Accounting problems on the classification of liability and equity from the perspective of cooperatives

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■Abstract

In June 2018, with regard to the classification of financial instruments under IAS 32, IASB has made a new proposal and invited the public to give comments on the classification of liability and equity based on the two new criteria, "timing feature" and "amount feature" of the delivery of the entity's economic resources.

This newly proposed criteria offer nothing but a working explanation on the controversial fixed-for-fixed condition for derivative financial instruments that are to be settled with their own shares, and on an equity instrument that is not classified as equity.

Cooperatives and other similar entities have expresses their concern that the implementation of the new 'amount feature' criterium could affect the handling of IFRIC 2, while it remains an unsolved problem that the members' shares in cooperatives in many countries are still treated as financial liabilities.

The reason the discussion has failed to achieve convergence is that an element contradicting the liability-based approach in the Conceptual Framework of IASB, has to be introduced in order to sort out the classification issue of liability and equity under IAS 32.

The classification of liability and equity is inherently and mainly based on the legal nature of the financial instruments. For the convergence of the discussion and the establishment of the standards applicable to any kind of entity, there would be no other option than to use the classification based on their legal nature.

In Japan, domestic accounting standards equivalent to IAS 32 are not yet discussed. If this will ever happen, the discussion must not take the existing standards as the precondition to focus on possible problems in their implementation. What is required here is to revert to the basic principles of accounting.

■Introduction

Last June, IASB (International Accounting Standards Board) published the Discussion Paper "Financial Instruments with Characteristics of Equity" with a deadline for comments on January 7, 2019 (DP/2018/1) (hereinafter referred to as "FICE DP"). With regard to the classification of financial instruments under IAS 32 (Financial Instruments: Presentation (Note 1)), FICE DP has proposed a new classification focused on the timing and the amount of a delivery obligation of the entity's economic resources from the perspective of the issuer of financial instruments. The interpretation guidelines on the members' share in cooperatives: IFRIC 2 "Members' Shares in Cooperative Entities and Similar Instruments" (hereinafter referred to as "IFRIC 2") and the exceptive clause on puttable financial instruments are not the issues there to be discussed nor to be revised. However, the current standards themselves are unacceptable for cooperatives in the first place.

If the new proposal was implemented, it causes cooperatives in the EU to feel concerned about a possible change in their current practice based on IFRIC 2, depending on how the discussion will develop. And what is more, the new proposal will not bring any classification solution for cooperatives of most countries. The cooperatives' side including ICA (International Co-operative Alliance) has, therefore, submitted critical opinions on FICE DP.

This article outlines the main points of the new proposal, addresses their problems and finally discusses the reason that the discussion still has not achieved convergence after nearly 20 years, along with its possible solutions.

(Note 1) IAS 32 was adopted in 1995, followed by a partial revision. The current standards are the revised version from 2003, which thereafter underwent further partial revisions a few times to this date.

1. Summary of the new proposals — Points of FICE DP (DP/2018/1) —

According to IAS 32, the issuer of a financial instrument (Note 2) shall classify the instrument, or its component parts, on initial recognition as a financial liability or an equity instrument not in accordance with its legal form, but in accordance with the substance of the contractual arrangement and the definitions of a financial liability and an equity instrument (IAS/32, paragraphs 15 and 18).

FICE DP states that a non-derivative financial instrument should be classified as a financial liability if it contains one or both of the followings (IN10).

① an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation (*hereinafter referred to as "timing feature"*)

② an unavoidable contractual obligation for an amount independent of the entity's available economic resources (*hereinafter referred to as "amount feature"*)

How this approach classifies financial instruments can be summarized as indicated in Table 1.

Table 1　Classification of financial instruments

Timing feature \ Amount feature	Obligation for an amount independent of the issuer's available economic resources	No obligation for an amount independent of the issuer's available economic resources
Obligation to transfer of economic resources required at a specified time other than at liquidation	Liability (e.g. simple bonds)	Liability (e.g. shares redeemable at fair value)
Obligation to transfer of economic resources required only at liquidation	Liability (e.g. convertible bonds with an obligation to deliver a variable number of the entity's own shares with a total value equal to a fixed amount of cash)	Equity (e.g. ordinary shares)

Based on IN11 of FICE DP

The "timing feature" is helpful for users of financial statements to assess and determine whether the entity has sufficient available economic resources (liquidity and sufficient cash flow) to fulfill its obligation of payment in a given period. The entity's "available economic resources" intend to mean the residual assets of the entity after deducting its liabilities. The "amount feature" is, therefore, meant to focus on solvency on the balance sheet and return on investment.

With this definition by the new proposal, the members' shares in cooperatives are still liabilities if they include the obligation of repayment at a time other than at liquidation (how to perceive "at liquidation" is also one of the issues).

The new proposal by IASB and its problems will later be discussed after presenting opinions from the cooperatives' side. The next section addresses the summary of classification definitions of liability and equity as well as the treatment of members' share in cooperatives under the current International Financial Reporting Standards

(IFRS).

(Note 2) A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity (IAS/32, paragraph 11). Hence the members' shares (contribution contracts) in cooperatives also fall into this category of financial instruments, while such "shares" are not securities unlike stocks. In Japan, as a matter of fact, the members' share in cooperatives and stocks are two separate concepts and they come with different terminologies. Thus, among the countries and interested parties there seem to be some discrepancies in the understanding of the conceptual differences, for instance, between a refund of shares and a redemption of equity interests. This could be one of the elements that complicate the discussion.

2. Summary of the current standards

2.1 The Conceptual Framework and IAS 32

According to the Conceptual Framework of IASB (Note 3), IFRS specifies that the credit on the balance sheet is to be classified as liability and equity, and defines equity as the residual interest in assets of the entity after deducting all its liabilities (IASB (2018a), paragraph 4.63).

It also defines liability as a present obligation of the entity to transfer an economic resource as a result of past events, and such an obligation is substantially unavoidable to the entity (ibid. paragraph 4.26).

On the other hand, IAS 32 specifies that a financial instrument is any contract that gives rise to a financial asset of one entity (Note 4) and a financial liability or equity instrument of another entity (IAS/32, paragraph 11) and that an equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities (ibid.), while it also defines a financial liability as follows.

① a contractual obligations:

ⓐ to deliver cash or another financial asset to another entity (*e.g. account payable*); or

ⓑ to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity (*e.g. written option*)

② a contract that will or may be settled in the entity's own equity instruments and is:

ⓐ a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments (*e.g. financial instruments redeemable with treasury stocks of equivalent book value*); or

ⓑ a derivative including the entity's own equity instruments that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments (*e.g. written option to have a net settlement with treasury stocks*). Therefore, rights to acquire a fixed number of the entity's own equity instruments, options or subscription warrants in exchange for a fixed amount of any currency, are considered to be equity instruments if the entity will provide such rights pro rata, options or subscription warrants to all the current owners of the entity's own equity instruments which are non-derivative but of the same class. Furthermore, the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 16A and 16B of IAS 32, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D of IAS 32, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

As an exception as described in the next section, a financial liability is classified as an equity instrument if the financial instrument satisfies the definition of financial liability, and has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of IAS 32.

(Note 3) The Conceptual Framework is a sort of basic standard to establish individual accounting standards. There are also other standard-setting bodies besides IASB that provide such a framework. Having the securities- and financial market players who intend to raise and manage funds (especially investors) as the target group, the framework generally has a basic role to set its purpose and basic concept, and, based on these, to stipulate a consistent system of basic accounting concepts by the deductive method through the normative approach. It can be said that the framework represents the ideal state that is envisaged by the people who set accounting standards setters (Iwasaki (2015) page 67). However, the Conceptual Framework of IASB is based on a specific perspective of accounting rather than on pure theory. It differs from the traditional basic theory of accounting (i.e. accounting convention → accounting theory → accounting principles → accounting treatment/accounting representation) as well as from the background perspective of accounting.

(Note 4) The "entity" here is a concept including an individual, a partnership, a corporation, a trust and a government organization. The "contract and contractual" means an agreement in any manner or form, that is reached among multiple interested parties with some inevitable economic consequences.

2.2 Exception in puttable financial instruments

A puttable instrument is a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder (IAS/32, paragraph 11). Hence "members' shares" in cooperatives is a form of puttable financial instrument (Note 5).

The puttable financial instruments is usually classified as a financial liability, since they contain a contractual obligation for the issuer to deliver cash or another financial asset to the holder, while they can be exceptionally classified as equity instruments if they have the features and meet the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of IAS 32.

Nevertheless, it remains exceptional with stringent and restrictive requirements. That is to say that a puttable financial instrument is classified as an equity instrument only if it has all the following features (IAS/32, paragraph 16A).

① It entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation.

② The instrument is in the class of instruments that is subordinate to all other classes of instruments, or the most subordinated instrument.

③ All financial instruments in the class of instruments that is subordinate to all other classes of instruments have identical features. For example, they must all be puttable, and the formula or other method used to calculate the repurchase or redemption price is the same for all instruments in that class.

④ Apart from the contractual obligation for the issuer to repurchase or redeem the financial 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 entity, and it is not a contract that will or may be settled in the entity's own equity instruments as set out in subparagraph ② of the definition of a financial liability (see page 4).

⑤ The total expected cash flows attributable to the instrument over the life of the instrument are based substantially on the profit or loss, the change in the recognized net assets or the change in the fair value of the recognized and unrecognized net assets of the entity over the life of the instrument (excluding any effects of the instrument).

Furthermore, for a puttable financial instrument to be classified as an equity instrument, in addition to the instrument having all the above features, the issuer must have no other financial instrument or contract that has the followings (IAS/32, paragraph 16B).

① Total cash flows based substantially on the profit or loss, the change in the recognized net assets or the change in the fair value of the recognized and unrecognized net assets of the entity (excluding any effects of such financial instrument or contract) and

② the effect of substantially restricting or fixing the residual return to the puttable instrument holders.

For the purposes of applying this condition, the entity shall not consider non-financial contracts with a holder of a financial instrument described in paragraph 16A of IAS 32 that have contractual terms and conditions that are similar to the contractual terms and conditions of an equivalent contract that might occur between a non-instrument holder and the issuing entity. If the entity cannot determine that this condition is met, it shall not classify the puttable instrument as an equity instrument. This means that a deal between a non-entity owner and the holder of a financial instrument will not be taken into account in order to consider the exception in puttable financial instruments.

Moreover, paragraphs 16C and 16D of IAS 32 describe some financial instruments that include a contractual obligation for the issuing entity to deliver to another entity a pro rata share of its net assets only on liquidation. It is about an unavoidable contractual obligation for the issuing entity with, for example, a limited life, to pay cash or another financial asset if it is certain that liquidation will occur and outside the control of the entity. Its specified features are similar to the above features mentioned above that are required for the puttable instrument with regard to cooperatives with a limited life or of a certain type of partnership.

(Note 5) For the protection of minority shareholders, the Companies Act in Japan allows shareholders to exercise a put option against the issuer in certain cases, whether the issuer is a closed or open company. Under current IFRS, such put options will not be considered at the time of classification of the underlying stock, but there is no persuasive explanation why not.

2.3 About IFRIC 2

The IFRIC 2 specifies application guidelines for the principles of IAS 32 related to the classification of members' shares in cooperatives and other similar entities as a liability. Such guidelines clarify the following points that include a nature that might conflict with the cooperative principle of open membership. It can be said that they are products of compromise for implementing IFRS.

① The contractual right of the holder of a financial instrument (including members' shares in co-operative entities) to request redemption does not, in itself, require that financial instrument to be classified as a financial liability. Rather, the cooperatives and other similar entities must consider all of the terms and conditions of the financial instrument in determining its classification as a financial liability or equity. Those terms and conditions include relevant local laws, regulations and the entity's governing charter in effect at the date of classification, but not expected future amendments to those laws, regulations or charter (paragraph 5).

② Members' shares that would be classified as equity if the members did not have a right to request redemption are equity if either of the conditions described in paragraphs 7 and 8 (*see below*) is present or the members' shares have all the features and meet the conditions in paragraphs 16A and 16B (*see above*) or paragraphs 16C and 16D of IAS 32 (*financial instruments that include the obligation for the issuing entity to deliver a pro rata share of its assets only on liquidation*) (paragraph 6).

③ Members' shares are equity if the cooperatives and other similar entities have an unconditional right to refuse redemption of the members' shares (paragraph 7).

④ Local law, regulation or the entity's governing charter can impose various types of prohibitions on the redemption of members' shares, e.g. unconditional prohibitions or prohibitions based on liquidity criteria. If redemption is unconditionally prohibited by local law, regulation or the entity's governing charter, members' shares are equity. However, provisions in local law, regulation or the entity's governing charter that prohibit redemption only if conditions—such as liquidity constraints—are met (or are not met) do not result in members' shares being equity (paragraph 8).

⑤ An unconditional prohibition may be absolute, in that all redemptions are prohibited. An unconditional prohibition may be partial, in that it prohibits redemption of members' shares if redemption would cause the number of members' shares or amount of paid-in capital from members' shares to fall below a specified level. If it is partial, members' shares in excess of the prohibition against redemption are liabilities, unless the entity has the unconditional right to refuse redemption as described in paragraph 7, or unless the shares═satisfy all the features of exceptional puttable financial instruments or financial instruments with the exceptional option of redemption on liquidation (paragraphs 16A and 16B or paragraphs 16C and 16D of IAS 32) (paragraph 9).

3. Milestones leading to the new proposal

Originally, the project on financial instruments with characteristics of equity was single-handedly launched by FASB (US financial accounting standards board). The involvement of FASB in this discussion stems from the project on financial instruments that started long back in 1986. During the liability/equity project among them the first discussion paper was published in 1990, but the discussion was suspended. In 2000 the new exposure draft was released and in 2003 part of it was published as SFAS No. 150 (Accounting For Certain Financial Instruments with Characteristics of Both Liability and Equity). As the SFAS No. 150 had defined mandatorily redeemable financial instruments as a liability, there were lobbying activities led by the National Cooperative Business Association and others. In November of the same year, SFAS No. 150-3 had indefinitely deferred the effective date to apply the provisions of SFAS No. 150 to equity instruments with a mandatory redemption obligation of non-public entities, including cooperatives.

Thereafter FASB and IASB have entered into a joint project to study the issues on the classification of liability and equity further, under the bilateral MoU in 2006 as part of a medium- and long-term convergence between IFRS and US GAAP based on the "Norwalk Agreement" reached in 2002.

Even though this joint project resulted in the Discussion Paper "Financial Instruments with Characteristics of Equity", published in February 2008, the discussion then became complicated and the joint project ended, after the last discussion in October 2010, on the grounds of the necessity to prioritize other projects, a lack of manpower etc.

Subsequently, in October 2012, IASB took the work up solely as one of the areas constituting the project "The Conceptual Framework" (See the above "Note 3") and resumed the discussion aiming to release the Discussion Paper (DP) at the end of 2017. Last June, a half year later than planned, the study results were published as the Discussion Paper (FICE DP) as mentioned in the introduction.

For the process and details of the study and the discussion in the project that led to the new proposal, please refer to the following literature in particular, as they had to be omitted in this article due to space constraints:

- Detilleux & Naett (2005) especially for the process of the discussions and response at an EU-level from the amendment to IAS 32 in 2002 to IFRIC 2;
- Shigeto (2008) for the process leading to the publication of the Discussion Paper produced by the joint project and to the invitation to the public for comments, as well as the responses of the cooperatives in various countries;
- Maglio, Agliata & Tuccillo (2017) for the analysis of the public to give comments on the Discussion Paper; and
- Ikeda (2015b, 2016), Ishida (2015, 2018) and others for the contents of the study and its process resulting in the new proposal.

Also it is recommended to refer to Tokuga (2014) in which all the underlying issues on the classification of liability and equity are examined.

4. Possible changes under the new proposal

According to its explanation, a new proposal by IASB in FICE DP will elucidate the principles of the classification of liability and equity without causing major differences in the classification outcomes based on the current IAS 32. Moreover, while it will increase the value of the provided information through the presentation and disclosure in addition to the classification, it will improve consistency, completeness and clarity of the classification requirements, especially the requirements on contractual rights and obligations of financial instruments that includes the entity's own shares (derivatives on own shares) as one of the subjects of the exchange of financial instruments.

It means that no recommendation has been made for additional changes regarding the members' shares in cooperatives and they have postponed the study on IFRIC 2, the interpretation guidelines on the members' shares in cooperatives, and on the requirements for puttable financial instruments as shares in cooperatives and other similar entities, in order to receive the exceptional treatment as an equity rather than a liability (IAS/32, paragraphs 16A and 16B).

However, the requirements of IFRIC 2 and their treatment are products of compromise reached by the negotiation in response to the revision of IAS 32 in 2003. They might be useful in practice in some countries, but theoretically they undermine the identity of cooperatives. The problem also remains that many of the members' shares in cooperatives are still treated as financial liabilities, because IFRIC 2 specifies that the amount of redemption in certain cases, such as a member's withdrawal, must be guaranteed by the pro-rata equity (share) rights to the net assets in order to have the exceptional puttable financial instruments classified as equity.

In the meantime, the implementation of the newly proposed requirements could cause some changes in the current situation under IAS 32. One of the typical examples is a financial instrument with the obligation to pay fixed cumulative dividends, e.g. cumulative perpetual preferred equity investments (stocks). Notwithstanding such an obligation, it is classified as equity under the current IAS 32 if it has an unconditional right to defer the payment indefinitely, whereas the new requirements will classify it as liability. This is the case, because the valuation of the financial instrument (amount to be paid) is determined by a component that is independent of available economic resources of the issuing entity.

The next example concerns derivatives on own equity, which satisfy the so-called fixed-for-fixed condition, in which a fixed amount of cash or another financial asset will be exchanged for a fixed number of the entity's own equity instruments. Under the new requirements, such derivative products as a whole will be classified as equity instruments, whereas the products that do not satisfy the conditions will be classified as financial assets/liabilities. This is the case, because the products run the same risk of value changes as stocks do; their value is not subject to dilution; therefore they are not independent of the entity's available economic resources, unlike the definition of the "amount feature". The third example is rights, options and warrants that are denominated in a foreign currency, and are issued exclusively to the shareholders, based on the number of shares owned by them. Under the current IAS 32, these are exceptionally treated as equities, even though they are exchanged for a fixed amount of foreign currencies, whereas they will be classified as a liabilities, since the value of the settled transactions reflects foreign exchange fluctuation i.e. an index independent of the entity's available economic resources.

5. Opinions from the Japanese concerned organizations and the cooperatives

In response to FICE DP, 128 opinions were received from all over the world. IASB intends to analyze these opinions within 2019 to determine the future direction that will be taken.

The Japanese body that is responsible for establishing Japanese accounting standards, ASBJ (Accounting Standards Board of Japan) pointed out that the scope of FICE DP would be limited, such as the clarification of the fixed-for-fixed condition, which has been considered as the application issue of the new proposal, and responding to problems arising from economic compulsion. They have also indicated that FICE DP is possibly insufficient to articulate the classification outcomes, especially in relation to the "amount feature" and that IASB should consider developing concepts that can be consistently applied to a wide variety of claims.

The Japanese Institute of Certified Public Accountants (JICPA) has submitted an opinion that IASB's preferred approach should be revised from the viewpoint that if all the claims with the "timing feature" are to be classified as liabilities without exception, the puttable financial instruments should not continue to be treated as exception; and that supposing there is a need to continue treating puttable financial instruments as equity, it would appear preferable to instead follow the approach of distinguishing liabilities from equity based solely on the requirements of the "amount feature". They also found it necessary to more clearly define the "at liquidation" concept in order to enable to clearly distinguish claims with and without the "timing feature" in practice, since even IAS 32 gives no clear guideline on what point in time is indicated by the concept "at liquidation", while it seems important to determine what point in time corresponds to "liquidation" in employing the requirement for the "timing feature" that involves the concept of a contractual obligation at "a specified time other than at liquidation." They have also mentioned that the expression "the entity's available economic resources," which is employed in the requirement for the "amount feature," should be more clearly defined as this is difficult to interpret and could cause confusion in the practical application (these points were also made in the ASBJ's opinion).

As Japanese cooperative-related organizations didn't submit their opinions on FICE DP, the following is a summary of what is regarded as a problem in the opinions of EU cooperative-related organizations instead.

In EU, IFRS has been applied to consolidated accounts of companies listed in EU regulated markets since 2005. As cooperatives were no exceptions here, the aforementioned IFRIC 2 was published in 2004. The following EU organizations, Crédit Agricole S.A., EACB (European Association of Co-operative Banks), DGRV (German Cooperative and Raiffeisen Confederation – reg. assoc.), Cooperatives Europe (European region organization of the ICA), Copa Cogeca (Committee of Professional Agricultural Organisations-General Confederation of Agricultural Cooperatives in the European Union) and ICA (International Co-operative Alliance) have respectively pointed out that the "amount feature" is ambiguously defined and not consistent with the concept of IFRIC 2, and demanded to incorporate IFRIC 2 into IAS 32, since they refer to IFRIC 2 as the blueprint for considering the equity of cooperatives under IAS 32 and also EU financial regulatory authority have established a framework of capital requirements based on IFRIC 2 as well. The financial regulatory authority, EBA (European Banking Authority) and the Basel Committee on Banking Supervision took the same stance in their opinions as these EU organizations.

In contrast to the above organizations, ICA does not only represent the cooperatives in the EU, but in the whole world, and mainly expressed the following opinions based on the general viewpoint of the cooperatives in the world: although the puttable exception needs to be retained with regard to the cooperatives, its requirements are based on what is not consistent with the nature of the actual investments in cooperatives; equity should be actively defined rather than as a concept 'residue'; the voting right would be the best basis to classify the equity instruments as equity.

On the other hand, according to IFRIC 2, members' shares are classified as equity if the (cooperative) entity has the unconditional right to refuse redemption of such shares and the redemption can be prohibited by laws/charter, or if the members' equity investments meet all the requirements set for the puttable exception in IAS 32 (IFRIC 2, paragraph 6). The "amount feature" alone would not wield a direct impact on IFRIC 2 unlike on the requirements of the puttable exception, but with the new addition of the "amount feature", concerns about the impact cannot be cleared.

6. Why convergence of the discussion is not yet achieved

If the definition of liability is automatically applied according to the Conceptual Framework of IASB, what conforms to the definition of liability will be classified as liability and what doesn't will be classified as equity; it seems easy to solve any type of problem.

However, in reality there are many financial instruments for which the classification of liability and equity is difficult. Some types of stocks are legally classified as stock but have, in fact, close characteristics to corporate bonds. On the other hand, a perpetual bonds is a type of bond with no maturity date nor obligation to repay, which is more like a stock. Considering this situation, the key will be the criteria to differentiate these two. As there are many stocks that vary by nature and each country has different laws as well, it is obviously better not to judge based on the legal form of financial instruments from the viewpoint of comparability of financial statements. At the same time, putting the legal form aside, the distinction between liability and equity is fiscally possible due to the difference in profit on the profit and loss statement (Yamada (2016) page 25), which is simply and mainly due to the difference in the legal nature (legal relations) (Arai, Kawamura (2018) page 39); thus, it would also be difficult to set the criteria merely based on the economic substance.

One possible solution of the classification problem of liability and equity could be not to differentiate liability and equity, but it will then make the concept of profit unclear and it will deviate largely from the current accounting system. Another possibility could be to set up a third classification in addition to the existing 'liability and equity,' but it will make the problem more complicated. Hence these options are both unpopular and the discussion has been held based on the classification as liability or equity.

Now, let's revert to the Conceptual Framework of IASB and confirm the definitions in the Conceptual Framework to begin with; a liability is a present obligation of the entity to transfer an economic resource as a result of past events (IASB (2018a) paragraph 4.26); for a liability to exist, three criteria must all be satisfied: (1) the entity has an obligation, (2) the obligation is to transfer an economic resource, and (3) the obligation is a present obligation that exists as a result of past events (ibid.); equity is the residual interest in the assets of the entity after deducting all its liabilities (ibid. paragraph 4.63). In other words, equity is defined here as a concept of balance or net amount of balance sheet.

Moreover, equity claims are claims on the residual interest in the assets of the entity after deducting all its liabilities; in other words, they are claims against the entity that do not meet the definition of a liability; such claims may be established by contract, legislation or similar means (ibid. paragraph 4.64).

As long as these definitions in the Conceptual Framework are observed, equity or share is only about the entity's obligation to transfer an economic resource. Thus, "the classification of liability and share should have nothing to do with the requirements such as the claim's seniority and subordination relation at liquidation; whether a financial instrument is legally classified as stock" (Ikeda (2015a) page 37). For this reason, the obligation to settle with cash will be classified as liability, whereas the one to settle with the issuer's own equity instruments (treasury stock) will be equity as this doesn't involve a transfer of an economic resource.

Nevertheless, IAS 32 has made exceptions to the classification principle of the Conceptual Framework. The major example is the exception of an obligation that is to be settled in the issuer's own equity instruments: only an obligation which satisfies the so-called fixed-for-fixed condition, in which a fixed amount of cash or another financial asset will be exchanged for a fixed number of the entity's own equity instruments, will be classified as equity and otherwise will be classified as liability (IAS/32, paragraph 16). This seems to be the case, because it is considered that a claim of the financial instrument holder is different from risk and return of the issuer's own equity instrument holder, and that the issuer's own equity instruments are used merely as payment instruments. However, this contradicts the concept of the Conceptual Framework and is also not consistent nor logical, since a different concept is introduced for the classification of liability and equity. Also, as long as the entity that is responsible for its accounting is considered a separate entity from its investors, all the claims should be eligible to demand the entity to deliver its economic resources, ergo, the key point should be the timing and conditions in which the claim can be exercised. As long as the entity is presupposed to be a going concern, any financial instrument will be classified as liability when it obliges the entity to deliver its economic resources at a specified time other than at liquidation, and otherwise it should be classified as equity, by logical thinking, regardless of the claim's seniority and subordination relation among the equity instrument holders.

The "amount feature" proposed in FICE DP seems to be devised to offer the explanation that the financial instruments are classified as equity only when they satisfy the current fixed-for-fixed condition, and also to present the theory that excludes the following cumulative perpetual preferred equities (investments) and the likes from equity classification. It is nothing but a symptomatic arrangement for the discussion and doesn't seem very logical.

As another exception of a totally different nature than the above, there is also a specification of the members' shares in cooperatives and other similar entities, that is, the puttable financial instruments (IAS/32, 16A-16D). The motivation of providing this exceptive clause is to address concerns, including the fact that the entity would have no equity on its balance sheet based on the definition of liability when the majority of its funding comes from the puttable financial instruments; the most subordinated claim, such as the members' shares in cooperatives, would be classified as liability, and consequently its book value fluctuation would be recognized in the net profit or loss. The latter will result in counter-intuitive accounting as in: when an entity (cooperatives) performs well, the present value of the settlement amount of the liabilities increases and the loss is recognized; when the entity performs poorly, the present value of the settlement amount of the liability decreases and the gain is recognized (IAS (2010) paragraph BC50).

At any rate, the major issues have been the treatment of the obligation to be settled with treasury stock and of securities (including the investments other than stock) with a mandatory redemption obligation. The reason that the discussion remained complicated and failed to achieve convergence in the past 20 years, seems to lie in the situation that the Conceptual Framework employed the so-called liability-based approach, in which liability is first confirmed and then equity as its residue, whereas the discussion of IAS 32 had to use and actually used a different concept, the so-called equity based-approach as well in the discussion on the classification of liability and equity. If this is the reason, further elaboration of the standards would still not see to it that the issues would be sorted out with a logical consistency. Eventually, the concept of liability in the Conceptual Framework, "an obligation to deliver economic resources" would even be questioned for its validity (Yamada (2016) page 32).

7. Towards a solution of the problems

Accounting is considered to have roughly two roles: "accounting for decision making" and "accounting for the harmonization of interests" (Ishikawa (2014b) page 36). These have been respectively referred to as the accounting functions of "information provision" and "the harmonization of interests". The latter is aiming at the profit harmonization with the entity's shareholders and creditors on the premise that the shareholders have limited liability. The harmonization of interest is also necessary to classify equity transaction and profit-and-loss transaction on an accrual basis as well as to regulate the distribution of profits. This function has been undertaken mostly by the existing traditional accounting.

As for the aim of the modern financial accounting, it is based on the viewpoint that the role of accounting information is solely consists of providing useful information for the decision making of investors in the capital market (Tsujiyama (2013) page 168 - 169), and this is also the case in the discussion about the usefulness of financial statements in the investment decision-making. While the Conceptual Framework of IASB takes the same stance on it, it must be noted what kind of investors are envisaged when "investors" are referred to, since the direction of discussion is depending on it. Hence, in the economic society of financial capitalism on the premise of the modern monetary economy, the management and collection of investments are conducted according to a different concept than the one of the existing traditional business investments, and accordingly, "the discussion on selecting the accounting standards could lead to a critically different conclusion" (ibid. page 182).

This issue is also related to the questions such as "What is the company", "For whom is the accounting meant." If these premises and standpoints are not shared, the discussion will be at cross purposes. The studies and discussions by IASB and others presuppose public companies that raise funds in the international market, and are not based on the accounting theory, including cooperatives and ownerless non-profit organizations. Although IFRS bears the word "international," which tends to give an impression of being open to the whole world, fair and clean, it needs to be understood first that "accounting standards are not pure water nor the product of pure theory" (Tanaka (2010) page 39). Besides, it is important to point out that accounting information is merely one of the types of information for investors and credit grantors, which decisions on investments or loans to entities are based on. It should, therefore, also be remembered that the misapprehension that accounting can provide all the necessary information for the decision making, creates a large pitfall in the discussion on the usefulness in the investment decision-making (Watanabe (2014)).

When it comes to accounting standards, it would be desirable to have an accounting theory and accounting standards that include any entity that is responsible for its accounting. However, requirements for financial statements will understandably differ when interests of their users differ. According to what IASB stated: if financial information is to be useful, it must be relevant and faithfully represent what it purports to represent (The Conceptual Framework of IASB, paragraph 2.4), the relevance of financial statements is supposed to vary depending on the business model. The author basically considers that accounting standards should be established best suited to each model taking the cost effectiveness into account. Although a concrete suggestion cannot be given here, here are a few alternative options for a solution to the problems on the classification of liability and equity in IAS 32.

First, without amending the liability concept of the Conceptual Framework, it is logically impossible to make the puttable financial instruments not exceptional, especially those that are related to the members' shares in cooperatives. If they are specified, not exceptional, the only option would be to actively define equity rather than as a residual interest. In this case, considering the fixed-for-fixed condition of the current

IAS 32 is "a rule based on the concept that a profit belongs to shareholders" (Yamada (2016) page 31), it is a possible approach in which a group of shareholders is supposed as a party to whom the entity's profit belongs, so as to focus on the internal claim that can be seen as where the profit belongs to (ibid. page 33). This is not an accounting thought based on the IASB asset-liability approach (which is of course not so consistent with the asset-liability approach as above), but coincides with the traditional perspective of accounting in Japan, which is an accounting thought based on the revenue-expense approach.

However, with regard to the "internal claim", in other words, the right of the entity's substantial owners, it is not necessary easy to define the owners concretely. It is also doubtful if the basic concept that is to be established can include accounting of Not-for-profit entities, including cooperatives; possibly a monothetic definition cannot be found for the group to which profit belongs, in the same way as for the group of corporate shareholders. To be the obtainer of profit, it seems that the disposal rights for the entity's profit must be considered as its prerequisite, while the voting right of cooperative members is derived from the membership itself, not from the "investments", unlike a financial instrument of a corporation, such as "common stocks". Therefore, it is not easy to define the entity's owner by using the right attaching to the investments. At least in the Japanese cooperatives' legislation, the investments are made as an obligation based on a membership not for acquiring the membership, and there are also the investments (of the same nature as those by the regular members) by the associate members under the Agricultural Cooperatives Act. Hence, it can be understood that it is difficult to find a concrete definition for the owners. Regarding the aforementioned opinions of ICA, it is valid to say that equity should be actively defined rather than as a concept 'residue', but the voting right would not be the basis to classify the instruments as equity, which is at least not applicable to the case of Japanese agricultural cooperatives. For comparison, IFRIC 2 regards that the investments made by cooperative members evidence the members' ownership interest in the entity (paragraph 3).

Pursuantly, these could be other possibilities: in terms of the obligation to deliver economic resources earlier than at liquidation, the definition of liability should specify that the redemption of shares as a partial liquidation of the property relations with cooperatives at a member's withdrawal or similar moment, should not be deemed as a refund or repayment of a financial instrument; or the "amount feature" should be more elucidated and refined as the only classification of liability and equity, regardless of the timing of "settlement" (as in the opinions of JICPA above). In this connection, the current requirements set for the exceptional puttable financial instruments stipulate that a claim of the holder must be most subordinate, and also that the holder must be entitled to a pro rata share rights to the entity's net assets in accordance with the number of units she/he held. From the perspective of the issuer on which FICE DP is based, however, whether the investor has a pro rata share rights to the net assets or not, has inherently nothing to do with the classification of liability and equity, regardless if the claim is the most subordinate or not. It all has to be sorted out.

Related to the "amount feature", the EU cooperatives personnel and bodies that are responsible for establishing accounting standards use the concept and term of "refund or repayment of investments par value". It cannot be said for sure as the entity theory varies among countries, but it is doubtful if the concept "par value" exists in the investments in cooperatives. Moreover, the valuation of members' shares in cooperatives is subject to fluctuation as the net assets fluctuate, unlike, for instance, cumulative perpetual preferred equity investments, whose valuation is determined independent from the entity's net assets under the legal right. Therefore, at a member's withdrawal from a cooperative, the redemption is not given to all of the member's shares, but merely to the original amount of investments made by the member at most. As long as the above is taken into consideration, there is no contradiction to the "amount feature" proposed in FICE DP. It should also be sorted out accordingly.

Although it is uncertain against which background the EU cooperative-related organizations as well as the ICA demand for incorporating IFRIC 2 into IAS 32, considering that they see the "amount feature" as a problem, it is possible to think that they are attempting to sort it out, only based on the aspect of being the members' ownership interest in the entity, that is, being the most subordinated claim.

To paraphrase the meaning of classification only based on the "amount feature", pursuantly, the classification of liability and equity is inherently and mainly based on the difference in their legal nature (not in the sense of a legal form such as a stock or bond) and this classification based on the legal nature would also be most appropriate if the classification has to be applicable to entities of any kind of business model. Hence, liability should be defined by whether it has contractually (including provisions in laws and charter) a fixed due amount even if undetermined at the present moment, which then involves the legal fact of default when the debt amount cannot be paid at the time of performance. In other words, the definition should be based on whether it is a claim that triggers compulsory execution against the assets of the entity or legal liquidation of the entity.

On a side note, there is a trend towards convergence between prudential rules for financial institutions and accounting rules since Basel III. In the first place, these rules are set up for different purposes and there should be no logical necessity for them to be regularized by unified rules. To prevent the political power balance from causing any distortion of the accounting standards, they should be deemed as separate things.

■Afterword

IFRS doesn't have a specific regulatory authority or organization that authorizes standards, thus it is depending on the prescribed procedure in each country whether IFRS will be implemented or not. The problems of IFRS with the classification of liability and equity have then no immediate impact on Japanese accounting standards.

However, being indifferent is not an option, because the problems with the classification relate to the foundation of accounting, and that the accounting standards set by ASBJ are more under the influence of IFRS since the so-called "Tokyo Agreement" in August 2007 for the convergence between accounting standards of ASBJ and IASB.

The endorsement procedure of IFRS in Japan works as follows: the accounting standards, etc. published by IASB are first assessed whether they are acceptable in Japan or not, and then, if required, a part of them will be "deleted or modified" in order to obtain the designation by the Financial Services Agency. As the IASB accounting standards, etc. have been all designated currently, the Designated International Accounting Standards are identical to the IASB's standards. The designated standards are applicable to the consolidated financial statements for the consolidated accounting period that ends later than March 31, 2010. For the consolidated financial statements for the accounting period that ends later than March 31, 2016, the applicable standards will be the Japanese Modified International Standards (composed of original IFRS and IFRS revised by the ASBJ). As for the public companies registered at U.S. SEC (Securities and Exchange Commission), it is allowed to apply US GAAP to their accounting since 2002.

It means that 4 accounting standards are currently applied among consolidated financial statements of the public companies listed in the Japanese Financial Instruments Exchange. Regarding IFRS, the only option left for Japan is its "adoption." While it would not be possible to make the decision on this issue independently of those of U.S. SEC, Japan should proceed with convergence with IFRS as per the "Tokyo Agreement" but then it is not necessary to make separate financial statements follow the rules of IFRS (Tanaka (2010) page 248).

In any case, if IAS 32 would be applied to separate financial statements even on voluntary basis, other problems will occur with regard to the coordination with the Companies Act (including the Cooperatives Act) and other Institutions [Note 6]. Therefore, it will be a matter beyond the question whether the accounting standards should be applied or not.

Although Japanese accounting standards equivalent to IAS 32 are not a subject of discussion at this moment, be aware that it is preposterous to revise the laws such as the Companies Act, because the accounting standards require it. If this discussion will ever take place, it must not take the existing standards as a precondition to consider possible problems in the implementation of the Japanese standards. In such a discussion, it is necessary to revert to the basic principles of accounting, so to start finding out what the real problems are with the current financial statements, and for what purpose, for whom and how they need to be revised.

(Note 6) See Akisaka (2009) and Yanaga (2012), etc. for the application of IFRS to separate financial statements and their problems in relation to the Companies Act.

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