STAFF PAPER

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IASB Meeting

Project	**Financial Instruments with Characteristics of Equity research project**
Paper topic	Relevance of identified features to particular assessments of financial position and financial performance

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Introduction

1. This paper discusses the relevance of features to various assessments that users might make using information in the statement of financial position and the statement of financial performance.

2. The objective of this session is to map the various assessments users might make to the **features that we have identified** that are relevant to those assessments.

Structure

3. This paper is structured as follows:

   (a) Background (paragraphs 4–8)

   (b) Assessments of financial position (paragraphs 9–33)

   (c) Assessments of financial performance (paragraphs 34–50)

Background

4. In June 2015 (Agenda Paper 5A) we discussed:

   (a) the features of claims against an entity and what makes information about a particular feature relevant to users. In particular, we stated that a feature is relevant if it potentially affects the amount, timing and uncertainty of (the prospects for) future cash flows.

(b) how information about relevant features is provided in financial statements. In particular we stated that to depict a feature, it must be measured and noted that there must be at least one claim that will be measured as a residual, because of partial recognition and mixed measurement.

(c) the features that we identified as being relevant are:

(i) the **type** of economic resource required to be transferred to settle the claim;

(ii) the **timing** of the transfer of economic resources required to settle the claim;

(iii) the **amount (or quantity)** of economic resources required to be transferred;

(iv) the **priority (or seniority/rank)** of the claim relative to other claims.

5. We also stated that different features affect the prospects for future cash flows in different ways, and information about those effects may influence different types of assessments that users need to make. Those differences may require:

(a) different recognition requirements or measurement bases;

(b) the inclusion of the amounts measured in different totals and sub-totals in the statement of financial position and statements of performance;

(c) additional information about those features to be disclosed in the notes to the financial statements.

6. At this meeting we will discuss the relevance of the features we identified to:

(a) assessments users make with the **statement of financial position** (for example, those mentioned in paragraph OB13 of the *Conceptual Framework for Financial Reporting (the Conceptual Framework)*[1]).

(b) assessments users make with the **statement of financial performance** (for example, those mentioned in paragraph OB15–OB19 of the *Conceptual Framework*).

7. Thus, this paper discusses information provided through the recognition and measurement of claims and does not discuss supplemental presentation and disclosure.

8. We will use the same instruments that we used at the June 2015 meeting to illustrate matters in this paper, namely:

(a) **Ordinary share**—A claim that contains no obligation of the entity, other than the obligation to transfer at liquidation a share of whatever type, and amount, of economic resources remain under the entity's control after meeting all other claims.

(b) **Ordinary bond**—A claim that contains an obligation of the entity to transfer cash, equal to an amount specified in a particular currency, at a specified time prior to liquidation, and senior to all other claims.

(c) **Share redeemable for its fair value**—A claim with equivalent features to an ordinary share, **except** that the entity has the obligation to settle the claim, at fair value in cash, on demand of the holder.

(d) **Share-settled bond**—A claim with equivalent features to an ordinary bond, except that the entity has to settle the claim using a variable number of its own ordinary shares of an equal value to the amount specified. We assume that the entity has the ability to issue a variable number of shares to settle such a claim.

[1] The IASB recently published the Exposure Draft *Conceptual Framework for Financial Reporting* (ED/2015/3). References in this paper to the *Conceptual Framework* are references to the existing *Conceptual Framework for Financial Reporting* unless otherwise stated.

(e) **Cumulative preferred shares**—A claim with equivalent features to an ordinary bond, **except** that the entity is **not** obliged to settle the claim in part, or in full, prior to liquidation.

Assessments of financial position

9. Financial statements provide information about the financial position of the entity, which is information about the entity's economic resources and the claims against the entity. [2] Importantly, the financial position of an entity is a snapshot at a point in time.

10. Information about the nature and amounts of an entity's economic resources and claims, helps users assess the reporting entity's:

    (a) financial strengths and weaknesses;

    (b) liquidity and solvency; and

    (c) needs for financing and ability to obtain financing.[3]

11. In particular, we are interested in possible assessments that users might make using the statement of financial position, including the totals for assets, liabilities and equity, other subclasses and line items within each total and financial position ratios of these amounts.

12. Based on the above parts of the Conceptual Framework, we have identified two different types of assessments of financial position that users might make, that for the purposes of convenience we call:

    (a) Assessment A (paragraphs 15-23)

    (b) Assessment B (paragraphs 24-31)

13. For each, we:

    (a) Describe the assessment and the features that are relevant to that assessment.

[2] OB12

[3] OB13

(b) Discuss what distinction(s) between claims[4] might help this assessment; and illustrate the consequences of those distinction(s) using the example instruments.

14. As we will illustrate in the analysis, the classification of some of the instruments (ordinary shares and ordinary bonds in paragraph 8) as liabilities or equity is the same, regardless of which of the assessments the classification is intended to help. However, other instruments have feature sets such that their classification as liabilities or equity results in information that is useful for one type of assessment and not the other. While the differences between the assessments can be on occasion subtle, they are intended to highlight the different effects on the prospects for future cash flows that different sets of features of a claim may have.

Assessment A

15. Assessment A is an assessment of the extent to which the entity is expected to have the economic resources required to meet its obligations **as and when** they fall due.

16. The features that are relevant to this assessment are the **timing of required settlement**, the specified **type of economic resource** required to settle the claim and the **amount of economic resources** required to settle the claim. Classifying claims on the basis of the **timing** of required settlement, and the **amounts** and **types** of economic resources required, will help users assess, when compared to the amounts and types of economic resources the entity has and their timing of expected realisation[5], to what extent the entity:

(a) has the economic resources required, or is expected to obtain the economic resource required at the time of required settlement, (eg by

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[4] Both distinctions between liabilities and equity, and additional distinctions within liabilities and/or within equity

[5] In existing IFRS, this is similar to the order of liquidity, or current/non-current analysis, required in IAS 1 *Presentation of Financial Statements*. IAS 1 further states that information about expected dates of realisation of assets and liabilities is useful in assessing the liquidity and solvency of an entity. IFRS 7 *Financial Instruments: Disclosure* supplements the presentation of the financial position with disclosures of the maturity dates of financial assets and financial liabilities. In addition, IAS 1 notes that disclosing the expected dates of realisation of non-financial assets and liabilities is also useful.

selling goods and services for cash through its normal operating cycle); or

(b) is not expected to have the economic resources required at the time required, and therefore has to either:

(i) obtain the economic resources required by issuing additional claims, or negotiating refinancing of existing claims; or

(ii) convert its other economic resources to those required outside its normal operating cycle, potentially disrupting its business activities and incurring associated costs. In extreme situations, such circumstances could force the entity to liquidate or cease trading.

17. Consequently, the primary feature that is relevant to this assessment is the timing of required settlement. The feature **timing** determines **when** the entity will be required to transfer economic resources.

18. If the **time of required settlement** of a claim is prior to liquidation, then the **amount** and **type** of economic resources that the claim requires the entity to transfer will also be relevant to Assessment A. The feature **amount** determines **how many** economic resources the entity has to transfer, for example specified units of currency, and the feature **type** of economic resource determines **what** economic resources the entity will have to transfer, for example cash, goods or services.

19. If the **time of required settlement** of a claim is **only** at liquidation, then other features of that claim are not relevant to Assessment A. For example, if all of an entity's claims are required only to be settled on liquidation (for example, a fully ordinary share funded entity) then no further information is required to make Assessment A. It is only when claims are introduced that oblige the entity to transfer economic resources prior to liquidation that information is required to satisfy Assessment A. Only then is the risk introduced that the entity may not have the economic resources required to settle the obligations as and when they fall due.

20. ***If* the aim of the distinction between liabilities and equity is to *solely* satisfy Assessment A**, then it might be helpful to classify:

    (a) claims that contain an obligation of the entity to transfer economic resources at a **specified time prior to liquidation** as **liabilities**;

    (b) claims that do not contain such a feature as **equity**.

21. We can illustrate the consequences of that classification using the instruments in paragraph 8:

    (a) **Ordinary bonds** and **shares redeemable at fair value** – classification as a **liability** will show that the entity will be obliged to transfer economic resources on redemption prior to liquidation.

    (b) **Ordinary shares, share-settled debt** and **cumulative preference shares** – classification as **equity** will show that the claims do not oblige the entity to transfer any economic resources prior to liquidation.

22. For **share-settled debt**, the above assumes that the entity has the ability to issue the required number of shares. The share-settlement feature is, in effect, similar to an automatic refinancing of otherwise normal debt by issuing a variable number of shares to equal to the value of the debt. If the entity does not have the ability to issue the shares, then it will be required to purchase existing shares which it will then transfer to the holders of the share settled debt. Thus, in this circumstance the claim *will* have a feature that requires the entity to transfer economic resources prior to liquidation. Information about that claim would be relevant to satisfy Assessment A, and in therefore, **liability** classification would show that the entity will be obliged to transfer economic resources prior to liquidation.

23. Within liabilities additional sub classifications might be helpful in making Assessment A, such as:

    (a) distinguishing between claims that require different types of economic resources (eg financial liabilities, obligations to transfer goods or services etc); or

    (b) distinguishing between claims that require settlement at different times prior to liquidation. For example, additional sub-classifications within liabilities might be useful to show that the shares redeemable at fair value can result in required settlement on demand, whereas ordinary bonds might have a required settlement at a later date prior to liquidation (eg, current/non-current or order of liquidity).

Assessment B

24. Assessment B is an assessment of the extent to which an entity has sufficient economic resources to satisfy the total claims against the entity **at a point in time**.

25. Classifying claims on the basis of the **amounts** specified, and the **priority** of claims on liquidation, will help users assess (when compared to the total amount of economic resources the entity has) to what extent:

    (a) the entity has sufficient economic resources to meet its obligations, and the potential allocation of any shortfall in economic resources amongst such claims.

    (b) the entity has claims that that responds to future changes in the amount of its economic resources. Importantly, this will show how resilient the entity's claims are to reductions in value of its economic resources.

    (c) the entity has the ability to obtain economic resources by issuing new claims or retain existing economic resources by refinancing existing claims. For example, if the entity has a shortfall in economic resources, this will impair its ability to access markets regardless of market liquidity.

26. Consequently, the primary feature that is relevant to this assessment is the **amount of resources required** to settle the claim. The feature **amount** determines **how many** economic resources the entity will be required to transfer to settle the claim. Because Assessment B is *at a point in time*, then the **timing of required settlement** is not relevant to Assessment B.

27. If the specified **amount of economic resources required** to settle a claim **does not depend on** (ie is independent of) the availability of the entity's actual economic resources, then the **priority** of the claim on liquidation will also be

relevant to the Assessment B. The feature **priority** determines the order of a claim's access to the actual economic resources available at a point in time.

28. If the specified **amount of economic resources required** to settle a claim **does depend on** the availability of the entity's actual economic resources, then other features of the claim are not relevant to assessment B. For example, if the specified amount of all of an entity's claims depended on the entity's available economic resources (for example, a fully ordinary share funded entity) then no further information is required to satisfy Assessment B other than information about the entity's economic resources. It is only when claims are introduced that specify an **amount** different, or independent of, the entity's total economic resources that information about those claims is required to satisfy Assessment B. Only then is the risk introduced that the entity may not have sufficient economic resources to satisfy the amount that it has promised at a point in time.

29. **If the aim of the distinction between liabilities and equity is to *solely* satisfy Assessment B**, then it might be helpful to classify:

    (a) claims that specify an amount that is independent of the availability of the entity's economic resources as **liabilities**; and

    (b) claims that specify an amount that is dependent on the availability of the entity's economic resources as **equity**.

30. We can illustrate the consequences of that classification using the instruments in paragraph 8:

    (a) **Ordinary bonds, share-settled debt and cumulative preference shares** – classification as **liabilities** will show that the claims specify an amount that is independent of the entity's economic resources. Thus, they oblige the entity to produce a promised return to the claim holders and give rise to the risk that the entity's economic resources will be insufficient to settle the claim.

    (b) **Ordinary shares and shares redeemable at fair value** – classification as **equity** will show that the specified amount of the claim will change in response to changes in the entity's recognised and unrecognised economic resources.

31. Within liabilities additional sub classifications might be helpful in making Assessment B, such as:

    (a) distinguishing between claims that have different levels of priority on liquidation (eg in order of priority: senior ordinary bonds, unsecured bonds, share-settled debt and cumulative preference shares etc); or

    (b) distinguishing between claims that specify different levels of variability in the specified amount (eg fixed rate bonds, derivatives etc).

Conclusion

32. Based on the above analysis, we note that:

    (a) The **timing, type and amount** features are relevant to Assessment A.

    (b) The **amount** and **priority** features are relevant to Assessment B.

Question for the IASB
1) Do you agree with our analysis of Assessment A and Assessment B? 2) Do you agree with our analysis regarding which features of claims are relevant to these assessments?

Financial performance

33. Financial statements provide information about the effects of transactions and other events that **change** the entity's economic resources and claims.[6] To properly assess the prospects for future cash flows from the entity, users need to be able to distinguish between changes in the entity's economic resources and claims that result:

    (a) from that entity's financial performance; and

[6] OB12

(b) from other events or transactions such as issuing debt or equity instruments.[7]

34. Information about a reporting entity's financial performance helps users to understand the return that the entity has produced on its economic resources.[8] Furthermore, information about the priorities and payment requirements (ie about the features or characteristics) of existing claims helps users to predict how future returns will be distributed among those with a claim against the reporting entity.[9]

35. The statement of financial performance is a statement of changes in economic resources and claims over a period. **Importantly, we are interested in the set of changes *other* than** those changes resulting from contributions of resources from claim holders, or distributions of resources to claim holders.

36. Based on the above parts of the Conceptual Framework, we have identified two different types of assessments of financial performance that users might make, that for the purposes of convenience we call:

(a) Assessment X (paragraphs 37-39)

(b) Assessment Y (paragraphs 40-49)

Assessment X

37. Assessment X is an assessment of the components of changes in economic resources, other than changes that result from contributions from issuing claims, or distributions from settling claims. This step helps in assessing the entity's past and future ability to generate net cash inflows. That information indicates the extent to which the entity has increased its available economic resources, and thus its capacity for generating net cash inflows through its operations rather than by obtaining additional resources directly from investors and creditors.[10]

38. Information about changes in the entity's economic resources are based on requirements in IFRSs that deal with the accounting for an entity's assets, and are

[7] OB15

[8] OB16

[9] OB13

[10] OB18

unaffected by claims or their features. To the extent that the obligations imposed by claims require an entity to change its economic resources, then those changes will be reflected in accordance with the recognition and measurement requirements for the economic resources that are affected.

39. Some features of claims, in particular the **type** of economic resource required to settle the claim and the **timing** of required settlement, have consequences for the entity's economic resources. For example, to the extent that the entity has to produce/convert existing economic resources, or obtain the specific type of resource by issuing other claims, the marginal cost, or marginal benefits, (for example, gains and losses on sale and transaction costs) of obtaining the right type of economic resource at the time required will flow to other claim holders. However, these changes in economic resources will be recognised as and when they occur, based on the recognition and measurement requirements for assets.

Assessment Y

40. Assessment Y is a comparison of the returns on the entity's economic resources to the promised returns of the entity's claims.

41. The features that are relevant to this analysis are the specified **amount** of economic resources required to settle the claim, and the **priority** of the claim on liquidation.

42. How the **amount** is specified (that determines **how many** economic resources the entity will be required to transfer to settle the claim) will be the primary source of the allocation of economic resources amongst claims, and how that allocation changes over time. If a claim specifies an amount independent of the entity's economic resources, and thus a promised return, then there might be a difference between the total return that the entity has actually produced on its economic resources, and the total return that it is obliged to produce to meet its obligations to claim holders. How this difference is distributed amongst such claims depending on their relative **priority** of the claim on liquidation.

43. Specifying an amount that is independent of the entity's economic resources is akin to specifying or promising a return on the claim. For example, the following

contractually specified amounts will have various effects on the allocation of returns amongst claims:

(a) face values, coupons, floors and/or ceilings denominated in units of a selected currency, commodity, financial asset or a basket or index of assets.

(b) rates of change of an amount over time, set by reference to market interest rates, fixed rates, or changes in prices of a reference economic resource denominated in units of a selected currency, commodity, financial asset or a basket or index of assets, including formulas that magnify (or supress) changes in the underlying reference economic resource.

44. If the specified amount of all of an entity's claims depends solely on the performance of the entity's economic resources ie **are not independent** of the entity's economic resources (for example, a fully ordinary share funded entity) then no further information is required other than information about the performance of the entity's economic resources. So, for such a funding structure, an increase in the entity's assets will be reflected as income or returns on the claims or a decrease will be reflected as expense or losses on the claims. For a single such claim, all that is required is information of how those returns are allocated proportionately amongst claims (ie earnings-per-share).

45. It is only when claims are introduced that specify an amount different, or independent of, the entity's total economic resources that information about that feature is required to satisfy Assessment Y. Only then will the returns on each claim differ from the returns on the entity's economic resources.

46. The **priority** of the claim on liquidation is commonly referred to as the 'pecking order' or 'waterfall' of returns and is a result of the limited liability of claims (ie that the only source of economic resources to meet claims against the entity is the entity's present economic resources and the future economic benefits produced from them). For example:

(a) If two claims against an entity have equal priority and other features, then they will participate equally in the prospects for future cash flows on its economic resources. So, for example, two similar junior bonds will yield similar interest, as would two similar senior bonds.

(b) If all other features are equal, but they have different priorities, then they will not participate equally in the prospects for future cash flows. So, for example, a senior bond will yield a lower return than a junior bond.

47. **If the aim of the distinction between liabilities and equity is to solely satisfy the Assessment Y**, then it might be helpful to classify:

(a) claims that specify a promised return that is independent of the actual returns on the entity's economic resources as liabilities (thus changes in these claims will be income or expense); and

(b) claims that specify an amount that is dependent on the actual returns on the entity's economic resources and in higher priority claims as equity (thus changes in these claims will not be income or expense, but may be included in the determination of the return to the most residual claim).

48. We can illustrate the consequences of that classification using the instruments in paragraph 8:

(a) **Ordinary bonds, share-settled debt and cumulative preference shares** – showing changes in the specified amount of these claims within the same total will show that the claims specify a return that is independent of the actual return on the entity's economic resources. Thus, they oblige the entity to produce a promised return (eg interest, cumulative preference dividends) to the claim holders and give rise to the risk that the returns on the entity's economic resources will be insufficient to meet the promised returns.

(b) **Ordinary shares and shares redeemable at fair value** – showing changes in these claims within the same total will show that claims specify a return that is dependent on the actual return on the entity's economic resources and higher priority claims.

49. Within these two categories of changes, additional sub classifications might be helpful in making Assessment Y in additional levels of detail, such as:

(a) distinguishing between the changes in claims that have different levels of priority on liquidation (eg interest on senior ordinary bonds, ‘interest’ on cumulative preference shares etc); or

(b) distinguishing between claims that specify different levels of variability in the specified amount (eg fixed rate bonds, derivatives etc).

Conclusion

50. Based on the above analysis, in our view the specified **amount** of resources required to settle the claim, and the **priority** of the claim on liquidation, are relevant to assessments of the entity’s financial performance. The **type** of economic resource required for settlement, and the **timing** of required settlement, are simply features that determine **when** the distributions of resources will occur, and **what** form that distribution will take, consequently they are relevant for assessments of financial position (Assessment B), but are not relevant for assessments of financial performance.

Question for the IASB
1) Do you agree with our analysis of Assessment X and Assessment Y? 2) Do you agree with our analysis regarding which features of claims are relevant to these assessments?