FINANCIAL REPORTING

EXPOSURE DRAFT

PROPOSED AMENDMENT TO

FRS 25 (IAS 32)

'FINANCIAL INSTRUMENTS: PRESENTATION'

CLASSIFICATION OF RIGHTS ISSUES

ACCOUNTING
STANDARDS
BOARD

This draft is issued by the Accounting Standards Board for comment. It should be noted that the draft may be modified in the light of comments received before being issued in final form.

For ease of handling, we prefer comments to be sent by email (in Word format) to

asbcommentletters@frc-asb.org.uk

Comments may also be sent in hard copy form to:

Deepa Raval
ACCOUNTING STANDARDS BOARD
5th Floor, Aldwych House
71-91 Aldwych
London
WC2B 4HN

Comments should be despatched so as to be received no later than 15 December 2009. All replies will be regarded as on the public record, unless confidentiality is requested by the commentator.

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We aim to publish responses within 10 working days of receipt.

We will publish a summary of the consultation responses, either as part of, or alongside, our final decision.

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ACCOUNTING STANDARDS BOARD

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PREFACE

Background

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 for those applying UK standards.

2 In October 2009, the International Accounting Standards Board (IASB) issued an amendment to IAS 32 'Classification of Rights Issues'. The amendment was published in response to an issue highlighted as a result of the global financial crisis. During the crisis there has been an increase in the number of entities using rights issues to raise capital. Some rights issues are denominated in currencies other than the entity's functional currency which, in the past, has led to classification as derivative liabilities. There was concern that the accounting treatment did not reflect the substance of the rights issue, which is a transaction with shareholders in their capacity as owners. Consequently, in July 2009, the International Financial Reporting Interpretations Committee (IFRIC) referred the matter to the IASB for its urgent attention. The IASB issued an Exposure Draft (ED) in August 2009 with a short comment period. Respondents to the IASB ED were broadly supportive of its proposals.

The IASB's amendment

3 IAS 32 requires that a financial instrument can be presented as equity only if settlement of the contract results in the entity delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset. A rights issue where the amount of cash received is fixed in a foreign currency

does not meet the 'fixed for fixed' criteria in IAS 32, as the functional currency an entity receives on conversion will be variable. The IASB amendment introduces an exception to the 'fixed for fixed' rule, so that equity classification is achieved in limited circumstances.

4 The IASB amendment states that if a fixed number of rights, options or warrants are issued pro rata to an entity's existing shareholders for a fixed amount of foreign currency, these should be classified as equity regardless of the currency in which the exercise price is denominated.

The ASB's proposals

5 FRS 25 (IAS 32) 'Financial Instruments: Presentation' is a converged standard. Therefore, this Financial Reporting Exposure Draft (FRED) proposes parallel amendments to FRS 25 to ensure continued convergence. The respondents to the IASB ED raised no significant issues and expressed support for the IASB's proposals. The ASB is not aware of any UK-specific issues that would affect the implementation of these proposals into FRS 25. For these reasons, the FRED has a short comment period and the proposed effective date is aligned with that in IAS 32.

Regulatory impact

6 The proposals set out in this FRED clarify the presentation of rights issues denominated in a foreign currency. The proposals have the effect that rights, options or warrants would no longer need to be shown at fair value through the profit and loss account where a fixed number of shares are being exchanged for a fixed amount of a foreign currency. In the ASB's view, the proposals set out in this FRED should not impose significant additional costs of preparation. The ASB believes that the amendments will result in information which is of benefit to users of the financial statements.

The ASB would welcome views on whether the benefits arising from the proposals in this FRED would outweigh any costs involved.

Date from which effective

7 It is proposed that the [draft] FRS will be effective for accounting periods beginning on or after 1 February 2010.

Invitation to comment

8 The ASB is requesting comments on its proposals for implementing the IASB's amendments in the UK, by 15 December 2009. The ASB would welcome comments on the following issues:

ASB Q1: Are you aware of any UK-specific issues that would affect implementation of the proposals set out in this FRED?

ASB Q2: Do you agree that the benefits of the proposals in the FRED would outweigh any additional costs involved? If not, please explain why.

PROPOSED 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 the changes to the existing standard. Instead, the changes are described in text boxes appearing at the start of each set of proposed 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~~ [Month] 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.

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

APPENDIX: OTHER MATERAL TO BE INSERTED IN FRS 25

Amendment to the Basis for Conclusions on IAS 32 Financial Instruments: Presentation

ASB Note: The amendments to the Basis for Conclusions that the IASB prepared to accompany its amendment is set out below in full. 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.

Dissenting opinions

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

DO1 Messrs Leisenring and Smith dissent from the amendment *Classification of Rights Issues* for the reasons set out below.

DO2 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.

DO3 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.

DO4 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.

DO5 Instead of trying to narrow the amendment, the Board simply acknowledged that under the amendment, '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.

DO6 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.

DO7 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.

DO8 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.

DO9 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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