EFRAG
European Financial Reporting Advisory Group

INVITATION TO COMMENT ON EFRAG'S ASSESSMENTS OF THE AMENDMENTS TO IAS 32 'CLASSIFICATION OF RIGHTS ISSUES'

Comments should be sent to commentletter@efrag.org by 4 November 2009

EFRAG has been asked by the European Commission to provide it with advice and supporting material on the Amendments to IAS 32 *Classification of Rights Issues* (the Amendments). In order to do that, EFRAG has been carrying out a technical assessment of the Amendments against the criteria for endorsement set out in Regulation (EC) No 1606/2002 and has also been assessing the costs and benefits that would arise from its implementation in the EU.

A summary of the Amendments is set out in Appendix 1.

Before finalising its two assessments, EFRAG would welcome your views on the issues set out below. Please note that all responses received will be placed on the public record unless the respondent requests confidentiality. In the interest of transparency EFRAG will wish to discuss the responses it receives in a public meeting, so we would prefer to be able to publish all the responses received.

1 Please provide the following details about yourself:

(a) Your name or, if you are responding on behalf of an organisation or company, its name:

German Accounting Standards Board (GASB)

(b) Are you/Is your organisation or company a:

☐ Preparer ☐ User ☒ Other (please specify)

National Standard-setter

(c) Please provide a short description of your activity/the general activity of your organisation or company:

(d) Country where you/your organisation or company is located:

Germany

(e) Contact details including e-mail address:

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2 EFRAG's initial assessment of the Amendments is that they meet the technical criteria for endorsement. In other words, they are not contrary to the true and fair principle and they meet the criteria of understandability, relevance, reliability and comparability. EFRAG's reasoning is set out in Appendix 2.

(a) Do you agree with this assessment?

☒ Yes ☐ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

(b) Are there any issues that are not mentioned in Appendix 2 that you believe EFRAG should take into account in its technical evaluation of the Amendments? If there are, what are those issues and why do you believe they are relevant to the evaluation?

There are no other issues.

3 EFRAG is also assessing the costs that will arise for preparers and for users on application of the Amendments in the EU, both in year one and in subsequent years. Some initial work has been carried out, and the responses to this Invitation to Comment will be used to complete the assessment.

The results of the initial assessment are set out in Appendix 3. To summarise, EFRAG's initial assessment is that:

(a) implementing the Amendments is likely to involve those preparers affected by them a decrease in preparation costs. This decrease seems likely however to be insignificant;

(b) the Amendments are likely to involve users in additional but insignificant analysis costs; and

(c) the Amendments are also likely to result in an improvement in the quality of the information provided about most foreign currency rights issues.

Do you agree with this assessment?

☐ Yes ☐ No

If you do not, please explain why you do not and (if possible) explain broadly what you believe the costs involved will be?

As a national standard-setter, we are not in a position to answer this question.

4 Based on the conclusions described in paragraph 3 above, EFRAG has tentatively concluded that the benefits to be derived from applying the Amendments are likely to exceed the costs involved.

Do you agree with this assessment?

☒ Yes ☐ No

If you do not, please explain why you do not and what you think the implications should be for EFRAG's endorsement advice?

5 EFRAG is not aware of any other factors that should be taken into account in reaching a decision as to what endorsement advice it should give the European Commission on the Amendments.

Do you agree that there are no other factors?

☒ Yes ☐ No

If you do not, please explain why you do not and what you think the implications should be for EFRAG's endorsement advice?

APPENDIX 1
A SUMMARY OF THE AMENDMENTS TO IAS 32 - *CLASSIFICATION OF RIGHTS ISSUES*

1 A common way for an entity to raise additional capital is to make a rights issue. Such rights issues can take a variety of forms, but in essence what they do is give some or all of the existing holders of the class of share involved the right to subscribe to further shares of that class, usually at a price below the market price. Equity rights issues have been used by a number of financial institutions over the last year or so to strengthen their capital base, although there have been a number of large rights issues made by other types of entity as well.

2 Under existing accounting standards, capital instruments issued by an entity are classified as either equity or as liabilities. In some cases they are split (bifurcated) into equity and liability components. Equity instruments and equity components are accounted for very differently from liabilities.

3 Some entities operate in a multi-currency environment. In such circumstances, existing standards require them to determine their functional currency (in essence the currency in which they carry out their key activities) and to treat all transactions in other currencies as involving a currency exposure that should be accounted for through profit and loss.

4 In recent times a number of entities have been making rights issues that require settlement in currencies other than their functional currency. Because these rights issues have a foreign currency exposure, existing accounting standards require such rights issues to be treated as a liability—specifically a derivative liability—and therefore marked-to-market through profit or loss. A number of commentators have questioned whether such accounting is appropriate, arguing that, notwithstanding the currency exposure, the substance of these rights issues is that they are equity instruments and should be treated accordingly. The IASB agrees with this argument and is therefore, through these amendments, changing the accounting standards so that foreign currency rights issues will in future be required to be treated purely as equity transactions.

APPENDIX 2
EFRAG'S TECHNICAL ASSESSMENT OF THE AMENDMENTS TO IAS 32 AGAINST THE ENDORSEMENT CRITERIA

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity as a contributor to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as adviser to the European Commission on endorsement of the final IFRS or Interpretation on the issue.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS or Interpretation against the European endorsement criteria, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRSs or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

Does the accounting that results from the application of the Amendments meet the criteria for EU endorsement?

1 EFRAG has considered whether it believes that the Amendments meet the requirements of the European Parliament and of the Council on the application of international accounting standards, in other words that the Amendments:

(a) are not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

(b) meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

EFRAG has also considered whether it is in the European interest to adopt the Amendments.

Relevance

2 According to the Framework, information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations.

3 EFRAG considered whether the Amendments would result in the provision of relevant information—in other words, information that has predictive value, confirmatory value or both—or whether it would result in the omission of relevant information.

4 Under existing IFRS, the transactions falling within the scope of the Amendment would result in the foreign currency exposure (arising from the difference between the currency in which the transactions are to be settled and the entity's functional currency) and the equity price risk exposure being marked-to-market with gains and losses reported in profit or loss. Under the Amendments, these gains and losses will not be reported in profit or loss. EFRAG has therefore considered whether the 'non-

reporting' of these gains and losses as they arise means that relevant information is no longer being provided in the financial statements.

5 The nature of transactions carried out by a reporting entity with its equity holders as equity holders is that they are fundamentally different transactions from other transactions ('ordinary transactions') carried out by the entity and that aspects of the transactions that would be relevant to report in the financial statements were they to arise in the context of ordinary transactions are not relevant. EFRAG's initial assessment is that this is the position in this case. For that reason, EFRAG's overall assessment is that the Amendments meet the relevance criterion.

Reliability

6 EFRAG also considered the reliability of the information that will be provided by applying the Amendments. The Framework explains that information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

7 There are a number of aspects to the notion of reliability: freedom from material error and bias, representationally faithful, and complete. In EFRAG's view, the Amendments do not raise any issues concerning freedom from material error and bias or completeness. Furthermore, it believes that the key issue to be considered in the context of faithful representation is whether the Amendments correctly differentiate between transactions that are transactions carried out by a reporting entity with its equity holders as equity holders and other transactions.

8 The Amendment applies only to rights issues, options or warrants to acquire a fixed number of the reporting entity's own equity instruments for a fixed amount of any currency that are offered pro rata to all of the entity's existing owners of the same class of its own non-derivative equity instruments. EFRAG has no concerns about such transactions when they embody the terms and conditions that usually relate to such transactions. However, some EFRAG members have some concerns about two types of transaction:

(a) long-dated rights issues; in other words, rights issues where the period between issue and exercise is much longer than the normal period; and

(b) rights issues that are disproportionately large compared to the amount of shares outstanding in that particular class.

In both cases, the concern is that the transaction has the potential to involve more than just a transaction carried out by a reporting entity with its equity holders as equity holders.

9 EFRAG notes however that, were such transactions to be carried out, they would be highly visible and, as a result, are likely to be both apparent to and understood by users of the financial statements. Furthermore, EFRAG believes that the Amendments will result in a significant improvement in the representational

faithfulness of the accounting treatment of the vast majority of transactions falling within the scope of the Amendments. As a result, EFRAG's initial assessment is that overall the Amendments will not give rise to reliability concerns.

Comparability

10 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.

11 EFRAG has considered whether the Amendments have been scoped in a way that results in transactions that are economically similar being accounted for differently, or transactions that are economically different being accounted for as if they are similar. EFRAG's initial assessment is that that is not the case with the Amendments. As a result, its initial assessment is that the Amendments meet the comparability criterion.

Understandability

12 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting and the willingness to study the information with reasonable diligence. Although there are a number of aspects to the notion of 'understandability', EFRAG believes that most aspects are covered by the discussion above about relevance, reliability and comparability (because, for example, information that represents something as similar when it is in fact dissimilar is not comparable, and that lack of comparability will mean it is also not understandable). As a result, EFRAG believes that the main additional issue it needs to consider in assessing whether the information resulting from the application of the Amendments is understandable is whether that information will be unduly complex. In EFRAG's view the Amendments do not introduce any new complexities.

13 EFRAG's initial assessment is therefore that the Amendments meet the understandability criterion.

True and fair view

14 EFRAG has also concluded that there is no reason to believe that the information resulting from the application of the Amendments would be contrary to the true and fair view principle.

European interest

15 EFRAG is not aware of any reason to believe that it is in the European interest not to adopt the Amendments.

Conclusion

16 Having considered the various arguments described in this Appendix, EFRAG has concluded that the Amendments satisfy the criteria for endorsement in the EU.

APPENDIX 3
EFRAG'S EVALUATION OF THE COSTS AND BENEFITS OF THE AMENDMENTS TO IAS 32

1 EFRAG has also considered whether, and if so to what extent, implementing the Amendments in the EU might involve preparers and/or users incurring incremental costs, and whether those costs are likely to be exceeded by the benefits to be derived from their adoption.

Costs for preparers

2 EFRAG has carried out an initial assessment of the additional work the Amendments are likely to create (or what work they might save) preparers. Under existing IFRS, transactions falling within the scope of the Amendments were treated as derivative liabilities and were as a result accounted for at fair value through profit or loss from the date the foreign currency rights are issued until the shares are delivered i.e. the rights issues are settled. Under the Amendments, changes in the fair value of the rights issues between issue date and settlement are not reported. Instead, the change in foreign currency exchange rates during that period would be accounted for when payment for the shares is received. EFRAG's initial assessment is that this will save the preparer some work, although in most cases this will involve only one reporting period and overall is likely to be insignificant in cost terms.

Costs for users

3 EFRAG has also carried out an initial assessment of the implications of the Amendments for the costs incurred by users of the financial statements. It concluded that there could be a small increase in costs to address the possibility that some rights issues within the scope of the Amendments might involve something more than just a transaction with equity holders as equity holders. This increase in costs is however likely to be insignificant.

Benefits for preparers and users

4 Finally, EFRAG assessed the benefits that are likely to arise from the Amendments. EFRAG's initial assessment is that the Amendments will result in an improvement in the quality of the information provided about most foreign currency rights issues, because the impact of exposure to an entity's own share price on instruments that are in substance equity will no longer be reported in profit or loss.

Conclusion

5 EFRAG's overall assessment is that:

(a) implementing the Amendments is likely to involve a decrease in preparation costs for those preparers affected by them. The decrease seems likely however to be insignificant;

(b) the Amendments are likely to involve users in additional but insignificant analysis costs; and

(c) the Amendments are also likely to result in an improvement in the quality of the information provided about most foreign currency rights issues.

6 EFRAG's initial assessment is therefore that the benefits that will arise from implementing the Amendments in the EU are likely to exceed the costs.