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Project	**Conceptual Framework**		
Paper topic	Feedback summary: equity		

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Introduction

1. This paper is a summary of the feedback received on the definition of equity in the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting*.

2. This paper provides a high level summary of the comments received. Where appropriate, we will provide a more detailed breakdown of the comments for future meetings.

Overview

3. Many respondents:

   (a) agreed that the definition of a liability should be used to distinguish equity claims from liability claims. However there were mixed views regarding the details and consequences of this approach, and whether those concerns should be addressed in this project or in a Standards-level project.

   (b) supported providing additional information on the effects of different classes of equity claims. However many of these respondents suggested that updating the measurement was not the best way to

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achieve this. They warned the IASB to consider whether the benefits of developing the proposals further would outweigh the costs.

Structure of paper

4. This paper is structured as follows:

   (a) Scope and content (paragraphs 5–11)

   (b) Definition of equity and distinction from liabilities (paragraphs 12–28)

   (c) Approaches to distinguish equity from liabilities (paragraphs 29–39)

   (d) Remeasurement of equity claims (paragraphs 40–43)

   (e) Classification of most residual claim as equity (paragraphs 44–46)

   (f) Co-operatives (paragraphs 47–51).

Scope and content

Background

5. Section 5 of the Discussion Paper discussed the definition of equity and the distinction between equity and liabilities. The existing Conceptual Framework has definitions of liabilities and equity. However, existing Standards and Interpretations do not apply the definitions consistently. Apart from the resulting requirements being complex and difficult to apply for preparers and auditors, these inconsistent requirements result in economically similar items being classified differently, with very different accounting outcomes. These differences in accounting for similar items make it unnecessarily difficult and complex for a user of financial statements to understand an entity's financial position and performance.

Summary of feedback

6. Most respondents supported addressing the distinction between liabilities and equity in the Conceptual Framework project. They agreed with the reasons outlined in the Discussion Paper, including the problems inherent in current

Standards and the inconsistent outcomes of IFRS 2 *Share-based Payment* and IAS 32 *Financial Instruments: Presentation* for similar instruments.

7. However, some standard-setters and various representative bodies noted that there is no consensus on how to distinguish equity instruments from liabilities. These and other respondents suggested that the IASB should have a more comprehensive discussion on this topic, potentially in conjunction with a project to develop a new Standard. Some respondents cautioned that the IASB should not attempt to provide a conceptual basis for the distinction between liabilities and equity in this project if such a discussion cannot be completed on a timely basis. They stated that if this topic is not well researched and robust, there is a risk that the IASB might depart from the Conceptual Framework when developing future Standards. They noted previous failures by the IASB and the US Financial Accounting Standards Board to reach a conclusion on this topic.

8. Some respondents suggested that, instead of seeking to change the Conceptual Framework and Standards fundamentally, the IASB could address the problems identified by making targeted amendments to IAS 32 and IFRS 2.

9. In addition to the above, respondents suggested that a number of other issues should be explored, but were not sufficiently addressed in the Discussion Paper. These issues included:

   (a) **Interaction with the liabilities discussion**—respondents noted that any changes to the liability definition would affect equity. In particular, it was suggested that the IASB should consider how the treatment of the following might affect equity:

      (i) existence uncertainty;

      (ii) constructive obligations;

      (iii) economic compulsion; and

      (iv) conditional obligations.

   (b) **Interaction with performance reporting**—whether the split between equity instruments and liabilities also needs to drive the definitions of income and expense. Both the current and proposed Conceptual Frameworks define income and expense in relation to changes in equity.

(c) **Perspective from which financial statements are presented**—whether the perspective (eg entity perspective or proprietary perspective) should form the basis for the distinction between liabilities and equity, performance reporting and related financial statement presentation and disclosure issues.

(d) **Boundary of the reporting entity**—the relationship between the entity and holders of equity instruments issued by the entity.

(e) **Distinguishing income (and expense) from contributions to equity (and distributions of equity)**—including the issue of whether 'discretionary' payments made to holders of an instrument that meets the definition of a liability should be classified as expenses.

10. A number of other issues were also raised for the IASB to consider within the context of amending or developing Standards, including:

(a) accounting for compound instruments;

(b) other depictions of the effects of dilution (eg earnings per share);

(c) financial statement presentation;

(d) disclosures for equity instruments;

(e) accounting for remote events; and

(f) hedge accounting for equity instruments (particularly if they are directly measured).

11. Nevertheless, many respondents also commented that the Discussion Paper included too much detail on this topic. They suggested that only the definition should be included in the Conceptual Framework, with all details dealt with in Standards.

Definition of equity and distinction from liabilities

12. This section includes the following:

(a) Background (paragraph 13)

(b) The objective of distinguishing equity from liabilities (paragraphs 14–15)

(c) Whether equity should be distinguished from liabilities (paragraphs 16–18

(d) Third category of claims (paragraphs 19–22)

(e) The meaning of ‘residual’ in the definition of equity (paragraphs 23-28).

Background

13. The Discussion Paper identified two competing objectives that the distinction between liabilities and equity is attempting to satisfy:

(a) depicting ‘cash leverage’—the ratio of claims[1] that must be settled with cash (or other economic resources) to other claims; and

(b) depicting ‘return leverage’—the ratio of (i) claims that do not share fully in the returns on the residual interest in an entity’s assets, less liabilities, to (ii) claims that do share in those returns.

The objectives of distinguishing equity from liabilities

14. Some respondents commented on the identified objectives as follows:

(a) they should focus on the usefulness of the information to providers of capital;

(b) they should be applicable to various legal forms and industries;

(c) they should begin with the objective of the statement of financial position as a whole; and

(d) the Conceptual Framework should be limited to outlining the competing objectives of the classification. The IASB should then apply the

[1] In this paper, ‘claims’ refers to both liabilities and equity claims.

qualitative characteristics to arbitrate between those objectives at the Standards-level.

15. Some respondents identified different objectives to those in the Discussion Paper:

(a) The objective should enable users to predict the risks and returns of each claim and how claims will be settled (liquidity).

(b) The objective should be to distinguish income (and expense) from contributions to equity (and distributions of equity).

(c) Equity should serve as a record of amounts invested by an identified class of owners, or returned to them. This record of investment is very relevant from a stewardship perspective.

(d) The classification should be consistent with what market participants perceive as equity. An instrument should be classified as a liability if its market price behaves more like the market price of debt, and as equity if its market price behaves more like the market price of equity.

Whether equity should be distinguished from liabilities

16. Some respondents observed that any distinction between equity and liabilities:

(a) will portray no more information on the nature of the claim than the criteria chosen to make the distinction, even though claims may vary in many different respects; and

(b) will lead to outcomes that seem counterintuitive or unhelpful for particular instruments and types of entities.

17. Some respondents suggested that, instead of making a binary distinction, the statement of financial position should depict and describe the claims as a continuum (described as a no-split or claims approach). They suggested that defining claims as a whole in the Conceptual Framework would not preclude defining other subsets of claims in Standards. For example, a Standard could be developed for different components of 'shareholders' equity'. These respondents gave the following reasons for their suggestion:

(a) By presenting the claims as a continuum, any distinction would be at the discretion of the users of the financial statements according to their specific needs.

(b) Parts of what is commonly referred to as retained earnings might be attributable to holders of instruments classified as liabilities.

18. Nevertheless, most respondents supported distinguishing equity from liabilities in some way. Some noted that at least one type of claim cannot be measured directly without measuring the entire entity. Thus, unless all claims (and thus the entity) were measured directly, any approach would need to identify at least two sets of claims: those measured directly and those measured indirectly. That distinction can form the basis for a distinction between liabilities and equity.

Third category

19. Some suggested that both liabilities and equity should be defined, with a third category ('dequity' or 'mezzanine capital'), which would act as a residual to capture:

(a) instruments that do not meet either definition; and

(b) instruments that meet both definitions.

20. These respondents think that defining both liabilities and equity explicitly would help meet both of the objectives identified in paragraph 13. In particular:

(a) defining liabilities based on whether the entity has an obligation to deliver economic resources would provide information about solvency; and

(b) defining equity as the claims held by the 'owners' of the entity would provide information about the performance of the entity from the perspective of these owners, after considering the effect of other claims.

21. Other reasons for a third category included:

(a) Developing an unambiguous definition of liabilities is difficult.

(b) The structuring of financial instruments to obtain a particular accounting treatment reinforces the problem caused by an ambiguous liability definition.

(c) In regulated entities, definitions of regulatory capital have a purpose other than financial reporting. A third category might better depict such instruments.

22. However, some respondents suggested that a third category would increase the complexity and confusion caused by the classification, and a number of consequential issues would need to be resolved in order to implement such an approach, including the accounting for changes in such instruments.

The meaning of ‘residual’ in the definition of equity

23. Some respondents observed that ‘residual’ has two important and distinct meanings in the definition of equity that should be dealt with separately:

(a) a claim on the entity which is not a liability (ie identifying the residual set of claims); and

(b) the part of the statement of financial position that is not directly remeasured (residual measurement of the identified claims).

Residual set of claims

24. Many respondents supported keeping the definition of equity as the residual set of claims on the entity. They observed that defining both equity and liabilities independently of each other is likely to result in some items being captured in both definitions and others being captured in neither definition (overlaps and gaps). However, as noted above, some suggested a third category could be defined as the residual set to address this.

25. Some respondents did not agree that the IASB should use the definition of liability to distinguish liabilities from equity instruments, mainly because some aspects of the existing definition of a liability are unclear (eg conditional obligations).

26. Other suggestions by respondents included that:

(a) The Conceptual Framework should also include principles to confirm the existence of equity and to classify different claims within equity. Applying the proposal to update the measurement of different claims within equity would require such distinctions to be made.

(b) Specific components of equity should be defined, including contributed capital, retained earnings and accumulated other comprehensive income.

Residual measurement

27. Many respondents also supported measuring equity as a residual, consistently with current requirements, because at least one set of claims cannot be directly measured. However, some respondents think this meaning of residual is inconsistent with the suggestion in the Discussion Paper to remeasure 'secondary' equity claims (see paragraphs 40–43).

28. Some suggested that under this meaning of equity as a residual measurement, an instrument that obliges an entity to transfer economic resources could arguably exhibit some characteristics of equity if the instrument is a claim on the residual (such as redeemable shares). They suggested that accounting for such instruments as liabilities might not faithfully represent the economic substance of the claim or provide relevant information for making decisions about providing resources to the entity (see paragraphs 35–36).

Approaches to distinguish equity from liabilities

Background

29. The Discussion Paper explored two approaches to defining equity and distinguishing between liabilities and equity:

(a) The 'strict obligation approach'—applying the existing definition of equity, the IASB should use the definition of a liability consistently in distinguishing equity claims from liability claims. This approach depicts cash leverage in the statement of financial position, and uses an enhanced statement of changes in equity to depict return leverage.

(b) The ‘narrow equity approach’—the IASB should define equity as only the existing equity instruments in the most residual existing class of equity instrument issued by the parent, and use this new definition of equity to distinguish liability claims from equity claims. This approach depicts return leverage in the statement of profit or loss and other comprehensive income, and would need to rely on disclosure to depict cash leverage.

Summary of feedback

30. This section includes the following:

(a) Comparison of views on the two approaches (paragraphs 31–32)

(b) Primary and secondary equity claims (paragraphs 33–34)

(c) Put options on own equity (paragraphs 35–36)

(d) Obligations that arise only on liquidation (paragraphs 37–38)

(e) Alternatives suggested (paragraph 39).

Comparison of views on the approaches

31. Overall, reactions to the approaches fell into three categories:

(a) Many respondents supported the ‘strict obligation approach’. However, many of these respondents did not support a key component of that approach (the enhanced statement of changes in equity), and other supporters of the approach raised a number of other concerns (see paragraphs 41–43).

(b) Some respondents, including many equity investors and analysts, supported the ‘narrow equity approach’.

(c) Other respondents did not support either approach. They stated that both approaches have significant and fundamental flaws and the Discussion Paper suggests various exceptions to deal with those flaws. This indicates that neither faithfully represents the economics in all cases.

32. The following table lists the advantages and disadvantages respondents raised for each approach. However not all respondents raised all of these issues and respondents gave greater weight to some factors than to others.

Strict obligation approach	Narrow equity approach
More consistent and comparable depiction of an entity's leverage, however dilution will have to be depicted elsewhere (see paragraphs 41–43.	More consistent depiction of dilution, however leverage will need to be depicted elsewhere.
Consistent with entity perspective.	Consistent with proprietary perspective.
Consistent with the existing treatment of non-controlling interests.	Non-controlling interests may need to be classified as liabilities.
Advantages	**Disadvantages**
Consistent with existing definitions of a liability and equity.	It would require a change to the definition of a liability; these changes have not been explored.
Consistent and comparable classification across a broad range of instruments and jurisdictions.	Instruments with the same characteristics could be classified differently by different entities, corporate structures and jurisdictions, thereby reducing comparability.
Equity would include all instruments that act as a buffer to protect holders of an entity's obligations from loss.	Equity would not include all instruments that act as buffer to protect holders of an entity's obligations from loss.

Strict obligation approach	Narrow Equity Approach
Disadvantages	**Advantages**
It would not resolve the classification difficulties that caused the IASB to depart from the liability definition in the past, including classification of instruments with settlement options.	It would provide a conceptual basis for solving classification issues that caused the IASB to depart from the liability definition in the past, including classification of puttable instruments.
Many classes of instrument have the economic characteristics of liabilities, even if there is no obligation to transfer economic resources. An example is an obligation to issue a variable number of equity instruments with a fixed total value (paragraphs 33–34).	Only one class of instrument would be classified as equity, eliminating the possibility of classifying as equity instruments with the economic characteristics of liabilities.
Many classes of instrument have the economic characteristics of equity even if there is an obligation to transfer economic resources. Examples are some interests in partnerships and other puttable instruments (paragraphs 35–36).	Many classes of instrument have the economic characteristics of equity without being the most subordinate class of instruments. Recognising changes in the fair value of such instruments through profit or loss may not be useful.
Disadvantages of both	
The proposal could be very form-driven. Almost any transaction could be structured to achieve equity treatment. Instruments with settlement options would be classified as equity, even if they were expected to be settled in cash.	The instrument that is most residual may change depending on other instruments (including those issued later), the legal form and the present circumstances, reducing comparability across entities and through time.

Primary and secondary equity claims

33. The Discussion Paper described informally primary and secondary equity claims and explained how they differ from each other. Some respondents suggested that the Conceptual Framework should explicitly acknowledge these differences. They commented that primary equity claims are fundamentally different from secondary equity claims:

    (a) Holders of secondary equity claims have an enforceable right or obligation for the entity to receive or deliver another equity claim. In contrast, primary equity claims do not have an enforceable right or obligation for the entity to receive or deliver anything.

    (b) Likewise, holders of secondary equity claims do not have a current unconditional claim on the residual assets of an entity, but have a potential claim that may or may not result in an eventual claim. In contrast, holders of primary equity claims have a current unconditional claim on the residual assets of an entity.

    (c) Secondary equity claims cannot be remeasured without valuing the primary equity claims that could ultimately be delivered or received. The value of those primary equity claims would depend on the value of the entire entity.

34. Of the respondents that commented on obligations to issue a variable number of equity instruments to a fixed value (an entity using its own shares as currency), many suggested that such obligations should meet the definition of a liability because:

    (a) Holders of such claims may be indifferent between holding those and holding straight debt.

    (b) The return on such claims will be fixed unless the firm enters bankruptcy.

    (c) Any obligation may be recorded as equity simply by requiring, or allowing, it to be discharged in a variable number of the entity's own shares.

Put options on own equity

35. Some respondents observed that if the strict obligation approach is applied, then put options written on own equity would result in the recognition of a financial liability. Most of these respondents stated that recognising changes in the value of such instruments in profit or loss would not result in useful information to users of financial statements. Of these respondents:

    (a) Some think that obligations for shares puttable or redeemable at fair value would be more faithfully represented if they were classified as equity. In their view, recognising a liability for the fair value of the instruments would be equivalent to valuing the entity, particularly if there are no other equity instruments.

    (b) The others think that classifying such instruments as liabilities faithfully represents the obligation to transfer resources to repurchase outstanding shares. However, to address their concerns, they suggested that changes in the value of such instruments should be recognised directly in equity, in particular when the strike price for the option is the fair value of the underlying shares.

36. Some respondents stated that addressing the issue of puttable instruments would provide insights into the robustness of the definitions of liability and equity. Similarly, some observed that this issue is the inverse of obligations to issue a variable number of equity instruments to a fixed value, suggesting that a robust definition of equity should result in a relevant and faithful representation for both.

Obligations that arise only on liquidation

37. Most respondents supported the proposal that obligations to transfer economic resources that arise only on liquidation of the entity should not be classified as liabilities, because financial statements are prepared on a going concern basis.

38. However, a few respondents disagreed. Comments included:

    (a) The central point in defining a liability is the existence of an obligation at the reporting date; the timing of the cash flow should not be relevant to the definition as long as there will be a payment in the future.

(b) Requirements to make a payment on liquidation can still be identified as either liabilities or equity, for example the payment to ordinary shareholders on liquidation results from a residual interest as opposed to an obligation.

(c) If the entity has contractually committed itself to liquidate a consolidated subsidiary and as a result is obliged to transfer an economic resource, it would be appropriate to classify such a contractual obligation as a liability.

Alternatives suggested

39. Respondents suggested various other approaches to distinguish liabilities from equity claims, including:

(a) whether the instrument participates in unrestricted rewards;

(b) whether the instrument reflects a proportionate share of net assets, irrespective of whether it also creates any obligation to transfer resources;

(c) giving entities a free choice to select a single class of instruments to classify as equity;

(d) based on the legal form;

(e) previous proposals by the IASB, by the FASB, proposals in a Discussion Paper *Distinguishing between Liabilities and Equity* published in 2008 and proposals from various European standard-setters; and

(f) the existing IAS 32 distinction.

Remeasurement of equity claims

Background

40. To supplement the strict obligation approach, the Discussion Paper suggested that more information could be provided to help users of financial statements understand the effect of different equity claims on each other. For example, the

IASB might require changes in the carrying amount of some equity claims to be recognised in the statement of changes in equity. The IASB would determine, when developing or revising particular Standards, whether that measure would be a direct measure, or an allocation of total equity.

Summary of feedback

41. About half of the total respondents commented on this question. Some welcomed the additional information and transparency that would be provided and acknowledged that the proposal would limit the accounting differences between liability and equity treatments, thereby limiting the incentives to structure instruments to achieve a particular accounting outcome. However, some of these respondents thought that the information might be more useful if it was provided in a different way and suggested that the approach should be explored in more detail. Users in particular supported providing additional information through the statement of changes in equity. However, they suggested that this might need to be supplemented by expanded disclosure of potential dilution in different scenarios.

42. However, many respondents that commented expressed concern about the suggestion to update the measurement of equity claims, and to report the effects of this within the statement of changes in equity.

    (a) Many of these respondents also supported the strict obligation approach. Consequently, two different views emerged from this set of respondents:

        (i) Some acknowledged the shortcomings of the strict obligation approach, but thought these shortcomings could be addressed more efficiently through disclosure of potential dilution instead of by remeasuring equity claims.

        (ii) The other respondents suggested that no further information is required, because no further changes in the entity's assets or liabilities, or future cash flows, occur as a result of changes in the relative value of different classes of equity instruments.

(b) The other respondents supported either an alternative approach or the narrow equity approach, even though the narrow equity approach could result in the classification and measurement of similar instruments as liabilities.

43. Additional comments made by respondents included the following:

(a) The proposal might be unlikely to meet its stated aims if the instrument is measured at market value. The market value would not merely reflect the recognised amounts of assets and liabilities. Changes in that market value do not provide relevant information about future distributions of cash by the entity. Reporting those changes as wealth transfers would make sense only if the entity's market capitalisation were recognised and disaggregated in equity, which would conflict with paragraph OB7[2] of the existing Conceptual Framework.

(b) The proposal might be unnecessary, in some cases, because the fair value of different classes of equity instruments is typically ascertainable from market information.

(c) Although the carrying amounts of some parts of equity, for example non-controlling interest, are currently updated, this is not a direct remeasurement: it simply reflects changes in the part of the residual (assets less liabilities) owned by non-controlling interests. This indirect measurement does not provide a precedent for directly measuring equity claims.

(d) It is unclear what problem this approach is intended to solve.

Classification of the most residual claim as equity

Background

44. The Discussion Paper suggests that 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

[2] OB7 states that general purpose financial reports are not designed to show the value of a reporting entity.

approach, and if so, when, would still be a decision for the IASB to take in developing or revising particular Standards.

Summary of feedback

45. Of the respondents that commented, many did not support this preliminary view. Reasons provided included:

    (a) If an entity does not have any equity, then all claims on it should be reported as liabilities if they meet the definition. The Conceptual Framework is not the place for exceptions.

    (b) If the IASB thinks these instruments are better represented as equity, then that indicates that the definition is not fit for purpose. The IASB should improve the definition instead of introducing exceptions at the conceptual level.

    (c) The exception may import some of the disadvantages of the 'narrow equity approach'.

    (d) While it may be appropriate in certain cases such as for puttable instruments, it may not be appropriate in all cases in which there are no equity instruments.

46. Others supported the exception and specifically noted the existing exceptions in IAS 32 for puttable instruments and limited life companies. They suggested that, without the exception, the entity's capital structure would not be faithfully represented. These respondents did not appear to object to an exception at the conceptual level. Some also stated that it would provide a satisfactory conceptual basis for puttables and for shares that are required by statute to pay a minimum dividend.

Co-operatives

47. The Discussion Paper did not specifically address issues related to particular entity structures; however the IASB received a number of letters from co-operative organisations and their representative bodies ('co-ops'). Those responses highlighted the specific circumstances of the co-op capital structure and

how the preliminary views might be applied to that structure. These responses suggested specific amendments to the preliminary views.

48. Most of these responses agreed, consistently with the preliminary views, that:

    (a) the existing definition of equity should be retained; and

    (b) as an exception, the most subordinated class of financial instruments should be treated as if it were equity if no other instrument meets the definition of equity. Many saw this as a valid use of the 'business model' concept in making the financial statements more relevant.

49. Some suggested additional specific requirements. For example, that the IASB should approach the classification between equity and debt in co-ops in a manner that groups the most subordinated instruments with materially similar characteristics and classifies these instruments as equity.

50. Many respondents suggested that the basis for IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* should be considered in the Conceptual Framework. As noted in IFRIC 2, an entity must consider all of the terms and conditions of a financial instrument, including relevant local laws, regulations and the entity's governing charter, to determine whether to treat its shares as equity or as a liability. Furthermore, these respondents suggested that IFRIC 2 aligns the definition of equity to the definition of an asset, because the unconditional right to refuse the redemption of a share reflects the same notion of control and applies it to an entity's capital: if the share capital is under the control of the entity it is not a liability.

51. Others suggested that IFRIC 2 interprets the members' rights to request redemption for cash too strictly, in a way that does not faithfully represent the co-op business model. They suggested that members' shares should be considered liabilities only upon resignation, exclusion or removal of the member.