STAFF PAPER

September 2014

IASB Meeting

Project	**Conceptual Framework**		
Paper topic	Equity - cover paper		
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Introduction

1. The objective of this session is to conclude the IASB's discussions for the equity section of the *Conceptual Framework* Exposure Draft.

2. At an education session in June 2014, the IASB discussed different approaches to the distinction between liabilities and equity. At this meeting, we discuss the consequences of those approaches for the *Conceptual Framework*.

Summary of staff recommendations

3. In Appendix A to this paper, we indicate our preference for the combined settlement and value approach.

4. However, in Agenda Paper 10H, we recommend that the IASB should not amend the tentative definition of a liability or the existing definition of equity in the *Conceptual Framework*. This is because we do not think that the benefits of amending the definition of a liability outweigh the costs of the added complexity at this time.

5. In addition, we think that applying the tentative definition of a liability (with the help of the accompanying guidance which the IASB has developed) would result in the following classification outcomes that would be **partly** consistent with the combined settlement and value approach:

(a) the classification as liabilities of **some** obligations to deliver the entity's own equity instruments, namely those obligations that are **capable of requiring** the entity to transfer its economic resources under some possible scenarios.

(b) the classification as liabilities of **some** obligations to deliver economic resources that can be deferred until liquidation, namely those obligations for which the entity has **no practical ability to avoid** earlier redemption.

6. If the IASB agrees with us that the combined settlement and value approach should be developed further, then we suggest that it develops that approach further in the research project on Financial Instruments with Characteristics of Equity (the Research Project). As a result of that project, the IASB may in due course wish to consider amending the definitions of a liability and of equity, or other aspects of the *Conceptual Framework*.

7. In Agenda Paper 10K we recommend that the *Conceptual Framework* should neither require nor preclude any accounting requirements for classes of claims within equity.

Papers included for this meeting

8. We have prepared the following papers for this meeting:

(a) **Agenda Paper 10H: Consequences of the approaches**—this paper discusses whether the *Conceptual Framework* needs to be amended to accommodate the approaches explored in Agenda Paper 10I. Appendix C of this cover paper includes a table summarising the consequences of the approaches for the *Conceptual Framework* and potential implications for IFRSs.

(b) **Agenda Paper 10I: Distinction between liabilities and equity**—this paper is an updated (marked-up) version of Agenda Paper 10H from June 2014 that reflects changes resulting from IASB member comments. Agenda Paper 10I is for information only. **Our preliminary conclusion has changed and is reflected in Appendix A**

to this cover paper. Appendix A also includes a brief summary of Agenda Paper 10I.

(c) **Agenda Paper 10J: Additional analysis and examples**—this paper includes some additional analysis and examples to supplement Agenda Paper 10I. At the June 2014 meeting, some IASB members requested additional examples that illustrate some of the concepts in Agenda Paper 10I. This paper also discusses the entity perspective, and structuring opportunities under the settlement and value approaches. This paper is for information only.

(d) **Agenda Paper 10K: Classes and accounting requirements within equity—**This paper discusses whether the *Conceptual Framework* should require or preclude any accounting requirements for claims within equity.

9. The appendices to this cover paper include the following:

(a) Appendix A—Overview of Agenda Paper 10I and updated conclusion.

(b) Appendix B—Feedback from CMAC and GPF meeting.

(c) Appendix C—Summary of consequences from approaches in Agenda Paper 10H.

Appendix A—Overview of Agenda Paper 10I and updated conclusion

10. In Agenda Paper 10B for the April meeting, we suggested that developing the objectives for distinguishing between liabilities and equity described in the Discussion Paper *A review of the Conceptual Framework for Financial Reporting* (the Discussion Paper) might help the IASB:

    (a) in addressing the problems identified in the Discussion Paper and the concerns raised by respondents on the suggestions in the Discussion Paper; and

    (b) consider what other accounting requirements will enable the IASB to meet those objectives that cannot be met solely by a distinction between liabilities and equity.

11. In Agenda Paper 10I we identify the following characteristics of claims and the effect of those characteristics on assessments made by users:

    (a) information about the nature of the economic resources required to settle an obligation, and the timing of settlement, will help users assess the liquidity of an entity and its requirements for additional financing.

    (b) information about the amount of the economic resources required to settle an obligation will help users assess the entity's solvency, its ability to obtain additional finance and the effect of the obligation on the distribution of returns.

    (c) information about the changes in value of different classes of claims will help users assess the distribution of returns.

12. In Agenda Paper 10I we also identify four approaches to distinguishing between liabilities and equity:

    (a) **Settlement approach**—helps users assess the entity's liquidity and its needs for additional finance by depicting as liabilities all obligations that require the entity to transfer its economic resources.

    (b) **Value approach**—helps users assess the entity's solvency and its ability to raise additional finance by depicting as liabilities all obligations that will require the entity to transfer its economic resources, or transfer new claims against it, if the amount of those resources or claims to be transferred is independent of the entity’s total economic resources.

(c) **Combined settlement and value approach**—helps users assess the entity’s liquidity and its solvency by depicting as liabilities all obligations that will require the entity:

(i) to transfer its economic resources (regardless of how the value is specified); or

(ii) to deliver claims against it if the amount of claims to be delivered is specified by a value that is independent of the entity’s total economic resources.

(d) **Narrow equity approach**—helps users assess how the most residual class of claim shares in returns.

Updated conclusion

13. Based on the analysis in Agenda Paper 10I:

(a) we think that the **combined settlement and value approach** would provide the most useful information that can be provided by the distinction between liabilities and equity.

(b) we think that, while both the settlement approach and the value approach have merits that are worth exploring, distinguishing between liabilities and equity using such ‘pure’ approaches may lead to anomalous results, including:

(i) for the value approach, some claims that will oblige the entity to transfer its economic resources may be classified as equity (eg puttable shares). This may be counterintuitive to users, who may expect that all claims within equity are permanent (or perpetual). Moreover, the value approach would make it easy to change the structure of claims to achieve equity classification without changing the liquidity effects of the claim (ie to classify ‘flighty funding’ as equity).

(ii) for the settlement approach, some claims that promise a fixed amount of value may be classified as equity if the entity has the option (or is required) to settle the obligation with its own shares. The returns on those claims are very similar to interest, and the settlement approach would present those returns as changes in equity, which may also be counterintuitive to users. Moreover, if markets for an entity's equity instruments are liquid, the settlement approach would make it easy to change the structure of claims to achieve either debt or equity classification without changing the distribution of the returns between claims.

(c) we do not think that the narrow equity approach would provide the most useful information that can be provided by the distinction between liabilities and equity. This is because, as shown in the analysis, many factors affect the distribution of returns to claim holders, and these factors may change over time, including which claim is the most residual.

Appendix B—Feedback from CMAC and GPF meeting

15. We had a brief discussion on 30 June 2014 regarding the distinction between liabilities and equity with members of the Global Preparers Forum (GPF) and the Capital Markets Advisory Commmittee (CMAC). We used the approaches in Agenda Paper 10I to illustrate different ways of making the distinction.

16. Apart from one or two exceptions, views appeared to be polarised between preparers and users. Preparers tended to lean towards a settlement approach and users tended to lean towards a narrow equity approach. This reflected concerns that each had regarding the approaches they did not favour:

    (a) regarding the settlement approach, users were concerned that if an entity could settle debt-like instruments using the entity's own shares, that fact could lead to classification as equity.

    (b) regarding the narrow equity approach, preparers were concerned that profit or loss (or other comprehensive income) could include income and expense driven solely by changes in the value of the reporting entity's own shares.

    (c) there was little to no support for the value approach.

17. Views were driven primarily by concerns about complexity. Both preparers and users were seeking a simple and intuitive approach to the distinction, however they leaned towards opposite ends of the spectrum. They found the settlement and narrow equity approaches to be more intuitive and simple than the value approach.

18. Users requested more disclosure regarding equity instruments, including dilution, terms, and information to help determine cost of capital.

19. Preparers were also concerned about the consequences of potential changes in the classification of items, including consequences for covenants and contracts based on existing debt/equity ratios, prudential regulatory requirements and potential divergence from US GAAP.

Appendix C—Summary of consequences from approaches in Agenda Paper 10H

<table>
<tr><th></th><th>Settlement approach</th><th>Value approach</th><th>Combined approach</th><th>Narrow equity approach</th></tr>
<tr><td>Conceptual Framework</td><td>None</td><td>Definition of a liability would need to be amended to capture share-settled debt and exclude puttable shares.</td><td>Definition of a liability would need to be amended to capture share-settled debt.</td><td rowspan="3">Major consequences for all:
- New definitions for all
- classification changes for all claims that are not the most residual (for IFRS 2 all would be liabilities)
- IAS 32 will need to be rewritten or replaced
- knock on changes to other areas, such as performance, statement of changes in equity etc.</td></tr>
<tr><td>IAS 32 Financial Instruments: Presentation</td><td>Will be inconsistent with IAS 32’s treatment of:
- Share-settled debt
- Derivatives
- Puttables exceptions</td><td>IAS 32 is broadly consistent with the value approach. The basis of the approach might help clarify the principles for some of the requirements.</td><td>Will be inconsistent with puttables exceptions.</td></tr>
<tr><td>IFRS 2 Share-based Payment</td><td>None</td><td>IFRS 2 is inconsistent with the value approach. Classification might need to change for both some cash-settled and some equity settled share-based payments.</td><td>IFRS 2 is inconsistent with the combined approach. Classification might need to change for some equity-settled share-based payments.</td></tr>
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	Settlement approach	**Value approach**	**Combined approach**	**Narrow equity approach**
Non-controlling interests	None	Depends - it might be possible to define the value approach in a way that treats a part of the group as a separate silo.	Depends - it might be possible to define the combined approach in a way that treats a part of the group as a separate silo.	
IFRIC 2 ***Members' Shares in Co-operative Entities and Similar Instruments***	None	Depends on whether the redemption amount is driven by the value of the economic resources of the entity.	Depends on whether the redemption amount is driven by the value of the economic resources of the entity.	
Other	Some participating insurance contracts might contain an equity component. Whether to bifurcate or not would depend on various factors, including cost-benefit.			