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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting: **21 February 2007, London**

Project: **Liabilities and Equity**

Subject: **Topic Paper – Measurement (Agenda Paper 4F)**

BACKGROUND

1. This paper discusses the measurement guidance, both on initial recognition and subsequently, under the three models.

2. This paper also comments on the equity volatility created by subsequent measurement and reassessment of instruments.

INITIAL MEASUREMENT

3. Initial measurement under the FASB models is always at transaction price.

4. For instruments separated into components, the total of the components under all three models will equal the transaction price on initial measurement.

5. Under the ownership and ownership-settlement models the liability is measured at fair value and the residual amount of transaction price is the equity component. Fair value of the liability is the NPV of the settlement amount discounted from the expected settlement date and is calculated on the basis of a 100% probability of a liability outcome (a 'maximum obligation' approach). For a share puttable at a fixed amount the liability element is not

the fair value of the embedded put option but is the full settlement amount discounted from the expected settlement date.

6. REO uses contingent claims modelling techniques to fair value the components. Hence the probability of outcome is considered. In the example given above of a share puttable at a fixed price the liability component would be the probability weighted settlement value and therefore more akin to separating out the embedded put option.

SUBSEQUENT MEASUREMENT

Equity Instruments

7. Under existing guidance equity instruments are currently not remeasured.

8. However, under all three proposed models equity instruments <u>with cash or asset settlement requirements</u> are remeasured at every reporting date to the current settlement amount. That is the amount that the instrument would be redeemed for at the reporting date, not discounted to any expected redemption date. Any change in the measured amount remains in equity.

9. Under ownership and ownership-settlement all other equity instruments or equity components of instruments are not subsequently remeasured.

10. Components of a split instrument under the REO method are remeasured. Under REO, as discussed below, the entire instrument is remeasured to fair value, and the split between the components of the remeasured instrument is reassessed based on current probability of outcomes. Any change in fair value is taken to the income statement.

Non-equity instruments

11. Non-equity instruments are measured under the requirements of the relevant existing standards.

12. It is proposed that the fair value option is available for both stand alone and separated non-equity components (if the criteria for use of that option has been met).

Separated components

13. Under ownership and ownership-settlement once separated the components are treated as stand alone instruments under their relevant classification. Therefore

the guidance discussed above for equity and non-equity instruments applies to the separated components on instruments under ownership and ownership-settlement models.

14. As noted above, under REO separated instruments are revalued in their entirety at each reporting date. The original model is updated for changes in all inputs and any change in the total fair value of the components is taken to the income statement. Any changes in probabilities of outcomes will also alter the split between equity and non-equity components. The two components will always sum to the fair value of the instrument.

Summary of subsequent measurement requirements

	Ownership-settlement	Ownership	REO
Equity Instruments	Instruments with a cash or asset settlement requirement are remeasured to current settlement value. Otherwise no remeasurement.	Instruments with a cash or asset settlement requirement are remeasured to current settlement value. Otherwise no remeasurement.	Instruments with a cash or asset settlement requirement are remeasured to current settlement value. Otherwise no remeasurement.
Non-equity instruments	Under existing GAAP.	Under existing GAAP.	Under existing GAAP.
Separated instruments	Components accounted for as an equity instrument or a non-equity instrument.	Components accounted for as an equity instrument or a non-equity instrument.	Entire instrument carried at fair value through the income statement. Split between components is reassessed based on probability of each outcome.

EQUITY VOLATILITY

15. All three models introduce a certain degree of volatility into equity by virtue of the fact that some equity instruments are remeasured at each reporting date. Additional volatility is created by the reassessment of classification at each reporting date. Reassessment as a distinct topic is discussed in Paper D, but the impact to equity volatility is discussed below.

16. Remeasurement of equity with potential cash or asset settlement requirements is consistent under all three models as discussed above. This will result in volatility within equity, but that volatility remains within equity and is not taken to the income statement. This will result in volatility between equity captions but will not impact equity as a whole.

17. Under REO volatility will also be seen in equity due to the remeasurement and reassessment of separated instruments. As discussed above instruments that are separated into components are carried at fair value in their entirety, the movements in fair value are taken to the income statement. The separation into components is also reassessed at each reporting date and readjusted for changes in probability of outcome. Equity movements will reflect an actual fair value movement of the entire instrument and a movement in the proportional split of the instrument into equity and non-equity components.