DRSC e. V. • Zimmerstr. 30 • 10969 Berlin

Telefon +49 (0)30 206412-12
Telefax +49 (0)30 206412-15
E-Mail info@drsc.de

EFRAG
Françoise Flores
35 Square de Meeûs

B-1000 Brussels

Berlin, 14 October, 2014

Dear Françoise,

EFRAG Discussion Paper: Classification of Claims

On behalf of the Accounting Standards Committee of Germany, I am writing to comment on the discussion paper *Classification of Claims* (hereinafter referred to as the “EFRAG DP”) issued by the European Financial Reporting Advisory Group (EFRAG) in July 2014.

We generally support EFRAG’s initiative to assist the IASB by pointing out significant questions to be dealt with when setting accounting rules for the credit side of the balance sheet. In our view those issues need to be considered by the IASB in more detail than the Board has done in recent deliberations in particular with respect to the IASB Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* and IAS 32, and we support EFRAG encouraging the IASB to do so.

We appreciate the opportunity to provide our view on the issues identified in the EFRAG-DP.

If you would like to discuss our comments enclosed in the Appendix further, please do not hesitate to contact me.

Yours sincerely,

Liesel Knorr
President

Appendix – Answers to the questions of the discussion paper

Question 1: *Overall objectives*

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?

Based on the general objectives of Financial Reporting as laid down in the Conceptual Framework for Financial Reporting (the CF), EFRAG derives the objectives of the classification of claims as being to depict

a) an entity's liquidity,
b) an entity's solvency,
c) an entity's financial performance and
d) returns to the holders of a particular class of instrument.

We agree that classification requirements for the credit side of the balance sheet need to be based on the general objectives of Financial Reporting. However, it is not obvious to us why and how these four objectives of classification requirements are derived from the general objectives.

Firstly, paragraph OB13 of the CF states that information about the nature and amounts of a reporting entity's economic resources and claims can help users to identify the entity's financial strengths and weaknesses. This can help users to assess the entity's liquidity and solvency, but we would not conclude that the classification requirements for claims directly aim at depicting liquidity and solvency. Rather, classification requirements may result in depicting claims in a way that enables users to derive their own assessment of liquidity and solvency. Furthermore, 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.

We note that the IASB, though focusing exclusively on the dichotomy, has discussed the objectives to depict liquidity and solvency in the same context as EFRAG does in its DP. Nevertheless, it remains unclear to us why and how these objectives establish relevant criteria for the presentation of claims in general, or the distinction of classes of claims in particular.

Secondly, we acknowledge that the financial performance of an entity is strongly related to changes in balance sheet elements, such as claims and economic resources. But – in analogy to the preceding paragraph – 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. Therefore, we are reluctant to follow the derivation of objective c) made in the EFRAG DP.

In our opinion, the review of all decisions EFRAG proposes to be made against the background of defined objectives is very useful. However, we note that EFRAG concludes that no single method of classifying claims (including the no-split approach) will meet all objectives. This fact may cause deciding on classification requirements to be difficult or impossible to make. Therefore, the objectives need to be weighted. We recommend considering an appropriate weighting when taking the feedback on the EFRAG DP to the next step.

Question 2: *Classification choices*

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?

We believe EFRAG has appropriately identified the relevant choices that need to be made in determining classification requirements.

Question 3: *Elements*

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?

We do not support the claims approach. We acknowledge that the claims approach appears to bear a significant advantage vis-à-vis other alternatives, as – by classifying all claims as a single element – it avoids any arbitrary (and often potentially questionable) distinction between two or more classes of elements. However, we believe that 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 ("General purpose financial reports are not designed to show the value of a reporting entity").

We further acknowledge that the dichotomy as currently established in IFRSs does not seem to be free of disadvantages either, as – for example – the arbitrarily fixed boundary will always give rise to intensive conceptual discussions and/or adjustments made by users (such

as analysts). Nevertheless, we feel that the existing dichotomy provides a meaningful starting point, on which any user-specific adjustments and conclusions can be based.

Were we to support the claims approach, whereas we do not, the accounting residual (as previously stated) would need to be calculated based on all balance sheet items recognised at fair value. In all other cases the accounting residual would be lacking in any useful information.

Generally speaking, a fully fair value based balance sheet would not result in financial performance calculated appropriately, as financial performance does not exclusively depend on changes in balance sheet items. At this stage, we have struggled somewhat with finding a sound answer on how financial performance should be depicted, as this issue needs to be addressed further and in more detail.

Question 4: ***Elements***

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?

Question 5: ***Elements***

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?

As we do not think that the objectives are derived convincingly, we are not in a position to answer Q4 and Q5 meaningfully. We refer to our discussion with respect to Q1.

Question 6: ***Elements***

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?

For the reason explained before, we answer this question without consideration of the condition “meeting some of the identified objectives”.

Generally speaking, we doubt that the inclusion of a third element would contribute to the distinction of equity and debt or to the classification of claims generally becoming more meaningful. Even the existence of a third element would not avoid the need of there being an accounting residual. The discussion about the “correct” distinction of the (then three) elements could not be abandoned but would continue, as the accounting residual may always

contain claims that may be classified into one or more of the other classes of claims. This argument is valid, irrespective of whether equity or debt or the third element is the accounting residual, because the residual can only be negatively, and thus unambiguously, defined.

Question 7: ***Dilution***

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?

We do not consider the term "dilution" to be helpful, as its meaning 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.

In our view, there is a variety of alternatives existing as to how dilution as defined in the preceding paragraph can be depicted. One possible approach is the proposal of the IASB made in its Discussion Paper *A Review of the Conceptual Framework for Financial Reporting*. This approach aims at addressing dilution by depicting wealth transfers between existing shareholders and option holders, i.e. the value movements within equity between primary and secondary equity claim holders.

However, we think 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.

Question 8: ***Glossary***

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?

We agree with the proposed descriptions/definitions contained within the glossary.

Question 9: ***Any other issues***
Do you have any other comments in relation to classification of claims?

Perspective of Financial Reporting

The EFRAG DP states that recent decisions of the IASB reflect an entity perspective of Financial Reporting. We agree that many of these decisions indicate that the Board tends to follow the entity perspective rather than the proprietary perspective. However, the content of some ongoing discussions of the IASB (depicting dilution) and a number of existing IFRSs (e.g. IAS 33 *Earnings per share*) involve the features of the proprietary perspective. Thus, we note that the Board does not consistently follow the entity perspective – yet. Given that, a clarification and explanation of the purpose of standards based on the proprietary perspective as well as their nature seem important. In conclusion, the ASCG recommends addressing this inconsistency when taking the feedback on the EFRAG DP to the next step.

We note the EFRAG DP addresses the discussion about the perspective of Financial Reporting in the context of a positive definition of equity. In our view, the perspective has to be seen as all-encompassing. We consider the discussion about the perspective of Financial Reporting to be of fundamental importance for all decisions on how to design Financial Reporting Standards including, but not limited to, how to positively define debt and how to positively define equity. The relevant perspective should be discussed and decided on before International Financial Reporting Standards are set. Therefore, we recommend addressing this issue as the most fundamental question to be answered before all other decisions, including the decisions for the development of classification requirements, can be made.