting for Convertible Debt (into a Fixed Number of Shares) under the REO Approach (at Fair Value)

- Classification:
  - Separated into liability and equity components based on identification of both payoffs.
- Initial Measurement:
  - Components are initially measured at fair value considering the probability of each outcome and expected settlement date.
- Subsequent Measurement:
  - Nonequity and equity components are remeasured based on probability of occurrences and recorded at fair values by adjusting all variables that affect fair value of entire instrument.
  - Changes in fair value are recorded in income.

Timing and Next Steps

- EPS implications will be considered in comparing the approaches.
- After choosing an approach, the FASB will discuss:
  - Substantive and nonsubstantive features for instruments that may embody constructive obligations
  - Interaction with other accounting literature, for example, Statement 133.
- 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.