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Employee share options and the equity-liability distinction: A way forward?

A research report submitted by

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SCHOOL OF ACCOUNTANCY

2014

DECLARATION OF OWN WORK

I, Craig Wallington (student number 302413), hereby declare that the work contained in this thesis is my own and can therefore be submitted in my name in partial fulfilment of the degree of Masters of Commerce in Accounting for the School of Accountancy.

SIGNED: DATED:

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ABSTRACT

This paper explores the distinction between ‘equity’ and ‘liabilities’ in financial reporting in order to assess the merits of the current system of accounting for share-based payment transactions. It applies an interpretive methodology. Data were collected from a series of interviews with purposefully selected experts. Criticisms of and support for the current accounting regime are interpretively analysed and used to identify key themes or principles for evaluating the merits of three models proposed in the academic literature: the strict liability, narrow equity and ownership-settlement models. The study finds that the strict liability approach remains supported on the grounds that it provides decision-useful information with which users are familiar. The other models are rejected as they are perceived as diminishing the usefulness of financial reporting. The study also identifies support for an obligation-centric approach, not fully developed in the literature, which may require detailed consideration by standard-setters.

Overall, these findings will be useful for both practitioners and academics grappling with the difficulty of defining ‘equity’ and ‘liabilities’. In addition, the research makes a valuable contribution by addressing the need for interpretive-inspired financial reporting research. To the best of the author’s knowledge, this thesis is also the first South African study to investigate the appropriate classification criteria for instruments such as share-based payments and provide normative recommendations for the International Accounting Standards Board.

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ABBREVIATIONS USED

APB	Accounting Principles Board Opinion
ASB	Accounting Standards Board
ASBJ	Accounting Standards Board of Japan
CFA Institute	Chartered Financial Analyst Institute
Conceptual Framework	The Conceptual Framework for Financial Reporting
Deloitte	Deloitte Touche Tohmatsu
EFRAG	European Financial Reporting Advisory Group
FASB	Financial Accounting Standards Board
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IFRS	International Financial Reporting Standard
PWC	PriceWaterhouseCoopers
SAAJ	Securities Analysts Association of Japan
SAICA	South African Institute of Chartered Accountants
SFAS	Statement of Financial Accounting Standards

GLOSSARY

Share-based payment	A transaction in which the reporting entity receives goods or services from a supplier which entitles the supplier either to equity instruments of the entity or a payment in cash or other assets for an amount that is based on the price or value of those equity instruments (IASB, 2004)
Employee share options	Options granted (awarded) to employees as part of their compensation package in exchange for services rendered to the employer company. These options typically include conditions which must be met before they vest in the employee and can be exercised, creating a vesting period for the awards (IASB, 2004)
Equity-settled options	Employee share options which will be settled at the employee's election by the transfer of shares to the employee in exchange for the payment of the exercise price by the employee. *Also* share-settled options, gross-settled options (IASB, 2004)
Cash-settled options	Employee share options which will be settled at the employee's election by a payment from the employer to the employee. The payment is determined with reference to the movement in the value of the employer's equity instruments (such as ordinary shares) over a defined period (IASB, 2004). A net-settled share appreciation right is an example of a cash-settled option
Contingent claims	Claims whose outcome or payoff depends on the performance of the reporting entity's share price (Ohlson and Penman, 2005). This would include both cash-settled and equity-settled share options
Primary equity claim	A present right to share in distributions of equity from the entity during its operations and on liquidation (IASB, 2013)
Secondary equity claim	A present right to receive, or a present obligation to deliver, another equity claim (IASB, 2013)

1 INTRODUCTION

1.1 Purpose of the study

The purpose of this study is to explore the relative merits of various models for defining equity and liabilities in financial statements, using International Financial Reporting Standard 2, *Share-based Payment* (IFRS 2) (International Accounting Standards Board [IASB], 2004) and, specifically, employee share options accounted for under this standard, as a case study.

1.2 Context of the study

The accounting for employee share options and other share-based payments has historically been a source of controversy (Aboody et al, 2004a; Zeff, 2002). Many political, conceptual and economic arguments have been raised against the recognition of a share-based payment expense (Guay et al, 2004; IASB, 2002).

Employee share option accounting under IFRS 2 highlights another contentious issue – the classification of these payments. Employee share options which are to be settled in the reporting entity's shares are classified as equity. Options to be settled in cash, on the other hand, are classified as liabilities (IASB, 2004)[1]. It has been questioned whether or not this distinction based on the manner of settlement is appropriate. The issue of IFRS 2 brought to the fore possible inadequacies in the 'liability' definition contained in the Conceptual Framework, and the reasoning which justifies this definition (McGregor and Street, 2007).

It is argued that classification under IFRS 2, based on the manner of settlement, opens up the potential for structuring of transactions to avoid accounting rules (Hirst et al,

[1] Remuneration of employees with share-based payments can take the form of gross-settled options (where employees receive shares upon vesting) or net-settled options (where employees receive cash based on the movement in the entity's share price). The structure of both types of awards is similar in that the employee elects to receive a benefit and that benefit is based on movements in the entity's share price; thus "share options" includes both share-settled and cash-settled compensation schemes (Ohlson and Penman, 2005).

2005). Furthermore, research indicates that users of financial statements may interpret share-settled employee share options as liabilities (Bagna et al, 2010; Landsman et al, 2006). The IASB utilised the definition of a 'liability' contained in the Conceptual Framework when developing IFRS 2. The apparently incongruous accounting treatment prescribed in IFRS 2 may, as a result, reflect inadequate notions of 'equity' and 'liabilities' in the Conceptual Framework (Bagna et al, 2010). For this reason, this paper uses IFRS 2 as a case study to evaluate whether or not there are deficiencies which need to be addressed by the IASB and other standard-setters.

1.3 Research question

To what extent do IFRS 2 and the Conceptual Framework prescribe appropriate accounting for employee share options, and how, if at all, could an alternative model for classifying claims improve this accounting treatment?

1.4 Significance of the study

Literature on share-based payment accounting has tended to focus on whether or not the reporting entity has incurred an expense which can be reliably measured (Aboody et al, 2004b; Espahbodi et al, 2002; Jennergren and Näslund, 1993). The nature of the wealth transfer effects of employee share options, and whether or not these payments are equity or liabilities, has received relatively little coverage (Landsman et al, 2006). As Barth et al (2013) state, 'whether employee stock options share key characteristics of liabilities or equity… is an open research and financial reporting question' (p. 643). The majority of positivist research on this matter appears to support classification of these awards as liabilities (Bagna et al, 2010). This support is not unambiguous, however, and is open to criticism (Barth et al, 2013). This study seeks to contribute to the literature on the equity-liability distinction so as to explore this issue further.

On a broader level, the distinction between equity and liabilities, and the ability of the current definitions to reflect this distinction, has been considered by standard-setters for at least two decades (IASB, 2013; Espahbodi et al, 2002). It has been suggested that the

debate on employee share options indicates that the current definitions in the Conceptual Framework are inadequate (Kirschenheiter et al, 2004). Efforts have been made to remedy these perceived deficiencies through a proposed project on financial instruments with characteristics of equity (IASB, 2008a) and a project to revise the Conceptual Framework used by standard-setters (IASB, 2013; IASB, 2010; IASB, 2008b). The project on financial instruments with characteristics of equity was ultimately abandoned, and a discussion paper on proposals for the new Conceptual Framework was released by the IASB in 2013, incorporating insights obtained from all related projects to date (IASB, 2013)[2]. This project is in its early phases, however, with a finalised Conceptual Framework only expected in 2015 (IASB, 2013). Accordingly, there is uncertainty as to what equity and liabilities actually represent. Even once the Conceptual Framework is finalised by the IASB, whether the resolutions reached are satisfactory and meet the needs of users will remain a point of discussion and research that can be analysed from multiple perspectives (Barth et al, 2013). This study aims to explore this uncertainty and obtain insights that can guide further debate and research surrounding the issue. It will also serve to highlight the context in which standard-setters are now evaluating the nature of equity and liabilities in the Conceptual Framework project.

Finally, a considerable body of share-based payments research is couched in an American economic or institutional context (Bagna et al, 2010). We know very little about financial reporting, including the interpretation of equity and liabilities, beyond traditional Anglo-Saxon settings (see Brennan and Solomon, 2008). What is more, much of the prior research has a strong positivist flavour (for example, Landsman et al, 2006; Aboody et al, 2004a) meaning that detailed accounts of the interpretation of IFRS 2, including rich exploratory analyses of the equity-liability tension which the standard raises are scant. This study contributes a qualitative perspective to the debates on IFRS 2, simultaneously providing insights arising from a South African environment.

[2] As is noted in Chapter 3, the interviews from which data were gathered for this research were conducted in November and December 2012, before the release of this discussion paper. As discussed in Chapter 2, the concepts on which the discussion paper is based are consistent with previous literature. The information obtained from the interviews can be compared with the theories established in the discussion paper, despite its later release date.

1.5 Delimitations of the study

This study only investigates potential issues in the equity-liability distinction that arise on consideration of employee share options. Issues arising from consideration of other instruments, while important (Botosan et al, 2005) are not within the scope of this research.

The issue of how to measure liabilities has generated considerable debate (Ohlson and Penman, 2005; Botosan et al, 2005). This study is only concerned with the identification of (i.e. classification of items as) liabilities, not their measurement. Fair value and historical cost accounting of liabilities is an important issue in its own right (Whittington, 2008). As a related point, any changes in the definitions of equity and liabilities will have an impact on profits and other comprehensive income. The challenges associated with defining and reporting these impacts will not be considered in this research. Such implications are in themselves complex and require significant investigation in order to arrive at a valid conclusion (Financial Accounting Standards Board [FASB], 2007).

Finally, numerous models have been proposed in the equity-liability classification debate. These include the reassessed expected outcome approach (FASB, 2007), the loss absorption approach (European Financial Reporting Advisory Group [EFRAG], 2007) and the claims approach (Whittington, 2008). These approaches offer opportunities for further research. The current study will only consider certain models of defining equity and liabilities, covered more extensively in the literature. The study will investigate the strict liability approach and the narrow equity approach[3] discussed in the IASB document, *A Review of the Conceptual Framework for Financial Reporting*. These approaches highlight the implications of the two theoretical perspectives possible in accounting, namely the entity view and the proprietorship view (IASB, 2013; IASB, 2008b; FASB, 2007). Furthermore, the ownership-settlement approach described in the project on financial instruments with characteristics of equity will also be evaluated. This

[3] The narrow equity approach, the strict liability approach and the ownership-settlement approach will be discussed in depth in Chapter 2.

approach has a number of features in common with current practice (IASB, 2008a) and it can be viewed conceptually as incorporating both solvency features (the entity view) and ownership features (the proprietorship view) (Ryan et al, 2001).

1.6 Assumptions

This study takes a social-constructionist view of reality. It is assumed that the 'reality' generated during the research process is dependent on the context in which it is generated (Rowley, 2012; Lukka and Modell, 2010; Ryan et al, 2002). No efforts are made to quantify the impact of the models evaluated in this study; in a complex social reporting environment, such efforts may be of limited relevance (Maroun, 2012).

This study furthermore assumes that, irrespective of the possible definitions arrived at for equity and liabilities, equity will retain its fundamental nature as a residual claim. To change this notion would be contrary to the historical interpretation of equity (FASB, 2007) and would, furthermore, run counter to the nature of a corporation as one in which equity holders bear residual risk (Penman, 2003). Such a change would be in conflict with the basic economic reality characterising the relationship between a reporting entity and its providers of capital and would render the resulting definitions meaningless[4].

Finally, it should be noted that this thesis uses detailed interviews as the primary data collection instrument. This introduces certain methodological limitations (see Section 3.6). In particular, despite the safeguards to ensure that respondents provide complete and accurate responses (see Section 3.4), complete candour cannot be guaranteed. Consequently, there is an assumption that all respondents have been honest and forthcoming with their responses.

[4] Note that the fact that equity is assumed to be a residual does not presuppose a conclusion that it will be defined as the secondary element after liabilities. As FASB (2007) demonstrates, equity can be defined first while still retaining the core concept of a residual.

2 LITERATURE REVIEW

The purpose of this chapter is to ground this research in the prior literature and theoretical work on the classification of equity and liabilities, as well as on the conceptual issues highlighted by the introduction and application of IFRS 2. This chapter is divided into three sections: Section 2.1 contains a historical discussion of the development of a standard on accounting for employee share options and identifies the classification concerns that arose as a result of the issuance of the standard. Section 2.2 discusses these classification concerns in the light of the current definitions of 'equity' and 'liabilities' in the Conceptual Framework. This serves to evaluate the extent to which the accounting treatment in IFRS 2 is conceptually based. In Section 2.3, three models for defining equity and liabilities are discussed, along with the entity and proprietorship perspectives which underlie such models, to provide a theoretical framework to evaluate the evidence in the study.

2.1 The dual classification system in IFRS 2

The development of a suitable accounting treatment for employee share options has represented a concern of standard setters, practitioners and academics since these awards were first introduced to remuneration packages in the 1960's (International Accounting Standards Committee [IASC], 2000). Today, such options are a standard component of the compensation packages of many executives of listed companies around the world (Hall and Murphy, 2003). Recognition of an expense for share-settled options has historically been resisted because the reporting entity has not incurred a cost which will be settled in cash or through another resource (IASB, 2004). Despite this, a standard requiring expense recognition of these awards has been pursued since the introduction in the United States of Accounting Principles Board Opinion No. 25 *Accounting for Stock Issued to Employees* (APB 25) (IASB, 2002). This required an expense for share-based payments to be measured at the intrinsic value of the awards on the measurement date (IASB, 2004). In the late 1980's and early 1990's, the FASB undertook to improve significantly the accounting for employee share options and

proposed that all options be expensed at the grant-date fair value of the awards (Landsman et al, 2006). This did not materialise and instead, due to pressure placed on the Board, Statement of Financial Accounting Standards 123 (SFAS 123) was released. This recommended, but did not require, expense recognition and simply required disclosure of the grant-date fair value of the awards (Aboody et al, 2004a; Zeff, 2002).

Outside of the USA, one of the first projects undertaken by the newly formed IASB was to deal with share-based payments, including employee share options (IASB, 2002). This resulted in the release, along with a revised SFAS 123 (SFAS 123(R))[5], of IFRS 2 in 2004 (IASB, 2004).

IFRS 2 applies to all transactions in which the reporting entity receives goods or services as consideration for equity instruments of the entity or amounts that are based on the value of equity instruments of the entity. The payments made by the entity for these goods or services are classified as either equity- or cash-settled. The former applies if the reporting entity pays the supplier in equity instruments, such as is the case when a gross-settled share option is exercised. An award is cash-settled if the payment is in cash or any other asset, such as is the case with a net-settled share appreciation right (IASB, 2004; Street and Cereola, 2004). This broad scope means that employee share options are governed by IFRS 2 (Barth et al, 2013). This is irrespective of whether they are ultimately settled by the issue of shares to the employee in exchange for the exercise price, or by the payment of cash in the amount determined by the movement in share prices (Barth et al, 2013). Payment schemes classified as equity-settled are measured using the grant-date fair value of the award and recognised as an expense and equity over the vesting period of the award (Chalmers and Godfrey, 2005; Street and Cereola, 2004). Consistent with the definition of 'equity' as a residual interest[6], the award is not re-measured after grant date (IASB, 2002). Cash-settled share-based payments result in

[5] Due to the recent codification project undertaken to clarify the hierarchy of US GAAP, the content of SFAS 123(R) is now contained in Accounting Standards Codification Topic 718 *Compensation – Stock Compensation* (Barth et al, 2013).
[6] The *Conceptual Framework for Financial Reporting* defines equity as 'the residual interest in the assets of the entity after deducting all its liabilities' (IASB, 2010, para. 4.4(c)). The discussion paper issued by the IASB to finalise improvements to the Conceptual Framework proposes to retain this definition of equity (IASB, 2013).

the recognition of an expense over the vesting period of the award, and a corresponding liability (IASB, 2004). This liability is re-measured to fair value at each reporting date via profit or loss (IASC, 2000).

The introduction of IFRS 2 represented a significant accounting development because it attempted to resolve the ongoing debate on whether or not an expense should be recognised for employee share options (Aboody et al, 2004b). In contrast with the detailed analysis regarding expense recognition and measurement, the classification of share-settled awards has not received much attention (Landsman et al, 2006; IASB, 2004; Kirschenheiter et al, 2004)[7].

The fact that share-based payment awards can be classified in two different ways with quite significantly different measurement principles has been criticised for enabling structuring of transactions (Hirst et al, 2005; Maines et al, 2004). This is because the dual classification system in IFRS 2 runs contrary to the evidence suggesting that cash-settled and share-settled options are economically similar (Barth et al, 2013; IASB, 2004; Penman, 2003). Irrespective of the manner of settlement, the supplier of the goods or services is likely to receive the same value from the reporting entity, either in cash or in the entity's shares (IASB, 2004). Furthermore, in both cases the entity has an obligation to deliver something, and it is only the item to be delivered (cash or shares) which differs (Bagna et al, 2010; IASB, 2002). The obligation is similar in nature in both cash-settled and equity-settled awards as it is a conditional obligation dependent on the counterparty's (employee's) performance (Barth et al, 2013). Moreover, the manner of settlement appears to be of little consequence in many circumstances because the recipient of shares (the employee) could immediately sell the shares on the market if the entity is listed, and in many cases, entities provide buyback facilities to their employees (FASB, 2007). Consequently, there appears to be a degree of arbitrariness in the manner of actual settlement and it does not seem justified to base classification on this

[7] For example, in the exposure draft released by the IASB on share-based payments, none of the 24 questions for respondents specifically addresses whether the proposed classification is appropriate. Out of the 310 paragraphs in the basis for conclusions of the exposure draft, only 31 address issues relating to classification of the awards as opposed to recognition or measurement (IASB, 2002).

feature (Hopkins et al, 2009). The different accounting treatment required for economically similar transactions could potentially encourage transaction structuring so that awards meet the definition of 'equity-settled' (Barth et al, 2013; Hirst et al, 2005). This is analogous to how the previous favourable accounting treatment of fixed share option plans over performance-related plans in the United States led to a proliferation of these fixed plans (IASB, 2004)[8]. This runs counter to the principle that economically similar transactions must be accounted for in a similar way (Ohlson and Penman, 2005; Maines et al, 2004).

Similarly, classification of share-settled options as equity, it is contended, results in *dissimilar* claims being classified as equity. The result is financial statements that do not faithfully represent the impact of economic phenomena on either type of claim (Kirschenheiter et al, 2004). Share price changes affect option-holders and ordinary shareholders differently. In addition, the fact that 'the interests of several different classes of stakeholders are commingled in equity' results in the provision of less useful information in financial statements (FASB, 2007, para. 62). This argument is countered by those who assert that share-settled options offer the holder a similar risk and return profile to ordinary shareholders and thus consistent classification is appropriate (Barth et al, 2013). There is a lack of clarity over whether or not options and shares are sufficiently similar to warrant the classification of both as equity (FASB, 2007).

Given these concerns over structuring – and the indication that economically similar awards may be classified in different ways in IFRS 2 – it is necessary to evaluate the extent to which current principles in the Conceptual Framework were applied in devising this classification system. It has been suggested that definitions which result in different treatment of two transactions with similar or identical economic effects indicate an inconsistency within the definitions (Ohlson and Penman, 2005).

[8] As noted above, APB 25 required measurement of intrinsic value (which determined the expense to be recognised) at the measurement date. For fixed plans, this was grant date, which generally resulted in no expense being recognised (as awards are typically granted such that they have an initial intrinsic value of nil). On the other hand, for performance-related plans, this was the date on which both the number of share options to be granted and the exercise price thereof were fixed. This would often occur when there was a positive intrinsic value of the award, resulting in a higher expense being recognised (IASB, 2004).

2.2 The distinction between ‘equity’ and ‘liabilities’ in the Conceptual Framework

The development of IFRS 2 was entrenched in the principles of the Conceptual Framework, with the IASB claiming to provide conceptual justification for both the expensing of equity-settled share-based payments and the classification of the corresponding credit (IASB, 2004; IASB, 2002). A liability is defined in the Conceptual Framework as a:

> ‘present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits’
>
> (IASB, 2010, para. 4.4(b)).

It is argued that, while share options do represent a present obligation of the reporting entity, this obligation is to deliver shares, rather than cash or other assets. As a result, no transfer of resources embodying economic benefits will occur on settlement of these obligations (Hopkins et al, 2009; IASB, 2004). This is consistent with the overall conclusion of the IASB that an obligation to issue an equity instrument does not meet the definition of a ‘liability’ (IASB, 2013; IASB, 2008a; IASB, 2002). Accordingly, share options which will be settled by the issue of shares must be classified as equity, which is the default classification should the ‘liability’ definition not be met (IASB, 2002). Although this is not specified clearly in the current Conceptual Framework, a proposed amendment clarifies the point that claims on assets must be evaluated by first considering the definition of a ‘liability’. This approach treats ‘equity’ as a residual, both conceptually and for classification purposes (IASB, 2013).

Literature indicates that this is already the way in which the classification question is approached, both in standard-setting and in practice (Hopkins et al, 2009; IASB, 2004; IASB, 2003a). Given these facts, liability classification for share-based payments currently meeting the definition of ‘equity-settled’ awards would be difficult to defend (Hirst et al, 2005).

Two objections have, however, been raised to the application of the definition of a 'liability' by the IASB. Firstly, the phrase 'resources embodying economic benefits', it is contended, does not necessarily mean only cash or other assets. The settlement in shares can satisfy the definition of a 'liability'. This is because the entity could utilise unissued shares to raise cash or to settle obligations in future, which would increase the value of the entity. By issuing shares at below market value (which will result when an 'in the money' employee share option is exercised), the entity has gained less benefit than it otherwise would have obtained. This means an outflow of resources has occurred, equal to the difference between the market value and the exercise price (Maines et al, 2004; IASB, 2002)[9]. This interpretation has, however, been identified as being inconsistent with the intention of standard-setters when creating the 'liability' definition (Maines et al, 2004; IASC, 2000). The discussion paper issued by the IASB on the Conceptual Framework project clarifies this matter, as it proposes to define a liability as a 'present obligation of the entity to transfer an economic resource as a result of past events', and it defines an economic resource as 'a right, or other source of value, that is capable of producing economic benefits' (IASB, 2013, para. 2.11). Under this revised definition, an entity's shares are not an economic resource as an entity cannot have a claim on itself. As a result, an obligation to issue shares does not meet the definition of a 'liability' (IASB, 2013; Ohlson and Penman, 2005).

The latest proposed changes to the Conceptual Framework interpret liabilities in a manner which is consistent with the current approach followed by IFRS 2 (IASB, 2013). This suggests that the argument for a broader interpretation of the 'liability' definition is not justifiable.

A second argument by proponents of liability classification for all employee share options is that the transfer of shares to employees at below market value causes a loss to current shareholders. This loss arises as the new shareholders pay less than market value but receive market value in return (Guay et al, 2004; Maines et al, 2004; Penman,

[9] The difference between the market value and the exercise price is also what would be paid by the company if the option were cash-settled, meaning that in both settlement situations, the wealth of shareholders is diminished by an equivalent amount (Maines et al, 2004).

2003). Based on this logic, the exercise of 'in the money' options results in the delivery of equity instruments to employees on unfavourable terms to the entity's existing shareholders (Maines et al, 2004; Clark, 1993). Liability classification for all employee share options would better reflect the economic impact of these options on the firm's existing shareholders (Bagna et al, 2010; Landsman et al, 2006). This is because, from a shareholder's perspective, cash settlement and settlement in shares are economically equivalent outcomes of an employee share option (FASB, 2007; Ohlson and Penman, 2005)[10]. Shareholders are aware that the obligation arising from an employee share option must be settled at their expense, irrespective of the manner of settlement (Ohlson and Penman, 2005). This expense will either be a reduction in the assets attributable to shareholders, in the case of cash settlement, or a reduction in the assets attributable to each shareholder as more shareholders take up shares (Ohlson and Penman, 2005). As these authors put it:

> 'Any value created for the holders of [employee share options] lowers the value of the pre-existing shareholders equity; there can be 'no free lunch' in this regard.'
>
> (Ohlson and Penman, 2005, p. 26)

Essentially, proponents of this view believe that the IFRS 2 classification rules are not consistent with the 'liability' definition in the Conceptual Framework. They interpret the definition more broadly to evaluate whether or not there has been a transfer of economic resources from the *shareholders* (Penman, 2003). It has also been argued that under a classification approach where the definition of a 'liability' is applied first, claims such as employee share options are included erroneously in equity as they do not presently represent a residual claim (Maines et al, 2004). It appears that the IASB intends to address this specific argument by clarifying that both primary and secondary equity claims fall within the 'equity' definition, with secondary equity claims representing future, rather than current, residual interests (IASB, 2013).

[10] Refer to footnote 8 for further details.

As has been noted, recent proposed amendments to the Conceptual Framework appear to suggest that criticisms of the interpretation of certain terms in the 'liability' and 'equity' definitions will be made redundant. In other words, the proposed changes to the Conceptual Framework will establish the appropriateness of the interpretations made in developing IFRS 2 (IASB, 2013 read with IASB, 2004). Nevertheless, the concerns raised in this section suggest that the well-established definitions of 'equity' and 'liabilities' may need to be revisited (IASB, 2008a; FASB, 2007). Section 2.3 addresses various concepts which can provide a resolution.

2.3 Theories for defining equity and liabilities

2.3.1 Decision-usefulness and the selection of criteria

The appropriate criteria to apply in the classification of equity and liabilities have been considered by standard setters since the FASB added a project on financial instruments to its agenda in 1986 (FASB, 2007). At a theoretical level, however, the difference between equity and debt has been debated since the birth of accounting, with many of the core tenets of the competing theories being developed in the early 1900's (Hopkins et al, 2009; Chow, 1942).

Standard-setters have been unable to establish a clear principle or set of principles to distinguish liabilities from equity and to clarify which type of claim is represented by employee share options (Barth et al, 2013; FASB, 2007). For the majority of instruments, such as ordinary shares and trade creditors, classification is straightforward as these instruments are clearly equity or clearly debt (FASB, 2007). More complex instruments, such as options, are not as straightforward. These instruments have characteristics of debt because the legal and economic rights attached to options differ from those inherent in the ownership of ordinary shares. Share options also have equity features, however, because the payoff of the options correlates with the share price performance of the entity's ordinary shares (Ohlson and Penman, 2005; Ryan et al, 2001).

Part of the inability to separate equity from liabilities at a conceptual level is that a balance sheet can be viewed simply as assets and claims on those assets (Whittington,

2008; FASB, 2007). To some extent, each claim shares in the risk and returns of the reporting entity (Hopkins et al, 2009). Furthermore, each claim has some form of decision-making ability, whether explicit or implicit, and each claim can be perceived as reflecting some attributes of ownership in some future state of the entity (Paton, 1922, in Hopkins et al, 2009). Accordingly, it is not clear that an objective criterion by which to resolve the classification issue can be found, as the distinction between liabilities and equity is not clear-cut (Paton, 1922, in Chow, 1942) and, as noted by the FASB (2007):

> 'Equity has historically been identified as a residual interest in the entity… A residual interest is one entitled to what is left over, that is, to the residual from the entity's activities. However, there are different levels of residuals. If all claims to an entity's assets were listed in order of seniority, a line could be drawn below any item in that list, and all claims below it would be residual because they are entitled to a share of anything left over after all senior claims were settled'. (para. 53)

The above quotation indicates the inherent subjectivity in defining equity and liabilities and the potential for any classification system to be arbitrary (EFRAG, 2007). In the absence of clear, unambiguous principles for distinguishing equity from liabilities, it is necessary to consider which dividing line (that is, which definitions of 'equity' and 'liabilities'), would meet the objective of financial reporting (Hopkins et al, 2009):

> 'to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity' (IASB, 2010, para. OB2).

That is, the appropriate conceptual definitions of 'equity' and 'liabilities' are those which result in the most decision-useful information for users of the financial statements (Bagna et al, 2010; IASB, 2008a; Watts and Zimmerman, 1986). In the accounting literature, two perspectives are adopted in order to interpret the concept of decision-usefulness and to evaluate whether an accounting treatment provides decision-useful information. These perspectives are adopted in order to create a structure of how the division of claims into equity and liabilities affects users' decisions. These two perspectives are termed the insolvency risk perspective and the common equity valuation perspective (Hopkins et al, 2009; Botosan et al, 2005).

The insolvency risk perspective assumes that users (including investors, lenders and other creditors) primarily use financial statements to assess the solvency of an entity and the risk of the entity defaulting on its obligations to deliver cash or other assets (IASB, 2013; Ryan et al, 2001). Under this view, liabilities are only those obligations that can potentially force a firm into insolvency, whereas claims that are non-obligatory or can be settled without risking insolvency are equity (Hopkins et al, 2009). This view establishes a contractually specified claim on the assets of the entity as the important criterion for identifying a liability (Ryan et al, 2001; Whalen et al, 1999).

In contrast, the common equity valuation perspective presumes that users primarily use financial statements to calculate a value for the ownership interests they hold (Ohlson and Penman, 2005; Kirschenheiter et al, 2004; Penman, 2003; Ryan et al, 2001; Clark, 1993). Under this view, equity constitutes the residual claim after all non-residual claims of other securities (Hopkins et al, 2009; Botosan et al, 2005). It defines ‘equity’ narrowly as the most residual existing class of ordinary shares (IASB, 2013). Using this approach, the criterion by which equity can be distinguished from liabilities is the presence or absence of an ownership relationship between the holder and the entity (Ryan et al, 2001).

Historically, the insolvency risk approach has been the primary criterion used by standard-setters to develop principles for assessing claims (Hopkins et al, 2009; Whalen et al, 1999). The latest developments in the Conceptual Framework project indicate that this approach remains the preferred one (IASB, 2013). It is justified in that assessing claims based on the presence or absence of an obligation to deliver cash or other assets meets the needs of investors, lenders and other creditors, who are all interested in the solvency of the entity. In contrast, a valuation perspective only meets investors’ needs, as the value of ordinary equity is of no consequence to lenders and other creditors (IASB, 2013; Accounting Standards Board of Japan [ASBJ], 2008). Furthermore, the ability of investors to value their interests is not impeded by the current reporting requirements, as valuation models exist which appropriately take into consideration other equity and debt instruments issued by the entity (Barth et al, 2013). A narrow definition of ‘equity’ arising from the valuation perspective is counter-intuitive to a creditor reading the

financial statements, and financial statements under this perspective will be less useful to such users (Fitch Ratings, 2008).

In the academic literature, however, the predominant approach for evaluating the decision-usefulness of claim classification is the common equity valuation perspective (Bagna et al, 2010; Landsman et al, 2006; Ohlson and Penman, 2005; Kirschenheiter et al, 2004; Clark, 1993). This is justified by the fact that financial markets focus on equity instruments, rather than debt instruments, and financial reporting which seeks to serve financial markets should prioritise shareholders' interests over creditors' (Ohlson and Penman, 2005). These two perspectives will be applied to the equity-liability distinction using the models identified in the literature in Sections 2.3.2 and 2.3.3.

Before the various classification models are considered, it must be noted that the categorisation of claims requires the identification of features which can be used to differentiate equity and liabilities (EFRAG, 2008; FASB, 2007). It has long been established that the most fundamental question in this debate is which characteristics differentiate the liabilities of an entity from its equity (FASB, 1990, in Clark, 1993). The similarities and differences of options settled in cash or shares in Section 2.1 provide a potential basis for answering this question. The classification models to be considered all

> '[use] the attributes of an object that are of central importance to the classification system's primary users to unite similar objects and distinguish them from fundamentally different objects' (Scott, 1979, in Botosan et al, 2005, p. 168)

Accordingly, the merit of a classification system will be determined by the extent to which it utilises features or attributes of either equity claims or liability claims to develop a decision-useful distinction between the two types of claims.

2.3.2 The entity perspective and the strict liability approach

In order to define equity and liabilities satisfactorily, it is necessary to specify the perspective from which one is viewing economic transactions and other phenomena (EFRAG, 2008; Accounting Standards Board [ASB], 2008; IASB, 2008b; Ohlson and Penman, 2005; Penman, 2003). This is because the application of accounting concepts

will lead to different results, depending on whether or not one assumes that reporting is aimed at current shareholders or all claim holders (Bagna et al, 2010; Maines et al, 2004).

Currently, financial statements are prepared based on the entity perspective, where it is assumed that the reporting entity exists separately from its owners. The legal separation between owners and the entity is a core feature of corporation law, which supports adopting the entity perspective (IASB, 2010). Under this perspective, the entity (rather than its owners or others who hold interests in the entity) is the focus of financial reporting (IASB, 2008b; Kirschenheiter et al, 2004). The Conceptual Framework states that:

> 'The vast majority of today's businesses have legal substance separate from their owners by virtue of their legal form of organisation, numerous investors with limited legal liability and professional managers separate from the owners. Consequently, the Board concluded that financial reports should reflect that separation by accounting for the entity (and its economic resources and claims) rather than its primary users and their interests in the reporting entity.'
>
> (IASB, 2010, para. BC1.8)

That the financial statements apply an entity perspective follows from the objective of financial reporting. By specifying that decision-useful information must be provided to both current and potential investors, as well as to lenders, the objective of financial reporting makes it clear that the entity, and not any one user, is the focus (Bagna et al, 2010). This is also clear in the current and the proposed liability definitions in the Conceptual Framework, both of which refer to a present obligation of the **entity**, not the **shareholders** (IASB, 2013; Hopkins et al, 2009; Maines et al, 2004). Accordingly, assets and liabilities reported under this approach are those resources and obligations of the **entity**, and do not include a consideration of the resources and obligations of **shareholders** (IASB, 2013).

Using this perspective, a classification system known as the strict liability approach can be derived (IASB, 2013). This approach is what is followed currently in the Conceptual Framework and is the approach which the proposed amendments to the Conceptual Framework endorse (IASB, 2013; IASB, 2010; Ryan et al, 2001). The strict liability

approach rests on the principle that obligations of the entity which will result in a diminution of the resources of the entity, considered independently of its stakeholders, represent liabilities. All other obligations, and all claims which do not represent obligations, are equity, as they do not imply an unavoidable transfer of economic resources from the reporting entity (IASB, 2013). That is, the definition of a 'liability' reflects the needs of those assessing the solvency of the entity, and equity is left to absorb claims that do not fall within the 'liability' definition (Botosan et al, 2005). It can be seen that the strict liability approach and its entity perspective are consistent with the insolvency risk approach discussed in Section 2.3.1 above.

If the entity has no obligation to pay cash or other assets which could force it into insolvency on default, the entity perspective necessitates that such claims be classified as equity (Hopkins et al, 2009; Whalen et al, 1999). Instruments to be settled in equity, such as employee share options, represent no credit risk to the entity. Including them in the liability category would be inappropriate for the purposes of assessing the likelihood of default, which is seen as a priority in this approach (Bagna et al, 2010). Accordingly, obligations to issue equity instruments (such as employee share options), which would have no impact on the resources of the entity, are classified as equity, which forms the default classification for non-liability items (IASB, 2013; IASB, 2002).

The strict liability approach, derived from the entity perspective, reflects the *status quo* in accounting practice and standard-setting (Hopkins et al, 2009). The definition of a 'liability', discussed in Section 2.2, which arises from this approach, is well established and has enabled standard-setters, preparers and users to resolve numerous accounting issues. The definition focuses on economic phenomena which exist in reality, namely obligations and resources, which are relevant to and capable of being understood by users (IASB, 2013). That is, the strict liability approach provides the most useful information, it is argued, because claims classified as liabilities possess identifiable, relevant characteristics (obligations, and a delivery of resources). These characteristics are also not associated with other classes of claims, meaning there is limited mixing of heterogeneous claims in the liabilities category (Hopkins et al, 2009).

The entity perspective has been criticised, however, for the ambiguous or arbitrary accounting treatments that may result from its application. This is attributable to the inherent vagueness of this perspective in terms of reporting information to any specific stakeholder (Ohlson and Penman, 2005). The aim of serving the information needs of all capital providers diminishes the usefulness of financial statements for owners of the firm, as the claims of owners are aggregated in equity with the claims of non-owners, such as option-holders (Bagna et al, 2010). Furthermore, since changes in the share price of an entity affect option-holders and ordinary shareholders differently, combining their interests in equity creates reported earnings that are not representative of either group's wealth (Maines et al, 2004; Kirschenheiter et al, 2004). Abandoning the entity perspective may actually provide more useful information to *all* capital providers, as there will be a clear distinction between current owners and all other parties and their interests will not be merged (FASB, 2007). Section 2.3.3 explores this possibility further.

Furthermore, the strict liability approach, which takes an entity perspective, has proven difficult to apply in practice (IASB, 2013). This is due to two core aspects of the 'liability' definition under this approach namely: the existence of a present obligation, and a settlement outcome which will require an outflow of economic resources (IASB, 2013; Whittington, 2008). There are a number of instances in which determining whether or not a present obligation exists is subjective or cannot be resolved satisfactorily (IASB, 2013; Chartered Financial Analyst Institute [CFA Institute], 2008; Maines et al, 2004). This creates inconsistency in the application of an entity perspective[11]. It has been noted in Section 2.1 that incorporating the settlement outcome into the definition of a 'liability' may enable structuring of transactions (Barth et al, 2013; Botosan et al, 2005). As explained in Section 2.2, there are a number of different interpretations of the concept of an economic resource, with some arguing that the current *application* of the Conceptual Framework in specific standards is based on an incorrect interpretation (McGregor and Street, 2007; Maines et al, 2004). Given the difficulties in applying the 'liability' definition,

[11] For example, a cash-settled share-based payment award is an obligation that is conditional on the counterparty's (the employee) performing (meeting the conditions of the award) and it could be interpreted that no present obligation exists until it has vested. This is not the interpretation that has been followed in IFRS 2, but does indicate possible complexity in identifying the present obligation (IASB, 2013; Whittington, 2008; Botosan et al, 2005; Maines et al, 2004).

it has been argued that a new approach is warranted. In conjunction with the criticisms levelled (discussed in the previous paragraph), it has been suggested that a proprietorship perspective be applied, which is dealt with further in Section 2.3.3.

2.3.3 The proprietary perspective and the narrow equity approach

An alternative approach to financial reporting is to adopt the proprietorship perspective (Sprague, 1907, in Hopkins et al, 2009). The IASB (2008b) describes the core tenets of this perspective:

> 'Under the proprietary perspective, no distinction is drawn between the entity and its owners – the entity does not exist separately from the owners. The resources of owners remain their resources and do not become resources of an entity because the entity does not exist separately from its owners. Lenders and other creditors provide economic resources to the owners of an entity in exchange for a claim against the resources that would otherwise accrue to the benefit of the owners. In other words, the claims of lenders and other creditors reduce the owners' equity in the resources associated with the reporting entity. Thus, the proprietary perspective places the owners in the central position of financial reporting. Assets represent resources of the owners, liabilities are debts or obligations of the owners, and revenues and expenses represent changes in the net residual of owners' equity'. (para. 108)

The proprietorship perspective results in financial statements that reflect the viewpoint of current ordinary shareholders (Bagna et al, 2010; Ohlson and Penman, 2005). If this perspective is adopted, 'the distinction between what is equity and what is debt is defined *a priori*' (Bagna et al, 2010, p. 164). Equity represents only those amounts attributable to the ordinary shareholders of the entity. Any claims which could lead to a reduction in the net assets available **to current ordinary shareholders** represent a liability (FASB, 2007; Penman, 2003). Accordingly, this perspective dispenses with the need to consider whether an obligation is present or not, and also does not rely on the manner of settlement to determine classification (Barth et al, 2013; FASB, 2007). The important criterion for classifying claims on assets, in this view, is whether or not an ownership interest arises from the claim (IASB, 2002; Ryan et al, 2001).

The proprietorship approach is justified by the fact that much of commercial practice and accounting theory is focused on the shareholders of an entity, rather than on the entity

itself. For example, directors have a fiduciary responsibility to shareholders, and the contracting theory of accounting is based on a contractual relationship between management and shareholders, not between management and the firm (Penman, 2003; Watts and Zimmerman, 1986). A proprietorship perspective is consistent with the common equity valuation approach to assessing decision-usefulness. As described in Section 2.3.1, this approach identifies equity as only those instruments which have a residual claim on the assets of the entity (Hopkins et al, 2009; Botosan et al, 2005). The literature on the distinction between equity and liabilities, which assumes that users primarily wish to value the ordinary shares of the reporting entity, tends to adopt a proprietorship perspective (Landsman et al, 2006; Ohlson and Penman, 2005). Proponents of the proprietorship view also argue that this approach is objective and is simpler to apply. Focusing on a single user[12] of financial statements, it is believed, will reduce the complexity involved in deciding on the most decision-useful accounting treatment for a transaction (IASB, 2010; Bagna et al, 2010).

The proprietorship perspective of financial reporting leads to the narrow equity approach, which contrasts with the strict liability approach (IASB, 2013). Using this model, claims other than the most residual ordinary shareholders' equity, represent claims against the wealth of those shareholders and are classified as liabilities (Barth et al, 2013). Therefore, in contrast to current practice, the narrow equity approach relies on a definition of 'equity' to drive classification of claims, and all instruments not satisfying the narrow 'equity' definition are classified as liabilities (Hopkins et al, 2009; IASB, 2008a; FASB, 2007; Botosan et al, 2005). This approach is endorsed by its proponents because it will significantly simplify the classification question. Equity is defined narrowly and there are limited situations in which the classification of a claim is unclear (FASB, 2007). It is contended that it will also eliminate many opportunities for structuring, as these classification criteria do not depend on the manner of settlement (Barth et al, 2013; IASB, 2008a; FASB, 2007; Ohlson and Penman, 2005).

[12] Consideration of the definition of 'user', and whether or not it is appropriately defined in the Conceptual Framework, is beyond the scope of this research. This concept is currently an unresolved matter, particularly in light of the ongoing debate surrounding integrated reporting.

As the narrow equity approach adopts the perspective of the ordinary shareholder, representing the most subordinated residual claimant, criteria must be established by which these ordinary shareholders can be identified and distinguished from other claimants (IASB, 2013). To this end, the basic ownership approach has been proposed by standard-setters (IASB, 2008a; FASB, 2007). This approach defines equity as comprised solely of the basic ownership instrument, which is the instrument issued by the reporting entity with the following features:

> (a) 'The holder has a claim to a share of the assets of the entity that would have no priority over any other claims if the issuer were to liquidate on the date the classification decision is being made; and
> (b) The holder is entitled to a percentage of the assets of the entity that remain after all higher priority claims have been satisfied. The holder's share depends on its share of the total claims with the lowest priority and has no upper or lower limit except for the amount of assets available'.
>
> (FASB, 2007, para. 18)

Accordingly, the basic ownership instrument is the claim that participates last in dividend and other distributions, and which would rank lowest in priority upon liquidation of the reporting entity (IASB, 2008a; FASB, 2007). A further identifying characteristic of the basic ownership instrument is that the interests of holders of these instruments are diluted by any claims that are senior to these instruments (Hopkins et al, 2009; FASB, 2007). This approach introduces a definition to 'equity' based on its attributes, rather than defining it simply as a residual (Hopkins et al, 2009). It nevertheless retains the essential concept of equity as a residual interest after other claims have been satisfied (FASB, 2007). All instruments which do not fall into this definition would be classified as liabilities, irrespective of whether or not they contain a present obligation and independent of the manner of settlement (Hopkins et al, 2009; IASB, 2008a). The basic ownership approach constitutes a radical departure from current accounting as many instruments currently accounted for as equity (including employee share options) would be accounted for as liabilities (Hopkins et al, 2009; FASB, 2007). Consistent with the overall arguments for the narrow equity approach, this model would reduce the opportunities for preparers to achieve a predetermined accounting treatment for a

transaction contrary to the spirit of the accounting standard being applied (Ohlson and Penman, 2005). It is also contended that the basic ownership approach will simplify the equity-liability distinction and eliminate the misleading reporting of claims in equity that do not have present ownership rights (World Bank, 2008; Kirschenheiter et al, 2004). Finally, proponents of this view argue that it increases the decision-usefulness of financial statements (Bagna et al, 2010) because:

> 'if sufficient information is provided to fulfil the information needs of the residual claimants, then most or all of the information needs of the more senior claimants will be met as well'
>
> (CFA Institute, 2008, p. 4)

The basic ownership approach, and accordingly the proprietorship perspective upon which it is based, have been criticised on four fronts: Firstly, contrary to points above, this approach does not necessarily provide decision-useful information because it contrasts significantly with the established and well understood means of classifying claims (Hopkins et al, 2009; Fitch Ratings, 2008). Users of financial statements view certain instruments as being equity in nature. The basic ownership approach contradicts this view in a manner that may reduce the usefulness of financial statements and increase the complexity of interpreting claims (PriceWaterhouseCoopers [PWC], 2008). Accordingly, although the basic ownership approach can be seen as achieving simplicity in the classification of equity and liabilities, it does so by failing to reflect the economic reality of claims which are perceived by users as equity (PWC, 2008). Defining equity narrowly in this way may run counter to the qualitative characteristic of faithful representation (as users perceive these instruments to be equity but they are classified as liabilities). It would also appear to fall foul of comparability (as the same instrument may be classified differently in different entities based on the relative rights of other claims) (Botosan et al, 2005).

Secondly, some argue that the merits of the basic ownership approach are not desirable goals of financial reporting unless they are associated with other benefits (Hopkins et al, 2009). It is not consistent with the objective of financial reporting to prioritise simplicity without a consideration of the consequences of this perceived simplicity (Ernst & Young, 2008). Furthermore, certain financial instruments, such as employee share options, are

inherently complex, and a simple accounting system may fail to accommodate these complexities (South African Institute of Chartered Accountants [SAICA], 2008). This criticism of the basic ownership approach contends that the degree of transactional or reporting complexity is a constraint which is inherent in financial reporting. Reducing this complexity should not be the objective of new accounting principles (Hopkins et al, 2009).

Thirdly, critics of the basic ownership approach argue that the simplicity associated with this approach would not be realised because the criteria are not operational or are not conceptually justified (Hopkins et al, 2009). The criteria would be difficult to apply in firms with complex capital structures or multiple claims with features of equity as it is currently understood (Barth et al, 2013). Assessing which claim ranks lowest on liquidation may be complex and ambiguous, as different claims may rank differently depending on whether liquidation is voluntary or forced. In addition, the outcome of liquidation may be the result of a negotiated settlement, as opposed to being in accordance with contractual rights specified before the liquidation (Hopkins et al, 2009). Furthermore, evaluating the rights of an instrument based on the priority of the instrument in liquidation is inconsistent with a core assumption inherent within accounting, that financial statements are prepared on a going concern basis (IASB, 2010; Deloitte Touche Tohmatsu [Deloitte], 2008). In order to adhere to this fundamental assumption, liquidation should not play a role in determining the classification of claims (IASB, 2013).

Criterion (b) of the ‘basic ownership instrument’ definition quoted above, which refers to a subordinated interest, is also difficult to apply (Hopkins et al, 2009). In companies with complex capital structures, the most subordinated claim with regards to, for example, dividend distributions may not have the highest level of voting rights which would grant decision-making ability over the entity (Hopkins et al, 2009). Instruments classified as equity in this scenario would not be the ones conferring voting rights. This would mean that control, a key concept behind the ‘ownership’ of an entity under proprietorship theory, would be absent from the basic ownership approach (Paton, 1922, in Hopkins et al, 2009). Counter-intuitive results would also arise in situations where, for example,

option-holders are entitled to participate in dividend distributions before exercise of the options (Barth et al, 2013).

The use of dilution as a criterion for identifying the 'basic ownership instrument' has also been criticised. It is not clear that the actual dilutive effect of various instruments is consistent with the theoretical dilution presumed by proponents of the basic ownership approach (Hopkins et al, 2009). An example of this, as Barth et al (2013) note, is employee share options – when these options are 'out the money', the options themselves are diluted by ordinary shares. Using the dilutive criterion in this situation would suggest that options are equity and ordinary shares are liabilities – which clearly runs contrary to the intention of the proprietorship perspective (Hopkins et al, 2009). Furthermore, this criterion is not consistent with the other criteria specified for basic ownership instruments. Unvested employee share options that are 'in the money', for example, cause dilution of ordinary shareholders but do not have priority over ordinary shares on liquidation of the entity (Hopkins et al, 2009). This means that the criteria specified by the 'basic ownership instrument' definition are not consistent. These are not the only criteria by which the proprietorship perspective can be applied. The weaknesses in these criteria do, however, indicate the difficulties in creating an acceptable equity definition (Maines et al, 2004) which captures the spirit of proprietorship in reporting claims (Ohlson and Penman, 2005).

Finally, under any narrow equity approach, only the most residual claim (the claim entitled to the remaining net asset value after all other claims are satisfied) would be classified as equity (IASB, 2013; IASB, 2008a). This means that perpetual instruments such as non-redeemable preference shares would be classified as liabilities (PWC, 2008). Such instruments are typically viewed as being part of the ownership structure of the entity and bear risk in a similar manner to ordinary shares (Securities Analysts Association of Japan [SAAJ], 2008; PWC, 2008; IASB, 2008a). Such classification might, therefore, mislead users (PWC, 2008; IASB, 2008a). The support for the basic ownership approach and its removal of the settlement method as a classification criterion is weakened as this approach results in non-obligations being classified as liabilities (Ernst & Young, 2008). This criticism, however, reflects an abandoning of the tenets of the

proprietorship approach, as it does not place ordinary shareholders as central to the classification decision (Ohlson and Penman, 2005). It also appeals to the obligation criterion which has been identified as problematic to apply (IASB, 2013) as noted in Section 2.3.2. Incorporating non-obligations other than the basic ownership instrument into equity under this approach was originally considered by the FASB. This notion was ultimately rejected on the grounds that it made this model 'more complex and difficult to describe logically and translate into a concept' (FASB, 2007, para. 66).

From the above it can be seen that the two models discussed in Section 2.3.2 and this section flow directly from the two theories of decision usefulness discussed in Section 2.3.1. Table 1 summarises this progression:

Table 1: Link between models discussed in Sections 2.3.1-2.3.3

Theory of decision-usefulness	Insolvency risk approach	Common equity valuation approach
Accounting perspective of the reporting entity	Entity perspective	Proprietorship perspective
Classification theory for claims	Strict liability approach	Narrow equity approach
Operational model for applying this theory	Current definition of a liability per the Conceptual Framework	Basic ownership approach

Given the criticisms of both the entity perspective and the proprietorship perspective and the approaches flowing from them, as noted in Sections 2.3.2 and in this section, a further possible model is one that incorporates aspects of both perspectives, which is considered in Section 2.3.4.

2.3.4 The ownership-settlement approach

The ownership-settlement approach, like the basic ownership approach, defines equity first and uses liabilities as the class of instruments that absorbs all non-equity items. It defines equity more broadly than this approach, however. Equity includes the basic ownership instrument (discussed in 2.3.3), and all instruments for which no settlement terms are present (such as perpetual instruments). Equity also includes all instruments which will, on settlement, represent the basic ownership instrument (for example, employee share options) (FASB, 2007). This is based on the intuition in accounting practice that if an instrument is to be equity in the future, it should be classified as equity presently (FASB, 2007). Instruments to be settled in the basic ownership instrument will, however, only be classified as equity if the returns of the instrument are indexed to the returns of the basic ownership instrument (IASB, 2008). This means that instruments to be settled in a variable number of ordinary shares will be classified as a liability, despite settlement occurring in equity (FASB, 2007).

Support for this model comes from the fact that it incorporates both ownership and solvency features into the classification of equity and liabilities. In order for a claim to be equity, it must not include an obligation to deliver cash or other assets, consistent with a solvency view (Botosan et al, 2005; IASB, 2003a). In addition, it must confer some residual risk to the holder of the instrument. As a result, situations where a variable number of shares will be issued to settle an obligation are not deemed to be equity. The holder does not bear any variability in returns from the instrument and is, therefore, not in the position of an owner of the entity (Botosan et al, 2005; IASB, 2003a). This approach, accordingly, represents a compromise between a purely entity-based perspective and a purely proprietary-based perspective (IASB, 2013; FASB, 2007).

The ownership-settlement approach can be viewed as being consistent with the current requirements of International Accounting Standard [IAS] 32, *Financial Instruments: Presentation* (IASB, 2008a; IASB, 2003a). The approach taken under the two models is different: IAS 32 defines a financial liability first, whereas the ownership-settlement approach defines equity first. Nevertheless, the results of each model will be the same

(IASB, 2008a)[13]. Despite criticisms of the IAS 32 model for distinguishing between equity and liabilities, there is a general perception that the requirements of this model are operational and provide a useful basis for classifying claims (SAICA, 2008). IAS 32 is, however, inconsistent with the Conceptual Framework (as IAS 32 accommodates some share-settled claims as liabilities, whereas the Conceptual Framework does not). The ownership-settlement approach is a competing model to both the strict liability approach and the narrow equity approach for distinguishing between equity and liabilities (IASB, 2013 read with IASB, 2008a).

A criticism of the ownership-settlement approach is that it relies on the definition of a 'basic ownership instrument' and is weakened by the same difficulties in identifying this instrument as were noted in Section 2.3.3 (PWC, 2008). Furthermore, due to the solvency perspective of this approach, the difficulties associated with determining whether or not an obligation is present, discussed in Section 2.3.2, are also seen in this model (IASB, 2008a). Finally, in attempting to strike a compromise between the entity and proprietorship perspectives, the ownership-settlement approach may fail to address adequately either perspective and may produce information of limited usefulness (Botosan et al, 2005).

Overall, each of the three models described brings with it perceived advantages but is also subject to criticism. Table 2 summarises the main features of each model:

[13] There are two primary differences between the ownership-settlement approach proposed by the IASB and the approach taken in IAS 32. Firstly, the ownership-settlement approach will require greater separation of claims into their equity and liability features. Secondly, under the ownership-settlement approach 'only those instruments *whose fair values change in the same direction as (not in the opposite direction to) the fair value of the basic ownership instrument* and are ultimately settled with a basic ownership instrument' would be classified as equity, whereas under IAS 32 the direction of movement in fair values is not relevant (IASB, 2008a, para. 47, emphasis added). The two approaches achieve the same classification outcome in most situations, including for written call options such as employee share options (IASB, 2008a; FASB, 2007). Accordingly, for the purposes of this study the two approaches are regarded as equivalent.

Table 2: Summary of contrasting models of equity and liabilities			
	Strict liability approach	**Narrow equity approach**	**Ownership-settlement approach**
Theoretical underpinning	Insolvency risk perspective and entity perspective	Common equity valuation perspective and proprietorship perspective	Mixture of solvency and valuation perspectives (hybrid)
Liability definition	A present obligation of the entity to transfer an economic resource as a result of past events	All claims on assets other than equity/the basic ownership instrument.[14]	A present obligation to deliver economic resources or to deliver equity instruments, where this obligation's fair value is not linked to, and does not vary with, changes in the fair value of the basic ownership instrument.
Equity definition	The residual interest in the assets of an entity after deducting all its liabilities	The single instrument which entitles the holder to a percentage of assets which remain after all higher priority claims have been satisfied and which ranks lowest on liquidation.[15]	An instrument that either: • Contains no obligation for settlement before liquidation, or • Experiences fair value changes that are linked to and vary in the same direction as the basic ownership instrument and which will be settled by issuing the basic ownership instrument.
Advantages	• Decision-useful information provided. • Definitions are well understood by investors	• Simplification of definitions. • Limited opportunities for structuring. • Increased information	• Incorporates ownership and solvency perspectives. • Currently applied successfully.

[14] The FASB (2007) defines a liability under the basic ownership instrument approach as 'a claim, the probability-weighted outcome of which would reduce the assets available for distribution to basic ownership instruments' (para. D11). The definition provided in the table is, it is submitted, simpler and reflects the spirit of the narrow equity approach in that the liability category incorporates all non-equity claims (IASB, 2013).
[15] Refer to Section 2.3.3 for the full proposed definition of the basic ownership instrument under the narrow equity approach.

		for present shareholders.	
Disadvantages	• Ambiguous or misleading information for current shareholders. • Obligation may be difficult to identify. • Emphasis on settlement enables structuring of transactions. • Varying interpretations of 'economic resource'.	• Reduced information for other users. • Simplicity inappropriate when claims are complex. • Criteria difficult to apply. • Classification of perpetual instruments inconsistent with economic reality.	• Basic ownership instrument criteria difficult to apply. • Obligation may be difficult to identify. • Fails to meet either information objective specifically.

Despite apparent shortcomings, these models represent three perspectives on financial reporting (the entity perspective, the proprietorship perspective, and a compromise between the two) which could be used as a consistent conceptual basis for distinguishing equity from liabilities, and which would have consequences for the accounting treatment in IFRS 2. Accordingly, they form the theoretical bases to be evaluated in this study.

3 RESEARCH METHOD

3.1 Research methodology

Although there have been numerous publications on the distinction between equity and liabilities it remains an area of accounting which is insufficiently understood (Barth et al, 2013; Botosan et al, 2005). Accordingly, a qualitative research methodology was used to help develop such an understanding, and to highlight the complexities surrounding the topic (as explained by Cooper and Morgan, 2008, in O'Dwyer et al, 2011). This methodology also offered the possibility of deeper insights into the issue than would have been possible in a quantitative study (O'Dwyer et al, 2011; Holland, 1998). It did so by developing explanations of the data gathered in the light of the theoretical framework present, a process known as abduction (Lukka and Modell, 2010). A qualitative approach, which avoids the use of statistical techniques and mathematical formulae, was applied. The intention was to produce results which are accessible not only to future researchers but also to practitioners in accounting (Parker et al, 2011). As such, this research is best described as interpretive.

This research was conducted with the aim of obtaining more than mere description of accounting practices, and of attempting to contribute to their enhancement. This is a feature of interpretive research described in, amongst others, Parker et al (2011), Coetsee (2011) and Leedy and Ormrod (2010). In doing so, it sought to present a challenge to current practice and provide suggestions of how to improve such practice (Parker, 2008). This normative aim sought to address the potential for meaningful change in accounting principles in the context of the highly dynamic social setting in which these principles are applied. It thus speaks to an inherent shortcoming of positivist studies which may ignore the ever-changing nature of accounting in order to present scientifically rigorous research (see Leedy and Ormrod, 2010; Creswell, 2009).

3.2 Research design

The study was designed to develop an understanding of the distinction between equity and liabilities, using the case of employee share options as a case study. It accordingly represents an exploratory case study (Ryan et al, 2002) designed to investigate the reasoning behind the concepts of equity and liabilities. It rests on the premise that understanding how to account for one type of instrument and identifying the reasons for this accounting will lead to insights into the accounting for other types of instruments (as argued in Ohlson and Penman, 2005). The conclusions reached in this study can then be used as a basis for further research (Parker, 2008; Ryan et al, 2002; see also Section 5.3).

This research was performed using semi-structured interviews. This technique enabled interviewees to talk about what they felt was relevant to the topic, allowing for a deeper and more comprehensive account of the individual's insights (Alvesson, 2003; Holland, 1998). This also ensured that participants were able to interpret and describe the matter under discussion in a manner with which they were comfortable (Holland, 2005). A pilot study was undertaken with one of the interviewees before the full study began. This ensured that the interview contained questions that were sufficiently clear and that appropriately addressed the research question (Rowley, 2012; O'Dwyer et al, 2011). The data from this pilot study were not used in compiling the findings of this report; instead, they were solely used to improve the interview agenda and to increase the validity of the research (see Section 3.7).

Questionnaires were considered as a research instrument but were ultimately not used for a number of reasons. Questionnaires generally generate weak response rates, meaning insufficient data is obtained. The nature of questionnaires means that detailed information about the responses provided cannot be obtained (Rowley, 2012). Although questionnaires enable a larger sample of respondents to be accessed, this is not a relevant consideration for this study. As noted in Section 3.3, this study aims to use a limited sample of purposefully selected individuals to provide a detailed account of the competing models in the equity-liability debate (Rowley, 2012).

Interviews varied in length from 45 minutes to 120 minutes, with the majority of interviews lasting between 60 and 90 minutes. The length of these interviews was appropriate in that it led to sufficient data being obtained to generate worthwhile findings (Rowley, 2012; O'Dwyer et al, 2011). The lengthy interviews also ensured sufficient theoretical saturation in the concepts being investigated (Smith-Lacroix et al, 2012; O'Dwyer et al, 2011).

The interview agenda has been derived from the theoretical framework discussed in Chapter 2. As the literature focuses on the economic features of instruments in determining classification criteria, a number of questions in the interview agenda focused on the features of share options. Due to the importance of the entity and proprietorship perspectives in the literature, questions surrounding the impact of options on the company and the shareholders were asked. Once this basis was established, questions focused more directly on the entity and proprietorship perspectives. Questions about the impact of the statements made by the interviewee on the definitions in the Conceptual Framework served to incorporate the strict liability approach into the interview. Depending on the respondents' viewpoints on the questions, further questions were asked in line with the theories discussed. For example, respondents who had strong views either for or against the proprietorship view were asked about the narrow equity approach (adapted from O'Dwyer et al, 2011).

3.3 Selection of interviewees

The sample of interviewees was selected using purposive sampling (Silverman, 2010, in Rowley, 2012). In total, eleven interviews were conducted. The interviewees can be categorised as follows: two academics in the Financial Accounting Department at a leading South African university, four staff members of technical divisions of two Big Four accounting firms, three accounting professionals currently working in the standard-setting and regulatory oversight of reporting arena, one preparer of financial statements working in the Finance Department of a listed South African company, and one accounting professional working as an advisor on corporate finance and accounting matters at a Big Four accounting firm. Although purposive sampling created a risk that bias may be

introduced into the study, it ensured that participants chosen were able to provide the insights needed to respond to the research question, owing to their knowledge and experience (Rowley, 2012).

A small sample size is a core feature of qualitative research (Ryan et al, 2002). Qualitative research seeks to explore a problem in depth and offer an understanding of its complexity, rather than to attempt to generalise a result that can be used to generate future predictions (Maroun, 2012; Leedy and Ormrod, 2010; Ryan et al, 2002). Interviews took place in Johannesburg between 5 November and 3 December 2012.

3.4 Data collection

The intended interviewees were contacted by e-mail or telephone and their involvement in the study was requested. In this communication, the nature and purpose of the study were explained and it was also highlighted that the 'equity' and 'liability' definitions, as well as IFRS 2, were to be under scrutiny. In the communication it was emphasised that the interview would be conducted and reported on an anonymous basis. The interview agenda was made available to participants at their request to ensure that they were informed and were in a position to give sufficient detail in their responses (adapted from O'Dwyer et al, 2011).

Before commencement of the interview, permission to record the interview on a Philips 'Voice Tracer' MP3 Dictaphone was requested. It was explained to the interviewees that the purpose of the recording was to ensure the accuracy of the interview and to enable the interviewer to explore issues arising more fully without being constrained by having to take detailed notes (Rowley, 2012; O'Dwyer et al, 2011). Recording of the interviews also facilitated more detailed reviews and allowed tone and non-verbal cues to be studied in more detail after the interview (O'Dwyer et al, 2011). Interviewees were given the opportunity to request that the interviewer stop recording at any stage, and were also informed that the recording, and any transcripts based on the recordings, will be kept confidential (O'Dwyer et al, 2011). Furthermore, interviewees were informed that they could obtain a transcript of the interview on request (Rowley, 2012; O'Dwyer et al, 2011)

and could make any changes to the transcript they felt necessary (Smith-Lacroix et al, 2012). Shortly after each interview, the recording was listened to and reflections and issues for probing in subsequent interviews were noted in a separate journal (O'Dwyer et al, 2011). After the interview, the contents of the interview were transcribed and kept secure to ensure confidentiality (Rowley, 2012).

The initial phase of each interview was used to establish a rapport with the interviewee, by discussing the background of the interviewee as well as why the interview was being conducted (O'Dwyer et al, 2011; Leedy and Ormrod, 2010). The fact that the interviewees were to remain anonymous was reiterated, so as to encourage detailed and complete responses (Smith-Lacroix et al, 2012). The themes included in the interview agenda were then used to guide the interview, in a manner that enabled the interviewer to pursue emerging themes in the various interviews (O'Dwyer et al, 2011). The sequence in which the issues were discussed differed in each interview, but the same themes were addressed in each one (Patton, 2002, in O'Dwyer et al, 2011).

3.5 Data analysis and interpretation

Data analysis and interpretation was inspired by a grounded theory approach, involving an iterative process (Rowley, 2012) with the researcher alternating between analysing the interview data and reading further literature related to themes arising in the interview (Rowley, 2012.; Leedy and Ormrod, 2010; Holland, 1998). Investigation primarily sought to establish the degree to which data corroborated or refuted well-established theories. If numerous data points supported a theory which was less developed, however, it was explored further. This exploration enabled the researcher to identify the validity of the information obtained and to avoid using models which failed to explain adequately the findings of the study (Lukka and Modell, 2010). This was done in order to avoid reductionist tendencies which would serve to hide the complexity inherent in the problem being studied (Leedy and Ormrod, 2010; Gergsen and Gergsen, 2000, in Lukka and Modell, 2010).

The transcribed interviews were analysed using a formal process of data reduction, data display, and conclusion drawing and verification (O'Dwyer et al, 2011). A detailed reading of all transcripts and notes resulted in identification of key themes that were most frequently raised by interviewees (Smith-Lacroix et al, 2012). These themes were then incorporated into a series of theme summary diagrams which identified the key themes, the respondents who addressed these themes, and the location of these themes in the transcripts (O'Dwyer et al, 2011). This assisted in structuring the key findings and formed the basis of Chapter 4 of this research report. Further readings of the transcripts took place until conceptual saturation and familiarity with the content was obtained (Smith-Lacroix et al, 2012; O'Dwyer et al, 2011). The identification of themes took place in conjunction with re-reading of the key literature, in order to place these themes in an appropriate context (O'Dwyer et al, 2011). Each theme was coded to assist in the above analysis (Rowley, 2012; Leedy and Ormrod, 2010). Specific attention was paid to apparent contradictions or disagreements among different interviewees and within specific interviews, so as to obtain a full picture of the data collected. This is consistent with the tradition of qualitative research that requires continuous challenging of interpretations (Alvesson, 2003). It also assisted in ensuring the validity of the findings of the study (refer to Section 3.7 below). Contradictions identified were evaluated to identify whether there was a need to conduct shorter follow-up interviews with some of the interviewees, conducted over telephone or via e-mail (Leedy and Ormrod, 2010). The above process was followed so as to present the findings of the study in a meaningful way that highlighted the insights gained and the themes developed (Rowley, 2012).

3.6 Limitations of the study

It is important to note that the findings of this study are not easily generalised. The data obtained from the interviews is not intended to be representative of the population studied, but have instead been used to explore the research question in more depth and to provide a basis for further research into the topic (Leedy and Ormrod, 2010; Holland, 2005; Holland, 1998). The inevitability of this limitation in interpretive research can be summed up as follows:

> ‘Any attempt at abstracting [the findings of a study] as a vehicle of expanding scientific knowledge is arguably doomed to fail due to the very partial nature of researchers’ understanding of individuals’ life-worlds and the nearly infinite variations in their interpretations.’ (Lukka and Modell, 2010, p. 464)

A further limitation of this study is that interviews as a research instrument bring with them the unavoidable risk that interviewees will provide rehearsed responses or give commentary that is modified due to social pressures, such as the need to remain consistent with the views of their employer organisation (Alvesson, 2003)[16].

3.7 Validity and reliability

This study maintained procedural reliability: a comprehensive research design was followed and all data from interviews and interpretations of this data were fully documented (Ryan et al, 2002). Refer to section 3.5 for a description of the documentation process followed in analysing the interview data.

Validity has a different level of importance in qualitative research from that in quantitative research, with some arguing that the concept is actually irrelevant in qualitative research (Leedy and Ormrod, 2010). This is arguably too extreme a position, as validation of some kind is typically integral for the results of research to be viewed as legitimate by its intended audience (Lukka and Modell, 2010). It is nevertheless the case that the concepts of internal, external and construct validity, central in a positivist study, are not meaningful in qualitative research (Lukka and Modell, 2010). Instead what is important is contextual validity, being the credibility of the case study evidence and the conclusions reached on the basis of this evidence (Holland, 2005; Ryan et al, 2002). Contextual validity is achieved through the researcher being mindful of its importance throughout the study:

[16] The fact that the findings cited in Chapter 4 were often critical of the particular model enquired about indicates that this is not a material threat to the study.

> '[In interpretive qualitative research validation must be viewed] as a process, not easily separated from the ongoing efforts of researchers to develop explanations as research projects unfold and far from reducible to mere technicalities of following pre-specified criteria presumably minimising various biases.' (Lukka and Modell, 2010, p. 462)

This study incorporated contextual validity into its method through a number of techniques. The first was negative case analysis, whereby the data was actively and continuously interrogated for information that contradicted existing hypotheses (Rowley, 2012; Leedy and Ormrod, 2010; Alvesson, 2003). This is integral to interpretive research, as the nature of the abductive method utilised in this research requires the researcher constantly to remain aware of alternative explanations. It also requires the elimination from consideration less plausible explanations as the researcher investigates the theoretical framework and the data collected (Ackroyd, 2004, in Lukka and Modell, 2010). This is demonstrated in the Findings section (Chapter 4) where arguments both in favour of and in opposition to the various models have been evaluated in order to arrive at the most plausible explanations, based on the data collected[17]. This negative case analysis also serves to promote the authenticity of the study as it indicates the multi-faceted nature of the problem being researched and provides the reader with the opportunity to draw his or her own conclusions (Lukka and Modell, 2010)[18].

The second was the collection of sufficient data in interviews of appropriate length to generate 'thick' descriptions of the issues, once again enabling readers to construct their own interpretations and so contributing to the authenticity of the study (Leedy and Ormrod, 2010). This also ensured that sufficient evidence was collected on each issue to mean that the data was triangulated[19] (Leedy and Ormrod, 2010; Ryan et al, 2002). This can be seen from the fact that sufficient information was obtained from the interviews conducted to explore the various models proposed and to provide multiple corroborations of each viewpoint. These 'thick' descriptions are used as the basis for explanations and

[17] As noted in Lukka and Modell (2010) validity in interpretive research can be viewed as consisting of the authenticity of the findings documented as well as the plausibility of the explanations provided. These notions can be seen to correspond with the credibility of the case study evidence (authenticity) and conclusions (plausibility) described in Holland (2005).
[18] Note that the quest for consensus is largely the domain of positivist research (Creswell, 2009).
[19] The term is not intended to imply a positivist technique.

interpretations of the data, which are therefore sufficiently detailed to contribute to the field of study (Lukka and Modell, 2010).

The third was the consideration of multiple theories or potential truths which can be used in the equity-liability debate (Koro-Ljungberg, 2004, in Lukka and Modell, 2010). This enabled greater reflexivity and a deeper investigation into the holistic nature of this question (Alvesson, Hardy and Harley, 2008, in Lukka and Modell, 2010). This is evident in the discussion of four different models of defining the elements of financial statements in Chapter 4.

The fourth means of ensuring validity in the study was incorporated into the interviews themselves. This was firstly attained by ensuring that only suitably experienced and knowledgeable interviewees were selected as the sample (Rowley, 2012; also see Section 3.3). Secondly, the interview agenda was derived following an extensive review of the literature and is based on the theories in this literature. It was also reworked, based on the results of the pilot interview to ensure it would elicit appropriate responses which could be used to answer the research question (see Section 3.2). Thirdly, open-ended questions were asked, to reduce the risk of rehearsed responses (Alvesson, 2003; also see Section 3.2). Finally, each interview commenced with an explanation of the purpose of the interview and an emphasis on the point that the results of the interviews were to be used for academic purposes only (Vaivio, 2006, in Lukka and Modell, 2010; also see Section 3.5).

Finally, the highest research ethics were followed. With the aim of obtaining complete and honest responses, the researcher informed interviewees that all responses would remain anonymous (see Section 3.4). Any quoted answers which could indicate the identity of respondents were either paraphrased or amended, with changes clearly indicated. Participants were also interviewed in comfortable environments where they were able to stop the interview at any time should they wish (Creswell, 2009). Owing to the potential sensitivities associated with interviews, the required ethics clearance was obtained from the University of the Witwatersrand. No material threats to research ethics were noted during the study.

4 FINDINGS

This chapter contains an analysis of the interviews conducted. This analysis highlights the support for and criticisms of the models identified in the literature review. Firstly, in Section 4.1, it identifies respondents' views on the similarities and differences between cash-settled and equity-settled share options, as well as between equity-settled options and ordinary shares. Based on interviewees' perceptions of the relative importance of the different features of these instruments, the contrasting models identified in Section 2.3 were either supported or opposed.

Section 4.2 discusses the strict liability approach which reflects the current and proposed Conceptual Framework definition. Section 4.3 deals with respondents' views on the narrow equity approach and the concept of a basic ownership instrument. Section 4.4 addresses the ownership-settlement approach. Each model had advocates and critics, and these findings explore the merits of the arguments raised. Finally, from the interviews – and in particular the enquiries surrounding perceived inconsistencies in the Conceptual Framework – a fourth model emerges in Section 4.5. This model emphasises the importance of an obligation being present for a liability to be recognised, but does not refer to the manner of settlement.

4.1 The economic features of options and ordinary shares

Respondents identified the importance of comparability in accounting. It was argued to be '[one] of the biggest qualitative characteristics… an overriding factor' in determining the accounting treatment of share options (R3). This concept was often relied upon to justify a particular view on the appropriate accounting treatment for share options:

> 'For example, why are we so big on saying if you borrow money from a bank you can have interest on it, [and] when we defer payment of something we are going to account for interest on that as well? So it is not going to be real interest, but we are going to account for interest, [the same amount of interest in both cases if the terms are consistent]. But the same amount

> of interest. We have done it completely legally different, yet we are accounting for it in exactly the same way.'[20] (R4)

Although there was agreement with the view that economically similar transactions should be accounted for in similar ways (Ohlson and Penman, 2005), there was disagreement as to whether or not options with different settlement outcomes are, in fact, economically similar transactions. Using the theory in Section 2.3.1, it can be said that there were conflicting views as to whether the similarities of cash-settled and equity-settled options outweighed the differences in the provision of decision-useful information.

Some respondents emphasised the similarities between the two awards from the perspective of the company. Irrespective of the manner in which the option is to be settled, the company issuing these options receives the same service from the employee, as the employee has the same incentive to improve the quality of his or her work (R2, R8). Furthermore, in both instances the company, by granting share options to its employees, has created an obligation which it must fulfil. The actions of the employee, and not the company, determine whether or not the obligation will be settled (R6, R4). It was also identified that, in each case, the company can be viewed as having granted the employee the same award, because employees receiving shares upon settlement can easily dispose of the shares should they wish (R1, R2, R4, R10). In addition, employees receiving cash can use this cash to purchase the equivalent number of shares as they would have received under a gross-settled award (R1). Employees of different levels of seniority in a company may behave differently, and may cash out their share options at different times. Nevertheless, the settlement outcome itself is largely irrelevant from the perspective of the employee. While the holder's actions may differ, the *potential* outcomes are the same, irrespective of whether the company settles in cash or in its own equity (R6). Despite an outflow of resources from the company only occurring in the case of cash-settled awards, it was argued that this was not relevant as the shareholders of

[20] The respondent is referring to two concepts in IFRS: firstly, loans payable are measured at amortised cost, whereby interest expense is accrued each reporting period (IASB, 2003b). Secondly, when an entity purchases an item on extended credit terms, IFRS requires the purchase to be measured at fair value, and interest is accrued each reporting period on the same basis as if funds had been borrowed to purchase the item (IASB, 2003c). Thus, despite the different structuring of the transactions, the accounting is very similar, in line with the qualitative characteristic of comparability.

the entity experience some diminution of their interests in each case (R4, R6, R8). In a cash-settled situation, the impact is indirect, while in the case of equity-settled awards, the impact on the shareholders is direct (R6, R7, R8). Only by looking at the shareholder's perspective can it be seen that a cost arises in each case:

> 'All dilutive. And that's a whole different debate; it's about whether the accounting is right at all. Because that's the real cost [of equity-settled options], [the existing shareholders] all get diluted. The accounting is all pretend, it's all notional. The real cost is the cost to the shareholders; they're the ones who get diluted. So we put through accounting entries to reflect the cost to the company, but if you really cut through it, it's a cost to the shareholders, the existing shareholder body, not to the company. Because you're giving away shares for free or at a bargain price, the people who are suffering are the rest of the shareholders, not the company, because the cake's being divided into smaller pieces.' (R10)

Some felt strongly that these similarities outweighed any differences between the awards and, therefore, they should be accounted for in the same way:

> 'But they say look at the economic phenomena. Whether you give shares or whether you give cash, the differences are so minimal – well, should I rather say the similarities are greater than the differences or should I say the similarities are just more clear – if you just talk about them like we are talking now, you will see that any reasonable thinking individual would say they are the same thing. Hence if they seem like the same thing to an average person, we should produce financial statements that a reasonable person can read. So I would account for [equity-settled options] as a liability.' (R4)

These arguments link directly to a narrow equity approach or an obligation-focused approach to defining equity and liabilities discussed in more detail in Sections 4.3 and 4.5 respectively. The points above are consistent with the academic literature discussed in Sections 2.1 and 2.3.3, which placed emphasis on the dilutive impact of equity-settled awards on existing shareholders and also noted the degree to which cash and shares can be interchanged by a holder of listed shares.

In contrast to the above, and in contrast to a majority of the literature in this area, some interviewees emphasised the differences between cash-settled and equity-settled awards. The similarities identified above were acknowledged, but were disregarded when identifying features of these awards that were relevant for accounting purposes.

The most important feature was identified by these respondents as being the outcome of the award: whether or not the options would be settled in shares or cash (R8, R9). Rather than introducing arbitrariness into the classification of share options, the focus on settlement was viewed as being appropriate because this represents a relevant viewpoint for users of financial statements (R1, R9, R10). While cash-settled awards could represent a significant cost to the reporting entity (R4, R9) equity-settled options represent little real cost to the company (R10) upon which financial reporting focuses. Despite the similarities noted, some felt that the differences took priority:

> 'For gross settled, you're writing out a piece of paper, you're issuing new shares. It's a transaction with minimal cost. Whereas with cash-settled, it's an additional cash disbursement to your employees, an additional salary you'll be paying. On resources alone, it's a very different commitment. I agree that they're both obligations, but in terms of what the company's doing, they're very different. Issuing shares bears a negligible cost; it's a zero cost to the company…' (R1)

On the basis of the above, these respondents argued in favour of the current classification of employee share options as either a liability or as equity based on the manner of settlement. This viewpoint was consistent with support for the strict liability approach discussed in Section 2.3.2.

There were disagreements about whether or not equity-settled share options could be regarded as comparable with ordinary shares and other interests that impose no obligation on the entity. This factor is an important consideration in the light of the assertion by Kirschenheiter et al (2004) that ordinary shares and share options are sufficiently different to reduce the usefulness of financial statements that aggregate these claims in equity. A key difference highlighted by respondents was the impact of holding instruments on the holder. Specifically, an option-holder is likely to have a more limited period of interest in the company as an option-holder's financial interest in the company is limited to the vesting period of the options. In contrast, shareholders may have a longer term view (R4, R6, R7). It was also noted that, while options purportedly create an alignment of interests between employees and shareholders, this alignment breaks down when share prices are depressed (R6). In these circumstances the holders

of worthless options may lose their motivation to work harder for the company (R6, R7, R9). For these reasons, supporters of consistent classification for all options argued that options and shares cannot be regarded as similar from an accounting perspective (R6), a view which leads to the narrow equity approach.

In response to this, the similarities between ordinary shares and share-settled options were emphasised by some interviewees. Despite the difference in viewpoints that may arise between an option-holder and shareholders, it was nevertheless noted that the interests of these parties would be broadly similar (R1). The primary argument in favour of the similarities between the claims of option and current shareholder however, was that share-settled options will ultimately be settled in equity and are, therefore, equity in the present (R1, R3, R6, R8, R10). This view is consistent with the strict liability approach, because it holds that the manner in which an instrument will be settled is key to determining the nature of that instrument. Focusing on the outcomes of an instrument for classification purposes was identified as more intuitively appealing than the alternative:

> 'I don't think [share-settled options] are a liability. I think the holders of these awards might not necessarily have the downside risk of an equity shareholder, [but] they do have similar interests… and they have the right to acquire a share and if that ultimately ends in equity I think that would be strange to call it a liability along the way if it is something you know will always end up in equity.' (R9)

The concept that equity settlement demands equity classification was a key element of arguments in favour of the strict liability approach. Section 4.2 addresses the further arguments for and against this model as presented by the interviewees.

4.2 The strict liability approach

The strict liability approach had most support from respondents. Some respondents argued in favour of this approach at a conceptual level. Others argued primarily on the basis that, irrespective of its theoretical merits, the strict liability approach provides the most decision-useful information for users. The focus on the 'liability' definition required

by this approach was justified by the fact that a wider variety of financial instruments encountered in regular business practice are liabilities. Using liabilities as the starting point means that a larger proportion of claims is specifically defined rather than being classified by default (R2). At a conceptual level, respondents emphasised the importance of the settlement outcome of a claim. Specifically, only obligations resulting in an outflow of cash or other assets should be classified as liabilities (R4). This was seen as being an intuitive and logical means of identifying liabilities and a driver of the classification system in IFRS 2:

> 'I don't know if anyone really thought about classification other than saying, if I'm going to make a payment in the future then that must lead to a liability and an expense. If I'm going to issue shares in the future that leads to an increase in share capital or equity and an increase in cash that's coming back the other way; thus they would seem to be fundamentally different types of transactions that get completely different types of accounting.' (R6)

In response to the view that all options are economically similar, proponents of this approach argued that the settlement outcome was the critical determinant of the economic reality of the instrument (R3, R5, R6). Different classification was the only way to reflect this reality (R2). In fact, it was contended that referring to share-settled obligations and cash-settled obligations as similar is misleading – the *nature of the obligation itself* is determined by the manner of settlement:

> 'The thing is you have an obligation but is that obligation to provide an outflow of cash resources? No, it is not. So to me it is still equity in nature. It just feels strange because you do have an obligation, but the thing is that the way you settle that obligation is not through cash or assets.' (R5)

> '…conceptually and overall there is an obligation but I think it comes back to, do you classify such an obligation as a liability or do you classify it potentially as equity, given the different rights and the nature and all of those things. So I think that is the dilemma [the standard-setters] have because it is on your own shares which are generally equity. So I fully agree with you there certainly is an obligation but it goes back to what should be the correct classification' (R8)

Support for this outcomes-based view is also evident in Section 4.1 where it was argued that if an instrument is to be equity in the future, it should be classified as equity in the

present. Respondents' views were also fully consistent with the prior literature advocating the use of the strict liability approach in Section 2.3.2. There were no significant variations in opinions based on the type of interviewee providing the response.

Criticisms of the conceptual justification for the strict liability approach came from those who, in line with Hirst et al (2005), argued that this enabled structuring to occur and allowed companies to make arbitrary decisions which affected the financial statements (R2, R5). Supporters of the approach countered this. It was emphasised that the settlement outcome truly determines the economic substance of an arrangement and describing this as structuring is inappropriate (R9). Even those who did concede that structuring possibilities were present still maintained that the strict liability approach was preferable. This was defended on the grounds that structuring and manipulation in corporate reporting was to some degree unavoidable. To a certain extent 'everything in accounting does not really show the economic realities' (R3) but it is necessary to adopt a pragmatic view which provides the best possible accounting treatment (R9). Appealing to structuring to criticise the strict liability approach rests on the assumption that accounting is neutral and simply acts as a veil to report economic transactions and events. This was met with scepticism, as it was argued that preparers of financial statements will inherently and inevitably seek to structure transactions to achieve a favourable reporting outcome:

> 'If you don't have any accounting rules, then no-one structures the incentive scheme in order to take advantage of the rules or to get around them; instead you offer a scheme that you think is right for the business as a whole.' (R6)

> '[The potential for structuring is] not unique to IFRS 2. I can take you to any standard and show you how to structure a transaction to achieve a desired result. IAS 39 almost invites you to do it, and IFRS 7. There's so many invitations for you to change the way you word things or do things and I'll get a different result, and a materially different result. So it's not unique to [the classification of equity and liabilities]' (R10)

It was argued that the potential for structuring should be limited, where possible, by accounting principles, but this should not be a goal to the exclusion of other accounting

objectives such as the provision of decision-useful information (R10). This serves as a rebuttal of the literature discussed in Section 2.1 which argues for a change in classification principles, primarily in order to curtail structuring opportunities. The view is, however, consistent with a key theme in the strict liability literature: that the approach provides more relevant information to the users of financial statements (the fact that pragmatism was also taken into account by interviewees did not alter this position).

Despite the conceptual arguments for the strict liability approach outlined above, support for this model primarily came from the belief that it resulted in the most useful financial statements possible (R9, R10). This echoes the argument presented in Section 2.3.2 that the justification for this approach comes directly from the aim of decision-usefulness (Bagna et al, 2010). Firstly, respondents regarded financial statements where liabilities are present obligations to deliver cash or other assets as the most understandable to users. Focusing on equity to define claims would not provide the same level of coherence and clarity:

> 'What's left for me, after my real measurables of assets and liabilities, which everybody understands, whereas equity is not understandable by your regular users. Not economists, not highly sophisticated accountants [who have] just qualified with everything [fresh in their minds]. If you ask them what equity is they won't understand, but if you ask them assets and liabilities, they will know. Your average businessman, investor, user will know exactly what assets and liabilities are, but if you ask them about equity they won't. Now you want to introduce a new concept to them, you want to change what they really do into what you'd like them to think about. It's nonsense. It's the wrong approach.' (R10)

This mirrors the argument presented by the IASB (2013) that assets and liabilities reflect economic phenomena that are accessible and relevant to users. A significant benefit of the model was identified as being the fact that a broader range of users could identify the principles behind this model:

> 'I know when I train these non-finance directors, one of the first things we talk about is what is the definition of an 'asset', and what is the definition of a 'liability' and they automatically always think about the outflow of resources as cash...' (R7)

This suggests that the general understanding of a liability is one in which the obligation and the settlement of that obligation are indistinguishable (R8). Importantly, many respondents highlighted how this perspective has become entrenched in accounting and business parlance and practice.

In this context, a number of the interviewees expressed concerns about changing fundamental accounting principles, such as definitions in the Conceptual Framework. The reason: this would have significant consequences for the whole of accounting, with it being unclear, at the outset, whether the benefits of this change would outweigh the cost (R2, R11). Essentially, respondents argued that one of the reasons the strict liability approach results in decision-useful information is that it reflects how users interpret financial statements. This was, in turn, partially attributable to the fact that this model has **always** been used to prepare said financial statements (R10). The first consequence of this is that sophisticated users are able to obtain information that is relevant to them because of their familiarity with the existing principles underlying the financial statements:

> 'So I would say in terms of the users of the financial statements, I think as long as they understand what is in [liabilities] and what is in [equity] it is just as useful… ultimately [it is] just claims. So as long as the users understand what is in [each category], I don't think it should have a material impact on how they interpret the business.' (R3)

The second consequence of the entrenchment of the current model (and the familiarity of users with this model) is that *change to the model would result in a loss of decision-useful information* (R11). An analogy was drawn to the current revenue project of the IASB, which proposes revenue recognition in accordance with an asset-based control model. This contrasts with the current risks and rewards model applied both in accounting and in contract law to draw up contracts of sale. The proposed changes could cause significant difficulties in tying the accounting to commercial practice (R11). Moving away from the strict liability approach was resisted on this same basis:

> 'And also the liability, I know we don't like to look at it from a legal perspective, but they do have a prior claim. And that's the whole basis for setting up companies, so you can't really have the accounting going contrary to that.' (R2)

Respondents argued further that any change to the accounting away from this model would require additional disclosures. This would be necessary because users would not be able to rely on their inherent understanding and would need greater information on all claims in the financial statements (R5, R9). Instruments such as share-settled options, it was contended, were recognised by users of financial statements as equity because of the settlement outcome, and any accounting model that suggested otherwise would not be beneficial to users:

> 'Well, then you're going to get an answer which, if you ask a sophisticated businessman or user, and you tell them that a warrant is a liability even though it's being equity-settled, they'll say, well why is it a liability? That's your test. A sophisticated user - how will he understand this? I'm never going to pay it in money, I'm going to issue shares, but you say I must reflect it as a liability? Isn't a liability something that I must pay? Ok, I'm paying it in shares, but you're going to go and create big problems. You're just going to create lots of liabilities that aren't really liabilities in the eyes of the users of financial statements. So they're already stripping out the income statement side, the debit, now they're going to start stripping out the credit side on the balance sheet as well. Don't you want to give them financial statements and say, you can use them as is, more or less? And again, I'm not saying that the existing model is perfect, it's not. We must face up and say, we accept the inconsistencies, we accept that some things are conceptually invalid, but that's ok. We'll live with it. But now you're striving for this sort of thing where it's conceptually the best, maybe, but arguably, let's assume you can formulate a wonderful conceptual argument for it, so what? Is it the most meaningful? No.' (R10)

The support for the strict liability approach is consistent with the argument by the IASB (2013), discussed in Section 2.3.2, that it provides the most relevant information for users. Furthermore, the view that change would have a negative effect on financial statements as a whole ties to the argument presented in Section 2.3.3: users *perceive* certain instruments as being equity irrespective of the theoretical model being applied. Very importantly, the strict liability approach, it is argued, accords with user perceptions.

The entity perspective also obtained support as the theoretical basis of the strict liability approach. Impacts on the existing body of shareholders at a particular point in time were seen as unimportant in a financial reporting context. Instead, the effect of transactions and events on the company itself was paramount (R1, R9). Again, appealing to the

concept of comparability, respondents supported the entity perspective as it enabled comparisons to be made between companies with different capital structures and different shareholder bodies (R3, R4, R5). It was argued that reporting on this basis was more objective and transparent (R5). This was seen, ultimately, as the means of providing decision-useful information to a broader range of users. In particular, potential investors benefited from this perspective; they would possibly be excluded if a focus on current shareholders was the *status quo*:

> 'But I think the purpose is not only for the impact on current shareholders, but do you want to invest in this company? So if you look at it from the impact on the current shareholders, then the potential shareholders have to work out if it impacts the current shareholders this way then this is the way it will impact me. But if you can see how it impacts the company, then you can decide whether to invest in this company based on how these share options actually impacted [the company].' (R4)

This comment suggests that the entity perspective was also perceived as a means of providing useful information as would be expected given respondents' justification of the strict liability approach which emerges from this perspective.

This consistency, however, was not present in discussions on the insolvency risk approach which, as noted in Section 2.3.1, is the theoretical foundation of the models discussed in this section. Broadly, respondents appeared to support this view as they justified liability classification only for asset-settled obligations, by appealing to the risk that the company is exposed to when it incurs such an obligation (R5). It was argued that only these claims should be liabilities as this enables users to assess the credit risk of the company, and to identify whether or not the company is in a solvent state (R1, R10). This falls in line with the view that decision-useful information is information that enables users to assess the solvency of a company (discussed in Section 2.3.1). Despite this, respondents did not identify with the insolvency risk approach in interviews. The concept that a liability is a claim which can force the reporting entity into insolvency was rejected as respondents viewed this as violating the going concern assumption central to accounting (R1, R5, R6, R10). Although a liability was seen as an obligation to surrender assets, this was always viewed in the context of a normal operating entity (R1). It was felt

that evaluating claims on the basis of insolvency was unwarranted when all other events and transactions are not evaluated on this basis (R10). It was also noted, in line with Hopkins et al (2009), that liquidation and insolvency are complex events that do not always follow contractual provisions in place. Furthermore, an entity could face the risk of insolvency, even if it does not appear that this is the case based on the terms of an instrument (R2). On the whole, the insolvency risk approach did not receive significant support, despite respondents *theoretically* advocating a model which was developed from this approach. This possibly suggests that this theory is not an appropriate means of describing decision-usefulness and may need to be revisited. This also reinforces what was noted above – the main support for the strict liability approach came from the perception that information presented in this way is coherent, useful and relevant. The fact that the strict liability approach has been broadly applied for a considerable period of time has allowed it to be generally accepted as a legitimate means for differentiating claims, regardless of whether or not the approach is conceptually sound.

The view that the strict liability approach is the most beneficial was by no means the consensus. Some interviewees rejected the current model and provided support for the narrow equity approach. Section 4.3 discusses the arguments for and against the narrow equity approach.

4.3 The narrow equity approach

Respondents who disagreed with the current accounting model for IFRS 2 viewed the narrow equity approach in a favourable light. This was driven by the notion that the strict liability approach in the Conceptual Framework fails to apply properly the definition of ‘equity’ (R3). In other words, by applying the current ‘liability’ definition, one arrives at claims in equity which do not meet the current definition of ‘equity’ (R2). The narrow equity approach was seen as a way of re-establishing the ‘purity’ of equity, which, historically, was felt to be an important feature of accounting but which had recently fallen away (R7, R10). Respondents felt that equity was treated as a ‘dumping ground’ (R3, R7) where claims that did not fit the confines of a liability were placed and left, as ‘nothing ever happens [in equity]’ (R6). In this context, it was argued that the narrow

equity approach, by defining equity and using it as the starting point for classifying claims, would provide more useful and clearer information to users:

> 'Equity used to be sacrosanct, that's another piece of history you should know. Decades ago, that was the one thing in the balance sheet that was sacrosanct. Equity must be real, share capital, real money per the Companies Act. Now that's gone.' (R10)

> 'I have thought about it a lot because you know when you train people who don't understand the basics, you have to think through it because it must make sense for them. So if I have to explain equity to them I cannot just say to them it is the residual between assets and liabilities [so I use an example:] if the company has assets of 100 and liabilities of 80 who does that 20 belong to? They would say the shareholders and then I would say what does that 20 represent? And they would say it is the money that the shareholders have put into the business but it is also the profits they have accumulated over time. And if you think about equity that is really what equity is. It is the money that you have put into the business and the profits and losses that you have accumulated over time and that is all that it is. So actually the default should not be equity… the default should be if in doubt it must be a liability.' (R7)

This reiterates the argument contained in literature advocating the narrow equity approach discussed in Section 2.3.3. This model reduces the scope for manipulation and obfuscation in financial statements and would provide more useful information to users (Ohlson and Penman, 2005). Another respondent argued in favour of this approach, using almost exactly the same reasoning provided by the FASB (2007) in developing the basic ownership approach:

> 'Well, no, the extreme is that present equity instruments, ordinary shares, at the bottom of the pile, have been issued. So once they've been issued, then I can understand that that's equity. But if it's a promise to issue something in the future, which is conditional on something happening. For example if you pay me money in the future I'll issue you with shares, then I can, well, I don't find it offensive to think that I have a liability. [The only equity that will be recognised] is equity that is presently issued to the current ordinary shareholders.' (R6)

The support for the narrow equity approach was reiterated by the support provided for the proprietorship perspective. Respondents noted that this perspective represented a novel means of looking at the reporting entity and financial statements, which had the

potential to provide useful information to users (R5, R10). It was also identified that current reporting, in attempting to meet the needs of a broader group of providers of capital and finance, perhaps failed to meet the needs of current shareholders who would wish to view the impact of transactions on their interests, rather than on the company as a whole (R1, R10). When explaining that current accounting standards adopt primarily an entity perspective, one interviewee discussed the potential need for a different viewpoint:

> '[The entity perspective] probably is an appropriate way of looking at it but I think you need to actually probably take it a step further [and adopt the proprietorship perspective] because I think the theory has always been, if you look at the company, that sort of reflects what the impact is on the shareholders. But that is if you see the shareholders as one big group [instead of] looking through the body of shareholders as to what the individual impact might be. So specifically when it comes to these types of transactions between shareholders and specifically employee share options you do need to actually look further.' (R7)

The proprietorship perspective was also supported for representing a means of resolving the tensions in IFRS 2 surrounding classification. A change in the way in which accounting is viewed would automatically lead to the consistent treatment of all types of share options (R5). In addition, it was contended that, despite the apparent application of the entity perspective in current accounting, the proprietorship perspective can be seen in various standards (R2). The very fact that equity-settled options are recognised as an expense was argued to be justified by a proprietorship perspective because the true cost of these options is borne by the shareholder, not the company (R10). The fact that the proprietorship perspective is suggested by certain prescribed accounting treatments was seen as an indication that it could be a viable means of providing useful information to users (R6).

Support for this perspective was not widespread. Some argued that, while it could potentially provide useful information, it could only do so as an addition to the existing reporting model, for example, through the disclosure of dilutions in shareholder interests (R10). This potential was not sufficient to warrant a complete overhaul of the current accounting standards (R9). Furthermore, it was noted, in contrast to Ohlson and Penman (2005) where it was proposed that the entity perspective was ambiguous, that, in fact, the proprietorship perspective would be arduous to apply and difficult to interpret. A

reporting model centred on shareholders requires one to understand who those shareholders are (R4). This suggests, as identified in Section 4.2, a tendency to favour the familiar entity perspective as the results of a change are difficult to conceptualise. It also reinforces the criticisms of the basic ownership approach made by, for example, Hopkins et al (2009) where it is suggested that this approach is not operational.

Further criticisms of the narrow equity approach (and the proprietorship perspective underpinning it) were present throughout the interviews, even when interviewees were purportedly supporting the approach:

> 'So I think because of the present [inconsistencies present], particularly in financial instrument liabilities, that the cleanest starting point, not necessarily conceptually the best, but the cleanest starting point, is to define what equity is. And then anything that is not an asset and is not equity must be a liability. And to help people you would need to describe what a liability is… *Now what this is going to result in is some counter-intuitive reporting that people will object to*.' (R6, emphasis added)

This represents a significant blow to the case for the narrow equity approach. As noted in Section 4.2, decision-usefulness is ultimately the key criterion for establishing the merit of an accounting system. The comment above appears to suggest that adopting the narrow equity approach requires one to acknowledge that financial statements will be less useful than they are at present. Consistent with one of the criticisms raised in Section 2.3.3, it appears that the benefits associated with the narrow equity approach would come at the expense, and may even *require* the neglect of, established accounting objectives and principles. This was seen by some respondents as enough to disregard this approach, as conceptual soundness could not justify the production of less relevant, less clear and, ultimately, less useful reporting:

> '[Liabilities are more understandable than equity for] the people who are actually using the financial statements. You want to make it relevant to them. Don't start with something that's back to front. Tell them what they want. Make it for their purposes, not for some economist who can produce a… well considered paper about why equity should be the [primary claim]. Because equally, someone could produce a… well considered paper about why liabilities should be the [primary claim]. But that's half the problem with the standard setting process. You can argue anything and then they take what's a very clever argument, but that's not the

> test. It's not what's the cleverest argument, it's what's the answer that's going to give the most useful, understandable and meaningful information to the users. Forget about who's got the best conceptual argument or who can make the most persuasive argument.'
>
> (R10)

This argument was developed further. As in Section 4.2, where it was noted that changes to the existing Conceptual Framework might bring fewer benefits than expected and ultimately represent a burden to users, it was contended that the narrow equity approach would be:

> 'Worse, worse than not meaningful. It's destructive of meaning. Much worse than not meaningful. Again, we've lost sight of who the financials are prepared for. We just like, forgot. So now we've got all these things in, and how must your reader who's not a recently qualified chartered accountant, how must they know what's going on? And I stress recently qualified, because anyone who's not recently qualified also has very little chance of following this. I don't think it's right, they're going to create bigger problems. We have long established definitions, what possible purpose could there be in changing what is well understood by the market? You're supposed to be reporting to suit what they think, not to try and make them think differently. Try and make the financial statements accessible, and I don't mean to the lower levels, I mean to the sophisticated businessman or investor. They're becoming less accessible, and this would make it another, further step away. I definitely wouldn't do it.'
>
> (R10)

Furthermore, while it was contended in the literature that providing information to current shareholders would meet the needs of all other users (CFA Institute, 2008), this was rejected. It was argued that information of interest to shareholders (such as whether their interests had been diluted) is of no relevance to other users identified in the Conceptual Framework such as lenders and other creditors (R10).

The basic premise of this approach, namely, that equity must be defined first and liabilities must represent all remaining claims, was also criticised as being illogical and, once again, inconsistent with established understanding of what equity means (R8, R9). This represents a rejection of the view that equity can be defined as the first point of reference and still maintain its status as a residual (R3). The concept of a residual was seen as not only an attribute of equity but also a mathematical consequence of the

accounting equation. This necessitates applying the definition of a 'liability' first, which the narrow equity approach does not allow:

> 'My initial feeling is I would rather seek to make sure that liabilities are defined and I would probably seek to have equity as being the balancing figure, rather than trying to define equity. It is almost like trying to define goodwill – you cannot really pin it down – it just happens to be the difference between that and that. So how do you pin down the difference? Personally I don't know if it really makes a lot of sense to try and explicitly define equity such that liability becomes the balancing figure. Currently we have some definitions of 'equity' but I would probably prefer [the strict liability approach] because in my mind I think equity actually is the balancing figure like goodwill so I don't think I would try and seek to determine that because by definition those must be equity.'[21] (R8)

In addition to an unfavourable assessment of the narrow equity approach as a whole, some respondents provided criticisms of the criteria established for the basic ownership approach that mirrored, for example, Hopkins et al (2009) as discussed in Section 2.3.3. Respondents were critical of the notion that rights on liquidation be used to identify the basic ownership instrument (R1, R6, R7, R10). Firstly, this was criticised because of the difficulty in identifying what would occur on liquidation of an entity at the date for which the financial statements are being prepared, given that liquidation can often take a path different from that suggested by the contracts in place (R1, R10). Secondly, there was a general consensus that appealing to liquidation as a criterion for classification was fundamentally inconsistent with the going concern assumption and should be avoided (R1, R7, R10), as discussed in Section 4.2. These concerns were summarised as follows:

> '[Liquidation should not be used] because a lot of people say that accounting is prepared on the going concern basis, so don't talk to me about liquidation. Liquidation to me is always the test of what rights you've got… I would rather put liquidation out of the debate in justifying something [and then] use liquidation… as the operational proof of [the theory]… But you should be able to argue from concepts without having to appeal to liquidation.' (R6)

[21] The respondent is here referring to the fact that goodwill is determined under IFRS as the difference, broadly, between what is purchased in a business combination and what is paid for that business (IASB, 2008c). This is seen by the respondent as analogous to equity, which is also simply a mathematical result of comparing assets to liabilities.

The difficulties in establishing what would occur on liquidation were also noted by respondents as a challenge in establishing subordination, one of the other criteria proposed as an identifying feature of the basic ownership instrument as discussed in Section 2.3.3. It was noted that the idea that options would be liabilities and ordinary shares equity under the basic ownership approach is challenged by as simple an instrument as employee share options where the holders are entitled to dividends before the options vest. Structures like this, while by no means the norm, serve to cast serious doubt as to whether subordination and the entitlement to dividends can be used as the identifying feature for equity (R8). This is consistent with the argument made by Hopkins et al (2009) that complex capital structures make the determination of subordination impracticable.

The final identifying criterion of the basic ownership instrument, that the interests of holders of these instruments are diluted by other claims, was identified by most respondents as being present when share options are in issue (refer to Section 4.1). Most respondents argued however, that this dilution would usually not be significant enough to impact shareholders (R5, R8) (this viewpoint was expressed by a number of respondents, irrespective of their background). In fact, shareholders would, in all likelihood, disregard such dilution as the perceived benefits of an incentivised workforce would outweigh any dilutive impact of the options (R1, R6). On the whole, the dilution faced by an instrument was not viewed as an appropriate criterion upon which to base the equity-liability classification question. This stands in stark contrast to much of the academic literature advocating the narrow equity approach, which tends to assume that the presence of dilution is sufficient reason to change the reporting model (Penman, 2003). The fact that none of these factors was embraced by respondents as an appropriate criterion for identifying equity highlights the conceptual difficulties associated with this approach. It also calls into question the perceived simplicity which its advocates claim it will bring to financial reporting (as noted in Section 2.3.3).

On the whole, despite some positive responses to the concept of the narrow equity approach, it does not compare favourably to the strict liability approach. The conceptual arguments in favour of this view are overwhelmed by the difficulties in applying the

model. There is also concern that, even if this model could be properly applied, financial reporting would be worse off as a result due to reduced decision-usefulness. It appears that this approach is not an appropriate avenue for future standard-setting and any challenges to the current model must come from elsewhere. Sections 4.4 and 4.5 consider two possibilities.

4.4 The ownership-settlement approach

Although the ownership-settlement approach was not advocated by many respondents, it did find some backing. The conceptual justification for this arose from the notion that equity instruments can be identified by their residual nature. This is similar to the narrow equity approach in that equity as a residue was viewed as an appropriate starting point in developing the theory (R1, R9). Interviewees, however, suggested that the ownership-settlement approach took neither an entity perspective nor a proprietorship perspective in classifying claims. Instead, it based the classification of claims by the *issuer* on whether or not the *holder* was exposed to residual risk (R1):

> 'Remember, [the reporting date] is simply telling people when the statement of financial position was drawn up. What I'm saying is that… because we're doing a theoretical exercise, we shouldn't distinguish between future and present shareholders. Essentially, the risk they're both exposed to is residual risk. They will only get what is left over after the legal claims have been satisfied.' (R1)

The presence of residual risk was primarily determined by whether or not the holder of the instrument would experience variable returns based on the performance of the company's share price. If a fixed number of shares were to be issued, the recipient of these shares would either gain or lose, based on movements in the share price (R8, R9). On the other hand, a holder of an instrument to be settled with a variable number of shares was seen to bear no residual risk as the returns on this instrument are, theoretically, guaranteed:

> 'But if instead of giving you a share today, I say to you, you have a right to get one share in the future if you have worked for me [for three years] so I have, therefore, deliberately made it a fixed number of shares. So then you say, well does it really matter if I have issued the

> share to you today or I am going to give you the one share in three years' time if you have worked for me, are you still not getting the residual interest in the company?... But then you see the complexities coming in, that if it is a case of being a variable number, now there is a concern of, am I really exposed to the change in the fair value of the share? Because let's say I have to issue you with as many shares as is equal to one million rand. Depending on what the share price does, I will either issue you with 10 shares or 100 shares or whatever it might be then they say that you are now really using your shares as a currency.' (R8)

Again, similarly to proponents of the narrow equity view, the primary argument for this approach was a conceptual one, based on the fixed or variable nature of equity settlement. Whether or not this provided the most useful information to users was not discussed. The limited coverage of this approach may suggest that, consistent with the literature, respondents did not find this a viable alternative to solving the equity-liability distinction. Furthermore, the ownership-settlement approach was identified as suffering from the same drawbacks as the narrow equity approach, by not presenting as liabilities only those instruments that are perceived by the market as liabilities (R10). It was also criticised by supporters of the narrow equity approach, as too broadly defining equity and grouping 'pure' equity with future, rather than present, equity claims (R2). This rejection of the model is consistent with the FASB and IASB's ultimate removal of the ownership-settlement approach from consideration in its equity-liabilities project[22].

Overall, interviewees concluded that the strict liability approach was likely the most desirable model for accounting for share-based payments. Using the data gathered from interviews, however, a fourth model can be established which may offer a competing theory to current practice. Section 4.5 describes and explores this model.

4.5 A fourth way: An obligation-centric approach

> 'My personal view is that in this case economics is being hampered by the definitions in the Conceptual Framework… And what annoys me is that we are being held to that treatment by the definition of a 'liability' (R1)

[22] The discussion paper issued by the IASB, *A Review of the Conceptual Framework for Financial Reporting*, only refers to the strict liability approach and the narrow equity approach as potential models for defining claims (IASB, 2013).

> 'I always thought practically [the difference in classification of cash-settled and equity-settled awards in IFRS 2] doesn't make sense – maybe if you try to link it back to the [Conceptual Framework] it does but practically that cannot be right.' (R7)

A number of respondents identified objections to the definitions currently contained in the Conceptual Framework (and the strict liability approach) which did not fit into the established alternate models described by the literature. These objections were primarily motivated by the view that the current system, as a result of applying the 'liability' definition and allowing equity to represent all non-liability claims, leads to claims being recognised in equity that do not meet the 'equity' definition (R2, R3, R5):

> 'I would struggle, to be honest right now, to give you a logical statement that would say yes, equity-settled [share options] are the residual interest in the business – it is difficult to say that.' (R3)

It was felt by these respondents that a model that presumed a primary classification and a default classification was conceptually unsatisfactory. Such a model places instruments in a category, despite its appearing that these instruments do not meet the definition specified for that category (R4). This view was driven by the economic similarities between different types of contingent claims noted in Section 4.1. Respondents felt these to be significant and to outweigh the differences between these instruments (R1, R4, R7). It was argued, contrary to the support provided for the strict liability approach, that the manner of settlement is not relevant from an accounting perspective (R2). It was also argued that the original intention when the Conceptual Framework was first published was for the 'liability' definition to capture all obligations, irrespective of the means of settlement (R1)[23].

In the light of the view that the spirit of the current 'liability' definition seeks to include all obligations as liabilities, some respondents argued that share-settled obligations do meet the current 'liability' definition as they are obligations to deliver the company's shares,

[23] The IASB has refuted this argument by stipulating that the intention of the liability definition has always been to include only asset-settled obligations (IASB, 2013; IASB, 2002). Nevertheless, this view indicates that alternate interpretations of the Conceptual Framework are supported and give credence to a new model.

which represent a resource (R4, R5, R6). This resembles the arguments provided in the literature that the issue of shares at below market value would represent an outflow of economic benefits from the entity (Maines et al, 2004). Respondents were less focused on the opportunity cost associated with the transaction, however, and more intent on emphasising the fact that shares are an economic resource (R4, R7):

> 'So, do I have a liability? And in the conceptual sense that isn't whether or not I'm going to pay you cash, the question is rather, is that going to result in the outflow of resources? And in the broadest sense, some of the resources I've got are, in fact, my shares, because I can issue my shares for cash into the market. So by issuing them to you, I'm not issuing them to the market, so that's an outflow of resources.' (R6)

> '… frankly, if you give employees the opportunity to get shares in the future and you are going to award those shares to them, even though it is your pool of authorised unissued shares, it means that instead of now issuing those shares to other shareholders that will give you the cash, you are now taking those shares and you are giving it to them so you are actually taking away from the benefit of what you would have gained from someone else.' (R7)

The argument that an entity's own shares are an economic resource was, however, countered by some. The notion that the obligation for equity-settled options represented the opportunity cost of not issuing shares at market value was viewed as "abstract" (R10). Such a concept was held to be inadequate for justifying a particular accounting treatment for financial statements read by reasonably sophisticated users (R8, R10). An argument more commonly raised was that to include an entity's authorised but not issued share capital as an economic resource would invalidate the definition of an 'asset'[24], as it would suggest that the entire unissued share capital of the entity should be capitalised as an asset (R2, R3, R5). These arguments indicate that justifying liability treatment for equity-settled obligations is not feasible under the current definitions in the Conceptual Framework. This fact prompted the comments quoted at the start of this section, and the view that it was not the interpretation of the Conceptual Framework that was deficient,

[24] The current and proposed definitions of an asset both define assets as resources under the control of the reporting entity (IASB, 2013; IASB, 2010).

but the Conceptual Framework itself (R4, R6). Specifically, respondents felt that a focus on the settlement outcome, as required by the strict liability approach, and as justified in Section 4.2, ran contrary to the ever-present need for comparability in financial statements:

> 'But it feels more to me like [in the case of share-settled options] you are just settling this obligation that you have with shares, and if you are settling the obligation that you have with shares, then shouldn't you from the start just account for the obligation rather [as a liability]?' (R4)

> 'And [by issuing shares to settle an employee share option] I'm released from my obligation to pay you. So in both cases [that is, in the case of share-settled and cash-settled awards] there's something flowing out; the question is, what is this obligation I've got to pay you at the beginning? And the obligation is the same obligation, it's just that the settlement is different… If you're saying the obligation is the same regardless, then there isn't a need to change the accounting [that is, to account for the instruments differently] until you settle, and when you settle then something different can happen.' (R6)

The above reinforces the perceived inconsistencies with the strict liability approach, where contingent claims that will in the future be settled in equity are accounted for as equity, despite these claims not representing present residual interests (R2, R4, R7).

Based on the above, a new model for defining equity and liabilities was described by respondents. This model would, in the same way as the strict liability approach, define liabilities first. A liability would, however, be defined more broadly as a present obligation of the entity as a result of a past event at the reporting date[25] (R1, R2, R4). The definition of 'equity' would again share similarities with the definition currently applied under the strict liability approach. The difference between this model and the current definition is that equity would be defined more narrowly to include only *present* interests in the assets of the entity after deducting all of its liabilities[26] (R2, R4, R6). Respondents who

[25] This definition parallels the current liability definition but removes the reference to settlement of this obligation taking place via an outflow of resources embodying economic benefits (that is, assets). It therefore includes in its ambit all obligations of the entity at the reporting date irrespective of the way in which these obligations will be settled (IASB, 2004, IASB, 2002).

[26] This contrasts with the definition of equity currently applied in the Framework, which does not refer to present residual interests and, therefore, appears to incorporate both current equity and instruments that will be equity in future (R2, R8).

supported this view argued that this would provide a clearer and cleaner distinction between equity and liabilities (R2). It would also reduce or remove entirely the status of equity as a 'dumping ground' (R3) as only claims meeting the definition would be recognised in equity (R6). Under this model, there would be no need to identify one definition as having priority over the other, as is the case at present; claims would be defined consistently, irrespective of the definition applied first (R4):

> That's where I start to find that things are different from what things are at the moment, because we [currently, under the existing model] describe liabilities in ways that is [sic] describing things that we've also called 'equity'. (R6)

As noted above, interviewees who favoured this view did so because it enhanced comparability and provided decision-useful information. Their argument for this was, however, focused on the effect of these awards on the profit or loss of the reporting entity (R1, R2). That is, respondents desired consistent treatment of the awards from a classification perspective in order to ensure that two awards that differed only on settlement outcome would be reported in the same way in profit or loss[27] (R1, R2, R5). This was necessary, it was argued, because of the importance of reported profits in the assessment of a company based on its financial statements; for example:

> '…when you value a company, you take profits and you obviously use a multiple to grow it up. And if your IFRS 2 expense is wrong [that is, reflecting an outdated grant-date fair value] then your valuation of the company will be wrong. So you can't completely ignore the expense, because it's relevant; but if it's been measured at a number [grant-date fair value] that doesn't make sense [because no re-measurement has occurred] then your answer is going to make no sense.' (R1)

As Barth et al (2013) note, the justification of a classification model based on the impact on the statement of profit or loss and other comprehensive income runs contrary to the balance sheet approach followed by accounting standards and theory. This approach

[27] As noted in Section 2.1, equity instruments are not re-measured to any representation of current value (be it fair value, amortised cost etc.) as this would run contrary to the status of these instruments as the residual interest. Liabilities, on the other hand, are re-measured, meaning the effect on profit or loss of liabilities is more reflective of the change in value to which the entity has been exposed by being obliged to settle the liabilities in question than the accounting for equity instruments.

defines assets and liabilities first and income and expenses follow from this. This argument was, however, countered by interviewees who noted that while the IASB follows primarily a balance sheet approach, this does not necessitate ignoring income statement effects (R9). The attainment of the most decision-useful information for users requires a consideration of the impact on both the statement of financial position and the statement of profit or loss and other comprehensive income:

> 'And I think that people don't realise the importance of this because of the balance sheet perspective, that we look at the balance sheet and the income statement can become almost a residual. But the fact is that profit or loss is a very important measure, and if you allow all these mismatches in the income statement, there is a danger that it will reduce its usefulness.' (R2)

This argument approaches the question of useful information from a different perspective to that supported by proponents of the strict liability approach, resulting in a different perspective on the accounting for share-based payments.

The approach described above is not detailed fully in the current literature. In fact, the FASB (2007) explicitly rejected this approach without further developing its implications, on the grounds that it was too difficult to describe conceptually. This notion is contradicted by the above findings, as it appears respondents were very comfortable expressing this obligation-centric approach conceptually. The difficulty faced by the FASB appears to have arisen due to its focus of utilising equity, and specifically the basic ownership instrument, as the starting point. This viewpoint actually comes from a revised definition of 'liabilities'. A case can be made for this approach to be considered as an alternative model in the equity-liability classification debate.

As this obligation-centric approach represents a hybrid of the strict liability and narrow equity approaches, it is open to some of the criticisms levelled against these approaches. By focusing on obligations as the key determinant of a liability, the approach must contend with the practical difficulty of identifying whether an obligation is present (R7) in the same way as the strict liability approach. Respondents who supported the strict liability approach were critical of this model as it would represent a significant change in accounting, which they perceived as damaging to the usefulness of the financial

statements (refer to Section 4.2 for further detail). This approach was also criticised in that, by including equity-settled obligations in liabilities, it would fail to reflect the credit risk of the entity and would reduce the usefulness of liabilities for users (R10).

The criticisms of this model were also responded to. The operational difficulties of identifying an obligation were seen as far less burdensome than the difficulties associated with identifying the basic ownership instrument under a narrow equity approach (R4, R7). As noted above, respondents specifically justified this approach by virtue of the improved decision-usefulness of the income statement that it was believed would arise (R1, R2), deflating the criticism of reduced usefulness. Finally, it was identified that IFRS 7 *Financial Instruments: Disclosures* (IASB, 2005) currently requires disclosure in respect of share-settled liabilities (R8, R9). This enables users to obtain the benefits of the strict liability approach, even though it is not currently being applied in its entirety. This indicates that the same benefits could be obtained under an obligation-centric approach.

The above suggests that this approach, despite not receiving unanimous support and despite the criticisms thereof, may be a viable alternative to the current model and is potentially an approach requiring more detailed consideration by standard-setters. Table 3 provides a summary of this model as developed from the data collected:

Table 3: Summary of the obligation-centric approach

Theoretical underpinning	Not clearly consistent with either the entity perspective or the proprietorship perspective
Liability definition	A present obligation of the entity as a result of a past event at the reporting date
Equity definition	The present residual interest in the assets of the entity after deducting all its liabilities
Advantages	• Consistent treatment of cash-settled and share-settled contingent claims • Increased decision-usefulness of the income statement
Disadvantages	• Obligation may be difficult to identify • Reduced information for users wishing to assess credit risk • Does not accord with a specific view of decision-usefulness

Following the evaluation of the findings in this section, Chapter 5 will conclude on the study and identify areas for further research.

5 CONCLUSION

This chapter summarises the key findings from the interviews and provides concluding remarks (Section 5.1). It then highlights the research contribution (Section 5.2). Finally, this chapter identifies the opportunities for further research (Section 5.3).

5.1 Summary of paper with concluding remarks

Share-settled and cash-settled employee share options have a number of similarities, including the fact that the company has an obligation to settle the option. Furthermore, share-settled options are similar in nature to ordinary shares, in that they expose the holder to a similar return profile. Nevertheless, the crucial difference between the awards (the fact that the company only has to reduce its net asset value in the case of cash-settled awards) appears to outweigh the similarities identified.

Consistent with the features of options identified above, the strict liability approach received greatest support from respondents. Responses did not vary significantly based on the interviewees' backgrounds and experience. Instead, support for the strict liability approach was grounded in pragmatism. The strict liability approach provides the most decision-useful information to users as liabilities are well understood by these users. Conceptual and theoretical support for this model is less readily available than the narrow equity approach. This is not seen as a shortcoming, however, because the emphasis must remain on the users of financial statements rather than the strength of the concepts used in preparing these financial statements. Respondents also downplayed the importance of addressing structuring, unless this was part of efforts to provide useful information. This echoes the calls in the literature to remain focused on the objective of financial reporting (Hopkins et al, 2009). Despite the support for the prevailing model, this was not accompanied by support for the insolvency risk approach. This suggests that the method used in the literature to analyse decision-usefulness may need to be revisited. The support for the strict liability approach also serves to highlight a tension between principles based accounting and the objective of creating useful

financial statements. This may arise when principles are established without keeping in mind the objective of these principles, as explained by one of the respondents quoted in Section 4.2:

> That's your test. A sophisticated user - how will they understand this?... Don't you want to give them financial statements and say, you can use them as is, more or less? And again, I'm not saying that the existing model is perfect, it's not. We must face up and say, we accept the inconsistencies, we accept that some things are conceptually invalid, but that's ok. We'll live with it. But now you're striving for this sort of thing where it's conceptually best, maybe, but arguably, let's assume you can formulate a wonderful conceptual argument for it, so what? Is it the most meaningful? No.' (R10)

The narrow equity approach was not as strongly supported as the literature suggests. It was seen in a favourable light as a means of restoring the 'purity' of equity. Ultimately, however, this is not enough to justify a model that reduces the usefulness of financial statements and provides counter-intuitive or illogical reporting. The means of narrowly defining equity, whether it be using liquidation, subordination or dilution, do not appear to be feasible or practical criteria for use in reporting. The rejection of the narrow equity approach was grounded in both the reduced usefulness of this approach and its conceptual shortcomings, consistently with the literature critical of this model.

The ownership-settlement approach was not strongly supported, as is the case in the literature. Although it could be conceptually justified, no appeal was made to its benefits for users. This may indicate that this model is inappropriate for financial reporting, and may suggest that IAS 32, which applies a form of this model, may require revisiting.

Over and above the established models described in the literature, evidence for a fourth model was identified. This obligation-centric approach defines liabilities as all obligations, irrespective of the manner of settlement. Conceptual support which fits into established theories was not present for this model; however there was a strong feeling that this model will improve the usefulness of the income statement and restore the 'purity' of equity.

On the whole, the strict liability approach remains the preferred model for classifying equity and liabilities. This suggests that standard-setters are justified in their application of this model in proposed changes to the Conceptual Framework. The arguments in favour of the obligation-centric approach, however, suggest that this model deserves greater consideration than it is currently receiving in the literature. This could occur through an incorporation of the model into future discussion papers or exposure drafts in the Conceptual Framework project.

5.2 Contribution

This thesis provides a novel approach to the equity-liability question by adopting a qualitative and interpretive method. This contrasts with the existing literature on the subject, which is rooted in modern financial theory (Barth et al, 2013) and the dominant paradigm of value relevance (Holthausen and Watts, 2001). It also provides a basis for further debate in an area which is currently inadequately covered in the literature (Barth et al, 2013; Landsman et al, 2006). Although the findings of this thesis may not be generalised in a positivist sense, the principles identified may form a basis for future researchers, irrespective of the method applied.

This thesis also provides a more detailed account of a model for defining equity and liabilities based solely on the presence or absence of an obligation. This model may represent a challenge to the existing strict liability approach, and further investigation of this model and its implications both on a qualitative and a quantitative basis is necessary. The exploration of the strict liability approach in this paper is also significant as academic literature tends to focus on a narrow equity approach, with the strict liability approach primarily being covered in standard-setting literature.

Finally, this thesis is among the first to provide a detailed interpretive account of financial reporting in an African setting. The existing body of financial reporting research is largely framed in an American or European context (Brennan and Solomon, 2008). Furthermore, its interpretive focus is of significance in that interpretive research has become well-

established in management accounting (Lukka and Modell, 2010) but remains an under-developed research method in financial accounting (Barth et al, 2013).

5.3 Opportunities for further research

As noted in Section 5.2, this thesis provides an exposition of the obligation-centric approach which has previously been absent from academic literature. This analysis was, however, developed via interpretive methodology. This could form the basis of further research which adopts models of economic rationality and value relevance, to attempt to measure the usefulness of financial statements prepared using this approach.

There are a number of competing models for defining equity and liabilities. As explained in Section 1.5, this thesis only considered certain models believed to be the most promising. Further research could adopt a similar research method but incorporate a consideration of, for example, the claims approach or the loss absorption approach, both of which are an integral part of the overall debate in this area (Whittington, 2008; EFRAG, 2007). Moreover, this research used employee share options as a case study; utilising IAS 32 and the instruments contained under its scope may yield different insights.

It was also noted in Section 1.5 that the question of measurement was not dealt with in this thesis. Given that the measurement of claims will have a direct impact on the profit or loss of the reporting entity, further research can investigate how best to report the income statement effects of the various classification models (FASB, 2007; Ohlson and Penman, 2005).

Finally, much of the support for the strict liability approach came from the fact that it is the established model and that change to the *status quo* would create unjustified difficulties for users. This may indicate that accounting concepts can become entrenched over time and this is what creates the legitimacy of these concepts. Further research could investigate the extent to which this is the case.

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APPENDIX A

Interview agenda

Note that this agenda was designed to address themes covered by this research: the questions listed here served as prompts for the interviewer, rather than a strict list of questions to follow.

Theme 1: IFRS 2 and the economics of share options

1. What is your understanding of share options granted to employees?
2. Why are they granted, and what impact do they have on the business?
3. What impact do they have on current shareholders?
4. How does the situation change, if at all, when these awards are going to be settled net? Are these awards economically different from gross settled share options? What are the similarities between the two types of awards?
5. What do you feel is the most appropriate way to account for employee share options?
6. Is you answer to the previous question different in the case of cash-settled awards? Why?
7. Given your answers above, do you believe that the distinction between cash-settled and equity-settled awards in IFRS 2 is justified economically? How does the opportunity for structuring of transactions affect your answer?
8. To what extent do you believe that the current accounting for IFRS 2 is based on the definitions of equity and liabilities in the framework? What does this tell us about the usefulness of the framework as a starting point for accounting?

Theme 2: The entity and proprietorship perspectives

1. Should accounting reflect the impact of transactions and events on existing shareholders, or on the business as a whole? How does the nature of employee share options affect your answer, if at all?

2. Suppose we were to attempt to develop the concepts of equity and liabilities from scratch, using the concepts we've talked about above. What would be an appropriate starting point? Equity or liabilities? What basic features of items that are clearly equity or clearly liabilities would be appropriate to use in the definitions of these elements?

Theme 3: Implications for the framework

1. Given your preferred perspective on accounting (reflecting the impact on current shareholders or on the entity), to what extent do you believe that the current definitions of equity and liabilities in the framework are adequate?
2. Is there any way in which you would wish to improve the framework to deal with these issues?
3. What impact would that have for the treatment of what is currently termed an 'equity-settled share-based payment transaction' in IFRS 2? How would this differ from IFRS 2 and what, in your opinion, are the reasons for the differences?