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STAFF PAPER

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Project	Conceptual Framework
Paper topic	Feedback summary—Elements of financial statements—Liabilities and equity

CONTACTS	Joan Brown	jbrown@ifrs.org	
	Manuel Kapsis	mkapsis@ifrs.org	+44 (0)20 7246 6459

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Accounting Standards Advisory Forum, April 2016, Agenda paper 2F

Purpose of paper

1 This paper is one of three papers that summarise feedback on Chapter 4 of the Exposure Draft *Conceptual Framework for Financial Reporting* (‘the Exposure Draft’).

2 Chapter 4 of the Exposure Draft identifies and defines five elements of financial statements. This paper summarises feedback on the definitions and supporting guidance for two of the elements—liabilities and equity.

Agenda paper	Definitions discussed
10D	Asset
10E (this paper)	**Liability** **Equity**
10F	Income, expenses Undefined elements

3 This paper provides a high-level summary of the comments received. Where appropriate, we will provide more detail at future meetings.

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Summary of key messages

4 Many respondents broadly agreed with the proposed definitions of a liability and of equity. Some respondents expressed a view that the Board should give high priority to addressing the problems that arise in classifying financial instruments with characteristics of both liabilities and equity. However, most of those respondents agreed with the Board's decision to explore those problems in a separate project on financial instruments with characteristics of equity, so as not to delay other improvements to the *Conceptual Framework*.

5 Many respondents broadly agreed with the proposed description of a 'present obligation'. Those respondents included most of the users of financial statements, regulators, standard-setters, accounting firms, and accountancy bodies responding, and most of the preparers of financial statements *except* banks. Most of the banks responding disagreed with the proposed description, expressing particular concern about the implications for the classification of claims as liabilities or as equity.

6 Even among respondents who broadly agreed with the proposed description of a present obligation, there were some who expressed concerns that the description, or aspects of the accompanying guidance, would be difficult to interpret and implement. Some respondents suggested that the Board should conduct further work to test the robustness and implications of the guidance.

Structure of paper

7 This paper covers feedback on:

(a) the definition of a liability (paragraphs 8-14).

(b) guidance on the meaning of the term 'present obligation' (paragraphs 15-30).

(c) other guidance supporting the definition of a liability (paragraphs 32-40):

(d) the definition of equity and guidance supporting that definition (paragraphs 41-55).

Definition of a liability

Exposure draft proposals *(paragraph 4.24, BC4.45-BC4.47 and BC4.101)*

8 The Exposure Draft proposed that:

> 4.24 A liability is a present obligation of the entity to transfer an economic resource as a result of past events.

9 The Exposure Draft explained that the Board is not proposing now to change the definitions of liabilities and equity to address the problems that arise in classifying instruments with characteristics of both liabilities and equity. It is exploring those problems in its Financial Instruments with Characteristics of Equity research project. That project will help the Board to decide, in due course, whether it should add to its standards-level programme a project on amending IFRS Standards, the *Conceptual Framework* or both. The Exposure Draft stated that the Board expects that any such project would not lead to changes in the Exposure Draft's proposals for identifying whether the reporting entity has a present obligation to transfer an economic resource. Those proposals are not designed to address problems in distinguishing between liabilities and equity.

10 The Exposure Draft asked respondents whether they agreed with the proposed definitions and the supporting guidance (excluding issues relating to the distinction between liabilities and equity).

Summary of feedback

Feedback common to both the definitions of both an asset and a liability

11 The main aspects of the proposed liability definition are similar to those of the proposed asset definition: neither definition requires 'expected' inflows or outflows; both definitions refer to a 'present' right or obligation; both link that right or obligation to the entity; and both refer to the right or obligation being 'a result of past events'. Consequently, many of the comments on the asset or liability definitions

applied to both of the definitions. And most respondents who broadly agreed (or disagreed) with the proposed asset definition also broadly agreed (or disagreed) with the proposed liability definition. Feedback that is common to both definitions is summarised in Agenda Paper 10D *Feedback summary—Elements of financial Statements—Assets*.

Feedback specific to the definition of a liability

12 However, some respondents who agreed with the proposed changes to the asset definition did not agree with the proposed changes to the liability definition. Most of those respondents said they thought that the Board should either:

(a) make no changes to the liability definition until it has completed its project on Financial Instruments with the Characteristics of Equity; or

(b) address the distinction between liabilities and equity in the *Conceptual Framework* project.

There is more discussion of comments on the interaction between the two projects in paragraphs 48-50 below.

13 Some of those respondents were concerned in particular about:

(a) the guidance on the meaning of 'no practical ability to avoid' in paragraph 4.32 of the Exposure Draft and the discussion of economic compulsion in paragraphs BC4.73-BC4.75 of the Basis for Conclusions. See paragraphs 20-30 below.

(b) the statement in paragraph 4.30 of the Exposure Draft that an obligation of an entity to transfer its own equity claims to another party is not a liability. See paragraphs 38-40 below.

14 An accountancy body suggested that the definition of a liability should include both present obligations and 'certain other planned future outflows arising from past events'. This suggestion is explained further in paragraph 24(d) below.

Guidance on meaning of the term 'present obligation'

Exposure Draft proposals (paragraphs 4.31-4.39 and BC4.48-BC4.75)

15 The Exposure Draft proposed that:

> 4.31 An entity has a present obligation to transfer an economic resource if both:
>
> (a) the entity has no practical ability to avoid the transfer; and
>
> (b) the obligation has arisen from past events; in other words, the entity has received the economic benefits, or conducted the activities, that establish the extent of its obligation.

16 The Exposure Draft proposed additional guidance on the meaning of the phrase 'no practical ability to avoid':

> 4.32 An entity has no practical ability to avoid a transfer if, for example, the transfer is legally enforceable, or any action necessary to avoid the transfer would cause significant business disruption or would have economic consequences significantly more adverse than the transfer itself. It is not sufficient that the management of the entity intends to make the transfer or that the transfer is probable.

17 The Basis for Conclusions explained the three different descriptions of a present obligation that the Board had considered when developing the Exposure Draft, and the Board's reasons for choosing the description proposed in the Exposure Draft (View 2). The other two descriptions were:

(a) a *narrower* description, which would restrict a 'present obligation' to legally enforceable, unconditional obligations (View 1); and

(b) a *broader* definition, which would encompass all possible future transfers resulting from past events, with the probability of the outflow being taken into consideration in deciding whether to recognise and how to measure the liability (View 3).

18 The Basis for Conclusions stated that the proposed description of a present obligation would help to resolve questions about whether ‘economic compulsion’ is sufficient to create a liability:

> BC4.75 The IASB thinks that [the two criteria specified in the description of a present obligation] make it clear that:
>
> (a) economic compulsion may be a factor that reduces the entity’s practical ability to avoid a future transfer—so it would need to be considered in assessing whether that criterion is met; but
>
> (b) economic compulsion on its own cannot create a present obligation—there is also the requirement for the obligation to have arisen from a past event (receiving economic benefits, or conducting activities, that establish the extent of the entity’s obligation).

19 The Exposure Draft asked respondents whether they agreed with the proposed description of a present obligation and the proposed guidance to support that description.

Summary of feedback

20 Many respondents commented on the proposed description of a present obligation. Of those who expressed an overall view, many expressed general agreement with the description. Few respondents thought that the Board should have instead developed a narrower (View 1) or broader (View 3) description of a present obligation.

21 Those expressing general agreement included:

(a) most of the users of financial statements, regulators, standard-setters, accounting firms, and accountancy bodies expressing an overall view; and

(b) most of the preparers of financial statements expressing an overall view, *except* banks and organisations representing banks. Most of the (predominantly European) banks and organisations representing banks expressing a view *disagreed* with the proposals.

22 The banks and organisations representing banks expressed concerns about the implications of the term ‘no practical ability to avoid’ in identifying liabilities. They tended to refer in particular to the implications for the classification of claims as liabilities or as equity. Some expressed particular concern about the role that economic compulsion might play in identifying liabilities, for example in the classification of instruments with a right of termination for the issuer or step-up clauses. Others referred in particular to the possibility of a change in the classification of the shares of co-operative entities. Some of the banks were also concerned that the consequences of applying the proposed guidance to some levies were unclear (see paragraphs 26(a) and 27(a) below).

23 In contrast to the banks, the Basel Committee on Banking Supervision expressed support for economic compulsion playing a role in classification decisions. It said that, although it recognised the risks that would arise if the door were opened inappropriately to economic compulsion, it was concerned that the inability to take economic compulsion into account when distinguishing between liabilities and equity can result in instruments that will have the same economic consequences for the issuer being accounted for very differently.

24 Others who disagreed with the proposed description of a present obligation gave a variety of reasons, and suggestions for alternatives:

(a) some respondents from Australia and New Zealand (including two standard-setters, a preparer of financial statements and an accountancy body), observed that liabilities must be present claims against the entity’s assets, ie that there must be another party or parties (which could be the public at large) that is or are entitled to receive, or benefit from, the future transfer of economic resources, and that would suffer harm if the entity failed to meet its obligations. Those respondents expressed a view that, by focusing on the entity’s practical ability to avoid a future transfer, the proposed description of a present obligation could encompass items that are not present claims—items such as

future asset maintenance costs, future salaries and future operating losses.[1] The standard-setters suggested that:

i) the proposed criteria should be replaced by a discussion of the characteristics of a present obligation; and

ii) the discussion should focus more on determining whether another party has a present claim against the entity's assets, rather than on whether a future transfer of resources can be avoided.

(b) one accounting firm and a few academics and individuals argued for a *narrower* description of a present obligation, akin to the View 1 description explored in the Discussion Paper. They would restrict the description to legally enforceable obligations, which would be consistent with the conclusions reached by the Interpretations Committee in IFRIC 21 *Levies*.

(c) a user of financial statements, an academic and an individual argued for a *broader* description of a present obligation, more akin to the View 3 approach explored in the Discussion Paper:

i) the user of financial statements thought that the definition of a liability should include all obligations that arise from past events and will *probably* result in an outflow of economic resources. That user thought that the guidance explaining the meaning of 'no practical ability to avoid' is too restrictive: the statement that 'any action necessary to avoid the transfer … would have economic consequences significantly more adverse than the transfer itself' is a high hurdle, which could result in liabilities not being recognised in a timely manner.

[1] *Staff note* The proposals in the Exposure Draft were not intended to encompass such items. Paragraph 4.39 of the Exposure Draft states that an entity does not have a present obligation for the costs that will arise if it will receive benefits, or conduct activities, in the future (for example, the costs of future operations); …

ii) an academic organisation suggested that, at a conceptual level, the definition of a liability should include *all* obligations that arise from past events. Those respondents suggested that the Board could include pragmatic restrictions within Standards to prevent preparers from having to identify obligations that were unlikely to result in a future outflow, many of which would be measured at nil.

(d) a European accountancy body also favoured a broader definition of a liability. But, rather than try to broaden the description of a *present obligation*, that accountancy body would define a liability to include both present obligations (legal and constructive) and 'certain other planned future outflows arising from past events'. The body stated that the latter category would cover expenses such as levies, bonuses and some pension costs that are incurred in earning the income of the accounting period, but that do not necessarily give rise to what can be regarded as a 'present obligation', in the ordinary sense of these words, at the reporting date.

(e) a few standard-setters and preparers of financial statements (from diverse geographical locations) opposed the proposed description on practical grounds. They thought that the description—especially the meaning of the term 'no practical ability to avoid'—was not sufficiently clear and could result in misinterpretation, subjective interpretations, diversity in practices, or unwelcome outcomes. Some suggested that, if the objective of the new guidance is to resolve problems with levies, that objective could be achieved more easily and without risking wider unintended consequences, by amending IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* or IAS 34 *Interim Financial Reporting*.

25 Even among respondents who broadly agreed with the proposed description, or expressed no overall view, there were some—from all regions and including users and preparers of financial statements, regulators, standard-setters, accountancy bodies and accounting firms—who expressed concerns that the description, or aspects of the accompanying guidance, would be difficult to interpret and implement. Most of those respondents were specifically concerned about difficulties in interpreting the term 'no practical ability to avoid'. Respondents suggested that:

(a) there will be substantial subjectivity involved, particularly in assessing whether 'any action necessary to avoid the transfer would cause significant business disruption or would have economic consequences significantly more adverse than the transfer itself'. Distinguishing transfers that an entity has no practical ability to avoid from others that are likely to be economically advantageous will be difficult. There is a scale of possibilities, not a clear cut-off point, assessments could change over time, and different stakeholders could make different assessments. The subjectivity could lead to selective interpretation by preparers of financial statements.

(b) more guidance is needed. Some respondents acknowledged that transaction-specific guidance could be included in individual IFRS Standards. However, others appeared to think that the guidance should be in the *Conceptual Framework*, one accounting firm explicitly stating it thought that the development of further guidance should *not* be deferred to individual Standards.

(c) the guidance should explain more fully the role of economic compulsion, and how the words 'significant' and 'significantly' should be interpreted. A few respondents suggested moving the discussion of economic compulsion from the Basis for Conclusions to the body of the *Conceptual Framework*.

(d) the statement that the entity must have no practical ability to avoid a future transfer seems to contradict the statement (in paragraph 4.27 of the Exposure Draft) that it need not be certain, or even probable, that the obligation will require a transfer. It appears to be a higher hurdle than the 'expected' or 'probable' threshold used for recognition of liabilities at present.

(e) the meaning of 'no practical ability to avoid' seems to be essentially the same as that of 'no realistic alternative to settling' (which is used in IAS 37) or 'little, if any, discretion to avoid' (which is used in the existing *Conceptual Framework*). The requirements could be clearer if they used one of these more established phrases.

26 Some respondents thought that difficulties would arise in interpreting the past event criterion ('the entity has received the economic benefits, or conducted the activities, that establish the extent of the obligation') and that the guidance proposed in the Exposure Draft is insufficiently clear:

(a) a few standard-setters and a few accounting firms noted that the proposals do not provide a definitive answer for all transactions because there may be more than one event that could be regarded as the event that satisfies the description of a 'past event'. Some noted, for example, that it is unclear whether obligations to make variable payments for the purchase of a tangible or an intangible asset (or for a right of use, or for a business) arise when the entity receives the asset (or right of use, or business), or at a later date when the entity receives the benefits on which the variable payments are measured. Other respondents noted that there might be several different activities that establish the extent of some obligations to pay levies. Respondents suggested that the *Conceptual Framework* needs to give a clear answer for such transactions to ensure consistency in future IFRS Standards.

(b) a few respondents (mainly accountancy bodies) requested more guidance (perhaps including examples) to clarify in particular:

i) the impact of any further conditions, for example to be operating on a particular future date or to meet a specified threshold.

ii) the liabilities that arise from 'stand-ready' obligations. The requirement that the 'extent of an obligation' has been established could suggest that no liability exists while the amount of a future transfer remains uncertain and conditional on future events.

27 A few respondents thought that the proposed description could be interpreted in unwelcome or inappropriate ways that are inconsistent with existing requirements. For example, they suggested that the proposed description could lead to conclusions that:

(a) some entities have liabilities not only for levies chargeable for current year operations, but also for levies expected to be charged for several (or many) future years' operations if entities do not have the practical ability to withdraw from the relevant market quickly.

(b) the enactment of a law could be the past event that leads to recognition of liabilities for all future payments that will be required under that law.

(c) liabilities arise for potential payments under long-term incentive plans as soon as the plans commence.

(d) ordinary shares give rise to liabilities, because some entities have no practical ability to avoid dividend payments.

(e) entities have liabilities for future expenses that they will be economically compelled to incur, such as:

i) aircraft or other asset maintenance obligations; and

ii) the future operating losses of a start-up company.

(f) entities cannot have liabilities for future restructuring costs because the obligations to pay restructuring costs do not arise from past activities.

(g) liabilities should be recognised for obligations arising from executory contracts.

(h) deferred tax balances do not meet the definitions of assets and liabilities.

28 The staff plan to analyse these suggestions for a future Board meeting.

29 Some respondents thought that, before the Board finalises the proposed guidance, it should conduct further work to test the robustness and implications of the guidance. Those respondents are geographically spread and include a regulator, accounting firms, standard-setters and preparers of financial statements. Specific further work suggested by respondents included:

(a) a thorough analysis of how the proposed guidance can be reconciled to, or conflicts with, existing Standards, and in particular:

i) how the proposed concepts fit with those in IAS 37;

ii) an explanation of why the Board has not identified some of the transactions listed in paragraph 27 as transactions for which existing requirements are inconsistent with the *Conceptual Framework* proposals.

(b) a fuller analysis of the practical implications of the proposed descriptions (and related guidance) for a range of transactions.

30 Although many respondents suggested that *more* guidance is needed in the *Conceptual Framework*, a few respondents suggested that there should be *less* guidance—the *Conceptual Framework* should set out the high-level concepts only. A few respondents specifically suggested removing paragraphs 4.32 and 4.33, which interpret the term ‘no practical ability to avoid’. One accountancy body thought that the *Conceptual Framework* should not define the term ‘past event’. It thought that the proposed definition could fail to encompass liabilities that arise through inaction.

Other guidance supporting the definition of a liability

31 The Exposure Draft asked respondents whether they had any other comments on the guidance proposed in Chapter 4. Regarding the guidance supporting the liability definition, respondents commented on:

(a) the correspondence between assets and liabilities (paragraphs 32-35);

(b) non-reciprocal transactions (paragraphs 36-37); and

(c) obligations of an entity to transfer its own equity claims (paragraphs 38-40).

Correspondence between assets and liabilities

Exposure Draft proposals (paragraphs 4.25-4.26 and BC4.76-BC4.80)

32 The Exposure Draft proposed that:

> 4.25 If one party has an obligation to transfer an economic resource (a liability), it follows that another party (or parties) has a right to receive that economic resource (an asset). The party (or parties) could be a specific person or entity, a group of people or entities, or society at large.
>
> 4.26 A requirement for one party to recognise a liability (or asset) and measure it at a specified amount does not imply that the other party must recognise the corresponding asset (or liability) or measure it at the same amount. Applying different recognition criteria or measurement requirements to the liability (or asset) of one party and the corresponding asset (or liability) of the other party may sometimes be an outcome of the decisions intended to meet the objective of financial reporting.

Summary of feedback

33 A few—mainly European—respondents expressed explicit support for including in the *Conceptual Framework* the statement that if one party has a liability another has an asset.

34 However, some other respondents—again mainly European—suggested that the statement should be omitted from the *Conceptual Framework*:

(a) a few questioned whether the statement always holds true. They identified decommissioning and other environmental obligations as examples of obligations that they think might not have corresponding assets. A few suggested that, even if the other party had a right to receive the economic resource, it might not control that right. For example, it is arguable whether society at large has the ability to direct, or prevent all other parties from directing, the use of the economic resource that arises from an entity's enforceable obligation to provide public goods.

(b) some respondents questioned the usefulness of, or need for, a definitive statement about symmetry given that:

i) they do not think it sheds any further light on the definition of a liability; and

ii) it would often relate to assets that holders would often be unaware they possessed and need not recognise. Respondents suggested that the *Conceptual Framework* should not imply that entities need to look for such assets.

(c) a few respondents expressed concern that the proposal could have unintended consequences, including illogical and imprudent changes in requirements. They suggested that, for example, entities might no longer be able to recognise liabilities for legal fees associated with a restructuring until the legal services had been provided, because until then, no lawyer would have a right to payment.

35 A few respondents commented on the statement that 'applying different recognition criteria or measurement requirements to the liability (or asset) of one party and the corresponding asset (or liability) of the other party may sometimes be an outcome of the decisions intended to meet the objective of financial reporting':

(a) a few European respondents supported this statement, suggesting that it was an acknowledgement of the role of prudence and asymmetry in recognition criteria. One suggested that the statement may not go far enough—different recognition criteria are required not just ‘sometimes’ but ‘more often than not’.

(b) a few respondents from South America and Oceania disagreed with the statement on the grounds that it conflicts with the notion of neutrality. One thought that the wording was ‘vague and unhelpful’ and ought to be explained better, but noted that a clearer statement may run counter to the qualitative characteristic of neutrality.

Non-reciprocal transactions

Exposure Draft proposals

36 The Exposure Draft contained no discussion of the assets and liabilities that arise in non-reciprocal (non-exchange) transactions.

Summary of feedback

37 A few respondents—including some accounting firms—think that the *Conceptual Framework* should include concepts specifically for non-reciprocal transactions such as donations, income taxes, value added taxes and other taxes and levies. Respondents suggested that:

(a) non-reciprocal transactions can be an important feature of business activity and the most appropriate concepts for those transactions are not necessarily the same as the concepts developed in the *Conceptual Framework*, which tend to assume commercial exchange transactions.

(b) IFRIC 21 demonstrates why such transactions need to be considered separately and urgently. IFRIC 21 does not give any guidance on the circumstances in which the cost of a levy should be recognised as an expense or an asset. It refers to the requirements of other IFRS Standards, but there are no other IFRS Standards that specifically address non-exchange payments.

Obligations of an entity to transfer its own equity claims

Exposure Draft proposals (paragraph 4.30 and BC4.47)

38 The Exposure Draft proposed that:

> 4.30 An equity claim does not contain an obligation to transfer economic resources. Furthermore, an equity claim is not an economic resource for the issuer. It follows that an obligation of an entity to transfer its own equity claims to another party is not an obligation to transfer an economic resource.

Summary of feedback

39 Some respondents disagreed with the inclusion of this paragraph in the *Conceptual Framework*. They noted the statement in the Invitation to Comment that the Exposure Draft proposals are not designed to address problems in distinguishing between liabilities and equity—these problems are being explored in a separate project. Respondents expressed concern that paragraph 4.30 implies that that an entity would never classify as a liability an obligation to transfer its own equity instruments, even if the obligation required the transfer a variable number of equity instruments with a fixed total value. They noted that such a requirement would be inconsistent with existing requirements, and suggested that the proposal is pre-judging the outcome of the project to distinguish liabilities from equity.

40 Some respondents thought that paragraph 4.30 implied that share-based payments would not be recognised as an expense in the income statement because an obligation to make such payments would not be classified as a liability.

Definition of equity and guidance supporting that definition

Exposure Draft proposals *(paragraphs 4.43—4.47 and BC4.93—BC4.103)*

41 The Exposure Draft proposed that:

> 4.43 Equity is the residual interest in the assets of the entity after deducting all its liabilities.

42 The Exposure Draft further proposed that:

- (a) equity claims are claims against the entity that do not meet the definition of a liability;
- (b) different equity claims convey to their holders different rights to, for example, receive some or all of the following:
  - i) dividends;
  - ii) the repayment of contributed equity on liquidation; or
  - iii) other equity claims;
- (c) to provide useful information, it may be necessary to divide the total carrying amount of equity to reflect differences between equity claims; and
- (d) the definition of equity applies to all types of entities.

43 The Basis for Conclusions on the Exposure Draft:

- (a) explained why the Exposure Draft proposed to:
  - i) continue to make a binary distinction between liabilities and equity;
  - ii) continue to define equity as the residual interest in the assets of the entity after deducting all its liabilities; and
  - iii) continue to allow the separate presentation of different classes and categories of equity to provide useful information to users.

(b) explained that the Exposure Draft did not include any proposed changes to the definition of a liability or of equity to address problems with the classification of claims with the characteristics of both liabilities and equity.

(c) explained why the Board decided to further explore how to distinguish between liabilities and equity in its research project on Financial Instruments with Characteristics of Equity.

Alternative views (paragraphs AV8-AV14)

44 Two Board members voted against the publication of the Exposure Draft because they disagreed with the limited nature of the changes proposed to the definition of a liability. In their view, the Board should have more fully considered changes to the definition of a liability to address the classification of claims against the entity as liabilities or equity. The two Board members thought that the distinction between liabilities and equity is an issue that:

(a) is not adequately addressed or explained in the current *Conceptual Framework* and should have been addressed in order to meet the objective of this project.

(b) is fundamental to reporting the effects of financial instruments with characteristics of both debt and equity. The classification has a fundamental effect on the reporting of an entity's financial position and financial performance.

45 The two Board members acknowledged that the Board has decided to consider the distinction between liabilities and equity in the Financial Instruments with Characteristics of Equity research project. However, they noted that the research project is primarily a Standards-level project, and is largely intended to focus on the current application questions that have arisen in relation to IAS 32 *Financial Instruments—Presentation*, instead of being used to develop concepts with a broader focus.

Summary of feedback

46 Question 3(c) of the invitation to comment on the Exposure Draft asked respondents whether they agreed with the proposed definition of equity, excluding issues relating to the distinction between liabilities and equity.

47 Less than half of the total respondents to the Exposure Draft responded to this question directly. Of those that responded to the question directly:

(a) many respondents agreed with the proposed definition of equity. Of those that agreed with the proposals:

i) some agreed without providing any rationale.

ii) some agreed tentatively, pending the further work that will be undertaken as part of the Financial Instruments with Characteristics of Equity project (see paragraphs 48-50).

iii) a few agreed with the definition of equity as a residual interest, but expressed concerns regarding the application of the proposed definition of a liability to the classification of claims between liabilities and equity. Their comments are included among those on the liability definition and guidance that are summarised earlier in this paper

(b) some respondents disagreed with the proposed definition of equity. Of those:

i) some disagreed because, in their view, equity should be defined independently of assets and liabilities (see paragraphs 51–55).

ii) one standard-setter disagreed because, in its view, dividing claims into three elements of financial statements would meet the objectives of financial reporting better than dividing them into only two (liabilities and equity).

iii) some disagreed because they think that the Board should consider the consequences of the proposed changes to the definitions of liabilities on the classification of claims as liabilities or equity before finalising the *Conceptual Framework* (see paragraph 50(b)).

(c) a few commented without explicitly stating a position. Some of these comments included suggested changes to the definition of equity and accompanying guidance.

Interaction with the FICE project

48 Many respondents, reflecting a broad cross-section of both geography and type of respondent, mentioned the interaction between:

(a) the proposed changes to the definition of a liability in the Exposure Draft; and

(b) the further work being undertaken as part of the Financial Instruments with Characteristics of Equity project.

49 Many of those respondents think that the Board should give high priority to addressing the problems that arise in classifying financial instruments with characteristics of both liability and equity, either within the *Conceptual Framework* project or within a separate project. Some of those respondents expressed concerns about the consequences of finalising the Exposure Draft without considering those problems further in one of the two projects. Their particular concerns were that:

(a) as noted by the Board members expressing alternative views, the classification of claims as liabilities or equity has a fundamental effect on the reporting of an entity's financial position and financial performance.

(b) the proposed changes to the definition of a liability have not been considered in the context of the distinction between liabilities and equity.

(c) the Board has not fully considered the conclusion in paragraph 4.30 of the Exposure Draft, ie that an obligation to deliver a variable number of shares is not a liability.

50 While most of those respondents suggested that the Board undertake further work as part of the Financial Instruments with Characteristics of Equity project, there were different views on whether the Board should delay the *Conceptual Framework* project and await the outcome of the Financial Instruments with Characteristics of Equity project:

(a) most of the respondents that supported further work on the distinction between liabilities and equity agreed with the Board's rationale that worthwhile changes to the *Conceptual Framework* should not be held up by that work. However, many of these respondents suggested that the *Conceptual Framework* should be updated at a later date to reflect the outcomes of that project.

(b) some of the respondents that supported further work on the distinction between liabilities and equity expressed the view that the Board should await the outcome of that work before finalising the revised *Conceptual Framework*. These respondents argued that:

   i) conclusions regarding the distinction between liabilities and equity will have consequences for the proposed definition of a liability.

   ii) the distinction is a fundamental part of the *Conceptual Framework* and any changes may have consequences for other areas, such as performance reporting, capital maintenance and measurement.

Alternative definitions of equity

51 Some respondents, reflecting various types and geographies, suggested that equity should be defined independently of assets and liabilities. In support of such an approach respondents suggested that:

(a) defining equity as the difference between assets and liabilities is inconsistent with the definition of those elements as rights and obligations; it assumes some degree of measurement.

(b) equity is not a claim, it is the entity's own funds, and should be defined by reference to capital contributed and retained.

(c) if equity is a claim against the entity, then the obligation it imposes on the entity must have some characteristics that can be identified.

52 Respondents representing co-operative entities and credit unions suggested that the definition of equity should include some of the characteristics that are particular to members’ shares in co-operative entities and credit unions, such as:

(a) the characteristics identified in IFRIC 2 *Members’ Shares in Co-operative Entities and Similar Instruments*;

(b) whether the claim is most residual and able to absorb losses, regardless of the entity’s limited obligation to redeem;

(c) the structure of voting rights; and

(d) the way in which the entity conducts its business activities.

53 Other respondents suggested that some of the other characteristics of claims which might be used in a potential definition of equity might include:

(a) loss absorption;

(b) the exposure to risks of variable returns;

(c) the characteristics of different categories of reserves (such as whether reserves are distributable);

(d) ownership.

54 One standard-setter disagreed with the proposed binary distinction between liabilities and equity. In addition to defining equity independently, it proposed a ‘three-category approach’ which distinguishes between:

(a) the most residual claim, which would be classified as equity;

(b) claims that constitute present obligations, which would be classified as liabilities; and

(c) claims that are neither equity nor liabilities, which would be classified in a mezzanine category.

55 In that standard-setter’s view, the ‘three-category approach’ would better meet the objectives of:

(a) distinguishing transactions or events that give rise to income or expenses from transactions with owners in their capacity as owners; and

(b) providing information about the solvency of the entity.