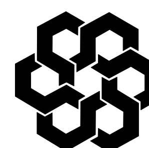

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**International Accounting Standards Board**

This document is provided as a convenience to observers at Financial Instruments Working Group meetings, to assist them in following the discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

Note: These notes are based on the staff paper prepared for the Financial Instruments Working Group Meetings. Paragraph numbers correspond to paragraph numbers used in the Financial Instruments paper. However, because these notes are less detailed, some paragraph numbers are not used.

**INFORMATION FOR OBSERVERS**

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| **IASB Meeting:** | **Financial Instruments Working Group** |
| **Paper:** | **Agenda Paper 1C** |

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# Financial Instruments: Liabilities and Equity Reassessed Expected Outcome (REO)

## 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 REO 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_REO_Approach_rev_jan2007.pdf

3. Under the REO model equity instruments represent a return on investment that is based on the performance of the issuing entity. The structure of the instrument is irrelevant as is the form of settlement. Participation in the performance of the entity, both directly and inversely, is equity. No participation results in a liability classification.

## EQUITY INSTRUMENTS

4. An equity instrument represents either (a) an ownership instrument of an entity or (b) an instrument that has a payoff to the counterparty that is either directly or inversely based on an entity's ownership instruments.

5. An ownership instrument of an entity has both of the following two characteristics:

   a. The instrument represents a proportional claim to a share of the net assets of the 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.

6. Any derivative that is linked to the performance of a direct ownership instrument would be equity, to at least some degree, under this method. Equity would therefore include instruments that are inversely linked to the performance of a direct ownership instrument. Equity would also include certain instruments that are net settled.

## LINKING INSTRUMENTS

7. An entity should link one 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 if they were a single instrument with the same or similar outcome (or possible outcomes). A linked group of

instruments is classified, measured, and displayed as if it were a single instrument, which includes possible separation into an equity component and a non-equity component.

8. 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 interdependency - 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**

9. The substantive features principle determines when terms (either stated or not-stated) of an instrument should be regarded, or disregarded, for classification purposes. For instance, if a term is so unlikely to ever be utilised that it essentially has no impact to the economic substance of the instrument then it should be disregarded for classification purposes.

10. REO does not have guidance on the substantive features principle due to the nature of the REO model; the probability of all the possible outcomes is considered in the classification of the instrument. Therefore, by default, a feature that is not substantive would not impact the classification of the instrument under this model.

**SEPARATION OF COMPONENTS**

11. An instrument or a group of linked instruments is separated into equity and non-equity components if it has potential for an equity payoff (one that is directly or

inversely based on the fair value of the entity's direct ownership instruments) or a non-equity payoff (one that is not based on the fair value of the entity's direct ownership instruments) at the outcome date. A separated component of an instrument or a group of linked instruments should be classified and displayed as if it were a freestanding instrument and measured under the requirements described below.

12. Equity payoffs are identified by examining the possible counterparty payoffs at the outcome date and determining whether one or more of those payoffs is directly or inversely based on the fair value of the entity's direct ownership instruments.

13. Instruments that require or have payoffs based on an exchange of assets for the issuance or repurchase of the entity's direct ownership instruments are separated into equity and non-equity components if the payoffs at settlement would differ. In other words, exchange contracts indexed to the reporting entities direct ownership instruments, would be reported gross if, at settlement the two legs could have a different value (ie there is some form of variability in one or both of the legs). Gross reporting is required even for net settled contracts. For example, a written option to buy an entity's shares at a fixed price would be recorded as an asset (the probability weighted cash to be received) and equity (the fractional shares to be issued) even if the contract will be net settled.

14. Instruments comprising just equity components or just non-equity components would not be separated. Instruments may be separated into more than two components. For example, some instruments may be separated into equity, liability, and asset components if all three payoffs exist. An instrument cannot have more than one equity, liability, or asset component.

15. An instrument that has an interim settlement is initially accounted for based on its payoff (or payoffs) at the interim settlement. Subsequent to interim settlement the instrument is accounted for based on the payoff (or payoffs) at its ultimate outcome. For example, a warrant on shares puttable at a fixed price has an interim settlement (exercise of the warrant) and an ultimate outcome (exercise or expiration of the put option).

## CLASSIFICATION OF OTHER INSTRUMENTS

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

## INITIAL MEASUREMENT

*Single instruments*

17. An instrument that is equity or non-equity in its entirety should be 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. The initial measurement of the components of a separated instrument should always sum to the transaction price of the entire instrument as described above. In dividing that total transaction price between two components, an entity should determine the fair value of a hypothetical instrument with terms that would produce the same or similar outcomes as each of the separated components. Each component is measured by applying probability-based modelling techniques that consider the probability and timing of each outcome's occurrence.

## SEPARATE REPORTING WITHIN EQUITY

19. The equity section of the balance sheet is separated into the following three categories: (a) potentially dilutive equity, which represents equity components of separated instruments, (b) equity instruments that may be settled with cash or other assets, and (c) all other direct ownership instruments.

## SUBSEQUENT MEASUREMENT

*Single Instruments, Equity*

20. Freestanding equity instruments that may be settled with cash or other assets are remeasured at each reporting date. The subsequent measurement attribute is the current settlement value. The fair value of the consideration that would be paid if the instrument were settled according to its terms at the reporting date.

21. Other freestanding equity instruments are not remeasured.

*Single Instruments, non-equity*

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

*Separated Components*

23. Components are remeasured to their fair value at each reporting date with gains and losses reported in net income.

    a. Separated components are measured by adjusting all relevant inputs (including the current direct ownership instrument price, volatility, interest rate, and remaining time to maturity) in the measurement model applied at inception.

    b. The remeasurement of non-equity and equity components reflects the current probability of each payoff's occurrence. The difference between the beginning period fair value and ending period fair value for the entire instrument less any interim payments is recorded as a gain or loss through income.

## REASSESSMENT OF CLASSIFICATION

24. An instrument should be 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).

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

26. Reassessment may result in reclassification and, in some cases, remeasurement of an instrument. Instruments reclassified to assets, liability, or separately reported equity that may be settled with cash or other assets, should be measured at the attributes at which they would have been measured if they were previously classified that way as of the date of the event that cause the reclassification.

27. No gains or losses are recognised in the income statement upon a reclassification unless it results in a debt extinguishment or a modification.

## EXTINGUISHMENT ACCOUNTING

28. 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 recognized for any difference between the extinguishment amount and the carrying amount.

29. 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.