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PRO-ACTIVE ACCOUNTING ACTIVITIES IN EUROPE (PAAinE)

DISCUSSION PAPER

DISTINGUISHING BETWEEN LIABILITIES AND EQUITY

JANUARY 2008

The development of this paper has been led by the German standard-setter, the Accounting Standards Committee of Germany (ASCG)/Deutsches Rechnungslegungs Standards Committee e.V. (DRSC), as part of Europe's PAAinE initiative.

The paper has been approved and is being issued by the German standard-setter, the European Financial Reporting Advisory Group (EFRAG), the UK standard-setter, Accounting Standards Board (ASB), the French standard-setter, Conseil National de la Comptabilité (CNC), the Danish standard-setter, Foreningen af Statsautoriserede Revisorer (FSR) and the Italian standard-setter, Organismo Italiano di Contabilità (OIC). It has also been approved by the Co-ordinating Group of PAAinE, which comprises representatives of the issuers and also the standard-setters of The Netherlands, Poland, Spain, Sweden and the UK.

The views set out in the paper reflect the preliminary views of the German standard-setter. The other bodies named above do not express any opinion on these at this stage.

The paper is available for downloading from the websites of the issuers and the intention is that it will also be made available on websites of other European National Standard-Setters. A limited number of copies will also be available in printed form.

Comment on any aspect of this paper is invited. Such comments should be sent:

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so as to arrive no later than 28 July 2008. All comments received will be placed on the public record unless confidentiality is requested.

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ABOUT THE PAAinE

About the PAAinE

EFRAG and the European National Standard Setters have agreed to pool some of their resources and work together more closely so that Europe as a whole can participate more effectively in the global accounting debate. It was agreed that this initiative should in the beginning concentrate on long-term pro-active work. The objective of the initiative is to stimulate debate on important items on the IASB agenda at an early stage in the standard-setting process before the IASB formally issues its proposals. The initiative has the joint ambitions of representing a European point of view and exercising greater influence on the standard-setting process. This initiative is known as the 'Proactive Accounting Activities in Europe' (or PAAinE) initiative.

Work carried out under the PAAinE initiative can take a number of different forms and the full objectives of the initiative are:

- to stimulate, carry out and manage pro-active development activities designed to encourage the debate in Europe on accounting matters and to enhance the quality of the pro-active input to the IASB;
- to co-ordinate and resource monitoring work of IASB and FASB projects; and
- to try to ensure, as far as is practicable, that the messages Europe gives the IASB are consistent.

A further description of the PAAinE initiative is available on the EFRAG website (www.efrag.org)

EXECUTIVE SUMMARY

Scope of this paper

ES.1 This paper analyses the distinction between equity and liabilities under current International Financial Reporting Standards (IFRS.) On the basis of this analysis, we demonstrate that the distinction principle used therein has apparent shortcomings. The shortcomings cannot be accommodated by merely “fixing” bits and pieces or by amending definitions. Rather, a fundamental review of the principle itself is warranted. This discussion paper is intended to stimulate and contribute to that debate.

Structure of this paper

ES.2 This paper is structured in seven sections:

- Section 1 discusses the nature of the credit side of the balance sheet, which comprises →claims to the entity’s assets as well as the various characteristics that the claims have. The section then analyses whether or not a distinction between two classes of capital, liabilities and equity, if based on one or more of these characteristics, would provide decision-useful information. Section 1 also highlights the implications of assuming a view that drives the presentation of the financial statements (proprietary vs. entity view) for the distinction between equity and debt.
- Section 2 describes the distinction between liabilities and equity under current IFRS and discusses perceived shortcomings of the distinction principle used therein.
- Section 3 discusses the buffer function of →risk capital and concludes that it is this buffer function that best meets the information needs of a wide range of users. It lays the foundation to what is labelled the Loss Absorption Approach.
- Section 4 refines the loss absorption approach further and discusses various issues around →loss-absorbing capital.
- Section 5 sets out some preliminary views on the application of approaches to distinguish between liabilities and equity within a group context.
- Section 6 contains examples that intended to illustrate and explain the loss absorption approach developed in this paper.
- Concluding remarks are contained in section 7.

Section 1

- ES.3 The credit side of the balance sheet comprises only claims. The structure of the claims (entity's capital structure) is multi-dimensional, i.e. the claims feature a distinctive bundle of substantive characteristics or criteria.
- ES.4 In order to transfer this array into a dichotomous structure (i.e. a two-part classification), one would have to choose one or more characteristics, but doing so is more or less arbitrary. As an overriding benchmark, one would look for a criterion that provides decision-useful information for a broad range of users in a majority of situations and for entities in different legal forms.
- ES.5 Most of the characteristics discussed in section 1 (see table in par. 1.10) can be used for distinguishing between liabilities and equity. However, these distinctions might provide decision-useful information only within a certain economic or legal setting or situation and/or only for a certain group of providers of capital, while providing less decision-useful information in other situations and/or for other users.
- ES.6 If more than one criterion was used to define the two classes of capital, a cumulative definition shall be employed in order to arrive at an unblended class of instruments sharing the same characteristics.
- ES.7 An alternative approach would be to seek to identify the "owners" of the entity and would classify only the capital provided by them as equity. Under such an approach, the characteristics of capital would be of secondary importance. The issue under that approach would be to identify a robust principle to isolate the owners across jurisdictions and for entities in different legal forms.
- ES.8 Classification of certain instruments (e.g. puttable residual interests, obligations to issue own shares) depend primarily on the view that drives the presentation of the financial statements (entity vs. proprietary view.) Given that the current IASB Framework does not contain an explicit reference to either view, one has to either deduce the view from the IFRS literature (see pars. 2.36 et seq.) or make an assumption (see pars. 3.23 et seq.).
- ES.9 A conceptually different approach would be to abandon the distinction entirely. This 'no split'-approach – sometimes called a "claims approach" –

would not require choosing one characteristic, but would merely list the claims on the entity's assets and disclose the characteristics of the type of capital in the notes. Any distinction between the different types of capital provided to an entity would be at the discretion of the user of the financial statements who could then make his/her own definition of equity according to his/her specific user needs.

ES.10 Given that a 'no split'-approach would give rise to a significant number of cross-cutting issues with implications to most of the projects currently on the IASB's agenda, such an approach could not be implemented in short- or even medium-term. On the other hand, the problems encountered under the current distinction principle require a response within a shorter timeframe, which is the reason for us not to pursue this approach.

Section 2

ES.11 The current distinction between liabilities and equity is based on the non-existence of an obligation. Other characteristics (residuality, ownership) are mentioned in the Framework, but remain vague and, in the end, are deemed irrelevant.

ES.12 Many residual interest-type instruments of entities in a legal form other than a stock corporation cannot or must not be traded on a market. In order to be able to reverse the investment decision, these instruments foresee a right to put the instrument back to the entity. This put right results in liability classification under the current literature, which – in our eyes – does not always lead to meaningful results. An example where this would be not the case are situations where the puttable instruments embody a claim of the owner to the residual upon liquidation of the entity.

ES.13 Furthermore, the current distinction between liabilities and equity is not a robust distinction for other reasons. Firstly, the distinction is based on the differentiation between individual and collective claims. Secondly, despite the lack of a contractual obligation, the terms and conditions of an instrument may interact in a way that the entity is economically compelled. However,

under IAS 32 the instrument would be classified as equity. Given that the existence of economic compulsion can be difficult to assess in certain situation, this may be a “robust” solution; however, the solution leads to doubtful results in certain situations.

- ES.14 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 probability of an outflow is remote.
- ES.15 Whether obligations to issue own shares do meet the definition of a liability under the Framework depends on the view that drives the presentation of the financial statements. Liability classification would be consistent with a proprietary view. However, classifying puttable residual interests as liabilities is inconsistent with a proprietary view. Conversely, assuming the entity view would be consistent with the current classification. Thus, an inherent inconsistency exists.

Section 3

- ES.16 The discussion in section 3 is centred around the question on what should be considered equity taking into account the objective of financial statements being providing decision-useful information to users as worded in the Framework. Investors in their capacity as providers of risk capital are identified as the user group having the most comprehensive information needs; therefore, a distinction between liabilities and equity should take this fact into account when determining the degree and sort of information to be provided.
- ES.17 Based on the discussion of different criteria in section 1, we reasoned that it is the buffer function of risk capital that provides the most decision-useful information.
- ES.18 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. Participating or sharing in losses is, thus, seen as the decisive factor for distinguishing equity from debt. The principle underlying the characteristic is generally called ‘loss absorption.’ The notion behind the loss absorption ap-

proach can be worded as follows: Is a particular type capital available to absorb losses, and if so: to what extent?

- ES.19 Classification of financial instruments as either liabilities or equity requires an assumption as to what view (proprietary vs. entity view) drives their presentation in the financial statements. The current IASB Framework is silent on this issue. Basing a distinction between liabilities and equity on certain characteristics rather than on the source of capital received seems to provide more decision-useful information. Generally speaking, any approach to distinguish liabilities from equity debt that is based on the characteristics of the capital provided is more consistent with an entity view. The loss absorption approach will, hence, be analysed taking an entity view.
- ES.20 Since the proprietary view seeks to report the financial position of the proprietors/owners and the performance to them, the primary criterion for classifying capital as either liability or equity under that view would be whether or not the capital was provided by the owners in their capacity as owners.
- ES.21 The loss absorption approach can be applied by combining both tests (“layers”.) Only capital that meets the definition of loss-absorbing capital (layer 1) and that is provided by the owners in their capacity as owners (layer 2) would be classified as equity.

Section 4

- ES.22 Losses are net negative results for a given period and can be defined in different ways. So far, we have tentatively decided to define losses as ‘accounting losses,’ but have not yet concluded on an operationalisation.
- ES.23 Capital that is loss-absorbing from an entity’s perspective is presented as equity. Since the entity cannot default on a loss-absorbing claim, loss-absorbing claims provide a buffer for the entity.
- ES.24 In order to qualify as loss-absorbing capital, capital must absorb the ultimate accounting losses of the reporting entity. Capital that absorbed losses of a business segment or a single asset would not meet this requirement.

- ES.25 Liabilities would become the “default” classification if the positive definition of loss-absorbing capital (equity) was not met.
- ES.26 Classification of an instrument is made on inception of the instrument. Any instrument would be classified according to its terms and conditions. An instrument would be reclassified if, and only if, its terms and conditions were changed.
- ES.27 If an instrument’s terms and conditions refer to other capital instruments, it is necessary to evaluate those terms and conditions in the light of the entity’s capital structure, in order to assess the total amount of loss-absorbing capital that is available to the entity to cover losses: For example, 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.
- ES.28 The concept of linkage requires an entity to view two or more instruments together as if they were one instrument, if the instruments are part of the same arrangement agreed between the transacting parties. Classification as either liability or equity would then be done for the joint instrument only.
- ES.29 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.
- ES.30 Retained earnings and measurement →reserves stemming from recognition of income directly in equity, such as the revaluation or cash flow hedging reserves, do generally meet the definition of loss-absorbing capital. Whereas retained earnings are generally available to absorb losses the entity incurs, measurement reserves do exist when income is recognised directly in equity instead. Had the income been recognised in the income statement, the measurement reserves would be accounted for as retained earnings (provided not distributed.)

ES.31 The loss absorption approach is not intended to provide information on insolvency. However, a requirement to disclose information on the term/maturity of the capital would provide some information on liquidity.

Section 5

ES.32 The classification determined for a single entity could be retained at the group level. This approach would be easy to apply, but might give rise to structuring opportunities and inconsistencies.

ES.33 The alternative would be to classify all instruments at the group level and independently from prior classification on the single entity level. This second alternative is significantly more complex. In particular, a number of criteria (e.g. subordination, loss absorption, claims to the net assets of an entity) are inherently inconsistent with the economic perspective on which the preparation of group financial statements is based: The group shall report as if it were a single entity. Conversely, questions relating to whether an instrument conveys a claim to the net assets, the level of subordination or loss absorption give rise to questions that would have to be answered from a legal perspective with a view to a legally existing, single entity.

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INVITATION TO COMMENT

Question 1

Do you believe that defining two different classes of capital on the credit side of the balance sheet does provide decision-useful information, even if the entity's capital structure is in fact multi-dimensional (the so-called "list claims"-approach, pars. 1.3 ff.)? If not, why?

Question 2

Do you believe that listing all claims to the entity's assets, ranking those claims by a certain criterion and providing additional information on all other characteristics of the claims in the Notes to the financial statements would have merit (pars. 1.3 ff)? Why? If not, why?

Note: The following questions are based on our view that defining two different classes of capital on the credit side of the balance sheet does provide decision-useful information (i.e. you disagree with question 1.)

Question 3

Do you agree with the analysis of the different characteristics of capital as the basis for distinguishing between equity and liabilities (pars. 1.14 ff.)? If not, why? Do you think that any other characteristics should be considered? If yes, which?

Question 4

Do you agree with the analysis in the paper on whether to base a capital distinction on one or more than one criterion (pars. 1.33 ff.)?

Question 5

Do you agree with the analysis in this paper that, in order to classify capital, either an entity view or a proprietary view has to be applied (pars. 1.40 ff.)? If not, why not? Do you agree with the paper's description of the implications of each approach (pars. 2.35 ff., 3.22 ff.)? If not, why?

INVITATION TO COMMENT

Question 6

Do you agree with the analysis of the needs of the users of financial statements in the context of classifying capital (pars. 3.1 ff.)?

Question 7

Do you agree that basing the distinction between equity and liabilities on risk capital would provide decision-useful information to a wide range of users of financial statements about entities in different legal forms (pars. 3.5 ff.)? If not, why?

Is there any other basis for the distinction that you would consider providing more useful information? If yes, which and why?

Question 8

Do you agree with the analysis of losses as either economic losses or accounting losses in the context of classifying capital as equity or liabilities (pars. 4.1 ff.)? If not, why? Would you agree that the Loss Absorption Approach should focus on accounting losses?

Question 9

Do you think that the Loss Absorption Approach is explained sufficiently clear in this paper (Section 4)?

Do you agree with the definition of loss-absorbing capital in par. 4.16? If not, why? How could this definition be improved?

Question 10

Do you agree that classification of an instrument as equity or liability should be based on the terms and conditions inherent in the instrument?

Do you agree that the passage of time should not be the trigger for reclassification of an instrument (pars. 4.22 ff.)? If not, why?

Question 11

Do you agree with the discussion on linkage (pars. 4.13 ff.)?

Question 12

Do you agree with the discussion on split accounting (pars. 4.36 ff.)?

Question 13

Do you agree with the discussion of the different approaches to distinguish equity from liabilities within a group context in general and with regard to the Loss Absorption Approach in particular (section 5)? If not, why? Would you prefer the approach set out in par 5.1(a) or the approach in par. 5.1 (b)? Why?

Question 14

Do the examples in section 6 illustrate the loss-absorption principle well? Would you have reached a different conclusion (or classification)? Why? Are there any other aspects of the Loss Absorption Approach that need to be illustrated?

Questions on the loss absorption approach in general

Question 15

Do you believe that the Loss Absorption Approach is sufficiently robust to be prescribed in an accounting standard? If not, why? If you are concerned about structuring opportunities what would be your suggestion to limit the structuring opportunities?

Question 16

Do you think the Loss Absorption Approach should be simplified? If yes, how could the Loss Absorption Approach be simplified?

Question 17

This Discussion Paper is based on the view that the current IFRS approach to distinguish equity from liabilities has shortcomings.

Do you agree with the analysis of the current IFRS approach to distinguish equity from liabilities (section 2)? Do you agree that the current approach has shortcomings as identified in this paper (pars. 2.17 ff.)? If not, why? Do you see any other shortcomings? Do you see advantages of the current approach?

Question 18

Do you believe that the Loss Absorption Approach would represent an improvement in financial reporting over the current IFRS approach? Do you think that the distinction based on this approach provides decision-useful information? If not, why? Do you have any other comments?

INTRODUCTION

An array of capital instruments and interests with various characteristics and a dichotomous capital structure

- 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. On the contrary, with regard to the elements of the financial statements, 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 reach far beyond labelling and affect measurement, classification of the servicing costs (see pars. IN.9 and IN.10) and consolidation techniques. But what are the factors that drive classification of capital as equity or debt?
- IN.3 People usually agree that any approach to distinguish between debt and equity should result in classifying at least common shares as equity. However, absent the common shares in a stock corporation, capital instruments may feature other combinations of criteria. People assign different weight to any or a combination of these criteria, because different user needs will ask for different classifications. In short, the distinction between equity and debt is more an accounting convention rather than a science – there is no “natural” definition of what equity or debt is. Equity is what different people *think* equity should be, and this thinking might be influenced by traditional accounting conventions. Given that there is no single predetermined criterion, any distinction requires picking and choosing criteria while at the same time rejecting

others. As mentioned before, different people have differing opinions about what shall and shall not be labelled equity, or debt, respectively.

IN.4 The distinction between equity and debt under current International Financial Reporting Standards (IFRS) is based on one criterion only: the presence of an obligation to sacrifice future economic →benefits. Although this criterion works well in many contexts, it has obvious shortcomings in several others. These shortcomings cannot be dealt with by merely revising or amending IAS 32. They rather require starting from scratch by looking at some fundamental aspects relating to the objective of financial reporting.

Scope of this paper

What this paper does address

IN.5 Having analysed and discussed the distinction between liabilities and equity in detail, we came to the conclusion that the principle driving the distinction under current IFRSs has apparent shortcomings which cannot be accommodated by “fixing” the principle. We have, therefore, developed an alternative approach. We demonstrate that the alternative approach provides better answers and more decision-useful information than the current obligation criterion in most circumstances to most users and for entities in various legal forms. This discussion paper summarises the discussion and is intended to stimulate and contribute to the ongoing debate of distinguishing between liabilities and equity and instruments with characteristics of both.

IN.6 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 IFRSs 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. However, in all other respects, this paper is intended to be consistent with the current Framework (see par. IN.11.)

IN.7 The views expressed in this Discussion Paper should be considered work in progress. There are a number of issues that have not yet been discussed in full, such as the application of the →loss absorption approach in a group context.

What this paper does not address

Application Issues

IN.8 This paper contains illustrative examples. These examples are intended to illustrate and explain the approach in this paper. Apart from the examples provided, this Discussion Paper does not deal with application or implementation issues. However, we think that this Discussion Paper sets out the principle in a sufficiently clear and understandable way in order to evaluate whether or not it has merit.

Measurement and income statement classification

IN.9 This paper is concerned with classification issues only. We acknowledge that, under current IFRSs, equity interests or equity instruments are not re-measured whilst liabilities are. However, these measurement conventions do not necessarily have to remain unchanged.

IN.10 The same statement is valid for classifications of items in the income statement. 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.

IN.11 However, with the obvious exception of the definition of the elements “liability” and “equity”, the thoughts discussed and expressed in this Discussion Paper are based on the existing IASB Framework as much as possible. References to ongoing projects or exposure documents are solely made to highlight or clarify an issue that the Board has stated a view on. We point out, though, that pursuing the approach outlined in this paper will most likely have

consequences for the Framework project, as the elements of the financial statements would need to be redefined.

Structure of this paper

IN.12 This paper is structured in seven sections:

- Section 1 discusses the nature of the credit side of the balance sheet comprising →claims to the entity's assets as well as the various characteristics that the claims have. The section then analyses whether or not a distinction between two classes of capital, liabilities and equity, if based on one or more of these characteristics, would provide decision-useful information. Section 1 also highlights the implications of assuming a view that drives the presentation of the financial statements (proprietary vs. entity view) for the distinction between equity and debt.
- Section 2 describes the distinction between liabilities and equity under current IFRS and discusses perceived shortcomings of the distinction principle used therein.
- Section 3 discusses the buffer function of →risk capital and concludes that it is this buffer function that best meets the information needs of a wide range of users. It lays the foundation to what is labelled the Loss Absorption Approach.
- Section 4 refines the loss absorption approach further and discusses various issues around →loss-absorbing capital.
- Section 5 sets out some preliminary views on the application of approaches to distinguish between liabilities and equity within a group context.
- Section 6 contains examples that intended to illustrate and explain the loss absorption approach developed in this paper.
- Concluding remarks are contained in section 7.

At the end of sections 1 to 5 a bulleted list summarises the main points discussed.

SECTION 1—CHARACTERISTICS OF CAPITAL AND CLAIMS TO ASSETS

Claims to assets and characteristics of claims to assets

Claims to assets on the face of the balance sheet

- 1.1 Generally speaking, the credit side of the balance sheet comprises →*claims* to the assets of the reporting entity, which are recognised on the debit side of the balance sheet. In addition, the credit side of the balance sheet contains “accounting figures”, such as retained earnings, currency translation adjustments and gains and →losses, which, under current IFRSs, are not recognised in the income statement (revaluation →reserve, cash flow hedging reserve etc.) These items are not capital instruments in their own right, as they are not based on contracts. Some of them are based on statutory requirements, such as retained earnings. Others, such as currency translation adjustments or gains and losses that have been recognised directly “in equity”, are neither based on contracts nor statute. They are simply figures that exist as a result of certain accounting conventions. Although not capital *instruments*, there is a claimant to these amounts, at least upon liquidation. In this regard, they do form capital *interests* that are attached to a capital instrument. Thus, recognising interests on the credit side of the balance sheet is consistent with the conclusion that the credit side of the balance sheet comprises only “claims”.
- 1.2 The claims to the entity’s assets will feature a combination of certain criteria. If one focused on three criteria only (for example “term”, “type of return” and “existence of voting rights”), and one assumed that – to simplify matters – each of those criteria may only have two attributes/values (fixed term vs. perpetual life, fixed vs. variable return and existence vs. non-existence of voting rights), based on combinatorial analysis, one could derive eight different “classes” of capital instruments or interests.

List & rank the claims: the no-split approach

- 1.3 Most concepts of accounting for hybrid financial instruments that are currently discussed share a preliminary decision for keeping the dichotomous structure of equity and liabilities on the balance sheet. Though all of them aim at a principles-based, rather than rules-based, conceptually sound approach, none could be applied without voluminous application guidance. The need for clear balance sheet structures from the point of view of →investors seems to be a strong supporting argument for maintaining a twofold capital structure. In considering the classification of hybrid capital claims and the complex classification rules that have been developed by different institutions, the decision usefulness of the equity-liability split may be doubted, though. A dichotomous structure forces preparers of financial statements to narrow down what today can be described as a continuum of claims between “straight equity” and “straight liabilities” to only two classes of capital. It is overlooked that the distinction between equity and liabilities may have become an artificial construct rather than a faithful representation of empirical capital structures.
- 1.4 To present a relevant and reliable picture, the balance sheet structure needs to reflect the structures of real world phenomena being reported. Within time, economic circumstances may change in a way that makes an existing twofold basic structure of the balance sheet no longer fit to economic reality. Up to now, changes in empirical capital structures have sometimes led to corresponding adjustments to the definitions of the basic elements “equity” and “liabilities” for accounting purposes. It might have been necessary to replace the elements themselves. The discussion on accounting for hybrid capital claims needs to go one step back and, firstly, ask for a comprehensive description of relevant empirical characteristics of capital claims (i.e. the real-world phenomena), and, secondly, develop an appropriate accounting concept.
- 1.5 One reason that has often led to abandoning alternative concepts lies in certain difficulties that arise from changing basic elements of the balance sheet.

Up to now “assets – liabilities = equity” is understood as a basic equation in accounting. Innovative concepts, such as a threefold capital structure, have been discussed, but usually disregarded for practical reasons. Implementing a third class of capital or a no-split approach would require addressing questions that reach beyond a stand-alone revision of IAS 32 and the Framework. Similarly, based on a 1922 publication by Paton, 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. After 20 years, the time may be right to explore this approach a bit further.

1.6 However, these approaches 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.)

1.7 A tentative result so far is that empirical capital structures are multi-dimensional. At first glance a “clear-cut” distinction between equity and liabilities on the balance sheet could be provided, if one and only one of the criteria, e.g. the existence of a fixed maturity date, was chosen as dividing criterion, but in this case, the labels “equity” and “liabilities” would obviously give no further information on the nature of the claim than the chosen criterion itself.

Characteristics of capital as the basis for distinguishing between equity and debt

Transferring an array of claims into a dichotomous structure

- 1.8 The terms “equity” and “debt” are generally associated with a certain combination of characteristics. As long as capital instruments embody the characteristics in this combination (as has been the case until the rise of mezzanine instruments), any of the characteristics may be used for a distinction and any of these distinctions will lead to the same classification. However, today one can observe a whole array of capital instruments, each with a different, unique, combination of characteristics. These new capital instruments do not always fit easily into a dichotomous structure of capital, as they “mix” characteristics that are generally associated with either “straight equity” or “straight debt”. Difficulties in classifying claims into the equity-liability scheme arise once the single characteristics point into different directions, e.g. if capital claims include participation in gains and losses – generally associated with “straight equity” – but are at the same time repayable at a fixed date – generally associated with “straight debt”.
- 1.9 In order to transfer an array of different capital instruments or claims (each with a different combination of characteristics) into a dichotomous set of elements, one would have to disregard some characteristics and require other characteristics to be present in the instrument. The characteristics one would need to focus on are “distinct” characteristics which are deemed more important or even “essential” for the purpose of providing decision-useful information to users of financial statements than other characteristics.
- 1.10 In some jurisdictions, the distinction between debt and equity is based on the distinctive bundle of characteristics inherent in a common share of a stock corporation: 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 summarise the main characteristics of common stock:

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- 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 once the entity has met its obligations assumed, will a residual 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 the proportionate share of the fair value of the entity.
- 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.

1.11 The following table contains some characteristics of capital instruments and their attributes/values and the classification that is associated with each of those attributes.

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	✓	

- 1.12 Each of those characteristics may be used for the purpose of distinguishing equity from debt. Each of the classifications derived from those features may provide decision-useful information within a certain setting or situation. The following paragraphs give an example for each of the features (and the classification based on them.)
- 1.13 In general, users of financial statements are concerned with future cash flows the entity is able to generate through its business and other activities. In particular, every provider of capital, such as investors, owners, →creditors and trade creditors, but also employees will be interested in the entity’s ability to generate future cash flows in order to make the required payments when due – dividends, interest, wages and salaries, trade payables etc. Information on the entity’s ability to generate future cash flows may be viewed as one purpose of financial statements and financial reporting in general. Fulfilling the afore-mentioned information neither requires a dichotomous distinction between equity and debt, nor do the information needs point at the relevant characteristics on which to base the distinction.

Discussion of different characteristics

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

- 1.14 The first three characteristics in the table all relate to the type of return that the capital instrument provides its holder with. One can envisage a range of

different attributes of this characteristic, the most extreme two being “fixed payments” and “participating fully in profits and losses”.

1.15 “Participating” means that the instrument holder’s entitlement under the instrument is reduced or increased, depending on the performance of the entity. In contrast, “fixed payments” mean that the instrument holder’s claim to the ongoing payments (i.e. servicing costs) on the instrument is unconditional. The instrument would have to be serviced regardless of whether or not the entity generated a profit or suffered a loss in a given reporting period. Usually, the payoff is based on amounts fixed at inception. Therefore, requiring one criterion to be present in equity (e.g. “participating in ongoing profits”) will automatically ensure that the other is *not*. A fixed return is usually associated with a debt instrument, whilst a variable return (i.e. a return which is based on residual profits¹) is associated with an equity instrument.

1.16 The type of return of an instrument may lead to a dichotomous structure of all claims recognised on the credit side of the balance sheet which provides decision-useful information:

- For example, a creditor will be concerned with the ability of the reporting entity to make the contractual payments when due. If the entity performs well (poorly), this will enhance (diminish) the ability to make the payments. Any instrument with a fixed return is an instrument which the entity will have to service even when the entity performs poorly. Thus, in a situation where the entity’s ability to make payments is diminished anyway, any instrument with a fixed return will require the entity to forfeit resources despite the loss situation. Consequently, instruments with fixed returns *ceteris paribus* will increase the entity’s credit →risk – the classification and the information provided by the classification is decision-useful.
- Further, as a starting point, let us assume that an investor has a residual claim – among other claims – to the ongoing profits. Obviously, his/her

¹ The working groups note that, under the current income statement structure and in accordance with IAS 1, there is no “residual profit”. The net income (= profit) or net loss itself is defined as the residual in the sense that some expenses and losses are deducted from revenue and gains. The net total is the residual. However, this income statement structure depends on the classification of capital instruments, because servicing costs on capital classified as debt is included when determining the profit (residual), whereas servicing costs in capital classified as equity is accounted for as a distribution of the residual (the profit). Absent a given income statement structure, one would have to differentiate between fixed servicing costs and those variable servicing costs where the actual amount is calculated as the residual after all other servicing costs have been deducted.

instrument would only be serviced if there was a residual profit (some profit left after all fixed, i.e. non-participating, claims have been provided for.) Not only will s/he be concerned about all instruments that provide its holder with a fixed return (that have to be serviced before any claim to a residual profit can even exist), but also about all instruments that s/he has to share his/her residual claim with, i.e. all other instruments within his (residual) class of instruments. Also, a classification based on the return will provide decision-useful information. However, his information needs are not focused on all instruments with a fixed return, but all capital instruments, as s/he is somewhat “last in line”. In contrast, the creditor does not need to be concerned about all instruments which have to be serviced after him (i.e. claim to residual profit). S/he may only be concerned about such instruments as they might influence the entity’s ability to generate future cash flows, i.e. in future reporting periods. This depends on whether residual profits are distributed to the holders of instruments that convey entitlements to residual profits or, alternatively, are allocated to some sort of reserve, i.e. retained earnings. In the latter case, they might be used in later reporting periods to service his fixed-return instrument.

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

- 1.17 Upon repayment or redemption of an instrument, the holder’s claim may be to an amount that is independent of the performance of the entity, i.e. a fixed claim. Such a claim is typically associated with a debt instrument. As long as the entity is able to repay the instrument because the entity generates sufficient cash flows, the creditor will not be concerned with the entity’s performance over the term of the instrument. In particular, any instruments that are redeemable at a variable (i.e. residual amount) are of no concern to him/her, as such instruments may not diminish the entity’s ability to repay the creditor’s instrument: the entity will only be obliged to forfeit resources equal to the residual. Hence, in order to calculate the residual, his/her fixed claims will have to be taken into consideration. Claims associated with instruments that have to be redeemed at a residual amount may never compete with a creditor’s fixed claim. Thus, a distinction based on the type of claim on redemption is decision-useful for him/her.
- 1.18 The holder’s claim may also depend on the performance of the entity, i.e. a claim to a residual amount. A residual claim is understood as a claim to the amount that is left over after all (fixed) claims upon liquidation have been

honoured. Such a claim is typically associated with an equity instrument. If the instrument is not repayable during the lifetime of the entity, the relevant claim will be the claim upon liquidation.

- 1.19 We reasoned that if the term of an instrument is shorter than the lifetime of the entity, 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. Thus, a residual claim on redemption is not necessarily associated with the instrument being perpetual. A distinction based on the type of claim on redemption will provide decision-useful information to any instrument holder with a residual claim, regardless of whether the instrument was perpetual, puttable by either holder or entity, or mandatorily redeemable.
- 1.20 A split based on the type of return upon liquidation may also be considered providing decision-useful information based on the following argument: The entity can *never* default on an instrument that conveys a residual claim: In the most extreme situation, the residual is zero and the claim under the instrument will be to a zero amount. The argument holds true regardless of whether the instrument was perpetual, puttable by either holder or entity, or mandatorily redeemable. Conversely, the entity can default on a fixed claim on redemption.

Term

- 1.21 The type of claim on redemption points at another feature which is viewed as an important factor for distinguishing between debt and equity by some: the term or maturity of a financial instrument. 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 as liabilities.

- 1.22 However, we 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. If a distinction would require a certain minimum term of capital provided, and the remaining term of an instrument would fall below this remaining term threshold, one would have to re-classify the instrument. However, if the distinction was based on one or more characteristics of the capital, but these characteristics did not change over the instrument's term, it would seem inconsistent to reclassify it solely because its term nears maturity.
- 1.23 Information on the maturity of the different capital instruments or interests on the credit side of the balance sheet will generally provide decision-useful information as estimations of the entity's future solvency can be based on this kind information. However, this observation is true for all classes of capital, regardless of whether the capital was classified as equity or debt. Basing the distinction between both classes on term seems questionable as the distinction would not provide *additional* information if the term of the different capital instruments and interests were disclosed in the notes to the financial statements anyway. Thus, we concluded that information on the term is decision-useful, but a classification based upon this characteristic is not.

Subordination

- 1.24 "Subordination" means that one claim 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.) Upon liquidation the notion of subordination determines the sequence in which claims are satisfied. The residual claimant is satisfied after all other claims. Thus, this claim is the most subordinated. In terms of ongoing payments, the notion of subordination determines the sequence in which the claims to the result of the reporting period are distributed or allocated to the various claimants. This sequence can be thought of as something as a "waterfall" (see

par. 4.9) of servicing costs, i.e. the order in which the different capital is serviced. Under the current IFRS literature, a split is built into this waterfall. Some servicing costs are included when determining income or “net total”, some servicing costs are classified as allocation of profit.

- 1.25 Subordination is linked to characteristics already discussed. As far as ongoing servicing costs are concerned, subordination is inherent in both participating in ongoing profits/losses and fixed payments. A claim of 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. Thus, the “subordination” criterion does not provide any new information value that is not already inherent in the aforementioned characteristics.
- 1.26 If viewed on a *stand-alone basis*, subordination is not sufficient to assign different instruments/interests to two classes of capital (equity and 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. Thus, subordination, if used as a criterion on a stand-alone basis, is unsuitable as a *relative* criterion (relative understood as distinguishing between two “buckets” of capital comprising different instruments, with one “bucket” being subordinated to the other, i.e. relatively.) However, subordination can be used as an *absolute* criterion on a stand-alone basis to identify exactly one type of instrument (a “class of identical instruments”) that is the *most* subordinated in the reporting entity.

Voting rights

- 1.27 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 we discussed the features

usually associated with either class of capital, we came to the conclusion that voting rights are indeed to be found predominantly with what is currently classified as equity. 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-capitalised 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.

- 1.28 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.
- 1.29 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.
- 1.30 Lastly, we identified practical reasons for discarding voting rights as the decisive criterion for differentiating between equity and debt. Voting rights can vary significantly between jurisdictions, 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.

1.31 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, we 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.

Characteristics applied in a group context

1.32 In the preceding paragraphs the different characteristics were discussed from a single entity's perspective. Conceptually speaking, these criteria can be applied to a group as well. However, application of some of the criteria in a group context is not as straightforward as on the individual entity level and gives rise to additional issues to be dealt with. As indicated in IN.7, we have not yet deliberated these issues at large. That said, some general remarks containing the conceptual questions to be answered and possible ways forward are addressed in section 5.

Whether to base a capital distinction on one or more criteria

1.33 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.) We think that a principles-based approach should preferably rely on as few criteria as

possible. The more criteria are used, the more classes of 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.

1.34 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.

1.35 The existence of eight classes of capital does not necessarily mean that there also have to be eight classes *for presentation purposes*. 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, we 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.

1.36 This may be demonstrated by the FASB’s Ownership/Settlement Approach² which uses two criteria to define equity: the (non-)existence of a settlement obligation (‘term/settlement’ criterion, criterion A,) and the type of claim, a subordinated, most residual claim (basic ownership instrument/‘ownership’ criterion, 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

1.37 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/settlement’ 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/settlement’ criterion would.

1.38 The aforementioned result of having three heterogeneous classes of capital being presented as equity seems questionable to us 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.

² Cf. FASB, Preliminary Views, Financial Instruments with Characteristics of Equity, par. A1 - A3. For the definition of a basic ownership instrument see pars. 18 et seq.

- 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.³

It is for these reasons that we 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.

Equity as the capital provided by the legal owners of the company

1.39 Another way to distinguish capital provided to an entity that 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,⁴ whereas capital provided by external contributors other than the legal owners is referred to as debt. Usually, capital provided by the legal owners has characteristics that have been discussed in the previous paragraphs, in that the capital is usually subordinated to all other sources of capital and is, thus, often being referred to as ‘→risk capital’ or ‘capital at risk.’ It is generally associated with a view to a claim on a company’s increases and decreases in value, and so has traditionally been understood as a ‘residual,’ i.e. the amount left after having deducted all (fixed) claims on the company’s assets.⁵ However, this approach requires finding a robust principle to identify the “owners” across different jurisdictions and for different legal forms.

Entity vs. proprietary view: a necessary assumption

1.40 The presentation of the financial statement can be driven by two basic views. One is generally referred to as the “entity view”, the other as the “proprietary”

³ The working groups note that in the milestone one draft (a preliminary version of the FASB preliminary views paper “Financial Instrument with Characteristics of Equity”) the ownership approach, now re-labelled basic ownership approach, did foresee equity classification for perpetual instruments similar to the current ownership/settlement approach. The FASB apparently changed its view in June 2007 and decided that perpetual instruments would not be classified as equity under the then labelled ownership approach and retain equity classification for perpetual instruments only under the ownership/settlement approach.

⁴ Cf. Brealey/Myers: Principles of Corporate Finance, 6 ed., p. 391.

⁵ Ibid.

or “investor’s view”. These two alternative views have implications for a number of accounting issues.

1.41 One of the issues where the view taken would have consequences is the distinction between equity and liabilities:

- For example, classification of an entity’s obligation to issue own equity instruments depends heavily on the view: If the financial statements were presented from an “entity’s view,” these obligations could not be considered a liability. Although the entity is obligated to act in a certain way, the obligation does not involve the entity forfeiting future economic benefits. The new equity instruments⁶ 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. There is no outflow of resources embodying economic benefits from the entity. Assuming that the entity receives no consideration at all in exchange for the newly issued equity instruments, the only effect is that the net assets are divided into more instruments (shares) than before, but the financial position of the entity (and its net assets) remain unchanged. If the entity receives some sort of consideration that embodies benefits, the net assets even increase (and not decrease, as the recognition of a liability might imply). However, under a proprietary view the financial statements are supposed to portray the financial position of the (present) investors. Only under this view an obligation to issue new equity instruments would constitute a liability, as the present investors – through the entity – would be obligated to forfeit resources.
- Further, some characteristics that might be used to base the distinction on are more consistent with an entity view, while others are more consistent with a proprietary view. One example is voting rights. Under a proprietary view, the financial statements are supposed to portray the financial position of the (present) investors. If an instrument is equipped with voting rights, and voting rights is the criterion the definition of equity is based on, the holder of this instrument is considered an investor. Since the financial statements were supposed to portray the financial position of the holders of this class of instruments, their capital would be regarded equity. On the other hand, if other characteristics were chosen, e.g. residual return, the question as to who provided this capital would not matter. Rather, the characteristics of the capital will be important from the perspective of the entity in order to structure its financing activities. Thus, looking at the characteristics of the capital seems more consistent with an entity view.

⁶ The groups note that, at first glance, this appears to be somewhat circular, since, in order to decide whether the obligation to deliver an equity instrument is classified as equity or debt, one must already know how an equity instrument is defined. However, this is not the case. The question is whether an obligation to deliver the very instrument or interest that meets the definition of equity – whatever this definition may be – should be classified as equity or not.

1.42 The current IASB Framework does not contain an explicit reference as to which view should drive the presentation of the financial statements (entity vs. proprietary view). Since any distinction between equity and liabilities depends on which of the two views is employed, we must assume a view in order to develop an approach (see section 3, pars. 3.23 et seq.). Without an explicit view or assumption, any approach to distinguish equity from debt is likely to give rise to inconsistencies (see section 2, pars. 2.39 et seq. for the current distinction).

Summary of the issues discussed in this section

1.43 The preceding section focused on the characteristics of capital as the basis for distinguishing between equity and debt. The key issues are summarised below:

- The credit side of the balance sheet comprises only claims. The structure of the claims to an entity's capital structure is multi-dimensional, i.e. the claims feature a distinctive bundle of characteristics.
- In order to transfer this array into a dichotomous structure, one would have to choose one or more characteristics. Choosing one or more characteristics is more or less arbitrary and depends e.g. on the situation and the user group. Thus, one would look for a criterion that provides decision-useful information for a broad range of users in a majority of situations and for entities in different legal forms.
- Most of the characteristics contained in the table in par. 1.10 can be used for a distinction between equity and debt when applied to a single entity. These distinctions will provide decision-useful information only within a certain setting or situation for a certain group of providers of capital, while providing less decision-useful information in other situations for other users. We note, though, that some characteristics will not lead to workable solutions when applied within the context of a group reporting entity.⁷

⁷ A conceptually entirely different approach would be to abandon the distinction entirely. This 'no split'-approach would not require choosing one characteristic, which may be regarded by some

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- Any principle on which equity was 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.
- Another approach would seek to identify the “owners” of the entity and would classify only the capital provided by them as equity. Under this approach, the characteristics of the capital would be of secondary importance. The issue under this approach is to identify a robust principle to identify the owners across jurisdictions and for entities in different legal forms.
- Classification of certain instruments (e.g. puttable residual interests, obligations to issue own shares) depend primarily on the view that drives the presentation of the financial statements (entity vs. proprietary view). Given that the current IASB Framework does not contain an explicit reference to either view, one has to either deduce the view from the IFRS literature (see pars. 2.39 et seq.) or make an assumption (see pars. 3.23 et seq.).

as more or less arbitrary. Any user of the financial statements could, based on the disclosed information on the different characteristics of the entity’s capital construct his/her own definition of equity according to his/her specific user needs. Given that a ‘no split’-approach would give rise to a significant number of cross-cutting issues with implications to most of the projects currently on the IASB’s agenda. The working groups are of the opinion that such an approach could not be implemented in short- or even medium-term. On the other hand, the need for a re-consideration of the current distinction requires a shorter timeframe.

SECTION 2—THE CURRENT DISTINCTION BETWEEN LIABILITIES AND EQUITY

The current distinction

The IASB Framework

Equity being a residual

- 2.1 The common share of a stock corporation is often regarded a ‘blueprint’ for describing the ‘purest’ form of equity. It is the unique set of the criteria listed in par. 1.10 that is deemed typical for an ‘equity’ instrument.
- 2.2 The current IFRS distinction between liabilities and equity is based on the 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.]

- 2.3 At first sight, a residual does not seem to have any particular characteristics, nor does it *need* to have any particular characteristics. A residual in a mathematical sense is a mere “accounting figure” that is needed to make the equation “assets = liabilities + [residual]” work.
- 2.4 If viewed in tandem with the definition of a liability, though, a different reading can be applied. There seem to be 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.

- 2.5 The notion of equity being a residual-type entitlement is somewhat linked to the characteristics described in pars. 1.11, 1.14 et seq.: A residual-type entitlement implies that this entitlement is *subordinated* to all other classes of capital.⁸ The entitlement is limited 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. Thus, the holder of an equity instrument *participates in ongoing profits and losses*.
- 2.6 The definition in par. 49(c) raises another question: Who is the claimant of that residual interest?

An ownership notion?

- 2.7 Par. 65 might shed some light on this question as it allows a reporting entity to sub-classify its equity. One characteristic that might be reflected when sub-classifying the equity is the *ownership interest* in the entity by some parties having differing rights with regard to ongoing payments and repayment of the contributed capital:

*“Although equity is defined in paragraph 49 as a residual, it may be sub-classified in the balance sheet. [...] Such classifications [...] may also reflect the fact that parties with **ownership interests** in an entity have differing rights in relation to the receipt of dividends or the repayment of contributed equity.” [emphasis added]*

- 2.8 The statement implies that there is some connection between equity, even if defined as a mere residual, and ownership interests. However, the connection remains vague and the nature of 'ownership interests' is not explained any further.
- 2.9 Ownership interests exist in every entity, regardless of legal form. However, depending on the legal form, those ownership interests feature different

⁸ 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. 1.27 et seq. By exercising this right, they might withdraw capital prior to liquidation of the entity or before creditor's claims are satisfied.

characteristics. Likewise, in every entity and every legal form, there must be at least one residual-type interest or instrument. Usually, the residual interest-type instruments simultaneously convey ownership interests.

Equity instruments under IAS 32

2.10 IAS 32 shifts the view from equity *interests* to equity *instruments*. IAS 32.11 defines an equity instrument as

“[...] any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.” (IAS 32.11)

2.11 As with the Framework, one has to take the definition of a financial liability into consideration to fully understand the substance of the aforementioned definition. IAS 32 defines a financial liability as

“any liability that is (a) a contractual obligation (i) to deliver cash or another financial asset to another entity [...].”

2.12 Similar to the definition contained in the Framework, the definition of a financial liability trumps the definition of an equity instrument and thus, restricts it. Even if a contract evidences a residual interest, it may not be classified as an equity instrument under IAS 32, since the contract may give rise to a claim at the side of the holder and an obligation at the side of the entity. Despite the residual interest, such a contract would be a financial liability under IAS 32.

2.13 In addition, IAS 32 defines certain derivatives as equity instruments, although these derivatives may or may not evidence a residual interest. IAS 32.22 states that:

“A contract that will be settled by the entity (receiving or) delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument.”

This additional rule and its consistency with the Framework will be discussed later in pars. 2.35 et seq.

Interim conclusions

- 2.14 Both the Framework and IAS 32 mention residual interests in the net assets of the entity in connection with equity or equity instruments. However, the nature of the residual interest remains vague and is not explained further. In addition, the Framework mentions ownership interests, but this notion is also not explained any further.
- 2.15 In essence, it is the non-existence of an obligation on the side of the entity and, correspondingly, the non-existence of a claim of the holder of the instrument or interests that is the decisive criterion for classifying an item as either equity or debt in accordance with IFRSs.
- 2.16 Neither the Framework nor IAS 32 explains why exactly the presence or absence of a present obligation was chosen as the distinguishing factor – both with regard to all the other possible characteristics (mentioned and discussed in pars 1.11. 1.14 et seq.) and with regard to the other characteristics mentioned in the Framework (ownership notion, residual claim.) In this regard, the current distinction promulgated by IFRSs is just as arbitrary as any other distinction (see discussion in pars. 1.14 et seq.).

Perceived shortcomings of the current distinction

- 2.17 Whereas the current distinction is just as arbitrary as any other distinction, we come to the conclusion that it has some obvious shortcomings, which will be discussed and demonstrated in the following paragraphs.

Other residual interest-type instruments: A meaningful presentation?

- 2.18 Residual interest-type instruments in legal forms other than a stock corporation share many of the characteristics of common shares. In one respect, however, they frequently differ, in that many instruments cannot be freely traded. 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.

- 2.19 Absent the right to put, this type of capital shares all or many of the characteristics listed in par. 1.10 for common shares. This is acknowledged by the IASB in par. 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*.
- 2.20 Since the right to put an instrument back to the issuer gives rise to an obligation on the side of the entity, the definition of a financial liability in accordance with IAS 32 would be violated. In this case, 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.
- 2.21 The consequential accounting treatment of the “right to put” is regarded as “counter-intuitive” by some.⁹ Among those counter-intuitive results is that an entity will have to record the more “negative equity” the more profitable it becomes. We accept that this 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.

⁹ 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*.

2.22 In order to improve¹⁰ the accounting for residual interest-type instruments for the above mentioned legal forms, the IASB proposed 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.

A robust criterion?

Individual vs. collective rights

2.23 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.

2.24 As mentioned in the introduction, the credit side of the balance sheet comprises only claims to the assets of the entity. The current distinction is based on differentiating between claims that can be executed individually (by the holder of the instrument) and claims that can only be executed collectively or arise only upon liquidation, where liquidation is subject to a collective decision. Collective claims are not regarded as claims, whereas individual claims are.

2.25 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 re-classified 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

¹⁰ Cf. BC7 of the Exposure Draft of Proposed Amendments to IAS 32 and IAS 1 Financial Instru-

equity. Only if and when that decision is made, the distributable portion is reclassified as a liability.

- 2.26 We 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. Our 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 members whether equity treatment for distributable →reserves is justified given the principles laid down in the Framework and IAS 32.
- 2.27 Secondly, we 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, we 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.

Interaction of the terms and conditions of an instrument and the existence of an obligation

- 2.28 Par. 91 of the Framework requires a liability to be recognised when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation. According to par. 14 of IAS 37, a non-financial liability is recognised when either a legal obligation or a con-

structive obligation exists. According to par. 20 of IAS 32, a financial instrument that does not explicitly establish a contractual obligation to deliver cash or another financial asset may establish an obligation indirectly through its terms and conditions. For example, the terms and conditions of an instrument can interact in such a way that the entity is economically compelled to act in a certain way without having a contractual obligation (“economic compulsion”). For example, an entity may be economically compelled to exercise a right to repay a liability that legally is a perpetual instrument if the terms and conditions contain a clause that the interest rate payable on this instrument will quintuple at a certain point in time. Although not a contractual obligation established explicitly through the terms and conditions of the instrument, the entity may be economically compelled to repay. The terms and conditions may be interpreted as, taken together, indirectly establishing an obligation, if not by form, though in substance.¹¹

- 2.29 Assuming that IAS 32 was intended to be interpreted such that *only* contractual obligations constitute a financial liability, we conclude that, in this respect, the “presence of a contractual obligation”-criterion is a robust criterion. Although a robust criterion, this interpretation would give rise to another inconsistency with the Framework (see pars. 2.33 et seq.).
- 2.30 Assuming that IAS 32 was intended to be interpreted such that in addition to contractual obligations also economic compulsion constitute a financial liability we conclude that, in this respect, the “presence of an obligation”-criterion is not a robust criterion: There may be situations in which the existence of economic compulsion might be difficult to determine. One might argue that professional judgement has to be applied. Consider a step-up interest clause in connection with an option of the issuer to redeem the instrument: Differentiating between a step-up interest rate that is simply disadvantageous from one that is so high to economically compel the entity to repay the instrument

¹¹ The groups note that at its meeting in March 2006, the IFRIC discussed a submission for a possible agenda item relating to the role of contractual obligations and economic compulsion in the classification of financial instruments. In May 2006, the IFRIC agreed not to take the item onto the agenda, but did not agree on reasons to be given for that decision either.

seems difficult, if not arbitrary. In order to apply professional judgement to a principle, that principle must be reasonably defined.

Perceived inconsistencies between the current Framework and IAS 32

Does probability of the outflow of resources matter?

2.31 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.¹² 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.¹³ 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]*

2.32 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.”

¹² The recognition criteria promulgated in pars. 85 and 91 of the Framework contain an additional explicit ‘probability’ hurdle.

¹³ Cf. IAS 32.25 and .AG28.

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.¹⁴

Interaction of the terms and conditions of an instrument and the existence of an obligation

- 2.33 As described in par. 2.28, the terms and conditions of an instrument can interact in such a way that the entity is economically compelled to act in a certain way without having a contractual obligation. In IAS 37, the IASB acknowledges this fact by requiring the entity to recognise a liability when there is a constructive obligation, but not a legal obligation. A constructive obligation may derive from creation of a valid expectation that the entity will discharge a responsibility.
- 2.34 Recognising a (non-financial) liability in such a situation in accordance with IAS 37 is also consistent with the Framework, in particular the substance-over-form principle. As discussed in par. 2.28, IAS 32 may be interpreted in a way that economic compulsion does not constitute a financial liability. We conclude that, if IAS 32 is interpreted in this way, IAS 32 could be considered inconsistent with the Framework and IAS 37.

Are obligations to issue own shares liabilities?

- 2.35 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. On the other hand, if the entity is obliged to deliver a fixed number

¹⁴ 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.

of its equity instruments against a fixed amount, such a contract would be classified as equity, *despite* the fact that the contract embodies an obligation.

- 2.36 However, we are not convinced that derivatives to deliver own shares (under whatever conditions) meet the definition of a liability under the Framework. Although the entity is obligated to act in a certain way, it is questionable whether the obligation to issue own equity instruments does or does not involve the entity forfeiting future economic benefits. The answer to this question depends on the view (entity vs. proprietary view) that drives the presentation of the financial statements. This issue was already highlighted in pars. 1.40 et seq. The current IASB Framework does not contain an explicit reference to neither entity nor proprietary view.

Assumption: The IFRSs are based on an entity view

- 2.37 Since the current IASB Framework lacks in explicit statement as to the view, one may try to deduce a view from the IFRS literature. If one assumed that the financial statements shall be presented from an entity's view, we conclude that obligations to issue own equity instruments do not meet the definition of a Framework obligation. As discussed in par. 1.41, issuance of new equity instruments does not involve an outflow of resources embodying economic benefits from the entity. It is the present → investor's financial position that is affected and it is their resources that are forfeited.
- 2.38 We conclude that under an entity view no obligations to issue own shares would meet the definition of a Framework obligation. However, this conclusion is only partly consistent with the classification requirements in IAS 32. Except for an obligation to issue a fixed number of new equity instruments for a fixed amount, all those obligations are classified as financial liabilities.
- 2.39 Since classifying obligations to deliver own shares as liabilities is only consistent with a proprietary view, one may conclude that it is the proprietary view that drives the presentation of the financial statements under IFRSs, although this view is not applied fully consistently, as all obligations to issue own shares would require classification as a financial liability.

Alternative assumption: The IFRSs are based on a proprietary view

- 2.40 Under the proprietary view the financial statements are supposed to portray the financial position of the (present) investors. Under this view (but not under an entity view) an obligation to issue new shares would indeed be a liability, as the present investors – through the entity – would be obligated to forfeit resources.
- 2.41 The assumption of the proprietary view however would give rise to other inconsistencies. If one embarks on a proprietary view 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 equity instrument. Thus, the right to put an equity instrument back to the entity at fair value 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.) Since, under the current IAS 32 those rights to put are classified as liabilities, one needs to assume that the IFRSs employ an entity view, since this is the only view that is consistent with this classification.
- 2.42 Since the classification of puttable shares and obligations to deliver own shares are based on different assumption as to the view that drives the presentation of the financial statements, one has to conclude that the current distinction is inherently inconsistent.

The need for re-deliberating the distinction between equity and debt

- 2.43 Based on the analysis of the current IFRS distinction between equity and debt and its perceived shortcomings, we reason that a re-deliberation of the criteria that lead to either debt or equity classification is warranted. The apparent shortcomings of the current distinction require starting from scratch,

as the issues concerned may not be accommodated by “fixing” the distinction.¹⁵

2.44 Since a growing number of entities that are not listed either voluntarily want to or must apply IFRSs, it seems justified to us to rethink the current criteria that drive the classification of financial instruments in the accounts of the issuer. We 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.

Summary of the issues discussed in this section

2.45 The preceding section focused on the current debt/equity distinction and its perceived shortcomings. The key issues are summarised below:

- The current debt/equity distinction is based on the non-existence of an obligation. Other characteristics (interest or instrument that evidence a residual interest, ownership interests) are mentioned in the Framework, but remain vague and, in the end, deemed irrelevant.
- 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. This put right results in liability classification under the current literature.
- Classifying puttable residual type-instruments or interests as liabilities does not lead to meaningful results. The situations are those in which residual type-interests or instruments embody a claim.

¹⁵ Similarly, in their comment letter, the Institute of Chartered Accountants in Scotland and Wales set out: “The amendments proposed in this Exposure Draft demonstrate that the division between equity and liabilities is no longer relevant or helpful, since the types of financial instruments and behaviour of holders of these would be more accurately represented as a spectrum dependent on the level of risk and where this lies.”

SECTION 2—THE CURRENT DISTINCTION BETWEEN LIABILITIES AND EQUITY

- Furthermore, the current debt/equity distinction does not seem to be a robust distinction for other reasons. Firstly, the distinction is based on the differentiation between individual and collective claims. Secondly, despite the lack of a contractual obligation, the terms and conditions of an instrument may interact in a way that there is economic compulsion. However, under IAS 32 the instrument would be classified as equity, which might be a robust solution but can lead to doubtful results in certain situations. On the other hand, the existence of economic compulsion can be difficult to assess in certain situation, raising doubts as to the robustness of this criterion.
- 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.
- Whether obligations to issue own shares do meet the definition of a liability under the Framework depends on the view that drives the presentation of the financial statements. Liability classification would be consistent with a proprietary view. However, classifying puttable residual interests as liabilities as well is inconsistent with a proprietary view. Assuming the entity view would be consistent with the current classification. Thus, an inherent inconsistency exists.

SECTION 3—DERIVATION OF THE LOSS ABSORPTION APPROACH

The objective of financial statements—meeting the information needs of users: Different user groups and providers of capital and the investors as the user group with the highest information need

3.1 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.

3.2 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].

3.3 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. This term will be used henceforward.

3.4 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. Providers of risk capital would presumably like to know about the risks (and rewards) of the capital provided. Thus, 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.

Risk capital: Decision-useful information

3.5 In section 1, a number of characteristics of capital were discussed on which a distinction between two buckets of capital, equity and debt, could be based on. It was demonstrated that many of those distinctions, based on those characteristics, some on a stand-alone basis, some in connection with others, may provide decision-useful information. Thus, any characteristic or any combination thereof and any distinction based thereon are more or less arbitrary. There is no natural split and no natural criterion for “equity”. However, there might be one more characteristic(s) that lead to a distinction that provides decision-useful information

- in a number of different situations,
- to capital providers in general,
- across different legal forms.

Characterising risk capital

3.6 The current debt/equity distinction was already discussed in section 1, both in accordance with the Framework and with regard to IAS 32. It was noted that the residual notion of equity is evident in both the Framework and IAS 32 but that, in essence, the non-existence of a present obligation is the decisive cri-

terion, regardless of whether the capital has residual →claims pertaining to it. In the following chapters, the notion of risk capital and its consistency with the Framework will be discussed.

3.7 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*.

3.8 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*.

3.9 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.

3.10 We 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:¹⁶

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

¹⁶ The groups note that these definitions are consistent with the IASB’s literature, e.g. those found in IAS 17.

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'

- 3.11 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.
- 3.12 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. 3.10 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?

- 3.13 As noted in par. 3.11 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

instruments traded in 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 – even if not proportionally – whilst the opposite would not hold true.

- 3.14 We evaluated each of the criteria listed in pars. 1.11 et seq., both, individually, and in combination. In our 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 we believe that the *participation in losses* is the decisive factor in distinguishing risk capital from all other types of capital. Furthermore, we came to the conclusion that using the loss absorption criterion, being a broad criterion (see pars. 3.18 et seq.) makes the use of additional features like 'sharing in profits' or 'subordination' redundant.
- 3.15 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 unchanged. 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 we 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

3.16 We 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. 78 et seq.) The next section of the paper contains an in-depth discussion of this issue.

Interim conclusions: The buffer function of risk capital

3.17 For us, it is the *buffer function of risk capital* that provides decision-useful information for both investors and creditors across different legal forms. The entitlements pertaining to risk capital vary in relation to the reporting entity’s performance: If the entity performs poorly, those claims decrease, thus providing a buffer, a cushion for the entity in terms of variances in its performance. This information is useful for creditors to assess the quality of the creditworthiness of the entity.

Loss-absorption as a comprehensive criterion: inherent characteristics

3.18 The loss-absorbing capabilities are related to a number of characteristics already discussed in the introduction. Thus, loss absorption can be regarded as a comprehensive criterion that implicitly includes a number of other (narrow) criteria.

3.19 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 with regard to decreases are implicitly inherent in the

loss absorption criterion. Loss-absorbing capital *participates in ongoing losses*.

3.20 Loss-absorbing capital is *subordinated* to any capital with a fixed return. It is serviced only after and if, there is a profit (i.e. positive net total) after all other capital with a fixed return has been serviced. Thus, it is a *residual claim on the entity's profit*. However, we note that the notion of subordination within a group context is not as easily understandable as it for a single entity (see section 5).

3.21 Upon repayment or redemption of risk capital, the entity is only obliged to forfeit resources equal to the *residual*, since, in order to calculate the residual claim, any fixed claims will have to be taken into consideration. Thus, the claim pertaining to risk capital is residual claim upon liquidation as well.

Assumption of a perspective that drives the presentation of the financial statements

Why an assumption is necessary

3.22 Pars. 1.40 et seq. discussed why any distinction is faced with the issue that classification of certain capital instruments, in particular obligations to deliver own equity instruments and puttable residual interests, depends on which of the two alternative views (entity vs. proprietary view) is employed. Pars. 2.35 et seq. demonstrated the inherent inconsistency between IAS 32, IAS 37 and the IASB Framework in this respect.

3.23 Given that the current IASB Framework does not contain an explicit reference to either view, it is necessary to make an assumption in order to further refine the approach developed in this paper (or any other approach.)

The view assumed in this paper

3.24 From a reporting entity's perspective distinguishing liabilities from equity based on the *characteristics* of the capital received seems to provide more decision-useful information than basing such distinction on the question as to

who provided a particular type of capital (i.e. *source*) of capital. We have, therefore, decided to assume an ‘entity view’ when making the distinction as this seems to be more consistent with the current thinking employed by the IASB in IASs 1 and 27.¹⁷

- 3.25 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.
- 3.26 It should be noted, though, that the decision to take the entity view should not be read as implying that an entity view will always provide more decision-useful information than taking the proprietary view. We did not discuss this issue outside the context of capital classification.
- 3.27 Also, the assumption does not mean that the approach developed in this paper would not – just as any other dichotomous distinction – work under a proprietary view. However, based on a proprietary view, classification of certain instruments would be different, in particular obligations to deliver own equity instruments and puttable residual interests. The classification of these instruments as equity or not is, thus, not only a result of the loss absorption approach, but primarily a result of the view employed. Similar questions (or differences) would result from any other dichotomous distinction.

Consequences if choosing the proprietary view instead

- 3.28 As noted before, the loss-absorption approach could also be refined further assuming a proprietary view, with other consequences though. The following paragraphs contain some of the consequences that a proprietary view would bring about.

¹⁷ It is also consistent with the reasoning in other parts of the IFRS literature, e.g. IFRSs 2 and 7

- 3.29 At first sight the proprietary view is inherently inconsistent with a distinction that is based on certain characteristics of the capital. Since the proprietary view is aimed at reporting financial performance to the owners of the entity (reporting changes in the financial position of the owners to them), any definition of equity must logically be linked to the capital provided by the owners in their capacity as owners. That capital might also evidence a certain combination of characteristics, but other capital featuring the very same combination would always be classified as liabilities.
- 3.30 One possibility to overcome this inherent inconsistency would be to apply a layered approach: In the first layer (loss absorption) one would seek to identify the capital that can potentially be classified as equity, subject to the second layer. In the second layer one seeks to assess whether or not the loss-absorbing capital identified in the first layer is provided by the owners in their capacity as owners. This would require a second set of criteria in order to identify the owners.
- 3.31 In its purest form, only capital that meets both criterion A (loss absorption) and B (ownership) would initially qualify for equity treatment. All other capital, whether provided by the owners or by non-owners but being loss-absorbing, would be classified as liability. To take account of other sources of capital that were provided by either (a) the owners of the entity but not loss-absorbing or (b) external parties but loss-absorbing from capital that was neither contributed by owners nor loss-absorbing, one could think of sub-classifying the liabilities for presentation purposes. This could also be regarded as a synthesis between the entity view based loss-absorption approach and the proprietary view: The total amount of loss-absorbing capital would be identical, but additional information consistent with a proprietary view is provided by sub-classifying this capital.
- 3.32 Another consequence of adopting a proprietary view would be a different classification of obligations to issue new equity instruments (i.e. loss-absorbing capital). As noted before (see pars. 1.40 et seq., 3.22 et seq.), this

and IAS 39. In its Exposure Draft on Proposed Amendments to IFRS 3 *Business Combinations* the IASB also followed an entity view.

conclusion is independent of the approach chosen to distinguish equity from debt, i.e. the conclusion is independent from the loss-absorption approach.

Summary of the issues discussed in this section

3.33 The preceding section was centred around the question on what should be considered equity taking into account the objective of financial statements being providing decision-useful information to users as worded in the Framework. The key issues can be summarised as follows:

- The criteria to be chosen were 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, a distinction between liabilities and equity should take this fact into account when determining the degree and sort of information to be provided.
- Based on the discussion of different criteria in chapter 1, we think that it is the buffer function of risk capital that provides the most decision-useful information.
- 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.’
- The notion behind the loss-absorption approach can be worded as follows: Is a particular type capital available to absorb losses, and if so: to what extent?
- Classification of financial instruments as either liability or equity requires an assumption as to what view (proprietary vs. entity view) drives their presentation in the financial statements. The current IASB Framework is silent on this issue.

SECTION 3—DERIVATION OF THE LOSS ABSORPTION APPROACH

- Basing a distinction between liabilities and equity on certain characteristics rather than on the source of capital received seems to provide more decision-useful information. The loss absorption approach will, hence, be analysed taking an entity view. This not to say that the loss absorption approach would not work under a proprietary view.

SECTION 4—REFINING THE APPROACH

What are losses?

- 4.1 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. We started off with the broadest definition possible, being a decrease in entity value. We 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

- 4.2 We 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.
- 4.3 Although the concept is easy to understand, we concluded that defining losses as economic losses has practical impediments. Firstly, there is a difference between using a DCF calculation 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?

- 4.4 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, we would envisage determining a performance number from a gross presentation of an entity's performance, i.e. a statement of comprehensive income for a given period.¹⁸
- 4.5 Such an approach would be easier 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, with changes in liabilities 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.¹⁹
- 4.6 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 instrument.) There might be convincing arguments for this link; we have not

¹⁸ The Framework does not contain definitions of performance numbers (e.g., "net income" or "comprehensive income") but only definitions of the elements of a performance statement (i.e. "income" and "expense".) The term "(total) comprehensive income" is defined in IAS 1 *Presentation of Financial Statements* as amended in September 2007 as follows: "Total comprehensive income is the change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners. Total comprehensive income comprises all components of 'profit or loss' and of 'other comprehensive income'." (IAS 1.8 (rev. 2007).)

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.)

- 4.7 Generally speaking, an entity will use a unique combination of certain assets to generate revenues, based on a given business model. Financing costs, besides other costs, are to be deducted from earnings 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. The 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 comprehensive income for a given reporting period 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 incurred if comprehensive income was negative.

- 4.8 We note that circularity is an unavoidable issue once the definition of equity depends on the return of the instrument to be classified. For example, as part of the re-deliberations of the Exposure Draft of Proposed Amendments to IAS 32 and IAS 1 Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation, the IASB uses a similar notion:

“The total return of the puttable instrument is based substantially on the net earnings or the change in net assets of the entity (excluding any possible effect the puttable instrument may have on net earnings or net assets).”²⁰ [emphasis added]

¹⁹ The circular element is a result of the general assumption made in this Paper that the concept is based on the existing Framework, cf. pars. IN.4 and .10. Re-deliberating other issues, e.g. the other elements defined in the Framework, might resolve the circular element.

²⁰ Cf. par 16A (e) of the IAS 32 staff draft made available to participants of the roundtable discussions in November 2007.

4.9 The circularity is partly due to the fact that this paper is based on the assumption that the current income statement was to be retained. The definition focuses on “net total from business activities before financing costs” but refrains from suggesting a different income statement structure. However, if one allowed for different income statement structures, one could, for example, imagine a kind of “waterfall” of different categories of financing costs, such as

- (1) Capital that must be serviced despite comprehensive income (before servicing cost and related tax impacts) being negative, thereby further increasing losses;
- (2) Capital that does need to be serviced (e.g. a coupon to be paid only if the entity had sufficient positive comprehensive income), but with the instrument being cumulative;
- (3) As (2), but with the instrument being non-cumulative; and
- (4) As (3), but with →claims to the assets of the entity (and thus the capital provided) being reduced.

4.10 The definition proposed in par. 4.8 tries to capture group (4). →Loss-absorbing capital must be residual on a going concern basis, i.e. claims to ongoing payments would exist only if the entity made profits. However, this would also include capital of type (3). Capital of type (2) is not considered loss-absorbing, since the “loss” incurred would merely be a decrease in the present value of the servicing costs as a result of the deferral of otherwise notionally constant claims (an opportunity loss.)

4.11 Another way of explaining accounting losses would be to look at the journal entries. If the net performance number was negative, the entry necessary to close the comprehensive income account would read:

<i>Dr</i>	?		
		<i>Cr</i>	<i>comprehensive income account</i>

Accounts that might be debited in this entry include profits/losses carried forward, retained earnings, share capital. Somebody must have a claim or enti-

tlement to this capital and by deducting the net comprehensive income from this capital, the claim of the respective holder is reduced.

Accounting losses as a proxy for determining economic losses?

- 4.12 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.
- 4.13 Most 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 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.
- 4.14 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.

- 4.15 We can even envisage situations where an accounting loss goes along with an economic gain 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 counter-intuitive, 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

- 4.16 Based on the view that the ability to absorb losses²¹ should be the decisive criterion for distinguishing equity from debt, we 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.”

Reduction of a claim vs. fair value of a claim

- 4.17 If the entity's net assets upon liquidation were negative or if an entity was in financial distress and, thus, not all claims to the entity's assets could be honoured, one might argue that all claims become “loss-absorbing” because every holder of a claim bears the risk that the claim is not fully honoured. In short: All capital is at risk. While any claim to the entity's assets and any capital may be at risk, or risky, in the sense that there is a credit risk involved, not all capital is *risk capital* as defined. Market participants would take possible credit deteriorations into account when trading such claims to the entity's assets. If an entity's credit risk increases, the fair value of the claims evidenced by the instruments decreases. However, this reduction in the fair value of the instrument is not reflected in the claim itself, which remains unchanged. This is the fundamental difference between capital that is at risk and risk (= loss-absorbing) capital as defined in this paper: If an entity incurs

²¹ Cf. par. 2.20, where this notion was introduced.

losses, both, the fair value, *and* the claim of loss-absorbing capital will be reduced.

- 4.18 The "loss absorption" capability of an instrument implies that the capital is available to the entity to absorb losses *without* any preliminary legal decision or contractual agreement. Conversely, a non loss-absorbing instrument (i.e., debt) requires the holder to either contractually or legally (e.g. insolvency procedures) accept reduction of his/her claim.

Unit of Account: On the level of absorbing losses

- 4.19 Both economic losses and accounting losses are defined as *ultimate* losses of the entity. An instrument would only be regarded as (fully or partially) loss-absorbing, if its terms and conditions are referenced back to the ultimate accounting (or economic) losses of the entity. Neither reference to a specific event, being typical for an insurance or a financial guarantee contract, nor reference to particular losses within the entity (e.g. losses of a business segment or a single asset) would meet this requirement.

Liabilities under the loss absorption approach

- 4.20 The current distinction between liabilities and equity under IFRSs is, in essence, based on a differentiation between claims that can be exercised individually (which give rise to a contingent or present obligation) and claims that can only be exercised collectively. In contrast, the loss absorption approach is based on distinguishing between claims to loss-absorbing capital (i.e. loss-absorbing claims) and claims that are not loss-absorbing (other claims.)
- 4.21 Thus, under the loss absorption approach, liabilities would be attributed a "residual" notion. By "residual" we mean that any claims to the entity's capital that do not meet the definition of claims to loss-absorbing capital would, by default, be classified as a liability. Liabilities would become the "default" classification if the positive definition of loss-absorbing capital (equity) was not met.

Further Issues

Terms and conditions and reclassifications

Classification based on the terms and conditions

- 4.22 Classification of an instrument would have to be made at inception of the instrument and according to the terms and conditions inherent in that instrument.

Passage of time as a trigger for reclassification?

- 4.23 We came to the conclusion that the remaining term of an instrument is not a decisive factor for classifying or reclassifying an instrument (see section 1, par. 1.21). Since in this case the essential feature of absorbing losses do 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.²²
- 4.24 Notwithstanding that decision, we discussed whether some sort of consideration should be given to the term of a financial instrument. In our 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.²³ 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.²⁴

²² In its Discussion Memorandum the FASB called this “temporary equity.”

²³ In such a situation, however, measuring the diminutions in the entity value can be an issue. 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 illustrative examples include a discussion of such an instrument (see par. IE11).

²⁴ The groups note that IFRS 7.39(a) already requires such an analysis for liabilities.

Interaction of classification and the entity's capital structure

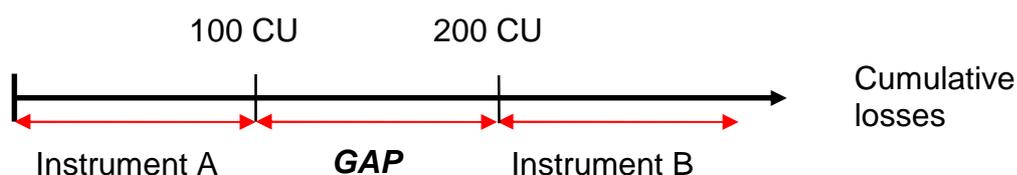
- 4.25 The classification would be independent of other instruments' classifications, unless the terms and conditions of one instrument refer to another instrument's terms and conditions. If those terms and conditions are invoked, this may require reclassification of an instrument. If an instrument's terms and conditions contain a conditional element under which, if invoked, the loss-absorbing characteristics 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 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.)
- 4.26 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.
- 4.27 The underlying notion of the loss absorption approach is the information about the total amount of loss-absorbing capital that, from the perspective of the entity, is available to absorb (cover) losses. If the loss-absorbing capabilities of one instrument depend on the existence or non-existence of other capital instruments, the interaction between those instruments with regard to the loss-absorbing capabilities has to be considered. Therefore, the same instrument may have different loss-absorbing capabilities within different entity's capital structures.

4.28 We envisage a number of different instruments that absorb losses only if certain conditions are met:

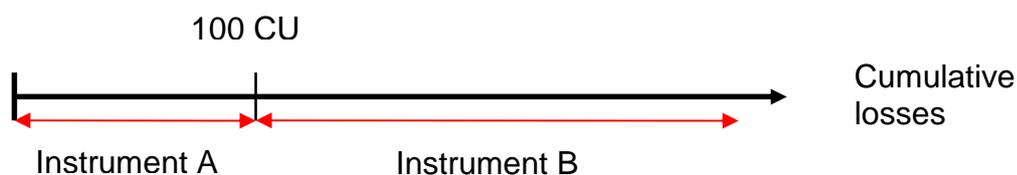
- (1) instruments which absorb losses up to a fixed amount from the first CU (“the first 100 CU of losses”);
- (2) instruments which absorb losses that exceed a *fixed* amount (“absorbing the losses after the first 100 CU of losses have been absorbed”);
- (3) instruments which absorb losses exceeding 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.)

4.29 We 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.



- 4.30 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 4.28, 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 assumption 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.)

Linkage and split accounting

Linkage between instruments

- 4.31 Linkage refers to considering two or more instruments issued at or around the same time together as if they constitute a single instrument, if they are part of the same arrangement between the transacting parties. In our view, linkage should apply to the loss absorption approach as it follows from the substance over form paradigm in par. 35 of the Framework. In the present context, linkage is introduced to avoid structuring opportunities which do arise if classification as liability or equity was always to be made on an instrument-by-instrument basis. For instance, an instrument that would initially receive liability classification could be split into two or more instruments where at least one instrument would be structured such that the criteria for equity classification under this approach (or any other approach, respectively) were met. Linkage would then require an entity to consider the instruments as if they were one instrument, i.e. the interdependencies and interacting payoffs of these instruments would have to be analysed to arrive at an appropriate classification.
- 4.32 Linkage of instruments is an issue under any approach to distinguish liabilities from equity that is based on the type of return of an instrument. This is because an instrument can always be structured in a way that the criteria for equity classification under any approach can be met, while at the same time structuring a second instrument that, when considered together with the (first, equity) instrument, will significantly modify the return, so that none of the two instruments would meet the definition of an equity instrument.

- 4.33 In its approaches to distinguishing between liabilities and equity, the FASB included the following guidance:²⁵

“Two or more freestanding instruments would be linked—that is, classified and measured as if they were a single instrument—if both of the following apply:

- a. They are part of the same arrangement (see paragraph 43); and*
- b. Reporting the instruments individually would result in reporting amounts of net income or equity that are different from the amounts that would result from accounting for a comparable single instrument, that is, a single instrument with the same or similar outcome(s). [...]*

Instruments would be deemed part of the same arrangement if at least one of the following conditions exists:

- a. The instruments are contractually linked. For example, two instruments are contractually linked if exercise of one depends on exercise of the other or causes the expiration of the other.*
- b. The instruments were entered into at or near the same time with the same or related counterparty and together achieve an overall economic outcome that could have been achieved as simply or more simply with a single instrument.”*

- 4.34 The loss absorption model seeks to classify capital as equity if it absorbs losses. Conversely, instruments that would have to be honoured regardless of the entity making profits or incurring losses could be described as “loss-generating” instruments. One could also think of an instrument that foresees payments, if, and only if, the entity incurs losses. Such instruments can be described as “loss-accelerating” and could be bundled with loss-absorbing instruments to, in essence, create a bond with a steady return. If viewed from the other end, such a “steady-return bond” – that would be classified as debt under the loss absorption approach – could be split and issued as two instruments where one would be loss-absorbing and one loss-accelerating. Without linkage, the loss-absorbing instrument would be classified as equity whilst the other would (still) be classified as liability, by default.

²⁵ Cf. FASB, Preliminary Views, Financial Instruments with Characteristics of Equity, pars. 41 and 43.

4.35 Although we agreed to have the concept of linkage included in the loss absorption approach, we have not yet deliberated how an entity would apply the concept. Application is straightforward, if the terms and conditions of the related instruments refer to each other, but would require more thoughts if that were not the case.²⁶

Split accounting

4.36 We 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. We questioned whether presenting only fully loss-absorbing capital is decision-useful for the users of the financial statements. In our view, it is rather the *total amount of capital* that is or might become available for loss absorption. For that reason, we 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.)

Interaction of linkage and split accounting

4.37 There may be situations in which an entity would be required to link two or more instruments to arrive at a single instrument and would then apply split accounting for it. In these instances one has bear in mind that the pieces that are linked together and the pieces that would be split apart will not be the same, since the principles of linking and splitting aim to achieve different things: In essence, linkage is applied to avoid granting loss-absorbing status to instruments that are, in substance, just part of a larger instrument that, if

²⁶ If application of linkage was not feasible due to practical constraints and if the results to be obtained by applying the concept of linkage were, nevertheless, to be retained, one could think of including guidance to classify loss-accelerating instruments as "negative equity", i.e. a *deduc-*

viewed as a whole, would lose their loss absorption capability. In other words, by applying linkage one would seek to find out whether or not there is loss-absorbing potential *at all*. Split accounting aims at determining *how much* loss absorption potential an instrument has.

Are measurement reserves loss-absorbing capital?

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

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

We 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. We 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, we 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.

tion from loss-absorbing capital within equity. The consequences such an alternative would bring about have neither been discussed by the groups nor could they be foreseen at this stage.

Defaulting on risk capital and information on liquidity

- 4.39 One characteristic of loss-absorbing capital is that the entity cannot default on such a claim. Every time the entity incurs a loss, the claim to the loss-absorbing capital could be reduced. Taken to the extreme, the claim would be zero.
- 4.40 However, one could not conclude that, as long as the entity presents loss-absorbing capital on the face of its balance sheet, the entity could never be forced into bankruptcy procedures by the →creditors (i.e. the holders of non-loss-absorbing claims). This is because insufficient assets (negative net assets) are only one trigger for bankruptcy procedures in most jurisdictions. Whereas the loss absorption approach would provide information on this trigger, the other trigger, insolvency, has no relation to the loss-absorbing capabilities of the capital classified as equity under the loss-absorption approach. However, information on the term/maturities of the capital is suggested either on the face of the balance sheet or in the notes to the financial statements and thus, some information on the entity's liquidity is provided, although the loss absorption approach is not intended to provide information on the likelihood of bankruptcy procedures.

Summary of the issues discussed in this section

- 4.41 The preceding section was concerned with the task of refining the approach developed in section 3. 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, we 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. Since the entity cannot default on a loss-absorbing claim, loss-absorbing claims provide a buffer for the entity.
 - 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. An instrument would be reclassified if, and only if, its terms and conditions were changed.
- If an instrument's terms and conditions refer to other capital instruments, it is necessary to evaluate those terms and conditions in the light of the entity's capital structure, in order to assess the total amount of loss-absorbing capital that is available to the entity to cover losses: For example, 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.
- The concept of linkage requires an entity to view two or more instruments together as if they were one instrument, if the instruments are part of the same arrangement agreed between the transacting parties. Classification as either liability or equity would then be done for the joint instrument only.
- The loss-absorption approach is not intended to provide information on insolvency. However, a requirement to disclose information on the term/maturity of the capital would provide some information on liquidity.

SECTION 5—CLASSIFICATION APPROACHES APPLIED WITHIN A GROUP CONTEXT

5.1 The application of the →loss absorption approach within a group context has not yet been fully discussed. We think that we have been able to demonstrate that loss absorption is a suitable principle to distinguish between equity and debt if applied to a single entity. Applying the loss absorption approach to a group will certainly – just like any other approach to distinguish equity from debt – give rise to additional issues. We envisage two conceptual ways of applying any approach to a group:

- (a) Classification is done at the level of a single entity and retained at the group level.
- (b) The classification is re-assessed at the group level.

Classification at the level of a single entity is retained at the group level

5.2 The advantage of retaining the classification made at the single entity level is that it is easy to apply. However, it might give rise to both structuring opportunities and inconsistencies.

Structuring

5.3 Let us consider, for example, an asset-linked note (see par. IE12). Such an instrument would not meet the definition of →loss-absorbing capital as it does not absorb the →losses of the entity, but of a single asset. To arrive at a different classification, an entity could set up a subsidiary whose only asset would be the asset to which the note is linked. Since the profit and loss of the subsidiary would be determined solely by reference to the single asset, the same instrument, if issued by the subsidiary, would meet the definition of loss-absorbing capital on that entity's level.

Inconsistencies

5.4 To demonstrate inconsistencies, let us consider an instrument that absorbs the losses of a business segment, but not the entity. In a group context, the segment might be identical to a subsidiary. If that was the case and the classification arrived at on the level of the single entity was to be retained at a group level, the instrument would meet the definition of loss-absorbing capital at the level of the subsidiary and retain that classification at the group level. Conversely, if the business segment was not identical to a subsidiary, the same instrument would not be classified as loss-absorbing capital at a group level. Thus, the same instrument would be classified differently, depending on the legal structure of the group.

Re-assessing the classification at the group level

5.5 The alternative to retaining the classification made on the entity level would be a re-assessment of each classification at a group level. This alternative would be consistent with other current pronouncements of the IASB (e.g. the accounting for intra-group hedging relationships in both, the separate accounts of an entity, and the group accounts to which it belongs under IAS 39 or the accounting for share-based payment transactions within a group under IFRS 2/IFRIC 11) and is likely to avoid the structuring opportunities and inconsistencies laid out in the preceding paragraphs. However, it would give rise to a number of new issues to be dealt with: Characteristics that seem straight-forward at the level of a single entity could become complex at a group level.

Example: Subordination in the context of a group

Subordination upon liquidation

5.6 In order to analyse the different levels of subordination of different →claims within a group context, one would need to assume the whole group being liquidated. If one embarked on the assumption of the whole group being liquidated, liquidation would take place bottom-up, i.e. one would first need to liquidate the subsidiaries, then intermediate parent entities, before arriving at

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the ultimate parent level.²⁷ The proceeds received from liquidating an entity would be distributed to the claimants of the entity at the next higher level. This procedure would have to be repeated until the ultimate parent was liquidated. The conclusion of this procedure would be that *no* capital located at *any* subsidiaries' level could ever be in the most subordinated class of a group. In other words: The level of subordination derived at the single entity level would be totally irrelevant if viewed from a group's point of view.

- 5.7 This conclusion is especially obvious if one focuses on non-controlling interests. Assuming that the distinction between equity and debt was based on the criterion of the "most subordinated class of instruments" (i.e. equity is defined as the most subordinated class of instruments), the non-controlling interests would be classified as equity on the level of the subsidiary, just as the controlling interest held by the immediate parent would.
- 5.8 When the subsidiary is liquidated, the →creditors' claims to the subsidiary's assets are honoured first. The remaining proceeds (liquidation surplus) are distributed to the holders of the instruments in the most subordinated class, i.e. the non-controlling interests and the controlling interests held by the immediate parent. Next, the immediate parent would be liquidated. Again, the creditors' claims to the immediate parent's assets (including the parent's share in the liquidation surplus from the subsidiary) would be honoured first. In this situation, the non-controlling interests in the subsidiary would be *less subordinated* to the all creditors of the immediate and all other parent companies.
- 5.9 Intriguingly, the maturity of capital located at any subsidiary's level would also be irrelevant. It might be permanent, short-term or puttable by the holder: Under the assumption that the group was to liquidate, capital placed at the parent's level would always be more subordinated to any capital placed at the subsidiary's level.

²⁷ NB: The respective parent company could liquidate itself either by *selling all its subsidiaries* (to a third party) or by *liquidating* its subsidiaries. However, the assumption of the whole group being liquidated would require not only the parent company, but every single entity within the group, to be liquidated.

Subordination with regard to ongoing payments

- 5.10 Similar conclusions can be drawn for the question of what subordination means in a group context with respect to ongoing payments. The consolidation procedures will aggregate all profits into a single number. Consider two capital instruments, where instrument A needs to be serviced on the condition that there is a positive net income for the period, and instrument B has a claim to the residual profit, i.e. after all other instruments including instrument A have been serviced. If both instruments are located at the same single entity, it is clear that instrument B is subordinated to instrument A. However, that would not necessarily be the case, if the two instruments were held by different entities in a group.
- 5.11 Consider that instrument B was issued by the subsidiary, whereas instrument A was issued by the parent. Consider that not all instruments of type B were held by the parent, but some were held by a third party. Only the servicing costs on those B-type instruments that are held by the parent are available to the claimants on the parent's profit. Although generally subordinated to the type A-instruments, in this setting the type A-instruments issued by the parent are subordinated to those type B-instruments held by the third party. Again, it is the level within the group structure that determines a first layer of subordination before the second layer (subordination on the single entity level as described in pars. 1.24 et seq.) becomes applicable.

Loss-absorption in the context of a group

- 5.12 Similar questions as the ones outlined in the context of subordination arise with regard to the loss absorption approach: A group's net results are a conglomerate of different profits and losses from all entities within the group. Likewise, loss-absorbing capital at the group level would be a conglomerate of loss-absorbing capital from different entities within a group, and the loss-absorbing capital at the group level would not necessarily be available to absorb a group loss. Consider, for example, the retained earnings of a subsidiary. This capital would not be available to absorb losses incurred by a sister subsidiary. However, both the subsidiary's retained earnings and the sister

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company's losses would show up in the group accounts as group losses and group equity, implying that the latter was available to absorb the group losses.

Other approaches to distinguish equity from debt in the context of a group

5.13 Application of any other approach to distinguish equity from debt is likely to give rise to similar problems. The questions involved are not limited to the loss absorption approach.

5.14 For example, all of the three FASB approaches foresee equity classification of "basic ownership instruments." A basic ownership instrument must have both of the following characteristics:²⁸

„a. The holder has a claim to a share of the assets of the entity that would have no priority over any other claims if the issuer were to liquidate on the date the classification decision is being made; and

b. The holder is entitled to a percentage of the assets of the entity that remain after all higher priority claims have been satisfied. The holder's share depends on its share of the total claims with the lowest priority and has no upper or lower limit except for the amount of assets available."

5.15 Both characteristics cannot be directly applied at a group level: Within a group context, the group itself is the reporting entity. Both conditions give rise to the problems that have already been discussed in pars. 5.5 et seq. Again, capital located at the level of a subsidiary would not meet characteristic A, as the claim under a basic ownership instrument of a *subsidiary* is generally not subordinated to any claimants to the parent company or (if there was more than one parent company, i.e. intermediate parent companies and an ultimate parent company) the parent companies. In addition, characteristic B seems to refer to a proportionate share, a percentage, i.e. an entitlement that is determined by the holder's share in relation to all other claims with the lowest priority. It seems unclear how this share would be determined in the case of a basic ownership instrument in a subsidiary that does not have *any* entitlement to the net assets of the parent company.

Concluding observations on the application of approaches to distinguish equity from debt at a group level

- 5.16 The purpose of consolidated financial statements is to present financial information about the group as if the group *were* a single entity.²⁹ Consolidated financial statements are not supposed to provide the legal, but rather an economic perspective of a reporting group.
- 5.17 However, a number of questions involved can only be answered from a legal point of view. Hence, the answers arrived at are inconsistent with the economic perspective underlying the preparation of group financial statements:
- For example, there is generally no liability of one legal entity, such as a parent company, for the obligations and commitments of another entity included in the same group (except in specific legal environments and depending of the statute of the legal entity). Legally speaking, a parent company could let a subsidiary go bankrupt. When preparing consolidated financial statements (the group being the reporting entity), losses of the subsidiary would automatically be set off against group profits, implying an obligation or loss-absorbing capability) that legally does not exist.
 - With regard to subordination, the legal structure of the group is relevant, as was demonstrated in the preceding paragraphs. But precisely this legal structure of the group is, by definition, disregarded when preparing group financial statements. In addition, a group cannot be liquidated from a legal point of view as liquidation occurs on an entity-by-entity basis, while economically one can assume liquidating the group.
- 5.18 Under the loss absorption approach, any capital that is classified as a liability will retain this classification at the group level. Capital that is not at least loss-absorbing at the level of a single entity cannot have loss-absorbing capabilities at a group level.
- 5.19 The essential question is whether some capital classified as equity retains this classification or is to be re-classified as a liability at a group level. On closer look, this question is limited to retained earnings and other reserves located at the subsidiaries' level:

²⁸ Cf. FASB, Preliminary Views, Financial Instruments with Characteristics of Equity, par. 18.

²⁹ Cf. IAS 27.22.

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- Firstly, non-controlling interests are required to be presented separately on the face of the balance sheet from the shareholder's capital under current IFRSs anyway.³⁰
- Secondly, in a business combination, the carrying amount of the parent's investment in each subsidiary and the parent's portion of "equity" of each subsidiary are eliminated against each other.
- Thus, the remaining loss-absorbing capital at the subsidiaries' level whose classification as loss-absorbing capital within a group context requires further analysis is the subsidiaries' retained earnings and other reserves.

³⁰ Cf. IAS 1. 68 (o), IAS 27.33.

SECTION 6—ILLUSTRATIVE EXAMPLES: THE LOSS ABSORPTION APPROACH APPLIED TO SOME COMMON CAPITAL INSTRUMENTS

These following examples are intended to illustrate and explain the approach in this paper. The table above contains all the issues that have been discussed in section 4 when refining the loss-absorption approach. In order to assist the reader, each example's analysis refers to the issues (by number) as summarised in the table below.

No	Issue	Principle / question to assess	Relevant sections in the discussion paper
1	Capital to be classified as loss-absorbing capital?	Capital is deemed risk capital and, thus, presented as equity if it is available for loss absorption from an entity's perspective	pars. 4.4 et seq.
2	Losses to be absorbed?	Ultimate accounting losses: "net negative comprehensive income for a given reporting period before conditional servicing costs and related tax impact on and re-measurements of capital provided"	pars. 4.16, 4.19
3	Is a claim loss-absorbing?	Reduction of a claim as a consequence of the entity incurring accounting losses	pars. 4.17 et seq.
4	Assumption as to the view that drives the presentation in the financial statement: Entity or proprietary view?	Entity view	pars. 3.24 et seq.
5	Capital is not loss-absorbing in accordance with issues 1-3?	Capital is classified as a liability (= default)	pars. 4.20 et seq.
Specific issues			
6	Instrument is only partially loss absorbing?	apply split accounting	par. 4.36
7	Terms and conditions refer to other capital instruments?	assess whether there is a continuum of loss-absorbing capital	pars. 4.22, 4.25 et seq.
8	Two or more instruments are part of the same arrangement?	Apply linkage	pars. 4.31 et seq.
9	No capital instrument, but measurement reserves?	determine whether reserves would have been reflected in the income statement rather than directly in equity	pars. 4.38 et seq.
10	No capital instrument, but retained earnings?	capital is loss-absorbing	pars. 4.38 et seq.

IE1 **Ordinary share**

Fact pattern:

- Entity A issues non-redeemable ordinary shares
- Entitlement on liquidation – residual share in net assets
- Entitlement before liquidation – no right to any payments except dividends as declared, out of profits

Analysis:

The instrument is loss-absorbing since there is no entitlement to any payment before liquidation. On liquidation, the instrument does not have any entitlement other than a share of net assets (i.e. after deduction of all losses and amounts due to others, see issues 1-3).

Result: Equity

IE2 Subordinated loan (repayable on specified date)

Fact pattern:

- Entity B issues a “subordinated loan”
- The subordination feature is as follows: If the entity was going to liquidate within the instrument’s lifetime, the claim as to redemption of this loan would be subordinated to all other debt instruments. On liquidation, the instrument holder would be entitled to payment of the par amount. The instrument holder’s claim may, in fact, not be honoured in full, if there were insufficient net assets after all preferential claims have been provided for.
- Entitlement before liquidation – repayment at par

Analysis:

The loan holder’s entitlement is to the full par amount of the loan, even on liquidation. Although subordinated to other creditors, the loan does not absorb losses, as the claim even upon liquidation is up to the full amount (see issues 1-3, 5.)

Result: Liability

Variation:

- The subordinated loan is repayable only on the entity’s option; there is no obligation on the entity to repay at a particular date.

Analysis:

Again, the loan does not absorb losses, either before or on liquidation, as it embodies an obligation to pay a fixed amount that would not be reduced later under any circumstances (see issues 1-3.) Although there is no obligation to repay on any *particular* date, the loan holder is still entitled to the *full amount* at some indeterminate future date (see issue 5.)

Result: Liability

IE3 ***Puttable share (at portion of the fair value of the entity)***

Fact pattern:

- Entity C issues 1,000 shares that are puttable to the entity at any time at a proportion of the fair value of the entity (i.e. a valuation of the whole entity is made at the time of repayment and divided by the number of shares then in issue)

Analysis:

The value attributable to each share can be regarded as comprising two parts:

- (a) the entity's book value, which will reflect, by definition, all accounting losses;
- (b) a bundle of unrecognised items. Being unrecognised, changes in this amount are neither reflected in the book value nor in the accounting losses.

In theory, the accounting losses should approximate the changes in the value of the entity, so diminutions in the entity's value should eventually be reflected in its book value

The amount on redemption will be reduced by any accounting losses made by the business. However, due to the recognition gap (b) these accounting losses may be offset by increases in unrecognised intangible assets (and the 'goodwill' of the business itself.) Thus, the instrument will absorb the accounting losses (see issues 1-3.) However, this reduction may be compensated by changes in (b.)

Result: Equity

IE4 Partnership capital

Fact pattern:

- Entity D is a partnership whose partners contribute 1,000 CU each as capital.
- Partners receive a pro-rata share of profits (which may be paid out or added to the capital account).
- Losses are allocated to capital accounts on a pro-rata basis made good if and when the entity makes subsequent profits.
- Partners are able to leave the partnership at any time (after giving notice) and receive their capital back, after deducting any losses not yet allocated to partnership accounts.

Analysis:

Since all losses are deducted from capital accounts before repayment, this capital is loss-absorbing equity (see issues 1-3.)

Result: Equity

IE5 Warrant for a fixed number of ordinary shares

Fact pattern:

- Entity E issues warrants for 1,000 CU that entitles the holder to exchange them for 1,000 new ordinary shares.
- The new ordinary shares are identical to the entity's existing ordinary shares which meet the definition of loss-absorbing capital.

Analysis:

There two different issues to consider. First, entity E receives 1,000 CU that entity will never have to pay back whatsoever. The warrant holders have no entitlement to any payment other than as a result of converting the warrants into ordinary shares, after which they have the same entitlement as the ordinary shareholder (to a share of net assets in liquidation, and dividends as declared out of profits.) The premium received (1,000 CU) is loss-absorbing capital – the entity can suffer losses up to the total of its existing shares plus the proceeds of the warrants before a shortfall arising (see issue 10.)

Second, entity E has an obligation to act in a certain way: Entity E is obliged to issue 1,000 new shares. Whether or not this obligation constitutes a liability and how this liability would have to be measured in case there was a recognisable liability depends on the view (entity vs. proprietary view) that drives the financial statements. This question has nothing to do with the loss absorption approach, but depends primarily on view chosen.

Assuming that the financial statements are prepared under an entity view (see pars. 3.23 et seq. of this paper, issue 4), this obligation would not be recognised as a liability, as the entity does forfeit somebody else's (the investors) resources.

Result: Premium received: equity

Obligation to issue own shares: Neither equity nor liability under an entity view.

Variation:

- The warrants entitle the holder to a variable number of ordinary shares to a fixed value (i.e. shares worth 1,000 CU at the date of conversion.)

Analysis:

As in the previous example, the warrant holder has no entitlement other than via a conversion to ordinary shares (which are loss-absorbing). If the entity suffers losses before conversion, the share value will decrease and the number of shares that each warrant holder will receive increases – but although

this means that conversion of the warrants result in the existing shareholders' interests become more diluted (see issue 4), the overall position of the entity is that it is still able to absorb losses up to the total of its existing capital plus the warrant proceeds (see issue 10.)

Result: Premium received: equity
Obligation to issue own shares: Neither equity nor liability under an entity view.

Variation:

- The warrants entitle the holder to a fixed or variable number of ordinary shares in entity Z.

Analysis:

Regardless of whether entity E already possesses the necessary shares in entity Z or would need to buy them in the marketplace when the entitlement under the warrant is due, the entity would be obliged to forfeit resources. Entity E would have to recognise a liability (see issue 5). Assuming that the liability would have to be recognised on initial recognition at the initial fair value of 1,000 CU, there would be no overall effect on the entity's loss-absorbing capital.

Result: Obligation to issue own shares: Liability

IE6 **Convertible bond**

Fact pattern:

- Entity F issues bonds for 1,000 CU that the holder can either convert to 1,000 shares, or request repayment at par.
- Interest payable on the bond is at the current market level for a non-convertible bond.

Analysis:

Unlike the warrants discussed above, the bondholder is entitled to full repayment (see issue 4.)

Result: Liability

Variation:

- The interest payable on the convertible bond is below the market interest rate for a non-convertible, but otherwise identical instrument issued by an entity with a similar credit risk.

Analysis:

The difference between the (lower) present value of the instrument's cash flows and the present value of the non-convertible but otherwise identical instrument can be considered the premium for the conversion option. The present value of this interest difference would be considered loss-absorbing capital, as it is loss-absorbing in the same way as the premium paid on warrant or on an ordinary option (see issue 10.)

Result: Option premium: Equity
 Present value of redemption amount and interest: Liability

IE7 ***Option to purchase ordinary shares***

Fact pattern:

- Entity G issues options to purchase its ordinary shares at a fixed price of 100 CU on a specified exercise date.
- Purchasers of the options pay a premium of 10 CU for each option.
- The ordinary shares themselves are loss-absorbing equity.

Analysis:

Whether the option holder exercises the option or not, the entity is never obliged to repay the option premium. Therefore, it forms part of the reserves of the entity that are available to absorb losses (see issue 10.) With regard to the obligation to issue its own ordinary shares, the issue is the same as in IE5: Whether or not the obligation to issue own shares is a recognisable liability is primarily a framework issue and a question of what view drives the financial statements (entity vs. proprietary view, see issue 4.)

Result Option premium: Equity

Obligation to issue own shares: Neither equity nor liability under an entity view.

IE8 Loss-absorbing loan stock

Fact pattern

- Entity H has 100m CU of loss-absorbing share capital and reserves. It issues 100m CU of 'loss-absorbing' repayable loan stock, sharing losses equally with the share capital.
- Entitlement before liquidation – repayable at par 10 years after issue, after deduction of 50% of any overall accounting losses in that period.
- Entitlement on liquidation – par amount less 50% of any overall accounting losses in the period since issue.

Analysis:

The loan stock absorbs a proportion of any accounting loss made in the period from issue to repayment (or earlier liquidation, see issues 1-3.) Since the entity has share capital and reserves of 100m CU and losses are split equally between the share capital/reserves and the loan stock, the entity is able to absorb a total of 200m CU of losses before showing a deficit (see issues 6, 7.)

Result: 200m CU total equity, 100m CU of which is the loan stock
(= Loan Stock to be classified as equity)

Variation:

- The entity has only 10m CU of loss-absorbing share capital and reserves, but still issues the same loan stock.

Analysis:

In this case, although the loan stock has the same rights as before, the entity is able to absorb only 20m CU of losses (10m CU against share capital and reserves, and – since the loan stock takes only a 50% share in losses – the same amount against loan stock.) In this case the entity has only 20m CU of loss-absorbing capital, and only 10m CU of the loan stock is equity (see issues 6, 7.) This analysis reflects the principles that, in order to determine the overall amount of losses the entity may suffer before a shortfall arises, one has to take the entity's respective capital structure as of the day the classification is made into consideration. As losses might be shared between instruments, one has to look at the whole capital structure.

Result: 20m CU total equity, 10m CU of which is the loan stock
(= 10m CU of the loan stock is to be classified as equity, the rest is to be classified as liabilities)

IE9 ***Loss-absorbing loan stock and 'buffer'***

Fact pattern:

- Entity I has loss-absorbing share capital and reserves of 100m CU. It issues 100m CU of 'loss-absorbing' repayable loan stock that takes all losses above 100m CU.
- Entitlement before liquidation – the loan stock is repayable in full after ten years, after deducting any net accounting losses that exceed 100m CU over that period.
- Entitlement on earlier liquidation – repayable at par less any net accounting losses in excess of 100m CU.

Analysis

The entity can absorb losses of 200m CU before a shortfall arises. It therefore has loss-absorbing capital of 200m CU, 100m CU of share capital and reserves and 100m CU of loan stock (see issues 6, 7.)

Result: 200m CU total equity, 100m CU of which is the loan stock
 (= Loan Stock is to be classified as equity.)

Variation

- The entity has only 10m CU of share capital and reserves, but issues loan stock with the same terms.

Analysis:

In this case, losses above 10m CU cannot be absorbed and the entity's loss-absorbing equity is therefore only its share capital and reserves of 10m CU (see issue 10); none of the loan stock qualifies (see issues 6, 7.)

Result: The loan stock is to be classified as liability.

IE10 Share puttable, exercise limited to par (cooperative bank)

Fact pattern:

- Entity J issues puttable shares, repayable at par at the holder's request.
- Entity J has reserves of 100m CU.
- Accounting losses are deducted from reserves, but if losses are sufficient to deplete the reserves, further losses are allocated pro-rata amongst shares then in issue, so a member's claim after depletion of the reserves is reduced.
- The claim of the shareholder is then for the par value less her/his share of further losses after reserves are depleted.

Analysis

The entity is able to absorb losses of 100m plus the shares in issue before a shortfall arises (see issues 1-3, 7, 10.)

Result: Equity

IE11 Short-term loss-absorbing loans

Fact pattern:

- The entity K has a December 31 reporting date. On December 25, it issues instruments that are mandatorily repayable on January 4 the following year. Repayment is made at par, less any losses that may be allocated to the instrument.

Analysis:

The instrument is loss-absorbing (see issues 1-3.) However, since the term of a capital instrument is not a decisive factor for the classification under the loss absorption approach, this paper proposes that any classification standard should require additional information being given preferably either as a 'thereof' remark on the face of the balance sheet or in the notes to the financial statement. Disclosure of this information should ensure that the financial position and the loss-absorbing capabilities of the entity are not misleading.

Result: Equity

Variation:

- The instrument is issued in January and redeemable in February the same year. The entity does not prepare interim or annual financial statements during the term of the instrument.

Analysis:

In theory, such a short-term loan can qualify as loss-absorbing in the same way as longer dated loans or the loan in the original fact pattern. However, in practice, it will be difficult to see how a mechanism could be put in place to ensure that losses were identified in order to be reflected in the amount repayable. However, such analysis depends on what kind of losses the loss absorption approach should be based on (accounting vs. economic losses, see pars. 4.1 et seq.). Since this paper is based on absorbing accounting losses, those accounting losses would have to be determined over the term of the instrument. However, if the approach were based on economic losses, such a short-term loan would be classified as equity as all economic losses would be reflected in the amount repayable, however short the term of the instrument.

Result: Equity, as long as a mechanism is established that results in (a) determining the accounting losses attributable to the instrument before it matures and (b) allocating all these losses to the instrument.

IE12 ***Asset-linked notes***

Fact pattern:

- Entity L issued an asset-linked note.
- The payments on this note are 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.

Analysis:

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* (see issue 2.)

Result: Liability

SECTION 7—CONCLUDING REMARKS

- 7.1 In this paper a number of characteristics that might be used for basing a dichotomous distinction between equity and liabilities on was described and discussed. All of these characteristics (and a distinction based on them) may provide decision-useful information to some users, in certain situations and for entities in a certain legal form.
- 7.2 A tentative result so far is that empirical capital structures are multi-dimensional, i.e. each capital instrument or interest embodies a distinctive bundle of characteristics. Choosing one of these characteristics (or a combination thereof) is arbitrary and may not lead to decision-useful information in every situation, to every user group and across all legal forms.
- 7.3 The no-split solution abandons the dichotomous structure and is part of a concept of disaggregated accounting for capital structure. The balance sheet shows capital →claims ranked by one of the original criteria, e.g. the level of subordination. As different criteria would lead to a different ranking of claims, additional information could be given on a second level of structuring claims or in the notes. The main advantage of this approach is that it no longer supports the implicit premise of an equity-liability split that becomes more blurred every day a new mezzanine instrument is being created.
- 7.4 Although we think 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, we feel that much more time is needed in order to fully evaluate the consequences that fall from such a “claims only” approach. We 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. We would be happy to assist the IASB in pursuing this task.
- 7.5 If one was of the view that a dichotomous classification was imperative or that consequential issues following from such a “claims”-approach could be

successfully addressed, one should choose the characteristic(s) for basing the split on it that will lead to decision-useful information in a wider range of situations and for a broad range of user groups across different legal forms.

7.6 In our view, the loss-absorbing capability of capital is the characteristic of certain capital that, if distinguished from other non →loss-absorbing capital, provides the most decision-useful information. We note that this is a broad characteristic. It encompasses:

- (a) The claims pertaining to loss-absorbing capital are residual claims, both upon liquidation of the entity, redemption of a capital instrument and with regard to ongoing servicing.
- (b) Since the claims will decrease if the entity incurs →losses, the entity can not default on a loss-absorbing claim. The claim would, taken to the extreme, be reduced to zero. Thus, loss-absorbing capital provides a buffer to all creditors.
- (c) Since the claims pertaining to loss-absorbing capital are residual claims, classifying those claims as equity is consistent with the notion of equity as a residual contained in the current Framework. However, it may not be entirely consistent with the current definition of a liability or with IAS 32. Apart from this exception, the loss absorption approach is intended to be consistent with the current IASB Framework.

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. 2.23 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. We 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. We 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.

GLOSSARY OF TERMS

Benefits	Positive deviations from expected future returns
Claim	A legally enforceable right to receive cash or other assets against the reporting entity
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</p>

capital". IAS 1.76 (b) requires "a description of the nature 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*