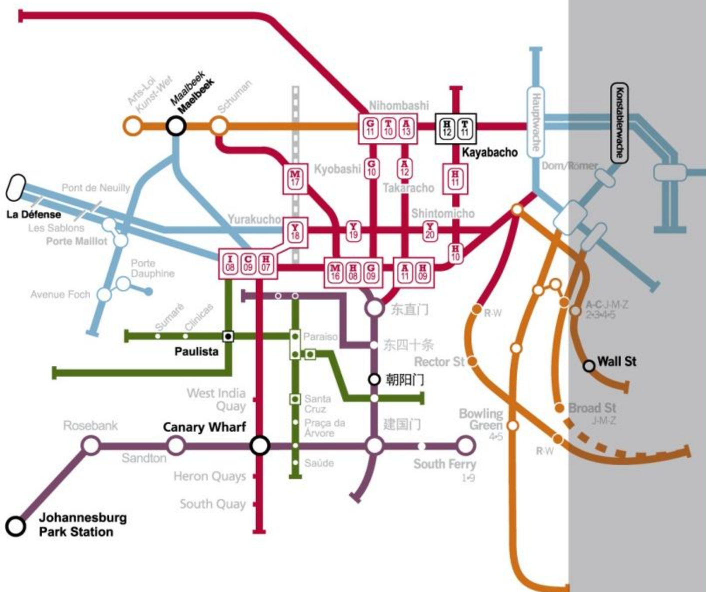
17 October 2013

International Financial Reporting Standards



CMAC meeting Agenda paper 2 Debt vs Equity

Conceptual Framework

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

What is wrong with the current distinction?

- Existing IFRSs do not classify instruments consistently

<u>Liabilities</u>
Trade payables
Bank loans
Bonds
Written call options

<u>Equity</u>
Employee stock options
Common stock

Written call option on own shares classified as liability under IAS 32
vs
Employee stock option classified as equity under IFRS 2

What if there is more than one class of equity?

- Limited information about transfers of wealth and dilution between different classes of equity.
  - Limitations of diluted EPS and ROE.
  - Extensive disclosure if classified as debt, practically no disclosure if classified as equity.
- What information do investors need if there is more than one class of equity?

What are we trying to convey?

- Cash leverage: liquidity and solvency
  - Ratio of obligations that result in cash outflows to equity
- Dilution of return
  - Differences in payoffs
- Both of the above are relevant to investors.
  - However, some instruments affect one and not the other.

Approaches explored

Strict obligation	Narrow equity
Liabilities Trade payables Bank loans Bonds	Liabilities Trade payables Bank loans Bonds Written call options EE stock options Minority interest
Equity Written call options EE stock options Minority interest Common stock	Equity Common stock

Approaches explored

	Strict obligation approach	Narrow equity approach
Cash leverage	Cash leverage reported on the face of the balance sheet.	Cash leverage will have to be reported through disclosure.
Dilution of return	Update the measurement of equity claims in statement of changes in equity each reporting date. - for example, measure options at fair value.	Changes in all claims other than most residual reported in P&L or OCI. - no need for diluted EPS.
Impact on definitions	More consistent with current framework	Less consistent with current framework

Discussion question 1

- The Discussion Paper considers two approaches on how to distinguish liabilities from equity:
  - strict obligation and
  - narrow approach.
- The IASB’s preferred approach is the strict obligation approach.
- Do you agree? Why or why not?

Illustration of enhanced statement of changes in equity

Statement of Changes in Equity (SOCIE)

	Share capital	Retained earnings	**Total existing shareholders**	**Obligation to issue shares**	**Total**
Opening 1 Feb 20X2	-		**-**		**-**
Written option issued 17 Feb 20X2	-	-	**-**	**5,000**	**5,000**
Profit/OCI		-	**-**	**-**	**-**
Change in carrying value of option		1,000	**1,000**	**(1,000)**	**-**
	-	1,000	**1,000**	**(1,000)**	**-**
31 Dec 20X2	-	1,000	**1,000**	4,000	**5,000**
Profit/OCI		-	**-**	**-**	**-**
Change in carrying value of option		1,000	**1,000**	**(1,000)**	**-**
	-	1,000	**1,000**	(1,000)	**-**
Shares issued 15 December 20X2	10,000	-	**10,000**	**(3,000)**	**7,000**
31 January 20X3	10,000	2,000	**12,000**	-	**12,000**

Option classified as equity

Wealth transfer from option holder to shareholder

Wealth transfer from option holder to shareholder

Exercise of option

Discussion question 2

- To provide more information on the dilution effects on the different classes of equity, the IASB suggests that an entity should:
  - at the end of each reporting period, update the measurement of each class of equity claim; and
  - recognise updates to those measurements in the statement of changes in equity as a transfer of wealth between classes of equity claim.
- Do you agree? Why or why not? If you do not agree, what changes do you suggest, and why?

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Thank you

Expressions of individual views by members of the IASB and its staff are encouraged.

The views expressed in this presentation are those of the presenter. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.