

## Benjamin Reilly

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**From:** Martin schmidt <mschmidt@escpeurope.eu>  
**Sent:** 19 December 2013 14:50  
**To:** CommentLetters  
**Cc:** Benjamin Reilly  
**Subject:** Thoughts on EFRAG's draft comment letter re: IASB DP A Review of the Conceptual Framework for Financial Reporting

Dear Mme Flores,

I would like to submit a couple of thoughts on EFRAG's draft comment letter (DCL) regarding the IASB's DP "A Review of the Conceptual Framework for Financial Reporting", and hope you might find these thoughts helpful.

- The DCL distinguishes between two notions of a residual (§ 137). I think the "lack of relevance and understandability" which motivated the IASB to give in to Europe's concerns regarding puttable instruments (which in turn led to the 'puttables amendment') is linked to this distinction: If the residual claim is classified as a liability, because the claim is puttable by the holder (legal owner), the claim is re-measured, and it is this re-measurement that causes the "lack of understandability" (i.e., no profit or loss, because any profit or loss would be „absorbed“ in re-measuring the residual claim, see also § 225, etc.). It is also this claim that requires the measurement of the entire entity (§ 142), if the claim is to a pro-rata share of the entity's value, which is the case in German partnerships (by German civil law). In other words, the combination of the requirements to (i) classify as debt and (ii) re-measure the claim requires re-measuring entity value. This scenario can also occur under the puttables amendment (because the exception does not extend to non-controlling interests), and it does occur regularly in Germany, as many subsidiaries will be partnerships with non-controlling interests (for various reasons, mostly tax).

- While I would generally agree with the arguments proposed in the DCL that (ref. § 146 (a)) one way to define equity is by defining the owners and proceed from there, this approach can be complex as well. For many legal forms, there can be more than one class of owners (think, for example, of common and preferred stock or limited and general partners). Consequently, this general approach is not fully consistent with the way in which the IASB describes the narrow equity approach (NEA): This approach is based on the notion of one residual class of claims, which are the claims by the owners. But there might be issues across Europe if there are legal forms with more than one class of owners (see above). These potential issues are difficult to evaluate, because the DP naturally lacks specific guidance or even a proposal for a standard-level definition, but I would encourage EFRAG to consider this potential issue. The evaluation will likely hinge on how „most residual“ will be defined under the NEA, and whether or not a one class of instruments has a sort of benefit over another class in terms of how profits are distributed (e.g., a preference share that has some sort of benefit over common shares in terms of how the profit is to be distributed). This might differ across Europe. The comment letter currently only hints at the issue in § 155 (b), but I think the issue might be more severe across Europe.

- Another potential way to look at a "residual" that is not mentioned in § 152 (b) is a sort of time dimension: The IASB, when working on the puttables amendment, was under the impression that any instrument that can be put (or matures) before another instrument classified as equity due to not imposing an obligation, can - by definition - not be "the" residual. This even applies if the puttable instrument is, by the extent of the claim, a residual one (i.e., the puttable instrument's claim is only a pro-rata share to the net assets, thereby acknowledging the existence of all other claims at that point in time). In this sense, I do not think that

EFRAG's proposal in § 153 is a solution to the issue mentioned in § 152 (c): How could a subsidiary ever designate any claim as residual?

- What surprised me was that, while EFRAG noted a number of advantages of an obligation-based approach (§ 162), EFRAG did not make mention of the difficulties. Many consider economic compulsion and including equity settlement alternatives without economic substance (i.e., IAS 32.20) to be major conceptual difficulties that come with any obligation-based approach. EFRAG may remember that the FASB discarded some of the FASB's own approaches because the FASB felt these issues could not be solved (see the minutes of the FASB meeting on 27 July 2007). I noted that §§ 86 f., 197 are linked to and hint at this problem. However, given that the underlying conceptual issue is more serious than what is currently hinted at in these three paragraphs, EFRAG might consider expanding on these obstacles. In find it somewhat surprising that the IASB chooses to propose an obligation-based approach without outlining a solution to these issues.

- I have trouble with understanding § 167 (a) – in my opinion, IFRIC 2 simply illustrates the application of IAS 32's principle. As such, one would arrive at the same conclusion even without IFRIC 2, and I do not see why this illustration needs to be included at standard level. I acknowledge that often interpretations go beyond what is set out in the respective standard (e.g., the former SIC-12, or IFRIC 10). But that is not the case with IFRIC 2.

As mentioned earlier, I do hope that you might find some of these thoughts helpful.

Best regards,

Martin

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