

STAFF PAPER

September 2014

IASB Meeting

Project	Conceptual Framework		
Paper topic	Equity – additional analysis and examples		
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Introduction

1. At the June 2014 meeting, some IASB members requested additional examples that illustrate some of the concepts in Agenda Paper 10I. This paper provides that additional analysis and those examples. It is for information only.
2. This paper includes the following:
 - (a) the entity perspective (paragraphs 3–10);
 - (b) arbitrage and structuring opportunities (paragraphs 11–20)
 - (c) additional examples (paragraphs 21–59)

The entity perspective

3. At the June 2014 IASB meeting, some IASB members suggested that we consider the implications of the entity perspective in distinguishing between liabilities and equity. Appendix A to Agenda Paper 10I discusses the proprietary perspective, however there is no corresponding discussion of the entity perspective in that paper.
4. As we note in Agenda Paper 10I, the perspective for financial reporting was discussed in Agenda Paper 10E of the IASB's meeting in May. At that meeting, the IASB tentatively decided that, consistently with the objective of financial reporting in paragraph OB2 of the existing *Conceptual Framework*, financial statements:

- (a) should be presented from the perspective of the entity; and
 - (b) should provide information that is useful to existing and potential investors, lenders and other creditors, focussing on their common information needs.
5. Furthermore, as noted in Agenda Paper 10E of the IASB's meeting in May, the *Conceptual Framework* already states that the reporting entity is separate from its capital providers. The economic resources are the entity's and do not belong to the capital providers. Capital providers' own claims against the entity distribute the returns produced on those economic resources, and the risks of variations in those returns, depending on the payment and priority requirements of the different claims (as described in Agenda Paper 10I).
6. The separation of the entity from its capital providers implies that financial statements should report economic phenomena that affect the entity and not those that affect its capital providers. In the staff's view, this means that transactions and contracts of capital providers that are entered into independent of the entity should not be reported in the entity's financial statements. For example, the buying and selling of debt and equity instruments by capital providers in secondary markets will not affect the entity and will simply result in changes in the ownership of the entity's debt and equity instruments. The rights of existing claims on the reporting entity attach to the claims, not to the particular party holding them now. Financial statements are directed at the holders from time to time of those claims, not to the particular parties who hold them now.
7. Likewise, holders of the entity's debt and equity instruments may enter into contracts with each other, such as forwards and options to buy and sell the entity's debt and equity instruments. These contracts only affect the contracting parties and do not affect the entity or other holders of the entity's debt and equity instruments.
8. In contrast, the entity's buying, selling and contracting on its own debt and equity instruments (ie its participation in the primary market for its instruments) affects the entity and its capital providers because such actions affect the capital structure of the entity and thus the distribution of risks and returns on its economic resources amongst its capital providers. For example, an entity entering into

contracts with some of its capital providers, such as forwards and options to buy or sell the entity's debt and equity instruments affect the entity and its other capital providers.

9. It is not clear how considering the presentation of the financial statements from the perspective of the entity as a whole will help in distinguishing between liabilities and equity. The *Conceptual Framework* already begins by stating that capital providers need information about the entity's resources and claims against the entity. The distinction between liabilities and equity is one piece of that information. On that basis, Agenda Paper 10I discusses the assessments that users might make based on the distinction, and the characteristics of claims that might be useful to such assessments.
10. In the staff's view, the above analysis does not help in deciding how claims should be distinguished between equity and liabilities and does not affect our analysis in Agenda Paper 10I. However, adopting the entity perspective removes the need to identify the proprietor, which would have been required under a proprietary perspective as discussed in Appendix A to Agenda Paper 10I.

Arbitrage and structuring opportunities

11. The below discusses the arbitrage and structuring opportunities under the settlement and value approaches.
12. Arguably, accounting standards should not be written to prevent abuse. However:
 - (a) the capital structure of an entity is within its control. The entity has the power to enter into contracts distributing various risks and returns to different claim holders (which, once entered into, must run their course until settled).
 - (b) accounting requirements that permit economically similar claims to be classified differently (depending on the structure used by the entity to achieve its preferred classification) will reduce the usefulness of the information provided. Arbitrage and structuring opportunities have been a prominent factor in considerations regarding the requirements

for distinguishing between liabilities and equity in the past, both at the US Financial Accounting Standards Board (FASB) and at the IASB.

The settlement approach

13. The entity may choose to raise capital or otherwise finance its operations using claims that may be settled by its own shares or by its economic resources. The amount of economic resources or shares required to settle the claims may be set by reference to an underlying value that is independent of how the instrument is settled.

14. As noted in Agenda Paper 10I, the settlement approach will result in claims being classified differently depending on whether they are settled in cash or in shares, even if the values of the claims vary by reference to the same underlying. An entity's use of its own shares as a currency to settle claims has been a concern in the past, and is one of the reasons why IAS 32 *Financial Instruments: Presentation* classifies obligations to issue a variable number of shares as liabilities.

15. Distinguishing between liabilities and equity based on how the obligation will be settled gives rise to opportunities to structure claims in such a way that, while the overall distribution of returns may be neutral to the entity as a whole, changes are recognised within profit or loss and other comprehensive income that are offset by changes recognised within equity. This could be accomplished simply as follows:
 - (a) enter into one contract where the entity will receive in cash an amount linked to the S&P 500 index. Changes in the fair value of this contract would be recognised in profit or loss.

 - (b) enter into another contract where the entity will issue a variable number of shares to the value of the same S&P 500 index at the date of settlement. Changes in the fair value of this contract would be recognised within equity (if at all).

 - (c) the net effect of (a) and (b) will be neutral (with respect to changes in the value of the claims), because any change in the value of the cash contract will be offset with the change in the value of the equity settled contract (in other words, the risks will be hedged). It will simply be

equivalent to the entity issuing shares in exchange for cash at the settlement date.

- (d) to completely neutralise the effect of this transaction (with respect to financial position), at the date of settlement the entity can purchase the same number of shares on the market at the same value. The total effect of the transactions would be trivial, and the entity and all its claim holders would end exactly where they started, however it will result in the recognition of items in profit or loss.¹

16. The above is not completely a zero-sum game. Importantly, the above structure would only be neutral in liquid markets. As soon as market liquidity affects the outcome, the result would not be neutral. In addition, if the counterparties of the contracts are different then the entity will also be subject to some counterparty credit risk. For example, if the entity is unable to claim the cash from the counterparty, then it would recognise a real economic loss.
17. If the objective is to depict liquidity, then **such an approach would faithfully represent** that the contracts above are subject to different liquidity risks than if they were structured to be entirely cash settled. This just reinforces the point that classification under the settlement approach is primarily driven by liquidity factors and not changes in value.

The value approach

18. As with the settlement approach, the value approach could also be seen as subject to accounting arbitrage. However, in the case of the value approach, the arbitrage would be of liquidity risk as opposed to value. By issuing shares that are puttable on demand, the entity will raise capital that, while it will not have an effect on the value of the entity, may pose a liquidity risk to the entity (ie it may be very ‘flighty’ funding).
19. The value approach distinguishes between liabilities and equity based on what drives changes in the value of the instrument (ie risk), regardless of how it will be

¹ The above example contains some risk that the changes recognised in profit or loss would be negative. It is possible to construct a more complicated example that results in income recognised in profit or loss under all scenarios, however the aim of the example was to show how arbitrary amounts could be presented within profit or loss irrespective of the neutral effect on the entity as a whole.

settled. This gives rise to opportunities to structure claims in such a way that the entity may be funded with very ‘flighty’ equity. While we have distinguished between liquidity and solvency for the purposes of the analysis, in practical terms liquidity issues can result in solvency issues. Many of the failures during the financial crisis resulted from companies funding illiquid, long-dated assets, with short-dated obligations requiring the transfer of the entity’s assets. In some cases these were equity-like in the way their value varied but the holder had the right to put the instruments back to the entity.

20. Again, if the objective is to depict solvency, then **such an approach would faithfully represent** that the claims requiring the entity to transfer its economic resources differ in how they respond to changes in the value of the assets.

Additional examples

21. These examples illustrate some of the ideas explored in Agenda Paper 10I, in particular the distinction we are trying to draw between assessments of liquidity and solvency. We have tried to use the same instruments we have identified in that Agenda Paper to show how a distinction based on the settlement requirements or the value requirements of the obligation might affect each assessment.
22. We have included examples of the following:
- (a) Solvency:
 - (i) Example 1—A simple example illustrating the effect of cash-settled debt on the assessment of solvency.
 - (ii) Example 2—A variation of Example 1 switching the cash-settled debt with share-settled debt (ie an obligation to deliver a variable number of shares equal to a fixed value).
 - (iii) Example 3—A variation of Example 1 switching the cash-settled debt with puttable shares (ie an obligation to deliver a variable amount of cash equal to the value of common shares).
 - (iv) Example 4—A variation of Example 1 switching the cash-settled debt with an obligation to issue a fixed number of shares.

- (b) Liquidity:
- (i) Example 5—A simple example illustrating the effect of cash-settled debt on the assessment of liquidity.
 - (ii) Example 6—A variation of Example 4 switching the cash-settled debt with puttable shares (ie an obligation to deliver a variable number of shares equal to a fixed value).
 - (iii) Example 7—A variation of Example 4 switching the cash-settled debt with share-settled debt (ie an obligation to deliver a variable number of shares equal to a fixed value).
 - (iv) Example 8—A variation of Example 4 switching the cash-settled debt with an obligation to issue a fixed number of shares.

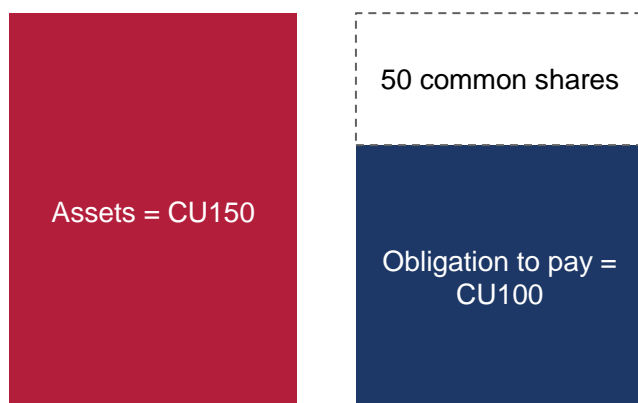
Solvency

Facts consistent across examples 1-4

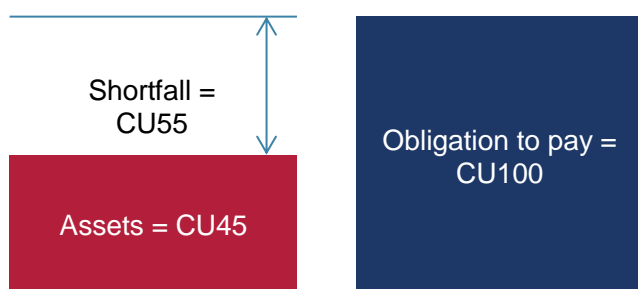
23. At the beginning of year 20X1, an entity has assets with a present value of CU150. **All of these assets are cash in the bank or immediately marketable securities measured at fair value.** The entity has no other recognised or unrecognised assets (including goodwill). The entity also has 50 shares outstanding. These examples ignore the time value of money.
24. At the end of 20X1, the value of the entity's assets drops to CU45 (a loss of CU105). Both the markets for the entity's assets and the credit and other capital markets (in general) remain liquid.
25. Assume that the entity will receive no further cash in exchange for any of the obligations in the examples.

Example 1: Cash-settled debt

26. The entity has an obligation which requires payment of **CU100 due at the end of 20X1**.



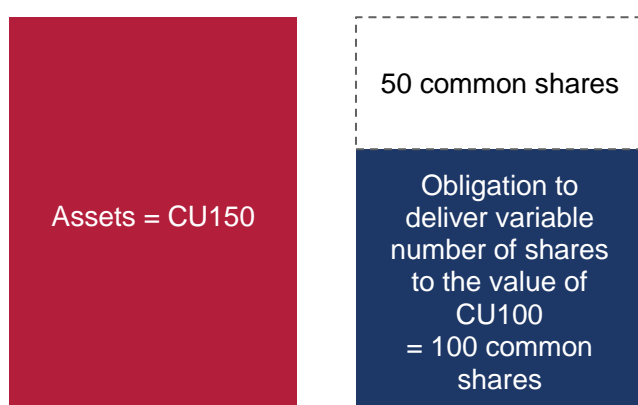
27. At the end of 20X1, the value of the entity's assets drops to CU45.



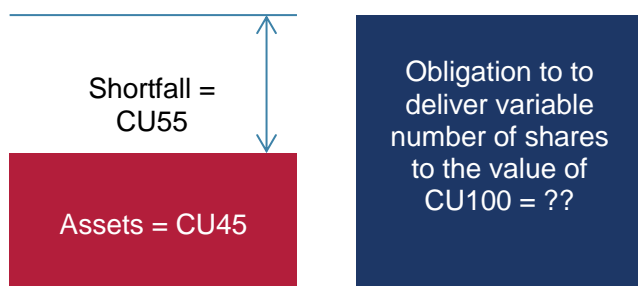
28. The entity has a shortfall of CU55 between the value of its assets and its obligation to pay CU100. Thus, the entity will try to find additional resources to meet its obligations otherwise it will need to enter liquidation (essentially settling its obligation by putting all its assets to the holder of the obligation). Potential providers of resources will expect a negative return on any new investment they make (to plug the shortfall first) and so are unlikely to provide the entity with additional resources.

Example 2: Share-settled debt

29. The entity has an obligation of CU100 to be settled by issuing a variable number of the entity's common shares with a total value of CU100. The number of shares to be issued depends on the share price immediately before settlement. If the share price at that date is the same as the share price at the beginning of 20X1, the entity would need to issue 100 shares to settle the obligation at (CU150 – CU100 = CU50/50 shares = CU1 value per share).



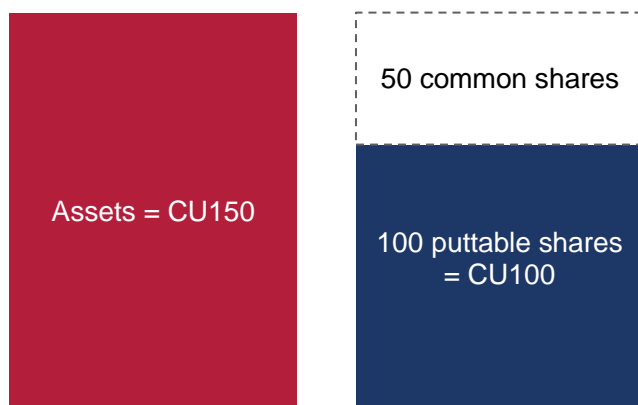
30. At the end of 20X1, the value of the entity's assets drops to CU45.



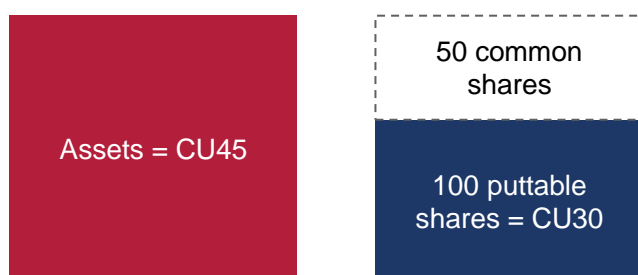
31. Just as in Example 1, at the end of 20X1 the entity will not be able to meet the obligation. This is because the obligation requires the entity to transfer a value beyond what its assets will support. In both situations, the entity cannot transfer a value beyond the value of its recognised and unrecognised economic resources. The entity will also face the same problems in obtaining finance, and for the same reasons, as in Example 1.

Example 3: Puttable shares

32. The entity has an obligation to deliver a variable amount of cash equal to the value of 100 common shares. When it delivers the cash, it will cancel a fixed number of shares.



33. At the end of 20X1, the value of the entity's assets drops to CU45. Therefore, the value of each common share and each puttable share drops to CU0.30.

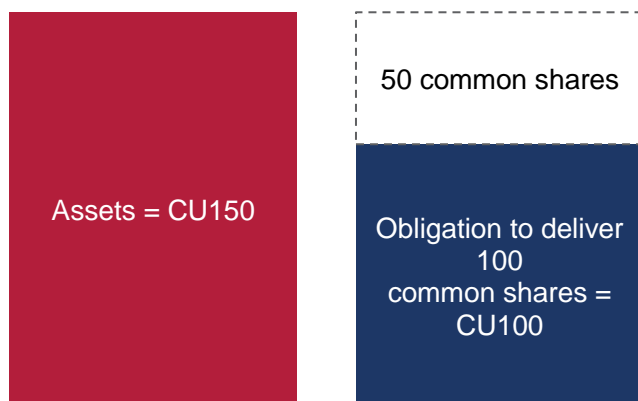


34. At the end of 20X1, the value of the entity's obligation to pay cash equal to the value of the common shares will change in the same way as the entity's share price. Thus, the entity will be able to meet its obligation at the end of 20X1.
35. The obligation to pay out an amount equal to the value of common shares will result in a transaction at the end of 20X1 that will reduce total assets. In these examples, we have assumed all of these assets are cash in the bank or immediately marketable securities measured at fair value. Therefore, there will be little to no implications for other claim holders of such an event. However, if the characteristics of the assets were different, or if the entity requires a given amount

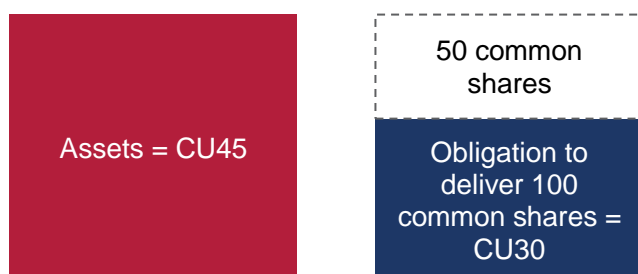
of operating capacity, such an obligation will affect other claim holders. We consider these effects in examples 5-8 illustrating liquidity.

Example 4: Fixed number of shares

36. The entity has an obligation to deliver a fixed number of 100 shares.



37. At the end of 20X1, the value of the entity's assets drops to CU45. Therefore, as in Example 3, the value of each common share and each obligation to deliver a share drops to CU0.30.



38. At the end of 20X1, the value of the entity's obligation to deliver a fixed number of shares will change in the same way as the entity's share price.
39. Unlike the obligation to pay cash equal to the value of common shares in Example 3, the obligation to deliver shares does not affect the assets of the entity, thus there are no solvency or liquidity consequences of such an obligation. The effect will be equivalent to the entity being financed entirely by 150 common shares from the beginning.

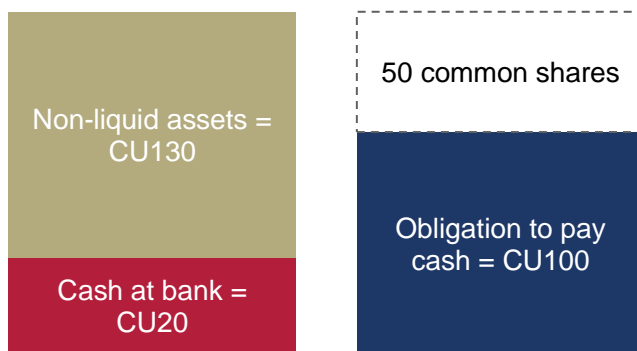
Liquidity

Facts consistent across Examples 5-8

40. At the beginning of year 20X1, an entity has assets with a present value of CU150. Of those assets **it only has cash of CU20 in the bank**. The rest of its assets are **not immediately convertible to cash**. The entity has 50 common shares outstanding.

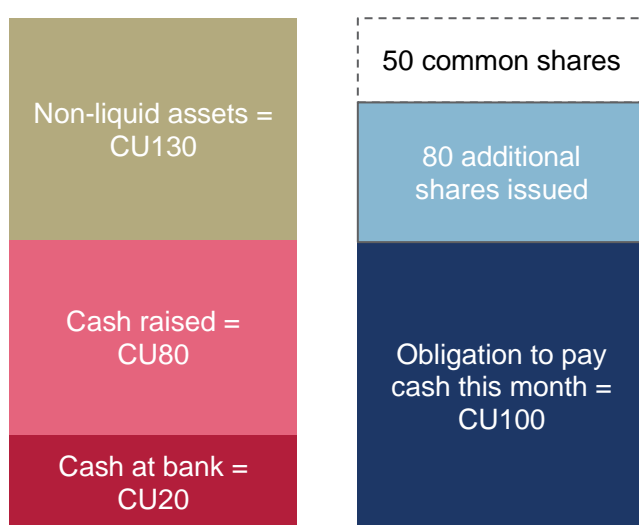
Example 5: Cash-settled debt

41. The entity has an obligation at the beginning of 20X1 to pay **CU100 in cash at the end of 20X1**.



42. At the end of 20X1, there are no changes to the value of the entity's assets, or in their marketability.
43. The entity will have a cash shortfall of CU80 compared to what it needs to settle its obligation. The value of the entity's assets exceed the value of the entity's obligations by CU50, however the lack of 'liquid' assets is a problem and could lead the entity to default on its obligations. This indicates that the entity needs to raise some additional resources.
44. If the entity has access to credit or other capital markets, the surplus of its assets of CU50 over its liabilities would be expected to give the entity the ability to borrow money or issue shares to obtain the cash it requires to pay its obligation (at some transaction cost). For example, a lender could lend the entity CU80 (at some interest rate to compensate for risk and the time value of money) with a maturity that matches the expected conversion of the entity's illiquid assets into cash.

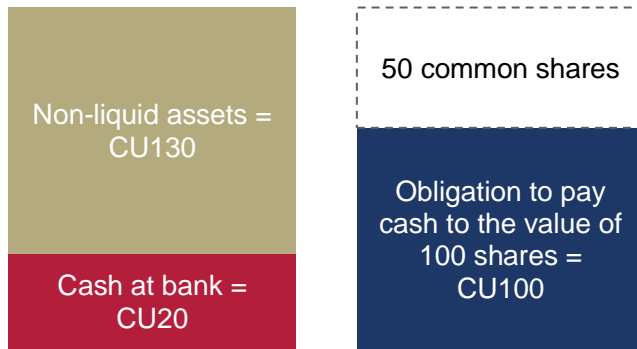
45. In this example, let's assume the entity issues 80 additional common shares at fair value in exchange for cash.



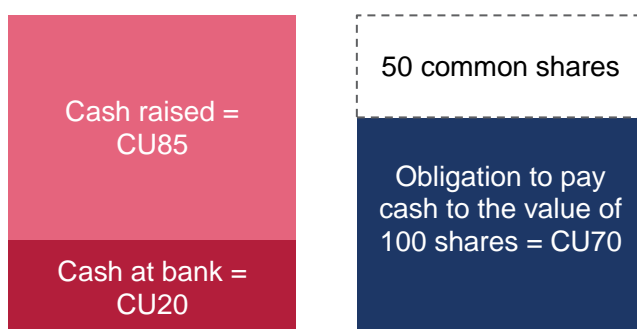
46. After raising the required capital, the entity would be able to meet its obligation, after which, its non-liquid assets would be totally funded by common shares. The entity would no longer face liquidity issues in the future.
47. If the entity is unable to obtain additional financing (because the market for finance is not liquid) it could attempt to sell its illiquid assets on the market. However, selling the assets on the market might result in the entity obtaining a lower value of economic resources in exchange than it would have if the entity converted its assets into cash as it had intended. If the value of the entity's economic resources falls below the value of the obligations, the entity will not be able to meet its obligations and will no longer be solvent. This illustrates how a liquidity problem can result in a solvency problem. If the illiquid assets are necessary for its operations, then the entity will effectively need to wind up its business.

Example 6: Puttable shares

48. The situation in Example 5 could be problematic even if the entity's obligations to pay cash change in value to match changes in the value of its assets.
49. In this example the entity has an obligation at the beginning of 20X1 to pay cash equal to the fair value of 100 shares at the end of 20X1.



50. At the end of 20X1, there are no changes to the value of the entity's assets, or their marketability.
51. The entity still has a shortfall in cash of CU80 compared to what it needs to settle its obligation. Because the value of the obligation is dependent on the value of the entity's share price, the (economic) value of its assets can never fall below the (economic) value of its obligations. However the lack of 'liquid' assets is a problem and could lead the entity to default on those obligations.
52. Just as in Example 5, the entity may have the ability to borrow money or issue shares to obtain the cash it requires to pay its obligation. However, in this example, let us assume that those markets are not liquid and therefore the entity tries to sell its assets on the market to obtain the necessary cash.
53. Assume that the entity incurs a loss of CU45 converting its non-liquid assets into cash. Therefore, the value of each common share and each puttable share drops to CU0.35.

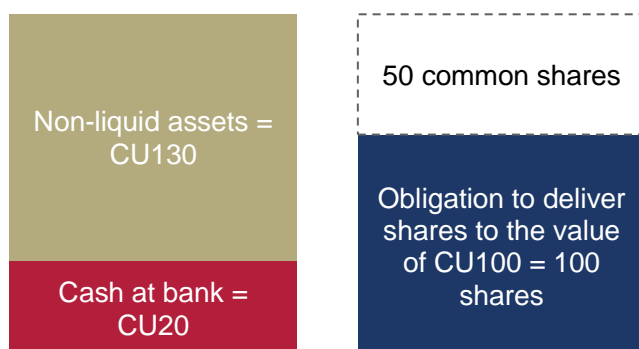


54. Because the (economic) value of the entity's obligation depends on the value of its shares, the value of the obligation falls with the value of the shares and, in this case, the liquidity problem does not lead to a solvency problem. However, if the

illiquid assets are necessary for its operations, then the entity will need to wind up its business.

Example 7: Share-settled debt

55. The entity has an obligation to deliver a variable number of shares with a value of CU100.



56. In this situation, because the liability will be settled in own shares, the liquidity of the entity's assets is not a problem. Therefore, regardless of the liquidity of those assets, the entity will be able to meet its obligation.
57. The end result will be similar to the situation in Example 5 where the entity could be expected to resolve its liquidity problems by issuing additional shares in exchange for cash. However the issuance of the shares in example 7 is prearranged (automatic), reducing the liquidity risk the entity faces compared to Example 5.

Example 8: Fixed number of shares

58. The entity has an obligation to deliver a fixed number of 100 shares.
59. Just as in Example 4, the obligation to deliver shares does not affect the assets of the entity, thus there are no solvency or liquidity consequences of such an obligation. The effect will be equivalent to the entity being financed entirely by 150 common shares from the beginning.