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Project	**Conceptual Framework**		
Paper topic	Draft Discussion paper Elements of financial statements: definition of equity and distinction between liabilities and equity instruments		

CONTACT(S)	Peter Clark	pclark@ifrs.org	020 7246 6451
	Rachel Knubley	rknubley@ifrs.org	020 7246 6904

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This paper is a very early draft of part of the Conceptual Framework discussion paper. It has been prepared by the staff for discussion by the IASB. Issues discussed and conclusions reached will be subject to change.

Section 5
Definition of equity and distinction between liabilities and equity instruments

What does this section cover?

This section discusses:

- How should the Conceptual Framework define equity?
- Conceptually, should the distinction between liabilities and equity instruments depend solely on the definition of a liability?

Why is this section important? What problems will this section help address?

This section addresses the following problems with the treatment of equity instruments and with the distinction between liabilities and equity instruments:

- Financial statements do not show users clearly how equity instruments with prior claims on the entity's resources affect possible future cash flows to investors.
- Existing IFRSs do not apply the definition of a liability consistently in distinguishing financial liabilities from equity instruments.
    - Existing standards introduce exceptions to the liability definition. These exceptions are complex, difficult to understand and difficult to apply, and cause many requests for interpretations.
    - Inconsistency makes financial statements less understandable, and creates opportunities for structuring.

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit www.ifrs.org

What are the IASB's preliminary views?

- The Conceptual Framework should retain the existing definition of equity as the residual interest in the assets of the entity after deducting all its liabilities.
- An entity should at the end of each reporting period update the measurement of each class of equity claim, either by remeasuring it or by reallocating total equity.
- An entity should recognise updates to those measurements in the statement of changes in equity, as a transfer of wealth between classes of equity claim.
- Obligations to issue equity instruments are not liabilities.
- Obligations that will arise only on liquidation of the reporting entity are not liabilities.
- If an entity has issued no equity instruments, it may be appropriate to treat the most subordinated class of instruments as if it were an equity instrument, with suitable disclosure. Identifying whether to use such an approach, and if so when, would still be a standards level decision.

Introduction

1. This section discusses:

   (a) the definition of equity, including the measurement and presentation of different classes of equity (paragraphs 2-13).

   (b) distinguishing liabilities from equity instruments (paragraphs 14-47).

Definition of equity

2. The existing framework defines equity as the residual interest in the assets of the entity after deducting all its liabilities.[1] This paper proposes no change to that definition.

3. This paper uses the following terms for convenience, without defining them formally:

[1] 4.4(c)

(a) *equity claim*: a claim on the equity of an entity (ie a residual interest in the assets of the entity after deducting all its liabilities). An equity claim is either a primary equity claim or a secondary equity claim.

(b) *primary equity claim*: a right to share in distributions of equity, during the life of the reporting entity or on liquidation;

(c) *secondary equity claim*: a right or obligation to receive or deliver another equity claim;

(d) *equity instrument*: an issued financial instrument that creates equity claims and creates no liability.

4. Examples of equity instruments include:

(a) Equity instruments that create primary equity claims:

(i) Ordinary shares;

(ii) Other classes of shares (eg preferred, deferred);

(iii) Non-controlling interests (NCI) in a subsidiary.

(b) Equity instruments that create secondary equity claims:

(i) Forward contracts to buy an entity's own shares;

(ii) Options to buy or sell an entity's own shares .

5. IFRSs do not in general prescribe which categories of equity an entity should present separately, because determining which categories are most relevant to users may depend on local legislation and on the reporting entity's governing constitution. IAS 1 requires an entity to disclose a description of the nature and purpose of each reserve within equity.

6. The following paragraphs discuss:

(a) classes of equity (paragraphs 7-11);

(b) measuring equity claims (paragraph 12);

(c) non-controlling interests (paragraph 13).

Classes of equity

7. Existing and potential investors need information to help them assess the prospects for future net cash inflows to an entity.[2] In addition, information about priorities and payment requirements of existing claims helps users to predict how future cash flows will be distributed among those with a claim against it.[3] In other words, (existing and potential) investors need information about both:

   (a) the future net cash inflows to the entity (cash inflows less cash outflows); and

   (b) the claims that determine how those net cash inflows will be distributed among holders of different claims.

8. This paper proposes that an entity should provide the following:

   (a) information to help investors assess the amount timing and uncertainty of future net cash inflows to the entity: in the statements of financial position, profit or loss and comprehensive income, and cash flows, and in the notes.

   (b) information about the claims on those net cash inflows: in the statement of changes in equity. This statement, with related notes, should be designed in a way to enable equity holders to understand:

      (i) the claims of all higher ranking equity holders (equity holders with a prior claim on the entity's total equity); and

      (ii) the changes during the period in the effect of those claims.

9. This could be achieved by designing the statement in the following way:

   (a) An entity would at the end of each period update the measurement of each class of equity instrument. Paragraph 12 discusses what measures might be appropriate for this purpose.

   (b) Updating measurements of different classes of equity would result in transfers between the amounts attributed to those classes. These represent transfers of wealth between those classes. Said differently,

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[2] OB3

[3] OB13

they show changes during the period in the dilution, or potential dilution, of each class of equity by other classes of equity. Currently, financial statements do not necessarily provide this information.

(c) The statement of changes in equity would display a separate column for each class of equity instrument.

(d) If equity includes different components, such as share capital or reserves, the entity would allocate those components to classes of equity on a basis consistent with legal and other requirements governing the entity. In many cases, such components would be allocated to the most residual class of equity (eg existing holders of ordinary shares).

10. Measuring equity claims would be a new feature of IFRSs. Many commentators have stated that IFRSs do not currently update measures of equity instruments. However, that is only partly true:

(a) IFRSs do not permit entities to update measures of equity instruments *through profit or loss*. There is no existing obstacle to updating those measures through equity (and reporting the resulting changes as transfers within the statement of changes in equity).

(b) IFRSs require entities to update measures of non-controlling interests (NCI) to reflect NCI's share in profit or loss, in other comprehensive income and in other equity movements.

11. Introducing a *requirement* to update measures of equity claims through the statement of changes in equity would bring a new feature into IFRSs. It would achieve two objectives:

(a) It would give equity holders a clearer and more systematic view of how other equity claims affect them.

(b) As discussed later, starting at paragraph 14, it would provide a way to resolve some liability/equity classification issues that have proved problematic over the years.

Measuring equity claims

12. The IASB would need to decide at a standards level what measure to use for particular classes of instruments, considering how best to convey how the claims of that class affect the holders of other classes that rank after (are subordinated to) that class. For example, the IASB might decide:

    (a) to use an allocation of the underlying net assets as the measure of primary equity claims. As an example, this basis is used currently for non-controlling interests. If an entity has more than one class of equity claims, the allocation would reflect the relative priorities of their claims on the total equity attributable to holders of all primary equity claims. An entity would not measure primary equity claims by reference to estimates of the cash flows that holders of those claims will receive because such measures would, in effect, require a measurement of the entity as a whole, which is not the purpose of general purpose financial statements.

    (b) to use amortised cost for a class of secondary equity claims if the claims of that class confer a right to delivery of equity instruments that have a fixed total value at a fixed date.

    (c) to use fair value for a class of secondary equity claims if the claims of that class confer a right to delivery of equity instruments that have a total value that varies because of changes in a price, index or other variable, other than the price of the issuer's own equity instruments or financial liabilities.

Non-controlling interests

13. The approach described in paragraphs 8-9 is largely consistent with, and an extension of, the way that IFRSs treat non-controlling interest (NCI) in a subsidiary. NCI does not meet the existing or proposed definition of a liability, because the entity has no obligation to transfer economic resources. Therefore, IFRSs treat NCI as part of equity, not as a liability. IAS 1 already requires entities to display prominently the NCI's share in equity, in profit or loss and in comprehensive income. An entity would display NCI as a separate column in the

statement of changes in equity. The treatment proposed in paragraph 8-9 would extend that requirement for a prominent display to all other categories of equity instrument, other than the most junior.

Distinguishing liabilities from equity instruments

14. This section discusses how to apply the definitions of a liability and of equity in distinguishing between financial liabilities (or indeed other liabilities) and equity instruments. This distinction has several effects:

    (a) These two categories are classified separately in the statement of financial position. If distinguished strictly in accordance with the framework's definition of a liability, the classification will distinguish those items that oblige the entity to deliver cash or other economic resources from those items that create no such obligation.

    (b) The statement(s) of profit or loss and other comprehensive income:

        (i) include(s) income and expense arising from financial liabilities (interest and, if applicable, remeasurement and gain or loss on settlement)

        (ii) do(es) not report as income or expense the changes, if any, in the carrying amount of the entity's own equity instruments.

        (iii) include(s) expenses arising from services acquired in exchange for financial liabilities or equity instruments (IFRS 2 *Share-based payment*).

    (c) In the statement of financial position:

        (i) the carrying amount of financial liabilities changes with the passage of time (and for other factors, if the liability is measured at fair value).

        (ii) the amount reported for particular classes of equity instruments does not typically change after initial recognition (except for NCI).

    (d) The statement of changes in equity:

(i) includes changes in the carrying amount of liabilities implicitly (because the statement includes comprehensive income). Thus it shows, albeit implicitly, how those liabilities affect the cash flows to equity holders.

(ii) shows NCI's share of comprehensive income and NCI's interest in recognised net assets.

(iii) Does not currently show how changes in the value of each class of equity (other than NCI) affect the value of, or possible cash flows to, more subordinated classes of equity. Thus, it does not currently show wealth transfers between different classes of equity holder.

15. The distinction between financial liabilities and equity instruments is currently governed by IAS 32 *Financial Instruments: Presentation* IFRS 2 *Share-based Payment*. IAS 32 is supplemented by IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*. In both IAS 32 and IFRS 2, the starting point is to determine whether the entity has an obligation to transfer economic resources, but there are exceptions to that basic principle. The following table summarises the approaches.

Table 1 Summary of classification under IAS 32 and IFRS 2
The following summary is highly condensed.

	IAS 32	*IFRS 2*
Liabilities	• obligation to deliver cash or another financial asset[4] • obligation (in a derivative or non-derivative) to deliver a variable number of the entity's own equity instruments • obligation (in a derivative only) that may or must be settled by exchanging a fixed number of the entity's own equity instruments for a variable amount of cash or other financial assets • derivative obligation that allows either the holder or issuer to elect whether the holder is to settle in cash or in shares	• obligation to transfer cash or other assets
Equity	• no obligation to deliver cash or other financial assets (and none of the above features present) • put option in a puttable instrument that entitles the holder to a pro rata share of net assets on liquidation, or earlier repurchase • obligation to deliver a pro rata share of net assets only on liquidation of the entity • derivative that must be settled by exchanging a fixed number of the entity's own equity instruments for a fixed amount of cash or other financial assets	• no obligation to transfer cash or other assets • no obligation for the entity at all because another group entity or other related party will settle the obligation

[4] or to exchange financial assets or financial liabilities under conditions that are potentially unfavourable

16. As the above summary shows, the distinction in IFRS 2 (between cash-settled and equity-settled share-based payment transactions) relies almost entirely on the conceptual framework's definition of a liability. IFRS 2 makes one adjustment to that definition, to address transactions for which the obligation rests with another group entity or other related party. In contrast, IAS 32 overrides that definition with complex exceptions for:

    (a) some obligations that require an entity to deliver its own equity instruments, or that permit an entity to elect to deliver its own equity instruments instead of delivering cash or other economic resources (see paragraphs 20-43)

    (b) some puttable instruments (paragraphs 44-47)

    (c) some obligations payable on liquidation. As noted in section 3 [agenda paper 10C(a)], this [draft] discussion paper proposes that no liability results from payments that would arise only on liquidation. It follows that relative priorities on liquidation of the reporting entity would play no role in determining whether instruments are classified as financial liabilities or as equity instruments. This conclusion applies even if the reporting entity has a pre-determined limited life (or even if another party can compel liquidation). However, that conclusion may not be appropriate in consolidated financial statements for obligations that would become payable on liquidation of a consolidated subsidiary before liquidation of the parent.

17. In their project on financial instruments with characteristics of equity (FICE), suspended in 2010, the IASB and the US Financial Accounting Standards Board (FASB) tentatively adopted an approach that classifies, as IAS 32 does:

    (a) some instruments as equity instruments, even though they create obligations to transfer economic resources.

    (b) some other instruments as financial liabilities, even though they create no obligations to transfer economic resources.

18. Thus, both IAS 32 and the FICE project started with the definition of a liability and overrode it with several exceptions. Such approaches have significant disadvantages:

(a) The exceptions are complex, difficult to understand and difficult to apply, as evidenced by a stream of requests for interpretations.

(b) Inconsistency with the definitions in the conceptual framework makes financial statements less internally consistent, and as a result, less understandable.

(c) Inconsistencies in approach may create opportunities to structure transactions to achieve a more favourable accounting result without changing the economics of a transaction significantly.

(d) The approach is inconsistent with the approach used for share-based payment in IFRS 2. This creates further opportunities for lack of comparability and for structuring, and makes it more important to establish whether particular obligations are within the scope of IAS 32 or within the scope of IFRS 2.

(e) Further inconsistencies arise because under IFRS 2, cash-settled transactions are remeasured but equity-settled transactions are not remeasured. This puts pressure on the distinction between these two types of settlement. It also means that investors receive different information about the effect of these transactions on their own investments, depending on the form of settlement.

19. The following paragraphs discuss whether there is a conceptual basis for the exceptions developed in IAS 32 and the FICE project, and whether those exceptions indicate a need to amend the conceptual framework.

(a) Paragraphs 20-33 discuss obligations to deliver equity instruments

(b) Paragraphs 34-41 discuss other approaches considered

(c) Paragraphs 42-43 identify some other factors that would need to be considered in applying the concepts at a standards level

(d) Paragraphs 44-47 discuss whether the conceptual framework should indicate that an entity should treat some puttable instruments as equity, even though the issuer has an obligation to transfer cash or other economic resources if the holder so requests.

Obligations to deliver equity instruments (equity claims)

20. An equity instrument is not an obligation of the issuer. Accordingly, an obligation for an entity to deliver its own equity instruments is not an obligation to deliver economic resources. Hence, it does not meet the current or proposed definition of a liability. Such an obligation is one form of 'secondary equity claim', as described informally in paragraph 3(c).

21. IAS 32 classifies some equity claims as liabilities and others as equity instruments. It classifies them as liabilities if an entity uses its own equity instruments 'as currency' in a contract to receive or deliver a variable number of shares whose value equals a fixed amount or an amount based on changes in an underlying variable (eg a commodity price). The *Basis for Conclusions* on IAS 32 explains that the IASB adopted this approach for the following reasons:

    (a) Because the entity has an obligation for a specified amount rather than a specified equity interest. For such a contract, the entity does not know, before the transaction is settled, how many of its own shares (or how much cash) it will receive or deliver and the entity may not even know whether it will receive its own shares or deliver them.

    (b) Precluding equity treatment for such a contract limits incentives for structuring potentially favourable or unfavourable transactions to obtain equity treatment. For example, the IASB believed that an entity should not obtain equity treatment for a transaction simply by including a share settlement clause when the contract is for a specified value, rather than a specified equity interest.

22. This paper identifies two ways to simplify the distinction between liabilities and equity, a narrow equity approach and a pure cash approach. The narrow equity approach would:

    (a) Classify as equity only existing instruments in the most residual existing class of equity instrument issued by the parent. (Defining the most residual class might require detailed work at the standards level.)

    (b) Classify as liabilities all other instruments, such as:

        (i) instruments that create no obligation to transfer assets

(ii) non-controlling interests (NCI)

(iii) forwards and options on those instruments that are classified as equity by the criterion in (a)).

(c) Recognise interest on all instruments classified as financial liabilities, and all gains and losses on them in profit or loss.

23. The narrow equity approach underlies some of the exceptions in IAS 32. It depicts the entity in one step directly from the perspective of holders of the most residual existing class of equity. It does this by categorising all prior claims on the entity's net assets as fundamentally different from those residual claims. Not all of those prior claims create an obligation for the entity to deliver economic resources (assets). A narrow equity approach could be supplemented by a requirement to distinguish prominently those instruments that are classified as liabilities but create no obligation to transfer economic resources.[5]

24. Unlike the narrow equity approach, the pure cash approach depicts the entity in two steps. The first step depicts the entity as a whole from the perspective of all providers of capital. It does this by identifying resources, obligations to deliver resources (such as cash), and changes in those resources and obligations. The second step depicts the entity further from the perspective of the holders of each class of equity claim by identifying the effects on those holders of all prior (higher ranking) equity claims.

25. The pure cash approach would:

(a) classify as liabilities only obligations to deliver economic resources. Thus, the statement of financial position would show the entity's resources and obligations, and the statement of comprehensive income would show changes in those resources and obligations (consistently with the entity perspective adopted in financial statements).

(b) classify as equity all equity claims, in other words:

(i) all claims that may enable the holder to receive distributions of equity

[5] A narrow equity approach differs from the mezzanine approach mentioned in paragraph 40 because the narrow equity approach classifies all claims as either liabilities or equities, without creating an intermediate category.

(ii) all obligations to deliver equity instruments.

(c) as suggested in paragraph 9, update measures of all equity claims, either by remeasuring them or by reallocating total equity. Thus:

(i) the equity section of the statement of financial position would show how all equity claims affect other equity claims.

(ii) the statement of changes in equity would show wealth transfers between different classes of equity claims.

26. Both the narrow equity approach and the pure cash approach would account in the same way for services acquired in exchange for issuing equity instruments: the services received are an asset; when the entity consumes that asset, it recognises an expense. In many cases, an entity consumes that asset immediately; if so, the entity recognises the expense at the same time as it recognises the related increase in equity.[6] However, the two approaches differ in how they account for any remaining obligation to issue equity instruments:

(a) The narrow equity approach would measure that obligation as if it were a financial liability, and would report changes in its carrying amount in profit or loss (or perhaps other comprehensive income).

(b) The pure cash approach would measure that obligation as if it were a financial liability, and would report changes in its carrying amount as wealth transfers in the statement of changes in equity.

27. The main advantage of the narrow equity approach is that it places less emphasis than the pure cash approach does on the need for equity investors to read and understand the statement of changes in equity. In addition, some may feel that reporting of dilution and wealth transfers between different classes of equity holder can be reported simply and understandably only by showing those effects on the face of the statement(s) of profit or loss and other comprehensive income, rather than in the statement of changes in equity.

28. However, this paper proposes the pure cash approach because it has the following advantages over the narrow equity approach:

[6] Basis for Conclusions on IFRS 2, paragraphs BC45-BC53

(a) It would provide a clearer, more understandable, more consistent, less complex and more easily implementable distinction between equity and liabilities.

(b) It is consistent with the existing definition of a liability, and with the existing treatment of non-controlling interest.

(c) It would separate two important distinctions more clearly than the narrow equity approach does:

(i) Does the entity have an obligation to transfer cash or other economic resources? The answer to this question is important to lenders because such obligations can affect the likely returns to lenders. That answer is also important to investors because such obligations can threaten the entity's survival. The pure cash approach answers this question by classifying obligations as liabilities if the obligation requires the entity to trsansfer cash or other economic resources.

(ii) Does an instrument create a prior (higher ranking) claim that will affect the returns to existing holders of the most residual class of equity instrument? The pure cash approach answers this question by reporting each class of equity claim separately in the statement of changes in equity.

(d) Measuring all equity claims will provide equity holders with clearer and more prominent information about the effects of other equity claims.

(e) It would eliminate the inconsistency between IAS 32 and IFRS 2.

(f) It would require remeasurement for all share-based payment, thus removing one source of complexity from IFRS 2.

29. Paragraph 21(b) explains that the treatment in IAS 32 limits incentives for structuring potentially favourable or unfavourable transactions to obtain equity treatment. It limits those incentives by using profit or loss to report prominently the effects that those transactions have on holders of [existing equity instruments]. The pure cash approach also reports those effects prominently, using the statement of changes in equity for this purpose.

30. Discussions on the distinction between liabilities and equity often concentrate on how best to depict leverage. Leverage can refer to two different, though related, conditions:

    (a) Cash leverage: the ratio of (i) financing obligations that must be settled by delivering cash (or other economic resources) to (ii) equity financing.

    (b) Return leverage: The ratio of (i) financing obligations that do not share fully in the returns on the residual interest in an entity's assets less liabilities to (ii) obligations that do share in those residual returns.

31. Traditional debt instruments contribute to both cash leverage and return leverage. In contrast, obligations that are settled by issuing equity instruments contribute to return leverage but not to cash leverage. The pure cash approach described in this paper uses the distinction between liabilities and equity to depict cash leverage, and it uses presentation in the statement of changes in equity to depict any additional return leverage that is not apparent from the depiction of cash leverage. On the other hand, the narrow equity approach uses the distinction between liabilities and equity to depict return leverage, and would need to rely on disclosure to depict cash leverage.

32. Most of the discussion in this section has focussed on equity claims that result in an obligation to deliver equity instruments. However, similar considerations apply to rights for the entity to claim delivery of its own equity instruments, such as a purchased call option on its own shares or a forward repurchase of its own shares.

33. This [draft] discussion paper contains several appendices to help readers understand some of the implications of different approaches. The IASB does not expect to include detailed appendices of this kind in the conceptual framework.

    (a) Appendix A provides two examples to illustrate a narrow equity approach (and the approach in IAS 32) and a pure cash approach.

    (b) Appendix B provides some background information to support one of the examples in appendix A. That information discusses how to measure liabilities arising under written put options on an entity's own equity instruments.

(c) Appendix C summarises how the pure cash approach would treat different types of instrument.

(d) Appendix D summarises the rights and obligations arising under options and forwards on an entity’s own shares.

Other approaches considered

34. In previous work, the IASB considered some other approaches included by the US Financial Accounting Standards Board (FASB) in 2007 in its Preliminary Views document *Financial Instruments with Characteristics of Equity* and discussed in 2008 in the IASB’s discussion paper *Financial Instruments with Characteristics of Equity*. Those approaches were labelled as the basic ownership approach, the ownership-settlement approach and the revised expected outcomes (REO) approach.

35. All three approaches refer to a *basic ownership instrument*, defined as an instrument for which the holder:

(a) has a claim to a share of the assets of the entity that is subordinate to all other claims if the issuer were to liquidate on the date the classification decision is being made, and

(b) is entitled to a percentage of the assets of the entity that remain after all higher priority claims have been satisfied.

36. The basic ownership approach would classify as equity only basic ownership instruments. It is a narrow equity approach. Paragraphs 27-28 discuss the advantages and disadvantages of the narrow equity approach.

37. The basic ownership approach is inconsistent with the current and proposed conceptual definition of a liability. The FASB Preliminary views document suggested that a definition similar to the following would be consistent with the basic ownership approach: ‘A liability is a claim, the probability-weighted outcome of which would reduce the assets available for distribution to basic ownership instruments.’ Appendix D of that document discusses possible definitions of liabilities and of equity for each of the three approaches discussed there. This [draft] discussion paper does not reproduce those definitions.

38. The ownership-settlement approach would as classify equity:

    (a) basic ownership instruments

    (b) other perpetual instruments and some derivative instruments that are indexed to and settled with the entity's basic ownership instruments.

    (c) a component of an instrument that has more than one outcome if one or more of those outcomes provides a return to the holder that has the same general profile as the return to the holder of a basic ownership instrument.

39. The REO approach would classify as equity:

    (a) basic ownership instruments

    (b) those instruments or components of instruments whose fair value changes in the same direction as ,or opposite direction to, the fair value of a basic ownership instrument.

40. The FASB Preliminary views document briefly discussed three other approaches:

    (a) a claims approach that does not distinguish liabilities from equity at all.

    (b) a mezzanine approach that defines an additional element between liabilities and equity.

    (c) a loss absorption approach that classifies instruments (or components of instruments) as equity if the instrument's claim on net assets is reduced if the entity incurs a loss.

41. After reviewing responses to the FASB's Preliminary views document and the IASB's discussion paper, both the IASB and the FASB decided not to pursue the ownership-settlement, REO, claims, mezzanine or loss absorption approaches. Reasons included complexity, lack of understandability and inconsistency with the conceptual definition of a liability. Accordingly, this [draft] discussion paper does not analyse these approaches.

Applying the concepts at a standards level

42. As noted earlier, IAS 32, IFRS 2 and some related interpretations provide the criteria for classifying instruments as financial liabilities or as equity instruments.

If the IASB wishes at some future date to consider changing those criteria, the IASB would need to go through its normal process for adding a project to its agenda, and for developing an exposure draft and an amendment to that IFRS.

43. In deciding in particular standards how to distinguish liabilities from equity instruments, the IASB might need to address some other issues, including:

    (a) Whether and when to separate single instruments into two or more components, for example:

        (i) whether to separate compound instruments into a liability component and an equity component, as IAS 32 requires in some cases.

        (ii) whether to separate some derivatives on an entity's own shares into separate components in some cases when that would produce a different result. For example, a forward contract can be viewed as a combination of a purchased option and a written option. The forward might be viewed as creating an obligation to settle that does not exist in the case of the purchased option.

        (iii) whether puttable equity instruments should be separated into an equity host and an embedded put option. One driver for the gross presentation required by IAS 32 was to achieve consistency between the treatments of puttable equity instruments and stand-alone written put options.

    (b) Similarly, whether to link two or more separate instruments into a single instrument for accounting purposes.

    (c) Whether some obligations within a subsidiary would be reclassified from liability to equity, or vice versa, on consolidation. For example, if an entity has an obligation to transfer economic resources on liquidation, that obligation would not be a liability in the financial statements of that entity. However, in some circumstances, it might be appropriate to treat it as a liability in the consolidated financial statements of the entity's parent, particularly if liquidation of the entity might occur before liquidation of the parent.

(d) Whether any specific guidance is needed on contractual terms that have no commercial substance, for example an option that is deeply in the money or deeply out of the money, with no genuine possibility that this will change before expiry. Ssection 3 [agenda paper 10C(a)] of this paper discusses contractual options that lack commercial substance.

Puttable instruments

44. IAS 32 requires an entity to classify some puttable instruments as equity instruments, even though they create an obligation to transfer assets, and thus they meet the definition of a financial liability. To summarise some complex and detailed requirements, this applies to financial instruments that:

    (a) give the holders a pro rata residual interest in the entity’s net assets, after deducting all its liabilities, but also

    (b) oblige the entity to deliver cash or other assets to the holders on liquidation, or on early redemption at an amount broadly equivalent to that pro rata share.

    Examples of entities that issue such instruments are some cooperative and mutual organisations.

45. The basis for conclusions on IAS 32 provides the following explanation for classifying these puttable instruments as equity instruments:

    (a) On an ongoing basis, the liability is recognised at not less than the amount payable on demand. This can result in the entire market capitalisation of the entity being recognised as a liability depending on the basis for which the redemption value of the financial instrument is calculated.

    (b) Changes in the carrying amount of the liability are recognised in profit or loss. This results in counter-intuitive accounting (if the redemption value is linked to the performance of the entity) because:

        (i) when an entity performs well, the present value of the settlement amount of the liabilities increases, and a loss is recognised.

(ii) when the entity performs poorly, the present value of the settlement amount of the liability decreases, and a gain is recognised.

(c) It is possible, again depending on the basis for which the redemption value is calculated, that the entity will report negative net assets because of unrecognised intangible assets and goodwill, and because the measurement of recognised assets and liabilities may not be at fair value.

(d) The issuing entity's statement of financial position portrays the entity as wholly, or mostly, debt funded.

(e) Distributions of profits to shareholders are recognised as expenses. Hence, it may appear that profit or loss is a function of the distribution policy, not performance.

46. The exception in IAS 32 treats some puttable instruments as if they were equity instruments. This [draft] discussion paper suggests that the IASB's reasons for creating that exception are still valid. To reflect that suggestion, the conceptual framework should indicate that an entity should treat some obligations that oblige the issuer to deliver economic resources as if they were equity instruments. This might arise if the obligations are the most subordinated class of instruments issued by an entity that would otherwise report no equity.

47. Identifying whether to use such an approach, and if so when, would continue to be a standards level decision. For example, the following topics might require analysis in a standards level project:

(a) whether an obligation could be treated as if it were anequity claim if would arise only on the liquidation of a subsidiary of the reporting entity.

(b) whether some or all of these puttable instruments should be separated into an embedded put option (for which a liability would be recognised) and a host equity instrument.

Questions for respondents

48. Do you agree with the following preliminary views of the IASB?

    (a) The Conceptual Framework should retain the existing definition of equity as the residual interest in the assets of the entity after deducting all its liabilities?

    (b) An entity should:

        (i) at the end of each reporting period measure each class of equity claim, either by remeasuring it or by reallocating total equity?

        (ii) recognise updates to those measurements in the statement of changes in equity, as a transfer of wealth between classes of equity claim?

    (c) Obligations to issue equity instruments are not liabilities?

    (d) Obligations that will arise only on liquidation of the reporting entity are not liabilities?

    (e) If an entity has issued no equity instruments, it may be appropriate to treat the most subordinated class of instruments as if it were an equity claim, with suitable disclosure. Identifying whether to use such an approach, and if so when, would still be a standards level decision.