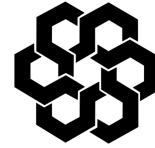

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International
Accounting Standards
Board

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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:	**Supplementary Paper – Ownership-settlement (Agenda Paper 4B)**

INTRODUCTION

1. This paper is a supplementary paper to the February 2007 board paper on Liability and Equity. This paper provides a summary of the Ownership-settlement model. For further details on the model please refer back to the original FASB documents circulated previously.

2. In 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. How the model considers those two different characteristics of an instrument in its classification is detailed below.

3. The models use a number of new terms. A glossary of those terms is included in the appendix to Agenda Paper 4.

EQUITY INSTRUMENTS

4. An equity instrument represents an ownership interest of an entity and is identified by the settlement outcome and the type of return the instrument conveys to the counterparty. An equity instrument may be a single instrument or a component of an instrument (identified based on differing outcomes and payoffs at settlement).

5. There are three types of equity instruments:

   a. a perpetual instrument issued by the reporting entity,

   b. a direct ownership instrument issued by the reporting entity, and

   c. an indirect ownership instrument issued or held by the reporting entity that is based on and will be settled with the same direct ownership instrument or instruments.

   These types of instruments are described below.

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 reporting entity that has both of the following 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 reporting 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.

Indirect Ownership Instrument

8. An indirect ownership instrument issued or held by the reporting entity has all of the following characteristics and is classified as equity only if it is settled with the direct ownership instrument from which it derives its value (ie a share option must be settled with the shares it has an option over as opposed to cash or any other instrument):

   a. The instrument is not perpetual

   b. The instrument lacks one or both of the characteristics of a direct ownership instrument, but has a counterparty payoff at settlement that is based on and varies in the same direction as the fair value of a direct ownership instrument.

   c. The instrument does not include contingent exercise provisions based on (i) an observable market other than the market for the reporting entity's direct ownership instruments or (ii) an observable index other than an index calculated or measured solely by reference to the reporting entity's own operations (for example, revenue of the reporting entity).

LINKING INSTRUMENTS

9. 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 were a single instrument, which includes possible separation into an equity component and a nonequity component (see paragraphs 14-18).

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

   a. Interdependency exists between the instruments. For example, interdependency exists if (i) exercise of one depends on exercise of the

other or causes the expiration of the other, (ii) an instrument is specifically tied to a second instrument, or (iii) there is contractual evidence of interacting payoff structures affecting an outcome.

b. 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

11. An entity should classify a single instrument, a linked group of instruments, or a component of an instrument 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.

12. 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 may not be called 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.

13. 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

14. An instrument is separated into equity and nonequity components if it (a) embodies an obligation and (b) has both equity and nonequity outcomes with differing counterparty payoffs at the outcome date.

15. First you should look to see whether the instrument has multiple payoffs, then look to see whether those payoffs are both equity and non-equity, finally look to see whether the non-equity payoff embodies an obligation.

16. For example, an ownership instrument issued by the reporting entity with an embedded put option for the holder contains an obligation for the issuer (the issuer would have to pay the stated settlement amount when the holder wants to put those instruments back to the issuer), and as such the instrument would be separated.

17. If that same instrument contained a call option instead of a put the instrument would not be separated into its components. This is because although the instrument has both equity and non-equity outcomes it does not embody an obligation, the issuer has control over whether or not the instrument is called.

18. Finally, if the original puttable instrument were puttable at fair value, then it would not be separated into its components. This is because puttable at fair value represents an equity outcome, therefore the instrument has two equity outcomes and no non-equity outcome to separate, even though the instrument embodies an obligation.

19. No instrument should be separated into more than two components. A separated component of an instrument should be classified and displayed as if it were a single instrument and measured under the requirements described throughout the model.

20. Equity outcomes are identified and based on the three types of equity instruments. Instruments comprising more than one equity component would not be separated.

21. The fair value option could be applied to the nonequity component in applying the measurement provisions of this summary if the instrument meets the fair value option eligibility criteria.

22. An instrument that has an interim settlement consisting of an instrument that would be separated (for example, a warrant on shares puttable at a fixed price) would not be separated until the interim settlement occurs. Prior to any interim settlement, the instrument would be classified as a liability or an asset in its entirety.

CLASSIFICATION OF OTHER INSTRUMENTS

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

INITIAL MEASUREMENT

Single instruments

24. An instrument that is equity or nonequity 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

25. The initial measurement of the two components of a separated instrument should always sum up to the transaction price of the entire instrument. In dividing that total transaction price between the two components, an entity should first determine the fair value of the hypothetical nonequity instrument with terms that would produce the same or similar outcome as the separated nonequity component. The separated nonequity component is initially measured at that amount. The equity component is measured by deducting the amount assigned to the nonequity component from the transaction price of the instrument as a whole.

26. In determining the fair value of a hypothetical nonequity instrument, an entity should consider the following:

    a. That factors such as the share price, put, call, and conversion features would be considered in determining a component's expected settlement date.

b. That a fixed settlement amount (a floor) results in describing a fixed amount that is 100 percent likely to be paid. For example, it is assumed that the fixed price in convertible debt or shares puttable at a fixed price would always be paid even if the equity outcome occurs.

c. That, if the amount or timing of a settlement obligation varies or is uncertain, the fair value of the nonequity component would be determined by considering the probability-weighted (expected) settlement date (or dates) and amount (or amounts) due. For example, since the amount due at the expected settlement date for a share with a make-whole provision is contingent upon the share price, the reporting entity must determine the probability-weighted amount of the contingent liability.

d. That if the nonequity component would be subsequently accreted (as in the floor component of convertible debt), the probability-weighted (expected) settlement date is determined first and then used to calculate the amount due at that date and the implicit interest rate for the settlement period.

SEPARATE REPORTING WITHIN EQUITY

27. Equity instruments or components that may be settled with cash or other assets should be reported under a separate heading within equity from equity instruments that are perpetual or settled with other equity instruments. Measurement requirements are described later.

SUBSEQUENT MEASUREMENT

Single Instruments, Equity

28. An equity instrument or component that may be settled with cash or other assets is remeasured at each reporting period. The subsequent measurement attribute is the current settlement value –the consideration that would be paid if the instrument were settled according to its terms at the reporting date. Other equity instruments are not remeasured.

Single Instruments, non-equity

29. Nonequity instruments will be accounted for under existing GAAP.

Separated Components

30. 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

31. 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).

32. 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.

33. 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. 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.

CLASSIFICATION IN CONSOLIDATED FINANCIAL STATEMENTS

34. The classification of an instrument of a consolidated subsidiary or variable interest entity should be reconsidered in the consolidated financial statement and could be different from its classification in the subsidiary's financial statements. For instance a perpetual share issued by a subsidiary would be equity in the subsidiary accounts, however if the parent entity issues a put at a fixed value over that share then at the consolidated level it may no longer qualify for equity classification.

EXTINGUISHMENT ACCOUNTING

35. An entity should apply extinguishment accounting consistently. 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.

36. If an instrument has been separated into liability and equity components and the liability component is subsequently extinguished or modified, that event is accounted for as if both components of the original instruments had been replaced by issuing a new instrument with the new terms. The new instrument is assessed for separation considering the modified terms.

37. If the entire extinguishment amount differs from the carrying amount of the liability at the date of extinguishment, a gain or loss will result for any remaining amount after reallocation to the liability and equity components.