AASB Staff Issues Paper on IASB Conceptual Framework Discussion Paper

Sweep Issue on Section 5—Liabilities and Equity: 'Puttable Instruments': Must an entity have equity?

Introduction

1 This paper raises for the Board's consideration a sweep issue in respect of a topic regarding the conceptual distinction between liabilities and equity discussed at the Board's September 2013 meeting (M133, Agenda Paper 8.2, paragraphs 38 – 41). That topic was the classification (as liabilities or equity) of puttable financial 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." (IASB Conceptual Framework DP, paragraph 5.55).

This topic is discussed in paragraphs 5.55 – 5.59 and Question 10(d) of the IASB DP, which are included in the attached extracts from the DP: see Agenda Paper 9.5.

2 AASB project staff think this topic provokes a broader topic that should be addressed in the Board's submission on the DP: namely, whether in concept it is necessary that an entity has equity. (This paper does not limit that question to equity *instruments*; rather, it discusses whether an entity must have any equity, regardless of its source. Note also that the IASB DP does not state that all entities must have equity; it only expresses concern that the above-mentioned puttable instruments would not be treated as equity under IFRSs and says the IASB Conceptual Framework should provide a concept (or an exception to a concept) that underlies their treatment as equity under IAS 32 *Financial Instruments: Presentation*. However, a logical extension of the IASB's preliminary views noted in paragraphs 4(a) and 5 below would arguably be that any entity should treat the most subordinated class of instruments it issues as equity.) In addition, Board members spoke to this broader topic at the September Board meeting. Accordingly, this paper includes discussion of whether, in concept, it is necessary that an entity has equity.

3 We are bringing back this topic as a sweep issue because of the introductory nature of its discussion at the September 2013 Board meeting (there was no staff recommendation in the agenda papers) and to discuss a possible treatment that was not addressed in either the staff issues paper or that previous Board discussion (see paragraphs 13 – 15 below).

Refresher on the topic

4 Question 10(d) of the DP (on page 105) includes IASB 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 decision for the IASB in developing or revising particular Standards.

5 Paragraph 5.57 of the IASB DP also expresses an IASB preliminary view that:

> "… the revised *Conceptual Framework* should indicate that an entity should treat some obligations that oblige the issuer to deliver economic resources as if they were equity instruments. … Arguably, this treatment might be appropriate if the obligations are the most subordinated (lowest ranking) class of instruments issued by an entity (such as some co-operatives or mutuals) that would otherwise report no equity."

Board members' informal comments (September 2013 meeting)

6 At the September 2013 AASB meeting, in a non-deliberative session Board members commented that they tentatively disagree with what appears to be the IASB's preliminary view[1] that the Conceptual Framework should indicate that, 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. Board members said, tentatively:

(a) they disagree because whether an entity has any equity should, in concept, be determined by applying the definition of a liability and the measurement basis or bases for the entity's liabilities;

(b) this reasoning in (a) above would be consistent with the IASB's preliminary view that, in concept, the definition of a liability should be used to distinguish liabilities from equity instruments; and

(c) options to put pro rata interests in the entity's net assets back to the entity should be treated as liabilities (for the reasons in paragraphs 6(a) and 6(b) above), unless they can only be exercised upon liquidation of the reporting entity.

7 Board members commented that they tentatively disagree with the IASB's preliminary view that identifying when (if ever) to apply the treatment described in paragraph 4(a) above would be a Standards-level decision. Board members said this is because the issue is conceptually significant and its resolution provides insights into the robustness of the proposed conceptual definitions of a liability and equity.

8 Board members also commented that the possibility that, in concept, some entities have no equity arises for a range of entity types, such as co-operatives and mutual entities (as identified in the IASB DP) and also accumulation vehicles giving interest holders in those entities the right to put their interests to the entity in return for a transfer of assets from the entity (such as defined contribution superannuation plans, some managed investment schemes and some structured entities).

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1 taking Question 10(d) and paragraph 5.57 of the DP together.

AASB project staff comments

9 AASB project staff agree with all of the tentative views of Board members set out in paragraphs 6 – 8 above. We think an exception should not be made in the IASB Conceptual Framework to the general principles that:

(a) equity is the residual interest in the assets of the entity after deducting all its liabilities (paragraph 5.2 of the DP); and

(b) consequently, a claim should not be classified as equity if it has the characteristics of a liability (unless the liability fails the criteria for recognition). This should be the case even if the claim represents the most subordinated class of instruments.

10 However, we think the puttable instruments described in paragraph 1 above should be treated as having both liability and equity components (for the reasons discussed in paragraphs 12 – 13 below), and thus that an exception to the general principles in paragraph 9 above is not needed to justify treating part of those instruments as equity.

<u>Measurement of liabilities arising from puttable instruments</u>

11 Paragraph 5.56 of the DP notes one of the main concerns with treating the puttable instruments described in paragraph 1 above as giving rise to liabilities is that, under IFRSs, they consequently would be required to be recognised at not less than the amount payable on demand. It also notes that such treatment could therefore result in the entire market capitalisation of the entity being recognised as a liability (depending on the basis for calculating the redemption value of the financial instruments) and this liability amount could even result in the entity reporting negative net assets.

12 AASB project staff disagree, in concept, with measuring such puttable instrument liabilities at an amount not less than the amount payable on demand. For example, we think it would be conceptually consistent with the 'spirit' of the guidance on fair value in paragraph 24 of IFRS 13 *Fair Value Measurement*[2] to measure the fair value of such puttable instrument liabilities (prior to liquidation) at an amount that takes into account the probability of the put being exercised. This is despite the guidance in paragraph 47 of IFRS 13 that: "The fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid." If so, in concept, it should not be presumed that the measurement of such puttable instrument liabilities would preclude the recognition of equity.

<u>Additional issue</u>

13 Furthermore, we note that an issue that was not addressed in the previous staff issues paper on Section 5 of the IASB DP is "whether some or all of these puttable instruments should be separated into an embedded put option (for which a liability would be recognised) and a host equity instrument" (paragraph 5.58(b) of the DP). AASB project staff support that treatment because we think:

[2] i.e. in relation to a liability, "Fair value is the price that would be … paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (ie an exit price) …".

(a) the residual interest described in paragraph 1(a) above is an equity instrument; and

(b) the obligation described in paragraph 1(b) above is a put option.

14 Because this paper focuses on the conceptual analysis of such instruments, it does not explore how that treatment would be applied in practice (e.g. whether significant difficulties might be encountered in measuring the liability and equity components).

15 Paragraph 5.58 of the DP indicates that the issue in paragraph 13 above would be considered by the IASB in a Standards-level project. We think it should also be addressed in the Conceptual Framework ED.

16 We note that choosing not to adopt a concept that the most subordinated class of instruments should be treated as if it were an equity claim might cause some entities to be identified, in concept, as having no equity. This is because, for those entities, holders of the most subordinated class of instruments arguably do not hold a residual interest with the characteristics of equity (unlike holders of the puttable instruments described in paragraph 1 above). We think that, in concept, it might be representationally faithful for some of the types of entities described in paragraph 8 above to report no equity. For example, this arguably would be the case for defined contribution superannuation plans, when members are collectively entitled to all of the plan's assets after deducting amounts due to other creditors. Payments to those members as a cohort would not be discretionary (even if *ex gratia* payments could be made to some members, these would affect the relative interests of different members, and not, from the plan's perspective, whether it has a discretion to retain assets for other purposes); therefore, members' rights to receive accumulated benefits would appear to be wholly liability in character.

Questions for Board members

Q1 Do you tentatively agree with AASB project staff's view in paragraph 12 above that the IASB Conceptual Framework should not assume that the puttable instruments described in paragraph 1 above would, if classified as liabilities, be measured at an amount not less than the amount payable on demand?

Q2 If so, do you tentatively agree that, in concept, it should not be presumed that the measurement of such puttable instrument 'liabilities' would preclude the recognition of equity?

Q3 Do you tentatively agree with AASB project staff's view in paragraph 13 above that such puttable instruments should be separated into an embedded put option (for which a liability would be recognised) and a host equity instrument?

Q4 Do you tentatively agree with AASB project staff's view that the issue in Question 3 should also be addressed in the Conceptual Framework ED?

Q5 Do you tentatively agree with AASB project staff's view that the Board's submission on the DP should argue that, in concept, for some entities it might be representationally faithful to depict them as having no equity (see paragraphs 8 and 16 above)?