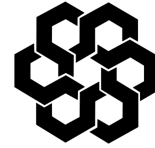

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International Accounting Standards Board

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: **Topic Paper - Equity (Agenda Paper 4D)**

BACKGROUND

1. This paper is focused on the definition of equity within each model.

WHAT DETERMINES EQUITY UNDER EACH MODEL?

2. Ownership. Under the ownership model equity is determined by the type of return the instrument conveys **or** the lack of a settlement requirement.

3. Ownership – settlement. Under the ownership-settlement model equity is determined by the type of return the instrument conveys to the counterparty **and** the settlement outcome.

4. Reassessed Expected Outcomes (REO). Under the REO model equity is based on the potential economic outcomes (or 'payoffs') of the instrument, and whether such outcomes are linked to the performance of the entity or not.

5. The models categorise instruments into different groups in order to determine equity. The labels used for the different groups are ownership instruments, indirect ownership instruments and perpetual instruments.

Ownership Instruments

6. All three models have an ownership instrument as equity. This is consistent with the 'equity' (rather than liability) focus of the three models.

7. *Ownership instruments have both of the following characteristics:*

   a. a proportional claim to a share of the net assets of the reporting entity that is neither limited nor guaranteed, and

   b. no priority over any other claim in the event of liquidation.

8. This definition underpins all three models. The definition of an indirect ownership instrument is also based on an ownership instrument.

Perpetual Instruments

9. Perpetual instruments are equity under both the ownership and ownership-settlement models.

10. The definition of a perpetual instrument is that the instrument *embodies no settlement obligation and entitles the holder to a portion of the issuer's net assets in liquidation*.

11. Perpetuality is not relevant to the classification of the instrument under the REO model.

Indirect Ownership Instruments under ownership-settlement model

12. The ownership model states that only ownership instruments and perpetuals are equity.

13. The ownership-settlement model also includes "*indirect ownership instruments*" as equity (if they are settled with the indexed instrument). The holder of an indirect ownership instrument could be said to be on the path to becoming the holder of a direct ownership instrument.

14. Indirect ownership instruments have all of the three following characteristics:

   a. The instrument is not perpetual

   b. The instrument is not 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 (a) an observable market other than the market for the reporting entity's direct ownership instruments or (b) an observable index other than an index calculated or measured solely by reference to the reporting entity's own operations.

Indirect Ownership Instruments under REO

15. Equity under REO is defined as:

An equity instrument is either (a) a direct ownership instrument issued by the reporting entity or (b) an instrument that has a payoff to the counterparty at the settlement or outcome date that is either directly or inversely based on the fair value of the reporting entity's direct ownership instruments. An equity instrument may be an entire instrument, a group of linked instruments, or a component of an instrument or a group.

16. REO does not define indirect ownership instruments, but the extension of the equity definition to include instruments with payoffs directly or inversely based on the reporting entity's ownership instrument effectively creates this second category of equity instruments.

17. In comparison to the Ownership-settlement definition the REO model includes instruments inversely based on the reporting entity's ownership instruments. It also includes instruments that are not settled with the underlying ownership instrument.

18. This extends the population of instruments that would be regarded as equity quite substantially.

SUMMARY OF EQUITY

19. The Ownership model is the narrowest view of equity. The model includes direct ownership interests and perpetuals as equity.

20. The Ownership-settlement model is a broader model (and closest to our current population of equity instrument – with a few obvious exceptions such as puttables). This model includes direct and indirect ownership interests as well as perpetuals as equity. However, this approach requires multiple identifying characteristics (ie both ownership and settlement) and is therefore more complex.

21. REO focuses on the economic payoffs rather than the characteristics of the instruments. The model represents a totally new approach to the L/E distinction. However, the REO model would require many instruments to be remeasured through profit or loss. Hence, although more instruments are classified as equity under REO than for the Ownership model, the impact of the remeasurement requirement actually means that the differences between the REO and Ownership models are largely presentational in nature. This issue is discussed in greater detail in the measurement paper.

INTERACTION WITH THE FRAMEWORK

22. There is tension between all three of these models and the existing conceptual framework.

23. All three models rely on a definition of equity to classify instruments. However, the Framework defines equity as a residual. Therefore there is potential for instruments to be classified as equity that meet the definition of a liability, or conversely for instruments to be classified as liability that do not meet the definition of a liability. An example is the classification of instruments puttable at fair value as equity. The put feature represents an obligation and the instruments meet the definition of a liability, but would be classified as equity under all three models.

24. Ownership and ownership-settlement both include perpetual instruments as equity, although they do not necessarily represent ownership interests in the

entity. Under REO not embodying an obligation is insufficient to classify an instrument as equity, therefore unless the perpetual instrument represents an ownership interest it would be classified as non-equity. However, without any obligation such an instrument does not meet the definition of a liability.

25. Finally, REO accounts for derivatives on ownership instruments on a gross basis. Any derivative contract that is an exchange contract will have two legs, but given that the two legs are interdependent they are generally regarded as one instrument on the balance sheet. In order for REO to achieve arbitrage free accounting it is necessary to gross those contracts up into their respective legs. An example is a written call option, such an instrument would involve receipt of cash and issuance of shares, therefore REO grosses up a written call option into an asset (being the probability weighted cash receipt) and equity (being the fractional shares that will be issued).

26. Splitting derivatives into their exchange components raises a number of conceptual issues. These might include:

    a. Whether it is the contract as a whole or the exchange components of a contract that should be tested against the element definitions.

    b. If the exchange components are split then components should be assessed to see if those components meet the element definitions. For example, the asset split out from an option is the expected cash receipt, but whether or not that cash is received is conditional on the option being exercised and the entity can not control whether or not the option is exercised.

    c. Splitting an option into its exchange components means recognising an asset from a written option, with an offsetting equity component. The recognition of an asset from a written option is a topic that has been extensively debated previously.