STAFF PAPER

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REG IASB Meeting

Project	**Conceptual Framework**
Paper topic	Initial strategy: Liabilities and equity

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Purpose of paper

1. This paper discusses the approach to the equity section of the *Conceptual Framework* Exposure Draft (the ED).

2. At this meeting, the IASB will also discuss a project plan for the Financial Instruments with Characteristics of Equity research project (see Agenda Paper 13B). That plan includes a preliminary discussion about how that project will interact with the IASB's work on the Conceptual Framework. As noted in that plan, the objective of the research project in the short term will be to inform the IASB's discussion of the elements in the Conceptual Framework project by identifying the problems related to the distinction in current Standards between liabilities and equity.

Summary of staff recommendation

3. We recommend that the *Conceptual Framework* should continue to define a liability and equity. It should not provide further guidance on how to distinguish liabilities from equity instruments.

Structure of paper

4. The rest of this paper is structured as follows:

   (a) Background (paragraphs 5–8)

   (b) Feedback (paragraphs 9–17)

   (c) Approach (paragraphs 18–27)

   (d) Scope of future discussions (paragraphs 28–30)

   (e) Staff recommendation (paragraph 31)

Background

5. Section 5 of the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* (the Discussion Paper) discussed the definition of equity and the distinction between equity and liabilities. The existing Conceptual Framework has definitions of liabilities and equity. However, existing Standards and Interpretations do not apply the definitions consistently. Apart from the resulting requirements being complex and difficult to apply for preparers and auditors, these inconsistent requirements result in economically similar items being classified differently, with very different accounting outcomes. These differences in accounting for similar items make it unnecessarily difficult and complex for a user of financial statements to understand an entity's financial position and performance.

6. The Discussion Paper identified two competing objectives that the distinction between liabilities and equity is attempting to satisfy:

   (a) depicting 'cash leverage'—the ratio of claims[1] that must be settled with cash (or other economic resources) to other claims; and

   (b) depicting 'return leverage'—the ratio of (i) claims that do not share fully in the returns on the residual interest in an entity's assets, less liabilities, to (ii) claims that do share in those returns.

[1] In this paper, 'claims' refers to both liabilities and equity claims.

7. In considering how to meet those two objectives, the Discussion Paper explored two approaches to defining equity and distinguishing between liabilities and equity:

   (a) The 'strict obligation approach'—the IASB should use the definition of a liability consistently in distinguishing equity claims from liability claims. This approach depicts cash leverage in the statement of financial position, and uses an enhanced statement of changes in equity to depict return leverage.

   (b) The 'narrow equity approach'—the IASB should define equity as only the existing equity instruments in the most residual existing class of equity instrument issued by the parent, and use this new definition of equity to distinguish liability claims from equity claims. This approach depicts return leverage in the statement of profit or loss and other comprehensive income, and would need to rely on disclosure to depict cash leverage.

8. The IASB indicated an initial preference for the 'strict obligation approach'. However, to supplement the strict obligation approach, the Discussion Paper suggested that:

   (a) more information could be provided to help users of financial statements understand the effect of different equity claims on each other. For example, the IASB might require entities to update the carrying amount of some equity claims and to recognise the resulting changes in the carrying amount in the statement of changes in equity. The IASB would determine, when developing or revising particular Standards, whether the updated carrying amount would be a direct measure, or an allocation of total equity.

   (b) if an entity has issued no equity instruments, it may be appropriate to treat the most subordinated class of instruments as if it were an equity claim, with suitable disclosure. Identifying whether to use such an approach, and if so, when, would still be a decision for the IASB to take in developing or revising particular Standards.

Feedback

9. This section includes feedback received:

    (a) from the responses to the Discussion Paper; and

    (b) from the March meeting of the Accounting Standards Advisory Forum (ASAF).

Responses to the Discussion Paper

10. Many respondents supported the IASB's preliminary view to use the definition of a liability to distinguish equity from liabilities (the 'strict obligation approach'). Some respondents suggested other approaches, including:

    (a) defining equity and using that definition to distinguish equity from liabilities, therefore defining liabilities as the residual claim (variations of the 'narrow equity approach');

    (b) defining three categories of claims, with one being the residual ('three categories of claims'); and

    (c) eliminating the distinction (the 'claims approach').

11. Many respondents, including supporters of the IASB's preliminary views, raised specific concerns regarding the details and consequences of the strict obligation approach. These included conceptual concerns regarding the application of the proposed definition of a liability to particular obligations and the resulting accounting outcomes. The two particular obligations most commonly cited were:

    (a) obligations of a fixed amount settled with a variable number of shares; and

    (b) puttable shares.

12. Of the respondents that commented, many (and users in particular) supported providing additional information on the effects of different classes of equity claims. However many of these respondents suggested that updating the measurement of those claims within the statement of changes in equity was not the best way to achieve this. They warned the IASB to consider whether the benefits of developing the proposals further would outweigh the costs.

13. Of the respondents that commented on the suggestion that an entity with no issued equity instruments should treat the most residual claim as if it were equity, many did not support the preliminary view. Many objected to including such an exception in the Conceptual Framework. On the other hand, some, particularly co-operative entities and limited liability partnerships with puttable or redeemable instruments, supported the preliminary view, but preferred that it not be described as an exception.

14. Some respondents commented on the scope and content of the equity section in the Discussion Paper. They suggested that, while addressing the issue in the Conceptual Framework is important, a more comprehensive discussion is required before the IASB finalises the amendments to the Conceptual Framework.

Discussion with ASAF

15. At its meeting in March 2014, the Accounting Standards Advisory Forum (ASAF) discussed the IASB's approach to the distinction between liabilities and equity. At that meeting some ASAF members suggested that further research work was required or that details of the distinction between liabilities and equity would be best dealt with in a revised Standard. However, they suggested that this should not hold up the completion of the Conceptual Framework. The IASB could, if necessary, revisit these sections of the Conceptual Framework once the research work or revised Standards have been completed. However, others suggested that the IASB should address the issue in the current project on the Conceptual Framework.

16. Some ASAF members stated that further work is needed on the suggestion in the Discussion Paper that the reported amounts for some classes of equity claims should be updated. However, others disagreed with the idea that the reported amounts for equity claims should be updated.

17. One ASAF member suggested that the IASB should consider introducing a mezzanine category for claims that have both liability and equity characteristics.

Approach

18. The existing Conceptual Framework has definitions of liabilities and equity, and uses the definition of a liability to distinguish liabilities from equity. In reviewing the Conceptual Framework, the IASB will need to decide on the extent of the changes that are required to that approach to address the problems that it has identified and the concerns raised by respondents.

19. We have identified three approaches to the equity section that the IASB could consider in developing the concepts for the *Conceptual Framework* ED. These approaches are listed below in order of our preliminary assessment of the extent of change from existing Conceptual Framework (from most to least):

    (a) Develop an approach that eliminates the distinction between liabilities and equity in the Conceptual Framework (the 'claims approach').

    (b) Develop an approach that defines three categories of claims, with one being the residual ('three categories of claims').

    (c) Keep the existing binary distinction of liabilities and equity and continue to develop these definitions, building on the feedback received on the 'strict obligation approach' and the 'narrow equity approach' discussed in the Discussion Paper ('variation of the strict obligation approach and narrow equity approach').

The claims approach and three categories of claims approaches

20. The difficulty with the existing distinction between liabilities and equity is that it attempts to distinguish between items that have various characteristics with a single distinction. Therefore, some suggest that the distinction should be eliminated altogether and the accounting for each item should be determined individually to better depict these different characteristics. However, we agree with other respondents that stated that, unless all claims are measured directly, any approach would need to identify a residual class of claim and therefore a distinction will need to be made. Moreover, it is not possible to measure all

claims directly without measuring the entire entity – which goes beyond the stated objective of general purpose financial reports.[2]

21. Other respondents suggested that introducing a third category might help the IASB in meeting the two objectives it had identified (refer paragraph 6). A third category might be used to deal with cases where the objectives of depicting cash leverage and of depicting return leverage conflict. However, other respondents noted that introducing a third category of claim (as another element) would increase the complexity of the classification and of the consequential accounting. Both the IASB and the FASB have considered such an approach in the past, however both decided not to pursue the approach because of that complexity.

22. However we make the distinction, a single distinction between liabilities and equity can only capture one of many characteristics of these items. However, that distinction is just one tool in depicting a diverse range of items, and should not preclude capturing other characteristics in ways that might provide useful information to users of financial statements. We will explore how best to do that, for example, by disclosure, sub-categories or updating measures of equity claims. The Conceptual Framework will probably only need to address the characteristic we capture through the definitions, the others will need to be addressed in other standards-level projects. Therefore, in the staff's view, developing the claims approach or introducing a third category may not be necessary to satisfy the objectives that a claims approach or a third category would seek to achieve.

Variation of the strict obligation approach and the narrow equity approach

23. In the staff's view, the IASB should keep the existing binary distinction of liabilities and equity and continue to develop these definitions, building on the feedback received on the 'strict obligation approach' and the 'narrow equity approach' discussed in the Discussion Paper.

24. In the March 2014 meeting, Agenda Paper 10F listed the advantages and disadvantages identified by respondents for the 'strict obligation approach' and

[2] General purpose financial reports are not designed to show the value of a reporting entity; but they provide information to help existing and potential investors, lenders and other creditors to estimate the value of the reporting entity. *Conceptual Framework*, paragraph OB7

the ‘narrow equity approach’. Some respondents (particularly some standard setters) placed more weight on the disadvantages of the approaches and therefore supported neither.

25. As noted previously, currently the distinction between liabilities and equity determines the items that will be included in total net assets and in profit or loss and other comprehensive income. Thus, as the Discussion Paper suggested, there are two different objectives (depicting cash leverage and depicting return leverage) that the IASB is attempting to achieve with the distinction, and the difficult cases are where those objectives conflict.

26. In the staff’s view, further developing those objectives might help the IASB in addressing the issues identified in the Discussion Paper and the concerns raised by respondents on the proposals. The outcome of that discussion might result in the IASB identifying a single objective, prioritising the objectives, or simply identifying the competing objectives that it might need to consider when developing requirements in Standards. It might also help the IASB consider what other tools will enable it to meet those objectives that cannot be met solely by a distinction between liabilities and equity.

27. That discussion would also help the IASB to address the concerns that were raised about the approaches included in the Discussion Paper. Addressing those concerns might bring the two approaches closer together, therefore we think it might be premature to assess whether the approach that would be developed would be closer to the strict obligation approach or the narrow equity approach.

Scope of future discussions

28. The Discussion Paper included a lengthy discussion of issues related to the distinction between liabilities and equity, some of which were beyond the intended scope of the Conceptual Framework. In our view, the section on equity in the ED will be limited to the definition of equity and the interaction of that definition with:

(a) the definition of a liability;

(b) the definitions of income and expense; and

(c) the nature of the reporting entity, and the perspective adopted for financial reporting.

29. Discussion of the additional matters included in the Discussion Paper, such as the classification of items as liabilities or equity and potential recognition, measurement, presentation and disclosure requirements for equity will continue in the Financial Instruments with Characteristics of Equity research project. Although many respondents did not support the suggestion to update the measure of some equity items, we do not think the Conceptual Framework should preclude the IASB from requiring entities to provide such information if it is useful. Respondents raised a number of other matters that should be considered in that research project as well, including compound instruments and alternative ways to depict the effects of dilution of particular equity claims.

30. Therefore, we expect the IASB to discuss the following at a future meeting on the equity section in the Conceptual Framework project:

(a) Objectives of the classification—The Discussion Paper suggested two objectives (depicting cash leverage and depicting return leverage) for the classification. Developing those objectives further might help the IASB address the issues identified in the Discussion Paper and the concerns raised by respondents on the proposals.

(b) Discussion of the definitions of a liability and of equity—Including possible amendments to the accompanying guidance.

(c) Accounting for classes within equity—Confirmation that the Conceptual Framework should not require or preclude matters to be discussed in a future project to develop or amend a Standard.

Staff recommendation

31. Based on the above, we recommend that the *Conceptual Framework* should continue to define a liability and equity. It should not provide further guidance on how to distinguish liabilities from equity instruments.

Question for the IASB
Does the IASB agree with the approach recommended by the staff?