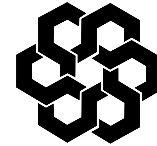

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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**20 February 2007, London**
Project:	**Conceptual Framework**
Subject:	**Phase B: Elements and Recognition—Claims Approach (Agenda paper 3)**

INTRODUCTION

1. In November 2006, the staff asked the Boards whether the conceptual framework team should explore alternatives to the ongoing efforts to converge and improve the Board's existing definitions of *liabilities* and *equity*. The alternatives posed were to replace those definitions with either a newly defined single element or three or more elements. The Boards directed the staff to more fully develop the single element approach and to determine the potential implications of adopting that approach.

2. This paper furthers that exploration. It focuses on developing a single element, tentatively called *claims*, that would replace the liability and equity elements. It presents two tentative definitions of the new claims element and seeks comments of Board members on those definitions and on what we call the *claims approach*.

3. This paper identifies and addresses some key benefits and concerns about adopting the claims approach. Many of them relate to matters that are to be

addressed in later parts of the conceptual framework project (recognition, measurement, and presentation and disclosure) or are best addressed at the standards level. The Boards agreed to **resist the temptation to peek ahead**,[1] but in this case Board members and constituents are not likely to support the change in thinking at the conceptual level without understanding how a claims element might influence future standards and practice. As we discuss the claims approach with Board members and constituents, we suspect that other benefits and concerns not yet identified will surface.

4. Our primary objective for this paper and meeting is to seek from Board members (a) input on our thinking about the claims approach and its implications and (b) direction for its further development. The staff does **not** plan to ask the Boards**,** at this time, to choose between the alternative approaches for defining the elements of a statement of financial position (three elements—*assets*, *liabilities,* and *equity*—or two elements—*assets* and *claims*). Rather, we think each alternative should be subjected to further development and discussion of their pros and cons, including discussions with the Boards' Advisory Councils and other constituents.

5. The staff plans to build on the input it receives from the Boards at these meetings in developing the claims approach more fully for consideration at the Boards' April meetings. We think this paper makes a good start by identifying the more significant implications of adopting a claims approach, but we acknowledge there will be more questions and perhaps some obstacles along our path. Nonetheless, we remain confident that with the help of Board members, FASAC and SAC, and others those obstacles can be overcome.

6. The paper includes the following sections:
   a. Background
   b. Definitions and Explanations
   c. Recognition
   d. Measurement
   e. Financial Statement Presentation

[1] Precept No. 8. Assessing the implications of replacing the liabilities and equity definitions seems both desirable and inescapable; thus, no red carding (this time).

f. Other Implications

g. Appendix A: Historical Origins of the Line between Liabilities and Equity

7. At the February meetings we will ask the Boards to consider the following relatively *high-level* questions about the claims approach:

   a. Are we on the right track with the development of the claims approach, including the two tentative definitions of *claims* (paragraph 19)?

   b. Do you have any significant concerns that we have not yet identified about the potential implications:

      (1) of the tentative definitions of claims and the characteristics of claims?
      (2) for recognition of claims?
      (3) for measurement of claims?
      (4) for financial statement presentation of claims and changes in them?

BACKGROUND

8. This is the third paper that discusses issues relating to the distinguishing between liabilities and equity (Phase B, Milestone V).

9. The first paper was discussed at the April 2006 IASB Meeting (IASB Agenda Paper 8B) and at the April 19, 2006 FASB Educational Session (FASB Memorandum 26). It identified similarities in and differences between the definitions of *liabilities* and *equity* and the (limited) discussion of the distinction between them in the IASB *Framework for the Preparation and Presentation of Financial Statements* (IASB *Framework*) and FASB Concepts Statement No. 6, *Elements of Financial Statements* (CON 6), as well as differing aspects in the conceptual frameworks of other standard setters.[2] That paper pursued the same general approach that the FASB has been pursuing in its Liabilities and Equity Project, namely, trying to sharpen the distinction between those financial instruments that should be regarded as liabilities and those that should be regarded as equity.

10. The second paper was discussed at the November 2006 IASB and FASB meetings (IASB Agenda Paper 3A; FASB Memorandum 43). It did not

[2] It also reviewed recent standards issued by the IASB and FASB in this area and the current FASB Liabilities and Equity Project, focusing on what those standards-level efforts revealed about Board preferences.

continue the approach taken in the first paper. Instead, it focused on whether to explore other alternatives to trying to converge and improve the existing liability and equity definitions and sharpening the distinction between them. It explained that "there are several reasons for questioning whether a hard-and-fast bright line must be drawn between liabilities and equity. One reason relates to the history of the line, specifically why the line between liabilities was originally drawn." Paragraphs 33–41 of that paper (which are included in Appendix A) noted that much of our current practice stems from accounting for proprietorship and partnership forms and how the characteristics of those forms differ from conducting business as a corporation.

11. Paragraph 40 of that second paper added that:

> . . . the formulation of the accounting equation A – L = P does not necessarily follow logically for the corporation as it does with sole proprietorships and partnerships. Indeed, a corporation's creditors and shareholders have more in common than is usually supposed. Generally speaking, their commonalities are as follows:
>
> a. they all supply capital to the corporation
>
> b. All their claims are against the corporation itself and they lack recourse to any other party
>
> c. Their claims are to interests in the corporation, not to the specific assets of the corporation
>
> d. They all share in the returns that the corporation generates on its assets
>
> e. They are not directly involved in the management of the corporation's business activities.
>
> Collectively, therefore, they might better be described as corporate claimants or claimholders rather than as creditors and shareholders.

12. That second paper also noted that the Boards' plan for the framework project contemplated exploring alternatives to retaining the liability and equity elements through the first and second of the cross-cutting issues of Milestone V of Phase B, which (reworded somewhat for clarity) are as follows:

EL.25: Should there be a distinction between liabilities and equity?

EL.26 Should there by only two elements? Why not three–debt, equity and "dequity"?

13. That second paper also observed that those two issues are not new issues. The 1990 FASB Discussion Memorandum (DM), *Distinguishing Between Liability*

and Equity Instruments and Accounting for Instruments with Characteristics of Both, included similar issues, as follows:

> ISSUE 2.8: Should a third "capital" element be added to handle instruments that combine certain features of liabilities and equity? If so, how should that element be defined?
>
> ISSUE 2.9: Should the present sharp distinction between liabilities and equity be effectively eliminated?

14. That second paper also noted that:

> With regard to Issue 2.9, the DM stated that one reason for eliminating or downplaying the distinction between liabilities and equity is because the line between liabilities and equity has outlived its usefulness and attempts to sharpen it are likely to fail. Another reason is that attempting to resolve the issue by adding more elements would likely compound the problem, given the proliferation of new financial instruments that combine features of both debt and equity, and thereby blur the line between liabilities and equity. For those reasons, a different approach is needed, one that would combine liabilities and equity into a single element. [Paragraph 49.]

15. In discussing the conceptual framework at their separate October 2006 meetings, the Boards also considered what an element is and its significance. The Boards agreed that the elements definitions should:

    a. Continue to focus on and define the economic things (resources and claims) and the changes in them that pertain to a particular entity. Those "things" and "changes" in them are also called "stocks" and "flows".

    b. Focus on the most basic of the real-world economic phenomena that pertain to an entity. Distinctions that are made for purposes of financial statement presentation (or display) go beyond the notion of basic elements.

16. The staff thinks the October 2006 decisions are consistent with the claims approach, namely using only two elements (assets and claims) to define and distinguish between all of the basic economic things that appear in the statement of financial position.

Prior Comments of Constituents

17. Subsequent to those meetings, the staff reviewed the FASB files on Issue 2.9 of the 1990 FASB DM. A March 13, 1991 FASB Memorandum presented an analysis of the comments received on that issue (which was discussed by the

FASB on March 21, 1991). That memo reported that 82 of the 102 respondents commented on Issue 2.9 and that:

> Approximately 90 percent of the respondents to this issue favored maintaining the present sharp distinction between liabilities and equity. They generally believe that practice problems result from applying the existing distinction, not from the existence of the distinction. Eliminating the distinction would be disruptive and require considerable cost and effort.
>
> The majority of the respondents who support eliminating the sharp distinction generally would favor arraying financial instruments along a continuum of claims to enterprise assets. They think the present sharp distinction between liabilities and equity has become less relevant in the current economic environment due to the proliferation of innovative financial instruments that have characteristics of both liabilities and equity. [Pages 23 and 24.]

18. The framework team reviewed the comment letters of the eight respondents that supported eliminating the sharp distinction and that analysis is consistent with our review. We noted that some of those respondents specifically called for separate presentation of the "absolute residual claim" but they suggested that can be accomplished through financial statement presentation rather than requiring a separate element.[3]

DEFINITIONS AND EXPLANATION

19. For purpose of further discussion and development, the staff proposes the following two tentative definitions for consideration:

Working definition: *Claims* are present interests[4] of others in the entity as a whole or in specific assets of the entity.

Alternative definition: *Claims* are present economic burdens for which the entity has a present obligation or duty to which claimants have an interest.

As discussed below, both definitions have some pros and cons. In both, the

[3] Contact Amy Mayrhofer at almayrhofer@fasb.org or +1-203-956-5376, if you would like to see a recap those eight comment letters with relevant quotes and staff observations or any particular letter. One of those respondents, Deloitte & Touche, also participated in the March 1991 public hearings.

[4] *Interest(s)* is used in this paper with the follow meaning: "a share, right, or stake in property or a financial undertaking" (Compact Oxford English Dictionary, online, definition number 6) and "1. a right or claim to something 2.a).a share or participation in something" (Webster's New World Dictionary, 2nd college ed. [New York; Simon and Schuster, 1984] p. 734). The staff has not ruled out the term *right*, which Webster's defines as "2. a) that which a person has a just claim to; power, privilege, etc. that belongs to a person by law, nature, or tradition [the *right* of free speech] b) [often pl.] an interest in property, real or intangible: cf. COPYRIGHT.

word *claims*[5] may be problematic if taken out of context because in general usage, *claims* is sometimes used to refer to rights of the entity (receivables).

Working Definition

20. To help avoid the problem with the word *claims*, we make clear in the working definition that claims are **interests of others in the entity**. However, unlike the asset definition, this definition is drafted from the perspective of the parties that have the interests in the entity rather than the perspective of the entity. We have not determined as yet whether that would present significant problems.

21. The pros of the claims working definition include its use of relatively simple, straightforward, plain English wording that does not rely on legalistic terms. However, because the word *interests* has numerous meanings, it could be open to misinterpretation. For now, a footnote explains the intended usage of *interests* but that explanation could be moved to amplifying text. Another alternative could be to replace *interests* with *rights* or modify it with *economic* but those modifications also have certain pros and cons.[6]

Alternative Definition

22. The alternative definition (paragraph 19) also has some pros and cons. Pros include that, like the asset definition, the alternative definition is drafted from the perspective of the entity and to some degree is a corollary of that definition. In addition, its use of the term *economic burden* can utilize the amplifying text that is being developed for the working definition of liabilities.

23. Some potential cons include that the term *economic burden* may not work well in bringing in the notion of residual interests for which there is no mandatory redemption. Modifying *present obligation* to include *or duty* may be a way to

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[5] The staff is still searching for better terms. In his 1922 accounting classic, *Accounting Theory*, William A. Paton suggests that to show the economic or financial condition of an enterprise requires only two fundamental classes (elements): *properties* and *equities*. This paper's counterparts are *assets* and *claims*. *Equities* may be just as good as the term *claims* but we are reluctant to recommend that term because it may be mistakenly viewed by some constituents as equivalent to the present definition of equity or an equity security (investment).

[6] For example, the modifier *economic* could be useful in distinguishing an *economic interest* in the entity from a donor's continuing *interests* in a charity's appropriate use of gifted assets, particularly those with restrictions as to their use. However, rather than burdening the definition with the modifier, that clarification also might be accomplished through amplifying text. Also, *rights* could be a useful as a corollary to its use in the asset definition, but may not be intuitive for residual claims where the other party has *interests* but no apparent present *right* to repayment of its investment, dividends, etc.

broaden the economic burden notion to include distributions in the event of liquidation. However, this requires further thought to ensure that unintended items are not swept in under the alternative definition.

24. The staff notes that while it seeks input from Board members on both definitions of claims, the more important objective for this meeting is obtaining your input on the claims approach and its implications.

Present Interests or Present Obligation or Duty

25. Similar to the asset working definition and its emphasis on the entity's **present** right, the tentative definitions of claims emphasize the **present** notion. In the working definition, the interests of the other party (claimant) must be a present interest at the entity's reporting date. In the alternative definition, the obligation or duty of the entity must be present at the entity's reporting date.

26. Clarifying text for the working definition may need to make clear that (a) the required settlement of the claim may entail delivery of specific assets (for example, cash or a commodity) but the entity need not presently have those assets and (b) in some cases, claimants have present interests in the entity as a whole with a secured interest in a specific asset. The secured interest may be contingent and may become a present interest in a specific asset upon the occurrence of a particular event. For example, the entity's failure to make a timely payment on a mortgage loan may be a default event that provides the claimant with a present interest in the mortgaged property of the entity.

Characteristics of Claims

27. Like assets, claims (interests) of others in a particular entity may arise in different ways and possess different characteristics. The staff thinks, however, that the differences in their characteristics are not sufficiently compelling as to require a separate element. Paragraphs 28–40 discuss some of the ways claims arise, the kinds of claimants involved, and different characteristics they might posses.

Claims of Others Arising from Deliberate Actions of the Entity

28. Most claims against an entity arise from its deliberate actions, such as exchange transactions with other parties (counterparties). Such actions include issuing debt or equity securities to bondholders and shareholders in exchange for cash received, making promises to suppliers to pay cash in exchange for goods received, and making promises to employees to pay cash and provide benefits in exchange for services received. Claims also may arise from deliberate actions of the entity that do not involve exchange transactions, but rather unilateral transfers like making a promise to contribute cash to a charity (enforceable pledges).

29. Claims arising from deliberate actions of the entity generally have identifiable counterparties, which are called *claimants*. More specific terms for those claimants would include *creditors, lenders, bondholders, owners*, *shareholders*, *beneficial interest holders*, *suppliers*, *employees*, *tax authorities*, and *donees*, among others. Thus, ample opportunity exists through the use of appropriate labels and line items to distinguish the various claims against an entity by their source, by liquidity, by both source and liquidity, or in other ways.

30. The form and time of the settlement of these claims usually is clear. However, settlement may depend on other uncertain events or circumstances. For example, a warranty, an insurance policy, and many derivatives may require an entity to render services, pay cash, or deliver other assets if a particular event occurs (or fails to occur). However, other than providing "coverage" for certain specified events (risks), the entity may never be required to render other services or deliver other assets to the claimant. These types of claims are sometimes referred to as *stand-ready obligations,* that is, obligations to stand ready to perform. They might also be called *claims with conditional settlements,* or may be referred to by other labels. Once again, there is ample opportunity through financial statement presentation and notes to financial statements to faithfully represent claims that have conditional, contingent, or otherwise optional or uncertain settlements.

31. Generally, settlements of claims of owners or partners also are uncertain as to their timing and amount and usually are conditioned on liquidation of the entity. Owners and partners usually have a pro-rata claim against the entity that, **if settled,** is to be paid from the proceeds remaining from residual assets after payment of all other claims on a specified liquidation date. We might refer to those claims as *ownership, proprietorship, or partnership interests*, *beneficial interests*, or *residual interests*. For certain limited-lived (special-purpose) entities, those claims might be more precisely called *mandatorily-redeemable residual interests* since liquidation is mandated by their corporate charter or partnership agreement.

32. Most corporations, however, have a perpetual or indefinite life and the owners generally have an interest in the assets of the entity as a whole and no unilateral right to demand settlement. If those owners' interests are settled, it usually is done so at the discretion of the entity. In many cases, entities pay regular pro-rata dividends to their owners that reduce the extent of each owner's interests but do not settle those interests. Sometimes entities buy back some of the outstanding ownership interests, which generally results in full settlement for those owners that tender their interests. However, corporations generally are not required to settle the claims (interests) of their owners.

33. The residual nature of these claims has implications for their measurement that may differ from the measurement of most claims for which the amount and timing of settlement is contractually specified. However, the Boards have had long-standing practices of requiring the use of different measurement bases (attributes) for particular items of assets and liabilities, but their frameworks do not call for separate elements of financial statements because of the way an item might be measured.

Statutory, Judicial, or Regulatory Claims Imposed by Actions of Others

34. Claims against an entity may also arise as a result of actions of others, such as legislative actions (for example, resulting in statutes such as tax laws), judicial actions (for example, court awards for damages), or executive actions (for example, regulatory requirements or fines). Generally, claims of that nature have identifiable claimants. Most tax laws, for example, specify the form and

time of settlement, including the identity of the claimant (a national or other jurisdictional taxing authority). Similarly, in the case of fines the claimant and the form and time of settlement usually are known.

35. Some statutory, judicial, or regulatory claims arise as a result of **unintended** actions of the entity. For example, statutes or judicial decisions may require entities to remedy a particular damage caused to a particular counterparty as a result of an accident. Sometimes those statutes, judicial, or regulatory actions allow certain latitude for the form and time of settlement. For example, to rectify damages caused to a class of citizens in a community, courts sometimes require an entity to perform specific kinds of services to charitable organizations within the community. However, rather than specifying a particular charity (claimant), the courts may allow the entity to choose among a list of qualifying charities.

36. Similarly, a law may specify that to remedy environmental damages an entity must take some specific corrective action but allow the entity to take the action itself, hire another entity to take the action, or permit the entity, if it owns the damaged property, to sell the damaged property to another entity willing and able to accept the property subject to the claim for corrective action.[7]

Certain "Claims" That May Not Be (Enforceable) Interests against the Entity

37. Oftentimes "claims" are asserted (*asserted claims*) against an entity for which there is element uncertainty—doubt about whether the asserted claim meets the present liability definition. The staff thinks such doubts also would arise under the tentative working definition of claims. Others can unilaterally assert a claim against an entity but an assertion by itself is not necessarily a liability or a *claim*, as tentatively defined—namely, the present interests of others in the entity as a whole or in specific assets of the entity. While some asserted claims are ultimately acknowledged and accepted, others are not.

[7] Laws or court actions that require an entity to fix (improve) its own assets raise questions under our present liability definition about whether such an action requires a future *sacrifice*. Similar questions are likely to rise with a claims definition. That is, do laws or court actions requiring an improvement to an entity's assets result in a claim of others in (or *against*) the entity? Such laws and court actions also raise questions about the unit of account. That is, is the required action a separate free-standing claim or should its measurement and recognition be linked to the related asset to be improved?

38. Asserted claims often arise from events that do not involve any **deliberate** actions (or inactions) of the entity. Examples include accidents in which the claimant asserts the entity was at fault or negligent. The legitimacy or enforceability of such claims often is in doubt, either because the factual basis of the claim is in doubt or the applicable laws or statues are unclear. The legitimacy or enforceability of asserted claims oftentimes becomes clear only after the facts have been established and the entity explicitly acknowledges and accepts the claim, or the claimant presents its claim to a court of law and it is resolved.[8]

39. Claims of that nature and their surrounding uncertainties present standard setters, preparers, and auditors with difficult problems in applying the current definition of liabilities that likely would continue using the working claims definition. They may require special attention through means of financial statement presentation, disclosure in notes, and perhaps separate criteria for their recognition and measurement in financial statements. However, determining whether a particular event (or set of events and circumstances)[9] results in a claim (present interest) against an entity is a matter of assessing the relevant facts to determine whether the definition has been met.

40. The claims discussed in paragraphs 29-40 possess a wide range and perhaps combinations of characteristics. As previously noted, that is not unlike items assets that differ in their nature, liquidity, certainty and other characteristics. The staff thinks that the nature, nearness to maturity, settlement options, uncertainties, and other characteristics surrounding claims are not so fundamentally different as to require separate elements for particular claims. Rather, the staff observes that their differing characteristics may be capable of being faithfully represented through appropriate financial statement presentation and disclosures.

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[8] Doubts or element uncertainty may exist for so-called *resolved claims*, as well. That is, some court decisions are appealed to higher courts and sometimes those lower-court decisions remain uncertain until the appeal has been heard and ultimately resolved.

[9] Sometimes a set of separate events and circumstances or a pattern of similar events, taken together, raises uncertainties and disputes between parties about whether an *implied contract* or a *constructive obligation* exists. Doubts arise about whether courts will resolve such disputes and, if so, which legal concepts they will stress (for example, by applying a strict notion of contract law or perhaps the notion of *promissory estoppel*). Those uncertainties will continue in practice regardless of whether the Boards retain the liability definition or adopt a claims definition.

Duties to Others That Do Not Result in Claims of Others against the Entity

41. Directors, managing partners, trustees, and similar officers generally have fiduciary duties to an entity's owners (partners, members, or other beneficial interest holders). Their duties generally are specified by the entity's corporate charter, partnership agreement, trust instrument, or similar instrument. Those instruments generally provide them with broad powers and responsibilities for the conduct of the entity's business, which generally require them to use their powers and the entity's resources in ways that are beneficial to the interests of the entity's owners. Those fiduciary duties of an entity's directors (managing partners, trustees, and similar officers) to its owners do not, however, create separate claims against the entity's assets.

42. Those duties or responsibilities of an entity's directors are sometimes said to compel the directors and the entity's managers to take an action in the interest of the entity or its owners. That notion of acting in its self-interest is sometimes referred to as *economic compulsion*. However, an entity's need to conduct business consistent with its governing instrument does not itself create a claim of others against the entity's assets. That is, a claim does not arise until the entity commits to others to take an action that gives those others such a claim. For example, directors generally have discretion as to whether to pay dividends to owners or reinvest earnings in the growth of the business. In certain circumstances, the accumulation of so-called *excess accumulated earnings* may subject the entity to additional taxation. In those cases, rather than accumulating resources for future investment opportunities, the directors may conclude that paying dividends and avoiding such taxes is a better use of entity resources. However, until the entity becomes subject to such taxation or promises to pay dividends, the fact that the directors might think they are compelled to take certain actions in the entity's self-interest or its owners' interests does not result in a claim against its assets until the action occurs.

43. Similarly, the intentions and business plans of an entity's directors, officers and managers do not create a claim of others against an entity. For example, the directors may *commit themselves* and the entity to a capacity expansion plan to be achieved through the acquisition of property, plant and equipment (PP&E), the acquisition of other companies, or both. Although they may feel

economically compelled to take such steps (use the resources entrusted to them in ways that are efficient and profitable) those intentions or plans do not give the potential suppliers of such PP&E or potential target companies a claim against the entity's assets.

Staff Observation

44. Much of the discussion in the Boards' current frameworks that describe items of liabilities and ownership interests would seemingly remain applicable to items meeting the definition of claims. Improvements to those discussions that are developed through efforts toward improving and converging the Boards' liability definitions also are likely to be relevant under a claims approach. However, discussions focusing on the line between liabilities and equity would not be necessary if the claims approach is adopted, at least not for the elements phase.

45. Much of the discussion and examples in this paper focus on corporations operating as for-profit business enterprises. However, the staff sees no obvious and compelling reason why the working definition of claims would not also apply to businesses formed as partnerships, proprietorships, and trusts or to not-for-profit corporations, partnerships, and trusts.

46. As we continue to develop the claims approach, there likely will be other implications requiring further consideration or clarification. However, at present, the staff does not see any insurmountable concerns with the claims definition that diminish our confidence in the claims approach and its promise.

Questions for the Boards

47. The staff asks Board members:

    a. Are we on the right track with the development of the claims approach, including the working definition of claims, which is defined as "present interests of others in the entity as a whole or in specific assets of the entity" (paragraph 19).

b. Do you have any significant concerns about the tentative definitions of claims and the characteristics of claims that we have not yet identified?

RECOGNITION

Timing for Recognition of Claims

48. The staff does not envision significant implications or new concerns related to **when** claims would be recognized, nor does it envision that the claims approach would resolve such recognition problems that exist under today's frameworks.

49. In concept, all economic phenomena that meet the definition of claims and criteria for recognition would be recognized and reported in the statement of financial position (as credit balances on the right-hand side of a balance sheet). (For purposes of discussion, this section presumes that a statement of financial position would continue to be a required financial statement; however, alternatives are possible, such as a statement of assets and a statement of claims.)

50. That notion of recognition is much the same as it is today. That is, all economic things that currently meet the definitions of liabilities or equity are candidates for recognition and all economic things that would meet the definition of claims would be candidates for recognition. Thus, if the claims definition appropriately includes all economic things that are now liabilities or equity and does not sweep in things that are not, absent any change in recognition criteria, we should continue to recognize the same economic phenomena. (Any changes to recognition criteria are yet to be considered in a later milestone of Phase B of the framework project.)

51. Moreover, absent changes in recognition criteria, many of the difficult recognition problems we encounter in practice for particularly troublesome items are likely to continue under the claims approach. That is, recognition will continue to be problematic when the facts surrounding a particular economic phenomenon result in element uncertainty. Examples include the uncertainties that surround unasserted claims and asserted claims not yet

acknowledged or accepted (known to be legitimate). Those types of problems are discussed in paragraphs 37–39 of this paper.

52. Similarly, to the extent that recognition continues to rely on notions of realization or identification of significant or critical events, we may continue to have problems determining if and when to recognize a new measurement basis for a particular claim. (This is becoming less problematic as more and more claims that are financial instruments are measured and remeasured at fair value, but claims for service obligations, especially on long-term contracts with multiple or ongoing deliverables, may remain problematic.)

Change in How Hybrid Instruments and Certain Other Claims Are Recognized

53. The claims approach does provide some opportunities to improve the way we recognize some claims. The November 2006 paper discussed the problems of classifying and measuring and recognizing certain hybrid instruments and other claims as liabilities or equity. Eliminating the sharp line between liabilities and equity may eliminate some of the problems (concerns) associated with the initial recognition and measurement, and representation of those claims. For example, reporting a claim that possesses characteristics of both liabilities and equity as if it were a liability (or were equity) may be a practical way to avoid the difficulties in measuring and reporting the claim in two parts (liabilities and equity). However, representing the claim wholly as a liability (or wholly equity) seems unsatisfactory.

54. By eliminating the sharp line between liabilities and equity, the claims approach may allow for more relevant and faithful representations of hybrid financial instruments. That is, those types of claims that posses similar characteristics could be aggregated and reported as line items with appropriate labels that distinguish them from claims that possess dissimilar characteristics. Under the claims approach, we should no longer feel compelled to split hybrid instruments into components to report them in part as liabilities and part as equity. Splitting such instruments seems less than satisfactory, particularly for hybrid financial instruments that generally trade as a whole, have readily determined market prices for the instruments, and do not have readily determinable measures for their components.

55. The staff acknowledges that replacing the liability and equity definitions with a single definition and element, such as claims, could result in the need for numerous "house-keeping" amendments to recognition standards, especially for those standards that rely on an item meeting the present definition of liabilities (or equity). We also caution that replacing a liability and equity classification scheme with other required classification schemes may come with other problems.[10] Matters of presentation are discussed further in a later section of this paper.

Questions for the Boards

56. The staff asks Board members: Do you have any significant concerns about the recognition of claims that we have not yet identified?

MEASUREMENT

New Opportunities and Significant Concerns

57. Adopting a *claims approach*—eliminating the present line between liabilities and equity—would give the Boards greater opportunities to develop new thinking and more meaningful ways to measure and present information about changes in an entity's assets and claims (flows). Those opportunities are open-ended and the possible improvements and related benefits (and detriments) are too numerous to capture in this paper. Rather, this section of the paper focuses on the more significant benefits and concerns that the staff identified for measuring liabilities and equity (claims) and changes in them that could arise under a claims approach.

58. Perhaps foremost among the benefits of a single element for all claims is the opportunity that it brings to rethink how items of claims (liabilities and equity) are to be measured. Presently, measurement is one of the most underdeveloped parts of the Boards' present frameworks. As a result, accountants have looked elsewhere for measurement guidance and perhaps

[10] As a part of its project on financial statement presentation, the Boards are considering how various types of economic resources, claims to them, and changes to resources and claims should be presented in financial statements—aggregated and classified. Generally they would be classified as part of business activities or financing activities, or as separate line items for assets and claims that may continue to defy such broad classification schemes. Examples include assets and claims related to income taxes and discontinued operations.

have blindly accepted long-standing conventions—including axioms like "equity interests should never be separately measured or remeasured."

59. The claims approach itself does not provide measurement guidance and by itself will not resolve disagreements among Board members, constituents, and others about which measurement basis (attribute) is most relevant for a particular claim or whether that claim should be remeasured. However, the staff thinks the claims approach would provide the Boards and constituents with an opportunity to step out of our old ways of thinking about how to measure particular claims. The staff also thinks that would facilitate new thinking as the Boards work through the measurement phase of the framework project in their efforts to develop measurement concepts (principles) to replace conventions (rules).

60. Perhaps for some, foremost among their concerns about eliminating the line between liabilities and equity (and the long-standing equation of Assets – Liabilities = Equity) are the implications for determining comprehensive income and its components[11]—both their measurement and presentation. The present line between liabilities and equity (nonowner claims and owner claims) is vital to determining the real-world transactions and other events and circumstances affecting an entity that are reported as changes (flows) that are part of (determinants of) comprehensive income and those changes that are not (determinants of it). (A later section of this paper discusses certain improvements in the presentation of information in financial statements that might overcome much of that concern.)

61. The measure of current period comprehensive income and its components is also affected by present standards that specify whether particular liabilities or items of equity (claims) are required or precluded from being remeasured to reflect real-world events, such as changes in their values. In some cases, remeasurement is a matter of choice that is made by the entity. To some extent, those standards and permitted choices depend on where the line between liabilities and equity (or more precisely those definitions) is drawn. Thus, eliminating the line between liabilities and equity is likely to require

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[11] Components of comprehensive income include individual line items as well as totals and subtotals such as *net income* or *profit or loss*.

(a) amending the language of existing standards if retention of existing measures is desired, (b) reconsidering present standards if retention is not desired, or (c) some combination of both.

62. The remainder of this section discusses implications about specific matters of measurement and concludes with the effects on the measurement of comprehensive income. That discussion is in the following parts:

    a. The Effect of the Boards' Commitment to Fair Value for Financial Instruments

    b. Alternative to Fair Value for All Financial Instruments

    c. The Effects on Measures of Comprehensive Income, including Its Components

The Effect of the Boards' Commitments to Fair Value for Financial Instruments

63. The FASB and IASB have publicly committed to requiring that **all** financial instruments be measured at fair value at each reporting period. That has been understood to include *financial assets* and *financial liabilities,* but not an entity's own *equity instruments*. Eliminating the liability definition will raise uncertainties about the future application of that commitment and could heighten anxieties among constituents. Undertaking significant educational efforts directed at improving understandings could help alleviate or mitigate such problems.

64. A definition of claims would not specify a measurement attribute for any particular financial instrument (or other claim). [Sentence omitted from Observer Notes]

65. Earlier, the staff noted that a claims approach provides an opportunity for new thinking. Conceivably, at one extreme, the Boards could move to an approach that requires all claims to be measured at fair value. (In that case, there would be no item of claims that is measured as a residual amount and, thus, the amount of all recognized assets likely would not equal the total fair value of all recognized claims.). However, the framework team is not now advocating any position on the measurement of all claims or any particular claim. The Boards and the framework team will be considering measurement concepts in Phase C

of the framework project and addressing measurement issues in their ongoing standards projects.

66. If no distinction were made between liabilities and equity in the new framework, the FASB's existing definition of a *financial liability* might still stand because it does not refer to or rely on the definition of a liability.[12] Instead, it refers to delivery of a financial instrument or exchange of financial instruments on unfavorable terms. Therefore, that definition would still be useable. Read literally, without a separate definition of an entity's own equity instruments, the FASB definition would treat all equity derivatives that might be unfavorable to the entity as financial liabilities. That result, in conjunction with the Boards' commitments to fair value measurement, seems to mean that all financial instruments except perpetual instruments (and exchange contracts to exchange perpetual instruments at fair value) would be measured at fair value.

67. The IASB's discussion in IAS 32 of *financial assets* and *financial liabilities* would require modification if there were no definition of equity, because it refers to an entity's own equity instruments.

Alternative to Fair Value for All Financial Instruments

68. The Boards, however, might want to modify their commitments to fair value by moving the line between those financial instruments measured at fair value and those not measured at fair value. The FASB, in its project on liabilities and equity, has considered "current settlement amount" as the measurement attribute for redeemable ownership instruments. Current settlement amount is defined as the amount that would result from applying the instrument's redemption formula (for example, fair value, book value, or twice book value less intangibles). If the current settlement amount is large enough to require more than the balance in retained earnings, a deficit would result.

69. [Paragraph omitted from Observer Notes]

[12] Statement 140 defines *financial liability* as "a contract that imposes on one entity a contractual obligation (a) to deliver cash or another financial instrument to a second entity or (b) to exchange other financial instruments on potentially unfavorable terms with the second entity" (paragraph 364). However, the definition of financial liabilities recently discussed for the financial instruments' due process document would rely on the definition of a liability and thus would be not be useable.

70. [Paragraph omitted from Observer Notes]

71. Once again, although the Boards have discussed some of the possible alternatives to fair value for all financial instruments in one or more standards-setting projects, the conceptual framework team is not now advocating any position on the measurement of all claims or any particular claim.

Effects on Measures of Comprehensive Income, including Its Components

72. As noted in paragraph 61, measures of current period comprehensive income and its components (for example, net income and profit or loss) are affected by present standards that specify how particular liabilities or items of equity (claims) are to be measured and when their remeasurement is permitted, required, or precluded. To some extent, those standards and permitted choices depend on maintaining the line between liabilities and equity (or more precisely their definitions). Thus, eliminating that line has implications for resulting measures of comprehensive income and its components. That is likely to require the Boards to:

    a. Amend the terminology in a number of existing standards if retaining existing measurement results is desired

    b. Undertake significant efforts to reconsider present standards if retention is not desired

    c. Make use of both (a) and (b).

73. Adopting a claims approach is likely to have some effect on measures of comprehensive income, but those effects depend largely on choices that are left open to the Boards. The following paragraphs discuss some of those choices. The staff does not suggest, however, that adoption of the claims approach should depend on whether it results (or is capable of resulting) in a measure of comprehensive income that is identical to the measure that would result using the current liability and equity distinction. That is, maintaining *status quo* is not an objective. (A later section of this paper addresses matters of financial statement presentation, including whether the claims approach facilitates, hinders, or precludes the presentation of a measure of comprehensive income

on the face of financial statements and, more importantly, whether it could improve financial reporting.)

Initial Measurements of Claims

74. Many, if not most, claims against an entity initially arise in the ordinary course of conducting business. Those transactions include an entity's (a) purchasing assets and services that it needs to produce the goods or services that it sells to its customers and (b) raising capital (monies) that it needs to finance its operations. Generally, claims arising from those transactions are initially measured at the transaction amount agreed to by the buying entity and the selling entity (claimant). There are exceptions for certain special circumstances, such as borrowings with off-market interest rates (for example, zero-coupon bonds) or exchanges involving specified quantities of assets to be delivered to settle the claim in which there is no stated cash equivalent price.[13]

75. In many cases, there is no effect on the entity's comprehensive income when initially recording those claims. Examples include receiving assets that are capitalized (for example, cash, raw materials and other inventory, and property and equipment) at amounts equal to the claim incurred. In other cases, there is an effect on comprehensive income. Examples include receiving services that are used immediately and recognized as expenses (for example, electricity, gas and other utilities) in exchange for the claims incurred.

76. In either case, there is no reason why adopting a claims approach would, in itself, require or preclude a change to those initial measurement practices. That is, as discussed earlier, certain practical problems arise in eliminating the liability and equity distinction, particularly when standards make the measurement of a claim dependant on that distinction. However, the Boards are free to amend their measurement standards to make needed terminology changes in ways that either retain the existing initial measurements or change them if they determine that improvements are needed.

[13] Claims for nonmonetary assets to be delivered by the entity in exchange for nonmonetary assets it received might be based on the fair value of the assets received or the assets to be delivered, generally based on whichever is more readily determinable.

77. Sometimes claims against an entity initially arise from transactions and other events that are not in the ordinary course of its business. Examples include acquisitions and sales of businesses. Under a claims approach, the Boards would also have the freedom to choose to retain or amend the initial measurement for claims arising on those transactions and other events. Adopting a claims approach, however, does not create a compelling need to reconsider any of those existing standards or decisions reached in the Boards' ongoing project on business combinations.

Settlement of Claims

78. Claims may be settled or partially satisfied using various types of consideration. The entity typically pays cash, delivers other assets, or provides services. Entities also may settle one claim against it by providing the claimant with a new claim against the entity. For example, it may issue a secured note to settle past due accounts payable, refinance a mortgage note, or issue equity shares to settle debt. A claim, such as a term life insurance policy, may or may not require any settlement in addition to the required standing ready to provide service (coverage) during a stated period. An ownership interest, such as common stock, may be satisfied by repurchasing the stock or by distributing assets in liquidation or may be partially satisfied by payment of dividends.

79. Reporting satisfaction of claims is relatively straightforward. The claim, or a portion thereof, will be removed from the statement of financial position (derecognized). If the consideration delivered is cash or another asset, that cash or other asset will be derecognized. If the consideration delivered is a new claim against the entity, that new claim will be recognized and the settled claim will be derecognized. If the consideration delivered is in the form of services provided by the entity, the cost of those services (employee compensation, consultant fees, supplies or materials, and similar items) will be recognized and the settled claim will be derecognized.

80. If the reported amounts of the settled claim and the consideration delivered are equal, there is no effect on comprehensive income. If the reported amounts are not equal, there will be a gain or loss on settlement of the claim.

81. Under the claims approach—without the present line between liabilities and equity—if a measure of comprehensive income is to be retained, it will be necessary to determine whether to report specific gains and losses on settlements of claims in comprehensive income or not. If not, one alternative is a direct *adjustment* (analogous to a direct charge to equity) of the interests of existing claimants (for example, holders of outstanding ordinary or common shares, preferred shares, corporate bonds and other similar instruments). The staff also needs to further consider other financial statement presentation alternatives that may be possible.

82. As discussed in the November 2006 paper, a reason for moving to a claims approach is that entities raise capital in several ways and from various long-term *investors* who collectively might be viewed as *corporate claimants* rather than *creditors* and *shareholders*. (See paragraphs 10 and 11 and Appendix A.) Thus, if the Boards accept the underlying premise that the existing line between nonowners and owners has become blurred (and unnecessary), that suggests that all gains and losses on settlements of those corporate claimants are sufficiently similar and should be reported similarly, rather than some of those gains or losses being reported through comprehensive income and others not. Whether separate line items or note disclosures might be used for settlements of specific claimants (creditor, convertible bondholder, preferred shareholder, common or ordinary shareholder) seem to be a standard setting matter for financial statement presentation and disclosure.

83. To illustrate, a typical and straightforward example is a gain or loss on an early extinguishment of long-term debt. As a result of changes in market rates of interest, credit standing, and other factors, unless the debt is being marked-to-market, the amount of cash (or other assets) paid to settle the debt usually differs from the recorded amount of the debt. Presently, the excess (or deficit) of the cash paid is reported as a loss (or gain) in comprehensive income. Presumably, such transactions **could** be reported in the same way under a claims approach.

84. Another example is the *loss* that occurs on the repurchase of outstanding shares of the entity when the cash paid exceeds the recorded amount of the shares. (For purposes of this discussion, it is assumed that the portion of additional

paid in capital, accumulated other comprehensive income, and retained earnings attributable to a share of stock are reported as a single amount or can otherwise be specifically identified.) Currently, the excess of the cost of repurchasing shares over the recorded amount of the shares repurchased is reported as an adjustment in equity—but not through comprehensive income.[14]

85. Similarly, if claims in the form of residual interests in the entity (shares of common stock) are issued to settle claims in the form of convertible bonds and the value of the claims issued (common shares) differs from the "recorded" amount of the claims settled (bonds) there will be a difference to be reported. An issue under the claims approach will be whether that difference should be reflected as a gain or a loss in comprehensive income or as a direct adjustment to the recorded amounts of other existing (retained) claims that have become impaired or enhanced as a result of the settlement.

86. As noted earlier, the use of the claims approach for identifying and determining the number of basic elements by itself does not seem to lead to specific answers or constraints for measurement. Rather, it gives the Boards new opportunities to rethink and make new choices about how items of a claims element are to be measured (as well as how they are to be recognized and presented in financial statements).

Subsequent Measurement of Claims (Value Changes)

87. Subsequent remeasurements of recognized claims also can affect measures of comprehensive income and its components. The staff thinks that the claims approach does not restrict the Boards' opportunity to have the same resulting measures of comprehensive income, if that is desired. That is, the claims approach does not restrict the Boards' freedom to amend their standards to make needed terminology changes in ways that either (a) retain the existing standards for remeasurements or (b) change them if they determine that improvements are needed.[15]

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[14] The entire amount paid may be reported as a debit to equity and labeled as treasury stock. Alternatively, other paid-in capital or retained earnings or both may be reduced.

[15] The measurement phase of the framework project is the place for considering and developing concepts for measurement that may guide (restrict) the development of future standards.

88. However, to retain identical measures of comprehensive income would require maintaining the owner/nonowner distinction and current measurements. That would bring the attendant problems encountered in present practice for financial instruments that possess characteristics of liabilities and ownership interests, which would defeat a main reason for considering a claims approach.

89. A key question about claims that will require consideration in the measurement phase of the project is: Which, if any, changes in values (remeasurements) of existing claims should affect the values of other claims (by a direct adjustment to the other claim) rather than the measure of comprehensive income? For example, if the Boards choose to measure some ownership interests (such as preferred stock, redeemable common stock, or minority interests in subsidiaries) at fair value or current settlement amount, it might also choose to recognize that change by reducing or increasing the value of other interests of claimants that will suffer or benefit.

Questions for the Boards

90. The staff asks Board members: Do you have any significant concerns about the implications for measurement of particular claims or changes in them that we have not yet identified?

FINANCIAL STATEMENT PRESENTATION

Introduction

91. The staff proposed two tentative definitions of claims for consideration and a description of their characteristics (paragraphs 19–43). The staff noted that claims of others against an entity have many different characteristics, but those differences are not sufficiently compelling as to require more than one element for all claims because they can be faithfully represented through appropriate financial statement presentation and disclosures. The staff also thinks claims against an entity are fundamentally different from assets of an entity and, hence, at least two basic elements for a statement of financial position are needed.

92. The more significant implications of adopting a claims approach for recognition and measurement were discussed in paragraphs 48–90 of this

paper. In paragraph 60, the staff acknowledged that for some eliminating the liability and equity elements and altering the long-standing equation of Assets – Liabilities = Equity raises significant concerns, particularly for measures of comprehensive income and its components. We also noted, however, that retaining current measures of comprehensive income would necessitate and perpetuate the kinds of protracted problems (distinctions and other complexities) that adopting a claims approach could overcome.

93. The more significant implications of adopting a *claims approach* for financial statement presentation (display on the face of financial statements), disclosures, and other reporting are discussed in paragraphs 94-125. Those paragraphs note that the approach opens up opportunities for new and more meaningful ways to present information about an entity's assets and claims (stocks) and changes in them (flows). All of the presentation possibilities are, however, too numerous to capture in this paper. Rather, several of the more significant possibilities (and underlying concepts) are discussed and the framework team's observations about (a) relationships to thinking in the standard-setting project on financial statement presentation, and (b) how presentation possibilities can overcome concerns.

Aggregation and Classification of Items

94. Before discussing the implications of the claims approach for any particular financial statement, it is useful to briefly review concepts and standards that underlie our present practices for aggregating and classifying items in financial statements.

95. If financial statements are to present information about an entity's economic resources, claims to those resources, and changes in them in ways that are meaningful and understandable, vast amounts of data about them must be simplified, condensed, and aggregated. Paragraph 30 of IAS 1 *Presentation of Financial Statements* explains that:

> Financial statements result from processing large numbers of transactions or other events that are aggregated into classes according to their nature or function. The final stage in the process of aggregation and classification is the presentation of condensed and classified data, which form line items on the

> face of the balance sheet, income statement, statement of changes in equity and cash flow statement, or in the notes. . . .

96. Similarly, paragraph 20 of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, says:

> Classification in financial statements facilitates analysis by grouping items with essentially similar characteristics and separating items with essentially different characteristics. Analysis aimed at objectives such as predicting amounts, timing, and uncertainty of future cash flows requires financial information segregated into reasonably homogeneous groups. For example, components of financial statements that consist of items that have similar characteristics in one or more respects, such as continuity or recurrence, stability, risk, and reliability, are likely to have more predictive value than if their characteristics are dissimilar.

97. It is generally understood by accountants, economists, and others that the process of aggregation can add meaningfulness and understandability. As the economist Kenneth Boulding famously stated, "It is a very fundamental principle indeed that knowledge is always gained by the *orderly* loss of information, that is, by condensing and abstracting and indexing the great buzzing confusion of information that comes from the world around us into a form which we can appreciate and comprehend."[16] Thus, aggregations and schemes for classifying information require care. If important details might be lost as a result of a need for aggregation at the financial statement level, the Boards generally use disclosure standards to avoid the loss of those important details. Many of those standards allow preparers latitude to provide such details through notes to financial statements or on the face of financial statements.

98. Problems seem to arise whenever the Boards mandate that a particular class of items be classified—distinguished from another class (or classes) of items. This paper focuses on eliminating one such problem—distinguishing certain claims that we call liabilities from other claims that we call equity. That problem is particularly troublesome for hybrid financial instruments that possess characteristics of each class. William A. Paton noted that particular problem in his 1923 classic treatise, *Accounting Theory*, the FASB did in its

[16] Kenneth E. Boulding, *Economics as a Science* [New York: McGraw-Hill Book Company, 1970], 2, emphasis added.

1990 Discussion Memorandum, *Distinguishing between Liability and Equity Instruments and Accounting for Instruments with Characteristics of Both*, and the current FASB and IASB members acknowledged it again when they directed the framework team to explore replacing the liability and equity elements with a single element. So, which is the best way forward?

99. Perhaps we can learn from similar classification problems encountered in the past, including most recently in the Boards' financial statement presentation project. For example, income tax expenses could be reported in part in *business activities* and in part in *financial activities*. However, the Boards have tentatively decided that reporting income taxes as a separate unclassified line item may be just as useful and perhaps a more faithful representation than allocated amounts. In fact, the Boards have often found that to accommodate such problems, rather than mandating hard and fast rules for presenting meaningful information on the face of a financial statement, it often is desirable, if not necessary, for disclosure standards to be flexible regarding how the information is reported (for example, in notes to or on the face of a financial statement).

100. However, because liabilities and equity are separate elements of financial statements in the existing frameworks, that suggests that standards must require that particular distinction. Eliminating the liability-equity distinction at the element level would remove that constraint, but more importantly it gives the Boards new opportunities to develop standards for financial statement presentation. Presumably, standards leading to more meaningful and understandable ways of communicating relevant information to users of financial reporting.

Implications for Presentation in a Statement of Financial Position

101. Certain ways in which both assets and claims might be presented in a statement of financial position are discussed in paragraphs 102–105. The various characteristics of assets were discussed in the November 2006 paper (in paragraph 41) and the various characteristics of claims were discussed in this paper (in paragraphs 27-40). The November paper said that "the differences between the various types of corporate assets are at least as great as

those between the various types of corporate claims." In this paper, we said "ample opportunity exists through the use of appropriate labels and line items to distinguish the various claims against an entity by their source, by liquidity, by both source and liquidity, or in other ways (paragraph 29).

Presentation or Arrangement

102. In practice, entities present what is called a *balance sheet* or *statement of financial* position in the "account form" of that statement. The assets are listed on the left side and the liabilities are listed on the right side followed by and separate from items of equity. The total of all of the listed assets usually is reported at the bottom of the left-sided listing and the total of the listed items of liabilities and equity is usually reported at the bottom of the right-sided listing. Those two totals (*assets* and *liabilities and equity*) are equal and said to be in *balance*.[17]

103. Separate subtotals also may be presented for the items of equity and items of liabilities. Instances in which separate subtotals are not reported often involve certain problematic claims that defy classification or arguably have been viewed by some constituents as neither liabilities nor equity. Those claims have been presented between liabilities and equity (in the so-called *mezzanine*). An example is the amount reported for the equity interests of minority shareholders in a subsidiary company, which some say must be segregated from liabilities and equity because they are not liabilities or equity interests in the parent company.

104. Adopting a claims approach would not restrict the Boards' choices for the presentation or arrangement of assets and claims. Moreover, by itself, the claims approach would not require the presentation of assets and claims in the same financial statement. That is, information about an entity's assets and about claims of others to those assets conceivable could be presented in separate statements, for example, a *Statement of Assets* and a *Statement of Claims*. The staff is **not** now suggesting that change; it merely reiterates that we need elements to define the economic phenomena to be recognized in

[17] That statement, however, could just as easily be in the "report form" with a single list with items of assets and their total shown at the top half and items of liabilities and equity and their total shown at the bottom half or vice-versa.

particular financial statements. Consistent with decisions in the current standards project on financial statement presentation, this paper presumes assets and claims would be presented in a single statement of financial position.

Classification or Arraying Items of Assets and Claims

105. There a number of ways in which assets and claims might be classified, arrayed, or both. Some may be more helpful than others. However, which is most helpful in a particular set of circumstances is not the subject of this paper. That is a matter for consideration in Phase E of the framework project and the project on financial statement presentation.

Relationship to Project on Financial Statement Presentation

106. Most recently, in their project on financial statement presentation, the Boards tentatively decided that classification schemes used in a statement of financial position, together with other financial statements, should present a *cohesive* financial picture of an entity such that the relationships between items on the different financial statements are clear (sometimes thought of in terms of articulation or linkage).

107. In January 2007, the Boards discussed certain issues that remain about the presentation of items of equity. Paragraph 2 of the January paper (IASB Agenda Paper 13D; FASB Memorandum #46C) explained that:

> As highlighted in the table below, under the working format the statement of financial position provides information about equity (owner) items and the statement of cash flows presents equity cash flows (from transactions with owners); however, the statement of comprehensive income does not include an equity category (transactions with owners). Thus, it could be said that the statement of comprehensive income is not cohesive with the other two statements. . . .

108. Following is that table, which illustrates the primary classification scheme and certain sub-categories:

Statement of Financial Position	Statement of Comprehensive Income	Statement of Cash Flows
Business Operating assets and liabilities Investing assets and liabilities	**Business** Operating income Investment income	**Business** Operating cash flows Investment cash flows
Discontinued operations	**Discontinued operations**	**Discontinued operations**
Financing Financing assets Financing liabilities ***Equity***	**Financing** Financing income Financing expenses	**Financing** Financing asset cash flows Financing liability cash flows ***Equity cash flows***
Income taxes	**Income taxes**	**Income taxes**

109. In the table, items of equity are distinguished from other claims (liabilities). That seems necessary for standards developed under the Boards' existing frameworks.[18] The point here is that if the Boards adopted the claims approach in their revised framework, items of equity could be reported on one or more descriptive lines and grouped and arrayed with other claims in their appropriate functional activity. Presumably, that would be within the financing activities classification for most, if not all, equity instruments and hybrid instruments.

110. A statement of changes that included changes in the amounts for items of claims, including items of hybrid financial instruments (for example, convertible bonds, mandatorily redeemable preferred shares) arguably would be both useful and feasible. That is, without the need to split out liability/equity components, changes in the amounts of those instruments could be presented on line items that are more faithful representations of the instruments and the changes in their amounts. That may result in information that is more relevant, understandable, and less costly to provide—which could

[18] At their January 2007 meetings on the financial statement presentation project, the Boards revisited their proposed working format that would include a single financing section that included financing assets, financing liabilities, and equity. The Board decided to modify that decision, requiring instead that the statements of financial position and cash flows include separate sections—one for financing assets and liabilities, the other for equity.

benefit not only users of information but also preparers and auditors of the information.

111. It is for such reasons that the staff believes the claims approach has promise. The implementation of such an approach, however, will require much more than the Boards can accomplish with concepts alone. A change in the elements of a statement of financial position together with rethinking in how best to present comprehensive income (or changes in assets and claims) is an appropriate place to start. The Boards will need to work through each financial statement, presumably building on the cohesiveness notion and other ideas being developed through the standards project, as well as developing concepts for presentation and disclosure.

Implications for Presentation of Comprehensive Income and its Components

112. The measurement section of this paper discussed implications for the measurements of comprehensive income and its components. This section of the paper addresses a few fundamental issues related to the **presentation** of comprehensive income and its components that would arise under a claims approach. They are:

   a. Would any of the alternatives for presenting the flows (changes in assets and claims) for the period facilitate the presentation of the key metrics that we call *comprehensive income, net income*, and *profit or loss*?

   b. Would potential presentation alternatives be **consistent** or **compatible** with the direction(s) the Boards are taking in their project on financial statement presentation?

113. The staff thinks the short answers are:

   a. Probably not

   b. Probably not consistent but compatible in certain respects.

114. The first response likely will give Board members reason for pause and perhaps raise anxieties among many constituents. We arrived at that thinking because we presume that the claims approach would not retain the owner/nonowner line as it is today. That is, the owner/nonowner line requires

the liability/equity distinction and, thus, would defeat many of the reasons for eliminating that distinction at the element level, which include reducing the complexities and costs encountered in that model.

115. To overcome concerns about the disruption to practice that change to a claims approach might raise, we think the Boards and staff will need to gain sufficient confidence that the concept of just two elements for the stocks (*assets* and *claims*) is capable of being a useful tool for future standard setting. This paper is a step in that direction but more will need to follow.

116. Regarding our second response, the staff thinks the claims approach can help the Boards in leading to new ways of presenting flows (changes in assets and claims) that are:

    a. **Compatible** with the improvements the Boards seek to make through the financial statement presentation project

    b. Capable of building on that effort in ways that are responsive to the information needs of the users of financial statements and not too disruptive (or costly) to implement in practice.

117. We use **compatible** rather than **consistent** or **identical** because the financial statement presentation project presently is bound by the Boards' existing frameworks. Thus, it seems likely that as long as the current frameworks stay in force, any standards emanating from that standards-level project are bound to retain the owner/nonowner distinction for reporting flows and call for the presentation of a measure of *comprehensive income*.

118. We think the claims approach is **compatible** with the classification schemes and cohesiveness notions being developed in the financial statement presentation project. As discussed in paragraph 110, items of liabilities, equity, and instruments that have characteristics of liabilities and equity could be presented on line items that are more faithful representations of the changes in their amounts. Those line items could be classified and arrayed in ways that provide useful information. For example, some constituents suggest that changes in claims of holders of corporate bonds, convertible debt, and preferred shares might be more meaningfully presented as separate line items

and perhaps grouped within the same section of that statement (for example, financing activities). The claims approach provides sufficient flexibility to achieve that.

119. However, it may be difficult or awkward to present the metric for what is presently defined as comprehensive income and include changes in corporate bonds, hybrid instruments, and preferred shares and perhaps other equity instruments in the same section of a change statement. To illustrate, following is a possible accrual-based flow statement (Statement of Activities). It would bring together flows that are reported in two statements (for example, comprehensive income and changes in owners' equity), which itself could be useful. However, to present the metric for comprehensive income, as defined today, it would require some awkward line items to remove items that are not presently part of comprehensive income. (Refer to lines (lines noted with **(a)** and **(b).**)

Business

Operating *income**
Investment income

Discontinued operations

Financing

Financing income

Financing *expenses**:

Interest (value changes) on corporate bonds

Interest (value changes) on convertible bonds

Dividends (value changes) on MRPS (a)

Dividends on Common Shares (b)

Income taxes

Subtotal

Less adjustment for items that are not expenses:
Dividends (value changes) on MRPS (a)
Dividends on Common Shares (b)

Comprehensive Income

Add Back Changes in Claims:
Dividends (value changes) on MRPS (a)
Dividends on Common Shares (b)

Increase (decrease) in residual claims	(c)

* The terms *income* and *expenses* are used for compatibility with the financial statement presentation project; however, those terms and the definitions of flow elements is a matter that the framework team will address as part of the effort to converge the Boards' present elements.
(c)—presumes that the residual claims would continue to be measured as an accounting construct [Asset – Claims other than residual interests = residual claim (interest); however, the claims approach does not dictate the measurement bases for any particular claims.

120. Rather than trying to preserve comprehensive income (as it is defined today), the staff thinks the Boards' financial statement presentation project and a claims approach can place more emphasis on the use of multiple metrics, including those related to stocks and cash flows. As even the existing frameworks acknowledge, the amounts (subtotals) for business activities, financing activities, income taxes, and discontinued operations and their trends over time communicate much more meaningful information than a single aggregate like comprehensive income, net income or profit or loss.

121. [Sentence omitted from observer notes] Moreover, the FASB made this an explicit point in its Concepts Statement 5, which says that although:

> simplifications, condensations, and aggregations are both necessary and useful, the Board believes it is important to avoid focusing attention almost exclusively on "the bottom line," earnings per share, or other highly simplified condensations. Summary data, such as the amounts of net assets, comprehensive income, earnings, or earnings per share, may be useful as general indicators of the amount of investment or overall past performance and are often used in efforts to compare an entity with many other entities. But, in a complex business enterprise, summary amounts include many heterogeneous things and events. Components of a financial statement often reflect more homogeneous classes of items than the whole statement. The individual items, subtotals, or other parts of a financial statement may often be more useful than the aggregate to those who make investment, credit, and similar decisions. [Paragraph 22, emphasis added.]

122. The staff acknowledges that metrics like earnings per share are ingrained in the marketplace and that any changes that might result in losing that metric would be controversial. However, that metric, like most analytical ratios, are or can

be constructed from information in financial statements and need not be presented on the statements themselves. The point is the Boards have an opportunity to avoid focusing attention almost exclusively on "the bottom line" or any single metric.

Other Statements and Presentation Matters

123. The staff has not yet given sufficient consideration to potential implications for a statement of cash flows or other potential financial statements. However, we do not have reason to think that the elimination of certain constraints that comes with the claims approach would present insurmountable problems.

124. [Paragraph omitted from Observer Notes]

125. We think the current effort to develop an improved common framework provides the Boards with a unique opportunity to set in motion a significant change in thinking that ultimately would further improve financial statement presentation formats. That change would both (a) build on the current standard-setting effort and (b) provide still better ways of presenting information that are useful and responsive to the needs of investors, creditors, and other uses of general-purpose external financial reporting.

OTHER IMPLICATIONS

126. Changing to a single element for all claims is also likely to require significant and intensive educational efforts for the Boards, their staff, and their constituents. Because such a change would be viewed as more significant than most other incremental improvements to the framework, it also could raise questions about whether that change to the framework should (could) be made mandatory without concurrently completing other phases of project, particularly those on measurement (Phase C) and presentation (Phase E). In the past the staff has said that it sees no need to link the completion of the elements phase with any other phase, but the claims approach may challenge that thinking.

127. It also raises questions about how to manage the change process and make effective use of limited staff resources, particularly when the Boards are working on standards projects at the same time. For example, should the

Boards go forward with certain changes in standards now if they are likely to be changed after further developing a claims approach? Should the Boards continue to have staff members work on dual or multiple tracks (for example, converging and improving their liabilities definitions and considering an approach that would eliminate that definition, or at least eliminate it as an element)?

128. It seems to the framework team that if the Boards agree that a claims approach has promise—could lead to significant improvements in financial reporting—the change to practice is such that we think that standards to make that change should be preceded by the development of sound concepts—first principles.