



European Financial Reporting Advisory Group ■



# Classification of Claims

## EFRAG DISCUSSION PAPER



JULY  
2014

This EFRAG Discussion Paper has been published to assist the IASB in the development of a discussion paper on distinguishing between equity and liabilities and to support constituents in engaging with the project.

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*Belgium, Commissie voor Boekhoudkundige Normen/Commission des Normes Comptables  
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**These bodies, while encouraging debate on the issues presented in the paper, do not express any opinion on those matters at this stage.**

*We welcome views on any of the points addressed in this Discussion Paper. Specific questions are given at the end of the document. These comments should be sent by email to [commentletters@efrag.org](mailto:commentletters@efrag.org) or by post to:*

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*So as to arrive no later than 31 October 2014.*

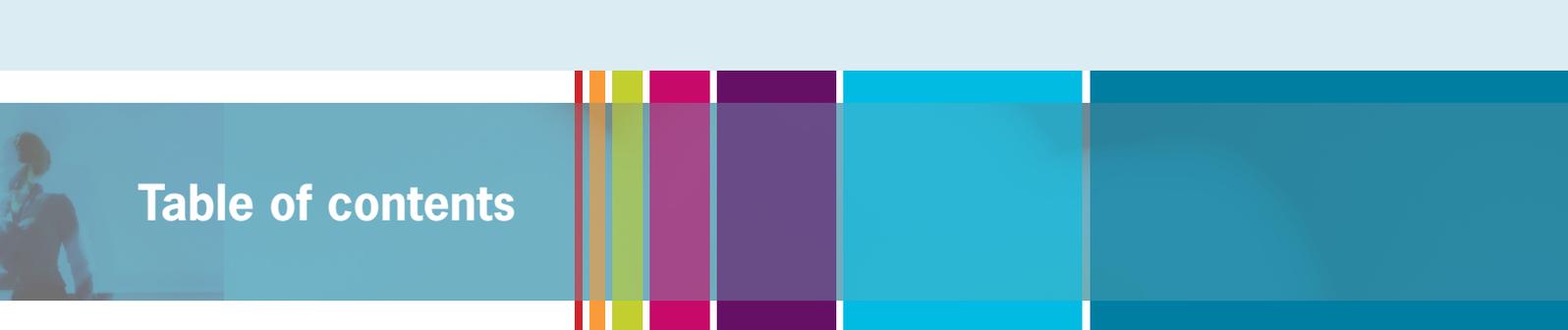
*All comments will be placed on the public record unless confidentiality is requested.*

# Introduction

- 1 This EFRAG Discussion Paper looks at the credit side of the Balance Sheet<sup>1</sup> and the classification of the claims on an entity.
- 2 The 2013 IASB Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* (‘the Conceptual Framework DP’) identified two potential ways of distinguishing between equity instruments and liabilities, which were described as the ‘narrow equity approach’ and the ‘strict obligation approach’. The majority of respondents to the Discussion Paper, including EFRAG, did not support either of the two approaches as discussed for a number of reasons. In its final comment letter EFRAG suggested that the IASB should not attempt to provide the conceptual basis for a distinction as part of the current revision of the Conceptual Framework but should, in parallel, undertake a more comprehensive discussion on what the distinction means and is attempting to portray.
- 3 Following consultation with the Accounting Standards Advisory Forum, the IASB has decided to tackle the equity/liability distinction in parallel with the wider Conceptual Framework project. The IASB plans to release a Discussion Paper on the equity/liability distinction at approximately the same time as the publication of an Exposure Draft of the entire revised Conceptual Framework.
- 4 This paper has been written to assist the IASB in developing its Discussion Paper and constituents in engaging with the project.
- 5 The scope is classification of claims in general rather than just the distinction between equity and liabilities, including some wider questions, such as how many elements the claims on an entity should be classified into, the objective of classification requirements and how dilution can be depicted.
- 6 This paper does not say how the distinction between claims should be made, but discusses approaches to defining elements, aims to identify the choices that must be made in classifying the claims on an entity and the consequences of those choices. The paper also identifies the extent to which each of the choices is consistent with the identified objectives and how these objectives may conflict with each other.
- 7 The paper also suggests a possible order in which these choices could be taken and identifies which ones appear to have been taken in developing current IFRS requirements.
- 8 To assist in reducing the identified conflicts between objectives in a two-element approach the paper identifies three additional elements that could reduce conflicts. These three additional elements have been identified based on current problems with financial reporting.

<sup>1</sup> In IFRSs this statement is now termed ‘Statement of Financial Position’ but in the interests of readability this paper uses the term ‘Balance Sheet’.

- 9 The paper also contains a glossary of terms that has been developed. In discussions around the classification of claims it has become clear that there is not a common vocabulary for describing and understanding the issues. The glossary has been developed in the aim of developing a common terminology to increase shared understanding and, within this paper, terms contained in the glossary are in **bold** on first usage.
- 10 Comments are welcomed on this Discussion Paper, including responses to the specific questions asked on page 58. Please respond by 31 October 2014.



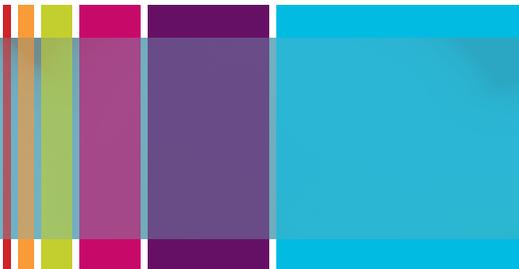
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# Classifying claims on an entity

## WHAT ARE CLAIMS AND HOW ARE THEY TREATED IN CURRENT IFRS?

- 11 The claims on an entity are the entitlements to the economic resources of the entity, including where the entity has an obligation to use its economic resources but there is no individually identifiable counterparty (e.g. environmental restoration provisions). The nature of these claims, how they arise and the rights they have can vary significantly. This paper does not cover claims that arise other than from **financial instruments**. For claims that do arise from financial instruments the paper discusses the classification of these claims and the implications of classification.
- 12 Under current IFRSs (recognised) claims on an entity are classified into two elements, being (recognised) liabilities and equity. Recognised liabilities depict an entity's obligations. Equity is a balancing figure, being the difference between the sum of recognised assets (directly **measured** on a number of different bases) and the sum of recognised liabilities (also directly measured on a number of bases) and incorporates the **accounting residual**. Whilst equity is often understood as being merely a balancing figure it can be thought of as actually being two things, which this paper calls **claimed equity** and **unclaimed equity**:
  - (a) Claimed equity – Claimed equity is a surplus of recognised assets over recognised liabilities upon which an actual, identifiable claim exists. Under current financial reporting conventions most of these claims are not themselves directly measured; and
  - (b) Unclaimed equity – Unclaimed equity is a surplus of recognised assets over recognised liabilities to which no entity has a claim (i.e. there is no matching asset in the records of the claimant). Circumstances in which this has arisen include, but are not limited to some cooperative entities, the UK Trustee Savings Banks, some defined benefit pension schemes and charities (e.g. a charity may have received funds, but not have an active project in which those funds will be used).
- 13 The key difference between claimed and unclaimed equity is that, for claimed equity, an asset exists for another party in its own records whereas for unclaimed equity no party records an asset in its own records. Claimed equity could, depending on the classification requirements, be classified as liabilities. Unclaimed equity is not distinguishable from the accounting residual.
- 14 Because income and expense are defined by changes in assets and liabilities, equity includes accumulated but undistributed profits, contributions from equity holders and other **reserves** required by IFRSs or legal requirements.



## THE IMPORTANCE OF CLASSIFICATION

- 15 Classification of the claims on an entity is a fundamental underpinning of financial reporting and has numerous consequences, including for reporting financial performance. This is because—as stated in paragraph 14 above— income and expense are defined by reference to changes in assets and liabilities, other than those caused by contributions from equity participants or distributions to equity participants.
- 16 Current IFRSs use a **binary split** between liabilities and claims on equity. Classification of a particular instrument<sup>2</sup> as a liability or as an equity instrument (or bifurcated between a liability and an equity instrument) has two main consequences under current IFRSs in that generally:
- (a) only instruments classified as liabilities are directly measured (other than on initial recognition in some cases); and
  - (b) changes in such measurement are presented in comprehensive income.
- 17 Sophisticated financial instruments are frequently designed to exploit the difference between equity and liability classification. As a result, two instruments that are economically similar may fall on different sides of the divide and therefore be reported very differently: one directly measured with changes reported in comprehensive income and the other not remeasured after initial recognition.

### Definitions of income and expense

The *Conceptual Framework for Financial Reporting* defines (in paragraph 4.25) income and expense by reference to changes in the elements of the Balance Sheet.

‘Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.’

‘Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.’

<sup>2</sup> Any single legal instrument may contain multiple claims. IAS 32 *Financial Instruments: Presentation* uses the term ‘equity instrument’ to mean a financial instrument (or part of a financial instrument) that contains one or more claims that have been classified as claims on equity.

- 18 Current IFRSs generally uses the conceptual definition of a liability to determine if a claim is classified as a liability or as a claim on equity, but with a number of exceptions, including:
- (a) obligations to deliver equity instruments are classified as liabilities, unless they are part of a share-based payment obligation, or the obligation is to deliver a fixed number of equity instruments in exchange for a fixed amount of cash; and
  - (b) if an entity would have no equity instruments, the **most residual** instrument might be classified as an equity instrument in certain circumstances.
- 19 These requirements are mainly contained within IAS 32 and IFRS 2 *Share-based Payment*, but as the distinction between equity and liabilities is fundamental, it impacts the financial reporting required by a number of other standards, in particular:
- (a) IAS 1 *Presentation of Financial Statements* and IAS 33 *Earnings per Share* for performance reporting and presentation;
  - (b) IFRS 3 *Business Combinations* for classification of contingent consideration in a business combination and the calculation of goodwill; and
  - (c) IFRS 10 *Consolidated Financial Statements* for classification of non-controlling interests, changes in intra-group holdings and group capital structure.

## THE OBJECTIVE OF CLASSIFICATION REQUIREMENTS

- 20 In any financial reporting regime classification requirements (and therefore definitions of elements) are driven by the choice of overall objectives, i.e. what the financial reporting is aiming to achieve. The Conceptual Framework for Financial Reporting states that the objective is '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. Those decisions involve buying, selling or holding equity and debt instruments and providing or settling loans and other forms of credit.' (paragraph OB2).
- 21 The Conceptual Framework goes on to explain that users require information to help them assess the prospects for future net cash inflows to an entity. It then states: 'To assess an entity's prospects for future net cash inflows, existing and potential investors, lenders and other creditors need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources... Information about management's discharge of its responsibilities is also useful for decisions by existing investors, lenders and other creditors who have the right to vote on or otherwise influence management's actions.'

- 
- 22 Within the overall objectives of financial reporting, choices on the classification of claims are based on a number of objectives. This paper identifies these objectives as being to depict (or contribute to depicting):
- (a) An entity's **liquidity**;
  - (b) An entity's **solvency**;
  - (c) An entity's financial performance; and
  - (d) Returns to the holders of a particular class of instrument.
- 23 The requirements chosen contribute to depicting an entity's economic resources (assets) and the interaction of the elements of the Balance Sheet with the elements of the other primary statements (especially in terms of how the elements of the other primary statements are defined).
- 24 Liquidity<sup>3</sup> can be described as the degree to which an entity has the economic resources required to meet its obligations as they fall due, or is able to meet them by selling its economic resources or issuing new claims without affecting the value of its economic resources or its existing claims.
- 25 Depicting solvency is showing the capacity of the economic resources of the entity to meet its obligations. It therefore depicts an entity's overall ability to meet its obligations to transfer economic resources. Classification requirements that depict solvency imply that an entity is able to bring about any changes it wishes to obtain a desired capital structure subject to its economic resources, including those that are not recognised as assets, exceeding its obligations to transfer economic resources.
- 26 Though liquidity and solvency are theoretically independent at any given point in time, in the real world they are inextricably linked. For the purposes of this paper, depicting liquidity and solvency are identified as separate objectives, but any classification choice that depicts solvency without depicting liquidity will fail to appropriately depict the real world. This is because it is not always possible to obtain a desired capital structure or access appropriate economic resources at the same time as an obligation to transfer economic resources comes due even for solvent entities.
- 27 Classification of claims is relevant to the reporting of financial performance because income and expense, which are the elements of the Statement(s) of Comprehensive Income (the primary statement(s) for depicting financial performance) are defined by changes in Balance Sheet elements.

<sup>3</sup> The descriptions of liquidity and solvency are based on, and consistent with, those proposed in IASB agenda paper 10H of June 2014. The use of these terms in this paper is consistent with that paper in order to align discussions in Europe with those at the IASB.

- 28 If only one class of instrument is classified as equity the statement(s) of comprehensive income report income and expense, and therefore returns, that are due to the holders of a particular class of instrument. No classification requirements that could result in more than one class of instrument being classified as equity would depict the returns to a particular class.
- 29 Some of the traditional roles of equity, such as acting as a buffer against losses by holders of what are seen as less subordinated claims (e.g. bondholders), are consistent with the objectives of depicting solvency and liquidity and an overall approach to financial reporting of being ‘prudent’ or expressing ‘caution in the face of uncertainty’.
- 30 Problems with setting classification requirements arise when these objectives conflict with each other, in particular between depicting solvency/liquidity and reporting the financial performance of an entity.
- 31 Some obligations of an entity to transfer economic resources depend upon entity-specific variables, or are based on an entity’s performance. Depicting these obligations as liabilities can reduce the relevance of reported financial performance because increases in the liability (for example because of expectations of higher future returns) are reported as an expense and decreases in the liability (for example because of expectations of lower future returns) are reported as income.

### Depicting liquidity and solvency

‘Even though liquidity and solvency are interrelated concepts, we have tried to distinguish between them because the drivers are different. Thus, [the characteristic selected to distinguish liabilities and equity] may affect a user’s assessment of liquidity and solvency differently. In particular:

(a) liquidity is dependent on the nature of the economic resources required to settle an obligation and the timing of the required settlement; and

(b) solvency is dependent on the amount of economic resources required to settle an obligation.’

IASB Agenda Paper 10H, June 2014

## Conflicting objectives in current IFRSs

Obligations to deliver economic resources are generally defined as liabilities in current IFRSs. Such obligations could be to pay a set percentage of profit or revenue every year, contingent consideration arising from a business combination (including those that have the legal structure of put options written on non-controlling interests) or **shares** puttable to the entity.

Increases in these obligations, for example caused by increased expectations of better future performance, meet the definition of an expense and are recognised as such.

Income is not usually recognised to reflect these increased expectations of future performance because the source does not meet the definition of an asset, is not recognised as an asset or is measured on a basis that does not reflect increases in expected future economic benefits (such as a cost basis).

Meeting only the liquidity objective therefore means that the overall solvency of the entity may not be effectively shown and reduces the relevance of reported financial performance.

## DIFFICULTIES IN SETTING GLOBAL STANDARDS

- 32 The challenges involved in distinguishing between the elements on the credit side of the Balance Sheet exist in all financial reporting regimes, but there are a number of factors that make developing requirements in IFRSs even more difficult. In particular, the fact that any IFRS requirement should be applicable:
- (a) across a wide range of corporate structures and no assumptions can be made about the corporate structure of the reporting entity; and
  - (b) in any and all legal environments and no assumptions can be made about the legal environment(s) in which the reporting entity operates.
- 33 Views on what constitutes equity are frequently based on experiences with national GAAPs, laws and common corporate structures. A number of previous attempts to address the distinction have focused on **'ordinary shares'** as a starting point and then encountered difficulties with the claims in other corporate structures and legal environments. It is important that any approach starts from a principles basis rather than setting requirements for a particular legal system and corporate structure and then attempting to apply requirements more widely.

- 34 Some of the criticism of the current requirements of IAS 32 appears to stem from what are felt to be **ownership instruments** in various corporate structures being classified as liabilities and therefore measured through comprehensive income.
- 35 If financial reporting was designed to report returns to owners, these instruments would be classified as equity (and financial performance reported by reference to changes in other elements). Whether being an ownership instrument has a role in classification decisions is one of the choices that needs to be made.
- 36 As well as being applicable across a range of jurisdictions and corporate structures, requirements also need to apply in both consolidated and separate financial statements. Some notions that work in separate financial statements (such as ‘most residual’ or ‘legal ownership’) may not be applicable in consolidated financial statements where the boundaries of the reporting entity are determined by reference to control rather than legal structure.

#### Example of the difficulties caused by legal frameworks

Certain entities formed under German law such as partnerships present a particular problem in classifying claims under IFRSs.

Members of these entities have the right to unilaterally leave the entity and receive a certain amount in exchange for their interest.

These claims are therefore obligations of the entity to transfer economic resources (as they are dependent upon an event outside of the entity’s control) and are classified as liabilities under current IAS 32 unless they meet one of the exceptions.

## THE CHOICES TO BE TAKEN IN DEVELOPING AN APPROACH TO THE CLASSIFICATION OF CLAIMS

- 37 As said in the introduction, this paper does not propose a particular solution for solving problems that have arisen in the classification of claims. Rather, it aims to identify the choices that need to be made in developing classification requirements, as well as some of the consequences of each of these choices.
- 38 Some of these choices would need to be made at the Conceptual Framework level, with decisions at the standards level naturally following from that. Other choices could potentially be made at the standards level.
- 39 This section briefly introduces those choices and sets out what we have identified as a possible order they might be considered in. The choices themselves, and the consequences of them, are explored from page 16 onwards.

*The number of elements that claims are classified into*

- 40 In paragraphs 53-75 the paper discusses the nature of the claims on an entity, the difference between additional elements and differential presentation/disclosure within an element and how many elements claims should be classified into. The options discussed are a single element (the 'claims approach'), two elements and more than two elements. The paper discusses the consequences of all of these.

*Positive or negative definitions to determine classification*

- 41 If claims are classified into more than one element it is necessary to determine how to distinguish between the elements. Paragraphs 78-84 discuss using a **positive definition of an element** or a **negative definition of an element** to distinguish between claims. Using the example of a binary split of the Balance Sheet the paper explores **a positive definition of equity, a positive definition of liabilities and a negative definition of equity**.
- 42 The paper also discusses the consequences for having multiple positive definitions of elements and what the implications of that are for financial reporting and classifying claims.

*A positive definition of equity*

- 43 The paper discusses potential positive definitions of equity, including whether the perspective of financial reporting taken could influence a positive definition. Paragraphs 89-115 discuss two perspectives of financial reporting (**proprietary perspective** and **entity perspective**) and what the consequences could be of choosing each of these perspectives for developing a positive definition of equity.

*A positive definition of liabilities*

- 44 Starting from the positive definition of a liability proposed in the Conceptual Framework DP, paragraphs 116-140 consider the two aspects of the proposed definition relevant to classifying claims: determining whether an obligation exists and what the obligation requires transfer of.

Determining whether an obligation exists

- 45 It may not be clear from the terms and conditions of an individual instrument whether an obligation exists. This paper identifies a number of factors that need to be considered, based on problems that have arisen in current requirements. These are the type of considerations that would need to be taken into account in any future standards-level project on classification of claims.

Determining what the obligation requires transfer of

- 46 The Conceptual Framework DP's proposed definition of a liability was that it should be an obligation for the transfer of economic resources. A claim on the equity of an entity is not an economic resource of the entity and therefore does not meet this obligation.
- 47 The paper considers how obligations to transfer claims on equity could be classified and the consequences of various options. The consequences considered include implications for the accounting for rights to receive claims on equity and instruments involving the exchange of claims on equity for economic resources.

*Is the unit of account the claim or the instrument?*

- 48 The paper considers whether a single instrument – which may contain multiple independent claims – must be classified as a single element and what the consequences of this would be or whether each claim (or group of claims) could be classified separately.
- 49 The Conceptual Framework DP suggested that the unit of account should be dealt with at the level of individual standards. The discussion in this paper would be relevant in the development of any new standard involving classification of claims.

## ILLUSTRATION OF THE CHOICES

- 50 Figure 1 is an illustration of how the choices may be considered, but it should be noted that there may be other orders in which the decisions can be taken. One area in which the illustration may be of particular help is in visualising the decisions taken in developing current IFRS (green boxes in Figure 1).
- 51 All of the questions (boxes in blue) in Figure 1 are discussed in this paper. For each of these, some possible choices are discussed and the consequences of these choices.
- 52 Where there is a question identified but no answers suggested, there may be potential follow up questions that are not identified in this paper.

*Key to Figure 1*

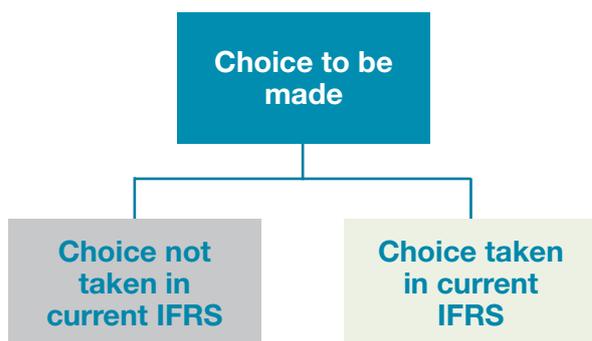
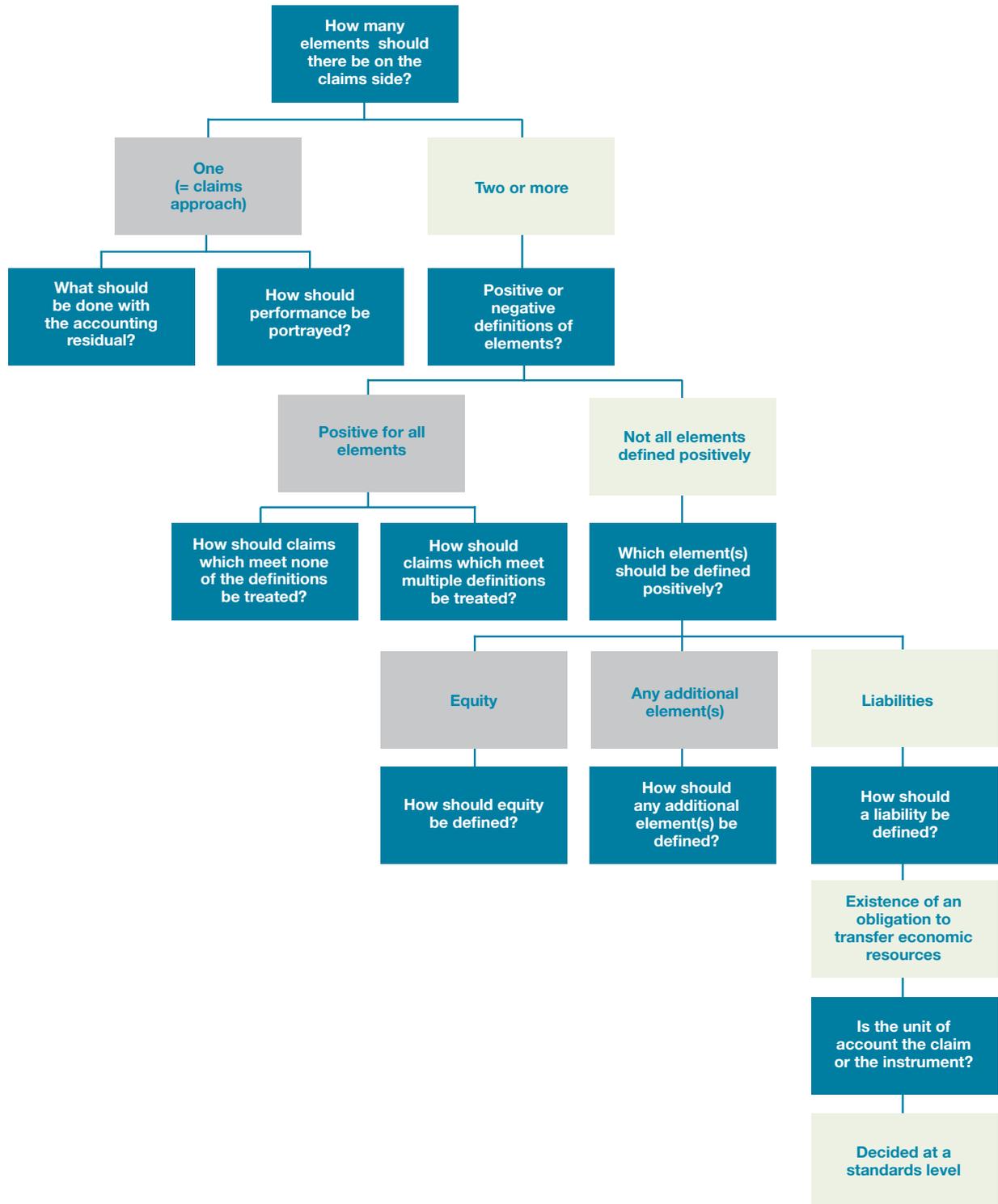


Figure 1: Illustration of the choices that need to be taken in developing classification requirements, including the choices taken in current IFRS



# The number of elements

53 This section discusses the nature of the claims on an entity, the difference between a new element and differential presentation and disclosure of claims within an element and how many elements these claims should be classified into. In particular, the section considers Balance Sheets containing:

- (a) One element (a 'no-split' or 'claims' approach);
- (b) Two elements (a binary approach); and
- (c) More than two elements.

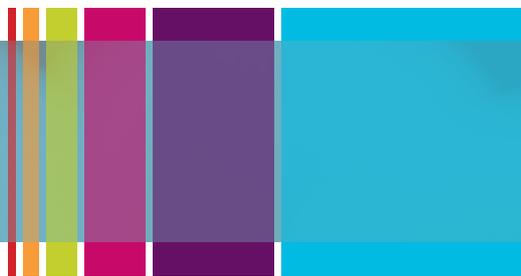
## *The nature of the claims on an entity*

54 The credit side of a Balance Sheet contains various claims to the economic benefits generated by an entity.

55 The 2008 Pro-active Accounting Activities in Europe Discussion Paper Distinguishing Between Liabilities and Equity ('the PAAinE DP') identified a number of the characteristics claims on the entity could have:

- (a) participation in ongoing profits;
- (b) participation in ongoing losses;
- (c) fixed payment on the instrument;
- (d) participation in liquidation excess;
- (e) variable claim on repayment/redemption;
- (f) possibility to agree on 'no redemption';
- (g) subordination;
- (h) fixed term/maturity;
- (i) participation rights (general assembly); and
- (j) control/voting rights.

56 Each of these characteristics, and others (such as the legal form of an instrument), could be used to determine a claim's classification and multiple characteristics could be combined in a single instrument. Therefore, any distinction between the various claims on an entity is unlikely to reflect each set of claims' true characteristics unless the distinguishing factor(s) reflects all important characteristics.



*The difference between a new element and differential presentation/disclosure within an element*

- 57 As the purpose of an element is to aggregate the financial effects of transactions and other events by grouping them for the purpose of constructing financial statements, the difference between elements needs to be pertinent for the purposes of constructing financial statements.
- 58 For the claims side of the Balance Sheet this paper defines the implications of classifying a claim as a specific element or another as being:
- (a) Whether the claim is directly measured or is included in the accounting residual; and
  - (b) which primary statement changes in the measurement are presented in (in current IFRSs in the Statement(s) of Comprehensive Income or in the Statement of Changes in Equity).
- 59 An alternative to recognising a new element is differential presentation/disclosure of the various claims contained within an existing element but without any difference in how the claims contribute to the construction of financial statements and interact with other elements.
- 60 For claims, this means that the consequence for the construction of financial statements of being classified as one element must be different to being classified as another. Differential presentation/disclosure requirements allow the different nature of the claims within an element to be highlighted to assist users of financial statements understanding the information presented but all claims classified as a single element have the same treatment in respect of measurement (are directly measured and remeasured or are part of the accounting residual) and which primary statement changes in the measurement are presented in.

**Differential disclosure/presentation within an element in current IFRSs**

The element of Income, where ‘The definition of income encompasses both revenue and gains’<sup>4</sup> is an example of conceptually recognised differential disclosure/presentation: all items classified as Income are treated the same in terms of interaction with other elements but revenue and gains are separately presented.

<sup>4</sup> Paragraph 4.29 of the Conceptual Framework.

- 61 In current IFRSs income and expense are defined by reference to changes in the elements of the Balance Sheet. Some ways in which a new element on the Balance Sheet could build the financial statements differently from those that currently depict claims are discussed later in this paper.
- 62 For claims, useful information may be presented by distinguishing between different types of obligations to transfer economic resources (e.g. redeemable shares and bank loans) but they are conceptually treated the same in current IFRSs (directly measured and changes in the measurement are income and expense).
- 63 Differential presentation/disclosure requirements may also be helpful in identifying any legal balances within particular categories. For example, in some countries share capital and share premium are legal balances related to classes of shares, and for claims that come from shares it may be useful for these balances to be identified.

## A SINGLE ELEMENT – THE ‘NO-SPLIT’ OR ‘CLAIMS’ APPROACH

- 64 There have been a number of suggestions, including one from an international Financial Instruments Working Group in 1990<sup>5</sup>, that the Balance Sheet should depict and describe the various claims on an entity as a continuum rather than a binary split – there would be **no-split** of the Balance Sheet. This would result in only a single element representing all claims. Different sorts of claims (such as trade creditors, ownership instruments, bank loans, bonds) could be differently presented/disclosed but would be conceptually treated the same in building financial statements.
- 65 However, if such an approach were to be taken, various fundamental aspects of current financial reporting would also have to be addressed:
- (a) how performance would be reported; and
  - (b) how claims should be treated in consolidated financial reporting (as the obligations of each legal entity in a group have different characteristics).
- 66 If there was only one element, then all of these claims would need to be treated conceptually the same and therefore measured directly. If all claims were measured directly, this would raise a question on how an entity should report the accounting residual. Different approaches exist, such as:
- (a) Having a Balance Sheet which does not balance. The accounting residual would therefore not present a problem for financial reporting.
  - (b) Having a free-floating debit or credit explicitly presented on the Balance Sheet and described as an accounting residual.

<sup>5</sup> Originally proposed by WA Paton in *Accounting Theory* (1922).

- 67 Some proponents of a no-split approach have stated that the ‘most residual’ claim would not be measured directly but would incorporate the accounting residual. Such an approach is not consistent with the view that all claims are conceptually the same but implicitly treats one class of claims differently to all the others. That is, it would be a binary split of the Balance Sheet, even if not called by that name.

*Consistency with objectives*

Liquidity Solvency	As all claims would be treated equally, users could derive their own judgements regarding liquidity and solvency.
Reporting financial performance	The approach would not be consistent with reporting financial performance according to current IFRSs as income and expense could no longer be defined based on changes in Balance Sheet elements. An alternative way of depicting performance would have to be developed; one possible way of doing so would be to classify items in the statement(s) of comprehensive income as operating, investing and financing rather than as income or expense. <sup>6</sup>
Returns to a particular class of instrument	Returns would be depicted in the Balance Sheet as the measurement of the claims would change but income and expense would not be reported by reference to the particular class.

## TWO ELEMENTS - A BINARY SPLIT

- 68 A binary split is consistent with current IFRS requirements where the two elements are labelled ‘equity’ and ‘liabilities’. Equity is the surplus of recognised assets over recognised liabilities and incorporates the accounting residual; claims classified as liabilities are directly measured.
- 69 Claims classified as equity are claims on the surplus of recognised assets over recognised liabilities, including the accounting residual. These claims are generally not directly measured, and in some entities there may not be a claim on all or part of the surplus of recognised assets over recognised liabilities (‘unclaimed equity’).

<sup>6</sup> Suggested in the IASB Discussion Paper *Preliminary Views on Financial Statement Presentation* published in 2008.

Liquidity  
Solvency  
Reporting financial performance

Consistency with these objectives depends upon how the elements are defined, which is discussed below. Choices made with the respect of meeting one particular objective may result in failing to meet one or more of the others.

Returns to a particular class of instrument

If only a single class of instruments is classified as equity, then a binary split is consistent with depicting the returns to a particular class of instrument. If definitions of the elements results in more than one class of instrument being classified as equity then the returns to a particular class of instrument will not be depicted.

## MORE THAN TWO ELEMENTS

- 70 Another approach would be for the Balance Sheet to contain more than two elements, with each of the elements contributing to the construction of the financial statements in different ways.
- 71 Some respondents<sup>7</sup> to the Conceptual Framework DP suggested the creation of a third element, for claims that were considered to have characteristics of both equity and liabilities.<sup>8</sup>
- 72 For any additional element the questions that need to be answered are:
- (a) Are claims classified as the element directly measured or are they part of the accounting residual; and
  - (b) Which primary statement shows changes in the measurement of the claims classified as this element.

<sup>7</sup> Including the Accounting Standards Board of Japan, who proposed that equity be defined as the most residual claim and items that are neither equity nor liabilities be presented in a mezzanine category. This mezzanine category would therefore include, for example, warrants, preferred shares and non-controlling interests.

<sup>8</sup> As noted in the section *Positive or negative definitions to determine classification* having claims with characteristics of both equity and liabilities requires positive definitions of both of these elements.

### Example of three elements (a 'ternary split')

The former UK GAAP standard FRS 4 *Capital Instruments* required three elements (in individual entity financial statements) to be recognised on the claims side of the statement of financial position:

- Equity shareholders' funds;
- Non-equity shareholders' funds; and
- Liabilities.

Liabilities were obligations to transfer economic benefits (unless they were in the legal form of a share) and equity shareholders' funds included warrants or options on equity shares.

Equity shareholders' funds contained the accounting residual (recognised assets less recognised liabilities less recognised non-equity shareholders' funds). Non-equity shares and liabilities were measured directly.

Dividends on both equity and non-equity shares were accounted for as an allocation of profit. Payments made on liabilities were interest expenses and therefore reductions in profit.

Differential disclosure/presentation requirements applied to different sorts of claims within each of these elements, including between convertible and non-convertible debt.

- 73 Additional elements could assist in solving classification problems for a number of areas, including:
- (a) obligations that may be settled by the transfer of claims on equity;
  - (b) claims that are obligations to transfer economic resources and whose value changes depending upon entity-specific variables; and
  - (c) obligations to transfer economic resources that are contractually written down in certain circumstances (such as contingent capital bonds issued by regulated banks).
- 74 Increasing the number of elements increases complexity, especially with respect to instruments that contain multiple claims and determining how they interact with the primary financial statements.

75 Paragraphs 171-195 identify three potential elements other than equity and liabilities. These paragraphs discuss how they could interact with existing elements and how they may be consistent with the objectives. The paper also considers possible advantages and disadvantages of including each of these three extra elements.

*Consistency with objectives*

Liquidity

Solvency

Reporting financial  
performance

Consistency with these objectives depends upon how any additional elements are defined, which is discussed below.

Returns to a particular  
class of instrument

# Positive or negative definitions of elements

- 76 This section of the paper discusses the consequences of positive and negative definitions of elements. It uses the example of a Balance Sheet where claims are classified into two elements (liabilities and equity), identifies some possible positive definitions of equity and analyses the IASB's proposed positive definition of liabilities from the Conceptual Framework DP.
- 77 Paragraphs 78-84 discuss the role of positive and negative definitions of equity and liabilities and the consequences for having multiple positive definitions.

## POSITIVE OR NEGATIVE DEFINITIONS

- 78 Positive definitions of elements use the presence of a distinguishing feature to define the element. Liabilities are defined positively in current IFRSs as the presence of an obligation to transfer economic resources. A negative definition is the opposite, and uses the absence of the distinguishing characteristic to drive classification – as in current IFRSs where equity is the absence of an obligation to transfer economic resources.
- 79 Using two positive definitions results in definitions of elements that overlap<sup>9</sup> or may not cover all claims.
- 80 To avoid this means that using a positive definition of equity requires a negative definition of a liability and using a positive definition of liabilities requires a negative definition of equity.
- 81 Having two overlapping definitions requires deciding:
- (a) how claims which meet both definitions should be classified; or
  - (b) whether claims which meet the definitions of both elements are therefore a new element.

### Consequences of two positive definitions

U.S. GAAP contains positive definitions of both equity (including requirements contained within securities laws and regulations) and liabilities.

There are instruments that meet either both of these definitions or neither, or which meet the (legal) definition of one but have economic characteristics similar to the other.

This has resulted in an additional 'mezzanine' or 'temporary equity' category on the Balance Sheet of many entities, despite the concept not being included in an accounting standard.

<sup>9</sup> It may be possible to have two positive definitions, but to avoid overlapping definitions by stating 'other than those that meet the definition of the other element'. This was the approach taken in FRS 4 for obligations to transfer economic resources, which were classified as financial liabilities unless they took the legal form of a share (and were therefore classified as either equity shareholders' funds or non-equity shareholders' funds).

- 82 Deciding which element the claim should be classified into could be done, for example, based on a notion such as the ‘predominant characteristic’ of the claim. If claims which meet both definitions are classified in a new element then the two questions identified in paragraph 58 need to be answered.
- 83 Having definitions of elements that may not cover all claims results in a new element, with the same consequences as above.
- 84 If there were more than two elements defined, multiple positive definitions would be required (in fact one less positive definition than the number of elements wanted). It would have to be decided how these interact with each other, for example if meeting the definition of one element ‘trumped’ the fact that the claim met another, or if a claim were to be classified based on its predominant characteristic.

### Approach taken in current IFRSs

Current IFRSs use a negative definition of equity and a positive definition of a liability. Equity on the Balance Sheet has no meaning other than being the surplus of recognised assets over recognised liabilities.

A **claim on equity** is a claim on the entity that is not a liability (described as ‘the residual interest in the assets of the entity after deducting all its liabilities’ in the Conceptual Framework for Financial Reporting).

‘Residual’ is therefore used in two distinct meanings when discussing equity, meaning both the part of the Balance Sheet that is a residual (the accounting residual) and the claims on the entity that are not liabilities.

# Which element should be defined positively

- 85 This section discusses which element should be defined positively within the example of a two element approach where only one element is defined positively.
- 86 Paragraphs 89-115 discuss potential positive definitions of equity, including whether the perspective of financial reporting taken (the entity perspective or the proprietary perspective) may influence a positive definition.
- 87 Paragraphs 116-140 discuss the positive definition of a liability included in the Conceptual Framework DP, analysing its two main components.
- 88 If there were to be more than two elements additional positive definitions would be required for these elements. Some potential additional elements are discussed in paragraphs 171-195.

## A POSITIVE DEFINITION OF EQUITY

- 89 The perspective of financial reporting may have a role to play in identifying a positive definition of equity and this paper considers the consequences of choosing a proprietary perspective or an entity perspective<sup>10</sup>.

### *A positive definition of equity within a proprietary perspective to financial reporting*

- 90 In a proprietary perspective to financial reporting, the financial report takes the perspective of the current owners of the entity. The instruments that are held by the owners of the entity in their capacity as owners ('ownership instruments') are the equity of the entity. All other claims reduce the resources available to these owners and therefore are something else (such as, but not limited to, liabilities). This would include claims where there is no current obligation to transfer economic resources, such as outside shareholders in partially owned subsidiaries, share options and warrants.
- 91 Some national GAAPs historically had a positive definition of equity based on legal definitions, for example a claim that was a share in a company was equity, irrespective of economic characteristics. This is consistent with a proprietary perspective, with financial reporting aimed at the owners of the entity.
- 92 In many countries the holders of ownership instruments have a special status in law, including the ability to influence the strategic direction of an entity (e.g. through voting and appointment of directors). Classifying ownership instruments as equity would be consistent with this special status and some may view it as consistent with the stewardship objective, although it would be at the expense of producing decision-useful information as classification would no longer be based upon economic characteristics.

<sup>10</sup> A parent-entity perspective may also be taken, in which case claims in financial instruments issued other than by the parent within consolidated financial statements are classified differently to claims in financial instruments issued by the parent. The claims could either be classified as a liability or as a different element. Before the 2007 amendments to IAS 27 *Consolidated and Separate Financial Statements* claims on the subsidiaries of a group that were not liabilities ('Minority Interests') were classified as a separate element between equity and liabilities, consistent with a parent-entity perspective.

- 93 Differential presentation/disclosure could be used to identify those claims that did not contain an obligation to transfer an economic resource.
- 94 The instruments held by owners may oblige the entity to transfer an economic resource if so required by the holders. For example, in some partnerships and cooperatives the ownership instruments are redeemable at the request of the holder. In the case of credit unions, these ownership instruments may take the form of demand deposits.
- 95 Treating ownership instruments as equity is consistent with the notion of equity as the owners' 'own funds', which is how 'equity' is translated in a number of languages. Instruments with identical economic characteristics might be treated differently within different entities, depending on whether they were considered to be ownership instruments or not.
- 96 Within a proprietary perspective a choice needs to be made on how to determine which claims are ownership instruments, and therefore equity.
- 97 Some ways of doing this include:
- (a) The most residual instruments;
  - (b) Shares/no-shares;
  - (c) Claims held by the legal owners in their capacity as owners;
  - (d) Control; and
  - (e) A free choice.

The most residual instruments

- 98 The possibility of defining an entity's 'most residual instrument' as equity has been raised in a number of documents, including the FASB Preliminary Views document *Financial Instruments with Characteristics of Equity* ('the FICE Paper') and the Conceptual Framework DP, but none defined the term. IAS 33 *Earnings per Share* defines Ordinary Shares but the definition has proven difficult to apply for entities other than those structured as companies and for those entities with multiple classes of instruments classified as equity.
- 99 The FICE paper also contained a proposed definition of a liability that was consistent with this definition of equity, being 'a claim, the probability-weighted outcome of which would reduce the assets available for distribution to basic ownership instruments'.

100 If otherwise there would be no instruments classified as equity, IAS 32 requires some instruments to be classified as equity if they are subordinate to all others and entitle the holder to a pro-rata share of the net assets of the entity only on liquidation. As was identified in the Conceptual Framework DP, identifying the most residual instrument may require significant work at a standards level, because:

- (a) The instrument that is most residual may change depending on the existence of other instruments (including those issued subsequently);
- (b) Different instruments may be the most residual depending on whether residual is defined by reference to participation in ongoing returns, subordination, participation on liquidation or otherwise; and
- (c) It is unclear how the concept of most residual interest applies in a group context, given the potential extent of structural subordination. For example, the holders of non-controlling interests in a partly-owned subsidiary are only 'most residual' when it comes to profits (losses) in that subsidiary, but are not 'most residual' in relation to profits (losses) elsewhere in the group.

#### Example of most residual instrument changing

The only share class in issue from a company is puttable to the entity at net asset value and is deemed to be the most residual<sup>11</sup> instrument.

The company later issues a share class that is not puttable but has equal rights to dividends. Because this later issued share class is not puttable, it is more residual than the earlier issued instruments.

101 Given these issues, applying the notion of 'most residual' is troublesome and may have little meaning in the context of consolidated financial reporting.

#### Shares/no-shares

102 In a number of national GAAPs, the distinction between equity and liability is driven by the legal form of instruments issued. For example, the shares of a limited liability company that convey ownership may be classified as equity. The terms and conditions that apply to these shares may be dependent upon applicable legislation.

103 A variety of legal and economic characteristics may be contained in an instrument with the legal form of a share, including obligations to transfer economic resources.

<sup>11</sup> Based on residularity being defined as access to capital invested before liquidation.

- 104 IFRSs cannot use a shares/no-shares distinction to classify claims, because IFRS must apply across a broad range of corporate structures and legal environments, including those entities where there are no shares (e.g. partnerships).

Claims held by legal owners in their capacity as owners

- 105 The notion of a distinction based on instruments being shares or not for companies could be expanded to other corporate structures, such as partnerships. Complications may arise if the legal framework does not specify whether instruments are ownership instruments or not.

Control

- 106 A distinction based on whether the holders of a class of instrument have the ability to control the entity would be consistent with IFRS 10, which uses the notion of control to define the boundaries of an entity. As with other options within the proprietary perspective, it would result in instruments with almost identical economic characteristics being classified differently, for example shares that have identical payoffs but with different voting rights. Such differences are common in technology companies where the founders wish to retain control but access public markets for liquidity reasons.

**Example of a problem caused by using a control notion**

Facebook's shares include Class A and Class B stock. These share classes equally participate in returns, but each Class B share has ten times the voting power of a Class A share.

As a class, holders of Class B shares can outvote all Class A shares. Using a control notion would therefore result in Class A shares being defined as liabilities but having identical return characteristics to Class B shares which would be classified as equity.

- Free choice
- 107 Entities could be allowed a free choice of how they identify 'ownership instruments', which would solve problem with the above approaches. However this would mean that there would be limited comparability and consistency between entities.
- 108 It should be noted that recent decisions of the IASB in a number of projects (including *Business Combinations* and *Consolidated Financial Statements*) reflect an entity perspective to financial reporting and this is expected to be explicit in the forthcoming Conceptual Framework Exposure Draft<sup>12</sup>. Classifying equity from a proprietary perspective would not be consistent with these decisions.

<sup>12</sup> As per the IASB decisions at its meeting of May 2014.

## Consistency with objectives

Liquidity Solvency	A positive definition of equity based on ownership instruments would not be consistent with depicting solvency or liquidity, as basic ownership instruments could include obligations to transfer economic resources.
Reporting financial performance	This objective would not be met as claims that do not include an obligation to transfer economic resources would be classified as a liability and therefore measured through the statement(s) of comprehensive income.
Returns to a particular class of instrument	Returns would be depicted in the Balance Sheet as the measurement of the claims would change but income and expense would not be reported by reference to the particular class.

### *A positive definition of equity within an entity perspective to financial reporting*

- 109 Within an entity perspective financial information is presented from the perspective of the entity as an economic unit separate from its owners. The distinction between classes of claims may be determined based on the economic characteristics of the instruments.
- 110 Although this is not explicitly stated anywhere in current IFRSs, an entity perspective is consistent with requirements in recently developed standards on business combinations and consolidated financial statements.
- 111 There are a number of views as to what an entity perspective means with respect to financial reporting and particularly the classification of claims. This paper uses the description of the entity perspective included in the May 2008 Exposure Draft of revisions to Chapters 1 and 2 of the *Conceptual Framework for Financial Reporting*. From that definition entity perspective financial reporting results in financial statements that ‘reflect the perspective of the entity rather than the perspective of the entity’s equity investors, a particular group of its equity investors or any other group of capital providers.’ As a consequence, an instrument with the same economic characteristics is classified in the same way across reporting entities.

### The problem of using a market participant perspective

Venture capital backed entities frequently issue shares that are valued similarly to equity, but have a cap on returns. Above this cap their returns become more like debt than equity.

With a market participant approach, these instruments would be classified as equity if it looks like returns would be below the cap and liabilities if the returns would be above the cap.

The opposite classification would happen with convertible bonds – they would be classified as liabilities if they were not expected to convert but equity if they were.

- 112 Within an entity perspective to financial reporting the PAAinE DP identified the contractual ability to absorb losses as the distinguishing characteristic of equity. Other possible positive definitions have been suggested, such as defining equity based on the views of market participants or as claims that do not increase either the **cash leverage** or the **return leverage** of the entity.
- 113 It has proven difficult to convert these conceptual approaches into standards, particularly in relation to suggestions around market participant perspectives. This is because approaches to valuation may change depending on the views of the economic circumstances of the entity.
- 114 It may be possible to develop a positive definition of equity that does not have these problems.

#### Consistency with objectives

Liquidity

Solvency

Reporting financial performance

A positive definition of equity could be consistent with meeting these objectives, but that would require developing a positive definition that could then be tested against them.

Returns to a particular class of instrument

If only a single class of instruments is classified as equity, then a binary split is consistent with depicting the returns to a particular class of instrument. If definitions of the elements results in more than one class of instrument being classified as equity then the returns to a particular class of instrument will not be depicted.

### *Consequences for the definition of a liability*

- 115 If only one element is to be defined positively and that element is chosen to be equity, a new definition of a liability as a residual would need to be developed, potentially including claims that do not include an obligation for the entity to transfer economic resources. Equity would no longer be calculated as assets minus liabilities, but liabilities would be assets less equity.

## **A POSITIVE DEFINITION OF A LIABILITY**

- 116 The other option is to positively define liabilities with a negative definition of equity. The Conceptual Framework DP suggested a positive definition of a liability as 'a present obligation of the entity to transfer an economic resource as a result of past events'. The assessment with respect to the objectives has been carried out based on this definition but other definitions are possible, which could result in different assessments.

- 117 The definition from the Conceptual Framework DP incorporates two important notions:

- (a) an obligation must exist; and
- (b) the obligation must be to transfer economic resources.

- 118 This positive definition of a liability is consistent with an overall objective of the Balance Sheet depicting the liquidity of an entity.

### *The existence of an obligation*

- 119 Although a simple concept, it has proven difficult in practice to identify whether an obligation exists. The areas in which decisions need to be taken for developing standards for determining whether an obligation exist include:

- (a) the breadth of the fact pattern to be included in determining whether a claim contains an obligation:
  - (i) economic compulsion and contractual options without commercial substance;
  - (ii) obligations that arise only on liquidation of the reporting entity;
  - (iii) implied terms (including terms brought into the instrument from statute and/or regulatory requirements<sup>13</sup>);

<sup>13</sup> IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* contains an example of how terms can be introduced into the instrument by statute or regulatory requirements and provides accounting requirements for restrictions on overall payments that do not affect individual claims.

- (iv) the boundaries of the entity; and
- (v) restrictions on overall payments that do not affect individual claims<sup>13</sup>;
- (b) obligations dependent upon future actions within a counterparty's control;
- (c) obligations dependent upon future actions outside the control of both a counterparty and the entity; and
- (d) obligations dependent upon future actions within an entity's control or measured by reference to entity-specific variables.

120 The Conceptual Framework DP contained extensive discussion on the problems of determining whether an obligation exists when the obligation is dependent upon future actions within an entity's control. The discussions in the Conceptual Framework DP did not focus on circumstances relevant to classification of claims, but do serve to illustrate some of the many difficulties in determining whether there is an obligation.

*The obligation must be to transfer economic resources*

- 121 As a consequence of the proposals in the Conceptual Framework DP obligations to issue equity instruments would not have been classified as liabilities.
- 122 The classification of obligations to transfer claims on equity is discussed separately below.

*Consistency with objectives<sup>14</sup>*

Liquidity	This definition of a liability would be consistent with depicting liquidity as liabilities would be limited to the entity's obligations to transfer economic resources.
Solvency	This definition of a liability (within the example of a two-element classification model) would not be consistent with depicting solvency due to the classification of instruments where holders of the claim give up their right to future participation in returns in exchange for the present fair value <sup>15</sup> , these instruments theoretically only impact an entity's liquidity, not its solvency.

<sup>14</sup> Based on the definition of a liability proposed in the Conceptual Framework DP.

<sup>15</sup> Fair value in this context means the wider concept rather than the specific results of an application of IFRS 13 *Fair Value Measurement*.

Reporting financial performance

This objective is not met for two reasons:

- for instruments where the obligation depends on entity-specific variables the relevance of reported financial performance may be reduced; and
- for obligations to transfer claims on equity the relevance of reported financial performance is reduced because the entity's own equity instruments could be being used as 'currency' to settle obligations arising from trading, borrowing or investing activities (as discussed further below).

Returns to a particular class of instrument

If there is more than a single class of instrument being classified as equity, the proposal is not consistent with depicting the returns to a particular class.

## OBLIGATIONS TO TRANSFER CLAIMS ON EQUITY

- 123 This section discusses obligations that require an entity to transfer claims on equity, or obligations that an entity may choose to settle by transfer of claims on equity. The classification of these obligations also has consequences for the classification of rights to receive equity claims and on the accounting for written and purchased **derivatives over own equity that are physically settled**.
- 124 An obligation to transfer (issue) claims on equity of the entity is an obligation of the entity but it is not an obligation to transfer economic resources [of the entity] and therefore does not meet the proposed definition of a liability as discussed above. This section discusses whether the proposed definition of a liability could be expanded to encompass these obligations.
- 125 A fundamental difference between obligations to transfer economic resources and obligations to transfer claims on equity is that economic resources must be obtained somehow by the entity and there may be external limits on how these economic resources can be obtained.
- 126 For claims on equity there are no externally imposed limits on how these claims can be obtained. Any restrictions are internal to the entity. For example, although many entities purchase shares, hold them as **treasury shares**, and use them to fulfil share-based payment obligations to avoid dilution of existing equity holders this is a choice of the entity. If there was an externally imposed requirement for the entity to purchase the shares, the entity would have an obligation to transfer economic resources.

- 127 In current IFRSs the classification of these obligations depends on how they arise:
- (a) if the obligations arise in exchange for goods or services they are accounted for under IFRS 2 and are classified as equity; and
  - (b) if the obligations arise in exchange for cash or another financial instrument they are accounted for under IAS 32 and classified as liabilities unless they fall under a number of exceptions, including:
    - (i) if the obligation is to deliver a fixed number of equity instruments<sup>16</sup>; or
    - (ii) if the obligation arose from a rights issue denominated in a foreign currency.
- 128 The Conceptual Framework DP suggested that all obligations to transfer equity instruments be classified as equity (the ‘strict obligation’ approach). This was thought to be consistent with the objectives of depicting liquidity and solvency.
- 129 This proposal was criticised by EFRAG and other respondents for a number of reasons, including:
- (a) Instruments with issuer settlement options would be classified as equity, even if they were expected to be settled in cash; and
  - (b) Almost any transaction could be structured to achieve equity treatment (and thus not be remeasured through comprehensive income). This could include instruments that arise through trading, borrowing or investing activities.
- 130 It was therefore felt that the strict obligation approach would not appropriately depict liquidity, solvency or financial performance of the entity.
- 131 The current requirements in IAS 32 appear to have been driven by similar concerns, in particular circumstances in which ‘an entity uses its own equity instruments ‘as currency’ in a contract to receive or deliver a variable number of shares whose value equals a fixed amount or an amount based on changes in an underlying variable...’<sup>17</sup>. In these circumstances the holder of the claim’s exposure to the entity is determined by the underlying variable rather than anything else.
- 132 Classifying obligations to transfer claims on equity as liabilities (but with disclosure that they may or will be settled by transfer of claims on equity rather than of economic resources) would solve these problems. However some exceptions (such as one similar to the fixed-for-fixed exception in IAS 32) would still need to remain. This is because, in many entities, instruments that never result in an obligation to transfer an economic

<sup>16</sup> Actual claims on equity that are not also liabilities or potential claims on equity (other than potential claims on equity where a fixed number of actual claims will be delivered). This is known as the ‘fixed-for-fixed’ criterion in IAS 32.

<sup>17</sup> Paragraph BC10 of IAS 32.

resource contain 'class switching' features. For example one share class may only be eligible to be held by the employees of the entity; an employee leaving automatically results in exchange of their current shares for those of a different class. Without such an exception these instruments would be classified as liabilities.

#### *Rights to receive claims on equity*

- 133 Classifying obligations to issue equity instruments as liabilities results in a problem in the classification of rights to receive claims on equity. Upon settlement the required equity instruments will be treasury shares (i.e. a debit within equity) rather than an asset. A right to receive a claim on equity will not result in the entity receiving an economic resource and therefore classifying rights to receive claims on equity as assets requires a different definition of an asset.

#### *Written and purchased physically-settled derivatives over equity claims*

- 134 The accounting for written and purchased physically-settled derivatives over equity claims depends upon the decisions taken with respect to obligations to transfer and rights to receive claims on equity.
- 135 If these obligations and rights are classified as liabilities and assets, the accounting should probably be the same as for any other written or purchased physically-settled derivative, with measurement incorporating both the probability of exercise and the net amount that would be transferred ('net presentation').
- 136 In the case of obligations to transfer an economic resource in exchange for receiving a claim on equity, net presentation does not depict liquidity because a claim on equity is not an economic resource; an entity cannot use a claim on itself to satisfy an obligation that requires transfer of an economic resource.
- 137 Net presentation would result in equity not depicting the amount of economic resources of an entity in excess of its obligations, thus being inconsistent with an objective of distinguishing between equity and liability of depicting an entity's liquidity.
- 138 If these obligations and rights are not classified as liabilities and assets then it needs to be decided how such instruments are presented.

### *Consistency with objectives*

- 139 The discussion on consistency with objectives assumes that, as a result of classifying obligations to transfer claims on equity as liabilities, rights to receive claims on equity would be classified as assets. Physically-settled derivatives over own equity are assumed to be accounted for in the same way as other derivatives.

Liquidity	Expanding the definition of a liability to include obligations to transfer claims on equity would not be consistent with depicting liquidity. Although differential presentation/disclosure could be used to identify which obligations could be met by transferring claims on equity classifying rights to receive claims on equity as assets means that the balance sheet would not meet the objective of depicting liquidity.
Solvency	Depicting these obligations and rights as liabilities and assets is consistent with the solvency objective as the balance sheet would depict rights and obligations for transfers of value, rather than of economic resources.
Reporting financial performance	Reported financial performance might have more relevance, as the revised definitions of assets and liabilities would mean income and expense be defined by respect to changes in value, rather than changes in recognised economic resources. This would be particularly the case for written put options over own equity, which involve an obligation to transfer an economic resource in exchange for a claim on equity.
Returns to a particular class of instrument	If there is more than a single class of instrument being classified as equity, the proposal is not consistent with depicting the returns to a particular class.

### *An additional element?*

- 140 Classifying obligations to transfer (and rights to receive) equity instruments as either equity or as liabilities (assets) have significant problems. One possible way of avoiding these problems would be to recognise an additional element on the credit side of the Balance Sheet, containing both rights to receive equity instruments and obligations to transfer equity instruments. These rights could be measured in accordance with contractual terms. Presenting remeasurement within comprehensive income would address the concerns associated with either of the two main options. This is further discussed in paragraphs 181-188 below.

# Is the unit of account the claim or the instrument

- 141 A single legal instrument can contain terms such that there is more than one claim and these claims could be classified differently. These instruments containing multiple claims can, in some circumstances, also include an asset. This paper identifies two broad types of such instruments<sup>18</sup>:
- (a) **instruments containing separate claims**; and
  - (b) **instruments containing mutually exclusive claims** (i.e. there are alternative settlement scenarios).
- 142 A single legal instrument could contain both separate claims and mutually exclusive claims (for some of the claims).
- 143 In developing classification requirements it needs to be decided whether such an instrument should be separated into two separate claims, or classified as a single claim, perhaps based on predominant features within the instrument. If classified as a single element, the instrument could be classified once when the instrument is issued, or it could be periodically reassessed to identify if the predominant feature has changed.
- 144 Classifying these instruments as a single claim based on predominant features within the instrument is only possible if both equity and liability are positively defined. If only one element is defined, then the claim would be classified based on whether it met that definition or not. For example, if only liabilities are positively defined any instrument containing a claim meeting the definition of a liability would be classified as a liability.

## INSTRUMENTS CONTAINING SEPARATE CLAIMS

- 145 A single legal instrument can contain both a liability and also be a claim on equity. Examples of instruments containing separate claims are:
- (a) a puttable/redeemable instrument (a liability) that also contains **rights to distributions (an actual claim on equity)**; and
  - (b) an (investment) insurance contract that contains a guaranteed return and a 'bonus' element that is at the discretion of the entity.
- 146 This single instrument could either be classified solely as a liability, the unit of account being the instrument, or it could be separated and two separate claims recognised, the unit of account being the claim.

<sup>18</sup> Other types of instruments that are not considered in this paper are those that contain multiple claims, none of which are claims on equity.

- 147 In current IFRSs, paragraph AG37 of IAS 32 generally requires that an instrument that is a liability and also a claim on equity is recognised as two separate claims (the unit of account is the claim). The June 2013 IASB Exposure Draft *Insurance Contracts* proposed recognising only a liability and paragraph 18 (b) of IAS 32 states puttable instruments are financial liabilities (the unit of account is the insurance contract/instrument).
- 148 The Conceptual Framework DP suggested that such decisions on unit of account continue to be made at the level of individual standards.
- 149 Classifying the entire instrument as a liability (and therefore recognising servicing payments as interest income and expense) may improve understandability and reduce complexity, but it has consequences. In particular, either:
- (a) if measurement of the liability does not incorporate payments that the entity is not obliged to make, day-one gains may be recognised; or
  - (b) if measurement of the liability includes payments that the entity is not obliged to make, gains may be recognised on (or before) settlement of the obligation.
- 150 Deciding the unit of account is the instrument would result in the financial statements portraying total liabilities as in excess of the entity's obligations to transfer economic resources, which has the potential to mislead users of financial statements.
- 151 Having the unit of account as the claim avoids both of these problems, but at the cost of additional complexity, both for preparers and for users. The existing requirements of paragraph AG 37 of IAS 32 have sometimes been criticised for leading to counter-intuitive outcomes, for example when the liability is initially measured at the full amount received for issue of the instrument and therefore the claim on equity is measured at zero (but dividends are still debited to equity).
- 152 One consequence of classifying multiple claims from a single legal instrument is that there needs to be a positive definition of a claim on equity. This is required to distinguish instruments that are issued at more than the value of the obligation between those containing a claim on equity and those where the entity was able to transact at an off-market price ('day one gains').

## INSTRUMENTS THAT CONTAIN MUTUALLY EXCLUSIVE CLAIMS

153 Some instruments may contain obligations to deliver economic resources, but may result in delivery of claims on equity. This could be either because of a choice made by the holder or because of a circumstance beyond the control of both the holder and the issuer. They have alternative settlement scenarios and are therefore instruments containing mutually exclusive claims.

154 The instrument is a liability because the entity has an obligation to transfer economic resources. The question that arises is whether and how to recognise the **potential claim on equity** (the classification of these potential claims on equity is dependent upon the decision on how to classify obligations to transfer claims on equity). Unlike instruments that contain both an actual claim on equity and are a liability, these instruments do not result in day-one (or settlement date) gains if the unit of account is considered to be the instrument rather than the claim.

### Examples of instruments containing multiple settlement options

A convertible bond is a simple example of an instrument that converts to claims on equity on the choice of the holder.

Contingently convertible bonds that convert to equity at the sole discretion of a regulator are instruments that convert because of a circumstance outside the control of both the holder and the issuer.

155 However the result of not separating instruments that have alternative settlement scenarios into multiple claims is that economic reality may not be reflected, particularly with respect to an entity's financing costs.

156 A simple convertible bond is economically identical to issuing a non-convertible bond and writing separate warrants that may only be exercised at the moment the bond matures. Accounting for these two sets of transactions differently would result in accounting for legal form (a single convertible bond), not economic substance (a non-convertible bond and warrants).

157 However for some instruments it may not be possible to value these alternative settlement scenarios independently because of the way they interact with each other.

# Depicting dilution and the rights of claims on equity

- 158 This section discusses options for depicting dilution and the rights of claims classified as equity.
- 159 Irrespective of any decisions on how claims should be classified, users of financial statements need information on how their claims may be diluted in the future and what could cause that dilution.

## DILUTION

- 160 Dilution is an increase in the number of actual claims on equity caused by the conversion of potential claims on equity into actual claims on equity. The effect of the increase is that if the same amount of money is distributed, each actual claim on equity is entitled to less money.
- 161 The Conceptual Framework DP suggested that remeasuring obligations to transfer equity claims (what it called ‘secondary equity claims’) would assist in depicting dilution, but not all potential claims on equity are obligations to transfer claims on equity and therefore the proposals would not have sufficiently depicted all sources of dilution.
- 162 Potential claims on equity may or may not have been recognised as obligations to transfer claims on equity and accounted for in the same way as other obligations to transfer claims on equity. Whether or not a potential claim on equity is accounted for as an obligation to transfer equity instruments depends upon all of the factors identified above in the section *The existence of an obligation*.

### **A potential claim on equity that is not an obligation**

As discussed earlier it can be difficult to determine whether an obligation exists, if there is a trigger event that is a discrete event within the control of an entity. In IFRSs these are not usually determined to be obligations.

In respect of potential claims on equity, the obligation may crystallise upon the occurrence of an event within the control of the entity, for example an Initial Public Offering. Because the trigger event is within the control of the entity this is not an obligation, and would presumably not have met the definition of a secondary equity claim in the Conceptual Framework DP.

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- 163 Some other potential claims on equity that would appear not to have been depicted by the proposals in the Conceptual Framework DP include where the entity is required to transfer either economic resources or an equivalent value of claims on equity at the option of the holder and instruments that convert to claims on equity only if a regulator/supervisor requires.
- 164 It may be more useful for users to be shown (potential) dilutive effects through disclosures, for example through:
- (a) scenario analysis, depicting the instruments in issue and their rights and/or payoffs in various material scenarios; and/or
  - (b) the provision by the entity of financial models showing the rights that holders of various instruments have on net cash inflows, and how the number and types of these instruments may change.
- 165 EFRAG would especially welcome future research on how dilution could be depicted.



## THE RIGHTS OF CLAIMS ON EQUITY

- 166 In order to be able to assess the potential for future returns the holders of claims on equity need to be able to assess not just how many claims on equity there are now and in the future (due to dilution) but also the rights these claims have. This is, at least in part, because more than one class of instrument may contain claims classified as equity. These different classes of instrument might be described as 'A' or 'B' shares, '**preference shares**' or 'privileged shares'.
- 167 These claims could have different rights such as fixed or variable returns. There may also be inter-dependency of rights, for example if one class of claim is only entitled to receive a dividend if another class also receives them. For each period the various classes of equity each receive an **attribution of net income**.
- 168 For some instruments the claim on equity may be contained within a single legal instrument with a liability or other obligation (for example an instrument that has a 5% fixed return each year, plus the right to receive discretionary dividends). If it was decided the unit of account was the claim, the right to receive dividends would be classified as a claim on equity. To understand the resources available to holders of equity claims, information also needs to be provided to users on recognised obligations that relate to instruments containing claims on equity.

169 Portraying the returns to holders of the various classes of claims on equity can be difficult, due to the way they interact with each other. The requirements of IAS 33 are based around a simple corporate structure in which the only claims on equity are ordinary shares and preference shares; the inherent assumptions it makes about corporate structure may not always be applicable.

170 The best way of depicting the rights of various claims on equity, including any linked liabilities, may be through models or other disclosure and should be a topic for further research.

### Meaning of 'preference shares'

There is no uniform meaning of 'preference shares' and they may or may not contain an obligation to transfer an economic resource.

Under German law they ordinarily entitle the holder to a higher dividend than ordinary shares but do not have voting rights.

These shares are usually classified as equity under IFRSs as there is no obligation to transfer an economic resource.

For companies formed under the Companies Acts of the United Kingdom, preference shares can have almost any rights and may or may not contain a claim on equity.

- 171 Using additional elements to depict some of the claims on an entity may assist in reducing the extent to which the objectives conflict with each other. This section identifies three potential additional elements, discusses how they may interact with existing elements and some advantages and disadvantages of including these elements.
- 172 The three elements identified for discussion are:
- (a) Obligations to transfer economic resources where the measurement of the obligation (or part of the obligation) is dependent upon entity-specific variables (henceforth '**participating obligations**');
  - (b) Obligations to transfer claims on equity; and
  - (c) Instruments that are contractually bail-inable.

## PARTICIPATING OBLIGATIONS

- 173 Participating obligations are common across corporate structures and jurisdictions. Examples include instruments that require the entity to pay a certain proportion of annual profit as a dividend, contingent consideration in business combinations and shares that are puttable to the entity at an amount dependent upon entity-specific variables.
- 174 Classifying all obligations to transfer economic resources as liabilities and therefore remeasured through comprehensive income results in reduced relevance of reported financial performance as expectations of changed future performance of the entity are immediately recognised in a counter-intuitive way<sup>19</sup>:
- (a) increased expectations result in the recognition of an expense; and
  - (b) reduced expectations result in the recognition of income.
- 175 Similar concerns regarding portraying in profit or loss the changes in measurement of obligations measured at fair value caused by changes in the credit risk of an entity resulted in the 'own credit risk' amendments to IFRS 9 Financial Instruments.

### *Interaction with existing elements*

- 176 The concerns could be addressed by introducing a new element of participating obligations. This would result in a separation of the present element of liabilities into two:
- (a) Participating obligations; and
  - (b) Non-participating obligations.

<sup>19</sup> This is for instruments where the obligation is positively associated with performance. Some instruments contain obligations negatively associated with performance, for example obligations to transfer economic resources if a capital ratio falls below a certain level which are discussed below.

177 The definition of income and expense would be changed to refer to non-participating obligations rather than liabilities.

178 Changes in the measurement of participating obligations could be reflected in a Statement of Changes in Participating Interests, combined with the current features of the Statement of Changes in Equity.

*Consistency with objectives*

Liquidity	Splitting the element of liabilities into two means that, overall, classification requirements would depict liquidity in the same way as if there was only a single element. This objective would therefore be met.
Solvency	Splitting the element of liabilities into two means that, overall, classification requirements would depict solvency in the same way as if there was only a single element. This objective would therefore not be met.
Reporting financial performance	Splitting the element of liabilities would assist in meeting the identified conflict if liabilities are only a single element. This is because changes in the measurement of liabilities due to entity-specific variables would no longer be reported in the statement(s) of comprehensive income. As it does not impact the reporting of obligations to transfer claims on equity, problems identified above remain in that relevance of reported financial performance is reduced because the entity's own equity instruments could be being used as 'currency' to settle obligations arising from trading, borrowing or investing activities (as discussed further below).
Returns to a particular class of instrument	This would not be consistent with depicting the returns to a particular class of instrument because reductions in this class's rights to economic resources would not be reported as an expense.

### *Advantages and disadvantages*

- 179 The key advantage of introducing this additional element is that it would meet the objective of depicting liquidity and would assist in depicting financial performance.
- 180 Disadvantages that have been identified include:
- (a) Additional complexity for users in understanding financial statements;
  - (b) Additional complexity for preparers and auditors, particularly with respect to financial instruments containing both participating and non-participating obligations;
  - (c) Increased importance of day-one measurement for obligations where the entity receives goods or services in exchange. Examples of such obligations include cash-settled share-based payments as defined in IFRS 2. Currently any error in initial measurement is 'trued-up' prior to payment, with measurement errors recognised in comprehensive income. If changes due to entity-specific variables were not recognised in comprehensive income, initial measurement errors would be reflected in the Statement of Changes in Participating Interests, not in comprehensive income; and
  - (d) It would not assist in solving the problems with depicting returns when obligations are to transfer claims on equity.

## **OBLIGATIONS TO TRANSFER CLAIMS ON EQUITY**

- 181 The strict obligation approach in the Conceptual Framework DP was not supported by many constituents because it would have resulted in:
- (a) Instruments with issuer settlement options being classified as equity, even if they were expected to be settled in cash; and
  - (b) Almost any transaction could be structured to achieve equity treatment (and thus not be remeasured through comprehensive income). This could include instruments that arise through trading, borrowing or investing activities.
- 182 Classifying these obligations as equity would be counterproductive for the reporting of financial performance because they may arise from trading, investing or speculating activities which would better be portrayed in the statement(s) of comprehensive income. This is especially the case when the equity instruments are used as a 'currency' for settling a transaction.

- 183 Classifying these obligations as liabilities is not consistent with liquidity or solvency objectives, especially because of the consequential implication that rights to receive claims on equity are assets.
- 184 A new element, containing obligations to transfer claims on equity, could assist in meeting these objectives if it was remeasured through comprehensive income. Rights to receive claims on equity could also be classified within this element (albeit as a debit rather than a credit). Liabilities and assets would show obligations to transfer or rights to receive economic resources and the new element would show obligations and rights for the transfer of value that is not the transfer of economic resources.

### Obligations arising out of trading activities

An entity's own equity instruments can be used as 'currency' to settle transactions.

An entity writes an option to buy gold such that, if exercised, is settled net in the entity's own equity instruments by the entity delivering as many of those instruments as are equal to the value of the option contract.<sup>20</sup>

If classified as equity no changes in the value of the option would be recognised in the statement(s) of comprehensive income.

- 185 This new element might also present a possible solution to what some see as the counter-intuitive accounting for puttable shares and physically settled derivatives over own equity (including put options written over non-controlling interests):
- (a) The obligation to transfer an economic resource meets the definition of a liability and is therefore measured through comprehensive income; and
  - (b) The right for the entity to receive the claim on equity in return would meet the definition of a debit within this element and also measured through comprehensive income.
- 186 Whether this new element presents a solution to this counter-intuitive accounting would depend upon decisions taken on the measurement of such claims.

<sup>20</sup> This example was included in the Application Guidance to IAS 32 following amendments that classified obligations to transfer equity instruments as liabilities unless the obligations passed the fixed-for-fixed test. The amendments were introduced following a growth in the number of instruments structured to achieve equity classification.

### *Consistency with objectives*

Liquidity	The new element would assist in depicting liquidity as it would clearly identify which obligations must be settled by transfer of economic resources and which obligations may be settled by transfer of claims on equity.
Solvency	The new element could assist in depicting solvency in respect of instruments puttable to the entity, because the right to receive the claim on equity would be depicted appropriately (as a debit within claims).
Reporting financial performance	The new element would make reported financial performance more relevant if an entity's own equity instruments were used as 'currency' to settle obligations arising from trading, borrowing or investing activities the obligation would be measured through the statement(s) of comprehensive income.
Returns to a particular class of instrument	This would have no impact upon depicting the returns to a particular class of instrument as, if there were to only be a single class of instruments classified as equity, obligations to transfer claims on equity would automatically be classified as liabilities and there would therefore be no difference in reported performance.

### *Advantages and disadvantages*

- 187 The key advantage identified would be that it would enable the depiction of liquidity and assist with the depiction of an entity's financial performance.
- 188 The main disadvantage identified is additional complexity for users in understanding financial statements. It is also not clear how such a proposal could interact with any additional element, such as one for participating interests.

## CONTRACTUALLY BAIL-INABLE INSTRUMENTS

- 189 Some obligations to transfer economic resources contain contractual clauses such that the amount required to be transferred is written down upon the occurrence of certain trigger conditions outside the control of the reporting entity, such as the breach of a capital ratio or a decision by a regulator – they are **bail-inable instruments**.
- 190 The amount of such instruments in issue is expected to increase substantially due to regulatory and supervisory requirements.
- 191 Similar to participating instruments, counter-intuitive accounting may result from classifying such instruments as liabilities. This is because the entity records income when the instruments are written-down.

### *Interaction with existing elements*

- 192 These obligations could be classified into a new element that does not involve remeasurement through Comprehensive Income, but instead the full par value of the obligation is recognised on the Balance Sheet (until the trigger point is reached), with the write-off being recognised as an increase in equity rather than income.

### *Consistency with objectives*

Liquidity	Users would be able to clearly identify which obligations of the entity may not result in an outflow of economic resources because they could be written-down.
Solvency	Bail-inable instruments are usually triggered by events that imperil an entity's solvency and therefore having such claims specifically identified may assist in users understanding an entity's solvency.
Reporting financial performance	The reporting of financial performance would be assisted because no income would be recognised if the instruments are written down.
Returns to a particular class of instrument	This would not be consistent with depicting the returns to a particular class of instrument because increases in this class's rights to economic resources would not be reported as income.



*Advantages and disadvantages*

- 193 As noted above, the key advantage of using this additional element is that it would assist in meeting the objective of depicting liquidity and would assist in depicting returns to an entity.
- 194 It would also highlight to the holders of these claims that they are of a different nature to other obligations of the entity to transfer economic resources.
- 195 The key disadvantage identified is that such claims are relatively rare and are mainly found within financial institutions. It may not be viewed as appropriate to include in the Conceptual Framework a special requirement for a sub-set of entities. An alternative approach would be to address such instruments at a standards level, perhaps by requiring differential presentation/disclosure of such claims and/or overriding the conceptual definition of income for this specific class of instrument.

# Summary of consistency with objectives

- 196 Classification requirements are developed with the aim of meeting the objectives of depicting liquidity, solvency, an entity's financial performance and returns to the holders of a particular class of instruments.
- 197 Figure 2 summarises how each of the identified classification options is consistent with the overall objectives. It does not appear that any option is consistent with all of the objectives, and most options are not consistent with more than one objective. Having additional elements may assist in meeting the objectives, but comes at the expense of increased complexity.
- 198 A positive definition of equity could have the potential to meet more of the objectives than any other approach, but this depends upon how it is defined. Previous attempts to positively define equity have foundered on implementation difficulties, and particularly applying the overall definition to complex instruments.

## FIGURE 2: CONSISTENCY OF CHOICES WITH OBJECTIVES

This table summarises only the discussion in each section of the paper on consistency with objectives. It provides an overview of whether the various approaches are consistent and should be considered in conjunction with the detail provided previously.

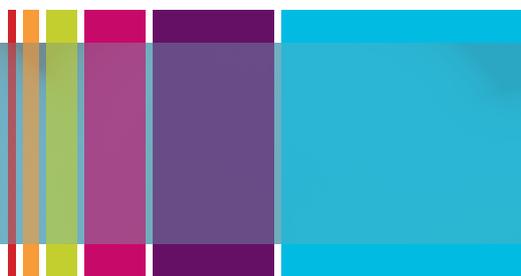
		Consistent (or assists) with the objective of depicting:				
		Liquidity	Solvency	Financial Performance	Returns to holders of a particular class of instrument	
One element – the claims approach		Yes	Yes	Would require a new approach	Not through the use of profit or loss	
Two elements	Positive definition of equity	Using 'basic ownership instruments' – a proprietary perspective	No	No	No	Yes
		Other possible definitions	Possibly	Possibly	Possibly	No
	Positive definition of liability	Obligation only to transfer economic resources	Yes	No	No	No
		Obligations include transferring claims on equity <sup>21</sup>	No	Yes	Assists	No
	Other possible definitions	Possibly	Possibly	Possibly	No	
Three or more elements	Participating obligations		Yes	No	Assists	No
	Obligations to transfer claims on equity		Yes	Assists	Assists	No impact
	Bail-inable instruments		Yes	Assists	Assists	No

<sup>21</sup> The analysis with respect to the objectives assumes that rights to receive claims on equity are consequently classified as assets.

# Common vocabulary/Glossary

- 199 In discussions around the classification of claims it has become clear that there is not a common vocabulary for describing and understanding the issues.
- 200 Below is list of terms and associated definitions/descriptions that are relevant to the classification of claims. The list has been compiled from previous relevant publications and developed in the hope that a common vocabulary will emerge to assist in developing classification requirements.

<b>Item</b>	<b>Definition/description</b>
Accounting residual	<p>The part of the Balance Sheet that is not directly measured. For a Balance Sheet to balance (debits=credits) there is at least one part that is not directly measured. This is the result of a number of factors including:</p> <ul style="list-style-type: none"><li>• measurement mismatches (i.e. mixed measurement model, including what may be termed the ‘prudence bias’ in measurement (onerous contracts recognised as a liability, an asset not recognised until the contract is fulfilled));</li><li>• recognition mismatches (e.g. contingent assets); and</li><li>• items that do not meet the definitions of assets or liabilities (for example future operating losses).</li></ul> <p>This accounting residual does not have a legal or economic substance per se but is a consequence of the accounting convention of double entry being applied in the preparation of financial statements.</p>
Actual claim on equity	Any contract that evidences a claim on the equity of an entity.
Attribution of net income	The attribution of an entity’s periodic surpluses and deficits amongst the various classes of equity claims, for example between equity holders of the parent and non-controlling interests.
Bail-inable instrument	An obligation to transfer economic resources that contains explicit contractual clauses such that the amount required to be transferred is written down upon the occurrence of certain trigger conditions, such as the breach of a capital ratio or a decision by a regulator.
Binary split	<p>The explicit split of the claims side of the Balance Sheet into two elements, commonly labelled:</p> <ul style="list-style-type: none"><li>• Equity (as defined below); and</li><li>• Liabilities.</li></ul>
Cash leverage	<p>The ratio of:</p> <ul style="list-style-type: none"><li>• financing obligations that must be settled by delivering cash (or other economic resources); to</li><li>• equity financing.</li></ul>



Claim	An entitlement to the economic resources of an entity. The entitlement may or may not incorporate an obligation for the entity to transfer economic resources.
Claim on equity	A present claim on the equity of the reporting entity. These include: <ul style="list-style-type: none"><li>• Actual claims;</li><li>• Potential claims on equity.</li></ul>
Claimed equity	The surplus of recognised assets over recognised liabilities upon which an actual identifiable claim is currently in existence. Under current accounting most of these claims are themselves not directly measured.
Derivatives over own equity that are cash settled	Instruments that will, upon settlement, result in the receipt or payment of cash (or another financial asset) but whose underlying is related to a claim on equity of the entity.
Derivatives over own equity that are physically settled	Instruments that will, upon settlement, result in the receipt or delivery of an actual or potential claim on equity. The occurrence of settlement may either be conditional (for example options) or unconditional (for example futures and forwards). Settlement may either be on a gross basis (delivery of claim(s) in exchange for an economic resource) or net basis (delivery of claim(s) for the exceeding amount only).
Dilution	An increase in the number of actual claims on equity. This increase may be caused by the conversion of potential claims on equity into actual claims on equity. The effect of the increase is that if the same amount is distributed, each actual claim on equity is entitled to less.
Element	The building block from which financial statements are constructed. Such building blocks are necessary because financial statements portray the financial effects of transactions and other events by grouping them into broad classes, the elements.
Entity perspective financial reporting	Financial reporting that acknowledges the reporting entity has substance of its own, separate from that of its owners, and reflects the perspective of the entity rather than the perspective of the entity's equity investors, a particular group of its equity investors or any other group of capital providers. Adopting the entity perspective does not preclude the inclusion in financial reports of additional information that is primarily directed to the needs of an entity's equity investors or to another group of capital providers.

Equity	In current financial reporting this is the difference between recognised assets and recognised liabilities and incorporates the Accounting Residual. Equity can be Unclaimed Equity and Claimed Equity.
Equity instrument	A financial instrument (or part of a financial instrument) that contains claims classified as equity and no claims classified as liabilities.
Financial instrument	Any contract that gives rise to a financial asset for one entity and claim(s) in another entity.
Instruments containing multiple elements	<p>A single legal instrument that contains both a claim on equity and that also meets the definition of a liability. Some instruments may also contain an asset.</p> <p>There are two types of such instruments:</p> <ul style="list-style-type: none"> <li>• Instruments containing separate claims; and</li> <li>• Instruments containing mutually exclusive claims.</li> </ul> <p>A single legal instrument could contain both separate claims and mutually exclusive claims.</p>
Instruments containing mutually exclusive claims	<p>An instrument that will, upon settlement, result in either the delivery of economic resources or claims on equity.</p> <p>An example is a convertible bond.</p> <p>It may or may not be possible to value these alternative settlement scenarios independently due to their interactions.</p>
Instruments containing separate claims	An instrument that contains claims that are both a liability and an actual claim on equity.
Instruments that change their nature	<p>A subset of instruments containing multiple elements may only meet the definition of a claim on equity or liability (or possibly another element) for a portion of their life.</p> <p>An example of such an instrument is an instrument that is only a liability for the first year following issue.</p>
Liquidity	The degree to which an entity has the economic resources required to meet its obligations, or is able to raise them by selling its economic resources or issuing new claims without affecting the value of its economic resources or its claims
Measured/ Measurement	<p>The process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the Balance Sheet and statement(s) of comprehensive income.</p> <p>Measurement incorporates both at initial recognition and subsequent changes.</p>
Most residual instrument/claim	<p>The claim on an entity that is subordinate to all other claims. This subordination could be defined in multiple ways, including with respect to participation in ongoing returns, on liquidation and with respect to the returns on certain entities within a group.</p> <p>The identification of this claim is dependent upon comparison with all other claims on the entity.</p>

Narrow equity approach	A method for distinguishing equity instruments from liabilities which would classify as equity only instruments in the most residual existing class of instrument issued by the parent.
Negative definition of an element	The definition of an element, and of claims classified as that element, is based on the absence rather than the presence of a distinguishing feature. For example in current IFRS an equity instrument is a claim that is not a liability [obligation to transfer an economic resource].
Negative definition of equity	Equity is defined as anything that does not meet the definition of another element (e.g. equity is the difference between assets and liabilities).
No-split approach	Only a single element is recognised on the credit side of the Balance Sheet and each claim on the entity is treated the same for classification purposes. The Balance Sheet would list the claims on the entity's assets and disclose the characteristics of the type of capital in the notes. Any distinction between the different types of capital provided to an entity would be at the discretion of the user of the financial statements who could then make his/her own definition of equity according to his/her specific user needs. This is a particular implementation of the entity perspective in which all claims on an entity are treated as conceptually the same. Implicit in this approach is the notion that every instrument is its own category, which may be aggregated for presentation purposes.
Ordinary shares	An equity instrument that is subordinate to all other classes of equity instruments.
Ownership instruments	Instruments that evidence ownership of an entity.
Participating obligations	Obligations to transfer economic resources where the measurement of the obligation is dependent upon entity-specific variables.
Positive definition of an element	The definition of an element, and of claims classified as that element, is based on the presence rather than the absence of a distinguishing feature. For example, liability is defined in current IFRS as an obligation to transfer an economic resource.
Positive definition of equity	Equity is defined as a separate element having certain attributes, such as loss absorption capability or based on the perspective of market participants.

Potential claim on equity	<p>A present obligation of the entity to transfer a claim on equity as a result of past events.</p> <p>This transfer could be at the option of either the issuer or the holder. The claim on equity that may be transferred could be either an actual claim or another potential claim.</p> <p>Current examples of such instruments include:</p> <ul style="list-style-type: none"> <li>• Convertible bonds;</li> <li>• Warrants;</li> <li>• Share options (including employee share options); and</li> <li>• Uncompleted rights issues.</li> </ul>
Preference share	<p>An instrument with the legal form of a share of a company that usually has different rights than an ordinary share. The nature of these rights depends upon various factors, including the legal environment (which may dictate what rights preference shares have).</p>
Proprietary perspective financial reporting	<p>Financial reporting that reflects the perspective of the entity's equity investors, a particular group of its equity investors or any other group of capital providers.</p>
Reserves	<p>Generic term for retained earnings, income and expenses recorded directly in equity (such as revaluation surplus as defined in paragraph 39 of IAS 16 <i>Property, Plant and Equipment</i>, cash flow hedging and other measurement reserves) and a capital surplus when the issuance price of new shares exceeds their respective par value.</p>
Return leverage	<p>The ratio of</p> <ul style="list-style-type: none"> <li>• financing obligations that do not share fully in the returns on the residual interest in an entity's assets less liabilities; to</li> <li>• obligations that do share in those residual returns.</li> </ul>
Right to receive equity claim	<p>A present right of the entity that may, upon settlement, result in the receipt of an instrument that contains a claim on equity.</p> <p>Upon settlement, these will be treasury shares.</p> <p>Examples of such instruments include:</p> <ul style="list-style-type: none"> <li>• Redeemable shares (with discretionary dividends);</li> <li>• Puttable instruments (with rights to discretionary dividends);</li> <li>• Put options written over own equity instruments (including Non-controlling Interests).</li> </ul>
Rights to distributions	<p>Rights to receive payments that are made at the discretion of the entity.</p> <p>The quantum of these distributions may be either fixed or determinable, or decided by the entity.</p>
Share	<p>An instrument evidencing ownership of a company within certain corporate structures and legal frameworks.</p>

Solvency	The degree to which the value of the economic resources of the entity exceeds the value of its obligations.
Strict obligation approach	An approach to distinguishing equity instruments from liabilities in which only obligations to transfer economic resources are classified as liabilities.
Ternary split	The explicit split of the claims side of the Balance Sheet into three elements.
Treasury share	<p>A claim on equity owned by the reporting entity. These are not assets because they are not capable of providing economic benefits to the reporting entity.</p> <p>Legally, reacquired own shares may be claims on the equity of the entity.</p>
Unclaimed equity	<p>The surplus of recognised assets over recognised liabilities upon which nobody has a claim. Circumstances in which this has arisen include, but are not limited to:</p> <ul style="list-style-type: none"> <li>• some cooperatives;</li> <li>• the UK Trustee Savings Banks; and</li> <li>• charities.</li> </ul>

# Questions to Constituents

## *Overall objectives*

- Q1 Do you believe EFRAG has appropriately identified the objectives to be used when assessing classification requirements? If not what other objectives do you think should be included or should any of the objectives be removed?

## *Classification choices*

- Q2 Do you believe EFRAG has appropriately identified the relevant choices that need to be made in determining classification requirements? If not, what other choices do you think need to be made and how do they fit with those that have been identified?

## *Elements*

- Q3 If you support classifying all claims as a single element (the claims approach) how do you think the accounting residual and unclaimed equity should be accounted for? How should financial performance be depicted?
- Q4 Do you think it is possible to positively define equity such that more of the identified objectives are met? If so, how should it be defined?
- Q5 Do you think it is possible to positively define liabilities such that more of the identified objectives are met? If so, how should it be defined?
- Q6 Do you think the inclusion of an additional element could assist in meeting some of the identified objectives? If so, what should that element be and how should it interact with the existing elements?

## *Dilution*

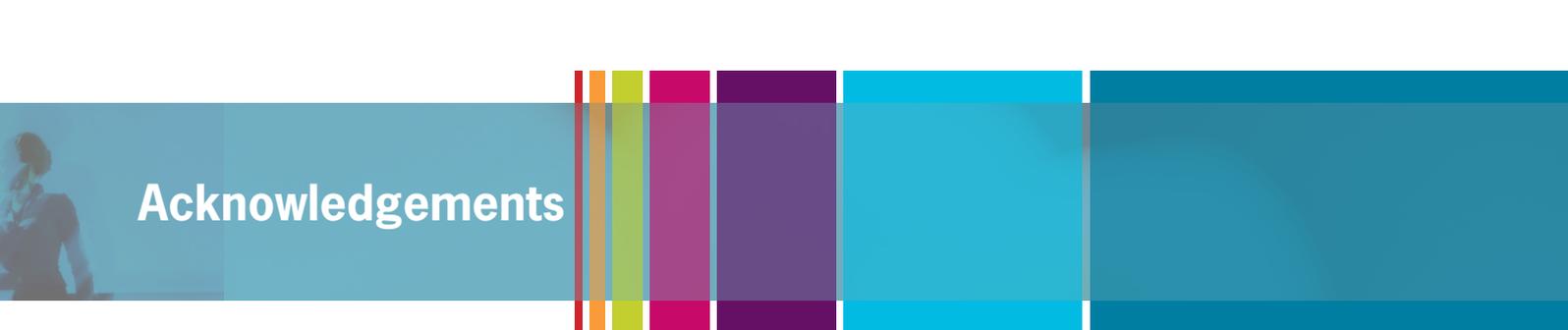
- Q7 How do you think dilution should be depicted? If more than one class of instruments were to be classified as equity how should the returns to the various classes be depicted?

## *Glossary*

- Q8 Do you agree with the proposed descriptions/definitions contained within the glossary? If not what changes would you suggest? Can you identify any additional descriptions/definitions you believe would assist in developing a common understanding of the issues?

## *Any other issues*

- Q9 Do you have any other comments in relation to classification of claims?



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