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RE: EFRAG's draft comment letter on the IASB's Exposure Draft *Classification of Rights Issues*

The Committee of European Securities Regulators (CESR), through its standing committee on financial reporting (CESR-Fin), has considered EFRAG's draft comment letter on the IASB's Exposure Draft (ED) *Classifications of Rights Issues*.

We thank you for this opportunity to comment on your draft response to the IASB's ED. CESR believes that the issues addressed in the ED should be dealt with urgently, given the current economic climate and the subsequent notable increase in rights issues. CESR therefore agrees with EFRAG in supporting the IASB's decision to address this issue on an urgent basis, despite other ongoing projects.

However, CESR notes that this particular issue of whether foreign exchange effects should be dealt with as equity or as a liability in equity was first raised with the IFRIC in 2005. CESR finds it regrettable that the IASB chose not to deal with this issue at that time. Although CESR welcomes the IASB's moves to respond to this concern through an accelerated due process procedure, we note that this has the unfortunate consequence of leaving little time for the IASB to address comprehensively all related issues, and for stakeholders to consider their responses. This lack of time is exacerbated by the volume of work generated by the ongoing comprehensive review of financial instrument accounting. With this in mind, CESR would encourage the IASB to complete its project on *Financial Instruments with Characteristics of Equity*, to ensure a long term and coherent solution to all related matters, to reduce the risk of such urgent issues arising in the future as a result of unintended consequences.

Despite these concerns about the process behind this ED, CESR supports the overall approach proposed by the IASB to classify certain rights issues as equity investments. It is a fundamental principle of accounting that an entity cannot generate profits or losses through transactions with owners (in their capacity as owners), but only through transactions with third parties. Furthermore, we believe that financial statements should be affected as little as possible by pure accounting constructs, such as "functional currency", especially where these do not fairly reflect the underlying economics of these transactions.

We note the concerns of EFRAG that the amendments as drafted could lead to structuring opportunities. With this in mind, we support the proposals made to limit the range of instruments covered to focus on an area of known practical difficulty and to limit as far as possible unforeseen consequences, ahead of the IASB's completion of its project on financial instruments with characteristics of equity.

I would be happy to discuss all or any of these issues further with you.

Yours sincerely,

Fernando Restoy
Chairman of CESR-Fin

Appendix: answers to specific questions

1. Do you agree with the proposal to limit the amendment to instruments with these characteristics? If not, why? Are there any other instruments that should be included and why?

CESR agrees with EFRAG regarding limiting the amendment based on the characteristics of a rights issue. We note EFRAG's concerns about possible structuring opportunities and, especially bearing in mind the short timescale available for comments, we would prefer that amendments proposed through an accelerated process are restricted to areas where there is a known practical difficulty and fewer risks of unintended consequences.

Nonetheless, like EFRAG, we are not fully convinced by the IASB's argument that the pro rata distribution of rights is critical to determining that a rights issue is a transaction with owners in their capacity as owners. It could be argued that any share issuance should be regarded as a pure equity transaction where fixed number of shares is exchanged for a fixed amount of any currency (provided these amounts are fixed using current exchange rates when the offer is published). We would welcome further explanation from the IASB in its Basis for Conclusions on this point, to better understand its reasoning, and encourage the IASB to address this point as part of its more fundamental ongoing review in this area. This fundamental review should also consider a broad range of related transactions, including, for example, convertible bonds.

We note that the terminology used may not always be immediately apparent to all of the IASB's constituents, especially as "rights issue" may be seen from the viewpoint of either the reporting entity (in line with the IASB's normal practice) or an existing shareholder. We think the IASB should ensure that the names of its (future) publications fairly reflect the scope of the amendments or standards proposed.

2. Do you agree with the proposal to permit an entity to classify rights with the characteristics set out above as equity investments even when the exercise price is not fixed in its functional or reporting currency? If not, why?

CESR agrees with the proposal to permit an entity to classify certain rights with equity investments when the exercise price is not fixed in its functional reporting currency. This is based on the following considerations:

- It is a fundamental principle of accounting that an entity cannot generate profits or losses through transactions with owners in their capacity as owners, but only through transactions with third parties. This is reflected in the IASB's Framework for the Preparation and Presentation of Financial Statements and IAS 1, "Presentation of Financial Statements".

- We believe that financial statements should be affected as little as possible by pure accounting constructs, such as issues of "functional currency". It is illogical that a rights issue payable in the functional currency of an entity has no impact on its income statement, whereas an issue denominated in another currency does. Assuming the currencies in question are freely exchangeable, with the issue prices set using currency exchange rates, there is no substantive economic difference between a firm offering to sell for example one share for €1 or one share for \$1.40 (assuming a current exchange rate of €1=\$1.40).

- Although we note EFRAG's concerns that the proposal may lead to an exception to the current principles in IAS 32, we believe that the treatment proposed is consistent with statements in other IFRSs. In particular, IAS 39 notes that there is no need to separate out a derivative in those cases where it bears "a close economic relationship to the host contract" or where an embedded foreign currency derivative is "integral to the contractual arrangements" (IAS 39 BC 37-40). CESR thinks this reasoning is relevant to the issues currently under consideration.

CESR supports EFRAG both when it suggests that the IASB should consider improving the drafting of the amendment to prevent structuring opportunities and when it encourages the IASB to explain its reasoning at greater length in some areas (as discussed above). Nonetheless, CESR reiterates that it believes the issue is urgent, that an amendment is necessary to resolve the practical difficulties currently experienced by issuers and that the underlying approach of classifying such rights issues as equity instruments is conceptually sound.

3. Is the requirement to apply the proposed change retrospectively appropriate? If not, what do you propose and why?

CESR agrees with the requirement to apply the proposed change retrospectively, since we believe that retrospective application provides more decision-useful information for the users of financial statements.

Yours sincerely,

Fernando Restoy

Chair of CESR-Fin