



Review of the *Conceptual Framework* Liabilities and Equity

Presenters:
Manuel Kapsis
Peter Clark
Li Li Lian

The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

Before we start...

- You can download the slides by clicking on the button below the slides window
- To ask a question, type into the designated text box on your screen and click submit
- A recording of the webcast will be available a few days after the presentation at <http://go.ifrs.org/Conceptual-Framework>
- The views expressed are those of the presenters, not necessarily those of the IASB or IFRS Foundation

Project objectives

- Not a fundamental re-think
- Focus on weaknesses that have given problems in practice
- Filling in gaps, and updating and improving existing guidance

Discussion Paper objectives

- Preliminary views
- Starting point for further discussion and consultation
- Seeking your views by 14 January 2014

Project consequences

- New *Conceptual Framework* will not override existing IFRSs

- Overview of current criticisms
- Objective of distinction
- Approaches explored in the Discussion Paper (DP)
- An example illustrating the approaches
- Comparison between the different approaches

- The distinction between liabilities and equity instruments is complex, difficult to understand and difficult to apply:
 - Inconsistent use of definition of liability (Table 5.1).
 - Unclear requirements.
 - Clear requirements but odd outcomes sometimes.

Overview of current criticisms

- If more than one class of equity, there is limited information about the distribution of risk and return (wealth transfers) between different classes.

	Liabilities	Equity
Subsequent changes	Interest and other changes presented in Profit or Loss or OCI	Wealth transfers and effects of dilution not reported until transaction occurs
Disclosure	Extensive disclosures required (eg IFRS 7)	Very minimal disclosure required

Objective of the distinction

- What are we trying to convey?
 - Balance sheet leverage
 - Ratio of cash obligations to equity
 - Dilution of return
 - Ratio of participation in returns on assets
- Both of the above are relevant to investors.
 - Some instruments affect one and not the other.
- Need to base distinction on one objective and find another way to meet the other objective

Approaches explored in the DP

- Simplify the distinction between liabilities and equity:
 - Strict obligation approach; or
 - Narrow equity approach.
- Provide users with more information about how different equity claims affect each other (dilution):
 - Enhance the statement of changes in equity to show wealth transfers between different equity claims.

Approaches explored in the DP

Strict obligation

Liabilities

Trade payables
Bank loans
Bonds

Equity

Share options
Minority interest
Common stock

Narrow equity

Liabilities

Trade payables
Bank loans
Bonds
Share options
Preferred stock
Minority interest

Equity

Common stock

Example: Written put option, settled net in own shares

- The following example will illustrate:
 - The narrow equity approach and strict obligation approach.
 - How the enhanced statement of changes in equity would look under the strict obligation approach.
- Key features of instrument:
 - Cash premium of CU5,000 received in exchange for the option.
 - Option entitles holder to put 1,000 shares back to the entity (issuer).
 - Strike price: CU98 per share.
 - Entity is not required to pay cash on exercise, but issue a variable number of its own shares.

	1 Feb 20X2	31 Dec 20X2	31 Jan 20X3
Fair value per share	CU100	CU95	CU95
Fair value of option	CU5,000	CU4,000	CU3,000

Example: Using narrow equity approach

	1 Feb 20X2	31 Dec 20X2	31 Jan 20X3
Cash	5,000	5,000	5,000
Put option liability	(5,000)	(4,000)	-
Net assets	-	1,000	5,000
Share capital	-	-	3,000
Retained earnings	-	1,000	2,000
Total equity	-	1,000	5,000

Written put option classified as liability

Once exercised, shares issued classified as equity and the liability is derecognised

Changes affect both the income statement and the statement of financial position

Note: similar result today under IAS 32
Financial Instruments: Presentation



Example: Using strict obligation approach

Statement of financial position

	1 Feb 20X2	31 Dec 20X2	31 Jan 20X3
Cash	5,000	5,000	5,000
Net assets	5,000	5,000	5,000
Share capital	-	-	3,000
Retained earnings	-	1,000	2,000
Obligation to issue shares	5,000	4,000	-
Total equity	5,000	5,000	5,000

Written put option classified as equity

Wealth transfers presented in the statement of changes in equity (refer next slide)

Once exercised, carrying amount reclassified to different class of equity

Example: Enhanced SOCIE (using strict obligation approach)

Statement of Changes in Equity (SOCIE)

	Share capital	Retained earnings	Total existing shareholders	Obligation to issue shares	Total
Opening 1 Feb 20X2	-	-	-	-	-
Written option issued 17 Feb 20X2	-	-	-	5,000	5,000
Profit/OCI	-	-	-	-	-
Change in carrying value of option	-	1,000	1,000	(1,000)	-
31 Dec 20X2	-	1,000	1,000	4,000	5,000
Profit/OCI	-	-	-	-	-
Change in carrying value of option	-	1,000	1,000	(1,000)	-
Shares issued 15 January 20X2	3,000	-	3,000	(3,000)	-
31 January 20X3	3,000	2,000	5,000	-	5,000

Put option classified as equity when issued

Wealth transfer from option holder to shareholder

Wealth transfer from option holder to shareholder

Reclassification on exercise of option (no cash transfer on exercise)

Advantages of enhanced statement of changes in equity

- Remeasuring equity claims will provide investors with clearer and more prominent information about effects of other equity claims than they get today.
- Providing similar information regardless of debt or equity classification:
 - Limits incentive to structure instruments to obtain equity classification.
 - Enables IASB to apply definition of liability more consistently without loss of information.

Comparison between narrow equity and strict obligation approaches

	Narrow equity approach	Strict obligation approach
Basis of classification	Relative to other claims – All entities will classify the most residual claim as equity even if that instrument creates an obligation to pay cash	Independent of other claims – All entities will classify a claim that creates an obligation as a liability even if that claim is the most residual - exception for puttable instruments if most residual
Effect on definitions	Will require a new definition of equity and a modification to the definition of a liability	Will retain similar definition of liability and retain the existing definition of equity
Judgements required	Identification of the most residual claim	Identification of whether a given claim creates an obligation

Comparison between narrow equity and strict obligation approaches (contd)

	Narrow equity approach	Strict obligation approach
Effects of dilution and wealth transfers between other classes of claims	Reported in P&L or OCI	Dilution from other equity claims reported in statement of changes in equity
Cash leverage (ratio of obligations to deliver cash to equity)	Cash leverage will have to be communicated through disclosure	Cash leverage reported on the face of the balance sheet
Other	<ul style="list-style-type: none">• Always at least one claim classified as equity• May need to reconsider classification of non-controlling interests	<ul style="list-style-type: none">• Opportunity to remove inconsistencies between existing IFRSs (eg IAS 32 and IFRS 2)

Issues not addressed in DP

- Compound instruments (convertible debt).
- Measurement basis for equity claims.



Other webcasts

Date	Topic
Tuesday 3 September 2013	Definitions of assets and liabilities and recognition criteria
Friday 13 September 2013	Profit or loss and other comprehensive income (OCI)
Friday 27 September 2013	Definition of equity and distinction between liability and equity elements
Wednesday 2 October 2013	Measurement
Thursday 10 October 2013	Guidance on liability definition—obligations conditional on entity's future actions
Tuesday 22 October 2013	Objective and Qualitative Characteristics
Friday 15 November 2013	Presentation and disclosure

- Discussion Paper
<http://go.ifrs.org/DP-Conceptual-Framework-July-2013>
– Comments to be received by 14 January 2014
- Snapshot
<http://go.ifrs.org/Snapshot-DP-Conceptual-Framework-2013>
- Existing *Conceptual Framework*
<http://eifrs.ifrs.org/eifrs/bnstandards/en/2013/conceptualframework.pdf>
- *Conceptual Framework* website
<http://go.ifrs.org/Conceptual-Framework>

Thank you

21



Expressions of individual views by members of the IASB and its staff are encouraged.

The views expressed in this presentation are those of the presenter. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.