Tuesday 24 September 2013
The Grange City Hotel (London)

Meeting documentation

World Standard-setters Meeting

Smaller group discussions:
Conceptual Framework: liability equity split
Smaller group discussion

Conceptual Framework: liability equity split

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IASB
Objective of the session

- Overview of current criticisms
- Objectives of distinction
- Approaches explored in the Discussion Paper (DP)
- Comparison between the different approaches
- Areas of further work

Overview of current criticisms

What are the problems with the current accounting?

- If more than one class of equity, there is limited information about the distribution of risk and return (wealth transfers) between different classes.
- The distinction between liabilities and equity instruments is complex, difficult to understand and difficult to apply.

What effect does the distinction between liabilities and equity have today?

<table>
<thead>
<tr>
<th></th>
<th>Liabilities</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subsequent measurement</td>
<td>Updated for interest and/or other value changes</td>
<td>Not updated (except NCI)</td>
</tr>
<tr>
<td></td>
<td>Interest and other changes presented in Profit or Loss or OCI</td>
<td>Wealth transfers and effects of dilution not reported until transaction occurs (eg exercise, expiry or payment)</td>
</tr>
<tr>
<td>Disclosure</td>
<td>Extensive disclosures required (eg IFRS 7)</td>
<td>Very minimal disclosure required about different classes</td>
</tr>
</tbody>
</table>

Unclear requirements

- Existence of a *contractual obligation*  
  - Are statutory requirements contractual?  
  - What about settlement of cash or shares at the option of the issuer, when the value of shares exceeds the cash?
- 'Fixed for fixed'  
  - What does ‘fixed’ really mean?
- Contingent settlement provisions  
  - Settlement option within control of holder?  
  - What about contingent events beyond control of both issuer and holder? When are they not ‘genuine’?
Clear requirements but odd outcomes

- Some entities have no equity
  - Shares redeemable at fair value
  - Exception to IAS 32 for puttables
- Inconsistent use of liability definition
  - IAS 32 vs IFRS 2
- Put options on own instruments
  - PV of redemption amount as liability, regardless of probability
  - Changes through P&L
  - NCI puts
- Fair value put options on own instruments
  - Fair value of unconditional interest and probability of exercise may be minimal
  - Mismatch with goodwill measurement

Typical features that cause problems

- Settlement options:
  - Within control of holder, but equity > cash
  - Beyond control of holder
- Put options written on own instruments
  - Put options on a class of shares (e.g., NCI)
  - Fixed exercise price vs FV exercise price
- Compounds
  - Puttable shares and convertible bonds
- Foreign currency variations of the above
- Perpetuals, partly paid shares, etc etc etc

Objectives of distinction

- What information are we trying to convey?
  - Liquidity or balance sheet leverage
  - Ratio of cash obligations to equity
  - Dilution or return leverage
  - Ratio of participation in returns on assets
- Are both of the above relevant to investors?
- Is the complexity of the current requirements a result of the tension between these two objectives?

What are the objectives of the distinction?

- Do both objectives need to be satisfied by the same distinction?
- If basis of distinction is liquidity, some instruments may not contribute to liquidity but may still dilute return
  - So how do we present dilution of return?
- If basis of distinction is dilution, some instruments may dilute the return but not contribute to liquidity
  - So how do we depict liquidity?

Approaches explored in the Discussion Paper
Approaches explored in the DP

- Simplify the distinction between liabilities and equity:
  - Narrow equity approach; or
  - Strict obligation approach.
- Provide users with more information about how different equity claims affect each other (dilution):
  - Enhance the statement of changes in equity to show wealth transfers between different equity claims.

Narrow equity approach

- Equity = most residual class of claim.
  - Typically common shareholders of parent (but might not be).
- Liabilities = other instruments.
  - Recognise in profit/loss all gains/losses from liabilities including interest expense.
  - Eg Non-controlling (minority) interests (NCI), forwards and options on equity, instruments that create no obligation to transfer assets.
- Based on the view that all senior claims are fundamentally different from the most residual claim.

Strict obligation approach

- Liabilities = present obligation to deliver assets (economic resources) to holder.
- Equities = residual.
  - Includes all claims that may enable the holder to receive distributions of equity (eg common shares).
  - Includes all obligations to deliver equity instruments (eg some options over equity instruments).
- Based on the view that claims that oblige the entity to deliver assets are fundamentally different from claims that do not.

Example:
Written put option, settled net in own shares

- The following example will illustrate:
  - Difference between the narrow equity approach and strict obligation approach.
  - How the enhanced statement of changes in equity would look under the strict obligation approach.
- Key features of instrument:
  - Option entitles holder to put 1,000 shares back to the entity (issuer)
  - Strike price: CU98 per share
  - Value changes with value of underlying shares.
  - Entity will not pay cash on exercise, but issue a variable number of its own shares.

<table>
<thead>
<tr>
<th></th>
<th>1 Feb 20X2</th>
<th>31 Dec 20X2</th>
<th>31 Jan 20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value per share</td>
<td>CU100</td>
<td>CU95</td>
<td>CU95</td>
</tr>
<tr>
<td>Fair value of option</td>
<td>CU5,000</td>
<td>CU4,000</td>
<td>CU3,000</td>
</tr>
</tbody>
</table>

Example: Using narrow equity approach

- Once exercised, shares issued classified as equity and the liability is derecognised.

Note: similar result today under IAS 32 Financial Instruments: Presentation
Example: Using strict obligation approach

Statement of financial position

<table>
<thead>
<tr>
<th></th>
<th>1 Feb 20X2</th>
<th>31 Dec 20X2</th>
<th>31 Jan 20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Net assets</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Share capital</td>
<td>-</td>
<td>-</td>
<td>3,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>-</td>
<td>1,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Obligation to issue shares</td>
<td>5,000</td>
<td>4,000</td>
<td>-</td>
</tr>
<tr>
<td>Total equity</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
</tr>
</tbody>
</table>

Example: Enhanced SOCIE (using strict obligation approach)

Statement of Changes in Equity (SOCIE)

<table>
<thead>
<tr>
<th></th>
<th>Share capital</th>
<th>Retained earnings</th>
<th>Total existing shareholders</th>
<th>Obligations to issue shares</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening 1 Feb 20X2</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Written option issued 1 Feb 20X2</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>5,000</td>
</tr>
<tr>
<td>Profit/OCI</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Change in carrying value of option</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>31 Dec 20X2</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Profit/OCI</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Change in carrying value of option</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Shares issued 15 December 20X2</td>
<td>3,000</td>
<td>2,000</td>
<td>5,000</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>31 January 20X3</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Advantages of enhanced statement of changes in equity

- Remeasuring equity claims will provide investors with clearer and more prominent information about effects of other equity claims than they get today.
- Providing similar information regardless of debt or equity classification:
  - Limits incentive to structure instruments to obtain equity classification.
  - Enables IASB to apply definition of liability more consistently while still providing information regarding dilution of return.

Comparison between narrow equity and strict obligation approaches

<table>
<thead>
<tr>
<th></th>
<th>Narrow equity approach</th>
<th>Strict obligation approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis of classification</td>
<td>Relative to other claims – all entities will classify the most residual claim as equity even if that instrument creates an obligation to pay cash</td>
<td>Independent of other claims – all entities will classify a claim that creates an obligation as a liability even if that claim is the most residual</td>
</tr>
<tr>
<td>Effect on definitions</td>
<td>Will require a new definition of equity and a modification to the definition of a liability</td>
<td>Will retain similar definition of liability and retain the existing definition of equity</td>
</tr>
<tr>
<td>Judgements required</td>
<td>Identification of the most residual claim</td>
<td>Identification of whether a given claim creates an obligation</td>
</tr>
</tbody>
</table>

Comparison between narrow equity and strict obligation approaches (contd)

<table>
<thead>
<tr>
<th></th>
<th>Narrow equity approach</th>
<th>Strict obligation approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Effects of dilution and wealth transfers between other classes of claims</td>
<td>Reported in P&amp;L or OCI</td>
<td>Reported in statement of changes in equity (equity) P&amp;L or OCI (liabilities)</td>
</tr>
<tr>
<td>Cash leverage (ratio of obligations to equity)</td>
<td>Cash leverage will have to be communicated through disclosure</td>
<td>Distinction between liabilities and equity on the balance sheet</td>
</tr>
<tr>
<td>Other</td>
<td>Always at least one claim classified as equity</td>
<td>Opportunity to remove inconsistencies between existing IFRSs (eg IAS 32 and IFRS 2)</td>
</tr>
</tbody>
</table>
Further work

Compound instruments

- Implications for instruments that contain both a debt outcome and an equity outcome:
  - Within entity’s control
  - Outside entity’s control
- To what extent should standalone instruments be combined?
  - Should a put on own equity and the underlying share be accounted for as a synthetic puttable share?
- How should a forward be reported?
  - Implications of put-call parity
    - Call – Put = FV of underlying – PV of strike price

Measurement

- What measurement attribute should be used for subsequent measurement of equity claims?
  - Cost and allocation of earnings? (similar to NCI)
  - Fair value? (perhaps suitable for some options)
- How should components of compound instruments be measured?
  - Liabilities as if unconditional, then equity residual (IAS 32).
  - Expected value (‘revised expected outcomes’).

Thank you

Expressions of individual views by members of the IASB and its staff are encouraged.
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NOTES