STAFF PAPER

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IASB Meeting

Project	**Financial Instruments with Characteristics of Equity research project**
Paper topic	Presentation: Attribution of profit or loss and other comprehensive to sub-classes of equity

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Introduction

1. The purpose of this paper is to explore how subclasses within equity might help in providing additional information about features we identified as being relevant. We have previously stated that financial statements need to provide information about relevant features one way or another. At present, there is a big gap between the information provided for items classified as equity and those classified as liabilities. Reducing that gap will help provide sufficient information for a user to make an informed assessment for all items regardless of their classification.

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

3. Based on our analysis in this paper, in our preliminary view[1]:

   (a) the attribution of profit or loss and other comprehensive income **should be expanded to classes of equity other than ordinary shares of the parent**. In our preliminary view, this will help users assess the allocation of returns amongst different classes of equity.

   (b) the carrying amount of each subclass of equity will also be updated to reflect the attribution.

[1] These preliminary reviews remain broadly the same for approaches Alpha and Beta, however additional subclasses of equity are suggested under those approaches (see paragraphs 36-44)

(c) subclasses of equity will include:

(i) Ordinary shares—the class of equity that is the most residual and requires the entity to transfer economic resources only at liquidation for an amount equal to a pro-rata share of the entity's net assets on liquidation.[2]

(ii) Senior classes of equity—the classes of equity that reduce the net assets available to ordinary shares. Examples under the Gamma approach might include equity components of compound instruments, derivatives on own equity and non-cumulative preference shares.

4. If the IASB agrees with the staff preliminary views, then at a future meeting we will develop recognition and measurement requirements for senior classes of equity.

Structure

5. This paper is structured as follows:

(a) Background and scope (paragraphs 6–17)

(b) Staff analysis and preliminary views for Approach Gamma (paragraphs 18–35)

(c) Preliminary views for Approaches Alpha and Beta (paragraphs paragraph 36-44)

Background and scope

6. 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

[2] The class of ordinary shares may include two or more 'alphabet' legal share classes which share the same priority and rights at liquidation, but which could have different right to say, voting.

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

7. This paper focuses on identifying subclasses of equity that will provide additional information through differential presentation requirements[3], that will be useful to assessing the allocation of residual returns based on the priority and payment requirements of claims.

Previous discussions regarding subclasses in the Conceptual Framework project

8. The 2013 Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* (the Conceptual Framework DP) suggested that additional information about subclasses of equity would provide useful information to users of financial statements, in particular about the allocation of returns.

9. The Conceptual Framework DP suggested expanding the statement of changes in equity to 'update' the carrying amount of different classes of claims. This would require users to look at both the statement of profit or loss and other comprehensive income and the statement of changes in equity to assess the allocation of returns amongst claims against the entity.

10. About half of the total respondents commented on this suggestion:

(a) Some welcomed the additional information and transparency that would be provided. They acknowledged that the proposal would limit the accounting differences between liability and equity treatments, thereby limiting the incentives to structure instruments to achieve a particular accounting outcome.

(b) However, some of these respondents thought that the information might be more useful if it was provided in a different way and suggested that the approach should be explored in more detail.

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

(c) Users in particular supported providing additional information through the statement of changes in equity. However, they suggested that this might need to be supplemented by expanded disclosure of potential dilution in different scenarios.

11. The IASB published the Exposure Draft *Conceptual Framework for Financial Reporting* (the Conceptual Framework ED) in 2015. While the IASB did not develop any of the suggestions regarding additional classes of equity from the Conceptual Framework DP into concepts for subclasses for the ED, the IASB decided that the Conceptual Framework should not preclude the presentation of additional information through subclasses.

Scope

12. 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.

13. All other claims will be classified as equity. Thus, approach Gamma will only classify claims as equity if they both:

(a) require the transfer of economic resources **only at liquidation**; and

(b) the **amount of economic resources** required to be transferred at liquidation depends on the available economic resources.

14. Although the claims within equity under Gamma will require neither an outflow of resources, nor a fixed return, differences between equity claims will remain. These differences may result in the attribution of different amounts of the residual return to different classes of equity under different scenarios based on other features of the claim, such as:

(a) priority to the residual net assets (eg non-cumulative preference shares).

(b) contingencies (eg contingently triggered warrants).

(c) restrictions on dividends or other distributions (ie upper limits, for example non-cumulative preference shares, callable shares).

15. In our view, understanding these and other differences between equity claims will be useful to users of financial statements in making various other assessments of the entity's financial position and financial performance that we are not focusing on for the purpose of the distinction between liabilities and equity.

16. Subclasses within equity will be more important in approaches Alpha and Beta (see paragraph 36-44), this is because:

    (a) Under approach Alpha, claims within equity may oblige the entity to produce a fixed or determined return. Information about these claims will be relevant to assessing whether the entity has sufficient economic resources and produced a sufficient return on its resources, to meet its obligations.

    (b) Under approach Beta, claims within equity may require the entity to transfer economic resources, other than at liquidation. Information about these claims will be relevant to assessing whether the entity will have the resources required when the transfers fall due.

17. In a future paper we will consider:

    (a) whether any changes are required to the attribution requirements for subclasses of equity.

    (b) whether additional information to be provided through disclosure.

    (c) the puttables exception in IAS 32 in the context of the three approaches we are exploring. There may be additional considerations that are applicable to claims that meet the puttables exception, because that exception includes various other features.

Staff analysis

18. At present, total profit or loss and other comprehensive income (for convenience, total comprehensive income) is only attributed between non-controlling interests and parent equity interests (see Appendix A).

19. IFRSs also attribute profit or loss attributed to the parent to other classes of equity through the earnings per-share disclosure required by IAS 33. However, this

attribution is not presented on the face of the statement of financial performance, and carrying amounts of equity are not updated to reflect that attribution.

20. As noted previously, the Conceptual Framework DP suggested that information about differences between different classes of equity should be provided through an enhanced statement of changes in equity.

21. In our preliminary view, the attribution of total comprehensive income should be expanded to other classes of equity. These classes could include, for example, non-cumulative preferences shares, derivatives on own equity and equity components of compound instruments. We think that this will be a much clearer way of presenting information about the attribution of returns than presenting them within the statement of changes in equity alone.

22. The advantages of this approach are that:

    (a) users would not need to look at both the statement of financial performance and the statement of changes in equity;

    (b) the amounts attributed would be attributed directly to the corresponding equity class in the statement of changes in equity without the need to call them 'wealth transfers'.

    (c) users will have a reconciliation of total comprehensive income to *basic earnings*[4], which is used to calculate basic earnings per share, on the face of the statement of financial performance.

    (d) this requirement should not add significant cost because some of these amounts are already calculated for the purposes of calculating Earnings per-Share.

23. As we have mentioned in June 2015, at least one claim needs to be measured as a residual. Therefore, in order to attribute total comprehensive income to subclasses of equity, we need to identify which class of equity will be the residual. In other words, our focus on features has shifted from the **timing** and **amount** to the **priority** of the claim to residual returns.

[4] The numerator defined in IAS 33 for the earnings per-share calculation

Defining the claim to be measured as a residual

24. Our starting point is to define the most residual claim against the entity. There are two possible definitions in IFRSs that we can draw on:

    (a) The definition of an "ordinary share" in IAS 33 *Earnings per Share,* that is an equity instrument that is subordinate to all other classes of equity instruments; and

    (b) The conditions in the puttables exception in IAS 32, including that:

        (i) they are the most subordinate claim on liquidation of the entity (or are not equally subordinate with other claims that do not share all the same features); <u>and</u>

        (ii) oblige the entity to deliver a pro rata share of the entity's net assets[5] to the holders on liquidation, or an amount broadly equivalent to the fair value of such a claim on early redemption.

25. We think that the two starting points above should be reconcilable, given that they both:

    (a) refer to the most subordinate class of claim; and

    (b) the pro-rata nature being implicit in the ordinary share given the purpose of IAS 33.

26. In the staff's preliminary view, the claim that should be calculated as the difference between total comprehensive income less other attributions should be the class of equity that is[6]:

    (a) the most residual claim;

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[5] The entity's net assets are those assets that remain after deducting all other claims on its assets

[6] We note that similar characteristics were identified for the definition of a Basic Ownership Instrument in the predecessor project lead by the FASB. A Basic Ownership Instrument was defined as having the following characteristics:

a) the holder has a claim to a share of the assets of the entity that would have no priority over any other claims if the issuer were to liquidate on the date the classification decision is being made; and

b) the holder is entitled to a percentage of the assets of the entity that remain after all higher priority claims have been satisfied. The holder's share depends on its share of the total claims with the lowest priority and has no upper or lower limit except for the amount of assets available.

(b) requires the entity to transfer economic resources only at liquidation; and

(c) the amount of resources to be transferred at liquidation is equal to a pro-rata share of the entity's net assets on liquidation.

27. For convenience, we refer to this class of claim as *ordinary shares*. This may include two or more 'alphabet' legal share classes which share the same priority and rights at liquidation, but which could have different right to say, voting.

Defining senior classes of claim and attributing total comprehensive income

28. A senior equity claim is any other claim that both reduces the claim of ordinary shares to the entity's net assets and is not a liability.

29. Senior equity claims could include:

(a) Non-cumulative preference shares;

(b) Components of compound instruments (potential ordinary shares or share that might potentially be called);

(c) Derivative contracts for the issue of equity instruments for economic resources; and

(d) Derivative contracts for the exchange of equity instruments.

30. In our preliminary view, the attribution of profit or loss and other comprehensive income **should be expanded to classes of equity other than the ordinary shares of the parent**. The carrying amounts for these classes should be updated by the amount attributed.

31. In our preliminary view, this will help users assess the returns amongst holders of different classes of equity.

32. We will need to develop additional requirements for the recognition and attribution of amounts to senior classes of equity. As a starting point, we intend to consider existing principles for attribution in IAS 33 for the purpose of calculating basic earnings for ordinary shares. For example, IAS 33 requires adjustments for:

(a) the after-tax amounts for preference dividends on non-cumulative preference shares and any difference between the carrying amount and the fair value of the consideration paid to repurchase such shares.

(b) amounts allocated to participation features for equity instruments that participate in dividends with ordinary shares in accordance with a predetermined formula.

33. By using IAS 33 as the starting point we will be hoping to reduce the cost of the requirements while also limited consequential amendments to IAS 33.

34. We will also consider how the attribution of amounts on derivatives on own equity should be measured when we continue our discussion of derivatives on 'own equity'.

Question 1
Does the IASB agree with the staff preliminary view that: (a) the attribution of profit or loss and other comprehensive income should be expanded to classes of equity other than ordinary shares of the parent? (b) the carrying amount of each subclass of equity will also be updated to reflect the attribution? (c) subclasses of equity will include: (i) Ordinary shares—the class of equity that is the most residual and requires the entity to transfer economic resources only at liquidation for an amount equal to a pro-rata share of the entity's net assets on liquidation? (ii) Senior classes of equity—Classes of equity that reduce the net assets available to ordinary shares? Examples under the Gamma approach might include equity components of compound instruments, derivatives on own equity and non-cumulative preference shares. If the IASB agrees with the staff preliminary views, then at a future meeting we will develop recognition and measurement requirements for additional items senior classes of equity within equity.

Illustration of preliminary views

35. We illustrate the preliminary view in the following example:

Assume an entity which has economic resources for which there is a change of CU100 in year 20X0. The entity is funded by:

- ordinary bonds, for which interest of CU50 accrues during 20x0;
- cumulative preference shares for which dividend of CU20 accrues during 20x0;
- non-cumulative preference shares for which a dividend of CU20 was paid during 20x0 if the economic resources increased; and
- ordinary shares.

Of the above changes in the carrying amount of claims, the interest on the ordinary bond and the dividend on the cumulative pref is independent of the changes in economic resources, therefore under the Gamma approach they would be classified as liabilities with income and expense in total comprehensive income.

There is no other comprehensive income.

All of its economic resources are recognised as assets.

Income from assets	100
Interest on ordinary bond	(50)
Dividend on cumulative pref	(20)
Total comprehensive income (expense)	**30**
Attributed to	
Senior equity claims (non-cumulative prefs)	20
Ordinary shares	10

Preliminary views for approaches Alpha and Beta

36. The staff's preliminary view to attribute profit or loss and other comprehensive income to classes of equity other than ordinary shares for approach Gamma will also apply to approaches Alpha and Beta.

37. However, subclasses within equity will be more important in approaches Alpha and Beta, this is because:

    (a) Under approach Alpha, claims within equity may oblige the entity to produce a fixed or determined return. Information about these claims will be relevant to assessing whether the entity has sufficient economic resources, and produced a sufficient return on its resources, to meet its obligations.

    (b) Under approach Beta, claims within equity may require the entity to transfer economic resources, other than at liquidation. Information about these claims will be relevant to assessing whether the entity will have the resources required when the transfers fall due.

Alpha approach

38. Obligations for a an amount independent of the entity's economic resources that **do not** require the entity to transfer economic resources other than at liquidation (eg cumulative preference shares and share-settled debt) would be classified as equity under Alpha instead of liabilities.

39. Therefore, in the staff's preliminary view, under the Alpha approach:

    (a) obligations for a specified amount independent of the entity's economic resources classified as equity should be presented prominently on the statement of financial position within equity. This will have an impact on assessments of whether the entity has sufficient economic resources to meet its obligations.

    (b) the attribution of changes in the carrying amount in such obligations should be presented more prominently than other senior classes of equity because these changes will have an impact on a user's assessment of whether the entity has produced sufficient returns to meet its promised returns.

40. We will need to develop more detailed requirements for particular types of these claims in future meetings, however examples could include::

    (a) Cumulative preference shares

    (b) Share settled debt

    (c) Various share settled derivatives

Question 2
Does the IASB agree with the staff preliminary view that, for the Alpha approach: (a) obligations for a specified amount independent of the entity's economic resources classified as equity should be presented prominently on the statement of financial position within equity? (b) the attribution of changes in the carrying value of such obligations should be presented more prominently than other senior classes of equity?

Beta approach

41. Some obligations that require the entity to transfer economic resources would be classified as equity under the Beta approach instead of liabilities (eg shares redeemable at fair value).

42. Information about these obligations will have an impact on assessments of the liquidity of the entity and show to what extent the entity will require economic resources to meet such obligations when they fall due. For the purposes of making that assessment, some of these claims might be measured at fair value (for example, shares redeemable at fair value on demand).

43. Therefore, in the staff's preliminary view, under the Beta approach, obligations that require the entity to transfer economic resources that are classified as equity should be presented prominently in the statement of financial position as *temporary equity instruments*.

44. Because of their equity classification, changes in the carrying amount of such obligations will be presented outside total comprehensive income and attributed before ordinary shares of the parent entity (consistent with our preliminary view for the Gamma approach).

Question 3
Does the IASB agree with the staff preliminary view that, for the Beta approach, that claims that require the entity to transfer economic resources that are classified as equity should be presented prominently in the statement of financial position as *temporary equity instruments*?

Appendix A: Relevant text of IAS 1

A1. Paragraph 81B of IAS 1 states that [**emphasis added**]:

> An entity shall present the following items, in addition to the profit or loss and other comprehensive income sections, **as allocation of profit or loss and other comprehensive income for the period**:
>
> (a) profit or loss for the period attributable to:
>
> (i) non-controlling interests, and
>
> (ii) owners of the parent.
>
> (b) comprehensive income for the period attributable to:
>
> (i) non-controlling interests, and
>
> (ii) owners of the parent.
>
> If an entity presents profit or loss in a separate statement it shall present (a) in that statement.

A2. Paragraph 106 of IAS 1 states that:

> An entity shall present a statement of changes in equity as required by paragraph 10. The statement of changes in equity includes the following information:
>
> (a) total comprehensive income for the period, showing separately the total amounts attributable to owners of the parent and to non-controlling interests;
>
> (b) …
>
> (c) [deleted]
>
> (d) for each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately (as a minimum) disclosing changes resulting from:
>
> (i) profit or loss;
>
> (ii) other comprehensive income; and

(iii) transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners and changes in ownership interests in subsidiaries that do not result in a loss of control.