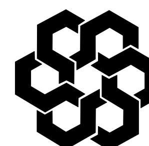

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International Accounting Standards Board

This document is provided as a convenience to observers at Financial Instruments Working Group meetings, to assist them in following the discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

Note: These notes are based on the staff paper prepared for the Financial Instruments Working Group Meetings. Paragraph numbers correspond to paragraph numbers used in the Financial Instruments paper. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IASB Meeting:	**Financial Instruments Working Group**
Paper:	**Agenda Paper 1**

Financial Instruments Working Group
Liabilities and Equity

NATURE OF PLANNED FIWG SESSION

1. We intend that the FIWG session on liability and equity should be a relatively high level and conceptually based discussion, illustrated with examples from IAS 32 *Financial Instruments: Presentation* and the three FASB liability and equity models.

2. We do not intend to have a discussion that focuses on detailed technical issues arising from each of the three FASB liability and equity models. However, we will use the FASB models to inform the discussion and hence an understanding of the three models will be required to ensure that the FIWG discussion is productive.

3. Papers 1A – 1C are supplementary papers to this paper. Those papers summarise the three FASB models. We do not intend to discuss those papers at the FIWG session.

4. In addition, and to answer any questions that FIWG members may have on the FASB models (and papers 1A – 1C), we intend to hold a separate education session on Wednesday 25th April from 9am to 10am. This session will be held before the FIWG meeting starts, and attendance is, of course, voluntary.

APPROACH OF THIS PAPER

5. This paper summarises the arguments as to why a distinction between liability and equity is important (and yet difficult to make), and discusses some of the conceptual issues that any liability and equity (L/E) model needs to consider.

6. Specifically, this paper:

    a. Summarises the L/E model in IAS 32 *Financial Instruments: Presentation* and some of the application issues and ongoing conceptual debates that have arisen as a result of that model.

    b. Summarises the three FASB models discussed in the L/E project

    c. Considers the general characteristics of 'equity' under both the IAS 32 and FASB models

    d. Discusses the specific characteristics of direct ownership, perpetual and indirect ownership instruments under the FASB models, as well as the need for, and criteria of, separation of an instrument into components.

BACKGROUND

7. The distinction between equity and liability has significant consequences for most entities, including balance sheet ratios, the determination of profit and loss and earnings per share. In some jurisdictions there may also be tax implications. Hence the extent of debate (and disagreement) about where that line should be drawn.

8. It is generally accepted that the dividing line between equity and liability should be conceptual rather than based on a set of (possibly inconsistent) rules. Issues, including the tension between legal form and economic substance, as well as the

overlapping nature of many “hybrid” financial instruments, make drawing a conceptually based line challenging.

SUMMARY OF THE L/E MODEL IN IAS 32

9. IAS 32 looks first to the definition of a liability when classifying whether a financial instrument is a liability or equity. The underlying principle is that if the instrument embodies a contractual obligation to deliver cash or another financial asset to another entity (or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity) the instrument is a liability.

10. The definition of a liability goes on to say that any contract settled in the entity’s own equity instruments, (i) for which the entity is or may be obliged to deliver a variable number of the entity’s own equity instruments in exchange for a fixed or indexed amount (variable shares for fixed amount) or (ii) that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity’s own equity instruments, also represents a liability (fixed shares for variable amount). The effect of this is that a financial instrument that would not meet the definition of a liability in the *Framework* is classified as a financial liability under IAS 32.

Issues Arising From IAS 32

11. IAS 32 has raised a number of implementation issues and continues to provoke ongoing debate at a conceptual level. An example is the classification of financial instruments puttable at fair value and obligations arising on liquidation (which are currently the subject of an Exposure Draft of proposed amendments to IAS 32).

12. The issues arising from the L/E model in IAS 32 could be categorised as follows:

    a. Issues created by uncertainty regarding application of the specific rules within the standard. These issues tend to arise when instruments do not neatly fall into the rules as written and hence there is uncertainty as

to how a specific rule should be applied to that situation. An example of this could be application of the ‘fixed for fixed’ rules to contracts involving the delivery of an entity’s own shares.

b. Issues created by results that some constituents regard as counter-intuitive. The answer reached by application of the IAS 32 model is clear, but that answer conflicts with the popular perception of how an instrument should be ‘faithfully represented’. A good example of such an issue is the treatment of financial instruments puttable at fair value.

c. Conceptual conflicts. This type of issue would include the debate over the classification of some share settled contracts as liabilities. It would also include the discussion around whether an executory contract should be treated as if it has already been executed – for example with regard to written put options and forward purchase contracts over an entity’s own shares.

13. The first category could be minimised in future standards by focussing on the principles and avoiding exceptions (which create the need for detailed rules).

14. The remaining two categories of issues generally arise due to conflicts between different ideas of what equity is. They also represent the conflict between a desire for a simple underlying principle and the complex reality of the multiple defining characteristics of many financial instruments.

OVERVIEW AND COMPARISON OF THE THREE FASB MODELS

15. Below is a brief overview and comparison of the three FASB models to provide a background understanding of the models. This section is provided to consolidate the information provided in the three supplementary papers.

Ownership

16. The ownership approach results in fewer instruments and components classified as equity than the other two approaches, and no outstanding instruments are classified as contra-equity. Only direct ownership instruments and perpetual instruments are equity. It also involves separating fewer instruments than the

other two approaches. Only instruments with two separate outcomes are separated. An instrument has two separate outcomes if it has a distinct payment requirement and, after payment, a perpetual instrument would remain outstanding. Finally, the ownership approach involves less linkage than the ownership-settlement approach (but probably more than the REO approach).

17. No instruments are classified as contra-equity (except possibly treasury stock, which the FASB did not specifically address). The method of settling an obligation is not a factor in determining classification of an instrument. Settlement by issuing or retiring equity produces the same result as by delivering assets with a comparable value.

REO Approach

18. The REO approach results in some instruments and components being classified as equity that would be assets or liabilities under one or both of the other two approaches. That occurs because:
    a. Instruments and components with fair value changes in the direction opposite the change in fair value of a direct ownership instrument are considered equity or contra-equity.
    b. An instrument (or component of an instrument) settled (or redeemed) in cash is classified as equity if the fair value of the settlement is based on changes in the value of a direct ownership instrument.
    c. It creates more components than either of the other approaches by separating more instruments (most notably forwards and options).

19. However, perpetual instruments other than direct ownership instruments, which are considered equity under the other two approaches, are considered liabilities under the REO approach.

20. The REO approach is based on the probabilities of outcomes. The total measurement of the instrument is split between an equity component and an asset or liability component based on the probabilities that each possible outcome will occur. That is, the fair values of two freestanding instruments with outcomes comparable to the equity outcome and the asset or liability outcome

would be determined and multiplied by the percentages of probability that each will occur.

21. The ownership-settlement approach eliminates the need for assumptions about probabilities by assigning a 100 percent probability to the liability outcome and using the fair value of a comparable instrument as the value of the liability component. The difference between the transaction price and the liability component is the recorded amount of the equity component. That approach to separation is referred to as the obligation first approach.

22. The REO approach requires no linkage for classification purposes because it subjects all instruments to scrutiny for purposes of separation and separates anything with an ownership return. However, it may require linkage to achieve consistent measurements. If an entity issued fixed rate debt and a stock option, it could achieve economics very similar to convertible debt, but the measurements would be different. The fixed rate debt as a freestanding instrument would be subsequently measured by accreting interest on the transaction price. The debt component separated from the convertible debt would be measured at fair value (as all components are under the REO approach). Consequently, the REO approach requires that the debt and the option be linked and then separated.

The Ownership-Settlement Approach

23. The ownership-settlement approach represents a middle ground between the ownership approach and the REO approach. All instruments that would be equity under the ownership approach also would be equity under the ownership-settlement approach. In addition, certain indirect ownership instruments also would be classified as equity.

24. All instruments that would be separated under the ownership approach also would be separated under the ownership-settlement approach. In addition, instruments that have only one outcome are separated if (a) the nature of that outcome is uncertain and (b) at least one possible outcome is an equity outcome and at least one is an asset or liability outcome.

25. Instruments that are required to be separated by the REO and the ownership-settlement approaches will tend to have larger initial equity values and smaller initial liability or asset values under the REO approach.

26. The method of settlement is an important factor in determining whether indirect ownership instruments are equity or not. An indirect ownership instrument is classified as equity only if it is settled by issuing the same direct ownership instrument on which its' value is based.

Reassessment of Classification and Separation

27. Classifications and separations should be reassessed under the three approaches as follows:
    a. REO—at each reporting date
    b. Ownership—only when the terms of an instrument are modified or when an expected settlement date passes without settlement
    c. Ownership-settlement—only when the terms of an instrument are modified or when an expected settlement date passes without settlement.

WHAT DETERMINES EQUITY UNDER EACH MODEL?

28. The following paragraphs summarise the factors that determine equity under IAS 32 and the three FASB models:

    a. **IAS 32** - An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

    b. **Ownership** - Under the ownership model equity is determined by the type of return the instrument conveys **or** the lack of a settlement requirement.

    c. **Ownership – settlement** - Under the ownership-settlement model equity is determined by the type of return the instrument conveys to the counterparty **and** the settlement outcome.

    d. **Reassessed Expected Outcomes (REO)** - Under the REO model equity is based on the potential economic outcomes (or 'payoffs') of

the instrument, and whether such outcomes are linked to the performance of the entity or not.

29. IAS 32 uses the presence of a liability as its defining characteristic and equity is the residual.

30. The three models discussed by the FASB focus on *identifying* equity rather than letting equity be the residual. This is the reverse of the conceptual thinking in IAS 32.

31. The three FASB models require consideration of some or all of the following characteristics to determine whether an instrument is equity:

    a. *Nature of the return.* What are the changes in fair value of the instrument based on?
    Direct ownership instruments are the most basic form of equity under all three approaches, and their fair values in total represent the value of the entity as a whole (discussed in the next section). Under the ownership-settlement and REO approaches, other instruments that derive their values from the values of direct ownership instruments are also classified as equity.[1]

    b. *Settlement.* Does the instrument require or permit settlement before liquidation of the issuer?
    If an instrument permits but does not require settlement, who makes the choice? An instrument that the issuer is permitted but not required to settle is treated as perpetual because the issuer can never be required to settle it. An instrument for which the counterparty can choose to require settlement is not treated as perpetual because the issuer can be required to settle it.

    c. *Type of consideration.* Will the entity deliver or receive its own direct ownership instruments?

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[1] The value of an instrument is derived from the value of another instrument if the terms of the first instrument refer to the second instrument for purposes of determining the fair value of the consideration to be delivered or exchanged.

If there are alternative types of consideration, who makes the choice or what condition or event leads to which type of consideration?

32. The nature of the return determines the classification under REO. The nature of the return and settlement both affect classification under the ownership approach. All three factors affect classification under the ownership-settlement approach.

Questions to members:

- **Should a L/E model define equity or be the residual after deducting all liabilities?**

- **If both equity and liabilities are identified, which bucket (equity or liability) should include items that do not meet the definition of either? Also, which definition should have priority for items that do meet both definitions, and why?**

- **The above descriptions of equity (both the FASB models and IAS 32) show four characteristics relating to the liability and equity distinction (there may be some overlap between these characteristics):**

    a. **Residual interest**

    b. **Nature of return**

    c. **Settlement**

    d. **Type of consideration**

- **Should any model incorporate a number of these characteristics or attempt to identify one key defining characteristic?**

33. IAS 32 is relatively simple (with known exceptions); equity is the residual after all liabilities have been deducted. The FASB models use three distinct categories of instruments that could potentially be categorised as equity depending on which model you are in: Direct Ownership Instruments, Indirect

Ownership Instruments and Perpetuals Instruments These will now be discussed in turn.

DIRECT OWNERSHIP INSTRUMENT DEFINITION

34. The direct ownership instrument underpins all three of the FASB models. We stated previously that REO does not include the concept of ownership, but instead focuses on the economic payoff to identify equity instruments. If that payoff is linked to the performance of the entity the instrument (element of instrument or group of instruments) would be equity. REO uses the direct ownership instrument criteria to identify participation in the entities performance. Equity under REO includes (a) direct ownership instruments, and (b) any instruments whose returns are indexed either directly or inversely to direct ownership instruments.

35. As such the direct ownership instrument underpins all three FASB models (in contrast with the approach in IAS 32). The definition of Direct Ownership Instrument included within all three of the FASB models is reproduced below.

36. The definition encompasses two fundamental ideas, both the residual nature of equity and full economic participation in the entity's performance

37. *Direct Ownership instruments have both of the following characteristics:*

    a. a proportional claim to a share of the net assets of the reporting entity that is neither limited nor guaranteed, and

    b. no priority over any other claim in the event of liquidation.

Question to members:

- **Does the proposed definition of a direct ownership instrument capture the essential characteristics of equity? Are both of these characteristics necessary? Are there other characteristics that should be considered (for example, voting rights)?**
- **Are you aware of different characteristics used by other groups, such as regulators, analysts, corporate financiers to differentiate between 'debt' and 'equity'?**
- **Must participation be economic, or could gains be received in non-economic form (ie access to preferential connections/ business networks)?**

PERPETUAL INSTRUMENTS

38. Perpetual instruments are equity under both the ownership and ownership-settlement models.

39. The definition of a perpetual instrument is that the instrument *embodies no settlement obligation and entitles the holder to a portion of the issuer's net assets in liquidation*.

40. Whether an instrument is perpetual is irrelevant to the classification of the instrument under the REO model**.**

Questions to members:

- **Should perpetual instruments be classified as equity under models where equity should represent the ownership of the entity?**
- **REO would classify perpetual instruments that are not direct ownership instruments as liabilities, although they do not contain any obligation. What comments do members have about classifying an item as a liability despite it not meeting the definition of a liability? How would that liability be measured?**

INDIRECT OWNERSHIP INSTRUMENTS

Indirect Ownership Instruments under ownership-settlement model

41. The ownership model states that only direct ownership instruments and perpetual instruments are equity.

42. The ownership-settlement model also classifies "*indirect ownership instruments"* as equity (if they are settled with the indexed instrument).

43. Indirect ownership instruments have all of the three following characteristics:

    a. The instrument is not perpetual

    b. The instrument is not a direct ownership instrument, but has a counterparty payoff at settlement that is based on and varies in the same direction as the fair value of a direct ownership instrument.

    c. The instrument does not include contingent exercise provisions based on (a) an observable market other than the market for the reporting entity's direct ownership instruments or (b) an observable index other than an index calculated or measured solely by reference to the reporting entity's own operations.

Indirect Ownership Instruments under REO

44. Equity under REO is defined as:

    An equity instrument is either (a) a direct ownership instrument issued by the reporting entity or (b) an instrument that has a payoff to the counterparty at the settlement or outcome date that is either directly or inversely based on the fair value of the reporting entity's direct ownership instruments. An equity instrument may be an entire instrument, a group of linked instruments, or a component of an instrument or a group.

45. REO does not define indirect ownership instruments, but the extension of the equity definition to include instruments with payoffs directly or inversely based on the reporting entity's ownership instrument effectively creates this second category of equity instruments in the REO model.

46. In comparison to the Ownership-settlement model the REO model classifies as equity instruments inversely based on the reporting entity's ownership

instruments. It also includes instruments that are not settled with the underlying ownership instrument.

47. This extends the population of instruments that would be regarded as equity quite substantially.

Questions for members:

- **Should derivatives on own equity instruments be regarded as equity? Why or why not?**
- **Should the form of settlement matter? Why or why not?**
- **Ownership-settlement would reduce the population of derivatives recorded as equity as compared with IAS 32 due to its requirement that the relationship between the derivative and the direct ownership instrument be directly not inversely related; should the direction of the relationship matter and, if so, why?**

CHARACTERISTICS THAT DETERMINE WHETHER INSTRUMENTS ARE SEPARATED

48. Separation of instruments plays a key part in IAS 32 and all three of the FASB models. A summary of the separation criteria within the three FASB models (not the mechanics of separation) is included below.

49. Some instruments cannot be classified as equity or as assets or liabilities in their entirety because they have characteristics of both. Consequently, each of the three approaches requires that certain instruments be reported as components, that is, as if they were two separate instruments. The characteristics that determine whether an instrument will be separated are different for each approach.

50. However, all three approaches require separation only if one of the separated components would be classified as equity and the other would be classified as an asset or liability.[2]

51. The characteristics that may require an instrument to be separated are:

   a. The outcome is not known at inception because of options, variable payments, or other uncertainties. At least one possible outcome would cause the instrument to be classified as equity if it were certain to occur, and at least one other possible outcome would cause the instrument to be an asset or liability if it were certain to occur.

   b. The instrument may or may not require settlement depending on options, conditions, or events.

   c. The instrument has two separate outcomes, one of which is a perpetual outcome and the other is an asset or liability outcome. That is, the instrument is perpetual but it has an associated obligation to deliver cash or other consideration. Examples of such associated obligations include an interest requirement, a dividend requirement, or a requirement for a net cash payment to guarantee a value to the holder.[3]

52. Any one of the three characteristics could require separation under the ownership-settlement and REO approaches, but only characteristic "c" could require separation under the ownership approach.

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[2] It is possible under any of the approaches to analyze an instrument as an asset component, a liability component, and an equity component. However, the end result is that an instrument is not presented as more than two components—net equity or contra-equity and net asset or liability.

[3] A payment to guarantee a value is sometimes called a "make-whole" requirement. If the value is guaranteed as of a certain date (or dates) and thereafter the instrument is perpetual with no guarantee, that instrument has two (or more) separate outcomes: the make-whole payment is a liability and the remaining perpetual instrument is equity.

Questions for members:

- **Should instruments be separated into components? Why or why not?**
- **Are the above criteria for separation appropriate? Why or why not?**

EXAMPLES

53. Classification of the following basic instruments under each of these models is illustrated in the table below,:

    - Common stock. The basic instrument is an ordinary share, perpetual, fully subordinated on liquidation, with full participation in profits or losses of the entity.

    - Preferred stock. The basic instrument is perpetual, discretionary non-cumulative fixed coupon, with preference to common stock on liquidation.

    - Hybrid instruments. The basic instrument is a zero coupon convertible bond, issued at a discount to notional, maturing at notional amount in five years or converting to a fixed number of ordinary shares.

    - Options and forwards. The basic instrument is a share settled written call option for a fixed value that must be settled with a fixed number of the underlying shares. (Value of the instrument moves directly with the underlying share).

    - Options and forwards. As above but cash settled. Written call option for a fixed value that must be settled with a fixed number of the underlying shares. (Value of the instrument moves directly with the underlying share.)

    - Options and forwards. Share settled written put option for a fixed value that must be settled with a fixed number of the underlying shares. (Value of the instrument moves inversely to the underlying share).

Table 1 – summary of classification of basic instrument.

	IAS 32	**Ownership**	**Ownership-settlement**	**REO**
Common Stock	Equity	Equity	Equity	Equity
Preferred	Equity	Equity	Equity	Liability
Convertible	Split – equity & liability	Liability	Split – equity & liability	Split – equity & liability
Written call option (share settled)	Equity	Liability	Equity	Split – equity & liability
Written call option (cash settled)	Liability	Liability	Liability	Split- equity & liability
Written put option (share settled)	Contra-equity	Liability	Liability	Split – contra-equity & liability

Questions for members:

This section is included to illustrate the application of the models and to consolidate the above discussion, no specific questions have been asked but discussion of the results is requested.