



European Financial Reporting Advisory Group ■

# **EFRAG Discussion Paper *Classification of Claims***

## **Key Themes and Comments Received**

Accounting Standards Advisory Forum, March 2015



This paper has been prepared for a meeting of the Accounting Standards Advisory Forum and to contribute to the development of global accounting standards. The content has not been approved by the EFRAG Board and it does not constitute an official position of the European Financial Reporting Advisory Group.

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#### Introduction

##### Background to development of the Discussion Paper

The 2013 IASB Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* ('the CF DP') proposed using the suggested definition of a liability to distinguish between equity instruments and liabilities. Based on this definition only obligations that could require the entity to transfer economic resources would be classified as liabilities. To provide additional information on obligations that the entity could satisfy by delivering equity instruments the CF DP suggested identifying two sorts of equity claims:

- a. Primary equity claims (being a present right to share in distributions of equity); and

- b. Secondary equity claims (a present right or obligation to receive or deliver another equity claim).

The CF DP suggested that primary equity claims could be indirectly measured using an allocation of underlying net assets and secondary equity claims could be directly measured in the same manner as would a comparable financial liability. Remeasurement of these claims would be presented in an expanded Statement of Changes in Equity.

Many respondents to the CF DP, including EFRAG, supported neither this or another identified proposal ('the narrow equity approach') 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.

During discussion and consultation regarding the proposals in the CF DP, EFRAG identified that there was:

- A lack of clarity on the consequences of certain decisions in the development of a classification model.
- Inconsistent use of terminology:
  - The same words were being used to mean different things; and
  - Different words were being used to mean the same thing.
- No common understanding of the conceptual underpinnings of the current IFRS requirements.

Financial reporting derived from the current requirements of IAS 32 *Financial Instruments: Presentation* has, particularly when

considered in combination with the legal requirements and corporate frameworks in certain countries, been criticised for leading to counter-intuitive accounting. Its underlying principles can be hard to understand and it is inconsistent with the *Conceptual Framework for Financial Reporting*. Significantly different financial reporting can come depending on whether a transaction is determined to be within the scope of IAS 32 or IFRS 2 *Share-based Payment*.

Within Europe, particular attention and comment has been made on the financial reporting under IAS 32 of:

- Puttable shares and written put options on an entity's own equity instruments, including those written to the holders of Non-controlling Interests ('NCI Puts');
- Foreign currency convertible bonds; and
- Contingently convertible instruments ('CoCos').

### EFRAG's aim in writing the Discussion Paper

The IASB has now separated discussion on the equity-liability distinction from the Conceptual Framework project, with a Discussion Paper on the distinction planned to be published in 2015. The forthcoming Exposure Draft of the Conceptual Framework will identify that the distinction remains unaddressed and further work is taking place. Based on the outcome of this further work, the conceptual distinction might be subsequently updated.

EFRAG's aim is to assist the IASB with the development of their project and the engagement of European constituents. To do this, in July 2014 EFRAG published *Classification of Claims*.

EFRAG's Discussion Paper provided a framework for developing classification requirements and in particular set out:

- **What it means to classify claims** – what makes 'an element' an element.
- **Why to classify claims** – what the objectives underlying classification requirements appear to be.
- **How it can be done** – the choices needing to be made in developing classification requirements and their implications.
- **How to talk about it** – a glossary that described/defined terminology for use in discussing the issues.

*Classification of Claims* did not say:

- **What choices should be made** – or the classification requirements to be developed.

### Sources of feedback

*Classification of Claims* had a comment period that ended 31 October 2014. Eleven formal comment letters were received, primarily from European National Standard Setters and accounting professional organisations. All comment letters received are available on the [project page](#) on the EFRAG website, along with a feedback statement summarising comment letters and a final version of the Glossary, which EFRAG has published as a standalone document to assist the development of a common terminology to discuss the issues.

As well as formal comment letters, the Discussion Paper was also presented at the International Forum of Accounting Standard Setters and in outreach meetings with European constituents including accounting professional organisations, European trade associations and prudential regulators.

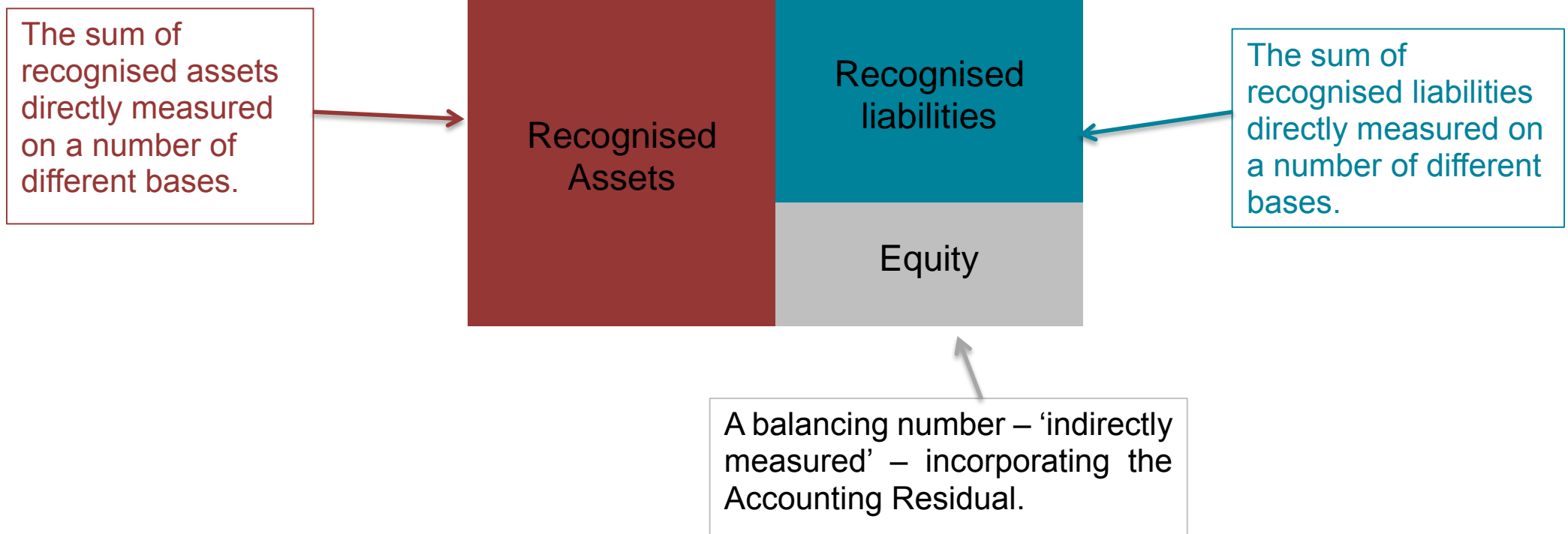
## 2. The current position and the ‘Accounting Residual’

The EFRAG Discussion Paper tried to assist in the development of a common understanding of the current requirements in IFRS and particularly the fundamental concepts.

*Classification of Claims* explicitly introduced the concept of the Accounting Residual, the part of the balance sheet that is not directly measured and is required to ensure that it balances.

Its existence is a result of a number of factors including recognition and measurement mismatches and it does not have any economic or legal substance in itself.

### Entity Balance Sheet



### 3. Key areas and feedback received

## What makes ‘an element’ an element

### What EFRAG’s Discussion Paper said

When distinguishing between claims on an entity, in order to create the building blocks of financial statements – elements – the consequences of a claim being classified as one particular element were:

- **The claim is either directly measured or indirectly measured and incorporated with the Accounting Residual**
- **If the claim is directly measured, whether the changes in the measurement are Income/Expense or something else**

Multiple elements might be aggregated for presentation purposes. For example, Equity as presented on a Balance Sheet could include two elements: one containing claims directly measured and one containing claims indirectly measured.

To provide sufficient information to users, different claims within a single element could be disaggregated and presented separately – as different sorts of liabilities are today.

### Feedback received

Support for this approach was received in outreach meetings.

Comment letters did not mention this.

### Implications

- Explicit identification of the consequences for classification is fundamental to the development of classification requirements.
- Using the proposed consequences of classification, the CF DP proposed three elements for claims:
  - Liabilities
  - Primary equity claims
  - Secondary Equity claims.

## The objectives of classification requirements

### What EFRAG's Discussion Paper said

Choices taken in deriving classification requirements appear to be driven by the underlying objectives of depicting (or contributing to the depiction of):

- **An entity's liquidity;**
- **An entity's solvency;**
- **An entity's financial performance; and**
- **Returns to the holders of a particular class of instruments.**

No particular priority was identified amongst these objectives.

While liquidity and solvency are theoretically independent, in the real world a claim that theoretically only affected an entity's liquidity could also affect its solvency. Classification decisions taken to achieve one objective could conflict with another.

Classification requirements contribute to the depiction of financial performance because of the definitions of Income and Expense, which are based on movements in balance sheet items, including claims.

### Feedback received

This section of the Discussion Paper received significant comments from constituents. In particular, they stated:

- It was not clear what 'depict' means in this situation;
- Assets are also relevant for liquidity and solvency; and
- Priority should be identified amongst the identified objectives, and the contribution to depiction of reported financial performance was very important.

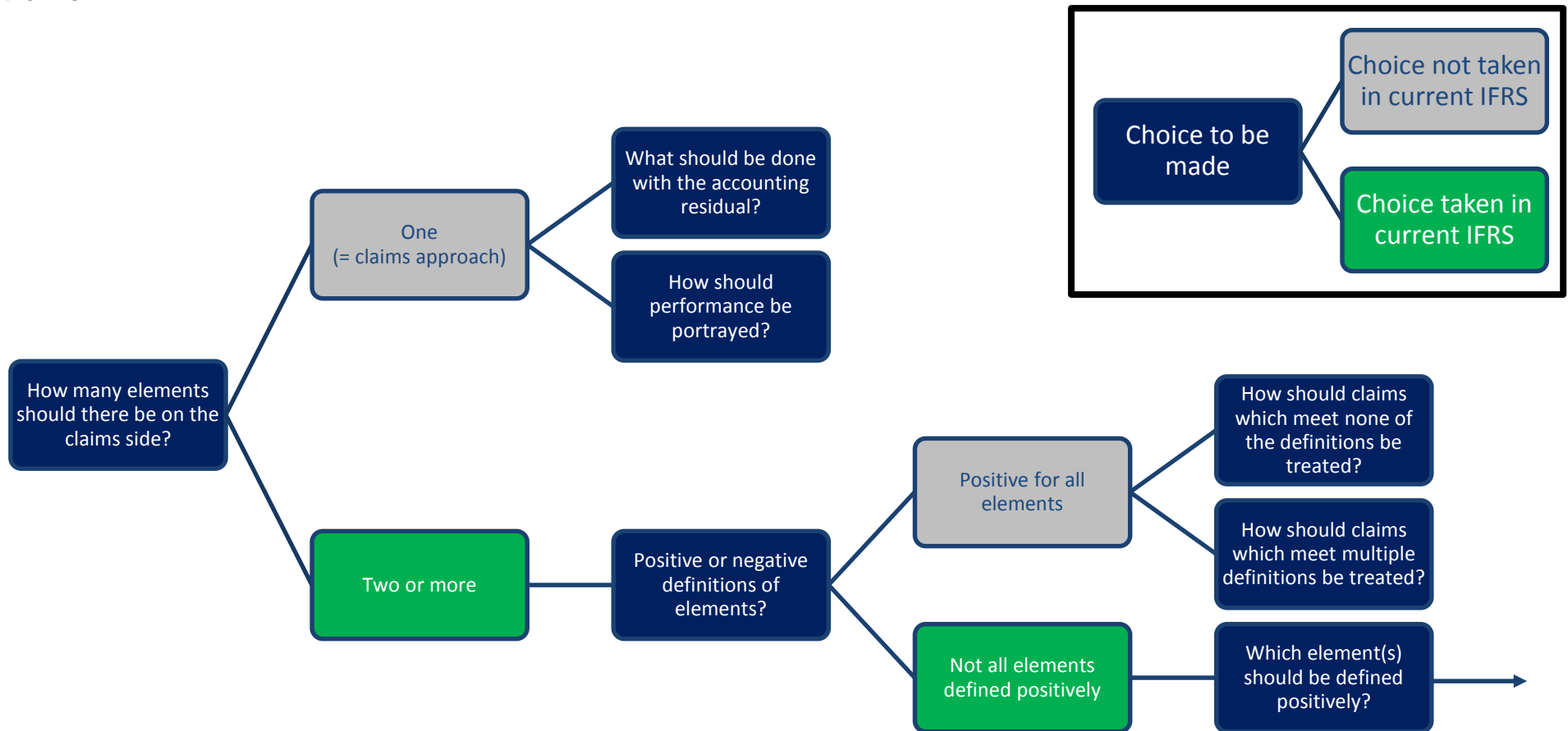
### Implications

- The meaning of 'depiction' should be clarified, and in this case of claims choosing which claims to recognise and directly measure.
- An explicit priority amongst the objectives may assist in resolving conflicts.

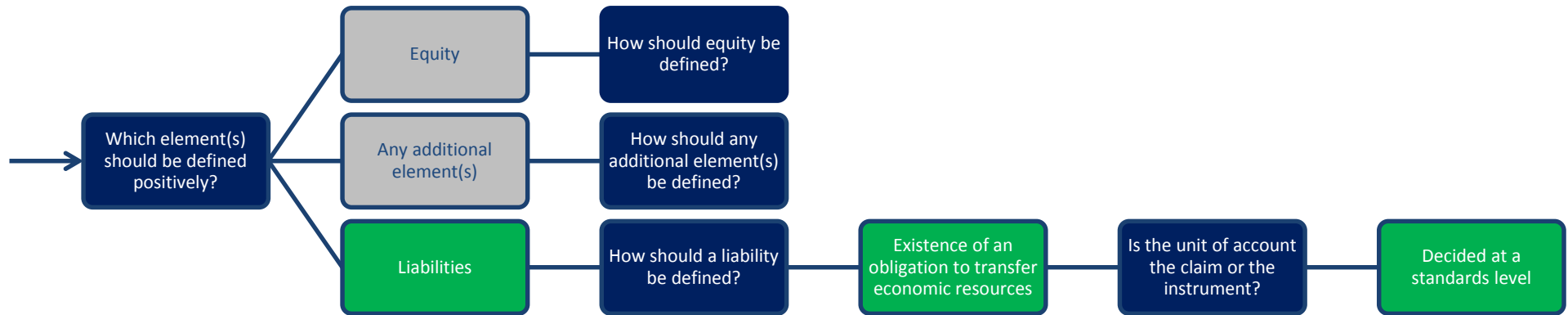
## The choices to be made in developing classification requirements

### What EFRAG’s Discussion Paper said

There were a number of choices that needed to be made, some of which appeared to have other consequences. A potential order in which to take them is.



## The choices to be made in developing classification requirements





## The choices to be made in developing classification requirements

### Feedback received

There was support, in both comment letters and outreach meetings, for:

- The identified choices that need to be made;
- The identified consequences of taking those choices; and
- The suggested order of taking those choices.

A significant number of respondents went further, in their comment letters, than commenting upon the model identified and specifically stated that:

- They supported a development of the approach taken in current IFRS: two elements for claims with a positive definition of a liability and a negative definition of equity.
- The claims approach would require a complete rethinking of the foundations of IFRS and was not supported.

### Implications

- It appears that the identified framework is suitable for developing classification requirements.
- There are significant unanswered questions regarding the claims approach regarding:
  - The Accounting Residual; and
  - The depiction of performance (new definitions would be needed for Income and Expense).

## How many elements should there be

### What EFRAG's Discussion Paper said

An additional element (a three-element classification model) might help in solving problems with current IFRS and conflicts between objectives.

Three potential additional elements were identified:

- **Participating obligations** where the amount of economic resources (cash) required to be transferred is dependent upon entity-specific variables such as profit or 'fair value' of a share.
- **Obligations to transfer or rights to receive claims on equity**, which are similar to existing liability and asset definitions but involve the transfer of claims on equity of the entity rather than economic resources.
- **Instruments that are contractually bail-inable** and the obligation to transfer an economic resource is written off in certain circumstances.

### Feedback received

In both comment letters and at outreach meetings, the feedback received was generally that:

- Additional elements would introduce excessive complexity.
- It is better to try and refine the existing binary classification model.
- It is important to clarify the status of rights to receive claims on equity – are they an asset or not.

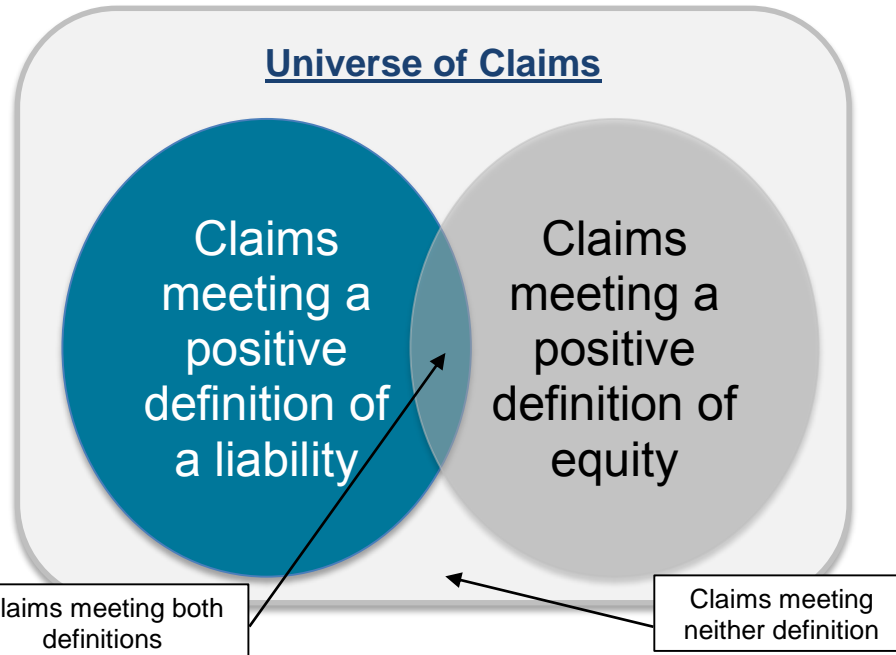
### Implications

- The trade-offs and conflicts between objectives in a binary classification model are seen as an acceptable price to pay in comparison to the increased complexity brought by an additional element.
- If there is not to be a separate element for obligations to transfer/ rights to receive claims on equity it needs to be decided whether they are an asset or not.

## Positive or negative definitions of elements

### What EFRAG’s Discussion Paper said

Elements can be defined positively (based on what they are) or negatively (based on what they are not). *Classification of Claims* suggested that having multiple positive definitions could lead to overlapping or gapping definitions.



Avoiding these undesirable consequences means that at least one element must be defined negatively.

### Feedback received

Feedback on this area of the Discussion Paper was primarily included within comment letters and included:

- Support for the identified implications of multiple positive definitions.
- In order to avoid these undesirable consequences, in a binary classification model there should only be one element defined positively.
- That element should be – as at present – liabilities.

A significant number of respondents explicitly stated that the current model in IFRS should be retained, but with improvements to the positive definition of a liability.

### Implications

Defining all of the elements positively will result in problems, and therefore in a binary classification model only one element should be positively defined.

## A positive definition of equity

### What EFRAG's Discussion Paper said

There could potentially be a link to the perspective of financial reporting, and that the perspective chosen could have an impact on the positive definition of equity chosen.

Within a proprietary perspective to financial reporting, the following might be ways to positively define equity claims:

- Most residual
- Shares/not-shares
- Legal ownership instruments
- Control
- A free choice

There were disagreements on what an entity perspective meant in this context, but some potential ways to positively define equity could include:

- Loss Absorption Approach
- Market participant approach
- Claims that increase neither cash leverage nor return leverage.

Positively defining equity was potentially inconsistent with equity being incorporated with the Accounting Residual.

### Feedback received

Feedback was received in both outreach meetings and comment letters. It included that:

- The link between the perspective of financial reporting and classification of claims was unclear, with academics using the term 'entity perspective' to mean something different to the IASB.
- Within an entity perspective it appears very difficult to positively define equity.
- It is unclear if equity is the residual, or the interest in the residual. This was important because, for some entities, all claims might meet the definition of a liability but the Accounting Residual would remain.

### Implications

- It should be made clear what is meant by the 'entity perspective' when discussing claims.
- Whether equity is the residual or the interest in the residual should be clarified.

## A positive definition of a liability

### What EFRAG’s Discussion Paper said

A positive definition of a liability is the approach currently taken in IFRS and in the proposed revisions to the Conceptual Framework.

The definition is based on the existence of an **obligation** to transfer **economic resources**. The revised Conceptual Framework is expected to provide additional guidance on whether an obligations exists.

Economic resources do not include an entity’s own equity claims, and the definition could result in economically similar transactions being accounted for very differently.

The definition was consistent with only one of the four identified objectives, being the depiction of claims that affect liquidity.

Liquidity	Solvency	Financial Performance	Returns
✓	✗	✗	✗

It did not meet the objectives of depicting (or contributing to the depiction of) solvency or financial performance because it resulted in shares that were puttable to the entity (including NCI Puts) at ‘fair value’ being classified as liabilities and remeasured through the Statement(s) of Comprehensive Income.

### Feedback received

Feedback was received in both outreach and in comment letters. Commented included:

- The definition could be expanded to include obligations to transfer equity claims.
- It was appropriate to have a positive definition of a liability, and IAS 32 was the right starting point for the development of that definition.
- The IAS 32 definition should be refined to try and address some of the problems in current IFRS.
- The definition is important not just for financial instruments but for all liabilities.
- The definition needs to be based on robust principles rather than being a reaction to counter-intuitive accounting for some current instruments.

### Implications

- The feedback received from constituents is generally consistent with the IASB’s tentative decisions to date.

## Dilution

### What EFRAG's Discussion Paper said

There were two dimensions to dilution (and anti-dilution):

- Changes in the number of claims on equity in issue; and
- The different rights of various classes of claims on equity.

There were a number of problems with the use of EPS, especially for entities with complex capital structures. Some instruments containing claims classified as liabilities may also contain claims on equity. The number of claims in issue can vary significantly. The causes of the change in number of claims in issue can include circumstances both in and outside the entity's control.

It may be more appropriate to use disclosures to depict dilution, including potentially:

- Scenario analysis; and
- Models of how different classes of claims on equity share in net income.

Additional investigation was needed to work out the most useful way of presenting information for users.

### Feedback received

Support was expressed, particularly in outreach meetings, for additional investigation of how dilution can be depicted.

### Implications

The depiction of dilution is a different topic than classification, and can be determined separately.

## Glossary

*Classification of Claims* contained a proposed glossary that was developed to assist in the emergence of a common vocabulary to use in discussing the issues.

Based on comments received during the consultation period, EFRAG has revised the Glossary and published it as a standalone document for use by all.

Item	Definition/description
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);</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>

*EFRAG Discussion Paper Classification of Claims – Summary and Feedback*

<b>Item</b>	<b>Definition/description</b>
Cash leverage	The ratio of: <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 asset) 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. For example, financial reports often



*EFRAG Discussion Paper Classification of Claims – Summary and Feedback*

<b>Item</b>	<b>Definition/description</b>
	include quantitative measures such as earnings per share, which may be of particular interest to holders and potential purchasers of those shares.
Equity	In current IFRS this is the difference between recognised assets and recognised liabilities and incorporates the Accounting Residual, 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	<p>An instrument that contains claims that are both a liability and an actual claim on equity.</p> <p>An example of an instrument that contains separate features is puttable/redeemable instrument (a liability) that also entitles the holder to discretionary dividends (a claim on equity).</p>
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 as they fall due, 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	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 changes presented in the statement(s) of comprehensive income. Measurement incorporates both at initial recognition and subsequent changes.

*EFRAG Discussion Paper Classification of Claims – Summary and Feedback*

<b>Item</b>	<b>Definition/description</b>
Most residual instrument/claim	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. The identification of this claim is dependent upon comparison with all other claims on the entity.
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	A present obligation of the entity to transfer a claim on equity as a result of past events. 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.

*EFRAG Discussion Paper Classification of Claims – Summary and Feedback*

<b>Item</b>	<b>Definition/description</b>
	<p>Examples of such instruments currently common 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	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).
Proprietary perspective financial reporting	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.
Reserves	Generic term for retained earnings, and other specifically identified components of equity, including those required by IFRS or regulatory requirements.
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. Upon settlement, these will be treasury shares. 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>

*EFRAG Discussion Paper Classification of Claims – Summary and Feedback*

<b>Item</b>	<b>Definition/description</b>
Rights to distributions	Rights to receive payments that are made at the discretion of the entity. The quantum of these distributions may be either fixed or determinable, or decided by the entity.
Share	An instrument evidencing ownership of a company within certain corporate structures and legal frameworks.
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	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. Legally, reacquired own shares may be claims on the equity of the entity.
Unclaimed equity	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: <ul style="list-style-type: none"><li>• some cooperatives;</li><li>• the UK Trustee Savings Banks; and</li><li>• charities.</li></ul>