

AMENDMENT TO FRS 25 (IAS 32)  
‘FINANCIAL INSTRUMENTS:  
PRESENTATION’

CLASSIFICATION OF  
RIGHTS ISSUES



ACCOUNTING  
STANDARDS  
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## **PREFACE**

### **Introduction**

- 1 In December 2004, the Accounting Standards Board (ASB) issued Financial Reporting Standard (FRS) 25 (IAS 32) 'Financial Instruments: Presentation'. FRS 25 implemented the requirements of International Accounting Standard (IAS) 32 'Financial Instruments: Presentation' for those applying UK financial reporting standards.
- 2 In November 2009, the ASB published a Financial Reporting Exposure Draft (FRED) 'Classification of Rights Issues'. The FRED proposed an amendment to FRS 25 in line with the amendment to IAS 32 issued by the International Accounting Standards Board (IASB) in October 2009. The objective of issuing this amendment is to keep FRS 25 converged with IAS 32.
- 3 The amendment requires a rights issue involving the exchange of a fixed number of an entity's own equity instruments for a fixed amount of cash denominated in a foreign currency to be classified as an equity instrument. The amendment applies to rights, options or warrants issued pro rata to all existing owners of the same class of shares.
- 4 Respondents to the FRED were supportive of the ASB's proposals on the basis that the amendment ensures consistency with IAS 32.

### **Date from which effective**

- 5 The effective date for the amendment to FRS 25 is for annual periods beginning on or after 1 February 2010. Earlier application is permitted. The effective date is aligned with the equivalent amendment to IAS 32.

## **Regulatory impact**

- 6 The effect of the amendment is that foreign currency rights issues which meet the criteria set out in the amended standard would no longer be classified as derivative liabilities with fair value changes reported in the profit and loss account. The ASB believes that the benefits arising from this amendment outweigh the costs of implementation.

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**Amendment to the Preface by the Accounting Standards Board**

The following paragraph is inserted to follow paragraph r:

- “s In January 2010 the Board amended FRS 25 to incorporate changes made by the IASB to IAS 32 Financial Instruments: Presentation ‘*Classification of Rights Issues*’. The amendment is applicable for accounting periods beginning on or after 1 February 2010 with earlier application permitted.”

## **Amendment to FRS 25 (IAS 32) ‘Financial Instruments: Presentation’**

[ASB note: The text of FRS 25 (IAS 32) ‘Financial Instruments: Presentation’ includes strike-through and underlining to show changes made by the ASB to the text of the corresponding IAS. The amended text of FRS 25 set out below adopts the same convention; as a result, it is not practicable to use strike-through and underlining to illustrate changes to the existing standard. Instead, the changes are described in the text boxes appearing at the start of each set of changes.]

Paragraphs 11 and 16 are amended to read as follows.  
Paragraph 97E is added.

### **Definitions (see also paragraphs AG3–AG23)**

- 11 **The following terms are used in this Standard with the meanings specified:**

...

**A *financial liability* is any liability that is:**

- (a) ...
- (b) **a contract that will or may be settled in the entity’s own equity instruments and is:**
  - (i) **a non-derivative for which the entity may be obliged to deliver a variable number of the entity’s own equity instruments; or**
  - (ii) **a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity’s own equity instruments. For this purpose, rights, options or warrants to acquire**

**a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the entity's own equity instruments ...**

## **Presentation**

### **Liabilities and equity (see also paragraphs AG13–AG14J and AG25–AG29A)**

- 16 When an issuer applies the definitions in paragraph 11 to determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met.
- (a) ...
  - (b) If the instrument will or may be settled in the issuer's own equity instruments, it is:
    - (i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
    - (ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the issuer's own equity instruments do

not include instruments that have all the features and meet the conditions described in paragraphs 16A and 16B or paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the issuer's own equity instruments.

A contractual obligation...

### **Effective date and transition**

97E Paragraphs 11 and 16 were amended by *Classification of Rights Issues* issued in ~~October 2009~~ January 2010. An entity shall apply that amendment for annual periods beginning on or after 1 February 2010. Earlier application is permitted. If an entity applies the amendment for an earlier period, it shall disclose that fact.

## **ADOPTION OF AMENDMENTS**

### **Approval by the ~~Board~~ IASB of Classification of Rights Issues (Amendment to IAS 32) issued in October 2009**

*Classification of Rights Issues* (Amendment to IAS 32) was approved for issue by thirteen of the fifteen members of the International Accounting Standards Board. Messrs Leisenring and Smith dissented from the issue of the amendment. Their dissenting opinions are set out after the Basis for Conclusions.

Sir David Tweedie	Chairman
Stephen Cooper	
Philippe Danjou	
Jan Engström	
Patrick Finnegan	
Robert P Garnett	
Gilbert Gélard	
Amaro Luiz de Oliveira Gomes	
Prabhakar Kalavacherla	
James J Leisenring	
Patricia McConnell	
Warren J McGregor	
John T Smith	
Tatsumi Yamada	
Wei-Guo Zhang	

**Approval by the Accounting Standards Board of  
*Classification of Rights Issues (Amendment to FRS 25)***

*Amendment to FRS 25 (IAS 32) 'Financial Instruments: Presentation'* was approved for issue by the ten members of the Accounting Standards Board.

Ian Mackintosh

Chairman

David Loweth

Technical Director

Nick Anderson

Edward Beale

Marisa Cassoni

Peter Elwin

Ken Lever

Robert Overend

Andy Simmonds

Pauline Wallace

## **APPENDIX: OTHER MATERIAL TO BE INSERTED IN FRS 25**

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### **Amendment to the Notes on the Standard's Application in the UK and the Republic of Ireland**

A heading and Paragraph N32 is added as follows:

#### *Classification of Rights Issues*

N32 An amendment to FRS 25 was issued by the Board in January 2010 following the IASB's amendment to IAS 32 Financial Instruments: Presentation 'Classification of Rights Issues' issued in October 2009. The objective of issuing this amendment to UK GAAP is to ensure that FRS 25 remains converged with IAS 32.

## **Amendment to the Basis for Conclusions on FRS 25 (IAS 32) ‘Financial Instruments: Presentation’**

ASB Note: The amendment to the IASB’s Basis for Conclusions, which accompanies IAS 32 (and has been reproduced in FRS 25) is set out below. All references in this section to ‘the Board’ and ‘Board members’ are references to the IASB Board and IASB Board members.

After paragraph BC4 a heading and paragraphs BC4A–BC4K are added.

### **Foreign currency denominated pro rata rights issues**

BC4A In 2005 the International Financial Reporting Interpretations Committee (IFRIC) was asked whether the equity conversion option embedded in a convertible bond denominated in a foreign currency met IAS 32’s requirements to be classified as an equity instrument. IAS 32 states that a derivative instrument relating to the purchase or issue of an entity’s own equity instruments is classified as equity only if it results in the exchange of a fixed number of equity instruments for a fixed amount of cash or other assets. At that time, the IFRIC concluded that if the conversion option was denominated in a currency other than the issuing entity’s functional currency, the amount of cash to be received in the functional currency would be variable. Consequently, the instrument was a derivative liability that should be measured at its fair value with changes in fair value included in profit or loss.

BC4B However, the IFRIC also concluded that this outcome was not consistent with the Board’s approach when it introduced the ‘fixed for fixed’ notion in IAS 32. Therefore, the IFRIC decided to recommend that the Board amend IAS 32 to permit a conversion or stand-alone option to be classified as equity if the exercise price was

fixed in any currency. In September 2005 the Board decided not to proceed with the proposed amendment.

- BC4C In 2009 the Board was asked by the IFRIC to consider a similar issue. This issue was whether a right entitling the holder to receive a fixed number of the issuing entity's own equity instruments for a fixed amount of a currency other than the issuing entity's functional currency (foreign currency) should be accounted for as a derivative liability.
- BC4D These rights are commonly described as 'rights issues' and include rights, options and warrants. Laws or regulations in many jurisdictions throughout the world require the use of rights issues when raising capital. The entity issues one or more rights to acquire a fixed number of additional shares pro rata to all existing shareholders of a class of non-derivative equity instruments. The exercise price is normally below the current market price of the shares. Consequently, a shareholder must exercise its rights if it does not wish its proportionate interest in the entity to be diluted. Issues with those characteristics are discussed in IFRS 2 *Share-based Payment* and IAS 33 *Earnings per Share*.
- BC4E The Board was advised that rights with the characteristics discussed above were being issued frequently in the current economic environment. The Board was also advised that many issuing entities fixed the exercise price of the rights in currencies other than their functional currency because the entities were listed in more than one jurisdiction and might be required to do so by law or regulation. Therefore, the accounting conclusions affected a significant number of entities in many jurisdictions. In addition, because these are usually relatively large transactions, they can have a substantial effect on entities' financial statement amounts.
- BC4F The Board agreed with the IFRIC's 2005 conclusion that a contract with an exercise price denominated in a foreign currency would not result in the entity receiving a fixed amount of cash. However, the Board also agreed with the IFRIC that classifying rights as derivative liabilities was not

consistent with the substance of the transaction. Rights issues are issued only to existing shareholders on the basis of the number of shares they already own. In this respect they partially resemble dividends paid in shares.

- BC4G The Board decided that a financial instrument that gives the holder the right to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency is an equity instrument if, and only if, the entity offers the financial instrument pro rata to all of its existing owners of the same class of its own non-derivative equity instruments.
- BC4H In excluding grants of rights with these features from the scope of IFRS 2, the Board explicitly recognised that the holder of the right receives it as a holder of equity instruments, ie as an owner. The Board noted that IAS 1 *Presentation of Financial Statements* requires transactions with owners in their capacity as owners to be recognised in the statement of changes in equity rather than in the statement of comprehensive income.
- BC4I Consistently with its conclusion in IFRS 2, the Board decided that a pro rata issue of rights to all existing shareholders to acquire additional shares is a transaction with an entity's owners in their capacity as owners. Consequently, those transactions should be recognised in equity, not comprehensive income. Because the Board concluded that the rights were equity instruments, it decided to amend the definition of a financial liability to exclude them.
- BC4J Some respondents to the exposure draft expressed concerns that the wording of the amendment was too open-ended and could lead to structuring risks. The Board rejected this argument because of the extremely narrow amendment that requires the entity to treat all of its existing owners of the same class of its own non-derivative equity instruments equally. The Board also noted that a change in the capital structure of an entity to create a new class of non-derivative

equity instruments would be transparent because of the presentation and disclosure requirements in IFRSs.

BC4K The Board decided not to extend this conclusion to other instruments that grant the holder the right to purchase the entity's own equity instruments such as the conversion feature in convertible bonds. The Board also noted that long-dated foreign currency rights issues are not primarily transactions with owners in their capacity as owners. The equal treatment of all owners of the same class of equity instruments was also the basis on which, in IFRIC 17 *Distributions of Non-cash Assets to Owners*, the IFRIC distinguished non-reciprocal distributions to owners from exchange transactions. The fact that the rights are distributed pro rata to existing shareholders is critical to the Board's conclusion to provide an exception to the 'fixed for fixed' concept in IAS 32 as this is a narrow targeted transaction with owners in their capacity as owners.

## IASB Dissenting Opinions

### **Dissent of James J Leisenring and John T Smith from the issue of *Classification of Rights Issues***

- D01 Messrs Leisenring and Smith dissent from the amendment *Classification of Rights Issues* for the reasons set out below.
- D02 Mr Smith agrees with the concept of accounting for a rights issue as equity in specified circumstances and supports both the IFRIC recommendation and staff recommendation in July 2009 that the Board make ‘an extremely narrow amendment’ to IAS 32 to deal with this issue. However, he dissents because he believes the change is not extremely narrow and will provide a means for an entity to use its equity instruments as a way to engage in speculative foreign currency transactions and structure them as equity transactions, a concern identified by the Board in the Basis for Conclusions on IAS 32.
- D03 In their comment letters on the exposure draft, some respondents expressed concerns that the wording of the amendment was too open-ended and could lead to structuring risks. Mr Smith believes that these concerns are well-founded because there is no limitation on what qualifies as a class of equity. Without some limitation, an entity could, for example, establish a foreign currency trading subsidiary, issue shares to a non-controlling interest and deem the shares to be a class of equity in the consolidated group.
- D04 The staff acknowledged the concerns expressed in comment letters that a new class of equity could be created for the purpose of obtaining a desired accounting treatment. However, the Board decided not to attempt to limit such structuring opportunities. The Board was concerned that a requirement that a pro rata offer of rights must be made to all existing owners (rather than only all existing owners of a particular class) of equity instruments would mean that the amendment would not

be applicable to most of the transactions to which the Board intended the amendment to apply.

- D05 Instead of trying to narrow the amendment, the Board simply acknowledged that under the amendment, ‘You could set up a new class of shares today and one minute later issue shares to that class and ... speculate in foreign currency without it going through the income statement’. Mr Smith believes the Board should have explored other alternatives. Mr Smith believes that the Board should have sought solutions that could in fact provide a means of narrowing the amendment to limit structuring while accommodating appropriate transactions.
- D06 Mr Smith believes that structuring opportunities could be curtailed significantly if some limitations were placed on the type of class of equity instruments that qualify for the exemption. There are a number of factors or indicators that could have been incorporated into the amendment that would limit the exception. For example, the amendment could have specified that non-controlling interests do not constitute a class. The amendment could have further required that qualification for the exemption is limited to those classes of equity instruments in which (a) ownership in the class is diverse or (b) the class is registered on an exchange and shares are exchanged in the marketplace or (c) shares in that class when issued were offered to the public at large and sold in more than one jurisdiction and there was no agreement to subsequently offer rights to shares of the entity; and the amount of capital provided by the class is substantial relative to the other classes of equity. Clearly, some combination of these and other alternatives could have been used to limit structuring opportunities. Mr Smith believes that a better solution could have been found and without introducing some limits around the type of class of equity instruments that qualify, the Board did not produce an extremely narrow amendment.
- D07 Mr Leisenring agrees that when an entity issues rights to acquire its own equity instruments those rights should be

classified as equity. However, he does not accept that the issue must be pro rata to all existing shareholders of a class of non-derivative equity instruments. He does not accept that whether or not the offer is pro rata is relevant to determining if the transaction meets the definition of a liability.

- D08 Paragraph BC4J suggests that the Board limited its conclusion to those transactions issued on a pro rata basis because of concerns about structuring risks. If that is of concern the suggestions contained in Mr Smith's dissent would be much more effective and desirable than introducing a precedent that transactions such as this rights offering must simply be pro rata to be considered a transaction with owners as owners.
- D09 Mr Leisenring would have preferred to conclude that a right granted for a fixed amount of a currency was a 'fixed for fixed' exchange rather than create additional conditions to the determination of a liability.

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