IASB Meeting | Agenda reference **3**

Staff Paper | Date **Sept 2009**

Project **Classification of Rights Issues**

Topic **Comment Letter Analysis**

Purpose of this agenda paper

1. This agenda paper summarises the staff's analysis of the comment letters received on the exposure draft *Classification of Rights Issues* published in August 2009. This paper includes:

   (a) background of the issue;

   (b) a summary background of the respondents;

   (c) analysis of specific comments including staff recommendations and questions for the Board; and

   (d) other issues for this project and related questions for the Board.

Background of the issue

2. In July 2009, the IFRIC deliberated a request to consider whether 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 a similar issue in 2005 in the context of foreign currency denominated convertible bonds. The conclusion was that the instrument should be classified as a liability. The question considered in July 2009 was whether a similar conclusion applies to a rights issue.

3. In a conventional rights issue, the entity issues rights pro-rata to its existing shareholders that entitle the holder to purchase a fixed number of additional shares at a fixed price. Because the rights entitle the holder to receive a fixed number of

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

shares for a fixed amount of cash, the entity would recognise the rights as equity instruments and they would not be remeasured.

4. An entity may be required to issue the rights in a currency other than its functional currency, for example, because it is listed on exchanges in more than one jurisdiction. Thus, considered in the functional currency, the amount of cash to be received for the issue of the shares is not fixed. In accordance with the IFRIC's previous conclusion, such a right is considered to be a derivative liability and is therefore remeasured through profit or loss until the right is exercised or expires.

5. The IFRIC noted that this conclusion results in the entity's profit or loss being affected by changes in its own share price as well as by changes in foreign exchange rates. In addition, in the IFRIC's view, the rights issue described above is different from the convertible bonds it discussed in 2005 because of the following differences in characteristics:

   (a) the rights must be allocated pro-rata to existing shareholders in their capacity as shareholders; convertible bonds are a separate instrument that may be issued to any investor.

   (b) the rights are priced in the various currencies to treat all shareholders in their capacity as shareholders equivalently at the date of issue, no matter which exchange the shares/rights are traded on. In other words, shareholders typically receive rights with an exercise price denominated in the currency in which the entity's shares trade. Convertible bonds could be denominated in any currency the entity chooses and are not necessarily denominated in the currency in which the entity's shares trade.

6. For these reasons, the IFRIC concluded that rights issues with the characteristics described above should be classified as equity instruments. However, the IFRIC noted that in accordance with its 2005 conclusion IAS 32 would not permit entities to classify such rights as equity instruments. The IFRIC recognised that the Board has a major project on its agenda relating to the classification of instruments as liabilities or equity that might eliminate this question. However, the IFRIC noted

that many entities are raising capital by issuing rights in the current economic environment, so the request has immediate, widespread practical relevance.

7. Consequently, the IFRIC decided to recommend that the Board amend IAS 32 urgently to permit rights issued pro-rata to existing shareholders to be classified as equity instruments if the exercise price is fixed in any currency. The IFRIC directed the staff to develop a proposal for the Board to consider at its meeting in July 2009.

8. The staff presented this issue to the Board at the July 2009 Board meeting. The outcome of the Board's deliberations (and subsequent due process procedures) resulted in the exposure draft *Classification of Rights Issues* published on 6 August 2009. The comment period ended on 7 September 2009.

Summary background of the respondents

9. A total of 41 comment letters were received on this ED. The respondents included accountancy bodies, accounting firms, preparers (and preparer representative groups), regulators, standard setters and others. They represent the major regions of the world including Africa, Asia-Pacific, Europe, North America and international organisations. Additional demographic information on the respondents is provided in Appendix A to this paper.

Analysis of specific comments

10. The 41 comment letters covered several specific comments. The comments include:

    (a) expansion of the scope (to include convertible debt);

    (b) clarification of the term 'rights issues';

    (c) pro-rata as a key concept;

    (d) existing owners of the same class of equity; and

    (e) other specific comments.

11. Each of the specific comments are analysed in detail by the staff and staff recommendations are included for each comment.

Expansion of the scope (to include convertible debt)

12. Several respondents recommended that 'the Board consider expanding the scope of this ED to cover equity warrants and **convertible debts** issued in foreign currency'.

13. Some respondents believe that:

> Foreign currency convertible bonds are in substance the same as rights issues denominated in foreign currency. There is no difference economically if the instrument consists of two components; a convertible with an embedded warrant, or two separate instruments; one debenture and one warrant. [The respondent] does not see the logic to why they should be accounted for differently. [The respondent] cannot see why fluctuations in the form of currency and measurement effects have to be recognized in profit or loss in one case. The proposal in the Exposure Draft is too bound by the form of the transaction and not by the economic substance.

14. The staff does not agree that the issue underlying this proposed amendment and the issue of foreign currency denominated convertible bonds are the same. The issue of foreign currency denominated convertible bonds is explicitly addressed by the IFRIC's 2005 agenda decision and has been a part of the focus of this proposed amendment with the Board's resulting clarification that these instruments are not

transactions with existing owners in their capacity as owners. Rather, foreign currency denominated convertible bonds are transactions with external entities to obtain financing where an element of the transaction relates to the potential future purchase of equity instruments of the entity. Therefore, staff does not believe that the scope of this proposed amendment should be expanded to include transactions such as foreign currency denominated convertible debt.

15. One respondent commented that a minor modification to paragraph 29 of IAS 32 could be made to expand the scope of this amendment. That respondent recommends clarifying that equity classification is appropriate if an entity combines a foreign currency denominated convertible bond with a 'currency future (realisation of which is contingent on the exercise of the call option by the holder of the instrument) to buy a fixed amount of the foreign currency for a fixed amount of the company's functional currency'.

16. The staff disagrees with the suggested amendment to paragraph 29 of IAS 32. The staff believes the transactions underlying the recommendation by the respondent (i.e. foreign currency denominated convertible bonds plus a foreign currency option) will provide an economic hedge of the foreign currency effects embedded in the convertible bond; however, this is created by two (or more) transactions. The staff believes that the transactions described should be presented in the financial statements of the reporting entity without combination.

17. Some respondents, while broadly in agreement with the proposed amendment, note that 'the reasoning set out in the Basis for Conclusions needs to be expanded in order to articulate more clearly the reasoning behind the proposals and the relationship between rights issues and similar transactions for example foreign currency convertible bonds or transactions with a single shareholder within a broader class.'

18. The staff recommends clarifications of the scope and rationale of this amendment to be included in the Basis for Conclusions to the proposed amendment.

Question 1 – Expanded scope
Does the Board agree that the scope of the proposed amendment should not be broadened to include foreign currency denominated convertible debt?

Clarification of the term 'rights issues'

19. Several respondents requested clarification of the term 'rights issues'. Many respondents requested that similar instruments such as **warrants** and **options** be permitted the same accounting treatment as rights issues.

20. The staff agrees that a broader range of instruments beyond those financial instruments explicitly termed as 'rights' were intended to be included in the scope of this amendment provided certain criteria are met. Examples of these instruments include warrants and written call options in addition to rights. Those criteria that must be met for the 'rights issues' to be within the scope of this proposed amendment are:

    (a) the instruments are given to existing non-derivative equity owners of a class of equity on a pro-rata basis, and

    (b) the instruments provide the ability to acquire a fixed number of the entity's equity instruments for a fixed amount of any currency.

21. The staff agrees with the respondent regarding long-dated foreign currency rights that states:

    > That guidance should, in particular, make it clear that long-dated foreign currency rights issues are not in substance equity in their entirety, nor are rights issues that are disproportionately large compared to the amount of shares outstanding. Without this guidance, [the respondent] believe[s] that the amendment as currently drafted could potentially apply to a broader range of instruments than the IASB envisaged and may as a result be susceptible to structuring risk.

    The staff does not agree with the respondent comment above regarding disproportionately large rights issues compared to the amount of shares outstanding.

In the staff's opinion, the amount of financing that an entity must raise is not indicative of the underlying transaction. In the staff's opinion, a rights issue within the scope of the ED is an equity transaction regardless of the size of the transaction.

22. The staff recommends clarification in the Basis for Conclusions that 'rights issues' include rights, warrants and written call options as long as certain criteria required by this proposed amendment (as noted above) are met. Additionally, the staff recommends clarification in the Basis for Conclusions that long-dated foreign currency rights issues are not in substance equity transactions.

Question 2 – Clarification of 'rights issues'
Does the Board agree that the term 'rights issues' should be clarified in this context to include rights, warrants, options or similar instruments provided to existing owners on a pro-rata basis?

Pro-rata as a key concept

23. Some respondents expressed the view that the concept of '**pro-rata**' is not necessary for an instrument to be equity classified. 'From the entity perspective it is an owner transaction regardless if all of the owners are treated the same or not. The issue of equal treatment of all the owners is not an accounting issue.'

24. Many of these respondents expressed the view that differences in accounting for similar instruments already exists leading to inconsistencies between standards in the classification of instruments as liabilities or equity. One respondent states:

> 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 recognized 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.

25. The staff is aware of the potential conflicts between standards; however, these conflicts are a broader issue that is being considered as part of the *Financial Instruments with Characteristics of Equity* project. The purpose of this proposed

narrow amendment is to address a limited fact pattern that has become more prevalent in the current environment.

26. The staff recommends that the proposed amendment should continue to require the 'pro-rata' concept to ensure that the scope of this exception remains narrow and is not analogised to other transactions.

27. The staff agrees with respondents who acknowledge both the equity and foreign currency features while realizing the primary nature of the transaction. One respondent states:

> We accept that reflecting interrelated equity and foreign exchange features separately could be difficult and would probably involve arbitrary and potentially complex rules that could impact other accounting standards, in particular IAS 39. Bearing that in mind, and because we are of the view that the substance of these transactions is that they are predominantly equity, we are broadly comfortable with the proposal (which in effect is to ignore for classification purposes the foreign currency component). That would mean however that the treatment of foreign currency rights issues proposed in the ED is an exception to the current "fixed for fixed" rule, rather than some sort of development of the "fixed for fixed" rule.

28. The staff recommends that clarification and acknowledgement in the Basis for Conclusions that this proposed amendment is an exception to the 'fixed for fixed' concept due to the embedded foreign currency features. Additionally, the staff recommends clarification in the Basis for Conclusions that the primary focus of transactions within the scope of this amendment are as transactions with existing owners in their capacity as owners.

Question 3 – 'Pro-rata' as a key concept
Does the Board agree that the concept of 'pro-rata' is a key concept of this proposed amendment? Does the Board agree that the concept pro-rata should be emphasised?

Existing owners of the same class of equity

29. Some respondents commented that the proposed wording to require that the rights are offered pro-rata to all of its **existing owners** of the **same class** of its own non-

derivative equity instruments was too restrictive. Further, several respondents noted the use of 'same class' could result in the structuring of financial instruments or the creation of new classes of equity for the purpose of obtaining a desired accounting treatment.

30. The staff acknowledges the narrow proposed amendment as written in the exposure draft may lead to certain entities initiating business transactions simply to create desired accounting treatments. However, in the staff's opinion, the purpose of this proposed amendment is to ensure transactions within a narrow scope are accounted for in accordance with the primary economic results underlying the transaction. In the staff's opinion, if the proposed amendment was changed to require pro-rata treatment for all existing equity holders at the entity level and in the context of the complex equity structures of the multi-national entities for which this amendment will likely apply, the scope would be narrowed to such an extent that the amendment would not be applicable to most transactions intended to be captured by the Board.

Question 4 – Existing owners of the same class of equity
Does the Board agree that the amendment should continue to require that the rights issue be made to all existing owners <u>of a class</u> of non-derivative equity instruments and that it should not require that the rights issue be made to all existing owners of non derivative equity instruments <u>of the entity</u>?

Other specific comments

31. The staff noted several other comments were noteworthy of consideration by the Board.

Acceleration of the Financial Instruments with Characteristics of Equity project

32. Numerous respondents stated that while they support this narrow amendment, the respondents believe the IASB should focus its efforts on completing the project on *Financial Instruments with Characteristics of Equity*. Most of these respondents believe that the concept of 'fixed for fixed' should be replaced with a principle that

will capture the underlying economics of the transaction and will also be consistent with other IFRSs and the Framework.

Convergence efforts

33. Many respondents also noted the continuing diversity that exists between IFRS and US GAAP. Respondents question why continued narrow amendments are made to IAS 32, especially when the amendments do not increase convergence. Notwithstanding these concerns, the staff believes the proposed amendment will improve financial reporting by capturing the primary economic results of transactions within its scope. The staff therefore recommends that the Board proceed with the amendment.

Question 5 – Other comments
Does the Board agree that this proposed amendment project should proceed even as the Board continues its *Financial Instruments with Characteristics of Equity* project and its convergence efforts with the FASB?

Other issues for this project

34. Provided the Board concludes that this project should proceed, the staff requests the Board provide the staff with guidance on the remaining other issues for this project to assist in its finalisation.

Re-exposure

35. The *Due Process Handbook* for the IASB states that after resolving issues arising from the exposure draft, the Board considers whether it should expose its revised proposals for public comment, for example by publishing a second exposure draft. Paragraph 47 of the *Due Process Handbook* states:

> In considering the need for re-exposure, the Board
>
> - identifies substantial issues that emerged during the comment period on the exposure draft that it had not previously considered

- assesses the evidence that it has considered
- evaluates whether it has sufficiently understood the issues and actively sought the views of constituents
- considers whether the various viewpoints were aired in the exposure draft and adequately discussed and reviewed in the basis for conclusions on the exposure draft.

36. The staff believes that re-exposure would not result in the identification of new issues or accounting alternatives. The staff also believes that any benefits from re-exposing the amendments would be too minor to justify the delay in issuing it. Therefore, the staff recommends that the Board should not re-expose the revised amendments.

Question 6 – Re-exposure
Does the Board agree that the revised amendments should not be re-exposed?

Effective date

37. If the Board agrees that a re-exposure is not necessary, it is likely that the final amendment will be issued in October 2009 in accordance with the estimated project timetable set out in the July 2009 Board agenda paper 3F. As discussed by both the IFRIC and Board, this amendment urgently addresses a concern where rights issues and other similar forms of capital raising have become more common in the current environment. As proposed in the exposure draft, the staff believes that a three-month lead time after issuance would be sufficient for entities to prepare for adoption. Therefore, the staff recommends that the final amendment be effective for annual periods beginning on or after 1 February 2010. The staff also recommends that earlier application is permitted; however, if an entity applies the proposed amendment before 1 February 2010, it shall disclose that fact.

Question 7 – Effective date
Does the Board agree with an effective date requiring that an entity shall apply this amendment for annual periods beginning on or after 1 February 2010?

Transition

38. The ED proposed retrospective application. As described in paragraph BC13 of the ED, IAS 32 requires retrospective application in all cases. The staff believes that a requirement to restate comparative information when the proposed amendment is first applied should not entail significant cost or effort. In addition, the Board's conclusions would not require an entity to use hindsight to make estimates to implement the amendment.

39. The staff also believes that no specific relief is required for first-time adopters of IFRS and accordingly no amendment to IFRS 1 is proposed.

40. The staff recommends that the Board reaffirm the same retrospective transition as proposed in the ED.

Question 8 – Transition
Does the Board agree with that retrospective transition is appropriate and that no amendment is required to IFRS 1?

Other issues

Question 9 – Authorisation to proceed with drafting and to ballot
Does the Board approve the staff to proceed with this proposed amendment including finalisation of drafting and a ballot to be provided to the Board for finalisation of this project?

Appendix A – Demographic Information on the respondents

A1. A total of 41 comment letters were received on this ED. Demographic information on the respondents is as follows:

	Africa	**Asia-Pacific**	**Europe**	**North America**	**International**	**Totals**
Accountancy Bodies	-	4	5	2	-	**11**
Accounting Firms	-	-	1	-	4	**5**
Preparers	-	2	8	1	-	**11**
Regulators	-	-	1	-	1	**2**
Standard Setters	1	6	3	1	-	**11**
Others	-	1	-	-	-	**1**
Totals	**1**	**13**	**18**	**4**	**5**	**41**