



30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

**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: Topic Paper – Linkage and Separation (Agenda Paper 4E)

BACKGROUND

1. This paper discusses the linkage and separation principles in each model, and the level of reliance each model places on these principles.
2. Linkage criteria determines when two or more instruments should be combined and accounted for as though they were one instrument. Separation is the reverse; when one instrument should be bifurcated and components accounted for as standalone instruments.

	Ownership-settlement model	Ownership model	REO model
Linkage	Heavy reliance	Less reliance than under O-S	Minimal reliance
Separation	Heavy reliance	Minimal reliance	Heavy reliance

LINKAGE

3. As discussed above, linkage concerns when two (or more) instruments should be viewed as one. This is a unit of account question.
4. This topic was recently considered in the Financial Instruments Due Process Document project; the conclusion in that discussion was that, if all financial instruments were measured at fair value, then in most circumstances there was no requirement for linkage.
5. However that is not the case for L/E, different instruments might be measured differently. To ensure consistency of classification and accounting treatment it is sometimes necessary to consider linking two or more instruments together.
6. The three FASB models depend upon linkage criteria to different degrees.
7. An example where issuing a single instrument or the individual components separately would give different accounting answers is issuing an ordinary share redeemable at fair value or issuing an irredeemable ordinary share and a separate put option. An ordinary share redeemable at fair value would be equity under all three models, remeasured at each reporting date to the current settlement value. Without the linkage principles the irredeemable ordinary share would be equity under all three models recorded at cost and not remeasured, the put option would

- be a liability under the ownership model subsequently measured at fair value, it would be equity under ownership-settlement and not subsequently remeasured, and finally it would be split under REO into equity and asset. The linkage criteria would link the separately issued put with the underlying share and have the separately issued instruments treated as an ordinary share redeemable at fair value.
8. All of the models require an entity to link two or more instruments 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. This is the underlying linkage principle.
 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) *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 the counterparty.*
 10. A linked group of instruments is classified, measured and displayed as if it was a single instrument.

SEPARATION INTO COMPONENTS

11. As discussed under linkage, in order to get consistent treatment across instruments, instruments containing elements of both equity and non-equity need to be bifurcated. Each component can then be classified and accounted for separately.
12. There are two elements to any guidance on separation. First, to identify which instruments require separation. Second, to provide guidance on how to separate components, once separation is required.

13. Identification of instruments to be separated is different under each of the three models. The mechanics of the separation are consistent between ownership and ownership-settlement, but significantly different under the REO model. The discussion below considers each of the models in turn.

Ownership

14. The Ownership model does not split instruments into components representing equity or non-equity outcomes for the instrument. An instrument is separated if an equity instrument embodies an obligation that will result in retaining the ownership instrument after the obligation is settled.
15. An example where separation is required is a fixed rate dividend in an instrument puttable at fair value. The host instrument is an equity instrument (puttable at fair value represents an ownership instrument), but the fixed dividend stream represents an obligation. Settlement of the fixed dividend stream still leaves the host instrument intact.
16. On measuring the separated components, the obligation is measured at the discounted settlement amount with any residual amount being recorded as equity.

Ownership-settlement

17. *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.*
18. *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.*
19. In this situation “embodies an obligation” means there has to be an existing obligation not just a non-equity payoff. For example, a direct ownership instrument with an issuer call feature has potential equity and nonequity payoffs, but it does not embody an obligation because the nonequity payoff (redemption of the instrument via the call feature) is under the control of the issuing entity.
20. Unlike the ownership model, settlement of the obligation may result in extinguishment of the instrument. For example, a convertible bond could convert

or mature. There is therefore an equity outcome (conversion into a direct ownership instrument) and a non-equity outcome (settlement of the debt).

21. More instruments would be separated under the ownership-settlement model than the ownership model. However, the method of separation and both initial and subsequent measurement of the separated components is consistent between the two models.

REO

22. An instrument is separated into components based on the potential equity and non-equity payoffs of the instrument. Separation is achieved by use of a contingent claims modelling technique, on which the REO model is based.
23. An instrument is separated if it has both equity and non-equity payoffs at the outcome date. A separated component of an instrument is classified and displayed as if it were a single instrument and measured under the requirements set out below.
24. Equity payoffs are identified by examining the possible counterparty payoffs at the outcome date. Instruments comprising just equity components would not be separated.
25. Instruments that represent or have payoffs based on an exchange of assets for the issuance or repurchase of the reporting entity's ownership instruments are separated into equity and nonequity components.
26. In other words, exchange contracts involving 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.
27. Separated instruments may result in more than two components. For example, some instruments may be separated into equity, liability and asset components if all three payoffs exist.
28. The initial measurement of the two components of a separated instrument should always sum up to the transaction price of the entire instrument as described above.

In dividing that total transaction price between the two components, an entity should determine the fair value of both components by applying probability-based modelling techniques that consider the probability and timing of each outcome's occurrence. That split will then be reassessed at each reporting date, and changes in the probabilities of relative outcomes will be reflected in a revised split.

Summary of separation

29. The Ownership model requires limited separation; namely when the instrument remains in existence following settlement of the obligation. The liability is measured first at its discounted settlement value, discounted from expected settlement date.
30. Ownership-settlement will require more instruments to be separated than the ownership model. The methodology for how to separate an instrument, once it is required, is consistent with ownership.
31. REO has the most prevalent separation requirements, and the most complex methodology for separation.