Tuesday 24 September 2013
The Grange City Hotel (London)

Meeting documentation

World Standard-setters Meeting

Smaller group discussions: Conceptual Framework: liability equity split

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Smaller group discussion
Conceptual Framework: liability equity split

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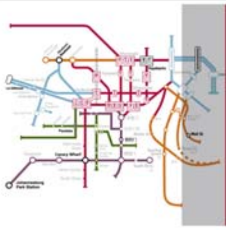

Liabilities and Equity

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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

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Overview of current criticisms

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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?

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

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

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- 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

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- 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 (eg 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

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Objectives of distinction

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What are the objectives of the distinction?

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- 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 are 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?

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- 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?

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Approaches explored in the Discussion Paper

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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.

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Example

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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.

	1 Feb 20X2	31 Dec 20X2	31 Jan 20X3
Fair value per share	CU100	CU95	CU95
Fair value of option	CU5,000	CU4,000	CU3,000

Example: Using narrow equity approach

Written put option classified as liability

Statement of financial position

	1 Feb 20X2	31 Dec 20X2	31 Jan 20X3
Cash	5,000	5,000	5,000
Put option liability	(5,000)	(4,000)	-
Net assets	-	1,000	5,000
Share capital	-	-	3,000
Retained earnings	-	1,000	2,000
Total equity	-	1,000	5,000

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

Changes affect both the income statement and the statement of financial position

Note: similar result today under IAS 32 *Financial Instruments: Presentation*

Example: Using strict obligation approach

Statement of financial position

	1 Feb 20X2	31 Dec 20X2	31 Jan 20X3
Cash	5,000	5,000	5,000
Net assets	5,000	5,000	5,000
Share capital	-	-	3,000
Retained earnings	-	1,000	2,000
		1,000	2,000
Obligation to issue shares	5,000	4,000	-
Total equity	5,000	5,000	5,000

Once exercised, carrying amount reclassified to different class of equity

Written put option classified as equity

Wealth transfers presented in the statement of changes in equity (refer next slide)

Example: Enhanced SOCIE (using strict obligation approach)

Put option classified as equity

Statement of Changes in Equity (SOCIE)

	Share capital	Retained earnings	Total existing shareholders	Obligation to issue shares	Total
Opening 1 Feb 20X2	-		-		-
Written option issued 17 Feb 20X2	-	-	-	5,000	5,000
Profit/OCI		-	-	-	-
Change in carrying value of option		1,000	1,000	(1,000)	-
	-	1,000	1,000	(1,000)	-
31 Dec 20X2	-	1,000	1,000	4,000	5,000
Profit/OCI		-	-	-	-
Change in carrying value of option		1,000	1,000	(1,000)	-
	-	1,000	1,000	(1,000)	-
Shares issued 15 December 20X2	3,000	-	3,000	(3,000)	-
31 January 20X3	3,000	2,000	5,000	-	5,000

Wealth transfer from option holder to shareholder

Wealth transfer from option holder to shareholder

Reclassification on exercise of option (no cash transfer on exercise)

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Comparison

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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

	Narrow equity approach	Strict obligation approach
Basis of classification	Relative to other claims – All entities will classify the most residual claim as equity even if that instrument creates an obligation to pay cash	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 - Add exception for puttable instruments if most residual?
Effect on definitions	Will require a new definition of equity and a modification to the definition of a liability	Will retain similar definition of liability and retain the existing definition of equity
Judgements required	Identification of the most residual claim	Identification of whether a given claim creates an obligation

Comparison between narrow equity and strict obligation approaches (contd)

	Narrow equity approach	Strict obligation approach
Effects of dilution and wealth transfers between other classes of claims	Reported in P&L or OCI	Reported in: statement of changes in equity (equity) P&L or OCI (liabilities)
Cash leverage (ratio of obligations to equity)	Cash leverage will have to be communicated through disclosure	Distinction between liabilities and equity on the balance sheet
Other	• Always at least one claim classified as equity • Classification of non-controlling interests?	• Opportunity to remove inconsistencies between existing IFRSs (eg IAS 32 and IFRS 2)

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Further work

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Compound instruments

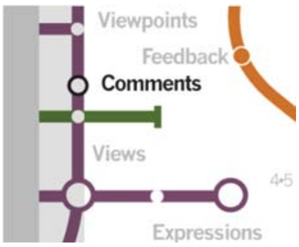
- Implications for instruments that contain both a debt outcome and an equity outcome:
  - Within entity's control
  - Outside entity's control
- To what extent should standalone instruments be combined?
  - Should a put on own equity and the underlying share be accounted for as a synthetic puttable 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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