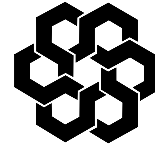

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**International Accounting Standards Board**

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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:** **Topic Paper – Other issues (Agenda Paper 4G)**

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## BACKGROUND

1. This paper contains discussion of a number of other issues, namely;

    a. The substantive features principle. This principle is concerned with when terms should be regarded or disregarded for purposes of classification. Both the Ownership and Ownership-settlement model rely quite heavily on this principle. However, REO does not use such a principle because it considers the probability of outcomes in its classification technique.

    b. Separate presentation in equity. The models create multiple categories within equity, and some of those categories are remeasured through the income statement, others are remeasured through equity, and others are not remeasured. The models require that the different categories are disclosed separately within equity.

    c. Consolidation. How classification of instruments by subsidiaries translates within the consolidated group.

d. Reassessment and reclassification. All of the models require the classification to be reassessed at each reporting date. Reassessment includes conclusions on substantive terms and changing probabilities of outcomes in REO separations.

e. Extinguishment. Ownership and REO have consistent guidance on the extinguishment of instruments. However, ownership-settlement is more complex regarding how separated instruments are extinguished.

**SUBSTANTIVE FEATURES**

2. The substantive features principle requires that an entity classify a single instrument or a linked group of instruments in the same manner as another instrument with the same or similar outcome. To do so, an entity should consider substantive features (stated or unstated) and ignore any features that are not substantive. An example of an unstated feature is a cash settlement option which may not be part of the contractual terms of an instrument but is innate in most contracts in the event of default.

3. The substantive features principle applies to both the ownership and ownership-settlement models. It is not relevant to the REO model; the reliance on the probability of outcome for classification in the REO model captures the impact of any non-substantive terms.

4. A feature is substantive if the feature:

   a. has more than a remote likelihood of affecting an instrument's outcome; and

   b. could have more than a minimal effect as compared to other features within an investment.

5. Substantive features in the FASB models could be compared with the "not genuine" clause in paragraph 25 of IAS 32, except that paragraph 25 of IAS 32 applies only to contingent settlement terms whereas the FASB substantive features principle applies to any term (stated or unstated) of an instrument.

## PRESENTATION WITHIN EQUITY

6. Under ownership and ownership-settlement, equity with a cash or asset settlement requirement is disclosed separately and remeasured.

7. Under REO the equity section of the balance sheet is separated into the following three categories:

   a. potentially dilutive equity, which represents equity components of separated instruments,

   b. equity instruments that may be settled with cash or other assets, and

   c. all other direct ownership instruments.

## CONSOLIDATION

8. Guidance on this topic is consistent across all three models, and essentially consistent with existing GAAP. It states that instruments should be reconsidered at the consolidated level. In all likelihood equity instruments of a consolidated subsidiary will remain equity instruments in the group, but, it is possible that linked features within the group may change the depiction of that instrument at a group level.

9. For example, a perpetual instrument in a finite-lived subsidiary would not be a perpetual instrument of the consolidated entity, and thus would only be an equity instrument of the consolidated entity if it was a direct ownership instrument of the subsidiary. Another example is that an ownership instrument of a subsidiary may contain a fair value redemption amount at the subsidiary level but, at the parent level, contain a guaranteed redemption amount. Such an instrument would be equity at the subsidiary level, but would have at least a component of liability (depending on which model you were in) at the parent level.

## REASSESSMENT AND RECLASSIFICATION

10. 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 (discussed later in this paper).

11. Reassessment may result in reclassification and, in some cases, remeasurement or separation of an instrument. For example, a put option embedded in a share may expire such that the share now meets the equity conditions for a single instrument.

12. All elements of the classification need to be reassessed, including substantive features. Terms that may have been regarded as non-substantive at the last reporting date may have become substantive during the reporting period, and could impact the classification of the instrument at a later reporting date. For instance a redemption feature on a direct ownership instrument may have been regarded as non-substantive due to legal restrictions over the level of capital required to be held in an entity, but changes to those restrictions may lead to the redemption feature being regarded as substantive and therefore the instrument being classified as liability.

13. There is no limit to the number of times and instrument can be reclassified.

14. Under REO the proportional split of an instrument into components is reassessed at every reporting date, this reassessment is discussed within both the separation and the measurement papers of this series of papers, and therefore is not directly dealt with in this section.

## EXTINGUISHMENT

15. Guidance on extinguishment is consistent under REO and ownership models, and is relatively straight forward.

    *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. A gain or loss is recognized for any difference between the extinguishment amount and the carrying amount.*

*The extinguishment amount is equal to (1) the amount paid, (2) the fair value of the new instrument issued, or (3) the new fair value of the old instrument as modified.*

16. Guidance gets considerably more complicated for the ownership-settlement model - especially for separated instruments.

*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.*

For separated instruments.

*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 instrument had been replaced by issuing a new instrument with the new terms. The new instrument is assessed for separation considering the modified terms according to the guidance on separation. 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.*

*a. The extinguishment amount is equal to either the amount paid or the fair value of the new instrument.*

*b. Extinguishment accounting for separated instruments is applied as follows:*

*(1) Allocate the entire extinguishment amount to liability and equity components.*

*(2) Determine the fair value of the liability component at the extinguishment-modification date by using the:*

*(a) Settlement period remaining from the original expected period, or, if zero, the new expected settlement period*

*(b) Amount due at the end of the remaining or new expected settlement period*

*(c) Discount rate for that period.*

*(3) Apply the remaining portion of the entire extinguishment amount to equity.*

*(4) If the entire extinguishment amount differs from the current liability carrying amount, the extinguishment gain or loss will be the remaining amount after reallocating to the liability and equity components.*

*(Note that the detailed reallocation steps b(1)–(4) need not be applied if an instrument is settled either (a) at its expected settlement date and at its contractual amount [in that case, the liability carrying amount is simply extinguished and there is no gain or loss to record], or (b) outside its contractual terms at the date the extinguishment accounting is applied [in that case, the gain or loss would be equal to the difference between the payment and the current liability carrying amount].)*

17. As can be seen from above, the extinguishment rules under ownership-settlement for separated instruments get quite complicated.