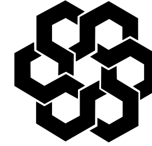

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International Accounting Standards Board

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.

INFORMATION FOR OBSERVERS

Board Meeting: **January 2009, London**

Project: **Financial Instruments with Characteristics of Equity**

Subject: **Alternative 1—A Different Approach (Agenda Paper 11A)**

INTRODUCTION AND PURPOSE

1. This purpose of this paper is to discuss the general characteristics of liabilities and equity as a way of introducing a suggestion for distinguishing between liabilities and equity. It is intended to provide a chain of logic leading to that suggestion. It does not suggest specific or detailed wording for a definition of a liability or an equity instrument.

EXISTING AND PROPOSED DEFINITIONS OF LIABILITIES AND EQUITY

2. The definitions of liabilities that the FASB and the IASB have been considering in the framework project (and the existing definitions) refer to requirements that an entity give up assets or economic resources, provide services, or otherwise part with beneficial things. The boards recently agreed that contracts (or other promises) settled by issuing one's own equity instruments also are liabilities. The boards have not recently discussed promises to deliver liability instruments, but presumably those

also would be liabilities. For example, a forward contract to issue my own debt instrument (such as a bond) at a price unfavorable to me would be a liability to me.

3. In short, every possible type of liability has one basic characteristic in common. Another entity has the right or ability to compel me to take an action that I would not take without demanding compensation (or additional compensation if my liability is to exchange things on unfavorable terms) if the liability had not existed.[1]

4. All ownership (equity) instruments or interests can be loosely described as similar to liabilities in that basic way. The holder has certain rights against the issuer. Clearly, an entity does not choose to pay dividends or otherwise distribute net assets to other entities that do not hold ownership instruments.

5. Many holders of ownership interests do not have the right or ability to compel the issuer to take actions unless the entity chooses to wind up its affairs, sell all its assets, or otherwise distribute net assets. We do not currently think of that feature as an obligation, but it is a right to compel the issuer to do things it would not do if the instrument did not exist. Admittedly, the issuer can indefinitely delay the time at which the holder can exercise its right.[2] In this paper, that is described as a *property interest* instead of a right to compel the entity.

6. Other holders of ownership interests are entitled to compel the entity to take actions. For example, holders of puttable or mandatorily redeemable instruments can compel the issuer to take actions that entity would not take if the instrument did not exist.

A Slightly Different Perspective on Those Definitions

7. FASB Statement 150 *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* and IAS 32 *Financial Instruments: Presentation* (prior to the recent amendments) classify some or all the ownership

[1] This discussion deliberately uses *right to compel* instead of *right to receive* or similar language. Some statutory liabilities, such as environmental remediation, give another entity—a government or agency—the right to compel me to fix my mess, but they do not give any particular entity the right to receive payment for doing the work.

[2] In this project, we have been describing instruments with that characteristic as perpetual.

instruments described in paragraph 6 as liabilities. The reason cited for that classification is the definition of a liability, which involves another entity's right to compel me to take actions. That is a reasonable reading of those definitions, but I'd like to suggest that a literal reading could lead one to a different conclusion.

8. Start with the following statement: A square is a rectangle. That means that every time I see a square, I also see a rectangle. However, the reverse is not necessarily true. I may see a rectangle that is not a square. Similarly, the existing liability definitions literally say that every liability is an obligation to take action. They do not literally say the reverse—every obligation to take action is a liability. (The reverse may have been stated or implied in explanatory text, but not in the definition itself.)

9. We currently attempt to make elements definitions serve two purposes—qualification for recognition and directions for classification. In other words, liability and equity definitions are intended both to determine which things are potentially recognizable and which recognized things can affect comprehensive income. That approach has not been notably successful. Existing standards of both boards make classification exceptions for various reasons. In addition, discussions over the past few years in the framework and the financial instruments with characteristics of equity projects have demonstrated the difficulties inherent in that approach. I suggest that the boards are trying to pack too much into one-sentence definitions.

10. In my opinion, the boards might be more successful if they separate the objective of determining what qualifies for potential recognition[3] from the objective of determining what affects comprehensive income. Those things are the subject matter for a discussion of recognition criteria and not for this paper.

11. The implications of that observation are as follows:

[3] I deliberately used the phrase *to determine what qualifies for recognition* instead of *to determine what to recognize* because not all things that qualify as elements will necessarily be recognized (currently, we sometimes do not recognize internally developed intangible assets and liabilities with values that are not estimable).

a. It would be necessary to describe or define all things that qualify for potential recognition on the credit side of the statement of financial position.[4]

b. It also would be necessary to describe separately the characteristics of things that have associated flows or value changes that can ***or*** cannot affect comprehensive income (which we currently call liabilities).[5] The word *or* is emphasized because obviously, there are only two choices. Therefore, it would be necessary to describe those that can affect or those that cannot affect, but not both.

SUGGESTED DESCRIPTIONS OF THINGS THAT QUALIFY FOR POTENTIAL RECOGNITION AS LIABILITIES OR EQUITY

12. The purpose of the following discussion is not to ask the boards for a decision, but to demonstrate that there is at least one way of describing things eligible for recognition other than the one-sentence definitions that have been tried previously.

13. The following are general, plain-English descriptions of the three types of things that would qualify for potential recognition on the credit side of the balance sheet:

a. Rights of other parties to compel an entity to take actions it would not otherwise take for no compensation or for no additional compensation. These would be current rights even if they are not currently exercisable as in the case of written options or other derivatives, guarantees and warranties, or noncallable-single-payment debt instruments. This would include actions required by law even if there is no identifiable counterparty.

b. Ownership or property rights in the entity held by other parties. Some of these rights also might be described by item (a), but since we are not attempting to use this description for classification, it does not matter whether they are included twice. The only important point is that everything that is potentially recognizable is included at least once.

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[4] If the boards ultimately decide that no separate recognition criteria are necessary, that description would provide both a barrier to entry and a barrier to avoiding entry.
[5] One might reasonably argue that the boards need to consider the definition or description of comprehensive income in developing that description.

c. Any amount of assets in excess of what would be required to satisfy the rights of other parties described in items (a) and (b). In other words, unallocated net assets or retained earnings. Many entities do not have unallocated net assets, but some do. Examples are mutual enterprises, some types of cooperatives, and not-for-profit organizations.

14. Item (c) as written does not refer to the retained earnings accounts of most entities. The retained earnings account is most often an accounting artifact and not a real, separate thing. In “fresh start” accounting of all assets, liabilities, and equity (similar to what is done in consolidation after a business combination), retained earnings of most entities would disappear because they would be included in the values of liability or equity instruments. Only the amount of net assets to which no party truly has any right would remain. That is what item (c) is referring to. Conceptually, ordinary retained earnings would be part of item (b), although it may be clearer in an Exposure Draft to describe them as part of item (c), and it would make no practical difference.

15. One immediate reaction is likely to be that the descriptions above are not as elegant as the existing definitions. The relevant definition of *elegance* in my *Webster’s Dictionary* is “scientific precision or accuracy.” Although the existing definitions meet one definition of elegance (“grace and refinement in appearance”), they clearly do not meet the more important one of precision and accuracy. Otherwise, the boards would not have spent so much time discussing them in two different projects.

SUGGESTED DESCRIPTIONS OF THE DISTINCTIONS BETWEEN THINGS THAT CAN AFFECT COMPREHENSIVE INCOME (LIABILITIES) AND THINGS THAT CANNOT (EQUITY)

16. The distinction between liabilities and equity could be considered a matter for the framework, for a standard, or both. This discussion does not presuppose that decision. In addition, this discussion relates to items (a) and (b) in paragraph 13. Item (c) is not an issue because it is the result of comprehensive income, not a source of comprehensive income.

17. After considering views of respondents to the initial documents on financial instruments with characteristics of equity and early redeliberations with the boards, it appears that the following principles-based descriptions might be acceptable and workable if they were coupled with clear objectives-oriented anti-abuse provisions. No attempt has been made to put these descriptions in standards language. They are intended to be plain English descriptions that explain the general ideas.

18. The equity classification would consist of the most subordinated property rights (item (b) in paragraph 13) and most subordinated rights to compel (item (a) in paragraph 13). The classification would not necessarily be limited to the single most subordinated rights.[6] A "natural" line could be considered to exist for any entity that issues perpetual interests (property rights with no associated right to compel). That perpetual interest and anything subordinated to it would be classified as equity. For entities that have not issued any perpetual interests, equity would consist of the most subordinated interest or interests if there are equally subordinated interests at the bottom of the subordination chain.

19. That classification criterion is based solely on one factor—the degree of subordination. (As an aside, it also could be described as a loss absorption approach, although not the same as the one described in the discussion paper "Distinguishing between Liabilities and Equity" which was published by EFRAG on behalf of the Pro-active Accounting Activities in Europe (PAAinE)) It would need to be further developed in at least two ways.

20. First, the boards would need to decide how classification is affected by consolidation. There are two obvious possibilities (and probably other less obvious ones).

    a. Classification by subsidiaries could be carried over into consolidation with abuse-preventing exceptions (such as parent guarantees that change subordination or limited life entities that create results similar to senior debt in the form of equities).

[6] In other words, this is not the same as the recent amendments to IAS 32 or the basic ownership approach described in the FASB Preliminary Views document.

b. Classification would be reconsidered from scratch in consolidation.

21. Second, the boards would need to consider supplementing this approach with explicit abuse-prevention language. The boards could probably describe in a straightforward manner what they don't want entities to do to achieve an accounting result. For example, don't use limited-life entities to create debt in the form of equity or don't issue a small value less subordinated perpetual instrument to move more subordinated debt instruments into equity.

QUESTIONS FOR THE BOARDS

22. The approach suggested in this paper might be more easily described and understood than most and it would allow for the possibility of including some puttable and mandatorily redeemable instruments in equity. Many would consider those outcomes desirable. On the other hand, there is no doubt that it would raise questions and create potential for abuses, but we have not identified any approaches other than extremely narrow or extremely broad approaches that do not have those features.

23. The questions for the boards are:

Would you like to explore further any or all of the following aspects of the approach described in this paper?

a. Separating the barrier to entry from the classification decisions as described in paragraphs 8–10

b. The descriptions of things that qualify for potential recognition described in paragraphs 13–15

c. The description of the distinction between liabilities and equity described in paragraphs 17–21.