EFRAG

European Financial Reporting Advisory Group

The costs and benefits of implementing the amendment to IAS 32 and IAS 1 "Puttable Financial Instruments and Obligations Arising on Liquidation"

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 *Financial Instruments: Presentation* and IAS 1 *Presentation of Financial Statements* "Puttable Financial Instruments and Obligations Arising on Liquidation" (hereafter referred to as '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 detailed initial assessments of the likely costs and benefits of implementing the amendment in the EU, to consult on the results of those initial assessments, and to finalise those assessments 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 to IAS 32 and IAS 1

4 All companies need financing, and they obtain that financing from a range of sources, including shares, traded loans, bank loans and overdrafts, and trade creditors.

5 The accounting model that underpins IFRS requires financing to be split into two categories: equity and liabilities. Currently in general the principle is that this is done by asking, in the case of shares, derivatives and other financial instruments, whether

the item is a financial liability as defined in IFRS. If it is, it is classified as a 'liability' and if it is not, it is classified as 'equity'. Thus, normal ordinary shares are equity. Some other types of share might be however treated as liabilities.

6 Normally the existence of secondary markets provides holders of capital instruments with a liquidity mechanism (i.e. the ability to sell their holdings). Even if a liquid market does not exist in a particular instrument, there remains the potential to liquidate the holding by finding a purchaser. However, some companies, such as for example partnerships or co-operatives, might be obliged (sometimes by the law in the country of their incorporation) to redeem ordinary shares they have issued if the holders of such instruments request the redemption. The purpose of the redemption could be to provide a liquidity mechanism for holders of such instruments.

7 Some entities are incorporated with an indefinite life. Some other entities however could be required to liquidate on the exit of any partner or in accordance with the law can have only a limited life (for example 100 years).

8 Under the version of IAS 32 that is currently endorsed ("current IAS 32"), the existence of an obligation to redeem ordinary shares at the request of their holders or on a liquidation that is outside the control of the entity means that the shares are treated as financial liabilities. In other words, even though the shares might be identical to ordinary shares except that the holder has the right to require the issuer to redeem the shares ("a put") that has been provided in order to enable holders to dispose of their holding, the shares will be classified as financial liabilities because of the put.

9 It is the treatment of certain puttable shares that the amendment will change.

10 In particular, the amendment will change the classification of certain instruments that are similar to an ordinary share except for an obligation to redeem (referred to in the amendment as puttable instruments or instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation); they would be classified as equity if they meet certain criteria. The purpose of those criteria is to ensure that the instruments, as a class, represent a residual interest in the net assets of the entity.

11 The amendment further requires disclosure of certain qualitative and quantitative information regarding these instruments even though the existing standards usually do not require such disclosures for equity instruments. The purpose of the disclosures is to ensure that the users of financial statements understand the nature of such instruments and are able to assess their effect on the entity.

EFRAG's initial analysis of the costs and benefits of the amendment to IAS 32 and IAS 1 and Stakeholders' views on it

12 EFRAG carried out an initial assessment of the costs and benefits expected to arise for preparers and for users from implementing the amendment, both in year one and in subsequent years.

13 On the basis of that initial assessment, EFRAG tentatively concluded that the amendment will improve the quality of the financial information provided and, as such, that its implementation will benefit users.

14 EFRAG further tentatively concluded that the amendment to IAS 32 and IAS 1 was likely to:

(a) involve preparers incurring some year one costs—in order to read, understand and implement the new requirements—but that those costs would not be significant;

(b) not involve preparers incurring significant incremental ongoing costs; and

(c) involve users incurring only insignificant incremental year one and no incremental ongoing costs. Indeed, the amendment might reduce the ongoing costs to some users by making it easier to understand and analyse the financial statements of entities issuing instruments of the type addressed in the amendment.

15 Finally, EFRAG tentatively concluded that the benefits expected to arise from applying the amendment were likely to exceed the costs involved in its implementation.

16 EFRAG published its initial assessment and supporting analysis on 26 March 2008. It invited comments on the material by 28 April 2008. The results of this consultation can be summarised as follows. Respondents generally agreed with EFRAG's assessment of the costs and the benefits associated with implementing the amendment. The respondents further agreed with EFRAG's conclusion that the benefits to be derived from application of the amendment were likely to exceed the costs involved. Some respondents had additional comments:

(a) One respondent was concerned that, because the amendment does not change the treatment in consolidated financial statements of puttable instruments issued by a subsidiary and held by the non-controlling interest holders, the amendment would not improve the transparency of the information provided. (Under the amendment, puttable instruments issued by a subsidiary and held by the non-controlling interest holders would be classified by the subsidiary in its own financial statements as equity if they meet the criteria set out but will continue to be classified as liabilities in the consolidated financial statements.)

(b) Another respondent thought it might be quite burdensome to disclose the expected cash outflow on redemption or repurchase of financial instruments, particularly if the redemption or repurchase will take place in a relatively distant future (such as in 10, 20 or 30 years).

(c) Several respondents pointed out that the costs of implementing the amendment could be relatively higher for smaller companies than for larger companies.

17 In addition, EFRAG consulted its User Panel in March 2008 on the impact that the amendment would have on users. Panel members were generally supportive of the amendment and of EFRAG's assessment of the costs and benefits that would arise for users from the amendment's implementation.

EFRAG's final analysis of the costs and benefits of the amendment to IAS 32 and IAS 1

18 Based on its initial analysis and the stakeholders' views on that analysis, EFRAG's detailed final analysis of the costs and benefits of the amendment to IAS 32 and IAS 1 is presented in the paragraphs below.

19 EFRAG has concluded, for the reasons explained in its Endorsement Advice, that the amendment improves understandability and consistency in the treatment of instruments that are economically very similar; and hence the comparability of the information provided, compared to that provided under current IAS 32, thereby benefiting all stakeholders. In reaching this conclusion EFRAG considered the comments referred to in paragraph 16 above.

20 Furthermore, EFRAG considered whether the accounting treatments required by the amendment would involve incremental costs for preparers. Its view is that implementing the amendment will involve some year-one work and some ongoing work.

(a) The year-one work will involve:

(i) Evaluating financial instruments against the specified criteria;

(ii) Reclassifying financial instruments as equity if they meet all the required criteria;

(iii) Developing systems and procedures to collect and evaluate information to meet the disclosure requirements; and

(iv) Restating the earliest prior periods presented in the financial statements as the amendment are to be applied retrospectively.

(b) The ongoing work will involve:

(i) Monitoring the effect of any new issues of financial instruments on the classification of any puttable instruments as equity (because one of the criteria would no longer be satisfied) and monitoring the effect of any withdrawals of existing financial instruments on the classification of any puttable instruments as liabilities (because criteria that were not previously satisfied might now be satisfied); and

(ii) Collecting and evaluating information to meet the disclosure requirements.

21 It is our understanding that generally an amendment may prove quite costly to implement if the implementation requires significant system changes. However, we do not think that any of the above mentioned work would require significant system changes.

22 The amendment requires disclosure "(to the extent not disclosed elsewhere)...of the expected cash outflows on redemption or repurchase" of the puttable instruments. There could be some costs associated with the estimates that entities would be required to perform in order to meet these disclosure requirements, especially if an entity does not have in-house valuation expertise to make these kinds of estimations. However, EFRAG notes that under current IAS 32 these instruments are financial liabilities and entities are required to provide an analysis by maturity of the contractual undiscounted cash flows arising from financial liabilities in accordance with IFRS 7 *Financial Instruments: Disclosures*.

23 The amendment would need to be applied retrospectively. EFRAG has not identified any significant difficulties that would mean that application of the amendment retrospectively would involve significant costs.

24 For the above reasons, EFRAG's view is that those companies that have instruments that fall within the scope of the amendment will not need to incur significant year one or ongoing incremental costs to apply the standard. Having said that EFRAG accepts that there will be some costs and those costs could be relatively higher for small companies than for bigger companies.

25 EFRAG understands the amendment concerns a limited number of entities (namely some partnerships, co-operatives and limited life entities) and that most entities do not have instruments of the type falling within the scope of the amendment. The only costs that such companies will incur will be the costs necessary to read and understand the amendment. Such costs will be insignificant.

26 EFRAG considered whether the amendment in some way increased the burden on users. Its view is that users will incur some year one costs in understanding the new requirements and perhaps also in adapting their models to make use of the different note disclosures. However, these costs will be insignificant. On the other hand, the amendment might reduce the costs to some users by making it easier to understand and analyse the financial statements of entities issuing instruments of the type addressed in the amendment. This is because these users generally consider equity classification of puttable instruments in the scope of the amendment to be more appropriate than the liability classification that results from current IAS 32, provided that sufficient information is disclosed to understand the nature of these instruments and their potential effect on the entity.

Conclusion

27 EFRAG's overall assessment is that:

(a) implementing the amendment will result in some year one costs and some incremental ongoing costs for preparers, but those costs will not be significant. The amendment will involve only insignificant costs for users;

(b) improves understandability and consistency in the treatment of instruments that are economically very similar; and hence the comparability of the information provided, compared to that provided under IAS 32, thereby benefiting all stakeholders; and

(c) the benefits that will result from applying the amendment to IAS 32 and IAS 1 are likely to exceed the costs of doing so.

28 During its consultation process, EFRAG did not become aware of any factors other than those mentioned in this report that should be taken into account in assessing the costs and benefits of implementing the amendment in the EU.

EFRAG
16 May 2008