ICAEW REPRESENTATION 139/14

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CLASSIFICATION OF CLAIMS

ICAEW welcomes the opportunity to comment on the discussion paper (DP), *Classification of Claims*, published by the European Financial Reporting Advisory Group (EFRAG) on 9 July 2014, a copy of which is available from this link.

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MAJOR POINTS

Support for the initiative

1. We welcome the DP, which provides a timely and helpful discussion of important issues in the development of a revised conceptual framework by the International Accounting Standards Board (IASB). We note that, as stated at paragraph 3 of the DP, the IASB proposes to publish a discussion paper on the equity/liability distinction at about the same time as it publishes an exposure draft of a revised framework.

Scope

2. The scope of the paper is limited to claims that arise from financial instruments. While we understand why there should be a focus on such claims, because of the difficulties that they give rise to in practice, we do not think that it is realistic to tackle the questions raised in the DP in isolation from claims that arise other than from financial instruments. We do not see why it would be appropriate to have one set of principles in the conceptual framework for the classification of claims that relate to financial instruments and another set of principles that relate to other claims.

Reporting financial performance

3. The DP identifies four objectives that are relevant to discussing the classification of claims. We believe that priority among these objectives should be given to reporting financial performance.

Number of elements

4. The most fundamental issue in the DP is whether the current two-element approach to claims (which the DP calls the ‘binary-split’ approach), distinguishing equity from liabilities, is the right one, or whether there should be a single-element approach (the ‘no-split’ or ‘claims’ approach) or whether additional elements should be recognised in addition to equity and liabilities. The DP does not make any definite proposals in this respect, but in our view the current two-element approach is the right one. The distinction between equity and liabilities provides users with useful information, and we do not think that the DP identifies any additional elements that it would be helpful to recognise, nor are we aware of any.

Road-testing

5. We suggest that the next step for developing the ideas in the DP should be for them to be road-tested by companies. This could be organised either by EFRAG or the IASB.

RESPONSES TO SPECIFIC QUESTIONS

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?

6. The DP identifies four relevant objectives (paragraph 22): ‘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.’

We doubt 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. Narrative reporting may well be equally or more important; this is certainly the case in relation to liquidity.

7. Liquidity is a forward-looking concept. It is not just about the state of affairs at the date of the balance sheet, but, as the DP points out, the ability subsequently to meet claims by raising funds in various ways. To assess this requires the sort of discussion that belongs in narrative reporting as well as financial reporting disclosures. The assessment of liquidity becomes less useful the further we look into the future, and it would be helpful to include a timescale in the description in the Glossary, eg, until the date of the next financial statements.

8. To some extent, similar considerations apply in the case of solvency. Users do indeed use financial reporting information to help them assess 'the degree to which the value of the economic resources of the entity exceed the value of its obligations' (DP: Glossary), but again other information is needed. In particular, not all of a company's economic resources are recognised on its balance sheet and those that are recognised are not usually shown at their current 'value'.

9. We do not disagree with the four objectives identified, but it would be useful to prioritise them and, in the case of liquidity and solvency, to recognise that they are about risk. We therefore suggest the following objectives, in order of importance:

- Financial performance.
- Returns to the holders of different classes of instrument.
- Solvency risk.
- Liquidity risk.

We place financial performance first because we believe that most users see the provision of information to help them assess this as the primary role of financial reporting. We place liquidity risk last for reasons outlined in paragraph 7 above.

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?

10. In our view, and reflecting our comments in the preceding paragraph, 'How should performance be portrayed?' is the key question and should therefore be at the apex of the decision tree on page 15 of the DP, applicable whether a one-element or two-element approach is adopted. The DP argues that a one-element approach would require 'an alternative way of depicting performance … to be developed' (paragraph 67). This may be so, but the point is not developed in the DP; we believe that it requires further thought and that, whichever approach is adopted for the classification of claims, reporting performance would remain the key objective.

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?

11. We believe that classifying all claims as a single element would provide users with less useful information than they currently receive, and so we do not support it. Question 3 indicates some of the issues that advocates of this approach would have to deal with; indeed, it is not clear to us how an accounting residual arises under the single-element approach. They would also have to address other questions such as how credit balances would be ranked in the balance sheet and how the equity of private companies would be 'directly' measured.

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?

12. We do not think that a positive definition of equity would be useful in helping to meet the objectives identified for the classification of claims. The DP notes that 'Some national GAAPs historically had a positive definition of equity based on legal definitions' (paragraph 91). The DP does not mention specific instances, but we suspect that such definitions may have existed for legal reasons rather than to help provide more useful financial reporting information. Introducing a positive definition would bring a risk that a third category would be required for claims that do not meet the definitions of either equity or liabilities.

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?

13. In our response (ICAEW Rep 06/14) to the IASB's discussion paper, *A Review of the Conceptual Framework for Financial Reporting*, we argued that the IASB's proposed definition of 'liability' was too narrow, mainly because the word 'obligation' seems to be too constricting if all the liabilities that we think it would be appropriate to recognise are to meet the definition. These would include liabilities for expenses incurred in an accounting period that need to be recognised in order to give the most useful measurement of financial performance in the period. We were unable to suggest a definition that would satisfactorily cover all the items that we think it should, but we see this as an indication of the dangers of being bound rigidly by a definition in the conceptual framework.

14. Subject to this, we agree that using a positive definition of 'liability' is the best way to proceed in relation to the classification of claims. As it may not be possible to find a definition of 'liability' that would work well in all circumstances, we believe that standard setters should be able to depart from the definition in standards. But when they do so, they should explain why they have.

15. This question demonstrates why it is unhelpful to consider claims arising from financial instruments in isolation from other claims, as it would be desirable to develop principles for accounting for liabilities that apply across claims regardless of their origin.

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?

16. The DP suggests three possible 'additional' elements: participating obligations, obligations to transfer claims on equity, and contractually bail-inable instruments.

17. We think that defining participating obligations as an additional type of claim would be unduly complicated. We are not sure whether in principle obligations to transfer claims on equity are an additional element within claims, but again we think that defining them as an additional element would be unduly complicated. We do not consider that contractually bail-inable instruments are in principle a different type of element. In all these cases, the nature of such claims is in our view best dealt with, not by treating them in the accounts as a form of claim distinct from liabilities and equity, but by full disclosure in the notes and, where appropriate, separate disclosure in the balance sheet.

18. The DP, in the box on page 21, gives FRS 4, *Capital Instruments*, as a specific example of the recognition of an additional element. We think this is misleading. The distinction in FRS 4 between equity shareholders' funds, non-equity shareholders' funds, and liabilities was made to meet UK legal requirements. It was not done as a matter of principle in order to provide more useful financial reporting information, but because legal constraints prevented more flexibility. We suspect that the same may be true of similar provisions in other countries, eg, the reference to US GAAP in the box on page 23 of the DP.

19. We are unaware of any other forms of claim that might be considered to constitute a third element within claims, distinct from equity and liabilities.

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?

20. We agree with the proposal at paragraph 164 of the DP that the effects of dilution are best dealt with by disclosures. We do not have any proposals on how best to show the returns on different classes of equity.

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?

21. We agree with most of the proposed descriptions, although, as noted above, we think that a timescale needs to be included in the description of 'liquidity'.

22. The description of 'reserves' needs to be corrected on one point. Under IAS 16, *Property, Plant and Equipment*, paragraph 11, revaluation surpluses go through other comprehensive income, not direct to equity. The same applies to revaluation surpluses under IAS 38, *Intangible Assets*, paragraph 85, and IAS 39, *Financial Instruments: Recognition and Measurement*, paragraph 55(b).

Any other issues

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

23. We have a few detailed comments on the draft, which we set out in the next section of this response.

OTHER POINTS

Components of equity

24. At paragraph 14, the DP identifies three components of equity: accumulated but undistributed profits, contributions from equity holders, and other reserves required by IFRS or legal requirements. It might be more accurate to identify just two basic components: contributions from equity holders and undistributed gains. IFRS or the law may require specific reserves within either of these two basic components.

Obligations to deliver equity instruments

25. At paragraph 18(a), the DP states that 'obligations to deliver equity instruments are classified as liabilities, unless … the obligation is to deliver a fixed number of equity instruments in exchange for a fixed amount of cash'. We do not think that 'in exchange for a fixed amount of cash' is correct. For instance, an obligation to deliver a fixed number of one's own shares is not a liability even if it is in exchange for something else, eg, an amount of oil.

Meaning of the 'residual'

26. Contrary to what is said in the box on page 24 of the DP, under IFRS the 'residual' is always the entity's net assets; equity is the *interest* in the residual.