Project	**Financial instruments with characteristics of equity**
Topic	**Developing a classification model: cover note**

Introduction

1. The purpose of this paper and agenda paper 2A is to discuss the general characteristics of liabilities and equity as a way of introducing an approach to distinguish between liabilities and equity. The proposed approach builds on the Boards' tentative decisions made to date and incorporates many of the ideas Board members have expressed during deliberations.

2. We propose that the Boards use the following three characteristics to develop principles for distinguishing equity instruments from liabilities:

   (a) Subordination or priority of the holders' rights to distributions of assets or other valuable consideration (In other words, if there were a shortage of assets to satisfy claims against the entity, are the holders' rights superior or inferior relative to other claimants?)[1]

   (b) The existence or lack of requirements to settle the instrument before the entity winds up its operations and distributes all remaining assets

   (c) A claim to a percentage of the assets remaining after settling all higher priority (senior) claims of the entity.

3. In its purest form, *an equity instrument* would have the following characteristics:[2]

[1] An instrument settled by issuing equity instruments would generally not be affected by the rights of other claimants because it does not require the entity to give up assets.
[2] A "pure form" equity instrument might also have voting rights, but voting rights are not always limited to equity instruments. Debt covenants can grant voting rights to debt holders on at least some major

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

(a) The instrument represents the lowest priority claim against the issuer; that is, if the entity converted all its assets to cash, the holder of the instrument would be last in line to receive a share of the cash (along with other equally subordinated claims).

(b) The issuer cannot be required to settle the instrument unless the entity winds up its operations and distributes all remaining assets.

(c) When the entity winds up its operations and distributes all remaining assets, there is no minimum or maximum amount that the holder would be entitled to receive; the amount would be determined only by the amount of assets remaining after all higher priority claims against the issuer were satisfied.

4. In its purest and most obvious form, *a liability instrument* would have the following characteristics:

    (a) The instrument represents a claim that is senior to most or all other instruments or claims against the issuer.

    (b) The issuer is required to settle the claim by delivering cash or other assets to the holder on or before a specified date.

    (c) The amount of the claim is a fixed amount (or series of fixed amounts in the case of instalment payments).

---

decisions of the entity to allow those creditors to protect themselves from credit losses or other undesirable outcomes.

5. Unfortunately, there are many instruments that do not have either complete set of characteristics. For example, some instruments commonly considered to be liabilities require settlement in variable amounts or on uncertain dates, and the consideration to be delivered may be equity or liability instruments instead of cash or other assets (for example, a loan that can be settled with the issuer's own equity instruments). Likewise, some instruments commonly considered to be equity represent claims to fixed, maximum, or minimum amounts in liquidation that are senior to one or two other classes of instruments (for example, preference shares generally have priority in liquidation over ordinary shares).

6. Consequently, unless the equity category is to be so narrow that many entities will have no equity at all, we think the Boards will be forced to assign weights to the three characteristics in paragraph 2. The FASB Preliminary Views, *Financial Instruments with Characteristics of Equity,* would have required that to be equity, an instrument must have characteristics (a) and (c) of "pure form" equity described above in paragraph 3—a claim to a percentage of assets (with no maximum or minimum limits) that is not senior to any other claims. Lack of a settlement requirement would not have justified classifying an instrument as equity. Contrariwise, the existence of a requirement to settle prior to liquidation would not have prevented an instrument from being equity if it met the other two characteristics.[3]

7. Agenda paper 2A describes our approach, which is based on the three characteristics described in paragraph 2, and its basis. Agenda paper 2B includes a decision tree that illustrates the approach and a table that describes how particular types of instruments would be classified.

---

[3] The settlement amount would have been permitted to be an approximation of the percentage of assets that would have been distributed if liquidation had occurred at the settlement date.