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

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Conceptual Framework – liabilities vs equity

- IASB project team asked for guidance on the strategy they should follow to progress the section on the definition of equity, and the distinction between liabilities and equity instruments
- The comment letters of the ASAF members on the discussion paper were taken into account in formulating the proposals in this document
- The proposals are intended to be strategic in nature, rather than technical
- This document is structured as follows:
  - IASB's tentative views as expressed in the discussion paper
  - Items that the Conceptual Framework should address
  - Items that the Conceptual Framework should not address

IASB Tentative views

- Retain the existing definition of equity – ie residual interest
- Use the definition of a liability to distinguish liabilities from equity instruments
- An entity should:
  - At end of each reporting period update the measure of each class of equity claim. The IASB should determine when developing or revising particular Standards whether that measure would be a direct measure, or an allocation of total equity
  - Recognise updates to those measures in the statement of changes in equity as transfers of wealth between classes of equity claims
- If an entity has issued no equity instruments, it may be appropriate to treat the most subordinate class of instruments as if it were an equity claim, with suitable disclosures. Identifying whether to use such an approach, and if so, when, would still be a decision for the IASB to take in developing or revising particular standards

Overview of the proposed strategy

- Items that the Conceptual Framework should address:
  - Equity is a residual (most ASAF members supported this proposal and many supported the 'strict liability' approach)
  - The reporting entity
  - More common features of instruments and their impact on the definition of a liability
  - The 'unit of account' in distinguishing liabilities and equity
- What the Conceptual Framework should *not* address:
  - The measurement of different classes of equity
  - Exceptions to the definitions – eg that it may be appropriate for entities that have no equity instruments to classify most subordinate liability as equity

Items that the Conceptual Framework (CF) should address

Clear and robust concepts with added explanation

- The CF should contain clear and robust concepts and definitions that will:
  - Aid the IASB in setting specific standards; and
  - Provide commentators with a solid foundation from which to comment on proposals put forward by the IASB when setting or amending standards
- For example, if it is not clear what the different parts of the definition of a liability mean, then there is a risk that inconsistent standards are developed and/or that commentators have diverse frames of references
- The process of issuing IFRIC 21 highlighted that there are diverse views on when there is a present obligation from a past event, yet each commentator believes their view is consistent with the definition of a liability in the current conceptual framework and IAS 37

Clear and robust concepts with added explanation (cont.)

- We acknowledge that the CF cannot and should not address specific types of transactions or instruments, such as levies or rate regulated activities. However, it should contain sufficient explanation of the concepts and definitions to ensure clear and consistent understanding as far as possible.

- The Discussion Paper contained two explanations which were welcomed – namely obligations to deliver shares and obligations to be settled only upon liquidation. The CF should contain more such explanations to reinforce the principles.

Clear and robust concepts with added explanation (cont.)

- Additional explanations should be considered for inclusion to ensure a clear and consistent understanding of the definition of a liability with the following common characteristics:
  - Settlement at option of holder (puttable instruments) or issuer
  - Settlement choices at option of holder or issuer
  - Settlement contingent on events outside control of issuer
  - Economic compulsion/ Settlement options with no or limited substance
  - Non-discretionary payments of a certain percentage of future profits

The CF should be internally consistent

- If equity is to be defined as the **residual of assets recognised less liabilities recognised**, then
  - Total equity should simply be this residual – i.e. the CF should not contain inconsistencies where some instruments meeting the definition of a liability are to be classified as equity and vice versa
  - CF needs to contain robust definitions and explanations of assets and liabilities (since equity is simply the residual) to ensure clear and consistent understanding (refer to previous slide)
  - CF needs to address the reporting entity to provide clarity on whether an item is an asset or liability of the reporting entity, and hence what is the residual of the reporting entity. Some commentators have questioned whether financial statements should be prepared from an entity perspective or an owner's perspective when contemplating what is equity.

Unit of account

- Although the CF should not address specific instruments or transactions, the IASB should address the ‘unit of account’ with respect to defining assets and liabilities because in practice the definitions will need to be applied to specific instruments or transactions. It should therefore be clear whether the definitions are to be applied to an instrument as a whole or to the elements/features of an instrument.

- For example the CF could
  - provide specific principles or concepts to determine the relevant unit of account; or
  - acknowledge that, for example an instrument may contain features which do, and those which do not, meet the definition of a liability, and that these different features would hence be classified independently, rather than the instrument as a whole

Items that the Conceptual Framework (CF) should *not* address

Measurement of different classes of equity

- The CF should only discuss measurement of *total* equity – ie being the residual of recognised assets less recognised liabilities
  - It should not address or determine the (re)measurement of different classes of equity – this should be done at a standards level.
  - Therefore, the CF should not address the ‘transfer of wealth’ notion
- The CF could acknowledge that there are different classes of equity

Exceptions to definition of equity or liabilities

- Any exceptions to the definition of liabilities or equity should only be dealt with on a Standards level with explanation for the deviation from the CF
- Consequently, the CF should *not* introduce notions that are exceptions, for example:
  - *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* (5.57)