European Financial Reporting Advisory Group

FEEDBACK STATEMENT

Responses to

EFRAG Discussion Paper

Classification of Claims

This feedback statement has been prepared by the EFRAG staff for the convenience of constituents and represents a summary of responses received to the EFRAG Discussion Paper. It does not represent an expression of the views of EFRAG.

Introduction

The EFRAG Discussion Paper *Classification of Claims* ('the Discussion Paper') was published on 9 July 2014. Its publication was supported by 15 National Standard Setters. These National Standard Setters, while encouraging debate on the issues presented in the paper, did not express any opinion on those matters at that stage.

The comment period on the paper closed on 31 October 2014. During the comment period, the Discussion Paper was discussed in outreach meetings with constituents and was presented at the International Forum of Accounting Standard Setters.

Why was the Discussion Paper written?

The 2013 IASB Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* ('the Conceptual Framework DP') identified two potential ways of distinguishing between equity instruments and liabilities, which were described as the 'narrow equity approach' and the 'strict obligation approach'. The majority of respondents to the Discussion Paper, including EFRAG, did not support either of the two approaches as discussed for a number of reasons. In its final comment letter EFRAG suggested that the IASB should not attempt to provide the conceptual basis for a distinction as part of the current revision of the Conceptual Framework but should, in parallel, undertake a more comprehensive discussion on what the distinction means and is attempting to portray.

Following consultation with the Accounting Standards Advisory Forum, the IASB decided to tackle the equity/liability distinction in parallel with the wider Conceptual Framework project.

Classification of Claims was written to assist the IASB with its project on the equity/liability distinction - the next stage of which is a discussion paper, expected to be published in 2015 - and to enable constituent engagement.

The aim of the Discussion Paper was not to suggest how claims should be classified. Instead, it provided a framework for use in developing classification requirements, explained and explored what appeared to be the objectives driving classification, identified the consequences of taking particular choices within the framework and provided a common terminology that could be used to discuss the issues.

Responses from constituents

Eleven comment letters were received in response to the Discussion Paper. A list of respondents is in the Appendix to this feedback statement. All comment letters received are available on the project's page on the EFRAG website.

Purpose and use of this feedback statement

This feedback statement has been prepared as a summary of the responses received. It summarises the messages received from constituents and notes any key themes identified.

This feedback statement should be read in conjunction with the Discussion Paper, which is available on the EFRAG website.

Key themes in the Discussion Paper

The Discussion Paper contained a number of key areas:

- The consequences of classification for a particular claim and the meaning of 'element' in that context;
- The objectives of classification;
- The choices to be taken in creating classification requirements (the decision framework) and the consequences of doing so;

- A discussion on whether some of the identified conflicts between classification objectives can be reduced through the use of one or more additional element(s); and
- A Glossary.

Questions asked in the Discussion Paper

The Discussion Paper asked eight specific questions on four main areas of the Discussion Paper and one general 'any other comments' question.

Overall objectives

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

Classification choices

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

Elements

Q3 If you support classifying all claims as a single element (the claims approach) how do you think the accounting residual and unclaimed equity should be accounted for? How should financial performance be depicted?

Q4 Do you think it is possible to positively define equity such that more of the identified objectives are met? If so, how should it be defined?

Q5 Do you think it is possible to positively define liabilities such that more of the identified objectives are met? If so, how should it be defined?

Q6 Do you think the inclusion of an additional element could assist in meeting some of the identified objectives? If so, what should that element be and how should it interact with the existing elements?

Dilution

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

Glossary

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

Key messages

The Discussion Paper provided a framework for making classification requirements, identifying the choices that need to be taken and suggesting an order in which they could be taken. It also identified the consequences of taking certain choices, including how they might conflict with the identified objectives of classification.

Respondents to the Discussion Paper generally supported the identified framework and choices to be taken, but in a number of cases disagreed with how the identified objectives were described and derived and/or the relative priority assigned to them.

As well as answering regarding the identified framework, most respondents went further and explicitly called for a binary classification model, with a positive definition of a liability and a negative definition of equity. As was identified in the Discussion Paper, this is the approach taken in current IFRS. In making this call, the respondents suggested that the definition of a liability should be adjusted (but without suggesting how) in order to address current problems in financial reporting but that the overall approach should remain the same.

The Discussion Paper identified a number of ways in which the objectives could conflict with each other, and in particular within a binary classification model that did not appear to be consistent with meeting all of the identified objectives. It stated that a three-element classification model could potentially assist in meeting more of the objectives, and identified some potential third elements.

In calling for a binary classification model respondents did not support further exploration of whether any of these third elements could assist with financial reporting.

A number of minor comments were made with respect to the glossary, and most respondents welcomed it as a worthwhile addition to the topic.

Analysis of responses

Overall objectives

What the Discussion Paper said

Within the overall objectives of financial reporting, choices on the classification of claims are based on a number of objectives. The Discussion Paper identified these objectives as being to depict (or contribute to depicting):

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

The Discussion Paper did not assign any particular priority or preference to any of these objectives.

Question to Constituents

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

Comments from constituents

This question was answered by nine constituents and was the one with the most varied opinions expressed.

Four respondents overall agreed with the identification of the objectives.

One respondent disagreed on the grounds that the identified objectives were too theoretical.

The comments from the other respondents were in a number of different areas, which for the purposes of analysis have been broken down into:

- The role and derivation of the objectives
- Prioritisation of the objectives; and
- Interaction of the objectives.

The role and derivation of the objectives

Two respondents particularly commented on the role of the objectives as they were included in the Discussion Paper. These comments included that 'classification requirements may result in depicting claims in a way that enables users to derive their own assessment of liquidity and solvency' and that the respondent doubts 'whether 'depict' is the right word to describe what financial reporting seeks to do in relation to all these objectives. While the force of this point probably varies for the different items in the list, for some of them at least financial reporting can only provide part of the information that users' need to form their own judgements.'

One of these respondents also stated that when users are assessing liquidity and solvency, information about the entity's assets was also important, and that 'the terms 'liquidity' and 'solvency' prima facie seem to be linked to an entity's economic resources rather than to the claims on those resources. In our view, the EFRAG DP does not explain sufficiently why and how these terms are linked to the credit side of the balance sheet so that objectives a) and b) can be derived.'

Prioritisation of the objectives

Four respondents commented on the priority of the identified objectives and, in some cases, disagreed with what they saw as the priorities applied to them in the Discussion Paper.

Given that the Discussion Paper asserted it did not appear possible to meet all of the objectives, some respondents suggested that other means would need to be used to enable the other objectives to be met. For example, to enable the objective of showing returns to the holders of a particular class of instrument to be met other tools such as earnings per share may be more appropriate.

Interaction of the objectives

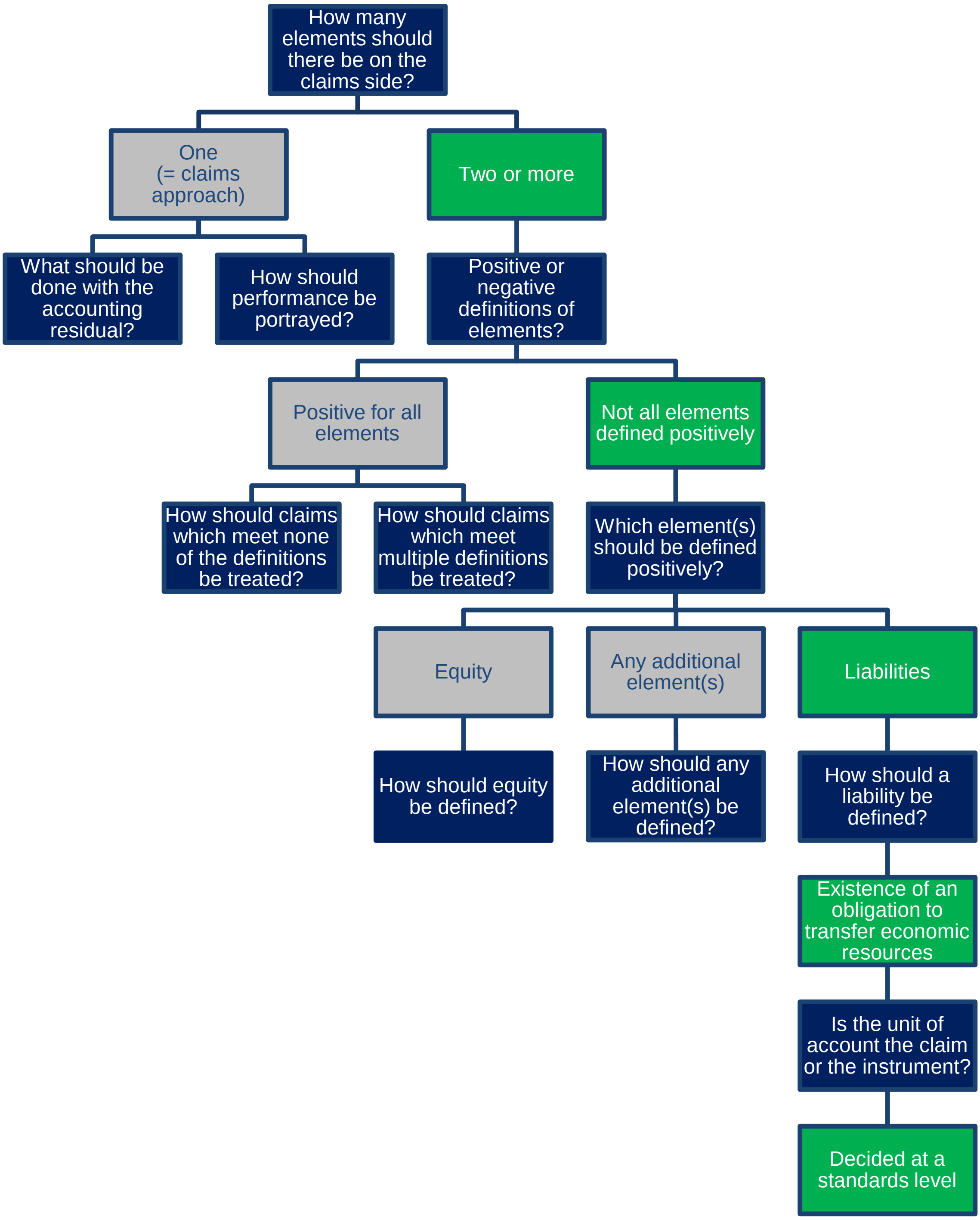
Three respondents commented upon the interaction of the objectives, particularly with respect to performance reporting. Two of these acknowledged that the financial performance of an entity is strongly related to changes in balance sheet elements, such as claims and economic resources, but also that financial performance is an issue of changes in claims and economic resources (see OB15 of the CF) rather than an issue of claims and resources themselves.

Another respondent believed that it was important to 'define positively the concept of performance as something other than simply the changes in assets and liabilities. We encourage EFRAG to explore the possibility in dissociating the presentation of gains and losses (in performance or elsewhere) from the presentation of the related instrument as liability or equity as a way forward in establishing principles that achieve relevant information from both a balance sheet and performance statement perspective.'

Classification choices

What the Discussion Paper said

The Discussion Paper identified a number of choices to be taken in developing classification requirements, and a potential order in which these could be addressed.



Question to constituents

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

Comments from constituents

Ten constituents answered this question. One constituent was not sure and asked for additional clarity on the choices. One constituent thought that there was an overarching question that needed to be decided first – 'how should performance be reported?' This was linked to the respondent's prioritisation of contributing to the depiction of financial performance as the primary objective.

The other eight constituents generally agreed that the identified choices to be taken were appropriate.

Elements

What the Discussion Paper said

The Discussion Paper identified a number of problems with classifying all claims as a single element, including how and whether the balance sheet would balance. Within a two element approach, it discussed positive and negative definitions of equity and liabilities and potential ways of developing these definitions. Having identified, in a two-element classification model, that there appears to be conflicts between the objectives, the Discussion Paper explored whether the use of additional element[s] could be of use in reducing these conflicts

Questions to constituents

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

Comments from constituents

Question 3 – challenges to be solved before progressing with the claims approach

Eight respondents answered this question. None of the respondents gave suggestions for how the identified challenges with the claims approach (including the accounting residual, accounting for unclaimed equity and performance reporting) should be addressed.

Seven respondents explicitly stated they did not support a claims approach. The reasons given included 'for the claims approach to be decision-useful, it would require all balance sheet items to be recognised at fair value. Doing this consistently would, in essence, mean to present balance sheet information for the purpose of presenting or approximating the value of the reporting entity itself, which conflicts with the objectives of financial reporting as stated in OB7 of the CF' and 'would provide users with less useful information'. One respondent did not believe it was, today, anything other than a purely theoretical option and that discussing' all types of approaches could prevent to focus on the most important aspects'.

One respondent, while stating it had not decided whether or not it supported the claims approach, thought that it 'could have advantages compared to other alternatives since having two classes would to a greater extent give rise to arbitrary distinctions (between the classes)' and that the approach should be further assessed by the IASB in its work.

Question 4 – Positive definition of equity

Nine respondents answered this question. None of the respondents made suggestions for how equity could be positively defined such that more of the identified objectives could be met. One other respondent did not answer due to their concerns regarding derivation of the objectives.

Seven respondents explicitly did not support defining equity positively. The reasons given varied, and included that it was inconsistent with current IFRS and would mean a complete shift away from the IFRS framework and standards, that IAS 32 is generally right in starting from a positive definition of liabilities and that it would not be achievable given defining an element based on a legal definition is not an option in the context of international standards.

One respondent stated they believed it was possible to define equity positively, but they were not sure if that would lead to more of the identified objectives being met and they were not currently in a position to suggest how it should be defined positively.

One other respondent had a nuanced approach, stating 'we are skeptical regarding a positive definition of equity: due to the enormous varieties of equity, a positive definition would have to be very complicated. This effect is amplified by the diversity of legislations in different jurisdictions. Moreover, due to the existing varieties, we doubt that it is possible to develop a definition that provides for strong and practical criteria for segregation' and also expressing support for the negative equity definition approach of IAS 32.

However, this respondent also stated that 'the proprietary perspective presented in the Discussion Paper as an approach to positively define equity has its merit. Even if we do not support a positive definition of equity, we believe that ownership could be better reflected by depicting the close relationship between company law (which is not internationally harmonized) and the legal forms derived from this on the one hand, and recognition in the balance sheet on the other hand. Generally speaking, limited-liability companies in Europe must have a minimum amount of equity at the time of their establishment (equity required under company law). This also applies to co-operatives. We are of the opinion that this kind of capital which represents owner rights and is liable in relation to all other creditors must in any case be recognized in the balance sheet as equity' and suggested that a final-control approach 'is the only way to define an internationally accepted term for equity.'

The respondent also emphasised the importance of IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* in considering the equity-liability distinction and the conceptual framework.

Question 5 – Positive definition of liabilities

Nine respondents answered this question. One respondent did not answer due to their concerns regarding derivation of the objectives.

Respondents made a variety of comments. These included that:

- A positive definition of liability should apply not just in respect of financial instruments, but wider and that it needed to be wider than just 'obligations', given the link to reporting of financial performance;
- the definition 'must be linked to the definition of assets and cannot be considered independently';

- the current definitions are adequate and that it would be better to decide things on a case by case basis by the IFRS IC or the IASB rather than 'to try to reach overall consensus and/or a perfect solution';
- the definitions in IAS 32 mostly work, but some aspects should be analysed in more detail. For example 'instruments held by others than owners may be accounting for equity and at the same time its returns could be presenting in the statement of comprehensive income' and the role of economic compulsion;
- 'the current definition of liabilities provides a good starting point for pursuing further research' but that further work is needed to refine the definition in some areas, for example NCI Puts and obligations that can be settled using a variable number of shares of the entity; and
- 'the current definition of liability does not reach all of the possible aims, however at this present time there is no better alternative'.

Question 6 – an additional element?

All eleven respondents answered the question. One respondent supported a three element approach. One other respondent considered it should at least be considered in further work on classification of claims.

The respondent who supported the use of a third element stated 'The question that arises is whether the instruments in this additional category shall be revalued. We think that they normally should not, since in many cases the value changes would be difficult to interpret e.g. that an increase in value attributable to an equity characteristic would have a negative effect on equity or that a decrease in value attributable to a debt characteristic would have a positive effect on equity. However, revaluation should be possible and the accounting treatment should be decided by the IASB on an individual standard basis. For instruments that are revalued a decision should be made whether the change in value should be classified as part of profit & loss or as other comprehensive income.'

The other nine respondents did not support the use of a third element. The reasons given included:

- There would still need to be an accounting residual that would be negatively defined;
- An additional element means at least one more positive definition would be required;
- The discussion about the 'correct' distinction between elements would continue;
- It would be unduly complicated and a better approach is full disclosure in the notes and, where appropriate, the balance sheet; and
- For contractually bail-inable instruments it would not represent economic reality due to the wide range of instruments, including demand deposits, which may actually get written down at the demand of a regulator.

Depicting dilution

What the Discussion Paper said

The Discussion Paper discussed options for depicting dilution (including scenario analysis and models) and the rights of various classes of claims on equity but made no concrete proposals.

Question to constituents

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

Comments from constituents

Eight respondents answered this question. Most respondents who answered commented generally, supporting the specific ideas regarding scenario analysis and modelling and/or generally on disclosures.

One respondent highlighted that the term dilution 'does not seem to be consistently understood. Some define dilution in relation to the parent entity shareholders, others link it to all types of capital providers. By establishing the notion of wealth transfers the IASB quite obviously applies the former understanding, which is consistent with our view. Therefore, we recommend instead using the phrase "parent entity shareholder dilution" or defining dilution in that particular context.'. This respondent also stated that 'the approach as proposed by the IASB bears some disadvantages which should be solved. A comprehensive depiction of all wealth transfers between different classes of equity holders could only be achieved if all classes of equity holders were directly measured. Given our belief that not all equity claims should be directly measured (as this would lead to a complete measurement of all items at fair value), the limitation of comprehensiveness needs to be compensated by some other kind of information. Nevertheless, we would support the IASB's idea to be explored further.'

One respondent was concerned that problems with positively defining equity in an international context would also be a source of difficulty in defining multiple classes of equity.

One other respondent, while supporting the use of disclosures stated 'We think that dilutive effects should not, generally, lead to economic effects, therefore we do not consider necessary to depict directly the dilution in Profit or Loss. In fact, we support an entity perspective of financial reporting according to which financial information is presented from the perspective of the entity as an economic unit separate from its owners, rather than a proprietary one.'

The glossary

What the Discussion Paper said

The Discussion Paper contained a glossary designed to assist in creating a common vocabulary.

Question to constituents

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

Comments from constituents

Those constituents who responded to this question generally agreed with the glossary, but with some comments on specific definitions. Some respondents explicitly welcomed the Glossary as being useful, either for the purposes of the Discussion Paper and/or the topic in general. One respondent thought that the Glossary was too detailed and contained too many items.

Based on the comments from constituents and other feedback, EFRAG has revised the Glossary, which has been published as a separate document, available from the EFRAG website, to provide a common terminology for the topic.

Any other comments

Question to constituents

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

Comments from constituents

Seven respondents had additional comments, which covered a number of different areas:

- The importance of the perspective of financial reporting and an apparent lack of clarity on both whether the IASB is following an entity perspective and what this means for standard-setting;
- That ‘the residual’ is an entity’s net assets and that ‘equity is the interest in the residual’;
- The focus needs to be wider than just financial instruments and that the interaction with the debit side of the balance sheet is important;
- That it was better to address these issues at the standards level and through rapid decisions by the IASB/IFRS IC than on an overall conceptual basis;
- It was of concern that there was an asymmetry in treatment between IAS 32 and IFRS 2 *Shared-based Payment* and, it would be better to recognise a liability for acquisition of a good or service with an obligation of future delivery of equity instruments, with the liability being fulfilled only by settlement of the obligation;
- It was important to recognise the role of the equity/liability distinction in bank regulatory requirements (Basel III and the Capital Requirements Regulation/Directives) and that any final standard should be consistent with the requirements of IFRIC 2; and
- Breaking the link to the definitions of income and expense may allow more flexibility in the classification of claims, which could also impact some of the discussions regarding unit of account.

APPENDIX – List of respondents

Name	Country	Nature
AFRAC	Austria	National Standard Setter
ASCG	Germany	National Standard Setter
DASB	Netherlands	National Standard Setter
European Association of Cooperative Banks	Europe wide	European Association
FEE	Europe wide	European Accounting Organisation
ICAC	Spain	National Standard Setter
Institute of Chartered Accountants in England and Wales	UK	Accounting Organisation
NASB	Norway	National Standard Setter
OIC	Italy	National Standard Setter
SFRB	Sweden	National Standard Setter
UAB Raimda auditas	Lithuania	Auditor