Dear Sir,

RE: EXPOSRE DRAFT - CLASSIFICATION OF RIGHTS ISSUES

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?

Comment

No, I disagree to limit the amendment to instruments with these characteristics.

All the equity element embedded in all other debt instruments convertible into an equity instrument of the issuer and all stand alone option denominated in a foreign currency should be included. Issuers of such instruments should follow the existing requirements of paragraph 28 of IAS 32 in accounting for these instruments.

Explanation:

At present, some companies treat debt instruments denominated in a foreign currency convertible into its equity instrument as a liability as a whole at fair value through profit or loss, and have not applied the requirements of paragraphs 28 to 32 and paragraphs AG32 to AG35 of IAS 32 "Financial Instruments – Presentation" on compound financial instruments. Some companies separate the equity conversion option embedded and treat it as a derivative. Although the background as set out in paragraph BC3 of this Exposure Draft cannot be found in the main body of IAS 32, its Basis of Conclusions or any other official interpretations on IAS 32, it seems that the underlying rationale of BC 3 have been applied by these companies.

Such practices have however created reported results that were counterintuitive. That is: when the share prices of these companies went down, they would report a gain due to the change in fair value of the embedded derivative; and when the share prices of these companies went up, they would report a loss accordingly.

The proposed treatment may help avoid causing such counterintuitive results in the case of a right issue, but more likely it may be interpreted as reinforcing the existing practice as suggested in BC3 of this Exposure Draft for all other compound financial instrument or options denominated in a foreign currency.

I consider that the existing requirements of paragraph 28 of IAS 32 have already taken care of these situations, and if the underlying principles had been applied correctly, the counterintuitive results mentioned above could be avoided.

Paragraph 28 of IAS 32 reads as follows:

"The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. Such components shall be classified separately as financial liabilities, financial assets or equity instruments in accordance with paragraph 15."

Paragraph 29 of IAS 32 gives further explanation of how these principles are applied in the case of a convertible bond, implicitly denominated in the entity's functional currency.

It appears that a minor modification of Paragraph 29 would result in a rather clear guidance for a convertible bond denominated in a foreign currency. The modification is as follows, with the added texts underlined:

"For example, a bond or similar instrument denominated in a foreign currency convertible by the holder into a fixed number of ordinary shares of the entity is a compound financial instrument embedded with a currency future. From the perspective of the entity, such an instrument comprises two three components: a financial liability (a contractual arrangement to deliver cash or another financial asset denominated in a foreign currency), 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 and an equity instrument (a call option granting the holder the right, for a specified period of time, to convert it into a fixed number of ordinary shares of the entity for a fixed amount denominated in the company's functional currency). The economic effect of issuing such an instrument is substantially the same as issuing simultaneously a debt instrument with an early settlement provision and, warrants to purchase ordinary shares and entering into a currency future (the realisation of which contingent on the exercise of the warrants), or issuing a debt instrument with detachable share purchase warrants and entering into a currency future (the realisation of which is contingent on the exercise of the warrants). Accordingly, in all cases, the entity presents the liability, a derivative and equity components separately on its balance sheet."

When Paragraphs 28 and 29 of IAS 32 are applied to a right issue denominated in a foreign currency, it would result in separately recognising a warrant as an equity instrument and a currency future contingent on the exercise of the warrant as a derivative, which may be a financial asset or financial liability as the case may be.

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?

Comment

Yes. I agree 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, provided the embedded currency futures are separated out as required by Paragraphs 28 and 29 of IAS 32.

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?

Comment

Yes. I agree. This follows the general principles of IAS 8.

Paul M. Y. Yeung
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