STAFF PAPER

September 2016

IASB Meeting

Project	**Conceptual Framework**
Paper topic	Definition of equity and supporting discussion

CONTACT(S) Manuel Kapsis mkapsis@ifrs.org +44 (0)20 7246 6459

Introduction

1. This paper considers comments received on the Exposure Draft *Conceptual Framework for Financial Reporting* (the Exposure Draft). It considers the main comments received on:
   (a) the proposed definition of equity;
   (b) the discussion proposed to support that definition; and
   (c) the discussion in the measurement chapter regarding equity.
2. The staff recommend that, consistently with the proposals in the Exposure Draft, the *Conceptual Framework* should:
   (a) continue to make a binary distinction between liabilities and equity;
   (b) define equity as "the residual interest in the assets of the entity after deducting all its liabilities";
   (c) include the discussion proposed in paragraphs 4.44–4.47 of the Exposure Draft to support that definition; and
   (d) include the discussion proposed in paragraphs 6.78–6.80 of the Exposure Draft about the measurement of equity.
3. This paper is structured as follows:
   (a) Exposure Draft proposals (paragraphs 4–9)

(b) Summary of feedback (paragraphs 10–18)

(c) Board decisions to date (paragraphs 19–20)

(d) Staff analysis (paragraphs 23–28)

(e) Appendix A—Other suggestions for the guidance accompanying the definition of equity

Exposure Draft proposals (paragraphs 4.43–4.47 and BC4.93–BC4.103)

4. The Exposure Draft proposed to retain the existing *Conceptual Framework* definition of equity:

> 4.43 Equity is the residual interest in the assets of the entity after deducting all its liabilities.

5. The Exposure Draft proposed in paragraphs 4.44–4.47 to include some discussion to support the definition of a liability. That discussion stated that:

    (a) equity claims are claims against the entity that do not meet the definition of a liability;

    (b) different equity claims convey to their holders different rights to, for example, receive some or all of the following:

        (i) dividends;

        (ii) the repayment of contributed equity on liquidation; or

        (iii) other equity claims;

    (c) to provide useful information, it may be necessary to divide the total carrying amount of equity to reflect differences between equity claims; and

    (d) the definition of equity applies to all types of entities.

6. Paragraphs BC4.93–BC4.97 of the Basis for Conclusions on the Exposure Draft explained why the Exposure Draft proposed to:

    (a) retain the existing *Conceptual Framework*'s binary distinction between liabilities and equity;

(b) retain the existing *Conceptual Framework* definition of equity as 'the residual interest in the assets of the entity after deducting all its liabilities'; and

(c) retain the existing concept that separately presenting different classes and categories of equity may provide useful information to users.

7. Two Board members dissented from the publication of the Exposure Draft because they disagreed with the limited nature of the changes proposed to the definition of a liability to address the classification of claims against an entity as liabilities or equity. These Board members thought that the Exposure Draft should have included either:

(a) the Board's conclusion that the definition of a liability that is being proposed is suitable for distinguishing between liabilities and equity; or

(b) additional changes to the definition of a liability that would have made it suitable for such a purpose.

8. The Exposure Draft proposed in paragraphs 6.78–6.80 to include some discussion about the measurement of equity. That discussion stated that:

(a) Total equity is not measured directly; instead it equals the total of the carrying amounts of all recognised assets less the total carrying amounts of all recognised liabilities.

(b) The objective of general purpose financial statements is not to show an entity's value; consequently, total equity will not generally equal:

(i) the market value of the entity's shares;

(ii) the sum that could be raised by selling the entity as a whole on a going concern basis; or

(iii) the sum that could be raised by selling all its assets after settling all its liabilities.

(c) Although total equity is not measured directly, some individual classes or categories of equity may be measured directly.

9. Paragraph BC6.69 of the Basis for Conclusions on the Exposure Draft explained that, although total equity is not measured directly, it may be necessary to measure individual classes or categories of equity directly to provide useful information.

Summary of feedback

10. Question 3(c) of the invitation to comment on the Exposure Draft asked respondents whether they agreed with the proposed definition of equity, excluding issues relating to the distinction between liabilities and equity.

11. Less than half of the total respondents to the Exposure Draft responded to this question directly. Of those that responded to the question directly:

    (a) many respondents agreed with the proposed definition of equity. Of those:

        (i) some agreed without providing any rationale.

        (ii) some agreed tentatively, pending the further work that will be undertaken as part of the Financial Instruments with Characteristics of Equity (FICE) research project. The interaction between the FICE project and the Conceptual Framework project was discussed in Agenda Paper 10E in April 2016 (see paragraph 19).

        (iii) a few agreed with the definition of equity as a residual interest, but expressed concerns regarding the application of the proposed definition of a liability to the classification of claims between liabilities and equity. These concerns will be discussed at a future meeting, with other comments on the liability definition.

    (b) some respondents disagreed with the proposed definition of equity. Of those:

        (i) some disagreed because, in their view, equity should be defined independently of the definitions of assets and liabilities (see paragraphs 14–16).

        (ii) one standard-setter disagreed because, in its view, dividing claims into three elements of financial statements would meet the objectives of financial reporting better than dividing them into only two (liabilities and equity) (see paragraphs 17–18).

        (iii) some disagreed because they think that the Board should consider implications for the distinction between liabilities and equity before finalising the *Conceptual Framework*. The interaction between the FICE project and the Conceptual

Framework project was discussed in Agenda Paper 10E in April 2016 (see paragraph 19).

(iv) a few did not explicitly state a position but suggested changes to the definition of equity and accompanying guidance.

12. Only a few respondents commented on the additional discussion accompanying the definition of equity. These comments are included in Appendix A and mostly related to drafting.

13. Only a few respondents to the Exposure Draft commented on the proposals regarding measurement of equity. Of those few respondents, most (mainly accounting standard-setters in the Asia-Oceania region) broadly agreed with the proposals, however these same respondents disagreed with the specific proposal that some individual classes or categories of equity could be measured directly. Reasons for disagreement included that:

(a) it would be inappropriate to measure a component of equity because equity is defined as a residual; and

(b) it would be inconsistent with the entity perspective because re-attributing total equity would not have a financial effect on the entity as a whole.

Alternative definitions of equity

14. Some respondents, of various types and geographies, suggested that equity should be defined independently of the definitions of assets and liabilities. They suggested that:

(a) defining equity as an interest in the difference between assets and liabilities is inconsistent with the definition of those elements as rights and obligations. It assumes some degree of measurement because obligations cannot be 'deducted' from rights.

(b) equity is not a claim, it is the entity's 'own funds', and should be defined by reference to capital contributed and capital retained.

(c) if equity is a claim against the entity, then the obligation it imposes on the entity must have some characteristics that can be identified and used to define equity.

15. Respondents representing co-operative entities and credit unions suggested that the definition of equity should refer to some of the characteristics that are particular to members’ shares in co-operative entities and credit unions, such as:

    (a) the characteristics identified in IFRIC 2 *Members’ Shares in Co-operative Entities and Similar Instruments*[1];

    (b) whether the claim is most residual and able to absorb losses, even if the entity has an obligation to redeem the claim in some circumstances;

    (c) the structure of voting rights; and

    (d) the way in which the entity conducts its business activities.

16. Other respondents suggested that a definition of equity might include some other characteristics, including:

    (a) loss absorption;

    (b) exposure to risks of variable returns;

    (c) the characteristics of different categories of reserves (such as whether reserves are distributable); and

    (d) ownership.

17. One standard-setter disagreed with the proposed binary distinction between liabilities and equity. In addition to defining equity independently, they proposed a ‘three-category approach’ which distinguishes between:

    (a) the most residual claim, which would be classified as equity;

    (b) claims that constitute present obligations, which would be classified as liabilities; and

    (c) claims that are neither equity nor liabilities, which would be classified in a mezzanine category.

18. In that standard-setter’s view, the ‘three-category approach’ would better meet the objectives of:

[1] For example, paragraph 7 of IFRIC 2 states that members’ shares are equity if the entity has the unconditional right to refuse redemption of the members’ shares. IFRIC 2 is an interpretation of the requirements in IAS 32 *Financial Instruments: Presentation*.

(a) distinguishing transactions or events that give rise to income or expenses from transactions with owners (holders of the most residual claim) in their capacity as owners; and

(b) providing information about the entity's solvency.

Board decisions to date

19. In April 2016, the Board discussed the interaction of the Conceptual Framework project and the FICE research project. At that meeting, the Board tentatively decided, consistently with the proposal in the Exposure Draft:

    (a) not to develop, as part of the Conceptual Framework project, concepts to address challenges that arise in classifying financial instruments with characteristics of both liabilities and equity; but instead

    (b) to continue to develop concepts to address those challenges in the FICE research project, acknowledging that one outcome of that project might be a need to make further amendments to the revised *Conceptual Framework*; and

    (c) to explain this approach, and highlight the possibility of further amendments to the *Conceptual Framework*, in the Basis for Conclusions accompanying the revised *Conceptual Framework*.

20. That decision is consistent with the approach proposed in the Exposure Draft. Consistent with that approach, the revised *Conceptual Framework* will include a definition of equity and supporting guidance. This paper considers the comments received on that definition of equity and guidance, other than comments relating solely to the distinction between liabilities and equity.

Staff Analysis

21. In developing the Exposure Draft, the Board considered whether to define equity directly, and to define liability indirectly by reference to equity (therefore defining liabilities as the residual claim). In the Board's view, such an approach would simply

shift the challenges of the distinction between liabilities and equity from one definition to the other.

22. The Board also considered a three-category approach when it was developing the Exposure Draft. As it explained in the Basis for Conclusions on the Exposure Draft, it acknowledged that defining equity directly and introducing another element (a third class of claim) may better depict claims that have some characteristics of both liabilities and equity. However, it concluded that introducing another element would make the classification and resulting accounting more complex, and that, in addition:

    (a) it would be necessary to determine whether changes in this third class of claim should meet the definition of income or expenses.

    (b) an outcome similar to introducing a new element could be achieved by simply introducing a new subclass within liabilities or equity.[2]

23. The inherent limitation of a distinction between liabilities and equity is that it attempts to make a single, binary distinction between claims that have various characteristics in varying degrees. The Board observed that whichever approach it takes, additional information would need to be provided about characteristics that are not captured by the distinction. Thus, in developing the Exposure Draft, the Board agreed with the respondents to the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* that it should retain the existing *Conceptual Framework*'s binary distinction between liabilities and equity, and use the definition of a liability to make that distinction.[3] The discussion supporting the definition of equity supported this conclusion by suggesting that separately presenting different classes and categories of equity may provide useful information to users.

24. In the staff's view, the Board has already considered fully all arguments made by respondents to the Exposure Draft for defining equity directly or for introducing a third class of claim.

25. Furthermore, the Board has decided to continue to develop concepts to address challenges that arise in classifying financial instruments with characteristics of both liabilities and equity as part of the FICE research project. The characteristics

---

[2] Exposure Draft BC4.97

[3] Exposure Draft BC4.96

suggested by respondents in paragraphs 15 and 16 are being considered as part of that project. The Board will consider whether further changes to the *Conceptual Framework* are required following that research.

26. With regard to the discussion of measurement of equity, in the staff's view, the direct measurement of some individual classes or categories of equity would not contradict the entity perspective of financial statements, nor would it be inconsistent with the definition of equity as a residual. Direct measurement of some individual classes or categories of equity might provide useful information to users of financial statements in making decisions about providing resources to the entity. This information would be provided from the perspective of the entity; it would not be provided from the perspective of some particular claimholder and it would not reflect other rights and obligations that affect a particular claimholder but not the entity. Also, directly measuring *some* individual classes or categories of equity to meet the objective of financial reporting is not the same as measuring *total* equity directly. Financial statements are not designed to show an entity's value. Therefore, even if some individual classes or categories of equity are measured directly, total equity will continue to equal the total of the carrying amounts of all recognised assets less the total carrying amounts of all recognised liabilities.

27. For the reasons in paragraphs 21–25, the staff recommends that, consistently with the proposals in the Exposure Draft, the revised *Conceptual Framework* should:

(a) continue to make a binary distinction between liabilities and equity;

(b) define equity as 'the residual interest in the assets of the entity after deducting all its liabilities';

(c) include the discussion proposed in paragraphs 4.44–4.47 of the Exposure Draft to support that definition; and

(d) include the discussion proposed in paragraphs 6.78–6.80 of the Exposure Draft about the measurement of equity.

28. The staff will consider suggested drafting clarifications for some of the supporting guidance when drafting the final *Conceptual Framework*. We have included our recommendations on these suggestions in Appendix A.

Question for the Board
Does the Board agree with the staff recommendation in paragraph 27?

Appendix A—Other suggestions for the guidance accompanying the definition of equity

	Respondent suggestion or comment	Staff recommendation	Reason for staff recommendation
A1	The drafting of the accompanying discussion should be altered to refer to 'obligations of the entity' as opposed to 'rights of the holders of equity claims'. Doing so would better reflect the characteristics of equity claims from the perspective of the entity.	Consider in drafting.	
A2	Consider clarifying the reference to 'other equity claims' in paragraph 4.45 of the Exposure Draft.	No changes.	We do not think it is necessary to clarify 'other equity claims'.
A3	Consider whether paragraph 4.46 of the Exposure Draft, which appears to relate to presentation and disclosure, should be included in a section on definition.	No changes.	The purpose of the paragraph is to clarify that, even though equity is defined as a residual interest, it may be sub-classified. However, we could add a cross-reference to the presentation chapter.
A4	Consider whether the heading 'Equity' should be 'Definition of equity' consistent with the headings for the other elements of financial statements.	Consider in drafting.	

	Respondent suggestion or comment	Staff recommendation	Reason for staff recommendation
A5	Consider whether the term 'interest' in the definition of equity should be replaced with the term 'economic resource'. Hence, the definition of equity is the residual economic resource in the assets of the entity after deducting all its liabilities. While the term 'interest' implicitly refers to economic resource in a sense that stakeholders are interested to economic resource, the use of 'economic resource' is preferable because it is consistent with the term 'economic resource' used in the definition of both asset and liability.	No changes	We think it is important to differentiate the entity's economic resources from the claims on those resources.
A7	We note that equity is defined as the residual, the difference between assets and liabilities. However where other comprehensive income (OCI) is used to record the difference in measurement between profit or loss and the balance sheet, amounts end up in equity which are essentially deferred gains or losses and not residual. It may be helpful to consider how the use of OCI impacts equity as the debt/equity project progresses.	No changes	Items included in other comprehensive income are income and expenses and hence result in increases and decreases in equity.