Introduction

1. Under Approach 4.1, two separately issued instruments will not necessarily be reported in the same way a single instrument with the same features/outcomes/results.[1] For example, a forward purchase contract and a physically settled written call option on an entity's own shares could be issued separately to achieve the same outcome as a freestanding written put option. Under Approach 4.1, the freestanding written put option would be reported as a liability and measured at fair value. Issued separately, the physically settled written call option would be classified as equity and not remeasured, and the forward purchase contract would be classified as a liability or an asset and measured at fair value. By issuing the instruments separately, the issuer would be able to avoid some volatility in net income since the written call option would not be remeasured.

2. At the December meeting, we will ask the boards if they would like to add a linkage principle to their classification approach.

Linkage Requirements under Current IFRS and US GAAP

3. Appendix A to this paper details the linkage criteria for financial instruments from the following three sources:

[1] Issues of linkage would also arise under Approach 4, but they are more prevalent under Approach 4.1 because some share settled derivatives are classified as equity.

This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB or the IASB.

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The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

a. FASB Accounting Standards Codification Subtopic 815-10, *Derivatives and Hedging,* (specifically the portion that was originally issued as Implementation Issue K-1)

b. IAS 39 , *Financial Instruments: Recognition and Measurement* (IG B.6)

c. EITF Issue 02-2, "When Certain Contracts that Meet the Definition of Financial Instruments Should be Combined for Accounting Purposes".

d. Draft criteria discussed (but not adopted) at the February 2003 IFRIC meeting.

4. IAS 32, *Financial Instruments: Presentation*, does not include any linkage principles.

Alternatives and Analysis

5. We have identified three alternatives for the boards to consider:

a. Alternative 1: Do not address linkage

b. Alternative 2: Adopt or modify the draft criteria from IFRIC in 2003 or EITF 02-2 (Appendix A)

c. Alternative 3: Develop a new linkage principle.

Alternative 1—Do not address linkage

6. An argument can be made that separately issued instruments are economically and legally distinct and should be accounted for that way. However, as illustrated by the examples in paragraphs 12-16, ignoring linkage allows inconsistent accounting and structuring opportunities. Addressing linkage is likely to be problematic no matter how it is done, and if not done right, it may create more problems than it solves.

Alternative 2—Adopt the criteria in Appendix A or a modified version of those criteria

7. The boards could decide to adopt the criteria in Appendix A or a modified version of those criteria. However, those requirements are rules-based, they seem

to be easy to circumvent, and in some cases, they do not seem to be operational. For example, under US GAAP and IFRS particular instruments may be linked if there is no apparent need or substantive business purpose for issuing two contracts separately that could not have been accomplished by issuing a single instrument. That criterion does not appear to be specific enough to be operational. For example, if transactions are entered into separately to achieve a particular tax effect, is that considered a "substantive business purpose"?

Alternative 3—Develop a Linkage Principle

8. A linkage principle will make the boards' classification approach more complicated, and that is undesirable. However, we believe a linkage principle is necessary to reduce structuring opportunities. We recommend the boards consider the following principle:

   a. Two or more freestanding instrument would be linked—that is, classified and measured as if they were a single instrument—if both of the following apply:

      (i) They are part of the same arrangement (see below (b)); and

      (ii) Reporting the instruments individually would result in reporting amounts of net income or equity that are different from the amounts that would result from accounting for a comparable single instrument, that is, a single instrument with the same or similar outcome.

   b. Instruments would be deemed part of the same arrangement if at least one of the following conditions exists:

      (i) The instruments are contractually linked. For example, two instruments are contractually linked if exercise of one depends on exercise of the other or causes expiration of the other.

      (ii) The instruments were entered into at or near the same time with the same or related counterparties and together achieve an overall economic outcome that could have been

achieved as simply or more simply with a single instrument.

9. Criterion (b)(ii) is limited to instruments that are issued to the *same or related counterparties*. Some may believe that the criterion should be applied more broadly, for example, to instruments that are issued to different counterparties or counterparties that are not related. People who support a broader criterion would argue that the selection of the counterparty should not be relevant in determining the accounting by the reporting entity. The economics to the issuer are the same regardless of whether two different counterparties are involved. However, those who oppose a broader principle note that some companies have high volumes of transactions that are not necessarily done in contemplation of one another. Those companies would be required to perform extensive linkage analyses if the conditions in paragraph b(ii) are not limited to particular counterparties.

10. The principle will require issuers and auditors to use a significant amount of judgement in deciding whether instruments should be linked. As a result, the boards will probably receive application questions. Some may view this as a disadvantage.

11. The following examples illustrate how the principle works and further illustrates why we believe a linkage principle is necessary. Each example assumes the instruments are physically settled, have the same strike prices, same number of shares and occur with the same counterparty. The examples also assume that the exercise and or settlement dates are the same or reasonably close to one another.

12. **Example 1—Forward purchase contract + written call option = Written put option**

    Description of the outcome: The issuer receives cash for the option premium as it would if it had written a put option. If the stock price is below the strike price, the holder will not exercise its call and the shares will be repurchased by the issuer at the settlement date just as if the holder had exercised a put option. If the stock price is at or above the strike price, the holder will exercise its call and will repurchase the same number of shares it is obligated to deliver just as if the holder had held shares and decided not to exercise its put option.

Without the linkage principle: The forward contract is a liability/asset measured at fair value through net income and the written call option is classified as equity.

With the linkage principle: A written put option is classified as a liability and measured consistently with other derivatives at fair value through net income. (Refer to the potential concerns and questions that may arise from this linkage principle in paragraph 17.)

13. **Example 2—Prepaid forward purchase contract + written call option = prepaid written put option**

Description of the outcome: The issuer pays cash equal to the current share price minus the option premium. If the stock price is below the strike price, the holder will return the shares to the issuer at the settlement date. If the stock price is at or above the strike price, the issuer will receive its cash back plus interest and no shares will be delivered or repurchased.

Without the linkage principle: The prepaid forward contract is an asset measured at fair value and a written call option is classified as equity.

With the linkage principle: The prepaid written put option is an asset measured at fair value but has a different fair value than a prepaid forward contract. (Refer to the potential concerns and questions that may arise from this linkage principle in paragraph 17.)

14. **Example 3—Purchased call option + written call option = perfect hedge**

Description of the outcome: The issuer receives and pays cash with a net result of zero. If the stock price is at or above the strike prices, the same number of shares are delivered and received.

Without the linkage principle: The purchased call option is an asset measured at fair value and the written call option is equity. Therefore, an entity can record gains from share price increases but no offsetting losses from share price decreases.

With the linkage principle: A derivative contract measured at fair value; the fair value will be zero value. (Refer to the potential concerns and questions that may arise from this linkage principle in paragraph 17.)

15. **Example 5—Convertible debt + purchased call option = Straight debt**

Description of the outcome: The issuer receives cash equal to the debt proceeds minus the option premium. If the stock price is at or above the strike price, the issuer pays the debt (through exercise of the purchased option) and no shares are delivered or repurchased. If the stock price is below the strike price, the debt is paid.

Without the linkage principle: Convertible debt is classified as a liability measured at fair value[2] with changes reported in net income and the purchased call option is an asset measured at fair value with changes reported in net income.

With the linkage principle: Straight debt is a liability measured at amortized cost. (No assets or gains or losses in the income statement are reported.) (Refer to the potential concerns and questions that may arise from this linkage principle in paragraph 17.)

16. **Example 6—Debt + written call option = convertible debt**

Description of the outcome: The issuer receives cash equal to the debt proceeds plus the option premium. If the stock price is at or above the strike price, the issuer pays the debt (through the exercise of the option) and delivers shares. If the stock price is below the exercise price, the debt is paid and no shares are delivered. (Note: This is a conventional description of convertible debt. As noted in agenda paper 5A/memo 73 a freestanding written call option and a freestanding debt instrument are not the same as a single convertible debt instrument).

Without the linkage principle: The debt is a liability measured at amortized cost and the written call option is equity.

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[2]At the June 10, 2009 board meeting, the FASB decided that convertible debt should be measured at fair value through net income, which is consistent with the FASB's tentative decisions in its accounting for financial instruments project. The FASB acknowledged that this decision may change at a later date based on decisions made in the accounting for financial instruments project. The IASB recently issued IFRS 9, *Financial Instruments,* which addresses the measurement of financial assets. The IASB has committed to deliberating the measurement of financial liabilities in the near future. If the current requirements in IAS 39 are applied to convertible debt, the instrument would be either (1) fair valued through the fair value option or (2) separated into a host contract and an embedded derivative.

With the linkage principle: Convertible debt is a liability measured at fair value. (Refer to the potential concerns and questions that may arise from this linkage principle in paragraph 17.)

Potential Concerns and Questions

17. The examples in the previous section raise the following questions:

    a. How close must the dates and prices be to require linkage? For example, in Example 1, if the forward purchase date and call option exercise date are not the same or similar, or the prices are slightly different, the combination looks less like a written put option.

    b. Should the linkage principle apply to instruments that are issued to different counterparties or counterparties that are not related?

    c. If the counterparties are related, how closely related must they be? When is one acting as an agent of the other?

    d. As illustrated in agenda paper 5A/ memo 73, two freestanding instruments (for example, a written call option and a straight debt instrument), are not economically equivalent to convertible debt. The instruments may be economically similar, but they are not the same.

Questions for the boards

Questions
1. Do the boards want to include a linkage principle in their classification approach? 2. Do the boards agree with the principle proposed in paragraph 8? If not, what changes would you make and why? 3. Do the boards want to address any of the issues raised in paragraph 17 regarding the linkage principles?

Appendix A

U.S. GAAP: Linkage Conditions

Derivative Implementation Guidance

A1. Under Subtopic 815-10, (originally issued as Implementation Issue K-1), if two or more separate transactions may have been entered into in an attempt to circumvent the provisions of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* the following indicators should be considered in the aggregate and, if present, should cause the transactions to be viewed as a unit and not separately:

a. The transactions were entered into contemporaneously and in contemplation of one another

b. The transactions were executed with the same counterparty (or structured through an intermediary)

c. The transactions relate to the same risk

d. There is no apparent need or substantive business purpose for structuring the transactions separately that could *not* have also been accomplished in a single transaction.

A2. Subtopic 815-10 (originally issued as Implementation Issues K-2 and K-3) considers the separate transferability of financial instruments. Specifically, derivatives that are transferable are, by their nature, separate and distinct contracts.

Draft EITF Linkage Indicators (Issue 02-2)

A3. The EITF Working Group concluded that the following four conditions must all be present to combine two or more financial instruments and account for them as one:

a. The transactions or contracts are with the same counterparties (or are structured through an intermediary).

b. The transactions or contracts are entered into in contemplation of one another.

c. The separate transactions or contracts share at least one underlying, and changes in that underlying (holding the other underlyings constant) result in at least one substantially offsetting change in fair value for those transactions or contracts.

d. The structure of the arrangement (separate contracts) does not serve a substantive business purpose that is fundamentally unrelated to the accounting (that is, the business purpose is not directly or indirectly based on the accounting result) and could not have been accomplished in a single contract or transaction.

IFRS: Linkage Conditions

IAS 39 (paragraph IG B.6)

A4. Non-derivative transactions are aggregated and treated as a derivative when the transactions result, in substance, in a derivative. Indicators include:

a. They are entered into in at the same time and in contemplation of one another.
b. They have the same counterparty
c. They relate to the same risk
d. There is no apparent economic need or substantive business purpose for structuring the transaction separately that could not also have been accomplished in a single transaction.

IAS 39 (paragraph IG C.6)

A5. Paragraph IG C.6 considers the separate transferability of financial instruments. Specifically, derivatives that are transferable are, by their nature, separate and distinct contracts.

IFRIC: Draft Linkage Indicators (taken from an agenda paper discussed at a February 2003 IFRIC meeting)

A6. Indicators/conditions that transactions should be linked are (not all must be present):

a. The transactions are entered into at the same time or as part of a continuous sequence and in contemplation of one another. Where this is the case, the transactions are usually with the same counterparty or with an entity that acts as an agent of that counterparty.
b. The transactions, in substance, form a single arrangement that achieves or is designed to achieve an overall commercial effect.
c. One or more of the transactions, considered on its own, does not make commercial sense, but they do when considered together. [Examples omitted.]
d. The contracts include one or more options or conditional provisions for which there is no genuine commercial possibility that the option(s) or conditional provision(s) will, or alternatively will not, be exercised or fulfilled.
e. The occurrence (or non-reversal) of one transaction is dependent on the other transaction(s) occurring.