Distinguishing between liabilities and equity

Preliminary views on the classification of liabilities and equity under International Financial Reporting Standards

A discussion paper prepared by staff of the Accounting Standards Committee of Germany on behalf of the

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A few reminders upfront:

1. The thoughts expressed in the Discussion Paper and offered in the following presentation are to be considered work in progress.
2. The Discussion Paper is written as a conceptual paper. That means:
   (a) It is concerned with discussing and arriving at another principle to distinguish between liabilities and equity and not merely with establishing new presentation or disclosure requirements
   (b) It does not deal with application or implementation issues.
3. Following 2(a), the paper does not build on the current Framework definitions of liabilities and equity!

AGENDA

Distinguishing between liabilities and equity

I. What's wrong with the current distinction?

II. Possible solutions

III. The Loss Absorption Approach

IV. Questions/Discussion

I. What's wrong with the current distinction?

- Rise of mezzanine instruments from the mid-1990s …
  - Difficulties in classifying compound instruments as *either* 'a liability' *or* 'equity' → blending of the traditional categories
- ... increasingly so because of opportunities to arbitrage accounting requirements, usually to arrive at
  - equity treatment in general purpose f/s
  - liability treatment in tax accounts
- Users frequently adjust the amounts presented in f/s
  - Rating agencies compute 'partial equity' to address level of subordination;
  - banks adjust numbers for prudence reasons; etc.

I. What's wrong with the current distinction?

- Individual vs. collective rights
  - Individual right of shareholder (e.g. to put): liability
  - Collective right of assembly (e.g. to require entity to distribute retained earnings): equity (up until decision)
  - Distinction becomes arbitrary in owner-manager situations
- Probability of an outflow of economic resources
  - Framework: recognise liability only when outflow probable
  - IAS 32: recognise financial liability regardless of likelihood
- Obligations to issue own shares
  - Framework: not a liability (no future outflow of resources)
  - IAS 32: financial liability, if exchange is not fixed for fixed

I. What's wrong with the current distinction?

- Entities in a legal form other than a stock corporation often find themselves left with no equity at all
  - although their capital has *"characteristics similar to ordinary shares, in that the instruments give the holder a residual interest in the net assets of the entity"* (Proposed Amendments to IAS 32.BC6)

→ Generally: Do current accounting requirements live up to providing information that is decision-useful?

→ Specifically: (Current?) Dichotomous approach seems questionable if judged by its results

II. Possible solutions

(1) Remove split entirely (so-called 'claims' approach)

- Approach would foresee only 'assets' and 'claims to assets' (which may or may not be ranked) in the balance sheet
- Reasoning: All claims to assets have substantive features; why pick and choose one? On what grounds?
- Supplementary disclosures in the notes about characteristics of capital provided (e.g., term, subordination, voting rights, etc.)
- Has implications on a sizeable number of active agenda projects (e.g. revenue recognition, consolidation, f/s presentation, etc.)

Judged the preferred solution by some, but difficult to implement; therefore: not pursued further for time reasons

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IASB February 2007 Meeting, AP 3, par. 17 (excerpt):

Approximately 90 percent of the respondents to this issue favored maintaining the present sharp distinction between liabilities and equity. They generally believe that practice problems result from applying the existing distinction, not from the existence of the distinction. Eliminating the distinction would be disruptive and require considerable cost and effort.

The majority of the respondents who support eliminating the sharp distinction generally would favor arraying financial instruments along a continuum of claims to enterprise assets. They think the present sharp distinction between liabilities and equity has become less relevant in the current economic environment due to the proliferation of innovative financial instruments that have characteristics of both liabilities and equity. [Pages 23 and 24.]

II. Possible solutions

(2) Introduce a third category ('mezzanine') on credits' side

- Approach would define 'equity' and 'liabilities' positively and would make 'mezzanine' a residual class of capital
- 'Mezzanine' class could contain a vast number of dissimilar items
- Has equally implications on a number of IASB/FASB projects

A perceived quick-fix for the balance sheet, but equally difficult to implement due to implications on other topics; therefore: discarded

II. Possible solutions

(3) Rethink definition of/classification criteria for the elements

- Every form of capital has substantive features
- Some features are inherent in one form of capital only, others are prevalent in more than one form
- Some features are interrelated, some appear independently from others
- General problem area: instruments that simultaneously convey a claim to the residual whilst creating an obligation on the part of the issuer

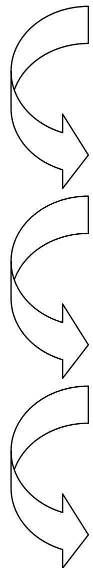
Any dichotomous approach cannot avoid arbitrariness.
Accounting is not a natural science, but a set of conventions!

III. The Loss Absorption Approach

Boundaries

- Perspective:
  - Classification shall be based on an entity perspective
- Element to be defined:
  - Seek to define equity rather than liabilities
- Definition to be based on as few criteria as possible:
  - Definition shall be established using either
    - one criterion only (met/not met)
    - a cumulative definition using several criteria (all met/at least one not met)

III. The Loss Absorption Approach



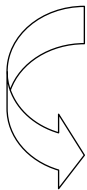
- Line of thinking:
  - Purpose of financial reporting = providing decision-useful information
  - User group with highest information needs = investors = providers of risk capital [F.9]
  - Providers of (risk) capital want to know the risks and benefits of providing capital
  - Risk according to finance theory:= variability of an expected future return (up- and downside)

III. The Loss Absorption Approach

- Line of thinking (cont'd):

"Risks of providing risk capital include the possibilities of participating in losses over the term of the investment and of variations in return because of adverse changes in the issuing entity's performance."

"Benefits of providing risk capital may be represented by the expectation of participating in profits over the term of the investment and of gain due to converse changes in the issuing entity's performance."



→ Risk = downside := 'participation in losses'

→ Benefits/return = upside := 'participation in profits'

III. The Loss Absorption Approach

- Line of thinking (cont'd):
  - 'Participation in losses' is thought to be a decisive, stand-alone criterion for distinguishing between liabilities and equity
  - Other criteria (such as upside, term, voting rights, etc.) can be used to narrow down equity, but are not decisive in and by themselves
- 'participation in losses' := 'loss absorption'

III. The Loss Absorption Approach

Some terminology

- Loss := net negative result for the period
  - economically: any decrease in entity value
  - specifically: accounting loss :=
    "net negative total recognised income and expenses before conditional servicing costs and related tax impact on and re-measurements of capital provided"

    NB: If the current income concept was to be retained, the definition would contain a circular element:
    - Income/expenses := changes in assets/liabilities
      → Liabilities are an input and an output factor in the equation
    - Hence: exclusion of servicing cost, tax and re-measurements

III. The Loss Absorption Approach

Some terminology (cont'd)

- Loss absorption := reduction of a claim to capital provided as a consequence of the entity incurring a loss

  NB: reduction of a claim ≠ reduction *in fair value* of a claim!

  → Fair value of a debt instrument might decline, but claim of the holder remains unchanged

- Loss-absorbing capital := capital available to the entity to cover losses incurred
- Equity := <u>overall</u> amount of loss-absorbing capital from an entity perspective
  In other words, the amount of equity equals the maximum loss the entity can incur before defaulting on its liabilities

III. The Loss Absorption Approach

Core principles

- Classification is made on inception
- Classification is made based on the terms and conditions of the instrument
- Re-classification only, if terms and conditions were changed (same principles as in IFRIC 9), unless there were …
  - … 'triggering events' (e.g. exercise of an embedded option, or terms, is equal to a change in the terms and conditions)
  - … terms that become operational only under certain conditions; require re-assessment at reporting date (see following slides)
- Split Accounting for instruments not fully loss-absorbing: instruments are to be split, fully loss-absorbing part → equity

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III. The Loss Absorption Approach

Core principles (cont'd)

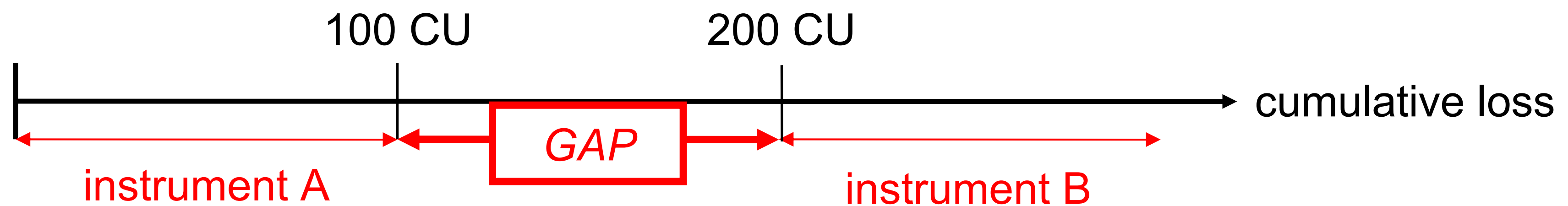
- Capital where loss absorption is contingent on certain events
  1. "Capital will absorb losses up to [fixed amount]"
     ⇒ retained earnings, reserves
  2. "Capital will absorb losses that exceed *[variable* amount]"
     ⇒ instruments, that start absorbing losses when other instruments have been fully absorbed by losses, e.g. common stock
  3. "Capital will absorb losses, that exceed [*fixed* amount]" – e.g.
     a) instrument that absorbs (cumulative) losses over 500+ billion CU
     b) instrument that absorbs (cumulative) losses exceeding 1 CU

III. The Loss Absorption Approach

Core principles (cont'd)

- Capital where loss absorption is contingent on certain events

⇒ entity needs to establish that there is a continuum of capital available for loss absorption as at the reporting date!



thus:

- alternative 1 and 2: no re-classification necessary
- alternative 3: Assess whether term is operational ('in-the-money') at reporting date!

III. The Loss Absorption Approach

Core principles (cont'd)

- Measurement reserves (such as revaluation reserve, cash flow hedging reserve, etc.) are considered loss-absorbing capital:
  - result directly from income concept promulgated by current IFRSs (dichotomy in income presentation)
  - would be retained earnings if accounted for as changes in fair value through profit or loss (→ equity)
  - would be kept unaccounted for if not considered income or expense → same with other loss-absorbing capital not presented

  NB: Neither are all assets and liabilities recognised nor are measured at fair value → the gross amount of loss-absorbing 'capital' will not be presented on the face of the balance sheet.

III. The Loss Absorption Approach

Main differences to the current approach

- Loss-absorbing capital would receive (partial) equity treatment regardless of its term or any obligations on the side of the entity to redeem or repay the capital
- No derivatives would classify for equity treatment
- Under the Loss Absorption Approach, the residual notion of equity is no longer needed, since both instruments <u>and</u> interests are judged by their loss absorption capability only