Technical Advisory Group
Issue Paper

AGENDA ITEM: TAGED16-05
12 December 2023 – Online

Equity – Amendments to Section 2 *Concepts and Pervasive Principles* and Section 22 *Liabilities and Equity*

Summary	The paper provides TAG members with an updated draft of Section 2 *Concepts and Pervasive Principles*. It reflects amendments made as a result of members views expressed at the September 2023 meetings.
Purpose/Objective of the paper	At the September 2023 TAG meeting, members were provided with a paper providing an overview of the existing concept of equity, the results of a survey to gain additional understanding of what kinds of equity instruments and claims NPOs might have, and potential changes to the concept of equity being considered by the Secretariat. This paper provides an update on the concept of equity for inclusion in Section 2 *Concepts and Pervasive Principles*, with the inclusion of an element of net assets and implications for fund accounting and Section 22 *Liabilities and Equity*.
Other supporting items	TAGED16 - 01 – Fund accounting
Prepared by	Philip Trotter
Actions for this meeting	**Comment on** the: • the introduction of a new financial statement element of net assets; • the concepts of equity and equity claims in INPAG**;** • implications for fund accounting; and • proposed amendments to Section 22.

Technical Advisory Group

Equity – Amendments to Section 2 *Concepts and Pervasive Principles*

1. Introduction

1.1 This paper provides an overview of :

- the definition of the financial statement element of net assets;
- the concepts of equity and equity claims in INPAG and their use in the NPO context following the introduction of net assets as a financial statement element;
- implications for fund accounting; and
- proposed amendments to Section 22 *Liabilities and Equity*.

2. Background

2.1 At the September 2023 TAG meeting, members were provided with an overview of how the concept of equity was included in Exposure Draft 1, responses to those proposals, and a survey that had subsequently been carried out to gain additional understanding of what kinds of equity instruments and claims NPOs might have.

2.2 The Secretariat highlighted potential changes to the concept of equity that were being considered and the implications this could have for Section 2 *Concepts and Pervasive Principles* and Section 22 *Liabilities and Equity.*

2.3 TAG members agreed that the current guidance related to equity that were included in Exposure Draft 1 needed to be revisited. This included agreement that net assets be defined as a financial statements element and that the definition of equity should be examined.

3. Net assets and equity in Section 2

3.1 A draft of key paragraphs of an updated Section 2 *Concepts and Pervasive Principles* has been included in Annex A. As part of this update, net assets is now defined as a financial statement element for INPAG as agreed at the September 2023 meeting.

3.2 Net assets are defined as “the residual available to the NPO to achieve its objectives of providing a benefit to the public after deducting all its liabilities from its assets.”

3.3 The updated INPAG guidance on net assets notes that rarely some of the net assets of the NPO may not be available to achieve its objectives. Instead these may be a financial interest that is due to holders of equity claims. Section 2 notes that this financial interest due to holders of equity claims is equity.

3.4 The definition of equity in the *IFRS for SMEs* Accounting Standard is “the residual interest in the assets of an entity after deducting all its liabilities.” The Secretariat’s view is that equity needs to be redefined for the NPO context in INPAG because of the definition of net assets. Rather than being the residual interest in the assets of an entity after deducting all its liabilities, equity in the NPO context is “the financial interest in the net assets of an NPO that is due to holders of equity claims arising from equity arrangements.” Equity may therefore be recognised as part of net assets where the holders of equity claims have established a financial interest in some of the net assets of the NPO as a result of equity arrangements.

3.5 Therefore, whereas equity claims in the *IFRS for SMEs* Accounting Standard are defined as “a claim on the residual interest in the assets of an entity after deducting all its liabilities” For INPAG this definition is amended to “ a claim that provides a financial interest in the net assets of an NPO arising from equity arrangements.”

3.6 Equity and equity claims in the NPO context are discussed in the Application Guidance which has been updated. The updated guidance in Section 2 also notes that net assets will include specific categories of items whose use may be either with restrictions or without restrictions. Further amendments in relation to fund accounting are highlighted below.

Question 1: Are TAG members:
(i) content with the introduction of a new financial statement element of net assets;
(ii) the definitions of net assets, equity and equity claims; and
(iii) is the distinction between net assets and equity/equity claims clear in the revised authoritative guidance?

4. Additional amendments

4.1 In addition to the changes related to net assets and equity, another small change is proposed to the concepts included in Section 2 following a high level review of responses to Exposure Draft 1.

4.2 This change make clear that fund accounting is used to manage and present financial statement elements. Further updates to INPAG for fund accounting are included in Section 36 *Fund accounting*.

Question 2: Are TAG members content with the other changes made to Section 2 in relation to fund accounting?

4.3 Section 22 has also been examined for potential amendments as a result of the proposed changes to Section 2. The most significant proposed changes to the text of Section 22 is to reflect the INPAG definition of equity.

4.4 The Secretariat considered removing the first example of an instrument that would be classified as a liability as the financial interest may be subject to cap. It was decided that this example should be retained as this would be more likely to see instruments classified as liabilities rather than equity which better reflects the nature of NPOs.

4.5 An additional example has also been included for instruments that can only be redeemed at par or an index-linked amount. This is intended to reflect member share type arrangements.

4.6 A draft of the updated Section 22 is included in Annex B.

Question 3: Are TAG members content with:

(i) the proposed amendments to Section 22 for the INPAG definitions of equity and equity claims?

(ii) the retention of the example of instruments that are classified as liabilities instead of equity and the additional of the example of instruments that can only be redeemed at par or an index-linked amount?

5. Next steps

5.1 The consequential amendments to Section 2 *Concepts and Pervasive Principles* including updates to the implementation guidance and examples and basis for conclusions to reflect will be reshared ahead of finalisation. Subject to TAG views it is not expected that Section 2 will require re-exposure.

5.2 Section 22 will also be revised on the basis of TAG member comment and reshared ahead of finalisation.

December 2023

Annex A

Draft Authoritative Guidance significant amendments

Section 2 – Concepts and Pervasive Principles

Core Guidance excerpts

Definition of net assets

G2.73 Net assets are the residual available to the NPO to achieve its objectives of providing a benefit to the public after deducting all its liabilities from its assets. Net assets will include specific categories of items whose use may be either with restrictions or without restrictions as per G2.75-G2.77.

G2.74 Rarely some of the net assets of an NPO many not be available to it to achieve its objectives of providing a benefit to the public but instead are a financial interest that is due to the holders of equity claims. This is equity. It is the financial interest in the net assets of an NPO that is due to holders of equity claims arising from equity arrangements. It may be recognised within net assets where the holders of equity claims have established a financial interest in some of the net assets of the NPO (see paragraphs AG2.6 – AG2.10).

Fund Accounting

G2.75 When assets and liabilities, and corresponding income and expenses, are recognised, they shall be categorised by an NPO as either being with restrictions or without restrictions. This allows an NPO to manage and present these elements by individual fund, as funds with restrictions and funds without restrictions. Section 36 *Fund Accounting* provides more detail on fund accounting.

Application guidance excerpts

Equity in the NPO context

AG2.6 Equity in the NPO context is expected to be rare. It is expected that the net assets of an NPO will be available to be used on achieving its objectives, and not for distribution to external parties who have established a financial interest in the net assets of the NPO arising from equity arrangements. Where equity claims that give rise to equity do exist, they are also unlikely to be material by magnitude but may be material by nature.

AG2.7 Where equity does exist, it provides a financial interest in the net assets of the NPO through an entitlement to (i) distributions of future economic benefits or service potential by the NPO during its life, such distributions being at the discretion of the NPO, and (ii) distributions of any excess of assets over liabilities in the event of the NPO being wound up where this excess has not otherwise been distributed to another NPO or entity with a similar purpose. In some cases this financial interest may be sold, exchanged, transferred or redeemed. Such a financial interest is similar but not the same to the concept of ownership in the *IFRS for SMEs* Accounting Standard, where investors in equity instruments that provide entitlement to the residual interest in the assets of an entity after deducting all of its liabilities are deemed to be owners.

AG2.8 Contributions from holders of equity claims are an inflow of resources to the NPO, contributed by parties external to the NPO in accordance with equity arrangements, which establish or increase a financial interest in the net assets of the NPO. Examples would include the purchase by external parties of share capital issued by the NPO or funds contributed by members that entitle them to a share of net assets.

AG2.9 The provision of funding by an external party that provides governance rights but does not establish a financial interest in the net assets of the NPO is not a contribution from holders of equity claims and does not lead to the recognition of equity. Also, if the amount contributed is required to be refunded in the future this will be recognised as a liability in accordance with Section 22.

AG2.10 Distributions to holders of equity claims are outflows of resources from the NPO, distributed to parties external to the NPO in accordance with equity arrangements, which return or reduce a financial interest in the net assets of the NPO. Examples would include the repurchase from external parties of shares issued by the NPO, or paying funds back to members so that they no longer had a further entitlement to a share of net assets.

AG2.11 Inflows of resources from contributions from holders of equity claims and outflows of resources from distributions to holders of equity claims are related to transactions with holders of equity claims in their capacity as holders of equity claims. Such transactions are different to transactions that give rise to income and expenses (see paragraphs G2.78-G2.80).

Annex B

Section 22 – Liabilities and Equity

Section 22
Liabilities and Equity

Scope of this section

G22.1 This Section establishes principles for classifying **financial instruments** as either liabilities or **equity** and addresses accounting for equity instruments issued to individuals or other parties acting in their capacity as investors in equity instruments (ie in their capacity as **holders of equity claims**). ~~Section 26 *Share-based Payment* addresses accounting for a transaction in which the NPO receives goods or services (including employee services) as consideration for its equity instruments (including shares or share options) from employees and other third parties acting in their capacity as providers of goods and services.~~

G22.2 This section shall be applied when classifying all types of financial instruments except:

(a) those interests in **controlled entities**, **associates** and **joint arrangements** that are accounted for in accordance with Section 9 *Consolidated and Separate Financial Statements*, Section 14 *Investments in Associates* or Section 15 *Joint Arrangements*.

(b) employers' rights and obligations under **employee benefit** plans, to which Section 28 *Employee Benefits* applies.

(d) ~~financial instruments, contracts and obligations under **share-based payment transactions** to which Section 26 applies, except that paragraphs G22.3–G22.7 shall be applied to **treasury shares** purchased, sold, issued or cancelled in connection with employee share option plans, employee share purchase plans and all other **share-based payment arrangements**.~~

Classification of a financial instrument as liability or equity

G22.3 ~~Equity is the residual interest in the **assets** of an entity after deducting all its liabilities.~~ Equity is the financial interest in the net assets of an NPO that is due to holders of equity claims arising from equity arrangements. For the purpose of this Section, a liability is a present obligation of the NPO arising from past events, the settlement of which is expected to result in an outflow from the NPO of resources embodying economic benefits. Equity includes investments by the holders of equity claims of the NPO, plus or minus changes to those investments earned through ~~profitable~~ surpluses ~~and~~ retained that are due to the holders of equity claims, minus reductions ~~to owners' investments as a result of unprofitable operations and distributions to owners~~ to those investments as a result of deficits assigned to the holders of equity claims and distributions to the holders of equity claims.

G22.4 An NPO shall classify a financial instrument as a **financial liability** or as equity in accordance with the substance of the contractual arrangement, not merely its legal form, and in accordance with the definitions of a financial liability and an equity instrument. Unless an NPO has an unconditional right to avoid delivering **cash** or another **financial asset** to settle a contractual obligation, the obligation meets the definition of a financial liability, and is classified as such, except for those instruments classified as equity instruments in accordance with paragraph G22.5.

G22.5 Some financial instruments that meet the definition of a liability are classified as equity because they represent a financial ~~the residual~~ interest in the net assets of the NPO:

(a) a puttable instrument is a financial instrument that gives the holder the right to sell that instrument back to the issuer for cash or another financial asset or is automatically redeemed or repurchased by the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder. A puttable instrument that has all of the following features is classified as an equity instrument:

(i) it entitles the holder ~~to a pro rata share of~~ to a financial interest in the NPO's net assets in the event of the NPO's liquidation or ceasing to be an NPO as set out in the equity agreement. ~~The NPO's net assets are those assets that remain after deducting all other claims on its assets.~~

(ii) the instrument is in the class of instruments that is subordinate to all other classes of instruments.

(iii) all financial instruments in the class of instruments that is subordinate to all other classes of instruments have identical features.

(iv) apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, the instrument does not include any contractual obligation to deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the NPO, and it is not a contract that will or may be settled in the NPO's own equity instruments.

~~(v) the total expected cash flows attributable to the instrument over the life of the instrument are based substantially on the **surplus or deficit**, the change in the recognised net assets or the change in the **fair value** of the recognised and unrecognised net assets of the NPO over the life of the instrument (excluding any effects of the instrument).~~

(b) instruments, or components of instruments, that are subordinate to all other classes of instruments are classified as equity if they impose on the NPO an obligation to deliver to another party ~~a pro rata share of the~~ a financial interest in the net assets of the NPO only on liquidation or ceasing to be an NPO.

G22.6 The following are examples of instruments that are classified as liabilities instead of equity:

(a) an instrument is classified as a liability if the distribution of net assets on liquidation or on ceasing to be an NPO is subject to a maximum amount (a ceiling). For example, ~~if on liquidation~~ the holders of the instrument receive a pro rata share of the net assets, but this amount is limited to a ceiling and the excess net assets are distributed to another NPO or the government, the instrument is not classified as equity.

(b) an instrument is classified as a liability if the instrument can only be redeemed at par or at amount index linked to the amount originally paid. In other words the holder of the equity instrument does not have a financial interest in the net assets of the NPO.

(c) a puttable instrument is classified as equity if, when the put option is exercised, the holder receives ~~a pro rata share of the~~ a financial interest in net assets of the NPO as set out in the equity arrangement measured in accordance with this Guidance. However, if the holder is entitled to an amount measured on some other basis (such as local GAAP), the instrument is classified as a liability.

(d) an instrument is classified as a liability if it obliges the NPO to make payments to the holder before liquidation or on ceasing to be an NPO, such as a mandatory distribution.

(e) a puttable instrument that is classified as equity in a controlled entity's **financial statements** is classified as a liability in the controlling NPO's consolidated financial statements.

(f) a preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, is a financial liability.

G22.7 Members' shares in a co-operative and similar instruments are equity if:

(a) the NPO has an unconditional right to refuse redemption of the members' shares; or

(b) redemption is unconditionally prohibited by local law, regulation or the entity's governing charter.

Original issue of shares or other equity instruments

G22.8 An NPO shall recognise the issue of shares or other equity instruments as equity when it issues those instruments and another party is obliged to provide cash or other resources to the NPO in exchange for the instruments:

(a) if the equity instruments are issued before the NPO receives the cash or other resources, the NPO shall present the amount receivable as an offset to equity in its **Statement of Financial Position**, not as an asset;

(b) if the NPO receives the cash or other resources before the equity instruments are issued, and the NPO cannot be required to repay the cash or other resources received, the NPO shall recognise the corresponding increase in equity to the extent of consideration received; and

(c) to the extent that the equity instruments have been subscribed for but not issued, and the NPO has not yet received the cash or other resources, the NPO shall not recognise an increase in equity.

G22.9 An NPO shall measure equity instruments, other than those issued as part of a business combination or those accounted for in accordance with paragraphs G22.14–G22.18, at the fair value of the cash or other resources received or receivable, net of **transaction costs**. If payment is deferred and the time value of money is **material**, the initial measurement shall be on a **present value** basis.

G22.10 An NPO shall account for the transaction costs of an equity transaction as a deduction from equity. **Income tax** relating to the transaction costs shall be accounted for in accordance with Section 29 *Income Tax*.

G22.11 How the increase in equity arising on the issue of shares or other equity instruments is presented in the Statement of Financial Position is determined by applicable laws. For example, the par value (or other nominal value) of shares and the amount paid in excess of par value may be required to be presented separately.

Sale of options, rights and warrants

G22.12 An NPO shall apply the principles in paragraphs G22.8–G22.11 to equity issued by means of sales of options, rights, warrants and similar equity instruments.

Capitalisation or bonus issues of shares and share splits

G22.13 A capitalisation or bonus issue (sometimes referred to as a stock dividend) is the issue of new shares to shareholders in proportion to their existing holdings. For example, an NPO may give its shareholders one dividend or bonus share for every five shares held. A share split (sometimes referred to as a stock split) is the dividing of an NPO's existing shares into multiple shares. For example, in a share split, each shareholder may receive one additional share for each share held. In some cases, the previously outstanding shares are cancelled and replaced by new shares. Capitalisation and bonus issues and share splits do not change total equity. An NPO shall reclassify amounts within equity as required by applicable laws.

Convertible debt or similar compound financial instruments

G22.14 On issuing convertible debt or similar **compound financial instruments** that contain both a liability and an equity component, an NPO shall allocate the proceeds between the liability component and the equity component. To make the allocation, the NPO shall first determine the amount of the liability component as the fair value of a similar liability that does not have a conversion feature or similar associated equity component. The NPO shall allocate the residual amount as the equity component. Transaction costs shall be allocated between the debt component and the equity component on the basis of their relative fair values.

G22.15 The NPO shall not revise the allocation in a subsequent period.

G22.16 In periods after the instruments were issued, the NPO shall account for the liability component as follows:

(a) in accordance with Part I of Section 11 *Basic Financial Instruments* if the liability component meets the conditions in paragraph G11.8. In these cases, the entity shall systematically recognise any difference between the liability component and the principal amount payable at maturity as additional interest **expense** using the **effective interest method** (see paragraphs G11.20–G11.25).

(b) in accordance with Part II of Section 11 *Other Financial Instrument Issues* if the liability component does not meet the conditions in paragraph G11.8.

Extinguishing financial liabilities with equity instruments

G22.17 An NPO may renegotiate the terms of a financial liability with a creditor of the NPO with the result that the NPO extinguishes the liability fully or partially by issuing equity instruments to the creditor. Issuing equity instruments constitutes consideration paid in accordance with paragraph G11.49. An NPO shall measure the equity instruments issued at their fair value. However, if the fair value of the equity instruments issued cannot be measured reliably without undue cost or effort, the equity instruments shall be measured at the fair value of the financial liability extinguished. An NPO shall derecognise the financial liability, or part of the financial liability, in accordance with paragraphs G11.47–G11.49.

G22.18 If part of the consideration paid relates to a modification of the terms of the remaining part of the liability, the NPO shall allocate the consideration paid between the part of the liability extinguished and the part that remains outstanding. This allocation should be made on a reasonable basis. If the remaining liability has been substantially modified, the NPO shall account for the modification as the extinguishment of the original liability and the **recognition** of a new liability as required by paragraph G11.48.

G22.19 An NPO shall not apply paragraphs G22.17–G22.18 to transactions in situations in which:

(a) the creditor is also a direct or indirect shareholder and is acting in its capacity as a direct or indirect existing shareholder;

(b) the creditor and the NPO are controlled by the same party or parties before and after the transaction and the substance of the transaction includes an capital distribution by, or contribution to, the entity; or

(c) extinguishing the financial liability by issuing equity instruments is in accordance with the original terms of the financial liability (see paragraphs G22.14–G22.16).

Treasury shares

G22.20 Treasury shares are the equity instruments of an NPO that have been issued and subsequently reacquired by the NPO. An NPO shall deduct from equity the fair value of the consideration given for the treasury shares. The NPO shall not recognise a gain or loss in surplus or deficit on the purchase, sale, issue or cancellation of treasury shares.

Distributions to holders of equity claims

G22.21 An NPO shall reduce equity for the amount of distributions to its holders of equity claims (holders of its equity instruments). Income tax relating to distributions to holders of equity claims shall be accounted for in accordance with Section 29.

G22.22 Sometimes an NPO distributes assets other than cash to its holders of equity claims ('non-cash distributions'). When an NPO declares such a distribution and has an obligation to distribute non-cash assets to its holders of equity claims, it shall recognise a liability. It shall measure the liability at the fair value of the assets to be distributed unless it meets the conditions in paragraph G22.23. At the end of each **reporting period** and at the date of settlement, the NPO shall review and adjust the **carrying amount** of the capital distribution payable to reflect changes in the fair value of the assets to be distributed, with any changes recognised in equity as adjustments to the amount of the distribution. When an NPO settles the capital distribution payable, it shall recognise in surplus or deficit any difference between the carrying amount of the assets distributed and the carrying amount of the capital distribution payable.

G22.23 If the fair value of the assets to be distributed cannot be measured reliably without undue cost or effort, the liability shall be measured at the carrying amount of the assets to be distributed. If prior to settlement the fair value of the assets to be distributed can be measured reliably without undue cost or effort, the liability is remeasured at fair value with a corresponding adjustment made to the amount of the distribution and accounted for in accordance with paragraph G22.22.

G22.24 Paragraphs G22.22–G22.23 do not apply to the distribution of a non-cash asset that is ultimately controlled by the same party or parties before and after the distribution. This exclusion applies to the separate, individual and **consolidated financial statements** of an NPO that makes the distribution.

Disclosures

G22.25 If the fair value of the assets to be distributed as described in paragraphs G22.22–G22.23 cannot be measured reliably without undue cost or effort, the NPO shall disclose that fact and the reasons why a reliable fair value measurement would involve undue cost or effort.

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