Accounting Standards Board

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Dear Michael

IASB Exposure Draft 'Classification of Rights Issues'

This letter sets out the comments of the UK Accounting Standards Board (ASB) on the above Exposure Draft (ED).

The ASB supports the proposals in the ED. We see the proposals as eliminating an inconsistency between accounting for rights issues in an entity's functional currency and that for rights issues denominated in a foreign currency. The amendment better reflects the substance of the rights issue, which is a transaction with shareholders in their capacity as owners. Our responses to the questions asked in the ED are set out in the Appendix to this letter.

The ED focuses on a specific issue and we agree that a narrow focus is necessary to address this practical problem. However, we believe that the need for the proposed and other recent related amendments highlight a broader issue, namely that the 'fixed for fixed' rule which underpins classification of derivatives over own equity leads to counterintuitive results. In light of this, we believe it is important for the IASB to replace the 'fixed for fixed' rule with a clear principle for equity/liability classification as part of the liabilities and equity project. We recommend that the starting point when developing a classification model for financial instruments with characteristics of equity should be the economic substance of the transaction. This could be made operational by considering the outcome of settlement of the instrument (e.g. cash outflow or equity). As part of the liabilities/equity project the IASB should review the wider issue of instruments being classified as liabilities when they are in substance 'equity' as this topic is not exclusive to rights issues.

The liabilities and equity project is an opportunity to consider the consistency of the IAS 32 classification model with other IFRSs. For example, under IFRS 2 share options under an equity-settled share based payment arrangement would be accounted for as equity. This would apply even when the option requires an entity to deliver a variable number of its own shares in return for services provided by an employee.

If you would like to discuss these comments, please contact Deepa Raval on 020 7492 2424 or myself on 020 7492 2434.

Yours sincerely

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Appendix: Response to the Invitation to Comment

Question 1 – Specifying the characteristics of the rights issue

The proposed amendment applies to instruments (rights) to be offered pro rata to all existing owners of the same class of equity instruments and the exercise price to be a fixed amount of cash in any currency.

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?

Scope of amendment

1. We agree with the proposal to limit the amendment. But we believe this should be restricted to rights issues with the characteristics described above rather than to all instruments (rights) as the broader scope in the current proposals could lead to structuring opportunities.

2. Paragraph 11 (ii) should refer to 'rights issues' rather than 'rights' to avoid misinterpretation. Preparers and users could infer that 'rights' in a broader context are any options over own equity which involve the exchange of a fixed number of shares for a fixed amount of foreign currency including any stand alone call options and convertible bonds with an embedded equity conversion option.

Principle for classification of equity instruments

3. We do not think that it would be beneficial to include any other instruments on an exception basis at this stage given that the IASB has the equity and liabilities project underway. Instead, a principle for classification to replace the 'fixed for fixed' rule should be established which considers the outcome of settlement of the instrument (e.g. cash outflow or equity). As part of the liabilities/equity project the IASB should review the wider issue of instruments being classified as liabilities when they are in substance 'equity' as this topic is not exclusive to rights issues. For example, a contract for preference shares convertible into a fixed number of ordinary shares is likely be treated as a liability if other factors such as price are variable. Nevertheless, the only outcome of settlement of the contract is equity (assuming that the entity has no obligation to deliver cash) so it seems counterintuitive that a liability arises from a share for share exchange when there is no cash outflow. Therefore, it is questionable whether variability is an appropriate basis for concluding on liability classification for instruments with equity features.

4. It is important that transactions relating to the issue of equity instruments are accounted for based on the substance of the transaction, this should involve 'looking through' the transaction or series of transactions to identify the ultimate outcome. If a transaction is undertaken with shareholders in their capacity as owners of the business we believe it is inappropriate that fair value gains and losses are recognised in the profit and loss account.

Consistency with other IFRS

5. The rules-based approach gives rise to differences in accounting for similar instruments. This results in inconsistent classification between standards. For example, the bases for distinguishing liability and equity is different under IFRS 2 thus creating a conflict with IAS 32. Under IFRS 2 where an entity delivers a variable number of shares in return for goods or services under an equity-settled share based payment arrangement the share options would be recognised as equity rather than as a liability. Similarly, a transaction between a parent and non-controlling interest (where there is no change in control) in IAS 27 would be viewed as a transaction with owners in their capacity as owners and would be taken through equity.

Question 2
Specifying the currency of the exercise price
The proposed amendment specifies that the fixed amount of cash the entity will receive can be denominated in any currency. If that currency is not the entity's functional or reporting currency, the proceeds it receives from the issue of its shares will vary depending on foreign exchange rates.

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

6. We agree with the proposal to permit an entity to classify rights issues as equity instruments where an entity issues a fixed number of rights pro rata to shareholders for a fixed amount of foreign currency. The accounting for rights issues with these characteristics should be the same regardless of the currency in which the proceeds are denominated as the amount of foreign currency to be received is fixed at the outset. The variability in the instrument arises from the foreign currency movements on the cash proceeds.

7. The ED refers to 'reporting' currency, which is a term that is not defined in IAS 21. To avoid confusion we suggest that this term is replaced with 'presentation' currency (IAS 21.8). If the IASB intends 'reporting' to have a different meaning to 'presentation' currency the amendment should include a definition of 'reporting' currency.

Question 3 - Transition
The proposed change would be required to be applied retrospectively with early adoption permitted.

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

8. We agree that retrospective application is appropriate as it enhances comparability in this particular case. Additionally, it is likely an individual entity will have undertaken only a few rights issues therefore there the practical difficulties of implementing the amended requirements are likely to be limited.