Project	**Improvements to IFRSs**
Topic	**IAS 32 *Financial Instruments: Presentation***
	Classification of rights issues

Background

1. In May the Board received a request for the IFRIC to consider whether its conclusion reached in 2005 that a call option entitling the holder to receive a fixed number of the entity's shares for a fixed amount of foreign currency should be accounted for as a derivative liability. The IFRIC previously discussed the issue in the context of foreign currency denominated convertible bonds. The question in this case is if a similar conclusion applies to a rights issue.

2. The issue was discussed at the July 2009 IFRIC meeting. After the agenda paper for the IFRIC meeting was posted on the website, the IFRIC received a number of additional submissions from preparers and others stating that the issue was also of importance to them. Copies of all the submissions are available to Board members on request.

3. The staff understands that financial instruments with the characteristics described in this paper are frequently being issued in the current economic environment. Many believe that the accounting results produced by the application of what seem to be the requirements of IAS 32 and the IFRIC's earlier conclusion do not reflect the substance of the transactions. Consequently, some are concerned that this provides support for other criticisms of current accounting requirements.

Objectives of this meeting

4. The objectives of this meeting are to:

(a) decide whether IAS 32 should be amended in the short term;

(b) if so, approve the staff's proposed approach and draft amendment or another approach

(c) decide on proposed transition requirements;

(d) decide whether the issue should be included as part of the annual improvements project or published as a separate exposure draft;

(e) determine if any Board members intend to dissent to the exposure draft; and

(f) discuss the project plan timing.

History

5. In 2005 the IFRIC was asked whether the equity conversion option embedded in a convertible bond denominated in a currency other than the issuer's functional currency met IAS 32's requirements for classification as an equity instrument. IAS 32 states that an instrument relating to the purchase or issue of an entity's equity instruments is classified as equity only if it results in the exchange of a fixed number of shares for a fixed amount of cash.

6. The IFRIC concluded that if the conversion option was denominated in a currency other than the issuer'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 marked to fair value through profit or loss.

7. 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. The IFRIC therefore 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. The amendment the IFRIC proposed is included in Appendix A. In September 2005 the Board decided not to proceed with the proposed amendment.

8. To minimise Board members' preparation time for this discussion, we have not included copies of the previous IFRIC and Board papers. However, they are available from the staff on request.

Accounting for rights issues

9. In order to raise capital, an entity issues pro rata to its existing shareholders rights to purchase additional shares. In an offering of this type, the entity issues one or more rights for a specified number of shares an investor already holds. The right entitles the holder to purchase a fixed number of additional shares at an exercise price that 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.

10. In jurisdictions in which such offerings are common, the rights are generally required to be listed or tradable for a minimum period. This permits those shareholders who are unwilling or unable to exercise their rights to sell them to other investors, thus limiting any dilution loss they would otherwise incur.

11. Because the rights are a distribution of something of value (they are in-the-money on issue) to owners in their capacity as owners, they would ordinarily be accounted for as a dividend at their fair value on the date of issue. Because they entitle the holder to receive a fixed number of shares for a fixed amount of cash, the entity would recognise the rights as equity instruments and they would not be remeasured.

12. When the rights are exercised, the entity would recognise the issue of the shares as follows:

    Dr Cash (exercise price of rights)

    Dr Rights (fair value on date of issue)

        Cr Share capital

13. The staff understands that in some jurisdictions no accounting recognition is given to pro rata distributions of rights or shares (stock dividends) to existing shareholders. In those jurisdictions, no entry is made when the rights are issued. The share capital issued on the exercise of the rights is recognised at the amount of cash received (the exercise price). This does not affect the staff's analysis or conclusions in the remainder of the paper.

14. The staff notes that this type of rights issue is already described in paragraph A2 of Appendix A, Application Guidance of IAS 33. That paragraph provides

specific guidance on how such a rights issue is to be included in the determination of earnings per share.

15. Paragraph 12 sets out the accounting result if the exercise price of the rights is in the entity's functional currency. If the IFRIC's previous conclusion applies in these circumstances, if the exercise price is fixed in a foreign currency the entity would not receive a fixed amount for the issue of the shares. Therefore, the right would be treated as a derivative liability rather than as an equity instrument. Consequently, after the rights are issued, changes in their fair value are recognised in the entity's profit or loss until they are exercised or expire.

16. In this case, the accounting for the rights issue is as follows:

(a) On issue

Dr Retained Earnings (fair value on date of issue)

Cr Derivative liability – written call (fair value on date of issue)

(b) While outstanding

Dr/Cr Profit or loss (changes in fair value while outstanding)

Cr/Dr Derivative liability (changes in fair value while outstanding)

(c) On exercise

Dr Cash (fixed FX exercise price at current exchange rate)

Dr Derivative liability (fair value at date of exercise)

Cr Shareholders' equity

17. Once the rights are exercised, the only difference between treating the right as a derivative liability rather than an equity instrument is between line items within shareholders' equity (share capital vs. other paid in capital or retained earnings); total shareholders' equity is identical. The issue is the profit or loss effect while the rights are outstanding.

IFRIC discussion

18. At its meeting in July 2009, the IFRIC discussed this issue. The IFRIC was asked to provide the staff with its advice on whether rights issues and other similar forms of capital raising are becoming more common in the current environment. The IFRIC was also asked whether significant numbers of rights

issues were denominated in currencies other than the issuing entity's functional currency.

19. IFRIC members advised the staff that in their experience many entities are issuing rights to raise capital. In addition, many of those entities fix the exercise price of the rights in currencies other than their functional currencies because they are listed in more than one jurisdiction and are required to do so. For example, an entity may be required to denominate the exercise price of a right in the currency of the jurisdiction in which the share register for those shareholders is maintained.

20. IFRIC members also believed that accounting for such instruments as derivatives liabilities was not appropriate. They did not believe that including the effect of changes in the entity's own share price in the determination of profit or loss in these situations provided useful information.

21. For example, the IFRIC noted that many constituents believe that the accounting described in paragraph 16 violates the requirement of paragraph 33 of IAS 32 that 'No gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of the entity's own equity instruments.' Obviously, for this requirement to apply the instrument in question must be classified as the entity's equity, so if it is determined to be a derivative liability there is no violation. However, because rights issues are so clearly considered to be equity issuances, many believe that the paragraph 16 accounting must be wrong.

22. The IFRIC recognised the concerns that led the Board not to proceed with the amendment the IFRIC recommended in 2005. However, they believed that the Board could and should consider making an extremely narrow amendment to IAS 32 to deal specifically with this question. Despite the existence of the major Board project, the IFRIC recommends that the Board amend IAS 32 as soon as possible. Major rights issues have already taken place and more are anticipated.

Staff analysis

23. The staff agrees with the IFRIC's conclusion that this type of instrument was not the sort the Board envisioned when it adopted the 'fixed for fixed' notion in

2005. We also agree with the IFRIC that rights distributed pro rata to existing shareholders with exercise prices set in foreign currencies because of securities regulation or other legal requirements are different from convertible bonds that are issued in a foreign currency to access a particular capital market.

24. The staff believes that if the Board decides to address this question and amend IAS 32 it could adopt a number of approaches:

    (a) Amend IAS 32 as recommended by the IFRIC in 2005.

    (b) Amend IAS 32 to permit the bifurcation of the equity and foreign currency components of the derivative so that only the changes in the foreign currency component are included in profit or loss.

    (c) Make a specific amendment to IAS 32 targeted at rights issues as recommended by the IFRIC at its most recent meeting.

25. The staff agrees with the concerns expressed in the 2005 Board paper about the complexity and potential unintended consequences of the broader proposed amendment. The staff does not believe that such an amendment is appropriate given the urgency of the issue and the existence of the major agenda project.

26. Similarly, making an exception to IAS 32 (and IAS 39) to permit the bifurcation of a derivative may have broader implications for other Board projects. Although the exercise prices of the rights in the various currencies are equivalent at the date of issue, measurement issues to separate subsequently the foreign currency effects from changes in the share price might raise difficulties.

27. As noted in paragraph 14, a description of rights issues and a required special treatment of them already exist in IAS 33. The characteristics in the IAS 33 description can be used as a basis for amending IAS 32. Therefore, the staff recommends that if the Board believes an amendment should be made at this time, the Board should adopt the narrow, targeted approach recommended by the IFRIC.

Question 1 – amendment of IAS 32
For the reasons outlined in paragraphs 18-23, the staff recommends that the Board amend IAS 32 urgently to address the question of rights issues denominated in a foreign currency. Does the Board agree?

Question 2 – approach to amendment

For the reasons set out in paragraphs 24-27, the staff recommends that the Board make an extremely narrow amendment to IAS 32 to deal explicitly with this issue. Does the Board agree?

Exposure draft

28. If the Board agrees with the staff recommendations in questions 1 and 2, we have included alternative proposed wording for the amendment in Appendix B.

29. In common with virtually all amendments the Board has made that affect the liability/equity classification of financial instruments, the staff recommends that the amendment be applied retrospectively. This will permit entities that accounted for their rights issues as derivative liabilities to put their reporting on the same basis as entities that issue rights after the amendment is effective.

30. The staff also recommends that the final amendment be effective 90 days after it is published with early adoption permitted. Because of the importance of this issue to many entities, we recommend that the intended effective date be included in the exposure draft rather than being left open for future determination.

Question 3 – drafting
Which alternative proposed wording of the proposed amendment in Appendix B does the Board prefer?

Question 4 – transition and effective date
Does the Board agree with the staff recommendations that the amendment should be applied retrospectively and that the intended effective date should be included in the exposure draft?

Project timetable

31. If the Board agrees to proceed with the amendment as recommended by staff, we propose the following timetable:

    (a) Approve project, approach and proposed wording of the amendment at the July meeting

    (b) Ballot draft circulated week commencing 27 July

(c) Exposure draft issued week commencing 3 August with a 30 day comment period

(d) Analysis of comment letters presented at September Board meeting and amendment finalised

(e) Final amendment balloted and issued late September or early October.

Question 5 – project timetable
Does the Board agree with the project timetable proposed by the staff in paragraph 31?

Appendix A

The following is the amendment to IAS 32.22 the IFRIC recommended to the Board in 2005:

> 22. A contract that will be settled by the entity (receiving or) delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset, regardless of the currency in which the fixed amount is denominated, is an equity instrument. For example, an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond is an equity instrument. Changes in the fair value of a contract arising from variations in either market interest rates or exchange rates that do not affect the amount of cash or other financial assets to be paid or received, or the number of equity instruments to be received or delivered, on settlement of the contract do not preclude the contract from being an equity instrument. Any consideration received (such as the premium received for a written option or warrant on the entity's own shares) is added directly to equity. Any consideration paid (such as the premium paid for a purchased option) is deducted directly from equity. Changes in the fair value of an equity instrument are not recognised in the financial statements.

Appendix B – Proposed exposure draft wording

[Appendix omitted from observer note]