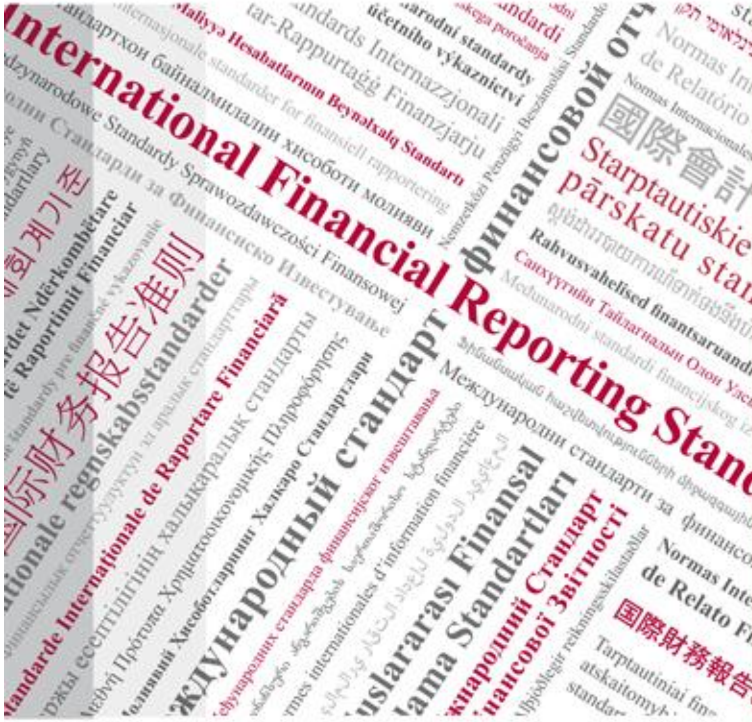
December 2012

International Financial Reporting Standards



Conceptual Framework: Liability/Equity

Agenda paper 3B

Education Session – December 2012

The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

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Current definitions

A *liability* is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Equity is the residual interest in the assets of the entity after deducting all liabilities.

What are the problems with the current liability/equity boundary?

- Puttable instruments
- Fixed for fixed exchanges
- IAS 32 Implementation issues
- Inconsistencies between IFRS 2 and IAS 32
- Contingent settlement provisions

Previous discussions – FICE project

- The Financial Instruments with the Characteristics of Equity (FICE) project attempted to define which financial instruments should be classified as equity.
  - The project did not use the existing definition of a liability.
  - Equity was not viewed as a residual.
- The FASB developed and issued a discussion paper in 2008
- Joint exposure draft developed. However…
- In November 2010 a decision was taken to pause work on the FICE project because of:
  - Concerns about the direction of the project
  - Need to concentrate on other convergence projects

Entity approach

- Current definition of a liability focuses on whether the *entity* has an obligation
  - Instruments that do not create an obligation but embody different rights from the rights of ordinary shareholders are classed as equity (eg preference shares)
- Some believe this approach does not meet the needs of ordinary shareholders and that equity should be defined more narrowly (or liabilities defined more broadly)
- However:
  - objective of financial reporting is to provide information to a wide range of users (not just equity shareholders)

Possible approach

- Define liability as an obligation of the entity
  - Helps users to assess the prospects for future cash out flows from the entity
- Treat equity as a residual
  - Defining both equity and a liability creates the risk that something will be missed
- Provide additional information about how future cash flows will be distributed between equity holders
  - Expand statement of changes in equity

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Example

On 1 January 20X1, Entity A receives CU 907 in cash and agrees to deliver on 31 December 20X2 its own shares to the value of CU1,000.

IAS 32 Treatment

- The promise to deliver a variable number of own shares is treated as a liability
- The liability is recognised at its fair value (CU907) and interest is accreted on the outstanding amount (assume the appropriate discount rate is 5%)
- The effect on the statement of financial position, profit or loss and statement of changes in equity is shown on the following slide

IAS 32 approach

Statement of financial position

	1 Jan X1	31 Dec X1	31 Dec X2
Assets	100	100	100
Cash	907	934	962
Liabilities	-907	-952	0
	100	82	1062
Equity	100	82	1062

Profit or loss

	31 Dec X1	31 Dec X2
Interest accretion	-45	-48
Interest income (3%)	27	28
	-18	-20

Statement of changes in equity

	31 Dec X1			31 Dec X2		
	Paid in share capital	Retained earnings	Total	Paid in share capital	Retained earnings	Total
Opening equity	100	0	100	100	-18	82
Profit for the period	0	-18	-18	0	-20	-20
Issue of shares	0	0	0	1000	0	1000
Closing equity	100	-18	82	1100	-38	1062

Example

On 1 January 20X1, Entity A receives CU 907 in cash and agrees to deliver on 31 December 20X2 its own shares to the value of CU1,000.

Possible Treatment

- The promise to deliver a variable number of own shares is not treated as a liability (the entity has no obligation to transfer economic benefits)
- The wealth transfer between existing and future shareholders is shown in the statement of changes in equity
- The effect on the statement of financial position, income statement and statement of changes in equity is shown on the following slide

Possible approach

Statement of financial position

	1 Jan X1	31 Dec X1	31 Dec X2
Assets	100	100	100
Cash	907	934	962
Liabilities	0	0	0
	1007	1034	1062
Equity	1007	1034	1062

Profit or loss

	31 Dec X1	31 Dec X2
Interest accretion	0	0
Interest income (3%)	27	28
	27	28

Statement of changes in equity

31 Dec X1

	Paid in share capital	Retained earnings	Total Existing shareholders	Future shareholders	Total
Opening equity	100	0	100	0	100
Profit for the period	0	27	27	0	27
Promise to issue	0	0	0	907	907
Accretion of interest	0	-45	-45	45	0
Issue of shares	0	0	0	0	0
Closing equity	100	-18	82	952	1034

31 Dec X2

	Paid in share capital	Retained earnings	Total Existing shareholders	Future shareholders	Total
Opening equity	100	-18	82	952	1034
Profit for the period	0	28	28	0	28
Promise to issue	0	0	0	0	0
Accretion of interest	0	-48	-48	48	0
Issue of shares	1000	0	1000	-1000	0
Closing equity	1100	-38	1062	0	1062

Non-controlling interests

- If focus is on whether the entity has an obligation to transfer economic benefits then non controlling interests (NCI) would normally be treated as equity
  – This is consistent with the approach taken in IFRS 3
  – Wealth transfers between ordinary shareholders and NCI could be shown in the statement of changes in equity
- If NCI have rights that create an obligation for the entity to transfer economic benefits then these would be treated as a liability
  – For example when NCI have the right to put their holdings to the entity for cash

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