

Technical Briefing Paper

Equity and Liabilities

April 2008

In March 2008, the International Accounting Standards Board (IASB) published for public comment a discussion paper (DP) on the distinction between equity financial instruments and other financial instruments (non-equity instruments).

The DP is the first stage of the IASB's project to improve and simplify the requirements in IAS 32 *Financial Instruments: Presentation*. In this respect the IASB issued a further discussion paper on *Reducing Complexity in Reporting of Financial Instruments*, in March 2008.

Background to project

Constituents have asked the IASB to simplify and improve the accounting for financial instruments. This is one of three long term projects on the IASB's agenda to address issues related to financial instruments.

IAS 32 provides the relevant guidance for distinguishing between asset and liability instruments (non-equity instruments) and equity instruments.

In general, a number of stakeholders around the world have signaled two broad classes of criticisms that arise from the distinction set out in IAS 32:

- a) uncertainty on how the principles in IAS 32 should be applied and
- b) whether application of those principles results in an appropriate distinction between equity instruments and non-equity instruments.

Joint project

The IASB and the Financial Accounting Standards Board (FASB) are conducting this project as a modified joint project, as part of the Memorandum of Understanding (MoU). In a modified joint project, one board leads the initial stage. The FASB led the research stage of this project and published a Preliminary Views document *Financial Instruments with Characteristics of Equity* in November 2007. If the project is added to the IASB's active agenda, the IASB intends to undertake it jointly with the FASB.

The FASB paper

The FASB document considers three possible approaches to distinguishing between liabilities and equity. Each of the approaches uses the concept of a 'basic ownership instrument' which is characterised by

- the holder having the **most residual** claim to a share of net assets of the issuing entity if it were to liquidate on the date of classification
- the holder being entitled to a share of the residual net assets, having no upper or lower limits on the claim, except for the amount of assets available.

A basic ownership instrument would be classified as equity under all three approaches. These are outlined below

Basic ownership

Under this approach, **only** basic ownership instruments would be classified as equity. Thus, the holders of these instruments would be the owners of the entity, and all other instruments would be classified as either financial assets or liabilities, to be recorded at fair value through profit and loss. This would also include preference shares that do not represent the most residual claim over the net assets of the entity - to be classified as a financial liability.

An instrument that contains both a basic ownership component and a non-basic ownership element would need to be separated into its equity and financial liability components, and classified accordingly. In practice the equity component would be measured as the residual between the liability component and the transaction amount.

Ownership-settlement

Under this approach instruments would be classified based on the nature of their return and their settlement requirements, with those instruments that do not have a prescribed settlement requirement being classified as equity. Equity instruments using this approach would also include perpetual instruments and some derivative instruments that are indexed to an settled with the entity's equity (basic ownership) instruments.

As with the basic ownership approach, the non-equity component of the instrument would have to be separated and measured at fair value, with the difference between the total transaction price and the fair value of the non-equity component being treated as equity.

Reassessed expected outcomes (REO)

Essentially, under this approach, any instrument (or component) with fair value movements in the same direction as or the opposite direction to the fair value of a basic ownership instrument would be classified as equity or 'contra-equity'. Under this approach the form of how the instrument is settled would not affect its classification. There is a focus on the outcomes when determining their classification and the separation of the components. These outcomes in turn would be measured based on the probability of occurrence, the probability-weighted amount and date of occurrence.

The FASB reached a preliminary view that the basic ownership approach is the appropriate approach for determining which instruments should be classified as equity.

The IASB paper

The IASB's DP has two parts – an Invitation to Comment and, as a separate document, the FASB's November 2007 *Preliminary Views Financial Instruments with Characteristics of Equity*. The IASB's Invitation to Comment includes background information and invites responses to the questions already included in the FASB document and to a number of additional questions raised by the IASB. Appendix A of the IASB's Invitation to Comment provides a table comparing how 25 financial instruments would be classified under IFRS, US GAAP and the three approaches in the FASB preliminary views paper. The IASB paper broadly summarises the impact of the three FASB approaches

- Significantly fewer instruments would be classified as equity under the basic ownership approach than under IAS 32.
- The ownership-settlement approach would be broadly consistent with the classifications achieved in IAS 32. However, under the ownership-settlement approach, more instruments would be separated into components and fewer derivative instruments would be classified as equity.
- The REO approach is likely to result in the classification of many more instruments (and components) as equity than the current IAS 32 model.

The goal of the IASB paper is to solicit views on whether FASB's proposals are a suitable starting point for the IASB's deliberations. The IASB paper also refers to the discussion paper issued by the European Financial Reporting Advisory Group (EFRAG) in January 2008, which also deals with the issue of distinguishing between equity and liability. This is discussed below.

The discussion paper *Financial Instruments with Characteristics of Equity* is available on the [IASB's website](#), as is the preliminary views document issued by the FASB.

The IASB invites comments on the discussion paper by **5 September 2008**.

PAAinE paper on Equity and Liability

In January 2008, the European Financial Reporting Advisory Group (EFRAG) published a Discussion Paper *Distinguishing between liabilities and equity* on behalf of the Pro-active Accounting Activities in Europe (PAAinE).

The PAAinE discussion paper, developed by the German Standard-Setter and issued jointly by EFRAG and the standard-setters of Denmark, France, Germany, Italy, and the UK, analyses the existing IASB distinction between equity and liabilities and concludes that it has apparent shortcomings. It goes on to note that rather than addressing the shortcoming it would be more appropriate to perform a fundamental review of the principle.

It concludes that the sharing of losses is the decisive factor in distinguishing equity from liability, therefore, any capital available to absorb an entity's losses are classified as equity under this approach – the 'loss absorption' approach. This is quite distinct from the current position under IAS 32, and would likely result in the classification of many instruments similar to that under the ownership-settlement model described in the FASB paper. Whilst the treatment of derivative instruments remains ambiguous in the EFRAG paper, it appears that there could be certain instruments which would be classified as equity rather than liabilities. These would include short-term loss absorbing loans.

The paper has been prepared to stimulate and contribute to the ongoing debate on the subject.

The Discussion Paper can be downloaded, free of charge, from the FRC website at: <http://www.efrag.org/projects/detail.asp?id=119>.

Comments on the Discussion Paper and responses to the specific questions raised in therein are requested by **28 July 2008** at: commentletter@efrag.org.

ACCA also welcomes members' comments on both the IASB and EFRAG discussion papers. Please submit these via e-mail condocomments@accaglobal.com by Tuesday 8 July 2008.

This briefing paper contains information in a summary form and is of a general nature. It is not intended to address all of the issues of a specific entity and is not a substitute for detailed research or the exercise of professional judgement.

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