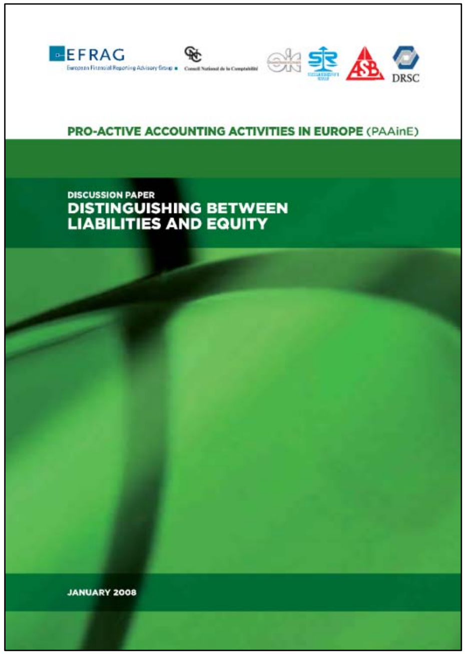


Distinguishing between liabilities and equity

- the PAAinE Discussion Paper containing the Loss Absorption Approach
- some general remarks, questions and observations on distinguishing equity from liabilities

Educational Session

IASB Board Meeting

July 22, 2008, London UK

Agenda Paper 3B

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

These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

Contents

Some general remarks upfront

(1) There are some questions that need to be answered before comparing different approaches, such as

- Who are the primary users of the classification?
- What are the attributes that distinguish equity from debt according to these users?
- Whose perspective shall govern the presentation of capital?

(2) There are some questions that (in our opinion) do not need to be answered before a distinction principle for the balance sheet has been identified

- Measurement and Disclosure
- Income Statement Implications

Some general remarks upfront (2)

Traditionally, there has been a link between balance sheet dichotomy (liabilities/equity) and income statement dichotomy (determination of income/income distribution)

NB:

- The PAAinE paper does not address this question, as it is considered an important, but downstream question
- Link may be abandoned → allows for looking for the most decision-useful P&L structure separately (might be ≠ balance sheet dichotomy)
- The PAAinE paper works with assumptions as to the structure of the performance statement in order to be open for a different structure in the future
- The FASB approaches abolish this link (in part)
  (some instruments classified as equity are re-measured through P&L)

Some general remarks upfront (3)

(3) The balance sheet classification includes a high number of cross-cutting issues

Framework Phase B (active project!)

Asset definition ←→ Liability definition
mirror

Liability definition → Equity (or liability) definition for financial instruments (i.e. IAS 32)

must be consistent with

Liability definition → definition for non-financial liabilities (i.e. IAS 37, active project!)

- Framework Phase D – Reporting Entity (application of the distinction within a group context, proprietary vs. entity view)
- Financial Statement Presentation (structure of performance statement)

Some general remarks upfront (4)

(4) One would believe it obvious that every business entity had some kind of equity (qua company law, regardless of legal form)

- IAS 32, if applied to entities other than a listed stock corporation, may lead to zero or negative equity (counterintuitive; in some cases even breach of principle re. IAS 38's non-recognition of self-generated goodwill)
- FASB's approaches remain yet to be tested whether applicable outside a US environment and for entities in different legal forms

Is there something wrong with IAS 32's principle?

(plus other issues: economic compulsion, the need for an additional fixed-for-fixed-rule, …)

Some general remarks upfront (5)

IASB DP/FASB PV and PAAinE DP

have different foci/scopes

IASB DP/FASB PV

- Positive definition of equity instruments
- Measurement & application

PAAinE DP

- Discussion of different potential criteria for distinguishing equity from debt & 'claims only' approach
- Development of the Loss Absorption Principle/Approach from first principles
- Principle intended to be applicable by entities in different legal forms and jurisdictions
- general remarks on perspectives, application within a group context, linkage
- no measurement & application issues

Equity and debt are multi-dimensional

Classification as / characteristic feature	Equity	Debt
Participation in ongoing profits	👍	
Participation in ongoing losses	👍	
Fixed or determinable payments		👍
Participation in liquidation excess	👍	
Type of claim on redemption/repayment	variable (performance-related)	fixed
Subordination	👍	
Fixed term/maturity	usually not	generally yes
Participation rights (general assembly)	👍	
Control/voting rights	👍	

Equity and debt are multi-dimensional (2)

If one aims at classifying only those instruments as equity that combine all the features deemed commonly prevalent in equity instruments, any of these features would suffice.

If an instrument does not combine all those features, different user groups are very likely to need different distinctions.

Many believe that reporting a multi-dimensional capital structure is best done by providing information on all features → most decision-useful information

List claims & disclose information on all features!

Equity and debt are multi-dimensional (3)

If one still believes that classifying claims into different classes of capital in a dichotomous (or other) structure

(based on selected – but in the end arbitrary – characteristics, thereby disregarding others)

is more decision-useful than providing information on all features by disclosing these

one characteristic (such as lack of an obligation à la IAS 32, subordination upon liquidation à la BOA, or loss absorption) might not be enough.

Cumulative definition

Equity and debt are multi-dimensional (4)

Loss absorption includes some of the characteristics in the table, such as subordination, participation in ongoing losses, …

Loss absorption is considered an essential (if not the only) characteristic of equity by many:

- Financial regulators / banking supervisory authorities
- Rating agencies
- IASB Financial Instruments Working Group (!)
- …

If one feels that the loss absorption principle does not lead to a distinction that is sufficiently sharp, one may consider adding additional characteristics

The Loss Absorption Approach – underlying thinking

- The buffer function of equity is the essential characteristic that, if used to distinguish between two classes of capital, provides the most decision-useful information to both creditors and investors
- „Buffer" refers to the amount of losses an entity can incur before defaulting on its liabilities
- The loss absorption approach follows from this buffer function:

  "Capital is deemed risk capital and, thus, presented as equity if it is available for loss absorption from an entity's perspective."

The Loss Absorption Approach (2) – which losses?

- generally: 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: In IAS 32.16A(e) (rev. 2008) the IASB used a similar notion.

The Loss Absorption Approach (3)

Approach as developed in the PAAinE paper is, for the time being, based on the current structure of the performance statement

…but that is just for the sake of developing the approach. There might be more appropriate performance statement structures, such as:

1.	…	
=	operating income / EBIT	
2.	./. financing costs	
	2.1	capital that must be serviced despite comprehensive income being negative
	2.2	capital that does not need to be serviced on profit being negative (cumulative)
	2.3	as (2.2), but non-cumulative
	2.4	…

The Loss Absorption Approach (4) – what do we mean by "absorbing losses"?

:= reduction of a claim to capital provided/claim to assets 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

The Loss Absorption Approach (5) – 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

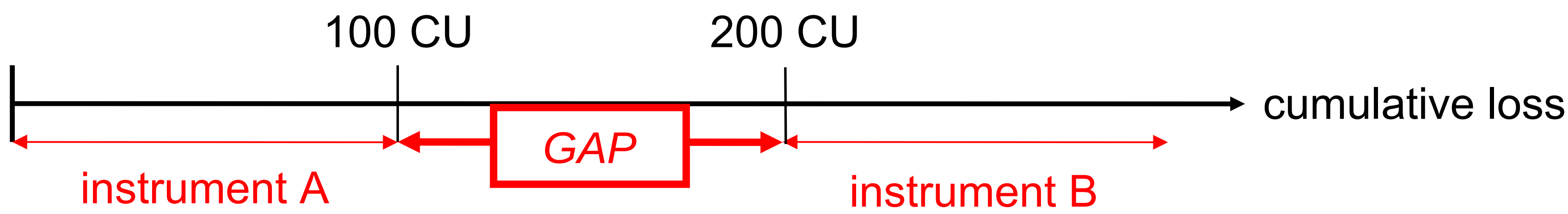
The Loss Absorption Approach (6) – core principles (cont'd)

- 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

The Loss Absorption Approach (7) – 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!

Some general issues – the question of perspective/view

Entity view: Entity is viewed as an institution distinct from the parties who contribute funds

Proprietary view / Investors' view: The firm is viewed as an association of investors/proprietors, who conduct business through the firm. The f/s are supposed to portray the financial position of this group of investors.

As yet, the IASB Framework does not state which view drives the presentation of the f/s, but the view has implications for some accounting issues, such as

- group financial statements / reporting entity
- presentation of non-controlling interests
- classification of certain capital instruments as either equity or liabilities (e.g. the fixed-for-fixed rule in IAS 32)

Some general issues – the question of perspective/view (cont'd)

Situation: Entity is obliged to deliver own equity instruments (entity issues new instruments), e.g. under a written call or convertible bond

- Current IASB Framework would suggest that this is not a liability, since the equity instruments of the reporting entity are not assets of the reporting entity (ref. IASB DP „Financial Instruments with Characteristics of Equity", par. 30 ff.)
- But what classification would the two views suggest?
- Under an entity view, the net assets of the entity remain unchanged. No assets are delivered. Issuance of new equity instruments will only result in net assets being divided into a higher number of shares. Result: The obligation is certainly not a liability (but probably no equity instrument either!)
- Under a proprietary view, the financial position of the present investors is weakened (plus delutive effect) Result: The obligation is a liability.

Some general issues – application within a group context

Affected: Every approach that seeks to define equity positively, such as:

- IAS 32 (rev. 2008)
- all FASB approaches / Basic Ownership Instruments
- Loss Absorption Approach

Problem does not arise when liabilities are defined positively and equity is defined as being a residual.

When equity is defined positively, application of the a.m. definition within a group context gives rise additional questions, in particular:
Is the definition applicable to NCI?

Some general issues – application within a group context (2)

Loss Absorption - do NCI absorb the reporting entities losses?
➡ No, only the losses of the respective subsidiary!

IAS 32 (rev. 2008) - are puttable instruments in the most subordinated class of the group?
➡ IAS 32.BC68 states: No! = Liabilities
NB: NCI do not need to be puttable to violate „subordination upon liquidation"-criterion

FASB's Basic Ownership Instrument – "no priority over any other claims if the issuer were to liquidate" (FASB PV par. 18a.)?
➡ par. 29 states basic ownership nature is retained in the consolidated f/s unless their "characteristics are different "
➡Characteristic is different, as Basic Ownership Instruments of subs are not subordinated within the group!
➡Would suggest that Basic Ownership Instruments held by NCI = liabilities!

Some general issues – application within a group context (3)

Parent

Assets	Providers of Equity
Investment Sub	Creditors

80%

Sub

Assets	Equity held by parent
	NCI
	Creditors

- Subordination not a defined term – only applicable to single entities, since only single entities can be liquidated
- Fictitious liquidation of the group

Some general issues – application within a group context (4)

Parent

Assets	Providers of Equity
Investment Sub	Creditors

4 (Assets) 6 (Providers of Equity) 5 (Creditors)

80%

Sub

Assets	Equity held by parent
	NCI
	Creditors

1 (Assets) 3 (Equity held by parent) 2 (Creditors)

Who gets settled first:

Creditors of parent or NCI?

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