# IFRIC POTENTIAL AGENDA ITEM REQUEST

## I. The issues:

## I.A. Application of IAS 32.37 - extent of transaction costs to be accounted for as a deduction from equity -

## I.B. Application of IAS 32.38 - allocation of transaction costs that relate jointly to more than one transaction -

### I.A.1. Extent of transaction costs to be accounted for as a deduction from equity

> *IAS 32.37 An entity typically incurs various costs in issuing or acquiring its own equity instruments. Those costs might include registration and other regulatory fees, amounts paid to legal, accounting and other professional advisers, printing costs and stamp duties. The transaction costs of an equity transaction are accounted for as a deduction from equity (net of any related income tax benefit) to the extent they are incremental costs directly attributable to the equity transaction that otherwise would have been avoided. The costs of an equity transaction that is abandoned are recognised as an expense.*

The following issues in applying IAS 32.37 relate specifically to the meaning of the terms '*incremental*' and '*directly attributable*' as further outlined below in I.A.2. **Accounting literature and practice** indicate a huge variety in interpreting the Standard with respect to the extent of the transactions costs to be accounted for as a deduction from equity. The costs which are treated as a deduction from equity range

- from external costs only (still in line with the understanding of the former SIC-17),
- to an approach of also including internal costs which are in a strict manner directly attributable to the equity transaction (e.g. excluding all non-variable payroll-expenses), and finally,
- to a much broader approach including all external and internal costs which are in the same manner attributable to the equity transaction.

Based on the prevailing opinion in accounting literature and practice and due to the fact that IAS 32.37 does not include the SIC-17 restriction of the '*incremental costs directly attributable to the equity transaction*' to be external, our following comments are based on the understanding that internal costs can qualify for inclusion in costs to be deducted from equity.

### I.A.2. Interpretation of the terms '*directly attributable*' and '*incremental*' in the context of IAS 32

The term '***directly attributable***' raises questions according to the extent of the transaction costs that can be deducted from equity, such as:

- is the term **strictly** restricted to **direct costs**, or
- is it also required to consider overhead costs which can be allocated directly to the equity transaction; for instance, payroll expenses for employees of the issuing company assigned in full to the team handling the IPO and therefore working exclusively for this IPO; or

- is it further required to **break down overhead costs** which can be attributed directly to the transaction based on a sound allocation scheme; for instance, costs for market / product studies in preparation for the IPO?

These issues in applying IAS 32.37 are best illustrated with reference to the following examples:

- **payroll expenses** for an **investor relations manager** just hired for an IPO and leaving the company immediately after the IPO has been completed: is it possible to deduct those payroll expenses that are incurred while the IPO is carried out as a deduction from equity? The '*incremental*' condition is fulfilled whereas it is not clear whether these expenses meet the "directly attributable" requirement in respect to the IPO as his or her activities might inherently serve the company's investor relationships in a more general meaning ; in this context – does it make a difference whether the investor relations manager is not on the company's payroll but working as a freelancer for the company?
- **expenses** for **language courses** for the management to be able to run road shows on an international basis: is it possible to deduct these expenses from equity although the benefits of such language courses normally can be used for virtually endless other purposes?
- **special success fees** (bonuses) paid to management for successfully completing the IPO: are those expenses to be considered as directly attributable to the IPO or part of the normal management's salary (and thus being considered general overheads not being directly attributable)?

The **main issue** to operationalise the term '*directly attributable*' in connection with the term '*incremental*' as used in IAS 32.37 is to properly draw the line between those costs that can be deducted from equity and those costs that have to be recognised as expenses in profit or loss. Apparently IAS 32 does not provide sufficiently clear guidance on this issue.

According to IAS 32.37 '***incremental***' means that costs incurred would have been avoided in case that the equity transaction would not have taken place. However, the term '***incremental'*** can also be found in other IAS/IFRS, for instance:

- IAS 17 - 'Initial direct costs are often incurred by lessors and include amounts such as commissions, legal fees and internal costs that are **incremental** and directly attributable…' (IAS 17.38).
- IAS 39 - 'Transaction costs are **incremental** costs that are directly attributable…' (IAS 39.9).

We understand that the term should be used in the same meaning throughout all IFRS unless it has <u>by purpose</u> a different notion. If the latter proves true, however, we would expect that this is explained or at least indicated in the relevant standard.

## I.B. Allocation of transaction costs that relate jointly to more than one transaction

According to IAS 32.38 transaction costs that relate jointly to more than one transaction, i.e.. costs of a concurrent offering of some shares and a stock exchange listing of other shares are allocated to those transactions using a basis of allocation that is rational and consistent with similar transactions. In the following we act on the assumption that only <u>one type of shares</u> exists.

It is our understanding that costs incurred from listing existing shares are not transaction costs since no capital increase results. Such costs are only incurred to make the existing shares more marketable and therefore should be expensed as incurred to the income statement. On the other hand, costs incurred in issuing new shares to raise capital are transaction costs of equity instruments and should hence be charged to equity.

Thus, in case of a concurrent offering of new shares and a stock exchange listing of other previously existing shares, **<u>in a first step</u>** companies would need to identify the costs that are specifically attributable to the issuance of the new shares. Such costs shall be accounted for as a deduction from equity (eg there may be costs incurred in listing the newly issued shares, which are directly attributable to the issuance of the new shares with no need for any allocation). Likewise, those costs directly attributable to the listing of the newly listed but previously existing shares should be charged to the income statement.

It is the understanding of the AIC that **<u>in a second step</u>** ,based on a rational and consistent basis, all remaining costs of the IPO which relate jointly to both transactions shall be allocated based on the number of shares, i.e. the number of the newly issued shares which lead to a capital increase plus the number of any newly listed but previously existing shares (allocation based on the ratio of the number of old to new shares). The AIC is of the opinion that the total number of shares –regardless of whether they were offered or sold during the IPO - is generally the most appropriate basis for a rational and consistent approach, unless there are dissenting contractual agreements.

Furthermore, the question arises whether a lock-up period, in which the existing shareholders are unable to sell their shares for a defined period after the IPO, alters the method used for allocating the costs incurred between the newly issued and previously existing shares. We come to the conclusion that lock-up periods should have no impact on the allocation of transaction costs as mentioned above.

The AIC is of the opinion that users are in need of clear guidance on these issues.

## II. Current practice: diversity in practice

Some members of the AIC are working in the National Competence Centers for IFRS of the Big Four accounting firms. Based on their insight into the actual accounting practice we have thorough support for the fact that currently there is diversity in practice in applying IAS 32.37-38. This is expected to continue or even increase in the future without respective guidance.

Furthermore, the German enforcer for financial reporting (the Financial Reporting Enforcement Panel (FREP)) as well as the SWX Swiss Exchange (enforcement department) have informed us that from their experience they support the view that diversity in practice regarding IAS 32.37-38 is a significant issue.

According to the above, diversity in practice due to different interpretations of IAS 32.37-38 is not merely a specific German but rather an important international issue.

## III. Reasons for the IFRIC to address the issue:

**a) Is the issue widespread and practical?**

Due to the simple fact that IPOs are common events in today's capital markets, the AIC is of the opinion that the issues addressed above are of widespread and practical importance.

**b) Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?**

Accounting literature and actual practice show a huge variety in interpreting IAS 32.37-38 as outlined above. We also refer to the comments as outlined above specifically in respect to current international practice (i.e. diversity in practice observed by Big Four accounting firms; the FREP and the SWX Swiss Exchange (enforcement department).

**c) Would financial reporting be improved through elimination of the diversity?**

Financial reporting will be improved by eliminating diversity in practice since the accounting for equity transactions based on an appropriate interpretation of the IFRIC would enhance comparability among companies' financial reporting.

**d) Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and *Framework for the Preparation and Presentation of Financial Statements,* but not so narrow that it is inefficient to apply the interpretation process?**

We are of the opinion that the issue is sufficiently narrow in order to be addressed by an interpretation of the IFRIC.

**e) If the issue relates to current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project? (The IFRIC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the IFRIC would require to complete its due process).**

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## Submitted by:

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| **Name:** | **Prof. Dr. Manfred Bolin** |
| **Orgainsation:** | **AIC (Accounting Interpretations Committee e.V.) / Germany** |
| **Address:** | **Zimmerstrasse 30**<br>**10969 Berlin**<br>**Germany** |
| **Telephone:** | **+49 30 2064 12 13** |
| **Email:** | **bolin@drsc.de** |