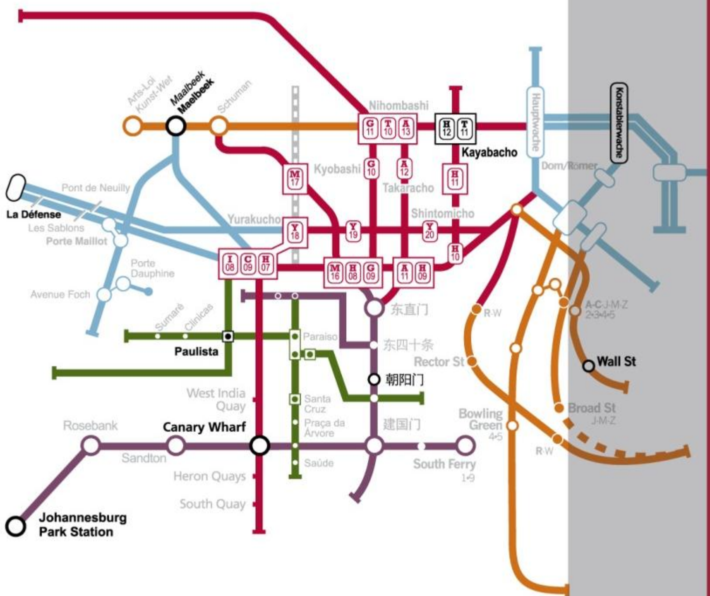
International Financial Reporting Standards



Joint CMAC-GPF meeting, June 2014
Agenda paper 2A

Liabilities and Equity

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

Agenda

- What is the problem?
- What have we heard?
- What do we need to do to progress?
- Scope of today’s discussion
- Questions
- Examples illustrating the three approaches

What is the problem?

- There are many different claims against an entity: a single distinction cannot convey all those differences.
- Distinguishing between liabilities and equity has consequences for balance sheet and performance ratios and analysis.
- Inconsistent treatment: Instruments get classified differently under existing IFRSs.
- It is difficult to classify instruments that have a mix of debt and equity features.
- Instruments with a mix of debt and equity features are becoming more prevalent.

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What have we heard so far?

- Many equity analysts and equity investors:
  - placed more importance on returns to the most residual class.
  - supported a narrower definition of equity, such as classifying as equity only the most residual claim or common shares of the parent, with a broad definition of liabilities.
- One user group:
  - placed more importance on how the amount of the obligation is specified and less importance on how it will be settled.
  - suggested classifying as equity only those instruments that participate in the returns of the business without limit.
- Credit analysts and many preparers:
  - placed more importance on how the obligation will be settled.
  - supported a broader definition of equity, such as classifying as liabilities instruments that will require the company to transfer its assets (ie obligations to transfer shares, regardless of how the amount is specified, would be equity).

What do we need to do to progress?

- Information about **all of the various characteristics** will need to be provided in the financial statements in some way.
- Our challenge is to identify:
  - what information is **best** provided using the debt/equity distinction; and
  - what information is **best** provided through disclosure, presentation and other means (such as EPS).
- To do the above, we need to better understand:
  - how investors use the information resulting from the distinction.
  - how different classifications might help (or hinder) the usefulness of the distinction.

Scope of today's discussion

- We have set out three different approaches to distinguishing liabilities and equity (see Appendix) to compare and contrast the results:
  - The settlement approach is based on how an obligation is settled.
  - The value approach is based on how the amount of the obligation is specified.
  - The narrow equity approach is based on the most residual class of equity.
- We would like you to focus on the classification of:
  - **Share-settled debt**: Obligations to deliver a variable number of common shares equal to the value of a fixed monetary amount (eg CU 100).
  - **Puttable shares**: Obligations to deliver a variable amount of cash equal to the value of a fixed number of common shares.
- We have limited the discussion to the above instruments because they best illustrate the different characteristics that investors appear to be interested in.

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Questions

- We have provided examples of how the instruments we have identified could be classified under the three approaches.
- Based on the results of these examples, we would like you to discuss how your analysis (or the presentation of your company's results) will be affected by:
  - items classified as liabilities although their value changes similar to common shares (or vice-versa)
  - items classified as equity although they will result in an outflow of cash (or vice-versa)
- You may want to think about how the classification affects the assessment of the entity's liquidity, solvency and performance.
- What information is best provided through the distinction between liabilities and equity?

Examples illustrating the three approaches

Instruments used in the examples

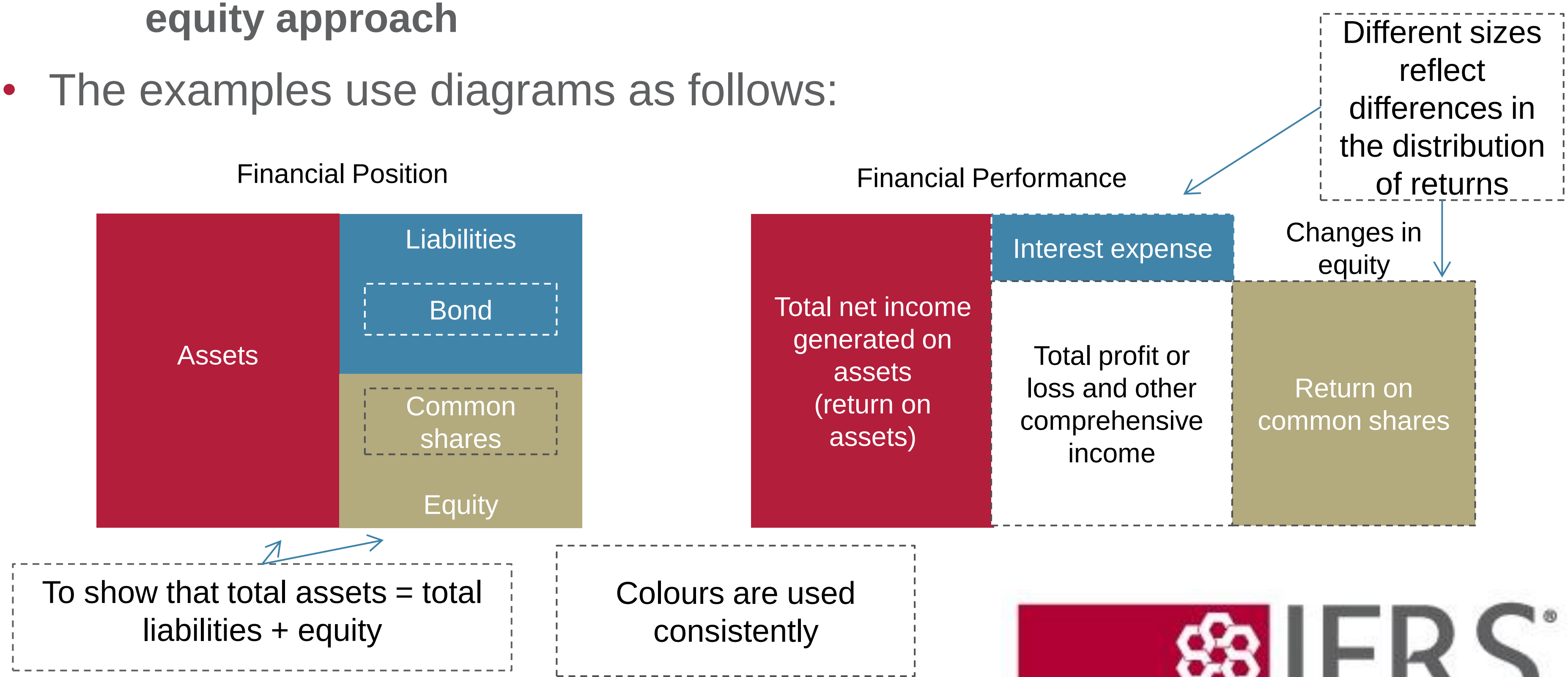
- We assume that the accounting for the following is not contentious:
  - Cash-settled debt (eg a bond) meets the definition of a liability
  - Common shares meet the definition of equity
- There are a broad range of instruments that have a mix of liability and equity characteristics, including derivatives on own equity, convertibles, puttables etc.
- However, for simplicity, we will focus the discussion on:
  - **Share-settled debt**: Obligations to deliver a variable number of common shares equal to the value of a fixed monetary amount (eg CU 100).
  - **Puttable shares**: Obligations to deliver a variable amount of cash equal to the value of a fixed number of common shares.

Reminder of the effects of the distinction

- Distinction between total liabilities and equity on the balance sheet effects ratios and analyses
- Changes in liabilities effect profit or loss and other comprehensive income, changes in equity do not.
- Liabilities are directly re-measured and equity is not.

Example set-up

- The examples consider three different scenarios:
  - Classification based on settlement: **the settlement approach**
  - Classification based on the amount of the obligation: **the value approach**
  - Classification based on the most residual class of equity: **the narrow equity approach**
- The examples use diagrams as follows:

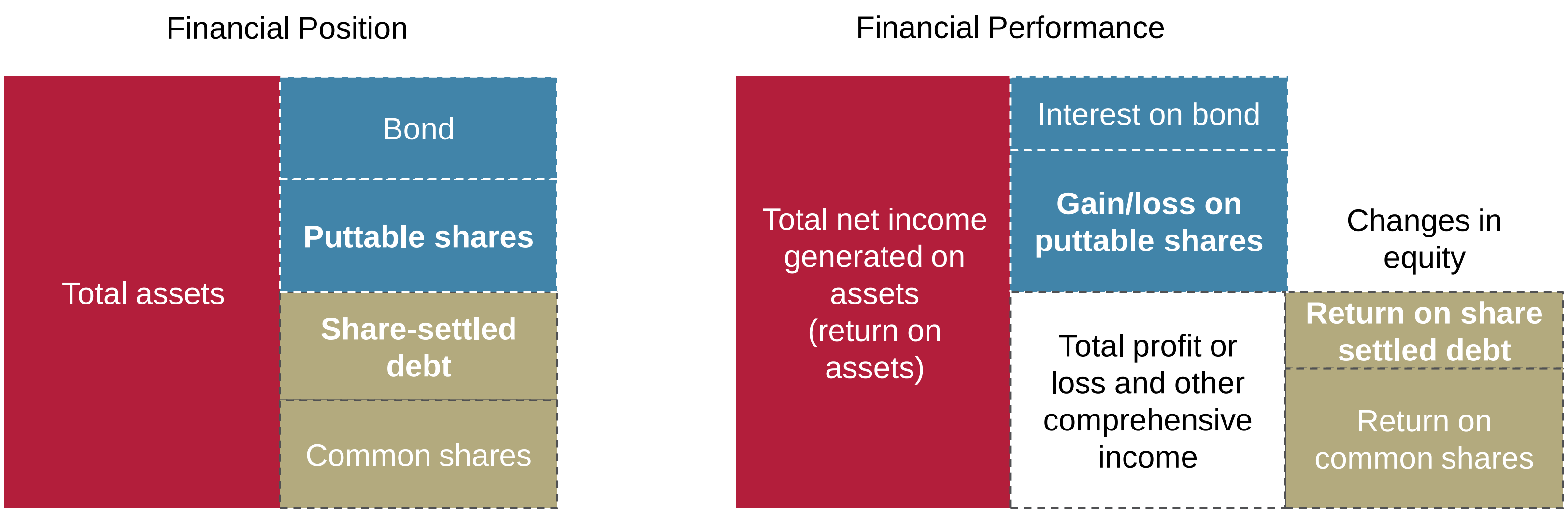


Settlement approach

- Distinguishes between claims that require the entity to transfer its assets and those that do not require a transfer.
- Possible benefits:
  - helps users assess the entity's liquidity and needs to raise finance
- However, the amount of the obligation is independent of the form of settlement (in liquid markets):
  - Puttable shares change in value similarly to common shares even if classified as liability
  - Share-settled debt changes in value similarly to cash-settled debt even if classified as equity
- Differences in returns will have to be presented prominently.
- Strict obligation approach in Discussion Paper

Settlement approach-results

- Classifying **puttable shares** as liabilities will show that the entity must transfer some of its **assets** to settle the obligation
- Classifying **share-settled debt** as equity will show that the entity will not have to transfer any of its assets (instead the entity must transfer its **equity** to settle the obligation)

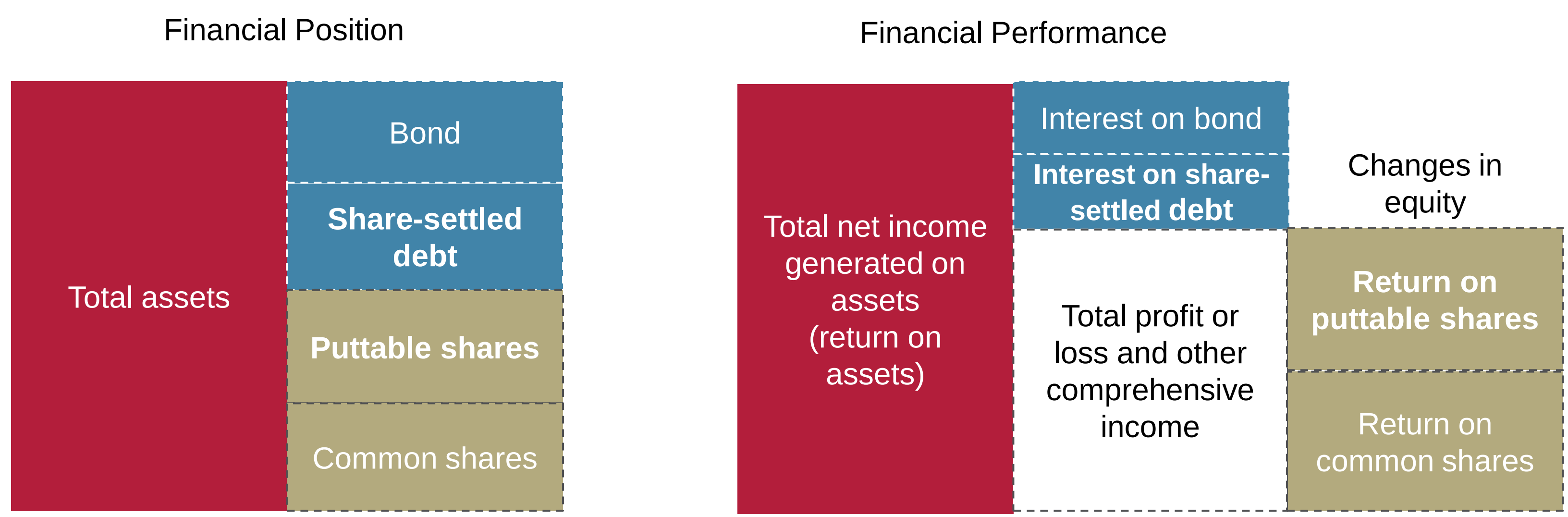


Value approach

- Distinguishes between claims that will require a transfer of a an amount that is specified independently of the entity (eg a fixed monetary value) and those that do not.
- Possible benefits:
  - helps users assess the sufficiency of the entity's assets to meet its obligations (solvency).
  - helps users assess the distribution of returns.
- However, it will not show which items will require the entity to transfer its assets and those that will not.
  - This will have to be presented prominently in some other way.
- This also resembles an approach suggested by a user group to classify as equity claims that participate in unrestricted returns of the business.

Value approach-results

- Classifying **share-settled debt** as a liability will show that the entity is required to transfer a specified amount.
- Classifying **puttable shares** as equity will show that the entity is required to transfer an amount equal to the value of its common shares.



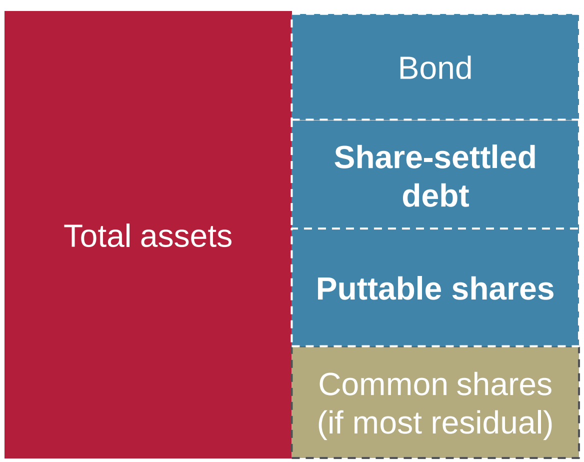
Narrow equity approach

- This approach will classify the most residual claim as equity and all other claims as liabilities (including other senior classes of shares).
- Possible benefits:
  - helps users assess the returns to the most residual claim.
- However, classifying both share-settled debt and puttable shares as liabilities will include all different types of items:
  - Both claims that will require a transfer of assets and some that do not.
  - Both claims that will require a transfer of a specified amount and some that do not.
- Identifying the most residual claim could be difficult and might change over time.

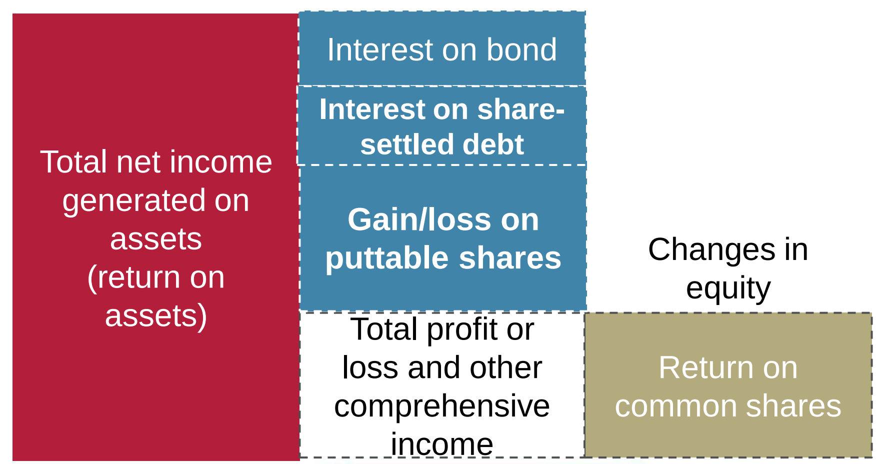
Narrow equity approach-result

- Will classify any claim that is not the most residual claim as a liability, including the following (if not the most residual):
  - Puttable shares
  - Share-settled debt

Financial Position



Financial Performance



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.