IFRS

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Introduction

1. The objective of this paper is to explore whether, and the extent to which, the definitions of liability and equity need to change in order to implement the approaches in Agenda Paper 10I.

2. In Appendix A of Agenda Paper 10G, we indicate our preference for the combined settlement and value approach. However, in this paper, we recommend that the IASB should not amend the tentative definition of a liability or the existing definition of equity in the *Conceptual Framework*. This is because we do not think that the benefits of amending the definition of a liability outweigh the costs of the added complexity at this time.

3. In addition, we think that applying the tentative definition of a liability (with the help of the accompanying guidance which the IASB has developed) would result in the following classification outcomes that would be **partly** consistent with the combined settlement and value approach:

   (a) the classification as liabilities of **some** obligations to deliver the entity's own equity instruments, namely those obligations that are **capable of requiring** the entity to transfer its economic resources under some possible scenarios.

   (b) the classification as liabilities of **some** obligations to deliver economic resources that can be deferred until liquidation, namely those

obligations for which the entity has **no practical ability to avoid** earlier redemption.

4. If the IASB agrees with us that the combined settlement and value approach should be developed further, then we suggest that it develops that approach further in the research project on Financial Instruments with Characteristics of Equity (the Research Project). As a result of that project, the IASB may in due course wish to consider amending the definitions of a liability and of equity, or other aspects of the *Conceptual Framework*.

5. This paper is structured as follows:

   (a) Scope of this paper (paragraphs 6–9)

   (b) Tentative decisions to date (paragraphs 10–16)

   (c) Consistency with tentative definitions in the *Conceptual Framework* (paragraphs 17–37)

   (d) Potential amendments to the tentative definitions (paragraphs 38–50)

   (e) Implications of the combined settlement and value approach for Standards (paragraphs 51–58)

   (f) Conclusion and staff recommendation (paragraphs 59–62)

   (g) Appendix A—Consequences of the other approaches explored in Agenda Paper 10I

Scope of this paper

6. We focus most of this paper on the consequences of the combined settlement and value approach because we recommend the IASB pursue that approach in the Research Project. However we discuss the consequences of the other approaches in Appendix A. If the IASB decides to pursue one of those approaches, then the analysis in Appendix A will be relevant.

7. This paper also includes a preliminary analysis of potential implications of the approaches in Agenda Paper 10I if the IASB decides in the future to undertake a project (or projects) to improve relevant Standards, including:

(a) IAS 32 *Financial Instruments: Presentation*.

(b) IFRS 2 *Share-based Payment*.

(c) IFRS 10 *Consolidated Financial Statements* (for the classification of non-controlling interests (NCI)).

(d) IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments.*

8. In analysing potential implications for particular Standards, we do not wish to imply that the *Conceptual Framework* project should try to avoid conflicts with existing Standards. **In addition, this paper does not intend to pre-empt any work on individual Standards. Any decisions to start an active project to consider whether to change existing Standards will be subject to an IASB agenda decision and the IASB's due process.** We intend to discuss with the IASB in October 2014 the scope of the parallel Research Project.

9. We think that the preliminary analysis in this paper will give the IASB a better understanding of the classification outcomes that would result from each approach and allow the IASB to compare those outcomes with the existing classification outcomes of particular Standards. This is particularly important in this topic because of the existing differences between:

(a) the definitions used in IAS 32; and

(b) the definitions in the existing *Conceptual Framework* and IFRS 2.

Tentative decisions to date

10. At its April 2014 meeting, the IASB tentatively decided that the *Conceptual Framework*:

(a) should keep the existing binary distinction of liabilities and equity and build on the feedback received on the Discussion Paper *A review of the Conceptual Framework for Financial Reporting* (the Discussion Paper) to develop definitions of liabilities and equity; and

(b) should not provide detailed guidance on how to distinguish liabilities from equity instruments.

11. The IASB's tentative definitions of an economic resource, an asset and a liability are:

> An **economic resource** is a right that is capable of producing economic benefits.
>
> An **asset** is a present economic resource controlled by the entity as a result of past events.
>
> A **liability** is a present obligation of the entity to transfer an economic resource as a result of past events.

12. The existing definition of equity is:

> **Equity** is the residual interest in the assets of the entity after deducting all its liabilities.

13. The IASB's tentative definition of economic resources does not include an entity's claims against itself (that is, a claim against an entity cannot produce economic benefits for the entity itself). Consequently:

    (a) an obligation that the entity is required to, or is permitted to, settle by delivering its own equity instruments **does not** meet the definition of a liability; and

    (b) an obligation that that the entity is required to, or is permitted to, settle by delivering a liability **does** meet the definition of a liability.

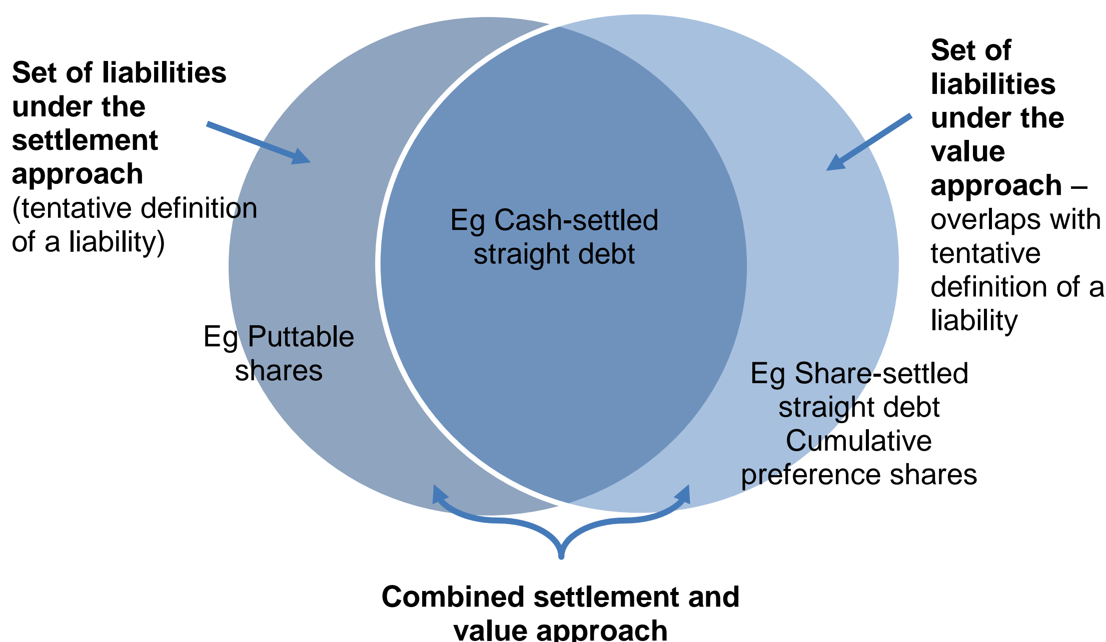
14. Given that we recommend in Agenda Paper 10G that the IASB pursue the combined settlement and value approach, the next section discusses the extent to which the combined settlement and value approach is consistent with the tentative definition of a liability and the existing definition of equity.

15. We consider the consequences of the other approaches explored in Agenda Paper 10I further in Appendix A. However, because our favoured approach is a combination of the settlement approach and value approach, we note here that:

    (a) the settlement approach would be consistent with the tentative definition of a liability, for the reasons described in the Discussion Paper.

(b) the value approach would **not** be consistent with the tentative definition of a liability, because some obligations to transfer economic resources would be classified as equity under that approach.[1]

16. Given the above, we can illustrate the extent that the combined settlement and value approach is consistent with the tentative definition of a liability as follows:



Consistency with tentative definitions in the *Conceptual Framework*

17. As can be seen above, the combined settlement and value approach will classify as liabilities all obligations to transfer economic resources prior to liquidation, which would be consistent with the tentative definition of a liability. However, the combined settlement and value approach would also classify as liabilities:

(a) some obligations to deliver an entity's own equity instruments (eg share-settled debt): those for which the value of those equity instruments to be delivered is independent of the entity's total economic resources (paragraphs 18–28).

[1] However, it could be argued that the value approach is consistent with the definition of equity (if the existing definition of equity as a 'residual interest' is interpreted as a positive definition of a residual claim as opposed to a residual definition), because only claims to the residual assets would be classified as equity (ie claims to something other than the residual assets would be classified as liabilities under that approach).

(b) some obligations to transfer economic resources at liquidation only: those for which the value of the economic resources to be transferred is independent of the entity's total economic resources (paragraphs 29–37).

Obligations to deliver equity instruments

18. The Discussion Paper suggested that obligations that an entity must or may settle by issuing its own equity instruments do not meet the definition of a liability because its own equity instruments are not economic resources of the entity.

19. The IASB has tentatively decided to include some additional guidance in the *Conceptual Framework* to support the definition of a liability. In particular the IASB has tentatively decided that the guidance supporting the definition of a liability should clarify that an obligation must contain an existing feature that is **capable of** requiring the entity to transfer an economic resource.

20. From the above guidance, to meet the definition of a liability, a claim needs to have **an existing feature that is capable of requiring the entity to transfer an economic resource**.

21. In the Discussion Paper, the IASB suggested that the requirement on, or the right of, an entity to use its own equity instruments to settle an obligation would result in that obligation not meeting the definition of a liability. However, that suggestion presumes that the entity can avoid transferring its economic resources under **all possible future scenarios**.

22. If a claim requires the entity to deliver a variable number of shares to equal a specified value, then it is possible for the value of the obligation to exceed the entity's recognised and unrecognised economic resources (eg if its share price has collapsed). Thus it is possible that the entity will be unable to issue enough shares to meet such an obligation. This is why in Agenda Paper 10I we suggest that classifying such claims as liabilities would assist users in assessing the entity's solvency.

23. Such situations beg the question of what alternative courses of action the entity has at its disposal to settle such a claim.[2] These alternatives will need to be considered in assessing whether the claim, or one of its features, is a liability or equity.

24. For example, for an obligation to deliver a variable number of equity instruments equal to a specified value, if the entity is unable to deliver the required value of equity instruments, the alternative courses of action (or default scenarios) available might include one of the following:

    (a) the entity could be required to deliver the specified value by transferring cash or some other economic resource. Such a feature (ie the requirement to 'stand ready' to deliver an economic resource) would meet the definition of a liability.

    (b) the entity could be required to settle the obligation by delivering a fixed number of a new class of equity instruments and to cancel the rights of other classes of equity instrument holders. Such a feature would not meet the definition of a liability and, consistently with the combined settlement and value approach, the feature would be classified as equity. It would not be possible for the value of the obligation to exceed the total value of the entity's economic resources.

25. The entity would have to consider all potential outcomes of the claim, whether explicit or implicit. The two features we discuss above would result in two very different economic outcomes for the entity and the holders of the claim, with different consequences for the assessment of the entity's liquidity, its solvency and the distribution of its returns.

26. In some cases, the potential outcomes may be ambiguous or unspecified. Moreover, because of the effect of local laws and regulations, the outcomes may differ for instruments with similar contractual terms but in different jurisdictions. However the available outcomes are a question of fact and identifying them will present challenges regardless of where within the spectrum of claims the distinction between liabilities and equity is struck. When setting requirements for

[2] There may be other situations or scenarios, such as an insufficient number of authorised shares, which may also be relevant to identifying whether the entity may be required to transfer economic resources.

inclusion in particular Standards, the IASB may, after weighing the relative costs and benefits, decide to address such practical difficulties by adopting some pragmatic tests or rebuttable presumptions for drawing the boundary between liabilities and equity (for example, that an obligation to deliver a variable number of equity instruments is a liability, unless the contract and local laws require the entity to deliver equity instruments in all possible scenarios).

27. Based on the above analysis, in our view, whether or not obligations to deliver equity instruments meet the tentative definition of a liability is not a question of whether the entity can avoid transferring its economic resources under **some** scenarios or settlement alternatives, but whether the entity can avoid transferring its resources **under all possible scenarios** (other than liquidation). In our view, this is an application of the IASB tentative decision that a liability is an obligation that is **capable** of requiring the entity to transfer its economic resources. As noted by the IASB in May 2014, the term 'capable' is intended to indicate that, in at least some outcomes, an existing feature of the obligation will require the entity to transfer an economic resource.

28. However, the application of the tentative decisions and supporting guidance only partially achieves the classification outcomes of the combined settlement and value approach. Application of the tentative decisions and supporting guidance, would result in liability classification for only some of those claims that require the delivery of equity instruments whose value is independent of the entity's total economic resources (those that are capable of requiring settlement by a transfer of economic resources). The combined settlement and value approach would require liability classification for all claims that require the delivery of equity instruments whose value is independent of the entity's total economic resources.

Obligations to transfer economic resources at liquidation

29. The Discussion Paper suggested that obligations to transfer economic resources only on liquidation of the entity do not meet the definition of a liability, because financial statements are normally prepared on a going concern basis.

30. The combined settlement and value approach would classify as liabilities some obligations to transfer economic resources **even if** the entity can delay transferring

economic resources until liquidation. This would be the case if the value of those economic resources to be transferred is independent of the entity's total economic resources. For the following analysis it might be helpful to distinguish between the following two instruments:

(a) an obligation to transfer at liquidation a fixed monetary amount.

(b) an obligation to transfer at liquidation an amount that increases at a specified rate.

31. If the entity is a going concern and liquidation is not likely, discounting the amount of the former instrument to a present value would result in a trivial value. Therefore, we focus on the latter instrument, the value of which will increase over time. However the following analysis applies equally to both.

32. It is the relationship between the rate of increase and the rate of return produced on the entity's economic resources that can result in the value of the obligation exceeding the value of the entity's assets. This is why in Agenda Paper 10I we suggest that classifying such claims as liabilities would assist users in assessing the entity's solvency. Even if the entity can delay transferring its economic resources until liquidation, the cost of finance may become prohibitive if the specified rate of increase is high enough and results in a negative return for other claims, thus deterring any further investment in the entity.

33. Some respondents to the Discussion Paper stated that, if the entity has the right to redeem a claim that increases in this manner, then the rate of increase in the value of the liability leads to the entity being 'economically compelled' to redeem the claim prior to liquidation (ie before the value 'takes off'). The extent to which one rate (the rate of increase in the obligation) exceeds the other rate (the rate of return on the assets) will determine whether the entity is 'economically compelled' to settle the claim before it has to. Furthermore, the degree of this difference and its direction might change over time.

34. In July 2014, the IASB discussed conditional obligations and 'economic compulsion' and tentatively decided that an entity has a present obligation to transfer an economic resource as a result of past events if both:

(a) the entity has no practical ability to avoid the transfer; and

(b) the amount of the transfer is determined by reference to benefits that the entity has received, or activities that it has conducted, in the past.

35. If the entity has no practical ability to avoid redeeming the claims described in paragraph 30, then the claim would be classified as a liability. The IASB indicated in July 2014 that courses of action that an entity has no practical ability to avoid include those that would cause significant business disruption or have economic consequences significantly more adverse than the transfer itself. The possibility that failing to redeem the claim may reduce the entity's ability to raise finance might be an adverse economic consequence, however the extent to which this is so might also change over time. Therefore, such a claim may change classification over time, even though the value of the total claim would be independent of its classification.

36. In our view, and for the reasons set out in Agenda Paper 10I, all claims for which the value of economic resources to be transferred is independent of the entity's total economic resources should be classified as liabilities, whether or not the entity has the practical ability to avoid redeeming these instruments until liquidation.

37. However, using the tentative definition of a liability and the additional guidance, we do not think that it is possible to classify all claims of the type described in paragraph 30 as liabilities because there may be a practical ability to avoid transferring economic resources prior to liquidation.

Potential amendments to the tentative definitions

38. Based on our analysis in the previous section on the tentative definition of a liability and its associated guidance, we think that:

(a) **some** obligations to deliver the entity's own equity instruments will be classified as liabilities, if the obligation is capable of requiring the entity to transfer its economic resources under some possible scenarios.

(b) **some** obligations to deliver economic resources that can be deferred until liquidation will be classified as liabilities, if the entity has no practical ability to avoid earlier redemption.

39. However, this would not fully implement the combined settlement and value approach. Therefore, to implement the combined settlement and value approach more completely, we considered whether:

    (a) to amend the definition of a 'liability' to include obligations to deliver an entity's own equity instruments, or to transfer economic resources at liquidation, if the total value of those equity instruments, or economic resources, is independent of the entity's total economic resources (paragraphs 40–43).

    (b) to amend the definition of 'equity' to include only claims whose value is dependent on the residual net assets only (paragraphs 44–50).

Amending the definition of a liability

40. The IASB could amend the definition of a liability to include some obligations to deliver a variable number of the entity's own equity instruments, and some obligations to transfer economic resources at liquidation, if the total value of those equity instruments to be delivered or economic resources to be transferred is independent of the entity's total economic resources.

41. Such a definition would be similar to the existing definition of a financial liability in IAS 32[3]. In our view, such an amendment would be sufficient to allow the IASB to implement the combined settlement and value approach.

> A **liability** is a present obligation of the entity, that exists as a result of past events:
>
> (a) to transfer an economic resource prior to liquidation, or:
>
> (b) to deliver the entity's own equity instruments, or transfer economic resources at liquidation, if the total value of equity instruments to be delivered, or economic resources to be transferred, is independent of the entity's total economic resources. ~~as a result of past events.~~

[3] The definition in IAS 32 does not include obligations to transfer resources at liquidation and includes further details for derivatives.

42. The advantages of amending the definition of a liability are that it would be unambiguous and would apply the principles of the combined settlement and value approach directly. However, the disadvantages of amending the definition are that it would be a fundamental change to one of the elements of financial statements, and, as can be seen above, will make the definition more complex and less understandable, particularly when applying the definition to matters that have nothing to do with distinguishing liabilities from equity.

43. In our view, the benefits of amending a definition in the *Conceptual Framework* to address the classification of a limited set of claims may not outweigh the costs of its complexity.

Amending the definition of equity

44. As another alternative, the IASB could amend the definition of equity to define it positively as a claim whose value is dependent only on the residual net assets of the entity. In other words, the holder's claim against the entity is limited to the residual net assets and nothing else. A claim for a fixed amount that is settled with a variable number of equity instruments, or a claim for a fixed amount of economic resources at liquidation, would not be a claim whose value is dependent only on the residual net assets of the entity, and thus would not meet such a definition of equity. That outcome would be consistent with the combined settlement and value approach.

> **Equity** is <u>a claim against the entity that entitles the holder to nothing other than</u> the residual interest in the assets of the entity after deducting all its liabilities.

45. Whether the above amendment is necessary, or is already implicit in 'residual interest', could be debated. Some interpret the existing definition of equity more positively than others. Amending the definition would remove any ambiguity.

46. However, defining (or interpreting) both liabilities and equity positively would result in overlaps and gaps:

    (a) an obligation to deliver a variable number of equity instruments with a fixed total value would not meet either definition (the gap).

(b) an obligation to transfer economic resources with a variable value equal to the value of an equity interest would meet both definitions (the overlap).

47. Eliminating the gap may require an additional element to be defined as a residual. However as noted in April 2014, we do not think an additional element is required, and introducing an additional element may increase complexity. Alternatively, the definition of a liability could be amended as described in paragraph 41. However, defining both elements positively will always carry the risk that some instruments may not meet either definition.

48. To address the overlap, we think sub-classes within liabilities or within equity, could be used to present differences between claims. Thus, the claims mentioned in paragraph 46(b) above could, depending on the approach selected, be either a separate sub-class of liabilities or a separate sub-class of equity. The IASB would have to decide which classification would better represent the claim when setting requirements in particular Standards.

49. However, we think that if the IASB wishes to amend the definitions to implement the combined settlement and value approach, the better option would be to amend the definition of liabilities and leave equity as the residual.

50. As we note in Agenda Paper 10K, the IASB could explore defining different classes of equity as part of the Research Project.

Implications of the combined settlement and value approach for Standards

IAS 32

51. For IAS 32, although the definitions in the Standard might be different to the combined settlement and value approach, the overall classification outcomes will be similar.

52. However, for the following types of instruments, their classification under IAS 32 would not be consistent with the classification outcomes of the combined settlement and value approach:

(a) those puttable shares classified, by way of exception, as equity under IAS 32 (paragraphs 16A-16D of IAS 32).

(b) cumulative fixed-rate or increasing-rate preference shares classified as equity under IAS 32 (paragraph AG26).

53. The requirements in IAS 32 for the classification of derivative instruments, including the fixed-for-fixed principle, would have to be reviewed to assess whether they are consistent with the combined settlement and value approach. However, we expect that a derivative that will be settled with a variable number of shares would be classified as a liability under the combined settlement and value approach.

IFRS 2

54. The classification outcomes of the combined settlement and value approach would be different to those in IFRS 2. IFRS 2 would classify as equity all obligations to deliver equity instruments. However, to the extent that the share-based payment transactions provide the entity with a choice of settlement, IFRS 2 states that the entity has a present obligation to transfer economic resources if:

(a) the choice of settlement has no commercial substance (because the entity is legally prohibited from issuing shares);

(b) the entity has a past practice or a stated policy of settling in cash; or

(c) the entity generally settles in cash whenever the counterparty asks for cash settlement.

IFRS 10: NCI

55. The combined settlement and value approach would classify claims as liabilities if the value of economic resources to be transferred is independent of the entity's total economic resources. For consolidated groups, this begs the question of whether the reference to the total economic resources is a reference to the reporting entity's consolidated economic resources, or the economic resources of the entity that is subject to the claim.

56. Assuming there are no instruments at the group level that change the nature of the equity claims in the subsidiaries on consolidation, then whether NCI will still be equity on consolidation depends on the exact wording of the description of the combined settlement and value approach.

57. It might be possible to define the combined approach in a way that treats a part of the group as a separate silo, and thus treats NCI on consolidation in the same way as the subsidiary treats those instruments in its financial statements. If the IASB wishes to do this, it could achieve this by clarifying that the reference to economic resources of the entity is a reference to the entity or component entity that is subject to the claim, rather than a reference to the reporting entity as a whole.

IFRIC 2

58. IFRIC 2 is an application of the requirements of IAS 32 to a specific type of obligation: members' shares in co-operative structures. Therefore, because we think the classification outcomes of IAS 32 would be broadly similar to those under the combined settlement and value approach, we do not think there would be any major effect on the classification outcomes of IFRIC 2. In particular, we think that the following key requirements of IFRIC 2 would not be affected by pursuing the combined settlement and value approach:

    (a) that an obligation **does not exist** if the entity has an unconditional right to refuse redemption of the shares, **unless** the redemption amount is independent of the economic resources of the entity; and

    (b) that an obligation **does exist** to the extent that the entity's right to refuse redemption is limited by specified conditions.

Conclusion and staff recommendation

59. In Agenda Paper 10G, we indicate our preference for the combined settlement and value approach. However, based on the analysis above, we recommend that the IASB should not amend the tentative definition of a liability or the existing definition of equity in the *Conceptual Framework* at this time.

60. Amending the definition:

(a) may make them more complex and less understandable.

(b) and may be disruptive, given that the definitions work for the classification of the majority of claims.

61. In addition, we think that applying the tentative definition of a liability (with the help of the accompanying guidance which the IASB has developed) would result in the following classification outcomes that would be **partly** consistent with the combined settlement and value approach:

(a) the classification as liabilities of **some** obligations to deliver the entity's own equity instruments, namely those obligations that are capable of requiring the entity to transfer its economic resources under some possible scenarios.

(b) the classification as liabilities of **some** obligations to deliver economic resources that can be deferred until liquidation, namely those obligations for which the entity is has no practical ability to avoid earlier redemption.

62. If the IASB agrees with the staff that the combined settlement and value approach should be developed further, then we suggest that it explores a more complete implementation of that approach within the Research Project. The IASB may in due course wish to consider amending the definitions of a liability and of equity, or other aspects of the *Conceptual Framework* as a result of that research. We will discuss the scope of the Research Project at the IASB's October meeting.

Questions for the IASB
Does the IASB agree with the staff recommendation that: (a) the definitions of a liability and of equity should not be amended at this time? If not, how should the definitions be amended and why? (b) the staff explores a more complete implementation of the combined settlement and value approach in the Research Project?

Appendix A: Consequences of the other approaches explored in Agenda Paper 10I

Settlement approach

Conceptual Framework and IFRS 2

63. As noted in Agenda Paper 10I, the settlement approach is consistent with, and therefore has no consequences for, the following:

    (a) the proposed definition of a liability in the *Conceptual Framework*; and

    (b) the existing definitions in IFRS 2 *Share-based Payment*.

IAS 32

64. The settlement approach is inconsistent with parts of the existing definitions and requirements in IAS 32 *Financial Instruments: Presentation*. In particular, the approach would be inconsistent with:

    (a) the share-settlement clauses of the definitions of financial assets and financial liabilities. This includes for financial liabilities:

        (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; and

        (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

    (b) the exceptions for puttable instruments. The puttable instrument exceptions are complex and are contained in paragraphs 16A-16D of IAS 32 (we have not reproduced them here).

65. If the IASB wishes to pursue the settlement approach with an objective of using the distinction to depict liquidity, then it would be consistent with that objective to:

    (a) amend IAS 32 to classify as equity all obligations settled with an entity's own equity.

(b) eliminate the exceptions for puttable instruments and classify as liabilities all puttable instruments, regardless of what their value is dependent on.

66. The Research Project will provide the IASB with information that will help it to assess whether it should consider adding to its active agenda a project to consider amending IAS 32, and to assess the scope of any such project. However, concepts that are inconsistent with IAS 32 will make the IFRS Interpretations Committee's job more difficult, in particular when applying IAS 32 to instruments not specifically addressed in that Standard.

67. As part of the Research Project, the IASB will also have an opportunity to explore presentation and disclosure. Many users have consistently requested improved disclosures to help them understand the effects of claims, and have suggested that introducing improved disclosures may be easier to achieve than fundamental changes in classification and measurement.

IFRS 10: NCI

68. Assuming there are no instruments at the group level that change the nature of the equity claims in the subsidiaries on consolidation, then we expect NCI will still be equity on consolidation under the settlement approach.

IFRIC 2

69. IFRIC 2 is an application of the requirements of IAS 32 to a specific type of obligation: members shares in co-operative structures. We think that the following key requirements would not be affected by pursuing the settlement approach:

(a) that an obligation **does not exist** if the entity has an unconditional right to refuse redemption of the shares; and

(b) that an obligation **does exist** to the extent that the entity's right to refuse redemption is limited by specified conditions.

Value approach

Conceptual Framework

70. The value approach is arguably not consistent with the existing and proposed definition of a liability in the *Conceptual Framework*, and the existing definitions in IFRS 2, in that the value approach:

    (a) would classify as equity some obligations to transfer economic resources prior to liquidation (for example, if the amount of resources to be transferred is dependent on the value of the entity's own equity instruments).

    (b) would classify as liabilities some obligations to transfer an entity's own equity instruments (eg share-settled debt) if the total value of equity instruments to be transferred would be independent of the value of any one of those equity instruments.

71. To fit the value approach within the proposed definition of a liability without any changes would be a stretch. It would require that the 'transfer of economic resources' be interpreted to be a transfer of the underlying value, and not of the economic resources used as the currency to transfer that value. In Agenda Paper 10I, we suggest that, under the value approach, an obligation to transfer a value that is independent of the entity's total economic resources would be a liability.

72. Such a fundamental change to the definition of a liability could have unintended consequences for IFRSs that apply to liabilities in general. We explore these consequences in paragraphs 80-82.

73. Another way to implement the value approach is simply to expand the definition of a liability to:

    (a) include obligations to deliver a variable number of equity instruments; and

    (b) exclude obligations to deliver a variable amount of cash equal to the fair value of an equity instrument.

74. Adding the additional legs to the definition of a liability would make the definition less understandable, however it may avoid any unintended consequences of a more fundamental change in the definition. Only obligations

for which the value or the settlement is based on an entity's own shares would be affected. However, such an approach might not classify as liabilities all obligations that the value approach intends, such as cumulative fixed dividend preference shares on which the entity can defer payment until liquidation.

IFRS 2

75. The value approach would not be consistent with the definitions in IFRS 2, which are similar to those in the existing *Conceptual Framework*. In our preliminary view, most share-based payments, whether cash-settled or equity-settled, would meet the definition of equity under the value approach (unless the total value of shares to be delivered is independent of the entity's total economic resources, in which case they would be liabilities).

76. Under the value approach, the settlement requirements would need to be prominently presented or disclosed, to alert the user to the liquidity effects of cash-settled instruments, and the IASB could consider requiring some kind of remeasurement within equity to present on the Statement of Financial Position the amount of the potential liquidity drain.

IAS 32

77. For IAS 32, although the definitions might need to be amended, the overall classification of items will be quite similar under IAS 32 and under the value approach. The boundaries might change slightly as follows:

    (a) the requirements for puttable instruments might need to change to distinguish between shares puttable at fair value, and those that are puttable at some other value (as opposed to the current requirements that classify as equity the puttable shares that are the most residual).

    (b) the requirements for derivatives on own equity, including the fixed-for-fixed principle, would have to be reviewed to assess whether they are consistent with the value approach.

IFRS 10: NCI

78. Assuming there are no instruments at the group level that change the nature of the equity claims in the subsidiaries on consolidation, then whether NCI will still be

equity on consolidation depends on the exact wording of any amendment to IFRS 10. It might be possible to define the value approach in a way that treats a part of the group as a separate silo, and thus treats NCI on consolidation in the same way as the subsidiary treats those instruments in its financial statements. This could be achieved by clarifying that the reference to economic resources of the entity is a reference to the entity or component entity that is subject to the claim, rather than a reference to the reporting entity as a whole.

IFRIC 2

79. IFRIC 2 is an application of the requirements of IAS 32 to a specific type of obligation: members’ shares in co-operative structures. However the classification outcomes of applying the value approach to co-operative structures would depend on whether the redemption amount is driven by the value of the economic resources of the co-operative or by other factors.

Implications for other standards and interpretations

80. Changing the definitions to refer to a transfer of a value that is independent of the value of the economic resources of the entity would be a fundamental change that might have consequences for standards that deal with liabilities in general. However, because such liabilities are typically not linked to the value of the entity, our view is that they would continue to be classified as liabilities under this approach. For example, performance obligations (IFRS 15 *Revenue from Contracts with Customers*), provisions (IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) and employee benefits (IAS 19 *Employee Benefits*) are obligations whose value is typically specified by reference to a specified amount of currency or a specified good or service.

81. One area where there might be consequences is the classification of participating contracts (including unit-linked contracts) in IFRS 4 *Insurance Contracts* or a future Standard replacing IFRS 4. Such contracts are linked to the value of part or all of the entity and some may have an equity component under the value approach. This is because part of the value of the obligation is dependent on the value of the entity’s economic resources. The application of the value approach to these contracts (such as whether they should be bifurcated) will depend on the IASB’s assessment of the costs and benefits.

82. Arguably, there is an equity component under the existing definitions, however the IASB has decided to not bifurcate such claims because of its assessment of the costs and benefits. We do not think that any of the approaches we are considering would change that assessment.

Narrow equity approach

83. We note that, out of the four approaches that we considered in Agenda Paper 10I, the narrow equity approach would have the most far-reaching effect on the *Conceptual Framework* definitions of liability and equity, on IFRS 2 and IAS 32.

84. The definitions would have to change to something similar to what the US Financial Accounting Standards Board (FASB) and IASB had previously attempted with the Basic Ownership Approach. That approach defined equity as the most subordinate ownership instrument and a liability as a claim that reduces the assets available for distribution to basic ownership instruments.

85. That approach was not pursued by the IASB and the FASB for a number of reasons, primarily because the IASB began expanding the definition of equity to include additional instruments (in particular, other classes of shares that converted into a fixed number of common shares).

IFRS 2

86. The effects on IFRS 2 would be to account for all share-based payments using the current cash-settled share based payment requirements. In effect, the equity-settled requirements would be unnecessary and could simply be eliminated.

IAS 32

87. For IAS 32, only instruments that are the most residual claim would be equity. It is not clear what the consequences for IAS 32 would be, or whether IAS 32 would be at all relevant under the narrow equity approach. Significant changes will be implied if the IASB proceeds with the narrow equity approach.

IFRS 10: NCI

88. Whether NCI will still be equity on consolidation depends on the exact wording of the description of the approach. It might be possible to define most residual in

a way that treats a part of the group as a separate silo, and thus treats NCI on consolidation in the same way as the subsidiary treats those instruments in its financial statements.

IFRIC 2

89. We think that applying the narrow equity approach to the members' shares in co-operatives would typically result in equity classification for such shares, if they are the most residual claim.