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**International
Accounting Standards
Board**

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.

INFORMATION FOR OBSERVERS

Board Meeting: 21 February 2007, London

Project: Liabilities and Equity

Subject: Session introduction (Agenda Paper 4)

BACKGROUND

1. This series of papers supports the Board's objective of being able to issue the FASB's preliminary views document on Liabilities and Equity (L/E) as an IASB discussion paper.
2. This education session has two aims, namely to:
 - a. enhance the Board's knowledge and understanding of the FASB models, and
 - b. identify possible issues and questions that the Board may want to ensure are included in the discussion paper.
3. The session papers are structured as follows:
 - a. This paper provides an introduction to the session;
 - b. Papers A, B and C are summary papers on each of the models. It is not intended that these papers will be discussed in the session but are

rather provided as background reading. These are followed by topic papers that will discuss the issues across all three models. The full descriptions of each model (per the FASB) have previously been circulated to Board members.

- c. Papers D-G form the basis for the board discussion and provide detailed analysis and comparison of the three models. They cover different aspects of the FASB models, namely:
 - i. Paper D – Definition of equity;
 - ii. Paper E - Linkage and Separation;
 - iii. Paper F - Measurement;
 - iv. Paper G - other issues
 - d. Paper H contains illustrations applying all three models to a series of examples.
4. These papers contain talking points at the end of each topic paper. The staff is not seeking any preliminary views from the Board.
5. At the end of this paper, in an appendix, is a brief glossary of terms used in describing the three models.

OVERVIEW

6. At the January meeting, the Board discussed IAS 32 *Financial Instruments: Presentation* model and various implementation and other issues that have arisen.
7. The issues arising from IAS 32 fall broadly into three categories: challenges in implementing the standard; discomfort with the answers when the standard is implemented; and conceptual conflicts between the guidance in the standard and the existing framework.
8. The last two categories are a result of differing views regarding what is equity. IAS 32's underlying principle (with some exceptions) is that an instrument is

equity only if there is no present obligation. This principle flows directly from our Conceptual Framework element definitions.

9. The IAS 32 model ignores, in most circumstances, any ‘ownership’ characteristics that might exist in instruments, concluding that the existence of an obligation should normally take precedence to any ownership interests.
10. The FASB models all attend to the ownership characteristics to some extent; all define what equity is as the basis for the model.
11. The three FASB models are the ownership model (narrow view of equity), ownership-settlement model (broad view of equity), and Reassessed Expected Outcome (REO) approach. A brief introduction to each of these models is included below for the convenience of Board members. A fuller description of each model is contained in papers A, B and C.
12. The March board paper will revisit some of the IAS 32 issues discussed in the January board paper and how the FASB models deal with those issues.

Ownership

13. The stated objective of the ownership model is to identify the owners of the entity and the instruments that will affect the net assets available to those owners.
14. Under the ownership model current ownership interests are equity. The model also treats instruments with no settlement obligations as equity. This narrow view of equity results in a simple model from both a conceptual and application perspective.

Ownership-settlement

15. The stated objective of the ownership-settlement model is to identify equity instruments or equity components based on the existence of settlement obligations and the nature of the payoffs to the counterparties. The intent of this approach is to provide useful information to the users of financial statements regarding liquidity and ownership.

16. Under the ownership-settlement model equity represents the current and future ownership interests in the reporting entity. The model identifies those ownership interests by considering both the type of return the instrument conveys to the counterparty and the settlement outcome.
17. The model results in three categories of equity instruments: ownership interests; perpetual instruments (equity because they have no settlement terms); and finally indirect ownership interests (mainly derivatives indexed to and settled with ownership interests). The model is relatively complex and relies heavily on the principles of linkage, substantive terms and separation.

REO

18. The stated objective of the REO model is to account for economically similar instruments consistently. It does this by using arbitrage free modelling techniques to split instruments with varying payoffs into those probability weighted payoffs.
19. The basis for the model is that equity instruments provide 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.
20. The model places heavy reliance on the separation principle. Instruments are separated into all the possible outcomes that could occur on the basis of the probability of those outcomes. That separation is done using contingent claims modelling techniques (such as Black Scholes Merton or a Binomial model). The transaction price is split into the respective fair values of the hypothetical components. The split is then reassessed at each reporting date and adjusted for moves in probabilities of outcomes.
21. Whilst the population of equity instruments is significantly broader under REO than the other models, REO subsequently measures all separated instruments at fair value in their entirety. Therefore from an income statement perspective REO results in an income statement that is comparable to the ownership model and more representative of a narrow view of equity.

Ownership Instrument

22. Key to all three of these models is the “Ownership instrument”. Even REO, which considers economic return rather than any idea of ownership, uses the definition of an ownership instrument as the indicator of an equity or non-equity return to the investor.
23. The definition of an ownership instrument is consistent across all three models. The criteria to be an ownership instrument includes having a proportional claim to a share of the net assets of the entity and having no priority over other claims on liquidation.

APPENDIX

GLOSSARY OF TERMS

There are a number of terms used within the models that are not used within IFRS’ to date, to aid understanding of the model these terms are defined below.

Settlement. Settlement is defined as the extinguishment of the reporting entity’s obligation or right, by delivery or receipt of consideration other than distributions of the entity’s net assets in liquidation. Settlement does not refer to the expiration of an unexercised option because generally, no consideration is delivered or received at expiration.

Outcome. An outcome is the settlement or any other result other than liquidation, which includes the expiration of options.

Payoff. The counterparty’s payoff is the fair value of that counterparty’s position at the outcome, ignoring any initial net investment. For example, if an entity enters into an option or forward contract, the counterparty’s payoff is equal to the difference between the strike or contract price and the fair value of the shares at the outcome date. Similarly, if an entity issues a mandatorily redeemable share, the counterparty’s payoff is equal to the redemption amount of those shares.