

The costs and benefits of implementing the Amendment to IAS 32 *Classification of Rights Issues*

INTRODUCTION

- 1 Following discussions between the various parties involved in the EU endorsement process, the European Commission decided in 2007 that more extensive information than hitherto needs to be gathered on the costs and benefits of all new or revised Standards and Interpretations as part of the endorsement process. It has further been agreed that EFRAG will gather that information in the case of the Amendment to IAS 32 *Classification of Rights Issues* ('the Amendment').
- 2 EFRAG first considered how extensive the work would need to be. For some Standards or Interpretations, it might be necessary to carry out some fairly extensive work in order to understand fully the cost and benefit implications of the Standard or Interpretation being assessed. However, in the case of the Amendment, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work. (The results of the consultations EFRAG has carried out seem to confirm this.) Therefore, as explained more fully in the main sections of the report, the approach EFRAG has adopted has been to carry out a detailed initial assessment of the likely costs and benefits of implementing the Amendment in the EU, to consult on the results of that initial assessment, and to finalise that assessment in the light of the comments received.

EFRAG's endorsement advice

- 3 EFRAG also carries out a technical assessment of all new and revised Standards and Interpretations issued by the IASB and IFRIC against the so-called endorsement criteria and provides the results of those technical assessments to the European Commission in the form of recommendations as to whether or not the Standard or Interpretation assessed should be endorsed for use in the EU. As part of those technical assessments, EFRAG gives consideration to the costs and benefits that would arise from implementing the new or revised Standard or Interpretation in the EU. EFRAG has therefore taken the conclusion at the end of this report into account in finalising its endorsement advice.

A SUMMARY OF THE AMENDMENT

- 4 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.
- 5 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 and liability components.
- 6 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.
- 7 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 this Amendment, changing the accounting standards so that foreign currency rights issues will in future be required to be treated purely as equity transactions.

EFRAG'S INITIAL ASSESSMENT OF THE COSTS AND BENEFITS OF THE AMENDMENT AND STAKEHOLDERS' VIEWS ON THE ISSUES

- 8 EFRAG carried out an initial assessment of the costs and benefits expected to arise for preparers and for users, both in year one and in subsequent years, from implementing the Amendment. In summary, the results of that initial assessment were that the Amendment is likely to involve:
 - (a) some preparers affected by the Amendment in a decrease in preparation costs. That decrease though was thought likely to be insignificant;
 - (b) users in additional but insignificant analysis costs;
 - (c) improvements in the quality of the information provided about most foreign currency rights issues. Taken individually, most of these improvements are likely to be relatively small; however, EFRAG's initial assessment was that taken

together the Amendment is likely to have a noticeable effect on the quality of the information provided.

- 9 The overall conclusion of EFRAG's initial assessment was that the benefits expected to arise from applying the Amendment are likely to exceed the costs involved in the implementation.
- 10 EFRAG published its initial assessment and supporting analysis for comment on 8 October 2009. The results of the consultation can be summarised as follows. Where specific responses to the questions posed were provided by respondents:
 - (a) All respondents agreed with EFRAG's assessment of costs involved for users and preparers.
 - (b) All respondents agreed with EFRAG's assessment of the benefits associated with implementing the Amendment and with EFRAG's conclusion that the benefits to be derived from application of the Amendment are likely to exceed the costs involved.

EFRAG'S FINAL ANALYSIS OF THE COSTS AND BENEFITS OF THE AMENDMENT

- 11 Based on its initial analysis and stakeholders' views on that analysis, EFRAG's detailed final analysis of the costs and benefits of the Amendment is presented in the paragraphs below.

Costs for preparers

- 12 EFRAG has carried out an assessment of the additional work the Amendment is likely to create (or what work it might save) preparers. Under existing IFRS, transactions falling within the scope of the Amendment 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 Amendment, 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 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

- 13 EFRAG has also carried out an assessment of the implications of the Amendment 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 Amendment 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

- 14 Finally, EFRAG assessed the benefits that are likely to arise from the Amendment. EFRAG's assessment is that the Amendment 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

- 15 EFRAG's overall assessment is that:
- (a) implementing the Amendment is likely to involve a decrease in preparation costs for those preparers affected by it. The decrease seems likely however to be insignificant;
 - (b) the Amendment is likely to involve users in additional but insignificant analysis costs; and
 - (c) the Amendment is also likely to result in an improvement in the quality of the information provided about most foreign currency rights issues.
- 16 EFRAG's assessment is therefore that the benefits that will arise from implementing the Amendment in the EU are likely to exceed the costs.

Stig Enevoldsen
EFRAG, Chairman
6 November 2009