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International Accounting Standards Board

INFORMATION FOR OBSERVERS

IASB Meeting: **26 April 2006, London**

Project: **Conceptual Framework: Distinguishing Liability from Equity (Agenda Paper 8B)**

INTRODUCTION

1. This paper is for the third meeting discussing the "elements" phase of the joint IASB/FASB conceptual framework project. It focuses on the definitions of liabilities and of equity and the distinction between them.

2. This paper first identifies similarities in and differences between the definitions of liabilities and equity and the (limited) discussion of the distinction between them in the IASB *Framework for the Preparation and Presentation of Financial Statements* (IASB *Framework*) and FASB Concepts Statement No. 6, *Elements of Financial Statements* (CON 6), as well as differing aspects in the conceptual frameworks of other standard setters. This paper then reviews, broadly, recent standards issued by the IASB and FASB in this area and the current FASB project that is explained in more detail in Agenda Paper 3 that is to be discussed earlier in this IASB meeting, focusing on what those standards-level efforts reveal about Board preferences. The paper then poses a classification question about four simple instruments and considers several possible internally consistent conceptual answers to that question that point toward possible approaches to distinguishing liability instruments from equity instruments,

building on the definitions of asset and liability proposed and discussed in more detail in Agenda Paper 8A, and discusses their ramifications. Finally, the paper recommends one of the answers and discusses the next steps that would follow adopting that or one of the other answers.

3. Like recent papers on assets and liabilities, this paper attempts to reason from first principles.[1] However, unlike recent papers, it does "peek ahead"[2] to consider some of the consequences of the distinction for particular conclusions reached in current accounting standards projects; given the recent efforts by both Boards in this area, that seems inescapable. This paper briefly mentions but does not really consider the effects of uncertainty, which are scheduled for discussion later in 2006.

4. This paper discusses the cross-cutting issues as they arise, rather than in numerical order. Cross-cutting issues addressed in this paper (reworded somewhat from the 2005 version for clarity) are as follows:

EL.25: Should there be a distinction between liabilities and equity?

EL.27 How should liabilities and equity be distinguished from each other (eg shares puttable at fair value)?

EL.28: Should all elements be defined (and if so, will anything fall through the cracks between the definitions), or should one be a residual (and, if so, which one)?

EL.31 If settlement is to be in the entity's own shares (or other equity instrument), can the entity have gains or losses from transacting in its own equity instruments?

Three cross-cutting issues not addressed in this paper, which will be addressed at a later meeting, are:

EL.26 Should there by only two elements, eg why not three – debt, equity and "dequity"

EL.29 Should equity (once determined) be divided into various sub-classes (eg reporting of parent and non-controlling interests, from investor's perspective as well as issuer's)? If so, is that division for presentation purposes only, or does it have broader implications?

EL.30 Should minority interests be part of equity?

5. For your possible reference, a table comparing existing IASB and FASB concepts and standards and the ownership-settlement approach currently being considered by the FASB standards project is included as Appendix A; there is no need for Board members to examine that Appendix in depth. The purpose of the Appendix is to

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[1] Precept No. 2.
[2] Precept No. 8.

demonstrate the great diversity in classifications between IASB and FASB standards, and between each Board's standards and its concepts.

6. A summary of the classification question and the possible answers is provided at the end of the paper. For convenience, the proposed working definition of liability is:

A *liability* of an entity is a present economic obligation of the entity.

with the proposed essential characteristic that "(c) The obligation is economic—it is an obligation to provide *its* economic resources to others."

Existing Definitions of Equity, and Distinctions from Liability, in Concept

7. The IASB *Framework* defines equity in the following manner:

> Equity is the residual interest in the assets of the enterprise after deducting all its liabilities.[3]

CON 6 defines equity in virtually the same words:

> Equity or net assets is the residual interest in the assets of an entity that remains after deducting its liabilities.[4]

8. Those definitions are similar in most respects, particularly in defining equity only as the result of an arithmetic process, the simple central equation that equity equals assets minus liabilities. The only difference of note is the FASB's use of "net assets," added in CON6 to make the definition apply better to not-for-profit entities, as well as business entities. CON6 notes that the terms *equity* and *net assets* are interchangeable.

9. The IASB lets the definition stand by itself, adding only a discussion focusing primarily on sub-classifications within equity.[5] The FASB dismisses sub-classification issues in a footnote saying that sub-classifications are primarily matters of display [presentation] beyond the scope of CON6[6], and in a single paragraph in an appendix, demonstrating that "categories labelled invested or contributed capital or earned capital may or may not accurately reflect the sources of equity of an

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3 IASB *Framework*, paragraph 49.
4 CON 6, paragraph 49, footnote references omitted.
5 IASB Framework, paragraphs 65-68.
6 CON 6, footnote 29.

enterprise."[7] Sub-classifications is a cross-cutting issue that the staff plans to discuss at a later meeting

10. Most other national frameworks use the term *equity*, as does the German draft. The UK and Canadian frameworks instead use the term *ownership interest*, but state that the term *equity* is often used for the same element. The Japanese discussion draft uses the term *net assets*. However, whatever the name, all national frameworks define it as the residual: assets minus liabilities.

11. CON6 defines equity as the residual, but goes on to state that "in a business enterprise, the equity is the ownership interest."[8] That sentence suggests to some that equity is not merely a residual but has (or ought to have) its own inherent defining characteristics. The CFA Institute's recent white paper shares that view.

12. The CFA Institute, in contrast to all the existing frameworks, does not define equity simply as the residual of assets minus liabilities. One of the conditions in its proposed definition of liabilities is that the obligation "does not meet the definition of equity." That makes liabilities the residual, or seems to do that. The CFA Institute's discussion reflects a widespread view that certain instruments that are in the form of equity ought instead to be liabilities.[Portions of paragraph omitted from Observer Notes].

13. Disregarding the CFA Institute's attempt, the straightforward definition that converges the existing definitions would seem to be:

Equity is the residual interest in the assets of an entity after deducting its liabilities.

14. But the staff knows it cannot disregard the CFA Institute's views, because both the IASB and FASB have been setting standards more in line with those views than with their own conceptual definitions of equity.

Distinguishing Equity from Liabilities at a Basic Level

15. The differing views about what should distinguish equity from liabilities influence opinions about how to account for complex instruments that require someone to stand ready to issue or purchase shares, that can be converted into shares, that give one of

7 CON 6, paragraph 214.
8 CON 6, paragraph 60.

the parties a choice among settlement alternatives, or that synthetically replicate the returns of some other instrument. However, much of the dispute focuses on the tension between obligations that require the outflow of economic benefits, on the one hand, and interests that convey the returns and risks of an owner, on the other hand. The extent of the differences suggests strongly to the staff that we need to start our reconsideration of these concepts at a very basic level. Four simple examples may be a good place to begin to study how to distinguish liabilities from equity instruments. Suppose that, after some transaction in which the reporting entity received cash in exchange, it has the:

Obligation to issue 100 shares,

Obligation to issue sufficient shares to be worth $1000,

Obligation to pay, in cash, the value of 100 shares, or

Obligation to pay $1000, in cash

(Since so much of the remainder of this paper focuses on those four examples, they are reproduced for convenience on a separate sheet at the end of the paper that you may wish to detach for easy reference.)

16. [Paragraph omitted from Observer Notes].

17. [Paragraph omitted from Observer Notes].

18. [Paragraph omitted from Observer Notes].

19. [Paragraph omitted from Observer Notes].

20. What are the possible internally consistent answers to those four simple examples? The staff can identify four that seem at least reasonable possibilities:

Obligation to sacrifice the entity's economic resources is what matters. Therefore, **(c) and (d) are liabilities, (a) and (b) are equity**, because the former two require the payment of cash but the latter two require only the issuance of shares which are not economic resources of the entity that is to issue them. That is consistent with CON6 and the existing IASB *Framework*, and with the definition of liability proposed in Agenda Paper 8A.

Conveyance of ownership returns and risks is what matters. Therefore, **(b) and (d) are liabilities, (a) and (c) are equity**, because the former two require the sacrifice or issuance of economic resources with a fixed value unaffected by share prices but the latter two require sacrifice or issuance of economic resources whose value varies directly with share prices. That might be most consistent with a pure current shareholder perspective, if solvency and liquidity are of little concern.

Obligation to sacrifice economic resources or conveyance of returns and risks differing from ownership *both* matter. Therefore, **(b), (c), and (d) are liabilities, and only (a) is equity**, because (c) and (d) require the payment of cash and (b) and (d) require the sacrifice or issuance of economic resources with a fixed value, while (a) requires no sacrifice of economic resources and only issuance of something whose value varies directly with share prices. That is consistent with some recent standards decisions made by both Boards.

Obligation to sacrifice economic resources or conveyance of returns, risks, or *rights* differing from *ownership all* matter. Therefore, **(a), (b), (c), and (d) are all liabilities**, because none of them convey *all* of the returns, risks, or rights of ownership and (c) and (d) also require sacrifice of economic resources. That may be most consistent with the CFA Institute's position.

21. While those four answers are internally consistent, choosing one of them is not easy. Answer (i) has the virtue of retaining present concepts and fitting with the definition of liability proposed in Agenda Paper 8A. However, some consequences of that answer, of which equity classification of obligation (b) is a prime example, have proved unpalatable. One possibility would be to retain the present definitions, leaving obligation (b) in equity, but to present in some new way the consequent transfer of wealth that takes place between holders of instruments like (b) and holders of ordinary shares as share prices change.

22. Answer (ii) differs completely from existing concepts and current standards. Among many other considerations, because it would classify as equity items like obligation (c) that require cash outflows, we would want to consider other ways of

communicating those cash flow obligations. However, that answer does avoid the result that if obligation (c) is classified as a liability, the issuer recognizes a gain if its share price decreases, or a loss if its share price increases, before the settlement date; some find that awkward, as indicated by one of our cross-cutting issues:

> EL.31: If settlement is to be in the entity's own shares (or other equity instrument), can the entity have gains or losses from transacting in its own equity instruments?

23. Answer (iii) differs from existing concepts, but it is consistent with current standards. However, it is a complex answer (as indicated by the principles of the FASB's tentative Ownership-Settlement Approach summarized on pages 6-8 of Appendix A) with even more complex ramifications, as Agenda Paper 3 to be discussed at Tuesday's education session makes clear. And the results of applying it to some instruments are troubling. One example is the instrument cited in another of our cross-cutting issues:

> EL.27: How should liabilities and equity be distinguished from each other (eg shares puttable at fair value)?

Answer (iii) would seem at first look to classify shares puttable at fair value as liabilities, since they include an obligation to provide others with economic resources—cash—if the shares are put. But those shares also convey all of the rights, returns, and risks of ownership, differing from ordinary shares only in providing an additional potential purchaser, a difference that may be insignificant for shares that can be traded in a ready market. The complexity, and the troubling results for some instruments, may reduce the attraction of this answer.

24. Answer (iv) is simpler than (iii) and would be responsive to the CFA Institute and others who advocate a much narrower view of equity. It would require making clear what returns, risks, and rights constitutes ownership, with difficult discriminations between "ordinary" common shares and shares with different voting rights, "letter" shares with returns pegged to the performance of part of the business, restricted shares, and various kinds of preferred or preference shares. Answer (iv) would result in recognizing gains and losses arising from the effects of changes in common share prices on obligation (c) and other kinds of instruments pegged in some way to share prices. And the income statement and statements of financial position and equity would convey little about the dilutive effects of instruments—all classified entirely as liabilities—that will potentially be converted into or settled in shares. The latter

failing perhaps could be compensated for with more fully developed earnings-per-share and equity-per-share calculations and disclosures.

25. Answer (iv) also comes the closest of the four answers to defining equity explicitly, rather than as a residual. That raises another cross-cutting issue:

> EL.28: Should all elements be defined (and if so, will anything fall through the cracks between the definitions), or should one be a residual (and, if so, which one)?

It might be possible to express answer (iv) entirely in the liability definition or amplifying discussion, leaving equity to appear to be the residual, perhaps by changing it along the following lines:

> A *liability* is a present economic obligation of an entity <u>that does not convey a proportionate share of all the rights, rewards, and risks of ownership of the entity</u>.

26. However, that possible definition's terminology--*proportionate, all*, *ownership*, not to mention *rights*, *rewards,* and *risks*—would need considerable further development to ensure that nothing fell through the cracks, and that definition obviously bends over backwards to keep from making liability the residual. In the staff's view, those are strong indications that Answer (iv) may not be so simple after all.

Staff Recommendation

27. The staff is more interested in hearing Board members preferences among the four answers in paragraph 20—and the reasons for those preferences—than in persuading the Board to a particular view. It will take more than one meeting to nail down the distinction between liability and equity, even at the concepts level.

28. Notwithstanding that, the staff does have a recommendation. It is Answer (i), that what matters in defining liabilities, and equity, is the presence or absence of obligations to sacrifice *the entity's* economic resources. That is the answer given clearly in CON6 and arguably in the IASB Framework, so it is not so difficult to converge on it in concept. The definition of liabilities proposed in Agenda Paper 8A accommodates it, the key word being "its" in the third essential characteristic: "an obligation to provide *its* economic resources to others." That answer is more familiar than (ii), far more straightforward than (iii), and more faithfully representative and perhaps more workable than (iv).

29. However, answer (i) does not result in liability treatment for items like instrument (b), the obligation that can be settled by issuing sufficient shares to be worth $1000, and some other troubling instruments that recent standards, interpretations, and other actions by both Boards have required to be accounted for as liabilities. It also differs from the FASB's tentative decision, proposed in an October 27, 2000 Exposure Draft, to amend the liability definition in CON6 specifically to include items like instrument (b). So how could it be the best answer?

30. One reason is that the troublesome instrument (b) differs from liabilities in that it cannot affect the entity's solvency or liquidity (assuming that the entity is able to issue the shares called for) because it does not result in any future cash flow—ever. A key objective of financial reporting, the Boards have agreed, is to provide investors and creditors with information to help them assess the amounts, timing, and uncertainty of the entity's future cash flows. Classifying items like instrument (b) among liabilities, the rest of which do require future outflows of cash or other assets, conflicts with that objective.

31. Another reason is that the disturbing aspect of instrument (b) is that, while its settlement will have no effect on the entity's net assets, it will transfer wealth from one class of owners to another in a way that has not been adequately reported. Most of the equity-related instruments that cause angst share that characteristic. And much more often than not, the transfer of wealth is from the ordinary continuing common shareholder to those who create or take positions in these kinds of instruments. The CFA Institute's proposals to "distinguish between two classes of equity interests: residual common shareowners' equity and other equity interests" and to rule entirely out of equity stock options and other financial instruments "masquerading as equity instruments whose terms provide the holder with prior or preferential access" are a cry for help for the ordinary shareholder. But rules classifying specific troubling instruments as liabilities or requiring other onerous reporting treatment don't seem to be providing that help.

32. For example, a newsletter reported in 2004 that "Delighted by the prospect of cheap financing and delayed EPS dilution, companies now issue more Co-Cos than regular convertible bonds. According to Bear Stearns, in fact, 84 percent of convertible bonds

issued this year contained a Co-Co provision."[9] "Co-Cos" is a Wall Street nickname for contingently convertible bonds, the contingency being a provision crafted primarily to delay application of the "as-converted" method in EPS calculations under US GAAP. After a year of investigation by the FASB staff and others, a consensus requiring timely EPS dilution was reached in November 2004 in EITF Issue 04-8. Co-Cos disappeared from the US market—for a while. But by early 2006, they were back. A recent news account happily reported the news that "investment bankers then figured out a way to meet the rulemakers' requirements. Sales of revamped CoCos by companies ranging from Amgen Inc. to auto-parts maker ArvinMeritor Inc. jumped to $7.6 billion so far in 2006."[10] That example, far from unique, of a standard arduously constructed and quickly undermined suggests that the reporting area requiring attention is a re-look at ways in which to better report transfers of wealth between owners—because convertible bonds do include an ownership interest and do transfer wealth from ordinary shareholders to bondholders, and current accounting and EPS rules don't seem to capture that very effectively. Approaching troubling instruments in that way will require study, both in later phases of the conceptual framework project that focus on measurement and presentation and at the standards level. One possibility for capturing and reporting such wealth transfers from complex instruments is the Reassessed Outcomes ("REO") approach that the staff discussed with the FASB in early 2004 and with the IASB in June 2004.

33. A third reason that the staff thinks that recommendation may be the best answer to this basic set of examples is that it seems to be more workable. That answer is the one given clearly in CON6 and arguably in the IASB Framework, so it is not so difficult to converge on it in concept. The definition of liabilities proposed in Agenda Paper 8A readily accommodates that answer, since the proposed amplifying language includes the essential characteristic that "(c) The obligation is economic—it is an obligation to provide *its* economic resources to others." That answer is more familiar than (ii), far more straightforward than (iii), and more faithfully representative and perhaps more workable than (iv).

34. That recommendation suggests the following answers to the cross-cutting issues cited earlier:

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[9] Don Durfee, *CFO Magazine*, September 01, 2004.

[10] Mark Pittman, "CoCo Bonds Revived by Merrill, Citigroup After FASB Crackdown," Bloomberg.net, March 28, 2006

EL.25: Should there be a distinction between liabilities and equity?

Yes, for the same reasons discussed by the Boards in February.

EL.27: How should liabilities and equity be distinguished from each other (eg shares puttable at fair value)?

Distinguish them based on whether they do or do not obligate the entity to transfer ***its*** *economic resources to others or stand ready to do so. Some have both a liability component and an equity component.*

EL.28: Should all elements be defined (and if so, will anything fall through the cracks between the definitions), or should one be a residual (and, if so, which one)?

No, equity should not be defined explicitly. It should be defined as a residual, what remains of the assets after deducting the liabilities.

EL.31: If settlement is to be in the entity's own shares (or other equity instrument), can the entity have gains or losses from transacting in its own equity instruments?

No, not from transactions in the instruments themselves. Those transactions are either investments by owners or distributions to owners, which need to be excluded from income, comprehensive or otherwise. Yes, from transactions priced based on share prices that are to be cash-settled.

Next Steps

35. The next steps depend largely on how the Boards decide on the simplest instruments and what the underlying reasoning is. All answers except (iv) require consideration of the unit of account issue of whether and how to separate components of complex instruments such as puttable stock and convertible debt. The recommended Answer (i) also would require the development of improved reporting and presentation of the transfer of wealth that takes place between holders of instruments like (b) and holders of ordinary shares as share prices change; as noted above, one possibility is the REO approach the staff discussed with the Boards in educational meetings in May and June 2004. Answer (ii) would require considering other ways of communicating the cash flow obligations arising from instruments classified as equity, among other new questions. Answer (iii) has complex ramifications, as indicated by the set of tentative FASB decisions recapitulated in Agenda Paper XX, and the tentative set of principles reproduced on pages 6–8 of Appendix A suggests that we might have difficulty in expressing it clearly and concisely. Answer (iv) would require making clear what package of returns, risks, and rights constitutes ownership and more fully developing earnings-per-share and equity-per-share calculations and disclosures.

36. The staff suspects that Board members would want to see some progress on those next steps before coming to agreement on those conceptual answers, notwithstanding our precept about not peeking ahead. That can start at meetings in June.

Four Simple Examples – Reproduced from Earlier Parts of this Paper

15. Suppose that, after some transaction in which the reporting entity received cash in exchange, it has the:

Obligation to issue 100 shares,
Obligation to issue sufficient shares to be worth $1000,
Obligation to pay, in cash, the value of 100 shares, or
Obligation to pay $1000, in cash

20. Four possible internally consistent answers to those four simple examples:

Obligation to sacrifice the entity's economic resources is what matters. Therefore,
(c) and (d) are liabilities, (a) and (b) are equity, because the former two require the payment of cash but the latter two require only the issuance of shares**.**

Conveyance of ownership returns and risks is what matters. Therefore,
(b) and (d) are liabilities, (a) and (c) are equity, because the former two require the sacrifice or issuance of economic resources with a fixed value but the latter two require sacrifice or issuance of economic resources whose value varies directly with share prices.

Obligation to sacrifice economic resources or conveyance of returns and risks differing from ownership *both* matter. Therefore,
(b), (c), and (d) are liabilities, and only (a) is equity, because (c) and (d) require the payment of cash and (b) and (d) require the sacrifice or issuance of economic resources with a fixed value, while (a) requires no sacrifice of economic resources and only issuance of something whose value varies directly with share prices

Obligation to sacrifice economic resources or conveyance of returns, risks, or rights differing from ownership both matter. Therefore,
(a), (b), (c), and (d) are all liabilities, because none of them convey all of the returns, risks, or rights of ownership and (c) and (d) also require sacrifice of economic resources.

[Appendix omitted from Observer Notes]