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International Accounting Standards Board

INFORMATION FOR OBSERVERS

IASB Meeting: **Financial Instruments Working Group**
Paper: **Agenda Paper 1A**

Financial Instruments: Liabilities and Equity Ownership (a Narrow View of Equity)

INTRODUCTION

1. This paper is a supplementary paper to paper 1. It is not intended that this paper will be discussed in the FIWG session on Liability and Equity. This paper is intended as background information for the FIWG discussion.

2. This paper summarises the Ownership model. If you require greater detail, or worked examples to illustrate concepts, please refer to the full model which can be found on the FASB website at the following web address http://www.fasb.org/project/Summary_of_Principles_for_the_Ownership_Approach_rev_nov2006.pdf

3. In the ownership model equity represents the current ownership interests in the entity. Equity also includes instruments with no settlement provisions. Current ownership interests are defined in the model as direct ownership instruments or perpetual instruments. Descriptions of these instruments can be found below.

EQUITY INSTRUMENTS

4. An equity instrument represents an ownership interest in an entity and is determined either by the absence of a settlement requirement or the type of return the instrument conveys to the counterparty.

5. There are two types of equity instruments:

   a. a perpetual instrument issued by the entity, and

   b. a direct ownership instrument issued by the entity.

Perpetual Instrument

6. A perpetual instrument issued by the entity embodies no settlement obligation and entitles the holder to a portion of the entity's net assets in liquidation. For example, some forms of common stocks, preferred stocks, and callable stocks are perpetual instruments. A perpetual instrument is equity even if the instrument is not a direct ownership instrument.

Direct Ownership Instrument

7. A direct ownership instrument may or may not be perpetual and is an instrument issued by the entity that has both of the following two characteristics:

   a. The instrument represents a proportional claim to a share of the net assets of the reporting entity that is neither limited nor guaranteed (that is, there is no ceiling or floor other than zero net assets) either before or at liquidation. An instrument that is redeemable at fair value meets this characteristic (either mandatorily redeemable or puttable by the holder). An instrument that is redeemable at book value or a formula based on book value also meets this characteristic if (i) there is no active market for the instrument or (ii) the instrument can be exchanged only with the entity.

   b. The claim represented by the instrument has no priority over any other claims if the issuer were to liquidate on the date the classification decision is being made.

LINKING INSTRUMENTS

8. An entity should link two or more instruments (account for as a single instrument) that are part of the same arrangement if accounting for the instruments individually differs from accounting for them as one. A linked group of instruments is classified, measured, and displayed as if it was a single instrument.

9. Instruments are part of the same arrangement if at least one of the following conditions is met:

    a. Contractual interdependency exists between the instruments. For example, interdependency exists if (a) exercise of one depends on exercise of the other or causes the expiration of the other, (b) an instrument is specifically tied to a second instrument, or (c) there is contractual evidence of interacting payoff structures affecting an outcome.

    b. Non-contractual dependency - the instruments have interacting payoff structures and are entered into at or near the same time with the same or a related counterparty or an agent acting on behalf of a counterparty.

SUBSTANTIVE FEATURES

10. An entity should classify a single instrument or a linked group of instruments (as described above) in the same manner as another instrument with the same or similar outcome (or set of possible outcomes with the same or similar probabilities of occurrence). To do so, an entity should consider substantive features (stated or unstated) and ignore any features that are not substantive.

11. A stated or unstated feature is substantive if the feature (1) has more than a remote likelihood of affecting an instrument's outcome (is reasonably possible) and (2) could have more than a minimal effect as compared to other features within an instrument. All other features are not substantive. For example, a prepaid warrant on a direct ownership instrument requires an initial net investment that is the same as the entity's direct ownership instrument price and

a minimal exercise price. Although it is not stated as a share, the instrument is a direct ownership instrument because the option element of the warrant is non-substantive. Another example would be a put feature embedded in a share that has a remote chance of being exercised, such a put feature should be regarded as non-substantive.

12. Substantive features are identified in determining whether instruments are linked by applying an iterative process. That process entails comparing the accounting results for the instruments both unlinked and linked by identifying substantive features under each scenario. Additionally, the likelihood of a settlement feature's occurrence is assessed by considering all facts and circumstances over the lifetime of the instrument.

SEPARATION OF COMPONENTS

13. An equity instrument that embodies a distinct non-equity obligation is separated into equity and non-equity components if the equity instrument continues to exist after the obligation has been extinguished. If the instrument has either an equity outcome or a non-equity outcome then the instrument is a liability in its entirety and not separated into its components.

14. An example of an instrument that requires separation into its components is a preferred share with required dividend payments. This is because the preference share represents a perpetual instrument and as such is classified as equity. However the fixed dividend stream is an obligation and must be separated out as a liability. An example of an instrument that is not separated into its components is a convertible bond. This is because such an instrument has either an equity or non-equity outcome, therefore does not meet the criteria for an ownership instrument, and is classified as a liability in its entirety.

CLASSIFICATION OF OTHER INSTRUMENTS

15. Instruments that are not equity instruments are classified as liabilities or assets in their entirety.

16. Generally, all options and forward contracts on an entity's equity instruments are included in this category as well as any other instruments that must first be converted into equity to meet the equity conditions above.

INITIAL MEASUREMENT

Single instruments

17. An instrument that is equity or non-equity in its entirety is initially measured at its transaction price. The transaction price does not include issuance costs whether they are included in the price quoted by the seller (to the buyer) or billed and paid separately.

Separated Components

18. In dividing a transaction price between an equity and non-equity instruments, an entity should first determine the fair value of the non-equity instrument. The residual amount is allocated to equity.

SEPARATE REPORTING WITHIN EQUITY

19. Equity instruments that may be settled with cash or other assets are reported under a separate heading within equity from equity instruments that are perpetual or settled with other equity instruments. An example of an equity instrument that may be settled with cash is a share puttable at fair value; the share represents a direct ownership instrument but also may be settled with cash or other assets.

SUBSEQUENT MEASUREMENT

Single Instruments, Equity

20. An equity instrument that may be settled in cash or other assets is remeasured at each reporting period (separately reported equity as described above). The subsequent measurement attribute is the current settlement value. The amount that would be paid if the instrument were settled according to its terms at the reporting date.

21. Other equity instruments are not remeasured.

Single Instruments, non-equity

22. Non-equity instruments will be accounted for under existing GAAP.

Separated Components

23. Upon separation into components the individual components are subsequently accounted for as if they were stand alone instruments in their own rights and should therefore comply with the subsequent measurement guidance for single instruments discussed above.

REASSESSMENT OF CLASSIFICATION

24. An instrument is reassessed at each reporting date to determine if the previous classification is still appropriate. No gain or loss is recognised as a result of the reclassification unless there is an extinguishment or contractual modification.

    a. Upon consolidation and at each reporting date, the reporting entity should reassess the substantive features (stated and unstated) of an instrument or linked group of instruments for classification purposes.

    b. Reassessment may result in reclassification and, in some cases, remeasurement of an instrument. For example, a put option embedded in a share may expire such that the share now meets the equity conditions. Instruments reclassified to assets, liabilities, or separately reported equity that may be settled with cash or other assets are measured at the attributes at which they would have been measured if they were previously classified that way as from the date of the event that caused the reclassification. No gains or losses are recognised upon a reclassification unless it results in a debt extinguishment or a modification. There is no limit on the number of times an instrument may be reclassified.

EXTINGUISHMENT ACCOUNTING

25. Extinguishment accounting includes settlement (a) per contractual terms, (b) at an amount outside the contractual terms, (c) by conversion into equity instruments, or (d) by modification of an instrument. A gain or loss is recognised for any difference between the extinguishment amount and the carrying amount.

26. The extinguishment amount is equal to (1) the amount paid, (2) the fair value of the new instrument issued, or (3) the new fair value of the old instrument as modified.