STAFF PAPER

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Project	**Conceptual Framework**		
Paper topic	Distinguishing between liabilities and equity: more background information		
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Purpose of this session

1. We are seeking your views on how we should distinguish liabilities and equity. We have provided a set of slides (Agenda paper 2) that provides an overview of the two topics that we want you to discuss.

2. The purpose of this paper is to provide a little bit more background on the problems, suggested approaches on how to resolve them and the IASB's preliminary views.

Definition of equity (paragraphs 5.1-5.9[1] and 5.28)

3. The existing *Conceptual Framework* defines 'equity' as the residual interest in the assets of the entity after deducing all of its liabilities. A liability arises when an entity has a present obligation to transfer economic resources.

4. A financial instrument that creates a claim on the equity of the issuer of that instrument is an equity instrument. Examples of equity instruments might include: ordinary shares, non-controlling interests (NCI) in a subsidiary, forward contracts to buy, sell or issue an entity's own shares or options to buy or sell an entity's own shares.

[1] References are to the relevant paragraphs of the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting*.

5. An equity instrument is not an economic resource of the issuer because the issuer cannot have a claim on its own equity. Therefore, an obligation to issue own equity instruments does not meet the definition of a liability because that obligation does not require the issuer to transfer its own economic resources.

Current distinction between liabilities and equity

6. Currently the distinction between liabilities and equity instruments is governed by IFRS 2 *Share-based payments* and IAS 32 *Financial Instruments: Presentations*. As shown in Table 1, the distinction in IFRS 2 (between cash-settled and equity-settled share-based payment transactions) relies almost entirely on the existing definition of a liability in the *Conceptual Framework*. 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.

7. As noted in Table 1, there is an inconsistency between IAS 32 and IFRS 2 because these Standards do not apply the definition of a liability and equity in the same way. This has resulted in:

   (a) Complexity, because it is difficult to apply the requirements and understand the results, as evidenced by a stream of requests for Interpretations. This also makes financial statements internally inconsistent and reduces comparability; and

   (b) opportunities to structure transactions to achieve a more favourable accounting result without changing the economics of a transaction significantly.

Table 1: Inconsistencies between IAS 32 and IFRS 2

	IAS 32	**IFRS 2**
Liabilities	• obligation to deliver cash or another financial asset.[(a)] • 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). • some puttable instruments that entitle 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.

(a) or to exchange financial assets or financial liabilities under conditions that are potentially unfavourable.

Simplifying the distinction between liabilities and equity (5.22-5.43)

8. This Discussion Paper identifies two approaches that could simplify the distinction between liabilities and equity: a narrow equity approach and a strict obligation approach.

9. The narrow equity approach would:

   (a) classify as equity only existing equity instruments in the most residual existing class of equity instrument issued by the parent. (Defining the most residual class might require detailed work when developing or revising particular Standards.);

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

      (i) instruments that create no obligation to transfer assets;

      (ii) NCI; and

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

   (c) recognise in profit or loss gains and losses (including, if applicable, interest expense) on all instruments classified as financial liabilities.

10. The strict obligation approach would:

   (a) classify as liabilities only obligations to deliver economic resources. Thus, the statement of financial position would show the entity's economic resources and its obligations to deliver economic resources. The statement(s) of profit or loss and OCI would show changes in those economic resources and obligations.

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

      (i) all claims that give the holder the right to receive a portion of any distributions of equity made to holders of that class of claim; and

      (ii) all obligations to deliver equity instruments.

   (c) as suggested in paragraph 18 of this paper (paragraph 5.13 of the Discussion Paper), reallocate total equity by updating measures of all equity claims. Thus:

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

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

11. Discussions on the distinction between liabilities and equity often concentrate on how best to depict leverage. Leverage can refer to two different, but related, conditions, which could be described informally as:

(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.

12. Typical debt instruments contribute to both cash leverage and return leverage. In contrast, obligations that are settled in their entirety by issuing equity instruments contribute to return leverage but not to cash leverage.

13. The strict obligation approach described in the Discussion 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.

14. The main advantages of the narrow equity approach are that:

(a) It places less emphasis than the strict obligation approach does on the need for equity investors to read and understand the statement of changes in equity. In addition, some may feel that 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 OCI, rather than in the statement of changes in equity.

(b) It does not require an entity to assess whether a particular instrument creates an obligation for the entity to transfer economic resources. In contrast, the strict obligation does require such an assessment, which may sometimes require considerable judgement, especially for some instruments containing an option that permits the issuer to settle by using its own equity instruments, although settlement in cash is more likely. Paragraph 5.42 refers to some of the complexities that may exist.

(c) All entities that issue financial instruments would classify the most residual class of instruments as equity. This might remove the concerns that led to the exemption for some classes of puttable instruments, as discussed in paragraphs 5.55–5.59. This is an important issue for many co-operatives and mutuals.

15. However, in the IASB's preliminary view, the strict obligation approach is preferable to the narrow equity approach because:

(a) The strict obligation approach is consistent with the existing definition of a liability. As a result, it is also consistent with the existing treatment of non-controlling interest. Amending the definition of a liability to make it consistent with the narrow equity approach would make the definition more complex and less understandable.

(b) 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 strict obligation approach answers this question by classifying an obligation as a liability if the obligation requires the entity to transfer cash or other economic resources.

(ii) Does an instrument create a prior (higher-ranking) claim that will affect the returns to existing holders of other classes of equity claim? The strict obligation approach answers this question by reporting each class of equity claim separately in the statement of changes in equity. (In contrast, the narrow equity approach answers this question by classifying prior claims as liabilities.)

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

(d) If applied when developing new or revised Standards:

(i) it would eliminate the inconsistency between IAS 32 and IFRS 2; and

(ii) it would require remeasurement for all share-based payments, thus removing one source of complexity from IFRS 2.

Discussion question 1
Which approach to distinguish between liabilities and equity

The Discussion Paper considers two approaches for distinguishing 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?

Meeting the needs of investors (paragraphs 5.11–5.13)

16. Existing and potential investors need information to help them assess the prospects for future net cash inflows to an entity. In addition, information about priorities and payment requirements of existing claims helps users of financial statements to predict how future cash flows will be distributed among those with a claim against the entity. 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.

17. To meet those needs, this Discussion Paper explores an approach in which an entity would 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 other comprehensive income (OCI), and cash flows, and in the notes; and

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

        (i) how their own equity claims are affected at the end of the period by other classes of equity claims; and

        (ii) the changes during the period in the effect of those other classes of equity claims. The Discussion Paper describes those changes as wealth transfers between different classes of equity claims.

18. This could be achieved by designing the statement of changes in equity in the following way:

(a) The statement of changes in equity would display a separate column for each class of equity claim. An entity would include equity claims within the same class if they have the same (or perhaps similar) rights.

(b) The column for each class of equity claim would be subdivided (on the face of the statement or in the notes), if applicable, into categories on a basis that would be consistent with legal and other requirements governing the entity. Depending on those requirements, examples of such categories might include share capital, retained earnings and reserves.

(c) An entity would, at the end of each period, update the measurement of each class of equity claim. This would update the allocation of total equity between the classes of equity claim, but would not affect total equity.

(d) Updating measurements of different classes of equity claim would result in transfers between the amounts of recognised net assets (assets less liabilities) attributed to those classes. These represent transfers of wealth between those classes. In other words, they show how each class of equity claim diluted the net assets attributable to other classes of equity claim during the period. Currently, financial statements do not necessarily provide this information.

Discussion question 2 Redesigning the statement of changes in equity

To provide more information on the dilution effects on the different classes of equity, the IASB suggests that an entity should:

(a) at the end of each reporting period, update the measurement of each class of equity claim. The IASB would determine when developing or revising particular Standards whether that measurement would be a direct measure, or an allocation of total equity; and

(b) 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?

19. The Discussion Paper contains several examples and appendices to help readers understand some of the implications of the different approaches. The IASB does not expect to include such detailed material in the *Conceptual Framework*. Example 5.1 and Appendix D have been reproduced in this document.

Example 5.1: Statement of changes in equity

	Existing shareholders of parent		Non-controlling interests	Obligation to issue shares	Total
	Share capital	Retained earnings			
1 January 20X2	10,000	20,000	4,000	—	34,000
Written option issued on 17 January 20X2	—	—	—	5,000	5,000
Total profit/comprehensive income for 20X2	—	3,500	200	—	3,700
Change in fair value of written option	—	1,000	—	(1,000)	—
Change in net assets	—	4,500	200	(1,000)	3,700
31 December 20X2	10,000	24,500	4,200	4,000	42,700
Total profit/comprehensive income for 20X3	—	3,700	300	—	4,000
Change in fair value of written option	—	800	—	(800)	—
Change in net assets	—	4,500	300	(800)	4,000
New shares issued on 15 December 20X3	4,700	—	—	(3,200)	1,500
31 December 20X3	14,700	29,000	4,500	—	48,200

Appendix D (of Discussion Paper)
Effect of strict obligation approach on different classes of instrument

D1 In Section 5 two approaches to distinguishing liabilities from equity instruments are discussed: a narrow equity approach and a strict obligation approach. Table D.1 compares the current treatment of various instruments under IAS 32 *Financial Instruments: Presentation* with how they would be treated under the strict obligation approach.

D2 In several cases, the treatment depends on whether the instrument would be settled by delivering a fixed number of the issuer's own equity instruments for a fixed amount of cash, or whether it would be settled in some other way. Table D.1 identifies those cases by the legend 'If not only fixed for fixed, then derivative'. For instruments labelled in this way, if they do not meet the 'fixed for fixed' criterion they are treated as derivatives and hence are classified as financial liabilities (or financial assets) measured at fair value through profit or loss.

D3 In paragraphs 5.18–5.20, the way to measure equity claims is discussed, but no specific proposals are provided. In Table D.1, it is assumed that equity claims are measured in the same way as otherwise comparable financial liabilities, unless otherwise stated in Table D.1.

Table D.1: comparison of the current treatment of various instruments under IAS 32 and the strict obligation approach

Instrument	Current treatment under IAS 32	Effect of strict obligation approach
Obligation to deliver a variable number of shares, whose total fair value equals a fixed amount. The entity will receive no further cash in exchange for that obligation.	Liability, measured at amortised cost, with interest expense reported in profit or loss.	Equity claim, measured as if it were a financial liability: most likely at amortised cost, with interest expense reported in the statement of changes in equity (SCE) as a wealth transfer to the future shareholders from existing shareholders.
Obligation to deliver a variable number of shares, whose total fair value equals a specified amount indexed to the gold price. The entity will receive no further cash in exchange for that obligation.	Liability, measured at fair value (under the fair value option) or at amortised cost with separate measurement of an embedded derivative at fair value through profit or loss.	Equity claim, measured as if it were a financial liability that requires the issuer to pay the specified amount (ie measured at fair value). Changes in carrying amount reported in the SCE.
Forward contract to repurchase own shares, settled gross.	Liability at present value of gross redemption amount. Subsequent changes in that amount in profit or loss.	Liability at present value of gross redemption amount. To be determined: whether to recognise subsequent changes in that amount in profit or loss, or in SCE (see paragraphs F4–F5).
Written put option on own shares, settled gross.	Liability at present value of gross redemption amount. Subsequent changes in that amount in profit or loss.	Liability. To be determined: measurement and treatment of subsequent changes in carrying amount (see paragraphs F2–F10).
Written put option on non-controlling interest (NCI put), settled gross for a cash payment equal to the fair value of the underlying non-controlling interest (NCI).	Liability at present value of the gross redemption amount (ie fair value of the underlying NCI). Subsequent changes in that amount in profit or loss.[a]	Liability. To be determined: measurement and treatment of subsequent changes in carrying amount (see paragraphs F2–F10).
Purchased call option to repurchase own shares, settled gross.	No asset or liability. Recognise in equity, initial measurement net at premium paid. No remeasurement. If not only fixed for fixed, then derivative.	No asset or liability. Equity claim: right to receive shares on request by electing to pay the strike price, initial measurement net at premium paid. Subsequent remeasurement (net) to fair value through SCE.
Forward sale of own shares, settled gross.	Do not recognise until settlement. If not only fixed for fixed, then derivative.	Asset at present value of gross sale proceeds. Subsequent measurement: same basis as for a financial asset that entitles the entity to receive the specified amount. To be determined: whether interest expense (and impairment loss on asset, if applicable) in profit or loss or in SCE. No liability. Equity claim: obligation to deliver own shares.

Instrument	Current treatment under IAS 32	Effect of strict obligation approach
Purchased put on own shares, settled gross.	No asset or liability. Recognised in equity, initial measurement net at premium paid. No remeasurement. If not only fixed for fixed, then derivative.	Asset, initial measurement net at premium paid. Subsequent remeasurement (net) to fair value through SCE to show wealth transfers between different equity claimants.
Written call on own shares, settled gross.	Equity claim, initial measurement net at proceeds received. No remeasurement. If not only fixed for fixed, then derivative.	Equity claim, initial measurement net at proceeds received. Subsequent remeasurement (net) to fair value through SCE.
All net cash-settled derivatives on own shares.	Derivative asset or liability measured net: fair value through profit or loss.	Derivative asset or liability measured net: fair value through profit or loss.
All derivatives on own shares if they must be settled by net delivery or net receipt of shares with no cash payment (net share settlement).	Derivative asset or liability: fair value through profit or loss. On settlement or expiry, derecognise the derivative asset or liability, with a corresponding decrease or increase in equity.	Equity claim measured net: fair value, remeasured through SCE.
Derivative obligation that permits the holder to elect whether the issuer will settle in cash or in shares.	Financial liability. Measure in accordance with IFRS 9 *Financial Instruments*.	Financial liability. Measure in accordance with IFRS 9.
Derivative obligation that permits the issuer to elect whether to settle in cash or in shares.	Financial liability. Measure in accordance with IFRS 9.	Equity claim (because the issuer is not obliged to deliver economic resources).[b] Measured as if it were a financial liability, with changes in the carrying amount reported in the SCE.
Cash-settled share-based payment.	Recognise as an expense and a liability. Remeasure the liability through profit or loss.	Recognise as an expense and a liability. Remeasure the liability through profit or loss.
Equity-settled share-based payment.	Recognise as an expense and as an equity claim. Do not remeasure.	Recognise as an expense and as an equity claim. Remeasure the equity claim through SCE.

(a) See draft IFRIC Interpretation *Put Options Written on Non-controlling Interests* and further discussion in paragraphs F6–F10.
(b) As discussed in Section 3, if the entity's option to settle in shares has no commercial substance, the entity might have a financial liability.