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Video Transcription: Liabilities vs Equity – The Distinction

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Liability or Equity? How do you decide, and what are the implications?
Do you know how to determine whether a credit balance is debt or equity, and what that classification implies? Sometimes it is easy. A fixed term financial loan is clearly a liability, and a capital contribution from a shareholder is clearly equity. In between, there are some challenging applications, and the consequences of getting the classification wrong are big. This video is aimed at helping you make that distinction in the trickier applications and reminding you of the consequential principles.

The core principle in making the classification is that if there is any circumstance, irrespective of how remote, in which the company could be forced to make a payment, there is an obligation. If there is no possibility of an obligation, there cannot be a liability and the amount will then be recognised as equity. Remember that equity is the residual interest in the assets after deducting all the liabilities.

There are two major consequences arising from the classification as debt or equity. The first is the expense and income definitions. As you know, an expense is a decrease in net assets other than those relating to distributions to equity participants. Interest relating to a liability is recognised as an expense. Conversely a dividend payment on shares relates to equity participants and therefore is recognised as a reduction in retained earnings in the statement of changes of equity and not as an expense. Payments relating to liabilities give rise to expenses that are accrued when calculating profit. Payments relating to equity instruments do not impact profit or comprehensive income – they are recognised as an adjustment to equity.

Consider preference shares. A preference share, with a cumulative dividend and a fixed redemption date, is a liability as the company has an obligation to make payments. The preference dividends therefore relate to a liability, which implies that they must be accrued for on a time basis and charged as an expense. The substance of the preference share is that it is a loan and financial reporting always reflects the substance. If the issuer has no obligation to either pay the preference dividend or redeem the preference shares, the instrument is classified as an equity instrument, and the dividends recognised as a reduction in retained earnings as and when they are declared. While preference shareholders may have a preferential right to dividends, as there is no obligation to declare dividends to ordinary shareholders, that preferential right does not create an obligation. The key point to remember is that the classification of the instrument drives the recognition of the related distributions.

Another implication of this distinction is in relation to the non-controlling interest that arises from a partly held subsidiary. The non-controlling interest represents the residual interest in the net assets of the subsidiary held by other shareholders. Those shareholders have no entitlement unless a dividend has been declared, and the company has no obligation to declare dividends. Non-controlling interest is therefore a class of equity, which is why profit and comprehensive income always includes 100% of the profits and comprehensive income of a partly held subsidiary. That profit is then attributed to the non-controlling interest and owners of the parent company. While the attribution is presented on the face of the statement of comprehensive income, it is not a charge against profit.

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As the definition of income and expense excludes all those relating to equity transactions, there is never a gain or loss from a transaction between shareholders or directly in relation to shares. For example, share issue costs are set off against equity, not expensed. Buying back your own shares (known as treasury shares), does not give rise to a gain or loss. A sale or purchase of shares in a subsidiary without a change in control is a transaction between the controlling and the non-controlling shareholders and therefore cannot give rise to a gain or loss. Those transactions are referred to as equity transactions, and any consequential adjustment will be recognised directly in equity.

The second important recognition implication is the measurement basis that is used to measure the credit balance. A liability represents an obligation to transfer resources, and therefore the amount that is recognised is the present value of what is to be paid. You have seen that in provisions, recognition of a lease liability etc. On the other hand, equity is a residual amount, and is recognised as the amount at which the other side of the transaction is measured, and then never remeasured. While equity may be shuffled around with equity, it is never remeasured to reflect current values. Share capital is recognised at the date that it is received, and measured at that date at the fair value of the consideration received. A subsequent increase in the fair value of the share will not change the amount recognised for share capital.

The financial reporting implications of share-based payments illustrate these principles. If there is any possibility that the employer would have to make cash payment, the amount is treated as "cash settled". This implies that the liability is remeasured at each reporting date with all adjustments recognised in profit or loss – just like a provision.

If the only obligation is to provide shares, that is an "equity settled scheme", which will give rise to the recognition of an expense and an equity balance, which is never remeasured after the date of recognition. The normal practice is for equity to be measured at the fair value of the consideration received, i.e. measuring equity as the residual. An exception applies if employment is the consideration received. It is impossible to measure the incremental value from the services of the employee as a result of the share-based payment award, and therefore the equity instrument issued as opposed to the services received is measured. This is why IFRS 2 requires equity-settled employee contracts to be measured at the fair value of the equity instrument at the grant date.

Some companies issue convertible debentures. In that case there may be both a liability component and an equity component in respect of the conversion option. To the extent that there is an obligation to make payments, either in the form of interest or if the holder has the option to choose settlement in cash, then an obligation should be recognised for that amount. Equity is calculated as the residual i.e. the difference between the fair value of the instrument as a whole and the liability recognised. It is measured at the date of issue and never remeasured or recognised in profit. Following on from the principle that tax follows the underlying transaction, any deferred tax adjustment relating to the initial difference between the liabilities recognised, for accounting and tax purposes, arises from the recognition of the equity element and therefore should be recognised in equity.

In conclusion, remember the three key issues:

- If there is a potential obligation to pay, it is a liability.
- Liabilities give rise to gains and losses, whereas transactions relating to equity go directly to equity.
- Liabilities are measured at what you expect to pay, whereas equity is a residual amount and never remeasured.

1	CF 4.4(b) & (c)	Definition of a liability and equity
2	IAS 32:11(a) & 11(b)	Definition of a financial liability - *% including settlement in own equity shares
3	IAS 32:28	An instrument may have debt & equity components e.g. convertible debenture
4	IAS 32: IE 1 – 6*^	Contracts on equity instruments of an entity
5	IAS 32: IE 9*	Example splitting debt & equity of compound financial instrument
6	IAS 12: Eg. 4	Deferred tax implications of compound financial instruments
7	IAS 32: 33	Treatment of treasury shares as equity transactions. See footnote E11 that indicates that no gain or loss even in shares held for trading.
8	IAS 32: 35	Linking nature of instrument to related costs/inflows as profit or equity
9	IAS 1: 107	Dividends recognised as distribution to owners must be disclosed
10	IFRS 2: App A	Definition of cash-settled transaction
11	IFRS 2: 30	Requirement to remeasure cash settled liability and adjust profit
12	IFRS 2: 10	Measurement of equity settled instruments
13	IFRS 10: 22	Non-controlling interest (NCI) is presented in equity, separately from the equity of the owners of the parent.
14	IFRS 10: 23	Transactions with NCI that do not change control, are equity transactions
15	IFRS 10: B94-96	Basis of attribution of profit and comprehensive income to NCI
16	IFRIC 19*	Explains treatment when financial instruments extinguished with equity instruments.
17	IAS 32: 15 Footnote E4*	Footnote E4 clarifies that if equity reclassified as a liability if terms change, the fair value adjustment is recognised in equity.

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- ❖ Application of principle, not directly referred to in video

^ While these examples may appear daunting, keeping in mind the basic principles will help you through them. Options are a derivative instrument, which implies that they always need to be measured at fair value. Depending on the terms of the agreement, the reporting entity may be called on to pay cash or to provide shares. Where the settlement could be in cash, the fair value adjustment to the option is recognised in profit or loss as it relates to a financial liability. Where the settlement can only be in shares, the fair value adjustment is taken directly to equity.

^Consider a contract that will be settled in shares. If the contract specifies that a fixed number of shares will be issued, the instrument is an equity instrument. If the number of shares varies in relation to some other measure e.g. a commodity price, then the shares are being used as a currency to settle an obligation. Where the number of shares to be issued varies, the instrument will be a liability, whereas if the number of shares is fixed, the instrument is an equity instrument.