STAFF PAPER

April 2016

IASB Meeting

Project	**Conceptual Framework**
Paper topic	Approach to redeliberations—Concepts for liabilities and equity

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

Purpose of paper

1. This paper considers approaches for developing concepts on liabilities and equity.

2. Specifically, this paper considers whether the Board should continue to follow the approach that it proposed in the Exposure Draft *Conceptual Framework for Financial Reporting* ('the Exposure Draft'). The Exposure Draft included concepts to address some problems in identifying liabilities, but did not include concepts to address challenges that arise in classifying financial instruments with characteristics of both liabilities and equity.

Staff recommendations

3. The staff recommend that the Board continues to follow the approach that it proposed in the Exposure Draft. The details of the recommendations are set out in paragraphs 4 and 5 below.

Regarding concepts to address challenges in classifying financial instruments

4. The staff recommend that, consistent with the proposal in the Exposure Draft, the Board:

   (a) does *not* develop concepts to address challenges that arise in classifying financial instruments with characteristics of both liabilities and equity as part of the *Conceptual Framework* project;

   (b) instead, continues to develop concepts to address those challenges in the Financial Instruments with Characteristics of Equity research project, acknowledging that one outcome of that project might be a need to make further amendments to the revised *Conceptual Framework*; and

   (c) explains this approach, and highlights the possibility of further amendments to the *Conceptual Framework*, in the Basis for Conclusions accompanying the revised *Conceptual Framework*.

   See paragraphs 6-20 below.

Regarding concepts to address other problems in identifying liabilities

5. The staff recommend that:

   (a) the Board continues to develop concepts to address other problems in identifying liabilities (such as the concepts describing a 'present obligation' in paragraphs 4.31-4.39 of the Exposure Draft), and add those concepts to the *Conceptual Framework*, as part of the *Conceptual Framework* project; and

   (b) in developing those concepts, the Board considers refinements to the proposals in the Exposure Draft to reduce the risk of adding to the *Conceptual Framework* new concepts that it may need to revisit as a result of future decisions on classification of financial instruments.

   See paragraphs 21-37 below.

Concepts to address challenges in classifying financial instruments

6. This section considers the approach for developing concepts to address challenges that arise in classifying financial instruments with characteristics of both liabilities and equity. This section is structured as follows:

   (a) Exposure Draft proposals (paragraphs 7-11)

   (b) Summary of feedback (paragraphs 12-14)

   (c) Staff analysis (paragraphs 15-19)

   (d) Staff recommendation (paragraph 20).

Exposure Draft proposals

7. The Exposure Draft did not propose any concepts to address challenges that arise in classifying financial instruments with characteristics of both liabilities and equity. However, the Exposure Draft discussed the matter in:

   (a) the Basis for Conclusions; and

   (b) the Alternative Views section.

Basis for Conclusions (paragraphs BC4.93-BC4.101)

8. The Basis for Conclusions on the Exposure Draft:

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

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

   (c) explained that the research project will consider various approaches to distinguishing between liabilities and equity, including approaches that could require changes to the definitions of a liability or equity in the *Conceptual Framework*. The Board would use the output from that project when it decided, in due course, whether to add to its active agenda a project to amend the relevant Standards, the *Conceptual Framework*, or both. Any decision to start an active project would require the Board to go through its normal due process for adding a project to its agenda.

(d) suggested that the research project was unlikely to result in changes to the proposals in the Exposure Draft that focus on identifying whether the reporting entity has a present obligation to transfer an economic resource. Those proposals were not designed to address challenges in distinguishing between liabilities and equity.

Alternative views (paragraphs AV8-AV14)

9. 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 considered the potential changes to the definition of a liability to address the distinction between liabilities and equity. This is because:

(a) the distinction between liabilities and equity is not adequately addressed or explained in the current *Conceptual Framework*. In failing to consider this, a fundamental conceptual issue remains unaddressed.

(b) the distinction between liabilities and equity is fundamental to reporting the effects of financial instruments with characteristics of both liabilities and equity, including the reporting of an entity's financial position and financial performance.

10. The two Board members acknowledged that the Board had decided to consider the distinction between liabilities and equity in the Financial Instruments with Characteristics of Equity research project. However, they noted that that 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.

11. The full text of the Alternative Views is presented in Appendix A.

Summary of feedback

12. Many respondents to the Exposure Draft, 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.

13. Many of those respondents think that the Board should give high priority to addressing the challenges that arise in classifying financial instruments with characteristics of both liabilities 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 challenges 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.

14. 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.

Staff analysis

15. The Board is currently considering challenges with the distinction between liabilities and equity as part of the Financial Instruments with Characteristics of Equity research project. The next stage of that project is likely to be the publication of a Discussion Paper that explores the advantages and disadvantages of alternative ways of making the distinction.

16. The starting point of the research project is IAS 32. As we have noted in the past, there are existing inconsistencies between the requirements in IAS 32 and the *Conceptual Framework* definitions of a liability and of equity. The Board will consider as part of the Financial Instruments with Characteristics of Equity research project whether any changes are required to the proposed definitions of a liability and of equity in the *Conceptual Framework.* It is expected that the forthcoming Discussion Paper for the Financial Instruments with Characteristics of Equity research

project will include an analysis of the potential consequences for the *Conceptual Framework* of the alternative ways of making the distinction.

17. Based on the completion of that research, and the responses to that forthcoming Discussion Paper, the Board will need to decide whether to add a project to its Standards-level programme to amend IAS 32 and whether any further changes are needed to the *Conceptual Framework*. If the Board decides to address the challenges with distinguishing between liabilities and equity as part of the *Conceptual Framework* project, that research would still need to be completed and the Board would need to expose the outcome of that research for comment.

18. A consequence of confirming the approach proposed in the Exposure Draft will be a revised *Conceptual Framework* that:

    (a) will be less complete, because it will not include a discussion of the challenges of distinguishing between liabilities and equity to help the Board in future deliberations on the topic.

    (b) will not provide a basis to resolve the existing inconsistencies between the *Conceptual Framework* definitions of liabilities and equity and the definitions applied in IAS 32.

19. However, in the staff's view, this approach is consistent with the Board's overall approach for the project, which is to make worthwhile improvements to the *Conceptual Framework* on a timely basis. Because the Financial Instruments with Characteristics of Equity research project is at an early stage (the next due process step is likely to be a Discussion Paper), awaiting the outcome of that project could introduce a significant delay to finalising other improvements to the *Conceptual Framework*.

Staff recommendation

20. The staff recommend that, consistent with the proposal in the Exposure Draft, the Board:

    (a) does *not* develop concepts to address challenges that arise in classifying financial instruments with characteristics of both liabilities and equity as part of the *Conceptual Framework* project;

    (b) instead, continues to develop concepts to address those challenges in the Financial Instruments with Characteristics of Equity research project, acknowledging that one outcome of that project might be a need to make further amendments to the revised *Conceptual Framework*; and

    (c) explains this approach, and highlights the possibility of further amendments to the *Conceptual Framework*, in the Basis for Conclusions accompanying the revised *Conceptual Framework*.

Question 1—concepts to address challenges in classifying financial instruments with characteristics of both liabilities and equity
Do you agree with the staff recommendation in paragraph 20?

Concepts to address other problems in identifying liabilities

21. The previous section of this paper discussed the approach for addressing challenges that arise in classifying financial instruments with characteristics of both liabilities and equity. If the Board agrees with the staff recommendations in that section—ie, if it decides not to develop concepts to address those challenges as part of the *Conceptual Framework* project—a second question arises.

22. That second question concerns the approach for developing concepts to address *other* problems in identifying liabilities—such as the concepts describing a 'present obligation' proposed in paragraphs 4.31-4.39 of the Exposure Draft. The Board developed those concepts to help it analyse various transactions (such as levies) for which there has been debate about *when* a liability arises. However, because the Board has proposed that the definition of a liability will also be used to distinguish between liabilities and equity, there is a risk that those new concepts on identifying liabilities could also affect classification of financial instruments.

23. The question is whether the Board should:

    (a) proceed with the Exposure Draft proposal to add the new concepts on identifying liabilities to the *Conceptual Framework* as part of the *Conceptual Framework* project; or

    (b) wait and add the concepts to the *Conceptual Framework* when the Board makes other changes resulting from its work on Financial Instruments with Characteristics of Equity.

24. This section considers that question. It:

    (a) summarises relevant Exposure Draft proposals (paragraphs 25-27);

    (b) explains concerns raised by respondents (paragraphs 28-29);

    (c) considers two approaches for addressing those concerns (paragraphs 30-35); and

    (d) recommends one of those approaches (paragraphs 36-37).

Exposure Draft proposals

25. Chapter 1 of the *Conceptual Framework* notes that the statement of financial position of an entity provides information about the economic resources of the entity and the claims against the entity.[1] The *Conceptual Framework* identifies two types of claim against an entity: liabilities and equity claims. The Exposure Draft proposed to define a liability as ‘a present obligation of the entity to transfer an economic resource as a result of past events’, and to make no changes to the existing *Conceptual Framework* definition of equity (‘the residual interest in the assets of the entity after deducting all its liabilities’).[2]

26. The Exposure Draft proposed additional concepts to support the definition of a liability. Among other things, the Exposure Draft proposed that:
    (a) an entity has a present obligation to transfer an economic resource if:
        (i) the entity has no practical ability to avoid the transfer; and
        (ii) 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.[3]
    (b) 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.[4]

27. The Basis for Conclusions explained the Board’s view on the role that economic compulsion could play in identifying a present obligation. It stated the Board’s view that:

1 Paragraph OB12.
2 Paragraph 4.4.
3 Paragraph 4.31.
4 Paragraph 4.32.

(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).[5]

Concerns raised by respondents[6]

28. Some banks and organisations representing banks commented on the proposed description of a present obligation. Unlike many other respondents, most of those banks and organisations disagreed with the proposed description. They expressed particular concerns about the 'no practical ability to avoid' criterion proposed in paragraph 4.31 of the Exposure Draft, often referring to the implications of that term for the classification of claims as liabilities or as equity. Some referred in particular to 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.

29. 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.

5 Paragraph BC4.75.

6 Paragraphs 22-23 of Agenda Paper 10E *Feedback summary—Elements of financial statements—Liabilities and equity*, IASB meeting, March 2016

Alternative approaches for addressing those concerns

30. At its meeting in March 2016, the Board noted the concerns raised by the banks and organisations representing banks. Board members suggested possible approaches for addressing those concerns.

Defer the concepts developed to address problems in identifying liabilities

31. One approach would be:

    (a) to finalise revisions to the *Conceptual Framework* without adding concepts to address problems in identifying liabilities—and in particular without adding the concepts describing a present obligation proposed in paragraphs 4.31-4.39 of the Exposure Draft; and

    (b) to continue to refine those concepts in parallel with the project on Financial Instruments with Characteristics of Equity, adding the finalised concepts to the *Conceptual Framework* when the Financial Instruments with Characteristics of Equity project is complete, at the same time as any other changes to the *Conceptual Framework* resulting from that project.

32. In support of this approach it can be argued that:

    (a) because the Board proposes to use the definition of a liability to distinguish between liabilities and equity, concepts that affect the scope of the definition of a liability inevitably also affect the scope of the definition of equity. Consequently, adding any new concepts on the definition of a liability would be inconsistent with the Board's decision not to address the challenges of distinguishing between liabilities and equity claims as part of this project.

    (b) the Board has developed the concepts proposed in the Exposure Draft primarily to assist in identifying when some (particularly non-financial) liabilities arise. The Board has not considered whether those concepts are appropriate for decisions about classification of financial instruments. Responses to the Exposure Draft indicate that some of the concepts might not be appropriate for such decisions—there are, for example, different views on whether economic compulsion should be taken into account. The Board should consider these questions before finalising the concepts it has developed to date. Otherwise, the Board's decisions in its project on Financial Instruments with Characteristics of Equity (which it has decided will not be constrained by concepts in the revised *Conceptual Framework*) may result in requirements that are inconsistent with those concepts.

(c) if the Board wished to eliminate any such inconsistencies, it would have to amend (or possibly even remove from the *Conceptual Framework*) some of the concepts that it had developed as part of the *Conceptual Framework* project when it completed its project on Financial Instruments with Characteristics of Equity. The Board should not add concepts to the *Conceptual Framework* now in the knowledge that it may wish to amend or remove those concepts in the not too distant future.

(d) changes to the concepts supporting the liability definition will have implications for both the Board and its stakeholders. Change management could be easier and more efficient if those concepts are changed only once. (However, the change management benefits might not be very significant: whether changed once or twice, the concepts supporting the liability definition would be changed at the same time as other revisions are made to the *Conceptual Framework*, and would have little direct effect on preparers of financial statements, because the changes to the concepts would not change the requirements of existing IFRS Standards.)

Refine the concepts developed to address problems in identifying liabilities

33. An alternative approach would be:

(a) to continue to develop the concepts proposed to address problems in identifying liabilities (including the concepts describing a 'present obligation' in paragraphs 4.31-4.39 of the Exposure Draft), and add those concepts to the *Conceptual Framework*, as part of the *Conceptual Framework* project; and

(b) in developing those concepts, consider refinements to the proposals in the Exposure Draft to reduce the risk of adding to the *Conceptual Framework* new concepts that the Board may need to revisit as a result of future decisions on classification of financial instruments.

34. When it considers refinements to the *Conceptual Framework* proposals, the Board could take into account any progress made by that time in its project on Financial Instruments with Characteristics of Equity. The Board could prioritise some topics for early consideration in that project. One topic that it could start to consider early could be the role (if any) of economic compulsion in assessing options within a financial instrument.

35. In support of the approach outlined in paragraph 33, it can be argued that:

(a) it ought to be possible to draft the concepts developed to explain the term 'present obligation' in a way that reduces the risk of inconsistencies between the *Conceptual Framework* and the Board's future decisions on classification of financial instruments. The Board has developed the concepts to help it analyse various transactions for which there has been debate about whether a liability exists, and if so why. Such transactions include, for example, transactions of rate-regulated entities, transactions resulting from pollutant pricing mechanisms and levies. In each case, the difficulty has been identifying whether, and if so when, there is a present claim against the entity—it has been clear for such transactions that, if and when there is a present claim against the entity, that claim is a liability, not an equity claim. The concepts have been designed to help identify the point at which a claim arises, not the nature of that claim; and the context in which the concepts have been developed (and so should be applied) could be made clearer in the drafting.

(b) the concepts explaining the term 'present obligation' are needed now. Projects for which these concepts could be particularly relevant include the current projects on rate-regulated activities and pollutant pricing mechanisms, and the possible project to amend IAS 37 *Provisions, Contingent Liabilities and*

Contingent Assets and IFRIC 21 *Levies*. Deferring the concepts until completion of the project on Financial Instruments with Characteristics of Equity could detrimentally affect those projects. For each project, the Board would have to decide whether to defer making decisions, or to continue the project without agreed concepts to support decisions and ensure consistency between Standards.

Staff recommendation

36. For the reasons set out in paragraph 35, the staff recommend the second approach, as outlined in paragraph 33.

37. Specifically the staff recommend that:

(a) the Board continues to develop concepts to address problems in identifying liabilities (such as the concepts describing a 'present obligation' in paragraphs 4.31-4.39 of the Exposure Draft), and add those concepts to the *Conceptual Framework*, as part of the *Conceptual Framework* project; and

(b) in developing those concepts, the Board considers refinements to the proposals in the Exposure Draft to reduce the risk of adding to the *Conceptual Framework* new concepts that it may need to revisit as a result of future decisions on classification of financial instruments.

Question 2—concepts to address other problems in identifying liabilities
Do you agree with the staff recommendation in paragraph 37?

Appendix A—Alternative views (paragraphs AV8–AV14)

AV8 Ms Lloyd and Mr Finnegan voted against the publication of the Exposure Draft because they disagree with the limited nature of the changes proposed to the definition of a liability (see paragraphs BCIN.25 and BC4.93–BC4.103). Ms Lloyd and Mr Finnegan agree that the definition of a liability should be used to distinguish between liabilities and equity. However, Ms Lloyd and Mr Finnegan believe that the IASB should have more fully considered changes to the definition of a liability to address the classification of claims against an entity as liabilities or equity. Ms Lloyd and Mr Finnegan think that the Exposure Draft should have included either:

(a) the IASB's conclusion that the definition of a liability that is being proposed is suitable for distinguishing between liabilities and equity; or

(b) additional changes to the definition of a liability that would make it suitable for such a purpose.

AV9 The objective of the *Conceptual Framework* project is to improve financial reporting by providing a more complete, clear and updated set of concepts. Ms Lloyd and Mr Finnegan believe that the distinction between liabilities and equity is an issue that:

(a) is not adequately addressed or explained in the current Conceptual Framework; and

(b) is fundamental to reporting the effects of financial instruments with characteristics of both debt and equity.

AV10 Ms Lloyd and Mr Finnegan believe that the lack of adequate concepts in the current *Conceptual Framework* is evidenced both by inconsistent application of the existing definitions of equity and liability in Standards and in inconsistencies between these definitions in the *Conceptual Framework* and in Standards. In particular, this is the case for more complex financial instruments that have characteristics of both liabilities and equity. For example, the classification of a financial instrument differs between IFRS 2 *Share-based Payments* and IAS 32 *Financial Instruments: Presentation* if the entity has an obligation to deliver a variable number of equity instruments equal to a specified amount (ie if it uses its own shares as 'currency' to settle the instrument). IAS 32 also includes a limited-scope exception from the definition of a liability for some puttable instruments that represent a residual interest in the entity.

AV11 As a result of responses to the recent financial crisis and to continuing financial innovation, increasingly complex financial instruments with characteristics of both debt and equity have been, and are continuing to be, created. Ms Lloyd and Mr Finnegan believe that there is a need to more fully consider how to classify such financial instruments to meet the information needs of investors, lenders and other creditors and to consider whether the existing definitions of equity and liability meet those information needs. Ms Lloyd and Mr Finnegan acknowledge that additional information can be provided through alternative presentation and disclosure requirements, and welcome further development of such requirements. However, Ms Lloyd and Mr Finnegan believe that the classification of claims as liabilities or equity has a fundamental effect on the reporting of an entity's financial position and financial performance. For financial performance in particular, classification is particularly important, because the definitions of income and expenses only include changes in claims if they are classified as liabilities.

AV12 Ms Lloyd and Mr Finnegan believe the *Conceptual Framework*'s definition of a liability and, as a consequence, of equity, need to be reconsidered in the light of these issues. In particular, Ms Lloyd and Mr Finnegan believe that the *Conceptual Framework* should more fully address whether and why the definition of a liability should or should not include:

(a) an obligation to deliver a variable number of equity instruments equal to a specified amount (ie when an entity uses its own shares as 'currency'); and

(b) an obligation to transfer a variable amount of cash or other economic resources equal to the value of an equity instrument.

AV13 Ms Lloyd and Mr Finnegan therefore disagree with the decision not to address the distinction between liabilities and equity in the Exposure Draft. They believe that, in failing to consider this, a fundamental conceptual issue for the classification of financial instruments is not addressed. Without reconsidering this distinction, including the effect on an entity's financial performance, Ms Lloyd and Mr Finnegan believe that the *Conceptual Framework* will fail to achieve the stated objective of 'assist[ing] the IASB to develop the Standards' when the issues at the Standards level relate to financial instruments that have characteristics of both liabilities and equity.

AV14 Ms Lloyd and Mr Finnegan acknowledge that the IASB has decided to consider the distinction between liabilities and equity in the Financial Instruments with Characteristics of Equity research project. However, the *Conceptual Framework* is intended to provide a basis for developing and revising Standards and Ms Lloyd and Mr Finnegan therefore believe that this analysis is better placed in the *Conceptual Framework* project. The research project is primarily a Standards-level project. A Standards-level project should ideally be based on applying or making considered departures from the *Conceptual Framework*, instead of being used to develop concepts that may subsequently be considered as changes to the *Conceptual Framework*. In addition, Ms Lloyd and Mr Finnegan believe that it will be more difficult to consider fundamental changes to the distinction between liabilities and equity in the research project than in the *Conceptual Framework* project. This is because the *Conceptual Framework* project will not necessarily result in subsequent changes at a Standards level and the research project is largely intended to focus on current application questions that have arisen in relation to IAS 32. Thus, by undertaking the analysis of the distinction between liabilities and equity in the *Conceptual Framework* project, it could be more aspirational and have a broader focus. Ms Lloyd and Mr Finnegan are also concerned that by considering this issue within the context of the research project, there will be a detrimental effect on the timeliness with which the IASB will be able to consider potential revisions or interpretations of existing Standards that deal with the distinction between liabilities and equity.