IFRS™

STAFF PAPER

February 2015

IASB Meeting

Project	**Financial Instruments with Characteristics of Equity research project**
Paper topic	Presentation: Subclasses of liabilities including presenting income and expense arising from particular types of liabilities

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Introduction

1. In prior meetings we have acknowledged that a single distinction between liabilities and equity can only achieve so much. Even if we make that distinction as useful as it can be, the population of claims is so wide, with such a variation in features, that it is impossible for a single distinction to convey all of the similarities and differences between claims.

2. This is why the IASB decided that the objective of this project should include exploring potential improvements to presentation and disclosure in addition to improvements to the distinction between liabilities and equity alone.

3. The objective of this paper is to consider whether the IASB should use **subclasses of *financial* liabilities** to provide additional information that will be useful to:

   (a) Assessing financial performance—by presenting separately income and expense arising from particular subclasses of liabilities, including considering whether that separate presentation should be accomplished by using the distinction between profit or loss and other comprehensive income.

   (b) Assessing financial position—through the presentation of different subclasses on the face of the statement of financial position, or within different subtotals within total liabilities. We also consider the arrangement of items on the face of the statement of financial position.

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4. As noted in Agenda Paper 5, we will focus on the **Gamma approach**, and show how Alpha and Beta might differ by comparison.

5. Based on our analysis in this paper, in our preliminary view under the Gamma approach[1]:

   (a) it will useful to present income and expense arising from liabilities for a specified amount that is not independent of the entity (ie those liabilities that do not promise a return independent of the entity) in other comprehensive income (OCI). This is because presenting this income and expense separately will help users compare the return on the entity's economic resources to its promised returns independent of those resources in profit or loss. Income and expense presented in OCI should not be reclassified in subsequent periods.

   (b) it will be useful to present liabilities for a specified amount that is not independent of the entity separately on the statement of financial position (within total liabilities). This is because differentiating these liabilities from other liabilities that promise a specified amount will help users assess the extent to which its liabilities respond to changes in its economic resources.

   (c) one class of instrument that the presentation requirements in (a) and (b) will be useful for is a share redeemable at fair value[2] (an obligation that requires the entity to transfer economic resources other than at liquidation for an amount equal to the fair value of a claim to a pro-rata share of the entity's net assets on liquidation).

6. If the IASB agrees with the preliminary views above, at future meetings we will consider extending these presentation requirements to other classes of liabilities with similar features.

7. Furthermore, the staff suggest that, in addition to arranging claims by order of liquidity on the statement of financial position, entities should be permitted (or

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[1] As discussed in paragraphs 74–82, these staff preliminary views would also apply to the Alpha Approach; however they would not apply to the Beta Approach.

[2] Assuming that it is not subject to the puttables exception.

required if most relevant) to present claims in order of priority. Classes of liabilities and equity can be arranged by order of **priority** within other arrangements (eg current/non-current), or additionally the alternative presentation can be presented within the notes if this is relevant information.

Structure

8. This paper is structured as follows:

   (a) Background and scope (paragraphs 9–18)

   (b) Financial performance (paragraphs 19–55)

   (c) Financial position (paragraphs 56–73)

   (d) Preliminary views for approaches Alpha and Beta (paragraphs 74–82)

   (e) Appendix A—Summary of relevant requirements in IAS 1 and IFRS 9

Background and scope

9. Agenda Paper 5 includes a summary of the IASB's discussion to date, including:

   (a) the features of claims that we have identified as relevant;

   (b) the various assessments of financial position and financial performance that users might make using information about those features; and

   (c) the three approaches that we identified for making the distinction between liabilities and equity, each focusing on different sets of features and assessments.

10. In June 2015, we stated that because information about features may influence different types of assessments that users need to make, we may need to develop requirements other than the distinction between liabilities and equity to deliver information about those differences. The tools we have available to provide information about those differences include:

    (a) Recognition and measurement—different recognition requirements or measurement bases;

(b) Presentation—the inclusion of the amounts measured in different totals and sub-totals in the statement of financial position and statements of performance;

(c) Disclosure—additional information about those features to be disclosed in the notes to the financial statements.

11. This paper focuses on identifying subclasses of *financial* liabilities[3] that will provide additional information through different presentation requirements[4], that will be useful to:

(a) Assessing financial performance—by presenting separately income and expense arising from particular subclasses of liabilities, including considering whether that separate presentation should be accomplished by using profit or loss and other comprehensive income.

(b) Assessing financial position—through the presentation of different subclasses or within different subtotals within total liabilities.

12. In this paper, we look at whether the identified economic phenomena should be presented separately **if it were recognised and measured**. We have assumed existing recognition and measurement requirements will continue to apply (for example that financial liabilities will continue to be recognised and measured in accordance with IFRS 9).

13. In a future paper we will consider:

(a) whether additional information to be provided through disclosure; and

(b) the puttables exception in IAS 32 in the context of the three approaches we are exploring. There may be additional considerations that are

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[3] The scope of this project is claims that are financial instruments. The **type** of resources required to be transferred (ie cash or another financial asset) is what makes the claim a *financial* liability, hence we do not consider subclasses of liabilities that oblige the entity to transfer different types of resources. IFRS Standards already have requirements for many of these different types of liability.

[4] IAS 32 *Financial Instruments*: *Presentation* does not include any presentation requirements for subclasses of liabilities or of equity. However, IAS 1 *Presentation of Financial Statements* does have some requirements (see Appendix A) and so does IFRS 9 *Financial Instruments*. We have not examined whether the staff preliminary views regarding subclasses of liability or of equity would be better included in IAS 1 or IAS 32.

applicable to claims that meet the puttables exception, because that exception includes various other features.

14. We are also aware of the IASB's primary financial statements project and will monitor that project for any developments that might cause us to reconsider our analysis.

15. Approach Gamma focuses the distinction between liabilities and equity on both

    (a) the **timing** of required settlement which is relevant to assessing the extent to which the entity is expected to have the economic resources required when it is required to transfer them; and

    (b) the **amount** of economic resources required to settle the claim, which is relevant to assessing the extent to which the entity has:

        (i) sufficient economic resources to satisfy the total claims against it if they were all to be settled at a point in time; and

        (ii) produced a sufficient return on its economic resources to satisfy the promised return on claims against it.

16. Approach Gamma will classify as a liability obligations:

    (a) to transfer economic resources **prior to liquidation**; or

    (b) for an **amount of economic resources independent** of the entity's economic resources.

17. Thus, approach Gamma captures within liabilities claims with two different features that are relevant for different assessments:

    (a) For many claims classified as liabilities under Gamma, such as ordinary bonds, both features are present.

    (b) However, for other claims, only one or the other features are present. This creates a tension within the liability classification because some claims might have features that are relevant for one assessment and not the other.

18. In the following sections, we look at how separate presentation of the types of claims in paragraph 17(b) may improve assessments of financial performance and financial position.

Financial performance

19. One of the main consequences of the distinction between liabilities and equity is that changes in the carrying amounts of liabilities are income or expenses, whereas changes in the carrying amounts of equity are not.

20. Furthermore, in its recent Exposure Draft *Conceptual Framework for Financial Reporting* (the Conceptual Framework ED) the IASB proposes:

    (a) that income and expenses included in profit or loss are the primary source of information about an entity's financial performance for the period.

    (b) a rebuttable presumption that all income and expenses should be included in profit or loss unless excluding them would enhance the relevance of the information in that statement for the period.

    (c) a rebuttable presumption that income and expense included in other comprehensive income in one period will be reclassified into the statement of profit or loss in a future period.

21. In July 2015, we stated that identifying claims that promise a predetermined return is relevant to assess an entity's financial performance. This is because it will help a user:

    (a) compare the returns the entity has produced on its economic resources to the promised returns of the entity's claims (for example, similar to an interest coverage ratio).

    (b) show any surplus or deficit in returns on economic resources after the promised returns are deducted. For convenience, we call this the **residual return** because it depends on both the return on the economic resources, and the promised returns on other claims.

22. Because approach Gamma will classify as a liability a claim with either one of two features (amount and timing), two different types of income and expense will be captured[5]:

    (a) Changes in the carrying amount arising from promised returns, which will meet the objective of the assessment in paragraph 21 (for example, changes arising from interest accretion on ordinary bonds, cumulative preference shares, and share-settled bonds); and

    (b) Changes in the carrying amount that depend on residual returns[6], which will not meet the objective of the assessment in paragraph 21 because they include the effect of changes in economic resources (for example, changes in shares redeemable at fair value).

23. We stated in July 2015 that we are interested in changes in the carrying amount of claims *other* than those changes resulting from contributions of resources from claim holders, or distributions of resources to claim holders. Thus the **type** of economic resource required for settlement, and the **timing** of required settlement, are simply features that determine **when** the distributions of resources will occur, and **what** form that distribution will take, consequently those features are relevant for assessments of financial position, but are not relevant for assessments of financial performance. For example, both an ordinary share, and a share redeemable at fair value will have similar returns, and would result in equal outflows of resources if the entity extinguished both at the same time. However, one requires a distribution of resources at a particular point in time, whereas the other does not.

24. In July 2015, we also stated that a second-order assessment of financial performance would be to determine how any potential surplus or deficit in returns will be attributed amongst claims. The attribution of any surplus or deficit will be determined by the **priority** of the claim on liquidation.

[5] We note that this problem is not present in Approach Beta, which focuses solely on the amount feature. However, even within Approach Beta, additional information is required to show the priority of the returns. We discuss Approach Beta in further detail in paragraphs 79–82.

[6] These meet the definition of income and expense only because a transfer of economic resources is required other than at liquidation

25. The **priority** of the claim on liquidation is commonly referred to as the 'pecking order' or 'waterfall of returns' and is a result of the limited liability of claims (ie that the only source of economic resources to meet claims against the entity is the entity's present economic resources and the future economic benefits produced from them). For example:

    (a) If two claims against an entity have equal priority and other features, then they will participate equally in the prospects for future cash flows on its economic resources. So, for example, two similar junior bonds will yield similar interest, as would two similar senior bonds.

    (b) If all other features are equal, but they have different priorities, then they will not participate equally in the prospects for future cash flows. So, for example, a senior bond will yield a lower return than a junior bond.

26. Specifying the priority of claims modifies the prospects for future cash flows depending on the relative ranking of the claims with the following result:

    (a) For claims that specify an amount independent of the entity's economic resources there are two components of the change:

        (i) There will be the change in the carrying amount that results from the change in the reference amount (eg interest rate etc) over time.

        (ii) There will be the change in the carrying amount that results from the attribution of residual returns dependent on the relative priority of that claim. This is commonly referred to as a **change in its own credit risk**.

    (b) For claims that depend on the residual return, the attribution of residual returns will also be dependent on the relative priority of that claim (for example, ordinary shares would have a lower priority to non-cumulative preference shares).

27. Based on paragraph 26, the residual return also affects claims that promise an amount independent of the entity's resources. This is because, in the presence of limited liability, if there is a deficit in economic resources, this will need to be taken as a loss by those claims for a specified amount depending on their priority.

In other words, the residual return is allocated amongst all claims against the entity:

(a) surplus returns result in reductions in own credit risk and increases in claims that depend on the residual; and

(b) deficit returns result in increases in own credit risk and decreases in claims that depend on the residual.

28. In the staff's preliminary view, if a claim that depends on the residual is classified as a liability and is recognised and measured, it would be useful to distinguish and present separately changes in the carrying amount resulting from the attribution of residual returns from other income and expense. **This is because it will help a user make the assessment in paragraph 21 separately from the assessment of the attribution of residual returns.**

29. Our primary focus is on claims that do not promise a return that is independent of the entity's economic resources, but are classified as liabilities because of the requirement to transfer economic resources other than at liquidation (eg shares redeemable at fair value). For these claims, the changes in the carrying amount will be driven by changes in the entity's economic resources and changes in other claims that do promise some return.

30. The objective of the above analysis is not to suggest that all components related to changes in own credit risk of various liabilities need to be measured and presented separately. Neither is it to suggest that information about the attribution of residual returns to various claims is not useful to assessments of financial performance.

31. However, understanding the relationship and similarities between the various components as described in paragraphs 25–27 might help understand similar concerns with presenting the attribution of residual returns that meet the definition of income and expense. It will also help to understand the similarities with changes in the carrying amounts of other claims that do not meet the definition of income and expense. In Agenda Paper 5B, we consider whether financial statements should provide additional information about the attribution of residual returns to sub-classes of equity to help a user assess the entity's financial performance.

How do we present residual returns classified as income and expense under current requirements?

32. Typically, we do not directly measure the attribution of residual returns amongst claims. For example:

    (a) the amortised cost of a financial liability will not include changes in own credit risk.[7]

    (b) changes in the value of ordinary shares (or puttable instruments that meet the exception) are classified as equity and are not remeasured directly.

33. However, if we measure claims subsequently at fair value[8], then this will include the effect of the attribution of the residual returns. If the claims are also classified as liabilities, then the changes in the carrying amount of those claims will meet the definition of income and expense.

34. At present, we do directly measure the attribution of residual returns amongst claims in the following instances:

    (a) Fair value option for liabilities under IFRS 9; and

    (b) Shares redeemable at fair value classified as liabilities under IAS 32, including non-controlling interest shares that are redeemable at fair value.

35. Under IFRS 9, if we measure liabilities at fair value, then entities present changes in own credit risk in other comprehensive income.[9] The primary reason why the IASB required such a treatment for own credit risk was because (IFRS 9 BC 5.35):

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[7] However, if the liability is settled prior to maturity, part of the gain or loss may represent changes in own credit risk.

[8] This might be useful, for example, for claims that require the transfer of economic resources, measuring the claim at fair value provides information for other assessments, in particular about the financial position of the entity (see paragraphs 56–73).

[9] That requirement applies to all non-derivative liabilities measured at fair value unless it would create or enlarge an accounting mismatch in profit or loss. A mismatch could arise because the entire change in the fair value of the assets would be presented in profit or loss but only a portion of the change in the fair value of the liabilities would be presented in profit or loss.

> … many users and others told the IASB over a long period of time that changes in a liability's credit risk ought not to affect profit or loss unless the liability is held for trading. That is because an entity generally will not realise the effects of changes in the liability's credit risk unless the liability is held for trading.

36. For shares redeemable at fair value that meet the puttable shares exception under IAS 32, changes in that carrying amount are not presented as part of profit or loss or other comprehensive income. In September 2015 we noted that one of the concerns that led to the puttables exception was that, if such instruments were classified as liabilities, then changes in the carrying amount of the liability would be recognised in profit or loss. This would result in counterintuitive accounting (if the redemption value is linked to the performance of the entity) because:
    (a) when an entity performs well, the present value of the settlement amount of the liabilities increases, and a loss would be recognised; and
    (b) when the entity performs poorly, the present value of the settlement amount of the liability decreases, and a gain would be recognised.
37. However, the concerns regarding the recognition in profit or loss of changes in the carrying amount of puttable shares would still apply to shares redeemable at fair value if they are not the most residual claim, including non-controlling interest shares that are redeemable at fair value. It also echoes those concerns expressed in response to the May 2012 draft Interpretation on the accounting for puts written on non-controlling interests.
38. Recognising and measuring a change in the carrying amount of a claim that depends on the attribution of residual returns may also *appear* anomalous because of incomplete recognition of changes in assets. The changes in the value of the claims have occurred. However, they appear anomalous because the changes in the economic resources, which are the driver of the change in such claims, are not recognised, but we recognise the full effect of those changes on the claims.

39. We illustrate these issues in the following example:

Example 1

Assume an entity for which has economic resources for which there is an absolute change of CU100 in year 20X0. The entity is funded by ordinary bonds, for which interest of CU50 accrues during 20X0, and shares. Half of the shares are redeemable at fair value, and the other half are ordinary shares.

We show the effect when economic resources increase or decrease.

Summary of changes during 20X0

	Increase	*Decrease*
Increases/(decreases) in economic resources	100	(100)
Increases/(decreases) in claims:		
Interest on ordinary bond	50	50
Change in own credit risk of ordinary bond	10	(30)
Change in shares redeemable at fair value	20	(60)
Ordinary shareholders	20	(60)
Total increases/(decreases) in claims	100	(100)

Of the above changes in claims, the interest on the ordinary bond is independent of the changes in economic resources. The changes in the shares redeemable at fair value and ordinary shares are dependent on the residual returns.

Scenario A

All of the entity's economic resources are recognised as assets and are measured at fair value and the change in own credit risk and shares redeemable at fair value are recognised in profit or loss.

	Increase	*Decrease*
Changes in assets	100	(100)
Interest on ordinary bond	(50)	(50)
Change in own credit risk of ordinary bond	(10)	30
Shares redeemable at fair value	(20)	60
Total profit or (loss)	**20**	**(60)**

Scenario B

Only 70% of the changes in its economic resources are recognised and the change in own credit risk and shares redeemable at fair value are recognised in profit or loss.

	Increase		*Decrease*	
Changes in assets	70		(70)	
Interest on ordinary bond	(50)		(50)	
Change in own credit risk of ordinary bond		(10)		30
Shares redeemable at fair value		(20)		60
Total profit or (loss)	**(10)**		**(30)**	

In Scenario B, because we have not recognised the changes in all of its economic resources, but we have recognised the effect of those changes on some of its claims in full, in the case where the economic resources have actually increased it appears as though the entity has made a loss, whereas the loss appears less than it should really be for the case where the economic resources have decreased.

Presenting residual returns which are classified as income and expense

40. Income and expense that arises from recognising and measuring a claim that depends on the residual can either be presented separately:

    (a) as a separate item in profit or loss (paragraphs 41–42); or

    (b) as a separate item in OCI (paragraphs 43–44).

Presenting separately within profit or loss

41. The advantage of presenting income and expense separately in profit or loss is that it is consistent with the default requirement. Applying the proposals in the Conceptual Framework ED, because the claim meets the definition of a liability, income and expense arising from that claim should be included in profit or loss, unless excluding that income and expense will enhance the relevance of profit or loss for that period.

42. The disadvantage is that including income and expense that depends on the residual within profit or loss may not adequately separate out income and expenses that would be useful for the assessment in paragraph 20 from other income and expense that would be useful for assessing the attribution of residual returns. It might be difficult for a user to understand the relationship between, and disentangle, those various aspects of performance. In addition:

(a) we have not identified a particular assessment of an entity's financial performance, for which it would be relevant to include all those different components of income and expenses together.[10]

(b) if income and expense depends on the residual, it also means that it may depend on unrecognised changes in economic resources and claims. Presenting that income and expense, which includes the effect of unrecognised changes within profit or loss, while not including all of the changes that it is derived from, may not enhance the relevance of profit or loss as the primary and most inclusive source of information about an entity's financial performance..

Presenting separately in OCI

43. The advantage of presenting income and expense that depend on the residual separately in OCI is that it will clearly separate out income and expenses that would be useful for the assessment in paragraph 20 from other income and expense that would be useful for assessing the attribution of residual returns. This will help users separately assess to what extent the entity has produced a return sufficient to meet its promised returns, and to assess how any surplus or deficit is allocated amongst claims

(a) In addition:

(b) the effect of unrecognised changes in the entity's economic resources on income and expense that depends on the residual will not be included in profit or loss. This will enhance the relevance of profit or

[10] In contrast, we have identified the assessment of financial position for which including information about claims that require the transfer of economic resources would be relevant.

loss because it avoids apparent anomalies that would arise if income and expense is presented in profit or loss without recognising changes in the economic resources and claims that it depends on. the income and expense that depends on the residual is similar to changes in own credit risk, therefore it should be presented similarly.

(c) it will allow the use of a current measure if it is relevant to a user's assessment of the potential effect of such claims on the entity's financial position (in particular relating to its liquidity).

44. The disadvantages are that:

(a) we are using OCI for a new type of income or expense. While, in our view, the rationale is similar to changes in own credit risk, it is still expanding the use of other comprehensive income.

(b) entities may try to structure claims to meet the description of this new class in order to avoid reporting changes in the carrying amount of claims within profit or loss.

45. Based on the above, in our preliminary view under the Gamma approach (and Alpha approach)[11], it will be useful to present income and expense that depends on the residual return in OCI. We consider whether this income and expense should be reclassified to profit or loss in a future period in paragraphs 51–55.

46. In our preliminary view, these items income and expense should be clearly separated from other items of income and expense because the nature of the change in such claims is different; it is not because the changes in such claims might be volatile. If the promised return on a claim is specified by reference to a volatile underlying variable that is independent of the entity (eg a derivative), then the return on that claim will still be presented within profit or loss (if it is recognised).

47. To mitigate the disadvantages of such an approach, we need to be careful with any definition of the subclasses, or the component of the changes in liabilities, that such a requirement will capture.

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[11] See Appendix A

48. In our preliminary view, one class of instrument that the presentation requirements will be useful for is a share redeemable at fair value that is classified as a liability[12]. We could define such an instrument using some of the criteria for the existing puttables exception for similar instruments in IAS 32. [13] For example, we could define it as an obligation that requires the entity to transfer economic resources other than at liquidation for an amount equal to the fair value of a claim to a pro-rata share of the entity's net assets on liquidation.

49. At future meetings, we could consider whether the approach should be expanded to other claims:

    (a) which are classified as liabilities; and

    (b) the measurement includes changes in amounts dependant on the residual returns.

50. We illustrate the staff's preliminary view using the same facts as Example 1:

Example 1 presented based on staff preliminary view

Only 70% of the changes in its economic resources are recognised and the change in own credit risk and shares puttable at fair value are recognised outside of profit or loss.

	Increase	*Decrease*
Changes in assets	70	(70)
Interest on ordinary bond	(50)	(50)
Total profit or (loss)	**20**	**(120)**
Other comprehensive income (expense)		
Change in own credit risk of ordinary bond	(10)	30
Shares puttable at fair value	(20)	60
Total comprehensive income (expense)	**(10)**	**(30)**
(attributed to ordinary shares)		

[12] That are not subject to the puttables exception, which will be the subject of a future paper

[13] In Agenda Paper 5B—Presentation: Attribution of profit or loss and other comprehensive to sub-classes of equity, we define ordinary shares using some of these criteria.

> Under the staff's preliminary view total profit or loss is only affected by the recognised changes in economic resources, and the recognised changes in claims that are independent of those resources. It is unaffected by the changes in claims that are dependent on the entity's economic resources.
>
> Even if the economic resources are recognised in full, total profit or loss still shows how the returns on the economic resources compare to the promised returns on the claims, before the attribution of those returns amongst claims.

Reclassifying amounts to profit or loss

51. IFRS 9 prohibits reclassification of gains or losses on own credit risk to profit or loss–sometimes called 'recycling'. The IASB acknowledged that it needs to address the overall objective of other comprehensive income, including when an item should be presented in other comprehensive income instead of profit or loss and whether amounts in other comprehensive income should be reclassified to profit or loss (and if so, when). However, in the absence of such an objective, the IASB noted that its decision to not recycle is consistent with the requirements in IFRS 9 for equity instruments measured at fair value with changes presented in other comprehensive income.

52. In 2015, the IASB published the Conceptual Framework ED, which proposed some requirements for the presentation of income and expense in profit or loss and other comprehensive income (see paragraph 20).

53. The analysis presented in this paper (paragraphs 19–31) goes further than the basis for existing IFRS 9 and the proposals in the Conceptual Framework ED, and presents a different view of the economic phenomena that drive changes in claims and that are relevant to particular assessments of performance. In that analysis, the changes related to own credit risk and ordinary shares (whether or not they are puttable at fair value) are similar in that they both represent an allocation, depending on their relative priority, of the deficit and surplus between:

    (a) the returns on the entity's economic resources; and

    (b) the promised returns independent of those economic resources.

54. That allocation of returns is a different economic phenomenon to the promised returns on the claim itself. The staff preliminary view is to separately present

those phenomena, because it will not be relevant to the assessment of performance in paragraph 21. It follows that, because the nature of that income and expense will not be different in the future, (for example, it will not become a promised return by the act of settlement of the claim), therefore it will not be relevant to that assessment to reclassify that income and expense to profit or loss. Reclassifying the changes due to the allocation of returns to profit or loss will be inconsistent with that rationale, because it will recombine those different phenomena and negate the purpose of separating them out in the first place. Therefore, in our preliminary view, the income and expense presented in OCI should not be reclassified in subsequent periods.

55. As a result of the allocation of the deficit or surplus to own credit risk, and measured changes in shares redeemable at fair value, the respective carrying amounts of the claims will be updated as a result of those changes. Assuming that the claim is measured at fair value, any repurchase or settlement of a liability (or of equity for that matter) for an equal amount of cash will simply result in the elimination of the liability (or equity).

Question 1

Does the IASB agree with the staff preliminary view that under the Gamma approach:

(a) it will useful to present income and expense arising from liabilities for a specified amount that is not independent of the entity (ie those liabilities that do not promise a return independent of the entity) in other comprehensive income (OCI), and that this income and expense presented in OCI should not be reclassified in subsequent periods?

(b) one class of instrument that the presentation requirement will be useful for is a share redeemable at fair value which is classified as a liability?

Assessments of financial position

56. Financial statements provide information about the financial position of the entity, which is information about the entity's economic resources and the claims against

the entity. Importantly, the financial position of an entity is a snapshot at a point in time.

57. Information about the nature and amounts of an entity's economic resources and claims, helps users assess the reporting entity's:

    (a) financial strengths and weaknesses;

    (b) liquidity and solvency; and

    (c) needs for financing and ability to obtain financing.

58. Approach Gamma classifies as liabilities claims with either one of two features (amount and timing). While this reduces the need to make additional subclasses with equity (see Agenda Paper 5B), the challenge under Gamma is to distinguish between the two different types of information, each meeting two different assessments of financial position, which will be included within total liabilities.

59. In July 2015 (Agenda Paper 5A), we identified the following assessments of financial position:

    Assessment A: For this assessment, users need information about the required **timing** of the transfer of economic resources to settle the claim. This will help them assess its future economic resource needs, and whether the entity is expected to have the economic resources required to meet its obligations as and when they fall due**.** If the timing of transfer of economic resources is other than at liquidation, then the amount and type of economic resources required will be relevant.

    Assessment B: For this assessment, users need information about the **amount** of economic resources required to settle the claim. This will help them assess whether the entity has sufficient economic resources to satisfy the total claims against it. If the **amount** of the obligation is **independent** of the availability of the entity's actual economic resources (eg a specified amount of currency units), then the **priority** of the claim on liquidation will also be relevant. This will help a user assess how any potential shortfall will be distributed amongst claims.

60. In July 2015, we stated that each of the particular assessments identified could be assisted with additional subclasses of liabilities that will make the distinctions

required in further detail. We explore those potential subclasses in the following analysis of:

(a) Assessment A (paragraphs 61–68)

(b) Assessment B (paragraphs 69–73)

Assessment A

61. In July 2015, we stated that within liabilities additional sub classifications might be helpful for Assessment A, such as:

    (a) distinguishing between claims that require different types of economic resources (eg financial liabilities, obligations to transfer goods or services etc). However, because this project focuses on financial liabilities, considering subclasses based on the type of resources is beyond its scope.

    (b) distinguishing between claims that require settlement at different times prior to liquidation. For example, additional sub-classifications within liabilities might be useful to show:

        (i) liabilities that are payable on demand (eg demand deposits, shares redeemable at fair value).

        (ii) liabilities that are payable at some point other than liquidation (eg ordinary bonds).

        (iii) liabilities that require a transfer of economic resources only at liquidation (eg cumulative preference shares, share-settled debt).

62. IAS 32, does not have any presentation requirements for subclasses of liabilities (or of equity). However, IAS 1 *Presentation of Financial Statements* does have some requirements which are relevant to Assessment A.

63. Paragraph 60 of IAS 1 requires that:

> An entity shall present current and non-current assets, and current and non-current liabilities, as separate classifications in its statement of financial position in accordance with paragraphs 66–76 except when a

> presentation based on liquidity provides information that is reliable and more relevant. When that exception applies, an entity shall present all assets and liabilities in order of liquidity.

64. Paragraph 61 of IAS 1 requires that:

> Whichever method of presentation is adopted, an entity shall disclose the amount expected to be recovered or settled after more than twelve months for each asset and liability line item that combines amounts expected to be recovered or settled:
>
> (a) no more than twelve months after the reporting period, and
>
> (b) more than twelve months after the reporting period.

65. Paragraph 69 of IAS 1[14] requires that:

> An entity shall classify a liability as current when:
>
> (a) it expects to settle the liability in its normal operating cycle;
>
> (b) it holds the liability primarily for the purpose of trading;
>
> (c) the liability is due to be settled within twelve months after the reporting period; or
>
> (d) it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period (see paragraph 73). Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.
>
> An entity shall classify all other liabilities as non-current.

[14] The IASB is currently proposing changes to the requirements in IAS 1 in its project classification of financial liabilities.

66. The existing requirements in IAS 1 to present current and non-current liabilities, or to present the liabilities in order of liquidity, make the distinction in paragraph 61(b):

    (a) Under the current/non-current presentation, the classification focuses on the immediate needs of the entity to transfer economic resources, versus those needs that are not immediate. Under those requirements, for example:

        (i) shares redeemable at fair value on demand would be classified as current liabilities; and

        (ii) cumulative preference shares would be classified as non-current.

    (b) Under the order of liquidity presentation, different classes of liability are arranged in a relative rank ordering based on maturity. Under those requirements, for example:

        (i) shares redeemable at fair value on demand would be ranked high in the order of liquidity; and

        (ii) cumulative preference shares would be ranked low in the order of liquidity.

67. The only additional requirement that we might suggest to help with Assessment A would be the separate presentation of those claims that require a transfer of economic resources only at liquidation, from other non-current liabilities. However, we question whether such a distinction would provide information that will be that useful for Assessment A, unless additional subclasses were made within non-current liabilities to show timing of obligations more generally. Furthermore, IFRS 7 *Financial Instruments: Disclosure* requires a maturity schedule for financial liabilities, which may be a more appropriate place to distinguish financial liabilities which require a transfer of economic resources only at liquidation.

68. Therefore, in our preliminary view, and for approach Gamma, we do not think that any additional requirements for subclasses or subtotals in the statement of financial position are necessary for making Assessment A. We will consider whether additional disclosures are required in a future meeting.

Question 2

Does the IASB agree with the staff preliminary view that no additional requirements for subclasses or subtotals in the statement of financial position are necessary for assessing to what extent the entity is expected to have the economic resources required to meet its obligations as and when they fall due?

Assessment B

69. In July 2015 we stated that within liabilities additional sub classifications might be helpful in making Assessment B, such as:

    (a) distinguishing between claims for an amount that is independent of the entity's economic resources (eg ordinary bonds, cumulative preference shares etc) from other claims which depend on the entity's economic resources (eg shares redeemable at fair value); or

    (b) distinguishing between claims that have different levels of priority on liquidation (eg in order of priority: senior ordinary bonds, unsecured bonds, share-settled debt and cumulative preference shares etc); or

70. In the staff's preliminary view, it would be useful to make these distinctions because they would help users assess the extent to which:

    (a) the entity has sufficient economic resources to meet its obligations, furthermore, arranging these claims by the priority will help a user asses how any potential shortfall in economic resources is allocated amongst such claims.

    (b) the entity has the ability to obtain economic resources by issuing new claims or retain existing economic resources by refinancing existing claims. For example, if the entity has a shortfall in economic resources, this will impair its ability to access markets regardless of market liquidity.

    (c) the entity has claims that respond to future changes in its economic resources (eg shares redeemable at fair value) from those that do not (eg

ordinary bonds). This will show how resilient the entity's capital structure is to reductions in value of its economic resources.

71. The above distinctions are not currently required under IFRS Standards.

72. In the staff's view, one class of instrument that it will be useful to present separately on the face of the statement of financial position is a share redeemable at fair value.

73. In our preliminary view, we think that entities should be permitted (or required if most relevant) to present claims in order of priority on the statement of financial position in addition to order of liquidity. Classes of liabilities and equity can be arranged by order of **priority** within other arrangements (eg current/non-current), or additionally the alternative presentation can be presented within the notes if this is relevant information. For example, liabilities could be arranged in order of priority as follows: demand deposits, senior ordinary bonds, unsecured bonds, share-settled debt and cumulative preference shares etc.

Question 3

Does the IASB agree with the staff preliminary view that:

(a) it would be useful under the Gamma approach to present separately on the statement of financial position liabilities for a specified amount that is not independent of the entity (within total liabilities)?

(b) one class of instrument that the presentation requirement will be useful for is a share redeemable at fair value which is classified as a liability?

(c) in addition to arranging claims by order of liquidity on the statement of financial position, entities should be permitted (or required if most relevant) to present claims in order of priority. Classes of liabilities and equity can be arranged by order of **priority** within other arrangements (eg current/non-current), or additionally the alternative presentation can be presented within the notes if this is relevant information.

Preliminary views for approaches Alpha and Beta

74. Because approaches Alpha and Beta focus on one feature (as opposed to the two features of Gamma), we will need less subclasses within liabilities for approaches Alpha and Beta. However, the consequence is that more subclasses are required within equity for Alpha and Beta (see Agenda Paper 5B).

Alpha approach

75. Under the Alpha approach, the focus is on the transfer of economic resources other than at liquidation. Therefore, similar to the Gamma approach, two different types of changes in carrying amounts will potentially be captured as income and expense under the Alpha approach:

    (a) Changes in the carrying amount arising from promised returns, which will meet the objective of the assessment in paragraph 21 (for example, changes arising from interest accretion on ordinary bonds, cumulative preference shares, and share-settled bonds); and

    (b) Changes in the carrying amount that represent residual returns[15], which will not meet the objective of the assessment in paragraph 21 because they include the effect of changes in economic resources (for example, changes in shares redeemable at fair value).

76. Therefore, the staff preliminary views, regarding separating changes in the carrying amount of these claims within total comprehensive income, will be the same as the Gamma approach.

77. Similarly, for the same reasons as under the Gamma approach, our preliminary view is that it would be useful under the Alpha approach to present separately on the statement of financial position liabilities for a specified amount that is not independent of the entity (within total liabilities).

78. However, under Alpha approach some obligations for an amount independent of the entity will be classified as equity (because they do not require a transfer of

[15] These meet the definition of income and expense only because a transfer of economic resources is required other than at liquidation

economic resources other than at liquidation). Therefore, we suggest that additional subclasses are required within equity for the Alpha approach. In particular, in Agenda Paper 5B we suggest that changes in the carrying amounts of those additional subclasses, representing promised returns, are classified more prominently than other changes within equity.

Question 4
Does the IASB agree the staff preliminary views under the Gamma approach are also applicable under the Alpha approach?

Beta approach

79. Under approach Beta, obligations that require the entity to transfer economic resources other than at liquidation for an amount that is not independent of the entity's economic resources would be classified as equity instead of liabilities (for example shares redeemable for fair value).

80. Because the distinction between liabilities and equity focuses on the amount feature, then changes in the carrying amount of claims will automatically be separated between:

    (a) Promised returns which will be classified as income and expense (ie changes in claims that are independent of the changes in the entity's economic resources such as interest on ordinary bonds, share-settled debt and cumulative ordinary shares).

    (b) Returns that depend on the residual, which will be classified as changes in equity (ie changes in claims that depend on the residual, such as ordinary shares, or shares redeemable at fair value).

81. Likewise, claims will be separated on the statement of financial position.

82. However, the consequence of the Beta approach is that we will need more information about subclasses within equity to help assess the liquidity of the entity (see Agenda Paper 5B). In particular, obligations that require the entity to transfer economic resources that will be classified as equity under Approach Beta will

need to be measured and presented prominently to help a user assess whether the entity will have the economic resources required to meet its obligations.

Question 5
Does the IASB agree the staff preliminary views under the Gamma approach are not applicable under the Beta approach?

Appendix A—Summary of relevant requirements in IAS 1 and IFRS 9

83. Paragraph 60 of IAS 1 requires that:

> An entity shall present current and non-current assets, and current and non-current liabilities, as separate classifications in its statement of financial position in accordance with paragraphs 66–76 except when a presentation based on liquidity provides information that is reliable and more relevant. When that exception applies, an entity shall present all assets and liabilities in order of liquidity.

84. Paragraph 61 of IAS 1 requires that:

> Whichever method of presentation is adopted, an entity shall disclose the amount expected to be recovered or settled after more than twelve months for each asset and liability line item that combines amounts expected to be recovered or settled:
>
> (a) no more than twelve months after the reporting period, and
>
> (b) more than twelve months after the reporting period.

85. Paragraph 69 of IAS 1[16] requires that:

> An entity shall classify a liability as current when:
>
> (a) it expects to settle the liability in its normal operating cycle;
>
> (b) it holds the liability primarily for the purpose of trading;
>
> (c) the liability is due to be settled within twelve months after the reporting period; or
>
> (d) it does not have an unconditional right to defer settlement of the liability for at least twelve months

[16] The IASB is currently proposing changes to the requirements in IAS 1 in its project classification of financial liabilities.

after the reporting period (see paragraph 73). Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

An entity shall classify all other liabilities as non-current.

A1. Paragraph 5.7.1 of IFRS 9 requires a gain or loss on a … financial liability that is measured at fair value shall be recognized in profit or loss unless:

(a) …

(b) …

(c) it is a financial liability designated as at fair value through profit or loss and the entity is required to present the effects of changes in the liability's credit risk in other comprehensive income in accordance with paragraph 5.7.7.

A2. Paragraph 5.7.7 states that, an entity shall present a gain or loss on a financial liability designated as at fair value through profit or loss as follows:

(a) The amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability shall be presented in other comprehensive income; and

(b) The remaining amount of change in the fair value of the liability shall be presented in profit or loss.