AASB Staff Issues Paper

IASB Conceptual Framework Discussion Paper: Section 5—Definition of equity and distinction between liabilities and equity instruments

Introduction

1 This AASB Staff Issues Paper provides the focus for the Board's non-deliberative high-level 'educational' session at the forthcoming AASB meeting on the IASB Conceptual Framework Discussion Paper (DP).

2 The **purpose of this paper** is to discuss the components of the IASB DP dealing with:

(a) the conceptual definition of equity;

(b) the conceptual distinction between liabilities and equity; and

(c) whether, in concept, 'wealth transfers' between different classes of equity claims should be recognised in the statement of changes in equity.

3 These aspects are discussed in the following components of the IASB DP (included in the attached extract from the DP: Agenda Paper 8.3):

(a) Section 5 (on pages 84 – 105 of Agenda Paper 8.3); and

(b) supporting Appendices C, D, E and F (on pages 209 – 224 of Agenda Paper 8.3).

4 Appendices D – F in the DP are provided for background information and are not analysed in this paper. AASB staff plan to return, selectively, to those Appendices in agenda papers for the Board's October 2013 meeting.

5 This paper includes the questions that AASB members will be asked to discuss regarding the above-mentioned extracts from the IASB DP. Those questions are:

(a) the IASB's Questions for Respondents on preliminary views (a) – (d) in Question 10 on page 105 of Agenda Paper 8.3 (termed Questions 10(a) – 10(d) below in this paper); and

(b) whether there are any other aspects of the recognition and presentation/disclosure of equity, and of the liability/equity distinction, that should have been discussed in the IASB DP.

6 Board members' tentative leanings on these questions would be welcome. Those tentative leanings will inform staff in identifying key concerns to raise in an initial draft of the AASB's submission on the IASB DP and in discussions with AOSSG and ASAF members.

7 This paper includes my recommendations on the issues discussed, except in relation to Question 10(d). Some remarks, but no overall recommendation, are provided on Question 10(d), which staff will explore further and bring back to the Board (with a staff recommendation) for discussion at its October 2013 meeting. Despite the absence of a recommendation on Question 10(d), Board members are invited to express any tentative views they have on it at the forthcoming meeting.

8 Consistent with the introductory nature of this Board meeting's discussion, my views on the various questions are tentative in nature. In addition, these views are not necessarily the views of other staff.

9 At the Board meeting session, AASB staff will give a PowerPoint-based verbal presentation on the parts of the DP covered by AASB Agenda Papers 8.2 – 8.3. (Copies of the PowerPoint slides will be tabled at the Board meeting.)

Summary of Tentative Recommendations

10 Regarding the issues identified in paragraph 2 above, I recommend that the Board tentatively should support the IASB's preliminary views:

(a) to retain the existing definition of equity as a residual interest in the assets of the entity after deducting its liabilities (see paragraphs 13, 14 and 16 below);

(b) that the Conceptual Framework should state that the IASB should use the definition of a liability to distinguish liabilities from equity instruments (see paragraphs 15 – 16 below);

(c) that obligations to issue equity instruments are not liabilities (see paragraph 17 below);

(d) that, in relation to distinguishing equity from liabilities, the 'strict obligation approach' should be preferred to the 'narrow equity approach' (see paragraphs 18 – 19 below); and

(e) that obligations that will arise only on liquidation of the reporting entity are not liabilities (see paragraph 20 below).

11 Regarding the issues identified in paragraph 2 above, I recommend that the Board tentatively should not support the IASB's preliminary views that an entity should:

(a) at the end of each reporting period, update the measure of each class of equity claim (with the measure determined at a Standards level); and

(b) recognise updates to those measures in the statement of changes in equity as a transfer of wealth between different classes of equity claim (see paragraphs 21 – 37 below).

12 Regarding the question in paragraph 5(b) above, I recommend commenting to the IASB that the DP should have discussed the issue of whether, in concept, it is appropriate to continue separate presentation of non-controlling interests in an entity's equity (see paragraph 42 below).

Discussion of IASB Questions

Questions for Respondents [page 105 of DP]: Q10(a) and stem of Q10(b)

<u>Recommendations</u>

13 I recommend that the Board tentatively supports the IASB's preliminary view that the Conceptual Framework should retain the existing definition of equity as a residual interest in the assets of the entity after deducting its liabilities [Q10(a)].

14 The recommendation in paragraph 13 is expressed on the presumption that a distinction should be made in concept between liabilities and equity as different elements (claims on the entity's assets). The more fundamental question of whether such a distinction should be made is not examined in the IASB DP (except in passing, in paragraphs 5.51(a) and 5.52). This reflects the IASB's decision not to fundamentally review its entire Conceptual Framework in its current Framework project.

15 I also recommend that the Board tentatively supports the IASB's preliminary view that the Conceptual Framework should state that the IASB should use the definition of a liability to distinguish liabilities from equity instruments [stem of Q10(b)].

<u>Reasons</u>

16 Regarding paragraphs 13 and 15 above, I agree with the IASB's preliminary views in Question 10(a) and the stem of Question 10(b) because developing an 'independent' definition of equity (i.e. one not circumscribed by the definitions of an asset and, in particular, a liability) would seem likely to give rise to the following concerns:

(a) it would not faithfully reflect that the interests of equity holders are subordinate to the interests of creditors; and

(b) if the definition of a liability were to remain independent of the definition of equity, overlaps (or gaps) between the definitions of a liability and equity could arise. Avoiding this problem could involve explicitly or implicitly defining a liability subordinately to equity, which would:

(i) reinforce the concern noted in (a) immediately above; and

(ii) in the process, place primary emphasis on an economic phenomenon (equity) that seems likely to be more complex to identify than a liability. AASB members have recently expressed a leaning toward defining a liability as an enforceable obligation to transfer an economic resource to another party: this seems a fairly straightforward notion in principle.

Question for Board members

Q10 Do you tentatively agree that the Board should tentatively support the IASB's preliminary views:

(a) to retain the existing definition of equity as a residual interest in the assets of the entity after deducting its liabilities; and

(b) that the Conceptual Framework should state that the IASB should use the definition of a liability to distinguish liabilities from equity instruments?

Questions for Respondents [page 105 of DP]: Q10(b)(i)

17 I strongly agree with the statements in paragraph 5.28 of the DP that:

(a) an equity instrument is not an economic resource of the issuer; and

(b) accordingly, an obligation for an entity to deliver its own equity instruments is not an obligation to deliver economic resources (liability).

18 Accordingly, in relation to distinguishing equity from liabilities, I strongly support the IASB's preliminary view (expressed in paragraph 5.37 of the DP) to prefer the 'strict obligation approach' to the 'narrow equity approach'. Under the 'strict obligation approach' (described in paragraph 5.34(a) of the DP), liabilities would only be identified in relation to 'obligations to deliver economic resources'. Under the 'narrow equity approach' (described in paragraph 5.30 of the DP), only the most residual existing class of equity instrument issued by the entity's parent would be classified as equity.

19 I also strongly support the IASB's preliminary view that, when an entity's own equity instruments are used as 'currency' in a contract to receive a variable number of shares whose value equals a fixed amount, or an amount based on changes in an underlying variable, treating those instruments as liabilities in accordance with IAS 32 *Financial Instruments: Presentation* would be conceptually inappropriate. Such treatment would be inconsistent with the IASB's preliminary view that, in concept, the liability/equity distinction should be based on the 'strict obligation approach' (paragraphs 5.29 – 5.38 of the DP). However, I strongly disagree with the IASB's preliminary view regarding another aspect of the 'strict obligation approach', which is discussed separately in paragraphs 21 – 37 below in relation to Question 10(c) of the DP.

Question for Board members

Q10(b)(i) Do you tentatively agree that the Board should support the IASB's preliminary views that:

(a) obligations to issue equity instruments are not liabilities; and

(b) in relation to distinguishing equity from liabilities, the 'strict obligation approach' should be preferred to the 'narrow equity approach'?

Questions for Respondents [page 105 of DP]: Q10(b)(ii)

20 I recommend that the Board supports the IASB's preliminary view that obligations that will arise only on liquidation of the reporting entity are not liabilities [Q10(b)(ii)]. This is because, as discussed in paragraph 3.89(a) of the DP, the IASB Conceptual Framework notes that financial statements are normally prepared on the assumption that an entity is a going concern.

Question for Board members

Q10(b)(ii) Do you tentatively agree that the Board should support the IASB's preliminary view that obligations that will arise only on liquidation of the reporting entity are not liabilities?

Questions for Respondents [page 105 of DP]: Q10(c)

21 In relation to the IASB's Question 10(c), I strongly disagree with the IASB's preliminary view that, at the end of each period, under a 'strict obligation approach', an entity should update the measurement of each class of equity claim and consequently:

(a) show transfers between the amounts of recognised net assets attributed to each class of equity, within the statement of changes in equity; while

(b) leaving unaffected the total amount of equity, which changes in response to transactions and events affecting the entity (paragraphs 5.11(b), 5.12(b), 5.13(c) and (d), 5.16 – 5.21, 5.34(c) and 5.35(b) of the DP).

22 The IASB's reasons for this preliminary view, and my arguments for disagreeing with that preliminary view, are set out in paragraphs 24 – 37 below.

23 Disagreeing with this aspect of the 'strict obligation approach' (in paragraph 21 above) does not mean I agree with the 'narrow equity approach'. Rather, I support applying the 'strict obligation approach' to distinguish liability and equity instruments (as per paragraphs 5.34(a) and (b) of the DP), but not the remainder of that approach, as described in the DP, which gives rise to reallocations within the total measured amount of equity.

<u>Analysis of arguments regarding remeasuring equity claims</u>

24 In its DP, the IASB argues its proposals for remeasuring equity claims would provide information to existing and potential investors about the claims that determine how the future net cash inflows to the entity will be distributed among holders of different claims [paragraph 5.11(b)]. The DP argues that, to meet these information needs, information should be provided to help equity holders to understand:

(a) how their own equity claims are affected at the end of the period by other classes of equity claims; and

(b) the changes during the period in the effect of those other classes of equity claims (‘wealth transfers between different classes of equity claims’) [paragraph 5.12(b)].

25 The DP argues that, to achieve these aims, an entity could, at the end of each period, update the measurement of each class of equity claim and show transfers of wealth between those classes [paragraph 5.13(c) and (d)]. Those updated measurements could be based on:

(a) in relation to ‘primary equity claims’ (i.e. present rights to share in distributions of equity during the life of the reporting entity or on liquidation, such as the entity’s own shares[1]), an allocation of the underlying net assets; and

(b) in relation to ‘secondary equity claims’ (i.e. present rights or present obligations to receive or deliver another equity claim, such forward contracts and options in relation to the entity’s own shares[2]), the same manner in which an entity would measure a comparable financial liability (e.g. amortised cost or fair value) [paragraph 5.18].

26 In summary, I disagree with the IASB’s preliminary view (discussed in paragraphs 21 and 24 – 25 above) because it:

(a) seems unlikely to meet its stated aims;

(b) seems unnecessary; and

(c) conflicts with the general principle that an entity’s financial statements depict economic phenomena affecting the entity, and not economic phenomena affecting other parties only.

These concerns are explained in paragraphs 29 – 37 below, after noting how distinctions between different classes of equity, *made from the viewpoint of the entity*, can provide useful information to users of financial reports.

Distinctions between different classes of equity from the viewpoint of the entity

27 Distinctions between different classes of equity, made from the viewpoint of the entity, can provide useful information to users of financial reports. These distinctions can be useful to present and potential investors, and any other users of financial reports, in assessing some of the entity’s key ‘stocks’ and ‘flows’ (as described in AASB Essay 2013-1 *Rethinking the Path from an Objective of Economic Decision Making to a Disclosure and Presentation Framework*, K. M. Stevenson, August 2013), and therefore (among other things) in assessing the future cash flows the entity might generate. For example:

(a) showing whether an entity increased net assets through capital raising or by generating profits (as reflected in retained earnings) provides insights into the

[1] Paragraphs 5.7(b) and 5.8(a) of the DP.

[2] Paragraphs 5.7(c) and 5.8(b) of the DP.

entity's prospects for future increases in net assets (including the sustainability of those increases, e.g. during periods of 'capital rationing'). It seems that, in AASB Essay 2013-1, this would be regarded as part of the capacity to sustain the entity's current funding model. Showing this information also provides insights into whether the entity has financed distributions to owners from retained earnings or by returning contributed capital; and

(b) showing the extent to which an entity increased its reported net assets by repricing the same service potential (e.g. a revaluation surplus recognised in respect of property, plant and equipment) provides another useful insight into the total change in net assets. It seems that, in AASB Essay 2013-1, this would be regarded as part of assessing whether the capacity of the entity to provide goods and services has in fact increased. Showing this information can also provide insights into whether the entity has financed distributions to owners by eroding the capacity of the entity to provide goods and services.

28 These aspects are mentioned because the DP's discussion of the IASB's preliminary view regarding remeasuring equity claims does not seem to acknowledge them, and because (as illustrated below in paragraph 35) adopting that IASB preliminary view might conflict with meeting users' needs for the information mentioned in paragraph 27.

Approach seems unlikely to meet its stated aims

29 In relation to paragraph 26(a) above, adopting the IASB's preliminary view regarding remeasuring equity claims would seem unlikely to meet its stated aims because it seems likely to depict notional, rather than substantive, transfers between different equity classes. Financial statements are not intended to report the values of owners' equity instruments. Even if an entity has only one class of equity holder (e.g. ordinary shareholders) and only two classes of equity (e.g. share capital and retained earnings), the carrying amount of equity in the statement of financial position could only by coincidence approximate the current value of those shares. Reasons for this include:

(a) the amount of net assets typically is composed of a mixture of historical and current measurements of assets and liabilities; and

(b) current values of equity interests reflect the amounts, timing and uncertainty of expected future cash flows from the entity, which include future cash flows from items not recognised as assets and liabilities.

30 Another reason why these 'wealth transfers' between different classes of equity 'claims' seem likely to be notional is that equity holders do not have claims to specified amounts of cash from the entity—if they did, those claims would in fact be liabilities. This applies even though different classes of equity interests might have specified higher priority in any distributions the entity elects to make, and voluntary payments to them might be based on a formula or rate (e.g. for some non-redeemable preference shares). The limited nature of equity holders' 'claims' against an entity is further illustrated by some entity types (e.g. start-ups) or jurisdictions in which dividends are seldom paid to equity holders, who typically realise the economic benefits embodied in their investments by selling those investments.

31 The fact that adopting the IASB's preliminary view would seem unlikely to meet its stated aims is also illustrated in Example C2 in Appendix C of the DP (on pages 210 – 214). In that example, for a written put option with settlement net in shares, changes in the fair value of the entity's shares (and thus of the options) have no effect on the reporting entity's assets and liabilities, and no effect on that entity's future cash flows. Thus, with reference to the stated aim in paragraph 5.11(b) of the DP, those value changes seem to have no information value regarding the amounts of future distributions of cash to holders of different classes of equity claims.

32 In relation to the *relative* interests of different classes of equity claims, accounting for transactions with a particular class of owners cannot cater for the indirect effects of those transactions on the value of other classes of equity claims. For example, the issue of ordinary shares at fair value during a period of credit rationing might enable an entity to finance a new investment opportunity and thus increase the value of all classes of equity interests in the entity. The issue of shares would be presented in the statement of changes in equity solely as an increase in issued share capital, even though the value of other equity interests (e.g. call options on the entity's shares) might also be enhanced.

Unnecessary remeasurements

33 In relation to paragraph 26(b) above, adopting the IASB's preliminary view seems unnecessary because the fair value of different classes of equity instruments is ascertainable from market information outside financial statements. In light of this, and because (as mentioned in paragraph 29 above) financial statements are not intended to report the values of owners' equity instruments, it is unclear which problem the IASB's preliminary view regarding remeasuring equity claims is intended to solve.

Accounting for economic phenomena affecting the entity

34 In relation to paragraph 26(c) above, I think the recognition of 'wealth transfers' between different classes of equity claims would conflict with the general principle that an entity's financial statements depict economic phenomena affecting the entity, and not economic phenomena affecting other parties (such as capital providers) only, because no changes in the entity's assets or liabilities occur as a result of changes in the value of its equity instruments to equity holders.

35 The concern in paragraph 34 above is illustrated in Example 5.1 (discussed in paragraphs 5.14 – 5.15 of the DP) and Example C2 (in Appendix C of the DP, on pages 210 – 214), both involving a written put option with settlement net in shares. The proposed treatment in each of these examples includes adjusting retained earnings for changes in the fair value of the option. This is despite no change occurring in the entity's assets or liabilities, and thus involves adjusting retained earnings without an entry in profit or loss. Adjusting retained earnings without an entry in profit or loss would undermine the useful distinction referred to in paragraph 27(a) above, which is dependent on changes in the reported balance of retained earnings (other than distributions to owners) being limited to items of income or expense.

36 The IASB DP seems to overlook the concern in paragraph 34 above—paragraph C13(b) says that upon writing a put option with settlement net in shares, an equity claim that is a "present obligation" to issue shares arises. (I think 'present obligation' should only be used in relation to liabilities.) Although the DP correctly says that, under the 'strict obligation approach' preferred by the IASB, the written put option does not represent a liability, it does not take that point to its logical conclusion—namely, that the entity has nothing further to account for when the value of the put option changes.

37 I think that, in both of the examples referred to in paragraph 35 above, it would be appropriate to treat the option premium as a contribution by owners when the option is written. Although the 'owner' (option holder) may subsequently relinquish his/her right of access to the entity's shares, such a subsequent event would not affect the 'capital' character of the transaction when the option premium was paid to the entity. From the entity's perspective, it is irrelevant how many equity holders have a remaining right to benefit from their equity contributions, or whether the option holder was speculating on a possible increase in the option's price when it purchased the option.

Question for Board members

Q10(c) Do you tentatively agree that the Board <u>should not</u> support the IASB's preliminary views that an entity should:

(i) at the end of each reporting period, update the measure of each class of equity claim (with the measure determined at a Standards level); and

(ii) recognise updates to those measures in the statement of changes in equity as a transfer of wealth between different classes of equity claim?

Questions for Respondents [page 105 of DP]: Q10(d)

38 The DP includes preliminary views that:

(a) if an entity has issued no equity instruments, it may be appropriate to treat the most subordinated class of instruments as if it were an equity claim, with suitable disclosure; and

(b) identifying whether to use the approach in (a) immediately above and, if so, when, would be a Standards-level decision.

39 This issue is raised in the DP in relation to puttable instruments that:

(a) give the holders a pro rata residual interest in the entity's net assets; but also

(b) oblige the entity to deliver cash or other assets to the holders on liquidation, or on early redemption, at an amount broadly equivalent to that pro rata share (see paragraphs 5.55 – 5.59 of the DP).

40 This paper does not include an overall recommendation on this issue. Staff will explore this issue further and bring it back to the Board (with a staff recommendation)

for discussion at its October 2013 meeting. Some introductory remarks on the discussion of this issue in paragraphs 5.55 – 5.59 of the DP are that:

(a) paragraph 5.56(a) notes one of the main concerns with treating these puttable instruments as liabilities is that such liabilities are required to be recognised at not less than the amount payable on demand. It would seem inappropriate to acknowledge in the Conceptual Framework a liability/equity classification exception that responds to a Standards-level measurement rule (which, itself, seems of questionable conceptual merit);

(b) the IASB's preliminary view in paragraph 5.57 of the DP is that the reasons in the Basis for Conclusions on IAS 32 for classifying these puttable instruments as if they were equity instruments are still valid and the Conceptual Framework should provide a concept that underlies the exception. It seems difficult to reconcile:

    (i) treating the most subordinated class of instruments as if it were an equity claim; and

    (ii) the IASB's preliminary view that the 'narrow equity approach' described in paragraph 5.30 of the DP should not be preferred to the 'strict obligation approach' to distinguishing equity from liabilities; and

(c) if an entity has issued no equity instruments, identifying whether to treat the most subordinated class of instruments as if it were an equity claim should not be addressed only at a Standards level. This issue would be a useful test of the robustness of the proposed concepts for liabilities and equity developed in the forthcoming IASB Conceptual Framework ED.

41 Despite the absence of a recommendation on Question 10(d), Board members are invited to express any tentative views they have on it at the forthcoming meeting.

Question for Board members

Q10(d) Do you have any initial comments on the IASB's preliminary views that:

(i) if an entity has issued no equity instruments, it may be appropriate to treat the most subordinated class of instruments as if it were an equity claim, with suitable disclosure; and

(ii) identifying whether to use the approach in (i) immediately above and, if so, when, would be a Standards-level decision?

Other Potential Issues

Non-controlling interests

42 Paragraph 5.21 of the DP seems to presume that separate presentation of non-controlling interests (NCI) in an entity's equity would continue under the revised IASB Conceptual Framework. The DP does not discuss the issue of whether, *in*

concept, it is appropriate to continue such separate presentation, even if the presentation requirements for NCI were retained in IAS 1 *Presentation of Financial Statements*. I think the DP should have discussed this issue, because the parent/NCI distinction apparently reflects a parent perspective, rather than an entity perspective, to an entity's financial reporting. A parent perspective is a form of proprietary perspective to financial reporting.

Questions for Board members

Q(1) Do you tentatively agree to comment to the IASB that the DP should have discussed the issue of whether, in concept, it is appropriate to continue separate presentation of non-controlling interests (NCI) in an entity's equity (and of particular changes in equity attributable to NCI)?

Q(2) Having regard to Section 5 and the related Appendices in Agenda Paper 8.3, are there any other topics you wish to raise regarding the definition of equity, the distinction between liabilities and equity, and any related presentation/disclosure aspects?