

Distinguishing between liabilities and equity

Preliminary views on the classification of liabilities and equity and under International Financial Reporting Standards

A discussion paper prepared by staff of the
Accounting Standards Committee of Germany
on behalf of the

European Financial Reporting Advisory Group and the
German Accounting Standards Board

under the
Pro-active Accounting Activities in Europe Initiative of the
European Financial Reporting Advisory Group and the
European National Standard Setters

Brussels/Berlin, 2007

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Disclaimer:

The thoughts expressed in this Discussion Paper should be considered work in progress, so we acknowledge that this document does not answer all questions that may arise. The Discussion Paper is written as a conceptual paper. It is primarily concerned with discussing and arriving at another principle to distinguish between liabilities and equity under International Financial Reporting Standards and not merely with establishing new presentation and disclosure requirements. In other words, the paper does not build on the current Framework definitions of liabilities and equity. Whilst we acknowledge that there will be questions as to how this principle might be applied in the context of certain financial instruments, this Discussion Paper does not deal with application or implementation issues. However, we think that this Discussion paper sets out the principle sufficiently clear and understandable in order to evaluate whether or not it has merit.

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EXECUTIVE SUMMARY

- ES.1 The funds provided to an entity usually differ with regard to their term/maturity, the type of return (fixed vs. variable,) the level of subordination or termination rights such as puts by either party, and so on. Although the forms of capital provided might differ considerably, the credit side of an entity's balance sheet comprises, generally speaking, simply claims to the entity's resources.
- ES.2 Dividing differing claims into two classes of capital (traditionally labelled "equity" and "debt"/"liabilities") seems somewhat arbitrary, as it inevitably leads to blending the capital classes. One approach would, therefore, be to simply list all claims, group or rank them according to a certain criterion and provide information on all other features deemed decision-useful in the notes to the financial statements. Such an approach would have far-reaching consequences for quite a number of other areas of accounting – presentation and consolidation being only two. Although the working groups view such an approach as being conceptually superior to the traditional dichotomous approach, they feel that much more time was needed in order to fully evaluate all the consequences that fall from such an approach. Given the tightness of the project timetable the working groups felt that this could not be done within the timeframe available. Under the assumption that the traditional dichotomous split was to be retained, this paper discusses an alternative approach to the one currently used by the IASB in its Framework and in IAS 32.
- ES.3 Traditional approaches to distinguish between equity and debt are mostly based on considering the characteristics of a common share in a stock corporation and working from there. The approach currently used by the IASB in both, the Framework, and IAS 32 makes reference to only one of these characteristics, namely the non-existence of a present obligation on the part of the issuing entity. In some respects, however, classification of financial instruments under IAS 32 does not seem to be entirely in line with the general distinction between liabilities and equity under the Framework.

- ES.4 Furthermore, the working groups are not convinced that the “present obligation” criterion has proven to lead to satisfactory answers across entities with different legal forms. The recent deliberations related to instruments puttable at fair value have demonstrated that instruments which convey a residual-type claim and are puttable ask for an arbitrary decision as to which of the two characteristics shall be given preference over the other.
- ES.5 Having taken various characteristics of financial instruments into consideration individually and in combination, both working groups came to the conclusion that the distinction between equity (risk capital) and debt (liabilities) should be based on the ability or inability of capital to absorb →losses incurred by the entity, losses being understood as possible negative outcomes of →risk. This is labelled the loss absorption approach.
- ES.6 →Loss-absorbing, i.e. →risk capital can be seen as a buffer or shield for other sources of capital. Capital provided to an entity is deemed loss-absorbing if it cannot be claimed back should the entity suffer a loss. The approach would allow for both capital that is fully loss-absorbing, and capital that is not fully loss-absorbing to be classified as (partial) equity. If an instrument is not fully loss-absorbing, the instrument is split accounted for, i.e. it is bifurcated into a fully loss-absorbing portion and a non loss-absorbing portion. Only the fully loss-absorbing portion is allocated to equity.
- ES.7 Under the approach, an instrument would be classified solely by reference to its terms and conditions and independently of the classification of other instruments. This will ensure that all instruments within the same class of capital and across entities will be accounted for in the same way, thereby not taking into account what other instruments had been issued or at which point in time an investment was being made.
- ES.8 Classification of an instrument would have to be made at inception and would not be changed unless either its terms and conditions are changed or settlement of the instrument gives rise to a new instrument. In particular, no re-classification would be made over the term of the instrument following recog-

dition of additional instruments, derecognition of existing instruments or passage of time. Embedded conditional features (such as the exercise of a conversion option or a condition to absorb losses only if these exceed a certain threshold) would not be considered a change to the terms and conditions of the instrument. Rather, they are conditions already implicit in the terms and conditions that may come into force and that, hence, would have to be tested for each reporting date as to whether they have actually come into force.

ES.9 →Reserves including retained earnings – whether or not attached or attributable to another financial instrument – are regarded loss-absorbing. The working groups reasoned that, from an entity perspective, all that matters is whether or not capital is available for loss absorption (and in this respect reserves clearly are.)

ES.10 When comparing the loss absorption approach to the present obligation approach in IAS 32, the groups note that in many cases both approaches will lead to similar results. This is the case when risk capital has no individual rights attached to it. The most prominent example would be a common share in a stock corporation. In other legal forms, where the members may have an individual right to redeem the instrument, IAS 32 does require these instruments to be classified as liabilities. In these instances, the loss absorption approach will generally lead to equity classification of these instruments to the degree the capital is loss-absorbing (which may be fully or partially.) Another difference in classification would arise for derivatives on equity instruments: Under certain circumstances, obligations to issue own shares are classified as equity under IAS 32. Under the loss absorption approach they would not, as derivatives entered into by the entity do not absorb losses as defined in this paper.

INTRODUCTION

- IN.1 Financing and investing are two core aspects of economic activity of an entity. Companies raise capital and invest the funds received. As the types of investments differ, so does the capital: Some funds may be long-term or even perpetual, others might be callable any time or repayable within a year; some capital might give the holder a fixed, guaranteed return for the period, or else be variable and neither floored nor capped; and some forms of capital might provide additional rights to the holder whilst others do not, e.g. voting rights.
- IN.2 In general, accounting has not taken these differences into account largely, on the contrary: Accountants have become accustomed to having just one dividing line within the credits of a balance sheet, referring to one class of capital as 'equity' and calling the other 'debt' or 'liabilities.' The consequences of this split are reaching far beyond labelling: Under current accounting regimes equity is not re-measured whilst debt is; periodic payments made to the debt claimants are accounted for as expense and decrease net income, whereas payments to equity holders do not influence the computation of net income; and so on. But what are the factors that drive classification of capital as equity or debt?
- IN.3 One way to distinguish capital provided to an entity, which is often found in the literature, is with regard to the source of contribution: Capital provided by the *legal owners* is referred to as equity,¹ whereas capital provided by external contributors other than the legal owners is referred to as debt. In this sense, capital provided by the owners is subordinated to all other sources of capital and is, thus, often being referred to as 'risk capital' or 'capital at risk.' As said above, this dichotomous structure with only two kinds of capital has traditionally been the basis for accounting purposes as well as when presenting the credit entries of the balance sheet. Since equity is generally

¹ Cf. Brealey/Myers: Principles of Corporate Finance, 6 ed., p. 391.

associated with a view to a claim on a company's increases and decreases in value, it has traditionally also been understood as a 'residual,' i.e. the amount left after having deducted all (fixed) claims on the company's assets.² Furthermore, depending on the different national legal environments, the claim of an owner may also be associated with other factors, such as participating features, voting rights etc.

IN.4 The collapse of the Bretton Woods Accord and the removal of historically imposed market restrictions during the 1980s and 1990s have led to "unpredictable movements"³ in market price factors. As a consequence,

*"[...] financial markets have responded to increasing price volatility. A range of financial instruments and strategies that can be used to manage the resulting exposures to financial price risk have evolved over the past 20 years."*⁴

IN.5 These new "financial instruments and strategies" do not always fit easily into a dichotomous structure of capital. In fact, some products comprise features of both equity and debt as defined. As a consequence, there is no black or white view to capital, but rather a capital continuum ranging from 'pure equity' (in the above mentioned sense) to 'pure debt,' with some products being more akin to equity and others more similar to debt. The working groups, therefore, feel that adhering to a dichotomous structure does not fully capture financial reality, since it inevitably leads to blending the traditional kinds of capital. In order to achieve a 'true and fair view' of the different sources of capital provided (or claims on the company's assets,) by taking into account the diversity of the financial products traded in the markets nowadays, the groups support the view that a classification of capital into more than two categories is an enhanced concept and leads to a better representation of the financial sources provided to an entity.⁵

² Ibid.

³ Cf. Smithson: Managing Financial Risk, p. 1.

⁴ Ibid.

⁵ Cf. FASB Discussion Memorandum *Distinguishing between Liability and Equity Instruments and Accounting for Instruments with Characteristics of Both* (Financial Accounting Series No. 94), pars. 200 et seq. and the literature cited therein for a more in-depth discussion of this issue.

IN.6 Taken to an extreme end, the groups may even think of a fully disaggregated balance sheet which contains no subsections labelled 'equity' and 'liabilities,' but which would list all different kinds of capital provided, or claims on the company's assets. It would also be conceivable to rank those capital sources, using *one* agreed-upon and predominant feature, e.g. level of subordination, maturity etc., and giving information on other features deemed relevant in the notes to the financial statements. The user of the statements may then 'draw his/her own line' and calculate capital, equity, or debt figures s/he believes to be suitable for his/her information needs.

IN.7 However, this approach would require a more fundamental revision of several aspects of current accounting. Amongst others, issues that would have to be considered include re-visiting

- (a) the elements of financial statements; and
- (b) the concept of income determination and distribution because, traditionally, the dividing line in the balance sheet has been used to determine the dividing line in the income statement as well, with payments on liabilities being included in the determination of income and payments on equity instruments being displayed as distribution of income.

The approach would also involve consequential changes related to other issues currently under review by the IASB (e.g. consolidation, performance reporting.)

IN.8 The FASB's Financial Instruments Working Group highlighted this aspect as early as in 1990, but to our knowledge has not received substantial support to pursue that route. The working groups were being told from equity analysts of rating agencies that, for financial statement analysis purposes, they would break down blended or compound instruments into what may be called 'partial equity' (e.g. 75%, 50%, 25% 'equity') instead of splitting the instrument into the fundamental building blocks and allocating these to either equity or debt. If that handling was seen within other user groups as well, the groups could see no convincing conceptual argument against the "claims

only” approach mentioned in par. IN.6, on the contrary: If financial statements were to be any meaningful and useful in making economic decisions, accounting should not portray something that is not there.

IN.9 Although the working groups believe that, conceptually speaking, such an approach is superior to every other approach, because it is arbitrary-free from picking and choosing criteria while at the same time rejecting others, they feel that much more time is needed in order to fully evaluate the consequences that fall from such a “claims only” approach. The working groups are of the opinion that such an approach could not be implemented in short- or even medium-term and would imply changes to most of the projects currently on the IASB’s agenda. They would, however, encourage the IASB to conduct further research into how the consequential issues mentioned above and involved in pursuing such an approach could be addressed. The groups would be happy to assist the IASB in pursuing this task.

IN.10 For the time being, the working groups have concentrated on rethinking the current dividing line that distinguishes liabilities from equity. They believe that there is no natural split between given classes of capital. Rather, different people have differing opinions about what shall and shall not be labelled equity, or debt, respectively. Nevertheless, all members felt that the current “present obligation approach” as implemented in IAS 32 has not proven to lead to acceptable answers in situations where non-listed entities are considered. Therefore, the working groups have started from scratch by looking at some fundamental aspects relating to the objective of financial reporting. They believe that the criterion they have chosen provides better answers in most circumstances considered than the current obligation criterion. However, the groups would like to point out that pursuing the approach developed in this paper would most likely have consequences for the Framework project, as the elements of the financial statements would need to be redefined.

IN.11 The thoughts discussed and expressed in this Discussion Paper are based on the existing IASB Framework. References to ongoing projects or exposure documents are solely made to highlight or clarify an issue that the Board

has stated a view on. The Discussion Paper is concerned with the classification of capital only; neither does it deal with recognition, measurement, or disclosure issues nor does it – at this stage – address implications on other elements and other IFRSs.

SECTION 1—THE CURRENT DISTINCTION BETWEEN LIABILITIES AND EQUITY

Common shares as the starting point for any equity classification

1.1 The common share of a listed stock corporation is regarded by many as the “purest” form of equity and is, therefore, often made a reference point for classifying capital as either debt or equity. The following bullets summarize the main features of common stock:

- The shares provide their holders with an entitlement to a pro rata interest in the net assets of the entity. Any →benefits and →risks in the form of increases and decreases in the fair value of the net assets of the entity will, thus, be reflected in the individual →claims of the shareholders.
- The claim is to the *net* assets only, i.e. it is subordinated to all other capital classes. Only if the entity has met its obligations assumed, a residual will then be divided amongst the shareholders.
- The shares are not redeemable, so there is no obligation on the side of the entity to buy them back, and there is no right on the side of the →investor to require the entity to deliver cash or another financial instrument in exchange for the shares. In other words, the investor’s entitlement to the pro rata interest in the net assets of the entity cannot be exercised by the shareholder unilaterally, i.e. s/he has no individual claim.
- Depending on the legal framework an entity operates in, a qualifying majority of the shareholders is needed to decide on either a partial distribution of past increases in the net assets of an entity (i.e., retained earnings) or a final distribution in the course of a liquidation of the entity. In other words, the shareholders can decide on a distribution collectively.
- The only way for a shareholder to unilaterally reverse a prior decision to invest in the entity would be to find a new investor who would then assume the rights conveyed by the shares, as the shareholder has no claim before liquidation of the entity. Since the old investor foregoes his entitlement to past and future increases in the net assets of the entity when leaving it before a partial or final liquidation, buyer and seller would generally agree a price that reflects this circumstance by calculation of the present value of any projected future cash flows. That is, a sale transaction is assumed to take place at fair value.
- In some jurisdictions common stock holders have the right to control the entity and/or replace management, through their elected representative body i.e. a supervisory board, or in the annual meeting.

Although people assign different weight to any or a combination of these criteria, they nevertheless agree that any approach to distinguish between debt and equity should aim at classifying at least common shares as equity.

- 1.2 Most of the criteria described in the preceding paragraph can be found in the current IASB literature. The differentiation between equity and liability is based on a notion of equity being a residual: Par. 49(c) of the Framework defines equity as

“[...] the residual interest in the assets of the entity after deducting all its liabilities.”

In turn, a liability is defined as

“[...] a present obligation, the settlement of which is expected to result in an outflow from the entity embodying economic benefits.” [F.49(b) and .60 et seq.]

In summary, there are two key criteria that are necessary to be met for an instrument to be classified as equity: Firstly, the instrument must foresee an entitlement of the holder to the residual interest in the net assets and, secondly, the instrument must not encompass a present obligation to deliver economic benefits to the holder of the instrument.

- 1.3 In essence, the first criterion means that the entitlement of an equity instrument holder is subordinated to all other classes of capital.⁶ The holder is entitled to what remains as an asset surplus after having satisfied all parties with a non-residual entitlement, hence, it is a variable entitlement on the entity's assets. The variability of the shareholder's entitlement relates to both, ongoing results/net profit or →loss, and any liquidation excess/deficit. The second criterion means that an equity instrument holder cannot be satisfied before and until all non-equity instruments have been provided for – with the

⁶ One has to keep in mind, though, that the shareholders may have a collective right, e.g. to distribute retained earnings. This is discussed in pars. 1.9 et seq. By exercising this right, they might withdraw capital prior to liquidation of the entity or before creditor's claims are satisfied.

exception of distributions made to equity instruments holders at the sole discretion of the entity.⁷

1.4 There are other attributes of common shares that are frequently associated with equity and which are used in some jurisdictions to distinguish equity from debt. Some of these could either be substituted by the aforementioned criteria (e.g. ‘subordination’ or ‘type of entitlement’) or may be regarded as not being a decisive criterion of and by itself (e.g. ‘term’ or ‘control/voting rights’) in distinguishing equity from debt. The following table lists some of the factors considered by the working groups and the classification that follows from them.

Classification as	Equity	Debt
Characteristic feature		
Participation in ongoing profits	✓	
Participation in ongoing losses	✓	
Fixed payment on the instrument		✓
Participation in liquidation excess	✓	
Variable claim on repayment/redemption	✓	
Possibility to agree on “no redemption”	✓	
Subordination	✓	
Fixed term/maturity		✓
Participation rights (general assembly)	✓	
Control/voting rights	✓	

Other residual interest-type instruments

1.5 Other residual interest-type instruments share many of the characteristics of common shares. In two respects, however, they frequently differ: Firstly, many instruments cannot be freely traded. Secondly, absent a market mechanism, they often are not transferred at fair value. Neither the Framework nor IAS 32, as currently drafted, contain an explicit reference to the entry or exit amounts of equity instruments which are to be met in order to ar-

⁷ These distributions would usually be covered – and limited – by company law in that an entity must not deliver assets to its shareholders beyond an amount that is necessary in order to meet all obligations assumed.

rive at a classification. Therefore, “price” is not a decisive factor given the current literature.⁸

- 1.6 The first issue, though, has an important impact under the current literature. If a residual interest instrument can or must not be traded, the only way for the holder to reverse his/her decision to invest in an entity would be to put the instrument back to the entity. In this instance, the put right does not serve the purpose of giving a provider of capital an additional benefit which otherwise would not be present, but to substitute the trading mechanism associated with common shares which is either not prevalent or may even be forbidden by law in many jurisdictions. This is the case for many partnerships and co-operatives in Europe, but may be the case for other legal forms and other jurisdictions as well.
- 1.7 Since the right to put an instrument back to the issuer gives rise to an obligation on the side of the entity, the second criterion cited in par. 1.2 would be violated: Exercise of the put right would lead to an outflow of cash to a residual interest instrument holder, before all non-residual interest instruments have been repaid. Since only instruments that meet both conditions – an entitlement limited to the residual and no present obligation to deliver economic benefits – qualify for equity treatment, the capital of residual instrument holders in legal forms other than a stock corporation generally do not qualify for equity classification under the current literature.
- 1.8 Absent the right to put, this type of capital shares all or many of the characteristics listed in par. 1.1 for common shares. This is acknowledged by the IASB in par. BC6 of its recent Exposure Draft of Proposed Amendments to IAS 32 and IAS 1 *Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation*. In order to improve⁹ the accounting for residual interest-type instruments for the above mentioned legal forms, the IASB pro-

⁸ The groups note, though, that the IASB’s recent Exposure Draft of Proposed Amendments to IAS 32 and IAS 1 *Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation* contains an explicit condition under which an instrument that is puttable can only qualify for equity treatment, if it was entered into at fair value and if its settlement will also take place at fair value.

⁹ See BC7 of the Exposure Draft of Proposed Amendments to IAS 32 and IAS 1 *Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation*.

posed to amend its current principle for distinguishing equity from debt. However, the proposals demonstrate how difficult it is to define exemptions from a general principle.

Individual vs. collective rights

- 1.9 As mentioned above, the current distinction between equity and debt in IAS 32 is based on the existence or non-existence of an individual instrument holder's claim against the entity and a corresponding obligation of the entity to sacrifice future economic benefits. As long as the entity does not have the sole discretion over a potential outflow of economic benefits, the claim would be deemed a financial liability.
- 1.10 At first sight, this principle seems to allow for a clear-cut distinction between equity and debt: Any individual claim that cannot be rejected by the entity would lead to classifying that claim as debt. On the other side, if the claim arises as a result of a decision reached by the shareholders collectively, that capital would not be treated as debt from the outset, but would rather be reclassified following the decision that has been made. For instance, the shareholders may decide upon the release of an amount out of retained earnings. Up to the point in time that the decision is made, retained earnings are nonetheless classified as equity. In other words: The mere possibility of shareholders deciding on a release out of retained earnings does not negate them being classified as equity. Only if and when that decision is made, the distributable portion is reclassified as a liability.
- 1.11 The working groups cast doubt on whether the differentiation between individual and collective claims is robust enough to make it a basis for distinguishing equity from debt instruments. Their concerns are twofold. Firstly, a distribution of amounts out of retained earnings might be seen as a violation of the basic principle under which a holder of a residual interest-type instrument cannot put it back to the entity before all non-residual-type instruments have been satisfied. Since a release of an amount out of retained earnings in many legal environments might happen without any precondition as to the occurrence and the amounts, it is at least questionable to some group mem-

bers whether equity treatment for distributable →reserves is justified given the principles laid down in the Framework and IAS 32.

- 1.12 Secondly, the groups can envisage situations in which the distinction between individual and collective claims becomes arbitrary on substance over form grounds. This can be illustrated for an entity with just one shareholder where, naturally, it would be hard to state whether the shareholder acts on behalf of the entity or on behalf of him- or herself. The situation is also prevalent in many family-owned businesses in Europe which may or may not be stock-listed. Typically, the founding family would hold enough voting rights to dominate the shareholder's meetings (legally or de facto.) Therefore, the working groups are not convinced that the distinction between collective and individual rights and interpreting a collective right of instrument holders as a decision of the entity is a robust criterion in all situations.

Perceived inconsistencies between the current Framework and IAS 32

Does probability of the outflow of resources matter?

- 1.13 If one holds that contingent obligations still meet the definition of a liability under the Framework, one would have to look at par. 91 of the Framework which requires that an outflow of resources be *probable* in order to recognise the liability on the balance sheet. Thus, for being recognised, meeting the definition of a liability alone is not sufficient. Since a liability would exist only in cases where the outflow of resources embodying economic benefits is *expected* to occur (and not merely *feasible* to occur,) there obviously is a probability notion embodied in the recognition criteria contained in the Framework. The predecessor version of IAS 32 (1995) contained a similar hurdle, which the Board removed when the standard was revised as part of the 2003 improvements project.¹⁰ The current text of IAS 32 requires the issuer of puttable instruments to classify these as debt, even if an exercise of the put and/or the outflow of economic benefits have a very remote possibility.¹¹

¹⁰ The recognition criteria promulgated in pars. 85 and 91 of the Framework contain an additional explicit 'probability' hurdle.

¹¹ Cf. IAS 32.25 and .AG28.

This contrasts former interpretation SIC-5 *Classification of Financial Instruments—Contingent Settlement Provisions*, which was superseded by IAS 32 (rev. 2003) and which contained an explicit exception to take into account probability:

*“Where the possibility of the issuer being required to settle in cash or another financial asset is **remote** at the time of issuance, the contingent settlement provision should be ignored and the instrument should be classified as equity.” [SIC-5.6; emphasis added]*

1.14 The removal of this probability criterion is further explained in IAS 32.BC17:

“The Board concluded that it is not consistent with the definitions of financial liabilities and equity instruments to classify an obligation to deliver cash or another financial asset as a financial liability only when settlement in cash is probable.”

In other words: It is consistent with the definition of a financial liability to classify an obligation as a liability even when settlement in cash is remote. One may take the view that this conclusion is inconsistent with the recognition criteria for a liability in the Framework, as the Framework prohibits recognition in situations when IAS 32 requires it.¹²

Are obligations to issue own shares liabilities?

1.15 Under the current literature, some obligations to issue own shares are classified as liabilities. For example, an obligation to issue a fixed number of shares for a variable amount or an obligation to issue sufficient shares to be worth a fixed amount are currently classified as financial liabilities according to IAS 32.

1.16 The working groups are not convinced that derivatives to deliver own shares meet the definition of a liability under the Framework. Although the entity is obligated to act in a certain way, the obligation does not involve the entity for-

¹² Even if one accepts that unrestricted residual interest-type claims are obligations of the entity, a questionable consequence exists in terms of measuring these claims: To determine the residual interest one would have to deduct all liabilities from the assets. If the liabilities included *all* obligations, both fixed and variable (= residual,) this approach inevitably would lead to zero equity, if *all* residual claims were puttable.

feiting future economic benefits. The new shares might have a dilutive effect on future earnings. However, it is the financial position of the present investors that is weakened. The new or potential investors' gain is at the expense of the present investors, but not of the entity. Therefore, in the working groups' view, one cannot argue that this obligation meets the definition of a liability under the Framework, as there is no outflow of resources embodying economic benefits from the entity.

- 1.17 The groups acknowledge that this view depends on the question as to what concept drives the presentation of the financial statements: As long as the IASB holds the view that financial statements shall be presented from an "entity's perspective," they conclude that these obligations do not meet the definition of a Framework obligation. On the other side, if financial statements were supposed to portray the financial position of the (present) investors, an obligation to issue new shares would indeed be a liability, as the present investors – through the entity – would be obligated to forfeit resources. However, if one embarks on an "investor's perspective," there would be other implications: One could no longer argue that instruments puttable at fair value were obligations, since the other investors' financial position is neither increased nor decreased upon redemption of another investor's share and, thus, cannot be an obligation. Furthermore, if instruments are puttable at an amount less than fair value, these would not constitute an obligation, but a gain (being the difference between the fair value and the amount the holder receives on exercising his/her right to put.) If one agrees with the view that classifying obligations to issue own shares is not consistent with the Framework, one has to conclude that the fixed-for-fixed criterion in IAS 32 mentioned in par. 1.15 is not part of or an interpretation of the principle contained in the Framework, but simply an additional rule in IAS 32.¹³

¹³ The groups note that at its meeting in April 2006 (see Observer Notes for Agenda item 8B) the IASB discussed a set for four different examples related to this issue: "Suppose that, after some transaction in which the reporting entity received cash in exchange, it has the:

- Obligation to issue 100 shares,
- Obligation to issue sufficient shares to be worth \$1000,
- Obligation to pay, in cash, the value of 100 shares, or
- Obligation to pay \$1000, in cash."

Implications from the issues around the debt/equity distinction according to the current IASB Framework and IAS 32

- 1.18 In this section we discussed a number of issues around the current debt/equity distinction. Among these are issues that some perceive as inconsistencies between the IASB Framework and IAS 32. Others take the view that these are not inconsistencies, but merely follow logically from application of stated principles. Nonetheless, there is one aspect that seems to warrant further reconsideration: The current split between debt and equity is based on a *positive definition* of what constitutes an obligation and thus, a *liability*.
- 1.19 Basing the distinction on a positive definition of a liability means that equity has two substantive characteristics:¹⁴
- Firstly, *equity instruments* are ‘non-liabilities,’ i.e. instruments that do not meet the criterion of embodying a present obligation to deliver cash or other financial instruments.
 - Secondly, the *overall amount* of capital presented as equity is calculated by deducting all liabilities from the gross assets recognised and measured according to IFRSs (i.e., equity equals net assets and is, thus, a *residual amount*.)
- 1.20 One would suspect these two characteristics to be present at least in capital instruments provided by the owners in their capacity as owners, e.g. a share in a stock corporation. However, in entities of other legal forms that is not always the case: Whenever a financial instrument embodies an obligation on the side of the reporting entity to deliver an amount *equal to a share in the residual*, the consequential accounting treatment that follows from application of the IFRSs will be that an entity will have to record the more “negative equity” the more profitable it becomes.¹⁵ The working groups accept that this

The IASB could not reach a conclusion as to which of these obligations meet the definition of a liability under the Framework; with the exception that (d) was viewed as a liability by all Board members.

¹⁴ Cf. pars. 1.2 et seq.

¹⁵ Cf. BC6 of the Exposure Draft of Proposed Amendments to IAS 32 and IAS 1 *Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation*.

counterintuitive result is mainly due to not recording all assets and liabilities on the balance sheet and not recording them at fair value. However, it seems questionable to them to apply an accounting concept that heavily relies on *other accounting issues* that have not yet being deliberated, let alone solved. The groups came to the conclusion that these problems are likely not to be overcome by reconsidering the definition criteria of a liability. Rather, they considered an approach that defines equity positively.

Summary of the issues discussed in this section

The preceding section focused on the current debt/equity distinction. The key issues are summarised below:

- Common shares are generally viewed as the blueprint of an equity instrument, since the holder they entitle has an entitlement to a pro rata share of the net assets of the entity but do not oblige the entity to sacrifice future economic benefits, as the single instrument holder has no claim.
- Many residual interest-type instruments of entities in a legal form other than a stock corporation can or must not be traded on a market. In order to discontinue the investment, these instruments foresee a right to put the instrument back to the entity.
- The differentiation between individual and collective claims is not convincing for entities with only one or a predominant shareholder who can exercise his/her voting power to force the entity to sacrifice economic benefits.
- In addition, a liability would exist under the Framework only if the outflow of economic resources was deemed probable. On the other side, a financial liability under IAS 32 can exist even if the probability of an outflow is remote.
- Obligations to issue own shares do not meet the definition of a liability under the Framework because there is no sacrifice of future economic benefits on the side of the issuing entity.

SECTION 1—THE CURRENT DISTINCTION BETWEEN LIABILITIES AND EQUITY

It is for the preceding reasons that the working groups feel a re-deliberation of the criteria that lead to either debt or equity classification is warranted. Since a growing number of entities that are not listed either voluntarily want to or must apply IFRSs, it seems justified to the working groups to rethink the current criteria that drive the classification of financial instruments in the accounts of the issuer. The groups came to the preliminary conclusion that use of a criterion other than the (non-)existence of a present obligation would improve financial reporting in distinguishing between equity and debt. That approach is labelled “*Loss Absorption Approach*” (LAA) and will be discussed in the following sections.

SECTION 2—DERIVATION OF THE LOSS ABSORPTION APPROACH

The objective of financial statements: meeting the information needs of users

2.1 According to the IASB's *Framework for the Preparation and Presentation of Financial Statements*, the objective of financial statements is

*“to **provide information** about the financial position, performance and changes in financial position of an entity that is useful **to a wide range of users** in making economic decisions.” [F.12; emphasis added]*

The *Preface* to the IFRSs contains a similar wording in par. 10.

Different user groups and providers of capital

2.2 In par. 9 of the Framework the IASB identifies potential users, including providers of →risk capital (→investors,) employees, →lenders, suppliers and other trade →creditors, customers, the government and the general public. These users may (and generally will) have specific and different information needs. However, the Framework goes on by mentioning that whilst not all information needs of each user can be met by financial statements, there are information needs which are common to all users. [F.10]

2.3 Amongst the different user groups identified in the Framework are three groups that provide capital to the reporting entity. The Framework (par. 9) uses the following terms and defines these terms as follows:

Investors. The providers of risk capital [...] are concerned with the risk inherent in, and return provided by, their investments.

Lenders. Lenders are interested in information that enables them to determine whether their loans, and the interest attaching to them, will be paid when due.

Suppliers and other trade creditors. Suppliers and other creditors are interested in information that enables them to determine whether amounts owing to them will be paid on due.

The similar wording used in defining “lenders” as well as “suppliers and other trade creditors” evidences that, as far as the capital provided to the entity is concerned, both user groups are creditors. We will use this term henceforward.

2.4 Generally speaking, a provider of capital will want to know

- what the →risks and →benefits of providing capital are; and
- who shares the same rank in order to determine the degree of risk and benefits sharing within a given class of capital.

Investors as the user group with the highest information need

2.5 According to the Framework, investors in their capacity as providers of risk capital to the entity will usually and arguably have the most comprehensive information need of all user groups mentioned in F.9. This is due to the fact that investors belong to the group whose →claims are subordinated to all other claims, i.e. there is no other group that will be satisfied after they have received their share. Creditors are primarily interested in information on the reporting entity’s ability to meet its obligations when due, i.e. its ability to service and repay the capital provided. From a creditor’s point of view questions as to who provided the risk capital subordinated to his/her claim or whether or not there are different levels of subordination within risk capital do not matter.

Perspective of capital classification: ‘entity view’

2.6 Basing the distinction between debt and risk capital (equity) on the characteristics of capital provided to the entity is consistent with what is known as an ‘entity view.’ The term ‘entity view’ is borrowed from the literature on consolidations and is usually used when deciding whether and how to present the capital and income attributable to minority interests. Under the entity view, the entity is considered an economic unit that is separate from its shareholders:

“[The concept] concentrates on the resources controlled by the entity, and regards the identity of owners with claims on these resources as being of secondary importance.”¹⁶

In the context of distinguishing between equity and debt classification of capital sources is judged from the perspective of the entity rather than from the perspective of a particular contributor of capital. From the reporting entity’s point of view the question as to who provided the capital does not matter. It is the characteristics of the capital and the overall amount of risk capital that is essential for the investment and financing decisions of the entity. In the view of the working groups, this would be consistent with the current thinking employed by the IASB in IASs 1 and 27.¹⁷

- 2.7 It is important to note that taking the definition of an investor as a provider of risk capital into consideration when distinguishing equity from debt does not mean focussing on the question of *who* is an investor and, following from that, simply classify any capital provided by him/her as risk capital. Rather, the definition of investors and creditors as different user groups in the framework is based on the *type of capital provided*: If capital shares certain characteristics, that capital is considered risk capital, and the provider of that capital meets the Framework’s definition of an investor.

Whether to base a capital distinction on one or more criteria

- 2.8 Most approaches to classify financial instruments foresee only two classes of capital into which they be categorised – equity and debt. Almost all of these approaches base the categorisation of funds provided to an entity on the presence or absence of substantive features or core characteristics. It is usually a combination of some of these criteria that people feel must be met in order to qualify an instrument as equity (or debt, respectively.) The working groups feel that a principles-based approach should preferably rely on as few criteria as possible. The more criteria are used, the more classes of

¹⁶ Cf. Ernst & Young (Ed.): International GAAP 2007, p. 373.

¹⁷ It is also consistent with the reasoning in other parts of the IFRS literature, e.g. IFRSs 2 and 7 and IAS 39. In its Exposure Draft on Proposed Amendments to IFRS 3 *Business Combinations* the IASB also followed an entity view.

capital arise: The general principle derived from combinatorial analysis leads to n^m classes of capital, where n denotes the number of potential outcomes ('met'/'not met') and m the number of criteria used.

2.9 Let's assume that a financial instrument would be classified as equity if, and only if, it met criteria A, B and C (i.e., a cumulative definition.) All capital instruments that fail to meet at least one of these criteria would be classified as liabilities. Such an approach would lead to different kinds of capital instruments being classified as liabilities – heterogeneous liabilities. Liabilities would encompass not only those meeting none of the three criteria ('pure' debt,) but also capital instruments that do meet

- *either* criterion A, B or C (debt with some similarity to equity;) and
- *either* criteria A and B, A and C, or B and C, being capital instruments that are even 'closer' to equity, except for not meeting the last criterion.

In summary, a capital classification that is based on three criteria will lead to eight classes of capital, one of which would be deemed equity and the other seven debt.

2.10 The existence of eight classes of capital does not necessarily mean that there have to be eight classes *for presentation purposes*, too: The eight classes can still be grouped into two main categories. Grouping dissimilar types of capital, though, will mean blending the categories and giving away decision-useful information that cannot be depicted by the users elsewhere, unless that information was presented or disclosed separately. The same would, of course, be true if just one criterion was used to differentiate between debt and equity, since such a classification of instruments would simply disregard their other features. However, if more than one criterion was used, the working groups believe that any classification would have to be based on a cumulative definition. Allowing for an alternative use of different criteria would be inconsistent with the underlying assumption that equity (or debt, respectively) has distinctive features.

2.11 This may be demonstrated on the FASB's Ownership Settlement and Ownership Approaches which uses two criteria to define equity: the (non-) existence of a present obligation (criterion A) and the type of claim (subordi-

nated residual claim/ownership interest, criterion B.) A financial instrument would be deemed an equity instrument, if it met criterion A or B or both. Such an approach will lead to four classes of capital and three classes of equity:

		Criterion B	
		met	not met
Criterion A	met	Equity type 1	Equity type 3
	not met	Equity type 2	Debt

Equity type 2 and 3 instruments can be illustrated as follows:

- Equity type 2: a mandatorily redeemable preference share with a fixed term that encompasses the same rights as are attached to common shares, i.e. the holders have a share in changes of the net assets; hence, the ‘ownership’ criterion would arguably be met, whilst the ‘term’ criterion would not.
- Equity type 3: a perpetual bond that provides a cumulative return, which is discretionary on the side of the entity, but will not be subordinated on liquidation. Obviously, the ‘ownership’ criterion would not be met, whilst the ‘term’ criterion would.

2.12 The aforementioned result of having three heterogeneous classes of capital being presented as equity seems questionable to the working groups from a conceptual point of view:

- Allowing for two criteria each thought to be a substantive feature of equity means, in essence, allowing for a ‘pick and choose’ approach that is open to accounting arbitrage.
- Equity 2- and 3-type instruments cannot be reconciled to each other, since each of them clearly breaks one criterion said to be substantive for equity classification.

It is for these reasons that the working groups believe that the use of more than one criterion will only lead to satisfactory results, if a cumulative definition for equity is used. Otherwise, both classes of capital will be blended with hybrid instruments and presentation of either class will become meaningless.

Characterising risk capital

'Risk and return'

2.13 The IASB describes the information needs of investors as follows:

*“The providers of risk capital and their advisers are concerned with the **risk** inherent in, **and return** provided by, their investments. They need information to help them determine whether they should buy, hold or sell. Shareholders are also interested in information which enables them to assess the ability of the entity to pay dividends.” [F.9(a); emphasis added]*

However, the Framework does not contain a definition of the terms *risk* or *return*.

2.14 In finance literature *risk* is usually defined as the variability of an expected future return and encompasses both negative and positive deviations from expected future returns (the comprehensive notion of *risk*.) In a narrower sense, *risks* are associated with only the negative deviations from expected returns, thereby referring to positive deviations as *benefits*.

2.15 In its Framework the IASB seems to have used both connotations at the same time: The term “*risk capital*” is obviously meant to capture both the risks **and** benefits associated with that form of capital (= a comprehensive notion,) whilst the phrase “*risks inherent in [...] their investment*” seems to encompass only the negative deviations (= a narrow notion,) leaving “*the ability of the entity to pay dividends*” to resemble a means of positive deviations, i.e. benefits.

2.16 The working groups have adapted these notions of “risk” and “benefit” to the context of capital contributions. The risks and benefits of providing risk capital are, thus, defined as follows:¹⁸

“Risks of providing risk capital include the possibilities of participating in losses over the term of the investment

¹⁸ The groups note that these definitions are consistent with the IASB’s literature, e.g. those found in IAS 17.

and of variations in return because of adverse changes in the issuing entity's performance."

"Benefits of providing risk capital may be represented by the expectation of participating in profits over the term of the investment and of gain due to converse changes in the issuing entity's performance."

'Participation in losses and profits'

- 2.17 Obviously, every investment in an entity goes along with risks and benefits. Any rational market participant will demand an adequate compensation for the risks assumed by providing capital with certain characteristics. Higher risks will generally go along with higher benefits and vice versa. Even the so-called "risk-free" investments carry the risk of losing the amount lent, though the probability of default may be quite low or insignificant.
- 2.18 Generally speaking, the benefits of an investment may take the form of interest, dividends, appreciation in value or a combination of these. Risks are generally associated with the probability of receiving less than the promised amount due at a given point in time under the terms and conditions of an instrument. The definitions in par. 2.16 above, however, contain a more specific element, being the *participation in* → losses, or profits, respectively. *Participation* means that the return of an instrument is closely related to the performance of the issuing entity. In other words, an instrument would be deemed participating in losses and profits only, if the holder's entitlement was linked to the entity's performance, i.e. its variability in wealth. This leads to the question whether it is participation in both losses *and* profits or just participation in losses that is decisive in distinguishing risk capital from debt.

'Participation in losses and profits' or 'participation in losses' only?

- 2.19 As noted in par 2.17 every financial instrument comes with risks and benefits. If these were symmetrical in the sense that both risks and benefits are either limited or unlimited, there would be no need to refer to participation in both losses *and* profits, since one would automatically come with the other. A closer look reveals that this is not necessarily the case: Plenty of financial in-

struments traded on the market contain a participation feature that is linked to a positive performance of the entity only while guaranteeing a minimum return or at least the notional amount. In other words, capital that participates in losses will also participate in profits whilst the opposite would not hold true.

- 2.20 The working groups evaluated each of the criteria listed in par. 1.4, both, individually, and in combination. In their view, it is the loss participation element that distinguishes risk capital from any other form of financing instrument and, therefore, best provides a user of financial statements with decision-useful information about an entity's types of capital. Capital that is not sharing in losses has a common characteristic: The instrument is not linked to a negative performance of the entity, i.e. the instrument's return does not decrease if the entity does not perform well. Due to this "fixed return" such instruments could force the entity into liquidation if it continuously suffered losses. In contrast, risk capital absorbs losses incurred because the claim to the capital provided is automatically reduced. By that, loss-absorbing capital serves as a buffer or cushion in protecting the claimants of non-risk capital. It is for this reason that the working groups believe that the *participation in losses* is the decisive factor in distinguishing risk capital from all other types of capital. Furthermore, the groups came to the conclusion that using the loss absorption criterion makes the use of additional features like 'sharing in profits' or 'subordination' redundant.¹⁹
- 2.21 It is important to differentiate between the investor's claim as such and the fair value of that claim: The claim of a provider of non-risk capital is either fixed or floored, so it does not fall below an amount specified in the terms and conditions of the instrument. The fair value of such a claim may, nonetheless, fall below the amount the holder may legally demand, i.e. his claim. That would, for example, be the case in situations where an entity is close to bankruptcy and, therefore, the claim is not expected to be settled in full (or at all.) Nonetheless, the decrease in the fair value of the claim would not be mirrored by a decrease in the claim itself – i.e., the claim remains un-

¹⁹ A discussion of the other criteria considered but rejected for capital classification is included in the Basis for Conclusions to this paper.

changed. That would not be the case for providers of risk capital: The sum of their entitlements would change in line with the economic condition of the entity. It is for this reason that the working groups believe that the *participation in losses* is the decisive factor in distinguishing risk capital from all other types of contracts.

‘Participation in losses’ = loss absorption

2.22 The working groups believe that the terminology can be improved by referring to the criterion as *‘loss absorption’* rather than *‘loss participation.’* The change makes it clearer that if the entity incurs losses, some capital – being the risk capital – must bear the negative consequences falling from them. What needs to be defined, though, is what is meant by the term ‘loss,’ especially as this is a term currently defined in the IASB’s Framework (pars. F.78 et seq.) The next section of the paper contains an in-depth discussion of this issue.

Summary of the issues discussed in this section

The preceding section was centred around the question on what should be considered equity taking into account the objective of financial statements as worded in the Framework. The key issues can be summarised as follows:

- Any principle on which equity is to be distinguished from debt should be based on robust criteria only: The fewer criteria, the more robust an approach. If more than one criterion was used to define the two classes of capital, a cumulative definition shall be employed.
- The criteria to be chosen shall be judged on whether or not they provide decision-useful information to the users of the financial statements.
- Investors in their capacity as providers of risk capital are identified as the user group having the most comprehensive information needs; therefore, an equity/debt distinction should take this fact into account when determining the degree and sort of information to be provided.

- Classification of capital as either risk capital (equity) or debt is based on the perspective of the issuing entity. From an entity's perspective it does not matter who provided the capital (i.e., who is an investor;) rather, capital needs to satisfy certain characteristics in order to qualify as risk capital.
- Risk capital differs from other forms of financing in that it participates in losses, i.e. its return is linked to a negative performance of the entity, too.
- Participation in losses is, thus, seen as the decisive factor for distinguishing equity from debt. To improve terminology, the term 'participation in losses' is superseded by 'loss absorption.'
- Other criteria by which equity could have been distinguished from debt that were considered but rejected include voting rights and the term/maturity of a financial instrument (see Basis for Conclusions.)

SECTION 3—REFINING THE APPROACH

What are losses?

3.1 Generally speaking, →losses are net negative results for a given period. A net negative result for a given period may be defined broader or narrower. The groups started off with the broadest definition possible, being a decrease in entity value. They then discussed a narrower definition based on the net negative performance result for the reporting period, i.e. an →accounting loss.

Losses = decreases in the value of an entity

3.2 The working groups started off with defining losses broadly as any decrease in the value of an entity (an 'economic loss.'). The idea was of a rather theoretical, economic nature: An entity's value can be determined by the entity's ability to generate future cash flows. The expected future cash flows are being discounted and added up to arrive at the value of the entity. If amounts and/or timing of the cash flows change, the entity value will do so as well. If the change affects the entity negatively, i.e. expected future cash flows decrease and/or occur later than expected, the value of the entity decreases – giving rise to a loss.

3.3 Although the concept is easy to understand, the groups feel that defining losses as economic losses has practical impediments. Firstly, there is a difference between using a DCF calculus to arrive at a point value or interval for the entity's value and referring to changes in DCF between two points in time to establish whether or not a loss has occurred. Given the uncertainties surrounding the estimation of future cash flows, a business valuation would usually lead to estimation of intervals, not points. Point values, however, are a must for calculating changes. Secondly, the value of an entity is not reflected in its accounts, which can prove to be an obstacle once the *exact amount of change* is needed to record the decrease of →risk capital in the accounts. To merely establish whether or not capital under consideration does absorb

economic losses from a conceptual point of view, i.e. for classification purposes, the exact amounts are not needed, of course.

Losses = accounting losses?

- 3.4 An alternative approach would be to define a loss as an accounting loss, i.e. a net negative performance number for the period determined under a given set of accounting principles. In light of the current discussions on reporting financial performance, the working groups would envisage determining a performance number from a gross presentation of an entity's performance, i.e. a statement of total recognised income and expense for a given period.²⁰
- 3.5 Such an approach would be rather easy to apply, but would nevertheless have impediments, too (these being of a more conceptual nature, though.) Currently, a loss is defined as the negative result of deducting expenses from income. Income and expenses are defined in the Framework as changes in assets and liabilities, the latter being subject to the definition of what does and does not constitute a liability. In other words, in order to decide whether capital absorbs losses one already needs to know the total amount of capital that is not absorbing losses. Hence, under the assumption that the definitions of income and expenses as laid down in the existing Framework were to be retained, there would be a circular element in referring to accounting losses.²¹
- 3.6 Further, classification of equity and debt instruments has traditionally been linked to the classification of the servicing costs payable on these instruments as either expense (debt instrument) or dividend/distribution (equity in-

²⁰ Currently, the Framework defines only income and expenses, but not comprehensive income. The term "total recognised income and expense" is used here with the same meaning as in pars 81 et seq. of the Exposure draft of proposed Amendments to IAS 1 *Presentation of Financial Statements. A Revised Presentation*. The term would seem similar to the "comprehensive income" as defined in FASB Concepts Statement 6 as "the change in equity [net assets] of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners" (FASB CON 6.70).

However, the IASB decided not to use the term 'comprehensive income', see par. BC.18 of the ED.

²¹ Cf. par. IN.11. The circular element is a result of the general assumption made in this Paper that the concept is based on the existing Framework. Re-deliberating other issues, e.g. the other elements defined in the Framework, might resolve the circular element.

strument.) There might be convincing arguments for this link; the working groups have not yet deliberated these and for the time being will, therefore, have to *assume* this link rather than *justify* it. Again, the link would give rise to circularity because calculation of the income (or loss) requires deciding whether the servicing costs on or re-measurements of this instrument are included in this calculation (debt instrument) or not (equity instrument.)

- 3.7 Generally speaking, an entity will use a unique combination of certain assets to generate revenues, based on a given business model. Financing costs are to be deducted from the revenue generated during the course of business. These financing costs may be interpreted as servicing costs for the capital provided, regardless of whether the capital was classified as equity or liability. This net result (result for the period before financing costs,) if negative, is what this narrower view tries to capture. An “accounting loss” would, thus, be defined as the

“net negative total recognised income and expenses before conditional servicing costs and related tax impact on and re-measurements of capital provided”

to avoid the definition being circular. „Conditional“ in this sense is meant to capture servicing costs that would not be expensed if the net total recognised income and expenses was negative.

Accounting losses as a proxy for determining economic losses?

- 3.8 Most economic losses, being reductions in the ability to generate future cash flows, are already depicted in the financial statements nowadays. These are decreases of assets and increases of liabilities with a corresponding decrease in equity, e.g. impairment losses. In this respect it does not matter whether the change is recorded directly in equity or in the income statement. However, there are also situations in which a diminution in entity value is currently not reflected in the financial statements. This would be the case for changes in the value of unrecognised assets and liabilities and unrecognised changes in the value of recognised assets and liabilities.

- 3.9 Most of the decreases in the value of an entity will be reflected in the financial statements *at some stage*. The fact that equity – as defined today – does not reflect the entire entity value does not mean that there are changes in assets and liabilities that will never be reflected in the financial statements because these assets and liabilities are either not recognised or not measured at fair value. Over the entire life-span of an entity all changes in entity value will be reflected in the financials; it is just that they may not be reflected in the period in which they occur – which is due to recognition and measurement conventions.
- 3.10 Among the 'temporary differences' referred to in the preceding paragraph are situations in which the financial statements depict an (accounting) loss that need not go along with an economic loss at all. For example, there might be entities whose →risk management strategy is to hedge a certain risk exposure economically, without choosing to present the hedge as such in the accounts according to the hedge accounting requirements of IAS 39. In this case a negative change in the fair value of the hedging instrument might not always be offset by a change in value of the hedged item (because it is measured at amortised cost.) In general, inconsistencies arising from a mixed measurement model are likely to lead to such timing differences.
- 3.11 The working groups can even envisage situations where an accounting gain goes along with an economic loss and vice versa. For instance, consider the measurement of a financial liability at fair value through profit or loss: An increase in the entity's credit rating will result in an increase in the fair value of the liability, thus giving rise to recording a loss. On a stand-alone basis this result is counterintuitive, since the entity is likely to have →benefited economically in this situation. Over the term of the liability these effects will compensate each other, but there can – and most likely will – be differences in timing.

Loss-absorbing capital

- 3.12 Based on the view that the ability to absorb losses²² should be the decisive criterion for distinguishing equity from debt, the groups developed the following definition:

‘Capital is deemed risk capital and, thus, presented as equity if it is available for loss absorption from an entity’s perspective.’

Split accounting

- 3.13 The working groups discussed whether or not to base classification of capital on the entire instrument in order to minimise structuring opportunities. That would have meant that any instrument with less than a 100% loss absorption capability would not qualify for equity treatment. The groups questioned whether presenting only fully loss-absorbing capital is decision-useful for the users of the financial statements. In their view, it is rather the *total amount of capital* that is or might become available for loss absorption. For that reason, the working groups decided to remove the restriction. In instances where an instrument is not fully loss-absorbing the entity splits the instrument in two parts, one of them being loss-absorbing and to be presented as equity, the other as debt. The split would be done by looking at how much of the instrument’s proceeds were available to absorb losses (i.e., if an instrument was issued for 100 and shared in losses up to 30, 30 would be classified as equity and 70 as liabilities.)

Terms and conditions and legal requirements

- 3.14 Classification of an instrument would have to be made at inception of the instrument and solely according to the terms and conditions of that instrument, i.e. independently of the classification of other instruments (although the application of this principle in some specific circumstances is discussed further below.) That means that all instruments within the same class of capital will be accounted for in the same way, without taking into account what other instruments had been issued or at which point in time an investment was being

made. The terms and conditions would include any legal requirements for the instruments.²³

Reclassifications

3.15 The working groups believe that the classification of an instrument shall not be changed unless either its terms and conditions are changed or settlement of the instrument gives rise to a new instrument. This treatment would be similar to that promulgated by IFRIC 9 *Reassessment of embedded derivatives*. In particular, no reclassification would be made over the term of the instrument because of

- recognition of new instruments;
- derecognition of outstanding instruments; or simply
- passage of time.

With regard to the last bullet the working groups came to the conclusion that the remaining term of an instrument is not a decisive factor for classifying or reclassifying an instrument (see pars. BC.11 and .21 et seq.) Since the essential feature of absorbing →losses would not change until the instrument is settled, it would seem inconsistent to reclassify it solely because its term – if any – nears maturity. In other words, the approach would not preclude equity classification for instruments that have a limited life, as long as the instrument is loss absorbing over the entire term.²⁴

3.16 If an instrument's terms and conditions contain a conditional element under which, if invoked, the substantive features of the instrument would change, the instrument shall be reclassified accordingly. An entity would have to test the instrument at each reporting date whether or not the condition is met. Examples include an embedded conversion option in a bond that, once exercised, would change the bond into a share. On exercise, the instrument

²² Cf. par. 2.20, where this notion was introduced.

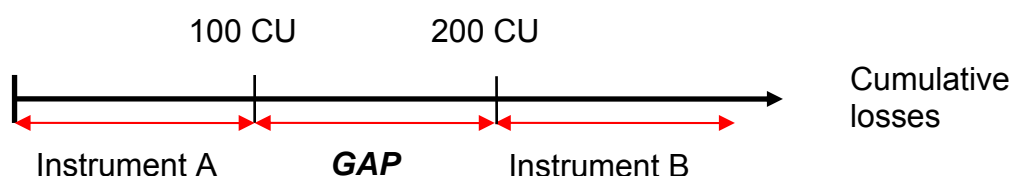
²³ A contract may contain a clause that would be in violation of applicable law. Such a clause could not be considered. Referring to terms and conditions is meant to be understood as terms and conditions "as enforceable by law." A contractual agreement may also refer to applicable law and, by this reference, incorporate legal requirements into the contractual agreement.

²⁴ In its Discussion Memorandum the FASB called this "temporary equity."

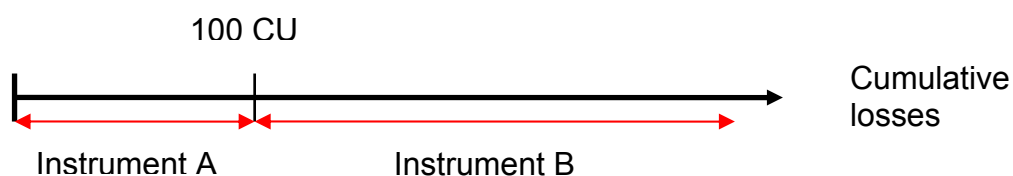
would be considered as having become loss-absorbing and would have to be reclassified into equity. Another example of a conditional element would be a term like ‘the instrument absorbs losses exceeding an amount of X’ (see below.)

- 3.17 The line of argument in the preceding paragraph might convey the impression that instruments with identical terms and conditions might be presented differently across entities and over time. This is because the very same instrument could have different loss-absorbing capabilities depending on the entity’s capital structure at a given point in time. However, this may seem counter-intuitive only at first glance: On closer look, the instruments are not identical, because in one entity or at one point in time, the term is operative whilst in another entity or at another point in time, the term is not (like an option being in-the-money and being out-of-the-money.)
- 3.18 The working groups envisage a number of different instruments that absorb losses only if certain conditions are met:
- (1) instruments which absorb losses up to a fixed amount from the first CU (“the first 100 CU of losses”)
 - (2) instruments which absorb losses that exceed a *fixed* amount (“absorbing the losses after the first 100 CU of losses have been absorbed”)
 - (3) instruments which absorb losses exceeding a *variable* amount (“absorbing the losses after another class of capital has been consumed up”.)
- The shares of an entity are an example of such an instrument, because the amount subscribed to the entity will only absorb losses once the entity’s →reserves are depleted (i.e. have absorbed all losses before.)
- 3.19 The groups take the view that a type (1) instrument would classify as loss absorbing up to the threshold defined in the terms and conditions. The rest of the instrument would have to be split from the equity part and be presented as debt. With type (2) and (3) instruments the answer is not that straightforward, since the question arises whether there is enough loss-absorbing capital in the entity to cover the first loss piece. Consider, for example, an entity with two capital instruments, the first absorbing all losses up

to 100 CU (instrument A,) the other absorbing losses that exceed 200 CU (Instrument B, the loss being determined on a cumulative basis.) After the first 100 CU of losses have been incurred by the entity, the claim to the capital provided under instrument A is already reduced to nil. If the entity incurs another loss of 1 CU, the entity would default on its liabilities, as claims to instruments that are liabilities would remain unchanged in this situation. The entity would become insolvent since the loss-absorbing capabilities of instrument B would never be triggered.



However, this conclusion would be different if instrument B's terms and conditions stated that it would absorb losses after the first 100 CU (rather than after the first 200 CU.) In this case, there is no 'gap' – any losses not absorbed by instrument A are absorbed by instrument B. As a result, B then qualifies as equity.



- 3.20 This line of argument leads to the conclusion that a type (2) or type (3) instrument should be classified as equity, if, and only if, the entity could demonstrate that there is a continuum of loss-absorbing capital. As explained in par 3.20, a gap would inevitably lead to the entity defaulting on its liabilities if the cumulative losses reach that gap. Instrument B does not meet the definition of loss-absorbing capital because the holder's claim to the capital is not reduced. The capital attached to instrument B is not available for loss absorption from the entity's perspective. It would become so only under the as-

sumption that the entity raised additional loss-absorbing capital to cover the losses equivalent to the gap and insolvency law did not require the entity to enter liquidation. Thus, application of the principle developed in this Discussion Paper leads to the conclusion that instrument B is not loss-absorbing due to the existence of a gap (and non-existence of a continuum of loss-absorbing capital.)

A continuum would exist if either

- there is other loss-absorbing capital that automatically covers any gap (= type (3) instruments,) one example being reserves that are depleted before another, usually pre-determined instrument is to absorb the losses next; or
- there is other loss-absorbing capital that, at the reporting date, and taking the entity's capital structure into consideration, covers that gap (= type (2) instruments.)

Are measurement reserves loss-absorbing capital?

3.21 Under the current IFRS literature, income and expenses are either

- recognised in profit or loss (net income) or
- recognised directly in equity.

The working groups considered whether measurement reserves stemming from recognition of income directly in equity, such as the revaluation or cash flow hedging reserves, were available for loss absorption. They reasoned that recognising income directly in equity is, in fact, an accounting convention. In other jurisdictions local GAAP may not provide for recognising gains and losses directly in equity, but rather in the income statement. Two observations follow from that:

- Had increases in assets or decreases in liabilities been reflected in the income statement rather than directly in equity, that would have impacted the calculation of the loss amount for the period (i.e., the loss would have been lower or would not have occurred at all.)

- A net positive performance number presented in a statement of total recognised income and expenses for a given period that is not distributed will remain in the entity and will be displayed as retained earnings. Since retained earnings are available for loss absorption, the groups reason that the same must be true for measurement reserves also.

This line of argument seems consistent with the tentative views reached by the IASB in its project on financial statement presentation.

Examples—the loss absorption approach applied to some common capital instruments

Common Stock/Shares

- 3.E1 Common stock in a stock corporation and equivalent types of shares in other legal forms would be deemed loss-absorbing risk capital, provided they absorb losses as defined. Even if the shares are redeemable at a fixed amount, this can only be done if the company has reserves out of which to redeem the shares; if these reserves have been absorbed by losses, the holders of the redeemable shares have no right to redemption. This distinguishes the redeemable shares from debt where the holders always have the right to repayment in full, but on an insolvent liquidation might not in fact receive their full entitlement.

Asset-linked notes

- 3.E2 Payments on asset-linked notes would be determined according to the cash flows received on a certain, specified asset. If the asset failed to pay a cash flow when due, the note would not be serviced.

Such an instrument would not meet the definition of loss-absorbing capital, since the instrument would not share in the losses of the *entity*, but rather mitigate losses incurred on a *particular asset*.

Convertible debt

- 3.E3 Convertible debt – regardless of whether mandatorily or freely convertible – would be classified as debt. Prior to the bond/loan being converted into loss-

absorbing shares of the entity, the bond/loan does not share in losses of the entity. The conversion option embedded in the terms and conditions of the instrument constitute a trigger element that would have to be tested for whether or not it became operational. Therefore, if the bond/loan was converted, the instrument would be reclassified as equity upon conversion.

Rights and obligations to buy back own shares

3.E4 Buyback arrangement can take different forms: An entity may have entered into a firm commitment to buy back own shares; or the entity may have written a put on its own shares; or, lastly, entity may have acquired a call option on its own shares.

Under the approach presented neither would the derivatives be presented as equity, since they do not absorb losses of the entity, nor would the shares outstanding be reclassified. As long as the firm commitment has not been executed or the options exercised, the shares keep their loss-absorbing capability and are, hence, classified as equity. However, the working groups believe that these buyback arrangements should be reflected in the financial statements by means of presenting separately the shares underlying this agreement on the face of the balance sheet and/or disclosing the fact in the notes that loss-absorbing capital will be reduced in the future.

Obligation to issue shares

3.E5 Like buyback arrangements, obligations to issue shares are not considered loss-absorbing capital under the approach. As long as the shares are not issued, the entity has not received any additional risk capital. Furthermore, the working groups believe that, from an entity's perspective, these arrangements are not debt either, since they do not constitute a future sacrifice of assets of the entity.

Summary of the issues discussed in this section

The preceding section was concerned with the task of refining the approach developed in section 2. The key issues can be summarised as follows:

- Losses are net negative results for a given period and can be defined in different ways. So far, the groups have tentatively decided to define losses as ‘accounting losses,’ but have not yet concluded on an operationalisation.
- Capital that is loss-absorbing from an entity’s perspective is presented as equity.
- If an instrument is only partially loss-absorbing, split accounting is applied. Under split accounting, an instrument would be bifurcated into a fully loss-absorbing portion to be classified as equity and a non-loss-absorbing portion to be presented as debt.
- Classification of an instrument is made on inception of the instrument.
- Any instrument would be classified according to its terms and conditions only. No reclassification would be made due to other instruments being recognised or settled or passage of time.
- An instrument would be reclassified if, and only if, its terms and conditions were changed. If the terms and conditions contain a conditional element that, if invoked, changes the substantive features, an entity would have to determine at each reporting date whether or not that conditional element has substance.
- If an instrument foresees loss absorption only if losses exceed a given threshold, the entity needs to establish that a continuum of loss-absorbing capital up to that threshold exists in order to classify this instrument as equity.
- Measurement reserves are considered loss-absorbing capital.

APPENDIX—SIMILARITIES AND DIFFERENCES BETWEEN THE PRESENT OBLIGATION APPROACH AND THE LOSS ABSORPTION APPROACH (LAA)

- A.1 Although relying on different principles, the present obligation approach as promulgated by the IASB in IAS 32 and the LAA developed in this paper will lead to the same classification of capital instruments in many cases. For example, common stock will be classified as equity under both, IAS 32, and the →loss absorption approach.
- A.2 One difference between the two approaches is that obligations to redeem risk-absorbing capital would not result in a liability classification under the LAA. Being risk-absorbing, this capital would be classified as equity despite the existence of a present or contingent obligation. In a stock corporation classification under both approaches would be identical, because the shareholders do not have an individual right to require redemption of their instrument (and thus, the entity has no obligation.) If the present obligation approach is thought to be leading to a meaningful distinction of capital and to be providing decision-useful information, the same would be true for the LAA. However, for entities in other legal forms, this conclusion may not be valid.
- A.3 As already discussed in pars. 1.9 et seq., the present obligation approach distinguishes between individual and collective →claims. Only claims that can be enforced by the holder individually give rise to obligations on the side of the entity. In turn, collective claims require collective decisions. As outlined before, differentiation between both types of claims can be difficult in practice and, thus, blend the categories falling from the split. Furthermore, absent a market mechanism →investors in entities in a legal form other than a stock corporation might be equipped with a redemption right by law to allow them reversing their investment decision. Given that redemption right, these entities are unable to present any equity under the present obligation approach. The LAA would take into account that the →risk capital provided to these entities does not differ from risk capital provided by shareholders to a

APPENDIX—SIMILARITIES AND DIFFERENCES BETWEEN THE PRESENT OBLIGATION APPROACH AND THE LOSS ABSORPTION APPROACH (LAA)

stock corporation, except for the redemption feature. The working groups believe that the capability of absorbing risks is decision-useful information and should, therefore, not be foregone by presenting the capital together with other, non-risk-absorbing capital.

- A.4 Another major difference between the present obligation approach and LAA is that no derivatives will be classified as equity under the latter. Generally speaking, derivatives are used in risk management to mitigate risks of individual assets or liabilities or portfolios of assets and liabilities. From the perspective of an investor, the fair value of a deep in-the-money call option on an entity's shares will vary in way similar to the fair value of the equity instrument itself. However, from the entity's perspective – and that is the perspective employed under this approach – these derivatives do not absorb →losses as defined. The groups point out that this conclusion is also consistent with the current Framework.
- A.5 Lastly, the perspectives used in both approaches differ. IAS 32 focuses on financial instruments only; it does not deal with other residual interests (e.g. →reserves including retained earnings.) One might take the view that retained earnings are attached to a primary financial instrument, e.g. share capital. If share capital was classified as equity, so would the reserves. This is because it is the shareholder who, when foregoing distribution of earnings, is the source of building up retained earnings. However, employing such a view confuses individual and collective claims, since in many cases the reserves cannot be claimed individually. That problem is solved in the LAA by not looking at *who* provided risk capital and who might have a claim to it, but rather *whether there is* risk capital available to absorb losses.

BASIS FOR CONCLUSIONS

Attributes of capital that are frequently associated with equity: Links between substantive features

BC.1 When looking at the different features listed in the table in par. 1.4 of this paper, the working groups noticed that there are some criteria which are partly or wholly inherent in another criterion.

Participating in ongoing profits/losses and fixed payments on the instruments

BC.2 “Participating in ongoing profits/→losses” means that the →claim or entitlement of the holder of an instrument *varies in amount in-line with net income*. “Participating” in this sense means that the holder’s entitlement under the instrument is reduced or increased, depending on the performance of the entity.

BC.3 In contrast, “not participating” does mean having either no claim/entitlement at all or having a claim/entitlement that is not affected by net income at all, i.e. the claim is unconditional. The claim would have to be honoured regardless of whether or not the entity generated a profit or suffered a loss in a given reporting period. Thus, “participating in ongoing profits and losses” would be the opposite of fixed payments or fixed servicing costs.

BC.4 Consequently, the groups concluded that “participating in ongoing profits/losses” and “fixed payments”²⁵ are two sides of a coin, the one being the reverse of the other. Requiring one criterion to be present in equity (e.g. “participating ongoing profits”) will automatically ensure that the other is *not*.

Participation in liquidation excess and type of claim on repayment/redemption

BC.5 Upon repayment or redemption of an instrument, the holder will either receive an amount that is independent of the performance of the entity over the life of

²⁵ I.e. the payments are not conditional on the entity incurring losses or on net total income for the period being positive. Usually, their payoffs are based on amounts fixed at inception.

the instrument or will receive an amount that is conditional on the entity's performance. The excess in a liquidation of an entity is the residual amount that is left over after all (fixed) claims upon liquidation have been honoured. If the instrument's terms and conditions foresee a participation in the liquidation excess, the holder's entitlement can be described as being variable. In situations where the instrument is perpetual, the questions as to whether or not the instrument's holder participates in liquidation excess and whether his/her claim is fixed or variable are, in fact, the same.

- BC.6 The working groups reasoned that if the term of instrument is shorter than the life of an instrument, the same logic can be applied. That is because the amount due on redemption would be calculated under the assumption that the entity was liquidated at the point of the instrument being repaid. Hence, the two criteria are thought to cover similar economics, if not the same.

Subordination

- BC.7 Subordination is linked to the criteria already discussed. "Subordination" means that one's entitlement may only be honoured after other claim(s) have been provided for. Thus, subordination could be a feature of both, claims to ongoing servicing costs of capital instruments, and claims upon redemption/repayment of an instrument (end of term of the instrument) as well as upon liquidation of the entity (end of life of the entity.) As far as ongoing servicing costs are concerned, subordination is inherent in both participating in ongoing profits/losses and fixed payments. The claim attached to an instrument that is *participating* in ongoing profits/losses is subordinated to all fixed claims, i.e. fixed servicing costs. Upon settlement, subordination simply means the same as participating in the liquidation excess or a variable claim to the residual that is left over after all fixed, i.e. non-subordinated claims, have been provided for. Consequently, the "subordination"-criterion does not provide any new information value that is not already inherent in the aforementioned features.

Attributes of capital that are frequently associated with equity: Discussion of their suitability as a sole criterion to distinguish two classes of capital

Participating in ongoing profits/losses and fixed payments on the instruments

BC.8 The working groups came to the conclusion that this criterion is not sufficient for basing the approach to distinguish equity from debt on it. Participating in ongoing profits/losses may be compensated by the settlement terms of the instruments and vice versa. For example, an instrument's terms and conditions might foresee loss absorption on a period-by-period basis, but might also include a provision under which the instrument's settlement amount was guaranteed. In essence, that would mean that the holder is compensated at the end of the instrument's term for any shortfalls over the term of the instrument. The groups believe that one must take a more comprehensive view and take the entire term of the instrument into consideration. This comprises both looking at ongoing servicing costs (i.e. participating in profits/losses vs. fixed payments) and the amount due on settlement of the capital. Otherwise structuring opportunities exist.

Participation in liquidation excess and type of claim on repayment/redemption

BC.9 Similar to participation in ongoing profits/losses vs. fixed payments, the groups feel that a more comprehensive view is warranted. This comprises all payments on an instrument, both over its life and upon settlement. Thus, on its own, the type of claim on redemption/repayment feature seems unsuitable for basing the split on.

Subordination

BC.10 If viewed on a stand-alone basis, subordination is not sufficient to distinguish equity from debt. Of course, equity would be understood as being subordinated to debt, but this is a mere tautology: Regardless of where a split based on the level of subordination between two classes of capital was placed, the split would logically result in all capital in one class being subordinated to all capital in the other class. However, if one embarked on the "claims only" ap-

proach mentioned in par IN.6, the “level of subordination in a certain situation” (e.g. with regard to ongoing payments or upon liquidation) could be a suitable criterion to *rank* all entitlements. For distinguishing between two classes, this criterion is unsuitable for logical reasons.

Term/Maturity

BC.11 Some view the term or maturity of a financial instrument as an important factor for distinguishing between debt and equity. They hold the view that equity does not mature whilst liabilities generally do. Absent other criteria, if a “debt” instrument has no fixed term (a perpetual instrument) and need not be repaid before liquidation of the entity, it would be treated as equity. Conversely, “equity” instruments that are puttable any time or upon a specified event would be regarded liabilities. However, the working groups concluded that the term of a capital instrument, regardless of whether repayment is certain or conditional, is not sufficient by and in itself for distinguishing liabilities from equity. This is because the characteristics of the capital provided do not change over the instrument’s term. This conclusion holds true regardless of which characteristics of the capital are considered and not only for loss-absorbing capabilities.

Voting rights

BC.12 Many instruments equip their holders with voting rights, so it seems logical to explore whether the presence or absence of voting rights could be used as a criterion to distinguish equity from debt. When both working groups discussed the features usually associated with either class of capital, they came to the conclusion that voting rights are indeed to be found predominantly with equity instruments.

BC.13 In the course of their deliberations, both working groups came to the conclusion that voting rights by and of themselves are not at decisive factor for distinguishing between equity and debt instruments. Voting rights are often interpreted as a means of legal power to exercise control over the entity. However, such control rights might be attached to certain debt instruments as

well. For example, debt covenants may grant a creditor the right to require immediate repayment, if the entity alters its business strategy. Also, a bank that originates a loan to a heavily under-capitalized entity will often be granted voting rights and decision-making power. Depending on the importance of these debt instruments and other possibilities to raise alternative financing, the rights of a holder of a debt instrument may in some cases be equal or even exceed the rights of a minority shareholder.

BC.14 Voting rights attached to different classes of instruments in an entity might equip some shareholders with fewer and other voting rights than other shareholders. For example, the limited partner in a commercial partnership may have the right to question the general strategy of the entity, but may not have the right to influence or even control the day-to-day operations.

BC.15 In some jurisdictions voting rights can be of temporary nature: They may be limited to certain periods or the existence or non-existence of certain conditions. For instance, in some jurisdictions non-voting preference shares become ordinary shares, if and as long as the preference dividend is not paid.

BC.16 Lastly, the groups identified practical reasons for discarding voting rights as the decisive criterion for differentiating between equity and debt. The term *voting right* is not defined and may encompass quite diverse →benefits, for example:

- In some jurisdictions the shareholders decide in the annual shareholders' meeting whether or not the entity is to pay a dividend and what amount is to be paid out. In other jurisdictions this decision might be at the discretion of the management.
- In some jurisdictions shareholders may have the right to vote for retrieving part or all of the retained earnings; in others they may not have this right.

- In some jurisdictions shareholders may vote on the future strategy and business model of the entity; in others the shareholders' right to vote does not encompass these decisions.

BC.17 Consequently, as voting rights may differ significantly across jurisdictions as well as across different kinds of shareholders in different legal forms, and as the legal voting rights of a shareholder may not be easily distinguished from other kinds of control rights that are provided to a holder of a debt instrument, the working groups came to the conclusion that voting rights by and of themselves do not meet the requirements of a principle-based approach to distinguish equity from debt.

Discussion of whether criteria could be used in a cumulative definition in addition to loss absorption

BC.18 Pars. BC.1 et seq. contained a discussion of links between different criteria. Some criteria (narrow criteria) were found to be partly or wholly inherent in other criteria (comprehensive criteria.) Under the assumption that a comprehensive criterion was deemed suitable and sufficient for distinguishing between equity and debt, there would be no use including further criteria, even if a narrow criterion was deemed important. In section 2 of this paper, the groups elaborated on the loss absorption criterion as the sole criterion to distinguish →risk capital (equity) from debt. Loss absorption is a comprehensive criterion that implicitly includes a number of other (narrow) criteria.

Criteria implicitly included in loss absorption

BC.19 As discussed in pars. BC.2 et seq., “participating in ongoing losses/profits”, or “participating in liquidation excess” respectively, means that the holder's entitlement under an instrument is reduced or increased depending on the performance of the entity. Consequently, both features are implicitly inherent in the loss absorption criterion.

Criteria not implicitly included in loss absorption

BC.20 Among the different features mentioned in par. 1.4 and discussed in this Basis for Conclusions, there are two criteria that are not implicitly inherent in the loss absorption criterion. Those criteria are term/maturity and voting rights. In the following paragraphs, we discuss whether they should be introduced as an additional criterion to loss absorption, resulting in a cumulative definition of equity.

Term/Maturity

BC.21 The workings groups discussed term/maturity as an *additional* criterion. Passage of time is not regarded a triggering event that would allow for reclassification of an instrument because the instrument's terms and conditions and, hence, its cash flows remain unchanged. Therefore, the working groups rejected the idea of adding a term criterion.

BC.22 Notwithstanding that decision, the working groups discussed whether some sort of consideration should be given to the term of a financial instrument. In their opinion, information about the life-span over which an instrument is available for loss absorption, is decision-useful. Users of the financial statement should be made aware of the fact that an instrument that was presented as equity on the reporting date, may be repaid a few days after the reporting date. Taken to an extreme end, one may think of a fully loss-absorbing instrument that was issued some days before the reporting date and repaid a few days after the reporting date. The working groups believe that if the entity incurred losses during this short term and if the instrument would absorb these losses, it shall be classified as equity regardless of its short term.²⁶ However, disclosure of the remaining (or short) term of these financial instruments, either on the face of the balance sheet ("thereof") or in the notes to the financial statements, seems appropriate.²⁷

²⁶ In such a situation, however, measuring the diminutions in the entity value can be an issue.

²⁷ We note that IFRS 7.39(a) already requires such an analysis for liabilities.

Voting rights

BC.23 The shortcomings of voting rights as a sole criterion were already discussed in pars. BC.12 et seq. The groups believe these shortcomings to be significant and just as relevant when used as an additional criterion. In addition, they have doubts as to the consistency of this criterion with the entity perspective: From an entity perspective, the groups deem the question as to who exercises control *over* the entity by virtue of control or voting rights more of a corporate governance issue. The entity cannot make decisions and act on its own, but requires people to decide on behalf of the entity. These people will exercise the entity's discretion by virtue of control or voting rights, according to the legal requirements of the relevant jurisdiction.

GLOSSARY OF TERMS

Benefits	Positive deviations from expected future returns
Claim	A legally enforceable right to receive cash or other assets
Creditor	A provider of capital whose claim to that capital is unaffected by the performance of the reporting entity. Used in this paper as a holder of a financial instrument, whose entitlement does not meet the definition of <i>→loss-absorbing capital</i>
Investor	A provider of <i>→risk capital</i> . According to the Framework, the providers of <i>risk capital</i> [...] are concerned with the risk inherent in, and return provided by, their investments
(Accounting) Loss	The net negative total recognised income and expenses before conditional servicing costs and related tax impact on and re-measurements of capital provided
Loss-absorbing capital	Capital that is sharing in losses and the claim to which is automatically reduced on the entity suffering a <i>→loss</i>
Reserves	<p>Generic term for retained earnings, income and expenses recorded directly in equity (such as revaluation surplus according to IAS16.39, cash flow hedging and other measurement reserves) and a capital surplus when the issuance price of new shares exceeds their respective par value.</p> <p>IAS 1.68 (p) uses the term for any capital that is attributable to equity holders apart from the “issued capital”. For an entity without share capital, e.g. due to legal form, IAS 1.77 uses the term “equity interests” instead of “issues capital”. IAS 1.76 (b) requires “a description of the nature</p>

and purpose of each reserve within equity”. The Framework uses the term “reserves” with a similar meaning in pars. 65 and 66.

Risk

Risk is usually defined as the variability of an expected future return and encompasses both negative and positive deviations from expected future returns, thus a comprehensive notion of risk. When used in conjunction with the terms “rewards” or “→*benefits*” (“risks and rewards”,) the term has a narrower notion. In this narrower notion, risks are associated only with the negative deviations from expected returns, the positive deviations being defined as *benefits*. In this paper used with the narrower notion

Risk capital

In this paper used alternatively for →*loss-absorbing capital*