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STAFF PAPER

September 2014

IASB Meeting

Project	Conceptual Framework		
Paper topic	Distinction between liabilities and equity		
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Introduction

1. This paper discusses the distinction between liabilities and equity[1]. This paper was discussed in an Education Session of the IASB in June 2014. We have marked-up the paper to highlight the changes that we have made as a result of that session, and have replaced our conclusion and recommendation as described in the Cover Paper of this meeting. ~~This paper is for an Education Session of the IASB and does not ask the IASB to make any decisions.~~

2. At its April 2014 meeting, the IASB tentatively decided that the *Conceptual Framework*:

   (a) should keep the existing binary distinction of liabilities and equity and build on the feedback received on the discussion paper *A Review of the Conceptual Framework for Financial Reporting* (the Discussion Paper) to develop definitions of liabilities and equity; and

   (b) should not provide detailed guidance on how to distinguish liabilities from equity instruments.

3. In Agenda Paper 10B for the April meeting, we suggested that further developing the objectives introduced in the Discussion Paper for the distinction between liabilities and equity might help the IASB in addressing the problems identified in

[1] This paper refers to the combined set of liabilities and equity as 'claims' against the entity.

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that Paper and by respondents. In our view, those problems are best illustrated by focusing on whether the definition of a liability should include:

(a) Obligations to issue a variable number of equity instruments (some of the claims that are described in the Discussion Paper as 'secondary equity claims'); and

(b) Obligations to transfer economic resources of a value equal to the value of an equity instrument (described in the Discussion Paper as 'puttable instruments').

4. To address the classification of the above claims, we aim to answer the following questions:

(a) What are users trying to assess about the claims against an entity?

(b) What information about the claims against the entity do users need to make those assessments? Of this information:

(i) which is best provided through the effects of the distinction between liabilities and equity?

(ii) which is best provided by other means?

5. We identify four different approaches to distinguishing between liabilities and equity, each of which links a particular assessment with the information required to make that assessment (these approaches are further explained in the analysis):

(a) **Settlement approach**—helps users assess the entity's liquidity and its needs for additional finance by depicting as liabilities all obligations that will 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 its own claims, that specify a value that is independent of the entity's total economic resources.

(c) **Combined settlement and value approach**—a combination of the settlement and the value approach, which depicts as liabilities obligations that meet the criteria in either approach.

(d) **Narrow equity approach**—helps users assess the distribution of returns to the most residual class of claim.

Structure, scope and assumptions

6. This paper is structured as follows:

   (a) Proposals in the Discussion Paper (paragraphs 11–15)

   (b) Feedback from respondents (paragraphs 16–20)

   (c) Staff analysis (paragraphs 21–87)

   (d) [Conclusion replaced with conclusion and recommendation in Cover Paper].

   (e) Appendix A—Perspective of the ‘owners’ of the entity

   (f) Appendix B—Classification of obligations under the settlement and value approach

7. For simplicity, this paper does not deal with rights to receive own equity, derivatives on own equity (such as options and forwards) or instruments with alternative outcomes (such as contingent convertible bonds). To be successful, any approach to distinguishing between liabilities and equity will need to deal with more complex instruments. Therefore, we will expand the analysis to include other types of instruments in the future, however we do not see any reason why the analysis in this paper would not be valid.

8. The focus of the paper is on identifying which terms of an instrument are relevant for the purposes of distinguishing between liabilities and equity. This paper assumes that it is clear whether an instrument creates a claim on the reporting entity, and that it is clear what the terms of that claim are. We will be bringing a paper to a future meeting to discuss the substance of contractual rights and contractual obligations, including substance over form, commercial substance, constructive obligations and economic compulsion.

9. In addition, we will be bringing a paper to a future IASB meeting that will discuss the accounting for classes within equity. We expect to recommend that the *Conceptual Framework* should neither require nor preclude accounting requirements for classes within equity. In the analysis below, we have assumed that the IASB will have the ability to use techniques in addition to classification to meet the information needs of users, in particular for items classified as equity.

10. We intend to consider specific requirements related to matters that are beyond the scope of this paper, including supporting disclosures that users have requested, as part of the Financial Instruments with Characteristics of Equity research project.

Proposals in the Discussion Paper

11. 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 that must be settled with cash (or other economic resources) to claims that are not settled with cash; 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.
12. 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.
13. 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.

14. These approaches can be illustrated with the following financial instruments:

(a) Typical debt instruments (such as an obligation to transfer a fixed amount of cash at a given date) contribute to both cash leverage and return leverage. Therefore, under both the strict obligation approach and the narrow equity approach they would be classified as liabilities.

(b) Common shares contribute to neither cash leverage nor return leverage. Therefore, under both the strict obligation approach and the narrow equity approach they would be classified as equity.

(c) Obligations to issue a variable number of equity instruments with a total value equal to a fixed amount (share-settled debt) contribute to return leverage but not to cash leverage. Therefore, under the strict obligation approach they would be classified as equity and under the narrow equity approach they would be classified as liabilities.

(d) Obligations to transfer a variable amount of cash equal to the value of a common share (puttable shares) contribute to cash leverage but not to return leverage. Therefore, under the strict obligation approach they would be classified as liabilities and under the narrow equity approach they would be classified as equity if they are the most residual class of equity, or liabilities if they are not the most residual.

15. We note that the classification of the instruments in paragraphs 14(a) and 14(b) is not contentious and these classifications will not change under any proposed distinction between liabilities and equity. However, the classification of the instruments in paragraphs 14(c) and 14(d) is contentious and is the primary focus of the analysis in this paper. These latter instruments are sometimes referred to as instruments with characteristics of both liabilities and equity.

Feedback from respondents

16. Some respondents commented on the objectives of the classification as follows:

    (a) the basis for the distinction should focus on the usefulness of the information to providers of capital;

    (b) the distinction should be applicable to various legal forms and industries; and

    (c) the objectives for the distinction should begin with the objective of the statement of financial position as a whole.

17. Some respondents identified different objectives to those in the Discussion Paper:

    (a) The objective should be to enable users to predict the risks and returns to holders of each claim and to depict how claims are required to be settled.

    (b) Equity should serve as a record of amounts invested by an identified class of owners, or returned to them. This record of investment is very relevant from a stewardship perspective. Some respondents also stated that the proprietary perspective should be adopted.

    (c) The classification should be consistent with what market participants perceive as equity. An instrument should be classified as a liability if its market price behaves more like the market price of debt, and as equity if its market price behaves more like the market price of equity.

18. Some suggested that the *Conceptual Framework* should be limited to outlining the competing objectives of the classification. The IASB should then apply the

qualitative characteristics to arbitrate between those objectives at the Standards-level.

19. Overall, reactions to the approaches fell into three categories:

    (a) Many respondents supported the ‘strict obligation approach’. However, many of these respondents did not support a key component of that approach (the enhanced statement of changes in equity), and other supporters of the approach raised a number of other concerns, in particular regarding the classification of the instruments mentioned in paragraphs 14(c) and 14(d).

    (b) Some respondents, including many equity investors and analysts, supported the ‘narrow equity approach’.

    (c) Other respondents did not support either approach. They stated that both approaches have significant and fundamental flaws and that the Discussion Paper suggests various exceptions to deal with those flaws. This indicates that neither approach faithfully represents the economics in all cases.

20. Some respondents suggested alternative bases for the distinction, including:

    (a) Classifying as equity only those claims that participate without limit in the returns of the entity.

    (b) Classifying as equity those claims that are rights to a proportionate share of net assets, regardless of whether there is an obligation to transfer economic resources prior to liquidation.

    (c) Giving entities a free choice to select a single class of claim to classify as equity.

    (d) Classifying claims based solely on the legal form.

    (e) Using the definitions in IAS 32 *Financial Instruments: Presentation*.

    (f) Other previous proposals by the IASB, FASB and other standard-setters.

Staff analysis

21. We agree with suggestions that the objectives of the distinction between liabilities and equity should flow from the general objective of financial reporting already established in the *Conceptual Framework* in paragraphs OB1–OB21. Those paragraphs not only set out the assessments that users could make using the distinction between liabilities and equity, but also begin to identify the information about an entity's economic resources and claims, and changes in those resources and claims, that would help them make those assessments.

22. However, those paragraphs do not identify:

    (a) the relationship between the assessments that users could make and the information required to make them; and

    (b) which assessment is best facilitated by providing the information using the distinction between liabilities and equity, and which assessments are best facilitated by other means.

23. This paper attempts to fill that gap and establish the link between the assessments that users make and the information provided, and identify what information is best provided through the distinction between liabilities and equity.

24. We also agree with suggestions that the distinction needs to be one that is useful when applied to various legal forms and industries. Thus, we do not support alternatives based solely on the legal form, or that give the entity a choice, because they will reduce comparability between entities. While the analysis that follows is still focused on corporation-type structures, we have tried to include facts and circumstances that reflect various other structures, such as the existence of puttable instruments.

25. In the following analysis we:

    (a) Provide an overview of the context for the discussion, including:

        (i) the relevant objectives in the existing *Conceptual Framework* (paragraphs 26–31);

        (ii) the effects of the distinction between liabilities and equity (paragraphs 32–33); and

(iii) the limitations of financial statements that might be relevant to the distinction (paragraphs 34–36).

(b) Identify the relationships between the assessments that users might make based on the distinction between liabilities and equity, and the information required to make those assessments. These relationships form the basis for the potential approaches to distinguishing between liabilities and equity (paragraphs 37–56).

(c) Analyse the advantages and disadvantages of each approach identified (paragraphs 57–87).

Objectives in the Conceptual Framework

26. From paragraphs OB3 and OB4 of the *Conceptual Framework*, existing and potential investors (ie users) need information to help them make decisions about buying, selling or holding equity and debt instruments. Those decisions will be based on their assessment of:

(a) the prospects for future net cash inflows[2] to the entity;

(b) how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources; and

(c) based on (a) and (b), the prospects for future cash inflows to the existing and potential investors themselves (ie expectations about the returns from investing in debt or equity instruments).

27. Paragraph OB12 of the *Conceptual Framework* states that information about the economic resources and claims against the entity, and changes in those economic resources and claims would help existing and potential investors make decisions about buying, selling or holding equity and debt instruments. In other words, OB12 identifies the types of economic phenomena that financial statements need to provide information about in order to be useful. Those economic phenomena are the **elements** of financial statements.

[2] The objectives paragraphs refer to *prospects for future net cash inflows*. This refers to both the direct or indirect flow of economic benefits. We use the terms *economic benefits* and *future cash inflows* interchangeably in this paper.

28. Paragraphs OB13–OB16 expand on the types of information that would be useful about an entity's economic resources and claims against the entity, and the assessments for which a user would need that information.

29. In particular, OB13 states that users need:

    (a) information about:

        (i) the **nature and amounts** of an entity's economic resources and claims against the entity; and

        (ii) the **priorities and payment requirements** of claims.

    (b) to help them assess:

        (i) the reporting entity's **financial strengths and weaknesses**;

        (ii) the reporting entity's **liquidity and solvency, its needs for additional financing and how successful it is likely to be in obtaining that financing**; and

        (iii) **how future net cash inflows** to the reporting entity **will be distributed among those with a claim against the entity**.

30. Paragraph OB15 differentiates between changes in a reporting entity's economic resources and claims against the entity that result from that entity's **financial performance** and from other events or transactions such as issuing debt or equity instruments (ie raising and returning finance). To assess the prospects for future cash flows from the reporting entity, users need to be able to distinguish between these changes.

31. In addition, the perspective for financial reporting was discussed in Agenda Paper 10E of the IASB's May meeting. In that meeting, the IASB tentatively decided that, consistently with the objective for financial reporting in paragraph OB2, financial statements should be presented from the perspective of the entity and should provide information that is useful to existing and potential investors, lenders and other creditors and the information provided should focus on their common information needs. For completeness, we have discussed the perspective of the 'owners' of the entity in Appendix A.

Effect of the distinction between liabilities and equity

32. The economic resources of the entity are grouped into a single element (assets), the claims on the entity are grouped into two elements: **liabilities** and **equity**.

33. The effects of the distinction between liabilities and equity include:

    (a) the statement of financial position distinguishes between total liabilities and total equity. The sum of the totals for liabilities and equity equals total assets.

    (b) the statement of profit or loss and other comprehensive income:

        (i) includes income and expenses resulting from changes in the carrying amounts of liabilities (including interest and gains and losses from remeasurements).

        (ii) does not include as income or expense the changes, if any, in the carrying amounts of equity.

    (c) the statement of changes in equity:

        (i) includes the total of profit or loss and other comprehensive income.

        (ii) shows the allocation of the total of profit or loss and other comprehensive income to classes of equity (such as non-controlling interests).

        (iii) shows contributions to equity and distributions of equity.

        (iv) could show capital maintenance adjustments if these are not included in comprehensive income.

        (v) shows the total change in equity which results from the items listed in (i)-(iv).

    (d) subsequent measurement:

        (i) the carrying amount of many liabilities changes.

        (ii) the carrying amount of total equity does not change unless there are changes in the carrying amounts of assets or liabilities. However, different amounts of these changes may be allocated to different classes within equity (eg non-controlling interests).

Limitations of financial statements

34. Apart from the above objectives and effects of the distinction, it is also important to remember the limitations of financial statements. These limitations include:

    (a) that the objective of general purpose financial statements is **not** to show the value of the entity as a whole (as explained in paragraph OB7 of the existing *Conceptual Framework*).

    (b) that not all economic resources of the entity and claims against the entity are recognised in the financial statements.[3] Thus the recognised elements may not be complete.

    (c) that the amounts recognised for items are measured using different bases.[4] These mixed measurement requirements result in totals that do not reflect a single measurement objective.

    (d) the pervasive cost constraint, that requires the IASB to balance the benefits of providing useful information with its costs.

35. The consequences of the limitations above might be relevant to discussions about the distinction between liabilities and equity in the *Conceptual Framework*:

    (a) Traditionally financial statements have recognised most, if not all, of an entity's liabilities and the equity claims on the entity. In contrast, not all of an entity's assets are recognised (most notably internally generated goodwill and some other internally generated intangible assets).

    (b) The partial recognition and mixed measurement of items results in anomalies when subsequently measuring liabilities and equity. For example, the subsequent measurement at fair value of items classified as liabilities will have the effect of recognising changes in the entity's own credit risk. Those changes may reflect changes in unrecognised assets, or unrecognised changes in the value of those assets (ie their

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[3] As proposed in the Discussion Paper, this could be because the information about individual items might not be relevant or might not faithfully represent the economic phenomena (ie might not be useful).

[4] As proposed in the Discussion Paper, this could be because a particular measurement might be more useful for some items than for other items.

recognition can give rise to so called ‘accounting mismatches’). Any accounting mismatches flow through profit or loss and other comprehensive income to equity, because equity is measured as a residual.

36. The Basis for Conclusion on IAS 32 *Financial Instruments: Presentation* illustrates the limitations described above in highlighting the following concerns about classifying some puttable instruments as liabilities:

    (a) on an ongoing basis, the liability would be recognised at not less than the amount payable on demand. This could result in the entire market capitalisation of the entity being recognised as a liability, depending on the basis for calculating the redemption value of the financial instrument.

    (b) changes in the carrying amount of the liability would be recognised in profit or loss. This would result in counterintuitive accounting (if the redemption value is linked to the performance of the entity) because:

        (i) when an entity performs well, the present value of the settlement amount of the liabilities increases, and a loss would be recognised; and

        (ii) when the entity performs poorly, the present value of the settlement amount of the liability decreases, and a gain would be recognised.

    (c) it is possible, again depending on the basis for calculating the redemption value, that the entity would report negative net assets because of unrecognised intangible assets and goodwill, and because the measurement of recognised assets and liabilities may not be at fair value.

    (d) distributions of profits to shareholders would be recognised as expenses.

Identifying relationships between the assessments made by users and the information they require

37. The IASB's tentative decision for the definitions of **assets**[5] and our proposed supporting guidance[6] for **economic resources** and **economic benefits** capture the following concepts noted in paragraphs 26–30 above:

    (a) That an economic resource is a right that is capable of producing economic benefits.

    (b) That an entity can derive economic benefits from an economic resource in many ways, including receiving cash flows directly from the resource (such as interest payments from debt instruments or dividends from equity instruments) or indirectly from the resource (such as changes in the value of debt instruments held or equity instruments held).

    (c) That an asset is a present economic resource that is controlled by the entity as a result of past events.

38. From the holder's point of view, claims against an entity are a type of economic resource. **The difference from the reporting entity's point of view** is simply that claims against it are the rights that an investor or other creditor (ie the claimant) holds against it. Thus, we can describe claims similarly to economic resources in that:

    (a) Claims against the reporting entity are a right capable of producing economic benefits to the claimant.

    (b) Claimants can derive economic benefits from those claims in many ways, including receiving cash flows directly from the entity, or indirectly through changes in the value of those claims.

    (c) Liabilities and equity are present claims against the reporting entity that are controlled by the claimant as a result of past events.

39. However the economic benefits derived from both (a) any single present claim against the entity and (b) the present claims against the entity in total, are limited by the future economic benefits that the entity can derive from its existing

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[5] Discussed in Agenda Paper 10A in May.

[6] Discussed in Agenda Paper 10C in July.

(recognised and unrecognised) economic resources. These limits are derived from the fact that the only source of payments to meet claims is the entity's present economic resources and the future economic benefits produced from them. These limits establish the basis for the accounting equation:

total assets = total liabilities + total equity

40. Therefore, if there is more than one type of claim against the reporting entity, then the holders of those claims will want to know how the (limited) economic benefits produced from the entity's economic resources will be distributed amongst all holders of claims against the entity. The distribution of those economic benefits is determined by the **priority and payment requirements** (or characteristics) of the claims referred to in paragraph OB13 of the existing *Conceptual Framework*.

41. From the reporting entity's point of view, the rights that claimants hold against it constitute an obligation of the entity to transfer its economic resources to the claimants (either before liquidation, or at liquidation)[7]. However, different claims will specify different payment and priority requirements for the transfer of the economic resources of the reporting entity.[8]

42. The specification of priority and payment requirements transforms the prospects for future cash flows flowing from the economic resources of the entity into the prospects for future cash flows flowing from the entity to the claimants. These terms will:

    (a) introduce the risk that the entity will fail to meet the obligations that are specified (credit risk) (see paragraphs (44-49); and

    (b) affect the distributions of returns among claim holders (see paragraphs 50-55).

43. The above can be illustrated with the following simple examples:

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[7] Under the going concern assumption, obligations that come into existence when the entity goes into liquidation are not present obligations at the reporting date. However, the entity's obligation to transfer any remaining assets to common shareholders at liquidation exists before liquidation.

[8] As we have noted in paragraph 8, we have assumed that the existence of the terms has been established.

Example 1- Common shares

A claim might specify no requirement other than to transfer to the claimant a share of any remaining economic resources that are controlled by the entity at the date of liquidation, and a share of any distributions made by the entity of its economic resources prior to liquidation (eg a common share).

For such a claim, *in the absence of any other claim*, the amount, timing and uncertainty of economic benefits flowing to the claimant will be equal to the amount, timing and uncertainty of economic benefits flowing from the economic resources that the entity controls. If there are any changes to the entity's economic resources, and therefore to the amount, timing and uncertainty of its cash flows, the effect of those changes will flow automatically to these claimants.

Example 2- Typical debt instrument

A claim might specify all the requirements regarding the priority, nature, amount, timing and uncertainty of economic resources required to be transferred (eg a senior bond that unconditionally requires the entity to pay CU100 in cash at a given date).

Such a claim will require the entity to transfer CU100 in cash on the given date, which it will either have on hand, or will need to obtain by selling some of its other economic resources or by issuing another claim.

However, if the entity does not have CU100 in cash, or cannot obtain it by selling its economic resources or by raising capital, then the entity will fail to meet its obligation (ie default). This risk is typically referred to as an entity's **own credit risk**. Thus, even if the requirements of the claim are fully specified, the economic benefits that flow through to the claimant are ultimately uncertain, because

> they depend on the sufficiency of the economic resources controlled by the entity.
>
> Holders of such a claim will expect a return that compensates them for the risk that they may not receive the specified amount of economic resources. This return will be a premium over the risk-free rate. Higher levels of credit risk will attract a higher premium.

Terms that introduce credit risk

44. In our view, the two primary terms of a claim that introduce credit risk are the specification of:

    (a) the **nature** of economic resources required to settle the claim (such as the requirement to transfer cash, a commodity, a service or any other type of economic resource); and

    (b) the **amount** of economic resources required to settle the claim (such as the requirement to transfer 100 currency units or 100 gold units worth of a specified resource).

45. We have distinguished between the nature and amount of economic resources required to settle a claim because the instruments that have proved difficult to classify are ones that specify the amount of the required transfer by reference to one economic resource but specify that it is required to be settled by transferring another economic resource[9]. In particular, this becomes problematic for distinguishing between liabilities and equity when one or the other economic resource is the entity's own shares, which are not an economic resource if held by the entity, but are an economic resource if held by the claimant.

46. Following from the above, the entity may fail to meet its obligation because:

    (a) The markets for either the entity's economic resources, the economic resources it requires to meet its obligations, or its claims are illiquid. Thus, regardless of the value of its economic resources, the entity is unable to obtain the type of economic resources required to settle its

[9] To the extent that the same resource is used to specify the amount and what is required to be transferred (which would be the case for most liabilities) the distinction we draw is not relevant.

obligations. We refer informally to an entity's ability to obtain the required economic resources as the entity's **liquidity**.[10]

(b) The value of the entity's economic resources is insufficient to meet its obligations. Thus, regardless of how liquid the markets for its economic resources, or its claims, are, the entity is unable to obtain the amount of resources required to meet its obligations. We refer informally to the sufficiency of the entity's economic resources as the entity's **solvency**.[11]

47. Even though liquidity and solvency are interrelated concepts, we have tried to distinguish between them because the drivers are different. ~~Thus, they may affect a user's assessment of liquidity and solvency differently.~~ In particular:

(a) liquidity is dependent on the nature of the economic resources required to settle an obligation and the timing of the required settlement; and

(b) solvency is dependent on the amount of economic resources required to settle an obligation.

48. Thus, the characteristic used to distinguish between liabilities and equity may affect a user's assessment of liquidity and solvency differently. This ~~The difference between liquidity and solvency~~ can be illustrated with the instruments we have identified:

(a) Information about obligations to issue a variable number of equity instruments with a total value equal to a fixed amount is relevant to assess solvency but not to assess liquidity. This is because the obligation will not require the entity to transfer or exchange any of its economic resources, however the value of the entity's economic resources might fall below the fixed amount required to be transferred

[10] IFRS 7 defines liquidity risk as the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset. However we do not think this definition is helpful in distinguishing between liquidity and solvency for the purposes of this paper.

[11] There is no readily available definition of solvency in IFRSs. The description used here is common in finance literature. It describes the default boundary which is used to predict default using structural models of credit risk (eg the Merton model).

(in essence, no amount of the entity's own shares would be sufficient to meet its obligation because the shares would be worthless).

(b) Information about obligations to transfer a variable amount of cash equal to the value of an equity instrument is relevant to assess liquidity but not to assess solvency. This is because the obligation will require the entity to transfer or exchange its economic resources, however the obligation cannot cause the value of the entity's (recognised and unrecognised) economic resources to fall below the amount required to be transferred.

49. We note that obligations to issue shares (or some other claims) may also lead to liquidity issues. If an entity is restricted from issuing additional shares (or some other claim) on the market (for example, by reaching the limit of the number of shares authorised by the shareholders), then the entity will be required to obtain those shares from the market by exchanging some of its economic resources for those shares, or the terms of the obligation may even require the entity to transfer its economic resources. Thus, obligations settled in own shares may still result in an outflow of economic resources. We will discuss at a future meeting whether an obligation to transfer economic resources exists even if the entity appears to have an option to avoid such a transfer, but does not have the practical ability to exercise that option. For this paper we have assumed that the entity has no restrictions in its ability to issue its own shares.

Terms that affect the distribution of returns

50. The distribution of returns amongst claims is affected by various factors including the amount of economic resources required to settle the obligation, and whether and how that amount changes with changes in the economic resources of the entity. Differences in how these two amounts change (ie their relative risks) will affect the distribution of returns amongst the claims.

51. However, the distribution of returns will be largely independent of the nature of the economic resources required to settle an obligation. This is because the value

of a claim is largely independent of how it will be settled[12]. Any difference will reflect only a liquidity premium, or the costs to exchange one type of asset for another (if such an exchange is required).

52. Other terms that will affect the distribution of returns include:

    (a) Priorities; and

    (b) Conditionality on future events.

53. As noted previously, the economic benefits derived from a claim will be limited by the future economic benefits that the entity can derive from its existing economic resources. To counteract this limitation, some claims establish a **priority** of the claim relative to other claims (typically referred to as seniority and subordination). If two claims against an entity have equal priority and payment requirements, then they will share in the economic benefits that the entity produces on its economic resources in proportion to their relative amounts.

54. For claims that specify the nature or amount of economic resources required for settlement, the distribution of returns of a particular claim will also be dependent on the relative priority of that claim, compared to other such claims. This is because the priority of a claim, and the amount of the obligation, affects its relative credit risk. Taking that credit risk into account in the measurement of the claim reflects the distribution of economic benefits produced from the entity's economic resources. That is, if the value of its economic resources increases, then the credit risk of both a senior and junior claim will reduce, however the reduction will be unequal. That is, the senior debt will increase in value less than the junior debt. This effect is often referred to as 'the waterfall' of returns.

55. The transfer of economic resources can also be conditional on future events[13]. That is, in some scenarios in the future, the obligation may cease to exist, or it may be converted into a different type of obligation (eg as occurs for written or

[12] Take, for example, an obligation to deliver a variable number of shares equal to the value of CU100. The fact that the obligation is settled with shares does not affect its value from the entity's point of view. If the entity can issue the shares without incurring costs, then the only issue is how many shares will be delivered. The valuation of the shares may be uncertain, and therefore the number of shares required to settle the obligation may need to be agreed with the claimant. However, this transaction would be no different to a transaction to issue an agreed number of shares in exchange for CU100 in cash from another potential investor.

[13] As explored in section 3 of the Discussion Paper.

purchased options to issue claims). The possibility of these events occurring will also affect the distribution of returns among claims. We will discuss obligations conditional on future events at a future meeting.

Relationships identified

56. Based on the above, we have identified the following relationships between the assessments that users need to make and the types of information that will help them make those assessments:

    (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 an 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.

Comparison of approaches

57. Based on the relationships identified in the preceding section, we have identified four potential 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 will require the entity to transfer its economic resources (paragraphs 59-66).

    (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 its own claims, with a value that is independent of the entity's total economic resources (paragraphs 67-77).

(c) **Combined settlement and value approach**—depicts as liabilities all obligations that meet the criteria for either the settlement approach, or the value approach (paragraphs 78-80).

(d) **Narrow equity approach**–helps users assess the distribution of returns to the most residual class of claim. The distribution of returns to all other claims will be recognised as part of profit or loss and other comprehensive income (paragraphs 81-87).

58. For each approach we briefly describe:

(a) how each approach would classify claims as liabilities or equity and its implications;

(b) the information that the approach would provide, and what assessments of the users it will facilitate;

(c) the advantages and disadvantages of the approach; and

(d) how information could be provided to help users make the other assessments.

Settlement approach

59. The settlement approach would be similar to the strict obligation approach as it was described in the Discussion Paper.

60. The settlement approach would:

(a) classify as liabilities all obligations to transfer economic resources of the entity.

(b) classify as equity all other claims against the entity.

61. The information provided by using the settlement approach to distinguish between liabilities and equity would help a user assess the extent to which the claims against the entity oblige it to transfer its economic resources prior to liquidation, and consequently, the extent to which the entity:

(a) has the specified nature (or type) of economic resources required to settle its obligations; or

(b) needs to obtain those economic resources by exchanging the resources it has or by raising additional finance.

62. One consequence of the settlement approach is that obligations to issue equity instruments are not liabilities (because equity instruments are not economic resources of the entity).

63. Implications of the settlement approach include:

(a) That it would be consistent with the existing definition of a liability in the *Conceptual Framework*.

(b) That it would be consistent with the existing definitions in IFRS 2 *Share-based Payments*.

(c) That it will be inconsistent with the existing definitions and requirements in IAS 32. Any changes to IAS 32 have not been explored and will need to be developed further in the Financial Instruments with Characteristics of Equity research project. The set of claims captured as liabilities would be very different to the set of claims that would be captured as liabilities under IAS 32 today.

Advantages and disadvantages of the settlement approach

64. The advantages of the settlement approach include:

(a) that it will show those obligations that require an outflow of the entity's economic resources. Thus, it will distinguish obligations that must lead to changes in the entity's economic resources from those that do not require such changes. If the entity needs to maintain operating capacity, such information may indicate a need to obtain additional financing.

(b) that such obligations will be remeasured and reflected as liabilities, thus total liabilities will always show the amount of assets that the entity may be obliged to transfer before liquidation.

65. The disadvantages of the settlement approach include:

(a) The relevance of how an obligation is to be settled will depend on market circumstances at the time of settlement. The ability to settle an

obligation in various ways adds liquidity options. If markets are liquid then the value of those options would be trivial. However if markets are not liquid then those options will be more valuable. From a user's perspective:

(i) if markets are liquid, then users will be indifferent between claims that are settled say, by cash, and those that are settled with an entity's own equity.

(ii) if markets are illiquid then this information may be critical.

(b) The value of a claim of a specified amount depends on the total **value** of the items that will be used to settle the claim, but is largely independent of the **nature** of the items with which it is required to be settled. Therefore, the distributions of returns on claims are also independent of the nature of items used for settlement. That is, an obligation for CU100 will produce similar returns whether it is settled by cash, or by the entity's own shares. Likewise, a common share will produce returns similar to those~~is~~ produced by a share redeemable at its fair value. Any difference will reflect a liquidity premium (as discussed in (a), the value of this premium will depend on market circumstances). Therefore:

(i) it is not clear why the nature of economic resources required to settle an obligation is relevant to deciding whether returns on that obligation should be recognised as income or expense.

(ii) recognising otherwise similar changes in different parts of the financial statements may make the financial statements less understandable and less comparable.

(c) This approach causes difficulties for claims that permit or require alternative forms of settlement (eg either cash or shares) (either at the option of the issuer, at the option of the holder or contingent on an event beyond the control of both). The IASB will need to develop requirements for the classification and reclassification of claims with settlement alternatives, including whether to split the claim into liability

and equity components, and the subsequent recognition and measurement of the components.

(d) Classifying as liabilities shares puttable at their fair value (and other obligations that specify the amount by reference to the economic resources of the entity) presents challenges for subsequent measurement and presentation of the resulting gains and losses. Recognising these changes in value magnifies the limitations of financial statements. This is because the changes in value of the claim may reflect changes in value of unrecognised assets, or unrecognised changes in value of recognised assets (ie there may be accounting mismatches). To address these challenges, the Discussion Paper suggested that, as an exception, the IASB may require some puttable instruments to be treated as if they were equity instruments.

Providing information required for the other assessments

66. Under the settlement approach, information about solvency and the distribution of returns will need to be provided in another way. The Discussion Paper suggested providing information about the distribution of returns amongst equity claims by updating the measure of some equity claims through the statement of changes in equity. This approach could be expanded to also provide information about the solvency of the entity, by distinguishing between liabilities that are specified by reference to the value of the entity's own equity instruments and those that are not. Furthermore, these distinctions could be required both within the liability classification and within profit or loss and other comprehensive income.

Value approach

67. The value approach would:

(a) classify as liabilities all obligations to transfer economic resources of the entity, or to transfer other claims against the entity, that specify a value that is independent of the total economic resources of the entity (for example a specified amount of currency, commodity, service or any other such economic resource or reference to such an economic resource).

(b) classify as equity all other claims against the entity (for example common shares, or obligations to transfer economic resources to the value of common shares).

68. In the above description, we use total economic resources of the entity, and not a reference to a residual, as the reference point because, as we have described in paragraphs 39-40, the total (recognised and unrecognised) economic resources of the entity determine the ultimate boundaries of value for any claim on the entity. Thus the value of any claim is, at least, dependent on the value of the total economic resources of the entity, less the value of any higher priority claims (in other words all claims, other than the most senior, can be a residual).[14]

69. The information provided by using the value approach to distinguish between liabilities and equity would help a user assess the extent to which the value of the total economic resources[15] of the entity is sufficient to settle its obligations and consequently, whether the entity has the flexibility or strength to raise additional finance.

70. The value approach is based on the definition of a liability, and is based on whether an obligation exists. However, it will require a modification to the guidance on the definition of a liability. In particular, it would need to be clarified that the obligation to 'transfer economic resources' refers to the **value** of economic resources, or claims, required to settle the obligation and not to the **nature** of the economic resources required to settle the obligation.

71. The value approach achieves similar outcomes to some of the approaches that were suggested by respondents. In particular, some suggested that the definition of equity should include:

(a) claims that participate without limit in the returns of the entity.

(b) rights to a proportionate share of net assets, regardless of whether there is an obligation to transfer economic resources prior to liquidation.

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[14] The value approach classifies as a liability any obligation that introduces a boundary of value for the claim that is different from the total economic resources of the entity.

[15] To make this assessment, the user will also have to estimate the total value of the recognised and unrecognised economic resources of the entity. We are not proposing that all economic resources of the entity should be recognised and measured at fair value.

72. The value approach achieves the above two outcomes, however it does so by identifying the relevant characteristic of liabilities rather than by defining equity.

73. The consequences of the value approach are that:

    (a) Obligations to issue a variable number of equity instruments equal to the value of a fixed amount are liabilities; and

    (b) Obligations to transfer a variable amount of economic resources equal to the value of the entity's equity instruments are equity.

74. Implications of the value approach include:

    (a) That it will require a change to the guidance on the definition of a liability to clarify that the notion of 'a transfer of economic resources' should:

        (i) Include transfers of an entity's equity instruments if the specified value of the obligation is independent of the total economic resources of the entity; and

        (ii) Exclude transfers of economic resources if the specified value of the obligation depends on the total economic resources of the entity.

    These changes have not been tested. However, the set of claims captured as liabilities would be broadly similar to the set of claims that would be captured as liabilities under IAS 32 today (including the exceptions for puttable instruments).

    (b) That it provides a better conceptual rationale for equity treatment of puttable instruments. Thus the IASB would not need an exception for equity classification of puttable instruments.

    (c) That it would be inconsistent with the definitions and requirements in IFRS 2. However, it would provide a basis to eliminate differences between the accounting for cash-settled share-based payments and the accounting for equity-settled share-based payments in IFRS 2.

Advantages and disadvantages of the value approach

75. The advantages of the value approach include:

(a) That it will help users in assessing:

  (i) the sufficiency of the entity's economic resources to meet its obligations.

  (ii) the distributions of its returns, by distinguishing between:

    1. returns on those claims that specify an amount that is independent of the total economic resources of the entity (changes in the carrying amount of such claims are recognised in profit and loss and other comprehensive income); and

    2. returns on other claims (changes in the carrying amount of such claims are recognised within the statement of changes in equity).

(b) That it would report as liabilities obligations that do not require settlement prior to liquidation, but for which the amounts are specified (such as preference shares with dividend step-up clauses). Including these obligations as liabilities would help a user assess an entity's solvency.

(c) That it alleviates some of the consequences of the constraints mentioned in paragraphs 34–36, by eliminating some accounting mismatches. In particular, claims (such as puttable shares) whose values depend on the values of the entity's recognised and unrecognised economic resources would be classified as equity.

76. The disadvantages include that this approach causes difficulties for obligations that specify amounts that are based on proxies (such as formulas based on financial performance measures) for values of the entity's total economic resources. The IASB will need to develop requirements for the classification and reclassification of such claims, including whether to split the claim into liability and equity components, and the subsequent recognition and measurement of the components.

Providing information required for the other assessments

77. Under the value approach, information to help a user assess the reporting entity's liquidity will need to be provided in a manner other than through the distinction

between liabilities and equity. However, most obligations to transfer economic resources of the entity that would be reported as liabilities under the settlement approach will also be reported as liabilities under the value approach. Of the obligations captured as liabilities under the settlement approach, the obligations would not be captured as liabilities under the value approach only if they do not affect the entity's solvency (for example puttable shares, or cash settled warrants). While liquidity information is equally important, information about the amount, nature and timing of the settlement of obligations classified as equity, or as liabilities, would need to be depicted through disclosure or presentation. This could be achieved by presenting these claims as separate classes within equity (eg labelling them as redeemable, puttable or cash-settled) and liabilities (eg labelling them as share-settled). To present information about the amount of economic resources that the entity may be obliged to transfer, some obligations within equity may need to be remeasured. For example, remeasuring within equity shares that are puttable at their fair value would show users how much of the entity's economic resources might be redeemed.

Combined settlement and value approach

78. We note that the **settlement approach and the value approach can be combined** to classify as liabilities all claims that meet either criteria. As a consequence, such an approach:
    (a) would include a larger set of claims as liabilities; and
    (b) would combine the advantages and disadvantages of both approaches discussed above.

79. This approach would be easier to implement than the value approach, as any additional guidance on the definition of a liability will focus on when obligations to issue equity instruments meet the definition of a liability. The set of claims will be similar to those captured as liabilities under the existing definitions in IAS 32 **without** the exceptions for puttable instruments.

80. The combined approach will include as liabilities obligations that meet either of the two criteria, therefore it will not help users make a particular assessment as

efficiently as one or the other approach. This may increase the complexity of the presentation of items as liabilities.

Narrow equity approach

81. The narrow equity approach would:

    (a) classify as equity only the existing equity instruments in the most residual existing class of claim issued by the entity.

    (b) classify as liabilities all other claims against the entity.

82. The information provided by using the narrow equity approach to distinguish between liabilities and equity would help a user assess the distribution of returns to the most residual class of claim. The distribution of returns to other claimholders will need to be provided by other means, as would information to assist the other assessments.

83. The narrow equity approach will not require the existence of an obligation to transfer economic resources to be established for classification as a liability. However, establishing the existence of a claim may be difficult for claims with no obligation to transfer economic resources, but that are not the most residual class of claim.

84. The implications of the narrow equity approach include that it is inconsistent with the existing definitions in the *Conceptual Framework*, IFRS 2 and IAS 32. Any changes to those definitions have not been explored.

85. Some have suggested that the narrow equity approach is consistent with the proprietary perspective. We discuss this in Appendix A.

Advantages and disadvantages of the narrow equity approach

86. The advantages of the narrow equity approach include:

    (a) It will include changes in all claims other than the most residual claim within profit or loss and other comprehensive income.

    (b) It would provide a conceptual basis for treating some puttable instruments as equity (if they are the most residual).

87. The disadvantages include:

(a) Instruments with similar characteristics will be classified differently, reducing comparability and understandability.

(b) Some classes of claims may have economically similar characteristics to the most residual class of claim. Classifying such instruments as liabilities may present challenges for subsequent measurement and presentation of the resulting gains and losses. Recognising changes in their value magnifies the limitations of financial statements. This is because the changes in value of the claim may reflect changes in value of unrecognised assets, or unrecognised changes in value of recognised assets (ie accounting mismatches).

(c) This approach would be difficult to apply if:

  (i) the most residual class of claim changes over time; or

  (ii) obligations exist that specify a different priority under different scenarios.

  The IASB would need to develop requirements for the classification and reclassification of claims with changing priorities.

Refer to Cover Paper Appendix A for updated conclusion

Appendix A-Perspective of the 'owners' of the entity

88. Some respondents suggested that equity should be based on the perspective of the 'owners' of the entity, and that such an approach:

    (a) is consistent with a proprietary perspective for financial reporting.

    (b) provides information to assess how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.

    (c) provides a record of amounts invested by an identified class of owners, or returned to them. These respondents stated that such a record of investment is very relevant from a stewardship perspective.

89. The perspective for financial reporting was discussed in Agenda Paper 10E of the IASB's May meeting. In that meeting, the IASB tentatively decided that, consistently with the objective for financial reporting in paragraph OB2, financial statements should be presented from the perspective of the entity and should provide information that is useful to existing and potential investors, lenders and other creditors, and the information provided should focus on their common information needs. Following from this decision, in our view:

    (a) information to assess how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources would be relevant for a wide range of users of financial statements, including existing investors in both debt and equity instruments (although the degree of relevance may vary).

    (b) recognising liabilities and equity, and changes in the carrying amounts of liabilities and equity, an entity will provide information about the amounts invested and returned to both holders of liabilities and equity.

90. We see no reason why such information should be of interest only to holders of a particular set of claims, although some may have more or less interest in this information than others.

91. The Discussion Paper suggested that the 'narrow equity approach' might be seen as more in line with the proprietary perspective than the entity perspective. However, in our view, proponents of the proprietary perspective might be trying

to identify as equity the class of claims that provides the holders with control of the reporting entity (ie the 'owners' of the entity), rather than the class of claims that is the most residual (which was how the narrow equity approach was defined in the Discussion Paper).

92. We do not support defining equity as the class of claims that provides the holders with control of the reporting entity because:

(a) a single class of claim may not provide control. If control is diffused over various classes, then different combinations of classes could potentially provide (joint) control to the holders. Moreover, if the definition of equity were extended to cover all classes of claim that will provide control, those classes of claim might have very different characteristics, reducing comparability between entities.

(b) that characteristic may be transitory (ie it may change over time as the entity changes its capital structure); and

(c) it may not meet any of the other objectives identified above.

Appendix B— Classification of obligations under the settlement and value approach

Assume that the entity will receive no further cash in exchange for the following obligations.

Example obligation	Settlement approach	Value approach
Obligation to pay CU100 in cash in 2 years (a zero-coupon bond)	Liability	Liability
Obligation to pay CU100 with an increase of 6% per year until the obligation is redeemed, however there is no obligation to settle before liquidation	Equity	Liability
Obligation to pay in cash an amount equal to the value of the entity's own shares	Liability	Equity
Obligation to issue a fixed number of shares	Equity	Equity
Obligation to issue a variable number of shares to the value of CU100 (a share settled bond)	Equity	Liability

Example obligation	Settlement approach	Value approach
Obligation to pay in cash an amount equal to the value of a written call option on the entity's own shares (a cash-settled share-based payment)	Liability	Equity
Obligation to issue a variable number of shares equal to the value of a written call option on the entity's own shares (a net share-settled share-based payment)	Equity	Equity