



30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

**International
Accounting Standards
Board**

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: July 2008, London

**Project: Transaction Costs Deducted from Equity
(Agenda Paper 6C)**

1. The IFRIC has received a request to add an item to its agenda to provide guidance on the extent of transaction costs to be accounted for as a deduction from equity in accordance with IAS 32 paragraph 37. In addition the submission requests guidance on how the requirements of IAS 32.38 to allocate transaction costs that relate jointly to more than one transaction should be applied.

Submission

2. The submission notes that IAS 32.37 includes the following requirement: "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."

3. This issue relates specifically to the meaning of the terms 'incremental' and 'directly attributable'.
4. The submission identifies a variety of views currently being applied in practice. The questions relate to whether incremental must be external or can an entity's internal direct costs be included, and whether direct costs can include costs that can be directly allocated to the equity transaction.
5. The second issue relates to what constitutes an equity transaction. For example, are costs incurred in listing existing shares on a stock exchange costs of an equity transaction? When new shares are issued concurrently with an offering of existing outstanding shares, do all the costs relate to an equity transaction?
6. The views currently found in practice are set out in detail in the submission which is attached as Appendix A to this agenda paper.

Staff Analysis

7. The submission raises the issue in the context of initial public offerings (IPOs) and concludes that because IPOs are frequent transactions the issue is widespread. The staff agrees that equity issuances are common transactions but does not believe that an IPO is necessarily an equity transaction as contemplated in IAS 32.
8. As the submission notes with respect to the second issue, an IPO or exchange listing may take place without the issue of new equity, or a secondary offering of existing shares may be made concurrently. In the staff's view, many of the costs that are identified in the submission are not the result of an equity transaction but rather are directly attributable to the entity becoming a public company. Only incremental costs directly related to the issuance of new equity instruments or the acquisition of previously outstanding equity instruments appear to meet the requirements of IAS 32.
9. The staff agrees with the point made in the submission that incremental costs are not necessarily limited to external costs, as was formerly specified in SIC-17. The Board removed that requirement to permit entities to treat commissions paid to internal sales forces as contract acquisition costs (transaction costs) in the same way as those paid to agents for originating similar contracts. However, in the staff's view it should be possible to identify the external cost that would have been incurred instead of the internal cost, and the internal cost must be incurred in addition to on-going expenditures, that it cannot simply be an allocation of payroll costs of permanent staff who would otherwise be employed on other projects.
10. The submission points out that the term 'incremental' is also found in other standards. The staff notes that this is also true of the terms 'direct' and 'directly attributable'. However, none of the terms is included in the IFRS Glossary of Terms. As staff search of *eIFRS* identified 18 standards and Interpretations in which one of more of the terms is used.

Staff recommendation

11. The staff recommends that the IFRIC not add this issue to its agenda. In the staff's view the transaction costs to be accounted for as a deduction from equity in accordance with IAS 32.37 are those the entity incurs in issuing or acquiring its own equity instruments. Other activities undertaken at the same time such as becoming a public company or acquiring an exchange listing are not part of the equity transaction. Consequently, the staff does not expect diversity in practice.
12. The staff also believes that the notions of 'incremental' and 'directly attributable' are used in sufficiently similar ways throughout IFRSs that constituents should be able to apply them consistently. However, if the IFRIC believes that additional clarification is required, the staff recommends that this question be referred to the annual improvements project with a recommendation from the IFRIC that common definitions be developed for both terms and added to the Glossary. In this case, the Board could explicitly note the circumstances in which it is making an exception from the standard usage of a term.
13. The staff has set out wording for the tentative agenda decision in Appendix B.

Questions for the IFRIC

14. Does the IFRIC agree with the staff recommendation not to add the issue to its agenda?
15. Does the IFRIC want to refer the issue to the annual improvements project with the recommendation set out in paragraph 12?

APPENDIX A

IFRIC 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 by purpose 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 one type of shares 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, **in a first step** 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 our understanding that **in a second step**, 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). We are 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.

We are of the opinion that users are in need of clear guidance on these issues.

II. Current practice: diversity in practice

Based on our knowledge about 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, [certain identified regulatory agencies] 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 jurisdiction specific question 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, we are 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.
- 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) **The issue does not relate to a current or planned IASB project.**