

Note for EFRAG's constituents

Because of the timetable to which the IASB is working, it has not been possible for EFRAG to complete all its normal processes before issuing this draft letter. However, the intention is that those normal processes will be completed when the letter is finalised in September.



XX September 2009

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

DRAFT COMMENT LETTER

Comments should be sent to Commentletter@efrag.org by 31 August 2009

Dear Madam/Sir

IASB Exposure Draft 2009/9 Proposed Amendment to IAS 32: Classification of Rights Issues

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on Exposure Draft 2009/9 *Proposed Amendment to IAS 32: Classification of Rights Issues* (the ED). This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive interpretations/amendments on the issues.

The ED proposes an amendment to IAS 32 *Financial Instruments: Presentation* so that a rights issue will not be classified as a financial liability simply because the exercise price for the rights issue is denominated in a currency other than the issuing entity's functional currency. If such rights issues were classified as financial liabilities, they would be treated as derivatives and measured at fair value, and the changes in those fair values would be recognised in profit and loss. The IASB believes that treating such rights issues as equity more appropriately reflects the substance of the underlying transactions.

Furthermore, because the current economic climate has meant that occurrence of such rights issues have increased significantly, the IASB has decided that the amendment is needed urgently. It is therefore proposing not to wait for completion of its project on financial instruments with characteristics of equity to make the change to IAS 32. It is also issuing the ED with a shorter than usual comment period so that a final amendment can be made in time for implementation in 2009.

EFRAG agrees that accounting for foreign currency rights issues as financial liabilities does not reflect the substance of these transactions. The transactions are more akin to equity and we agree with the IASB that IAS 32 should be amended to reflect this. We understand that this issue is significant and immediate for a number of the IASB's constituents and we agree that in those circumstances it makes no sense to continue to

require entities to report transactions, even for a finite period of time, in a manner that does not provide relevant information. We therefore support the IASB's decision to amend IAS 32 urgently.

Having said that we broadly agree with the proposals in the ED, we do have some concerns about aspects of the proposals. Our detailed comments are set out in the appendix to this letter, but to summarise:

- We do not find the IASB's arguments in the Basis for Conclusions comprehensive, for example:
 - We believe 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 these proposals and the thinking underlying earlier agenda decisions.
 - We believe the Basis for Conclusions should make it clear that the proposals represent an exception to the current equity/liability model in IAS 32.
- Furthermore, we believe the IASB should provide further guidance on the nature of rights issues. 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, we believe 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.

In the longer term we would expect the IASB to address the issue of foreign currency rights issues, foreign currency convertible bonds and similar instruments in its active project on financial instruments with characteristics of equity.

If you would like further clarification of the points raised in this letter, please contact Kristy Robinson or me.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

APPENDIX—EFRAG'S DETAILED COMMENTS

General comment

The proposal in the ED is that the requirements of IAS 32 as they apply to derivative contracts for the exchange of a fixed number of the reporting entity's equity instruments for a fixed amount of foreign currency shall be amended; that amendment shall apply only to rights issues as defined; and the amendment shall apply regardless of the foreign currency involved. Question 1 deals with the proposal that the amendment shall apply only to rights issues as defined and Question 2 deals with the proposal that the amendment shall apply regardless of the foreign currency involved. In the paragraphs below we comment on the amendment itself.

Notes for EFRAG's constituents

- 1 *Paragraph 16(b)(ii) of IAS 32 Financial Instruments: Presentation states that a derivative that will or may be settled in an entity's own equity and involves the exchange of a fixed amount of cash for a fixed number of the entity's own equity instruments shall be classified as equity.*
- 2 *In April 2005, the IFRIC considered whether this reference to 'a fixed amount of cash' included a fixed amount of foreign currency.¹ It noted that, although this matter is not directly addressed in IAS 32, it is clear that when the question is considered in conjunction with guidance elsewhere in IFRS, particularly IAS 39 Financial Instruments: Recognition and Measurement, an amount denominated in a foreign currency represents a variable amount of cash. This is evidenced, for example, by the fact that IAS 39 allows cash flow hedge accounting for transactions denominated in a foreign currency because such transactions expose the entity to variability in cash flows.*
- 3 *In June 2005 the IASB considered IFRIC's April 2005 agenda decision² and decided to explore the possibility of making some limited scope amendments to IAS 32 so that, for classification purposes only, derivative contracts are classified as equity if they will be settled by an entity by delivering a fixed number of its own equity instruments for a fixed amount of cash or another financial asset denominated in a foreign currency. However in September 2005³ the IASB decided not to amend IAS 32 in respect of foreign currency convertible bonds because:*
 - (a) *the proposed amendment would result in equity and foreign exchange features whose values are interdependent being recognised in equity and excluding from equity the value attributable to the foreign exchange features would require arbitrary rules;*
 - (b) *allowing dual indexed contracts (to share price and foreign exchange rates) to be classified as equity would require additional and detailed guidance to avoid structuring opportunities aimed at obtaining a desired accounting result.*

¹ IFRIC Update-April 2005: *Convertible instruments denominated in a foreign currency;*

² IASB Update- June 2005: *Convertible bonds issued in a foreign currency.*

³ IASB Update-September 2005: *Classification of contracts settled in own equity denominated in a foreign currency*

- 4 *A number of entities have recently issued pro rata rights issues to all existing shareholders to acquire a fixed number of additional shares in exchange for a fixed amount of foreign currency. Those entities have been required to present these transactions as derivative liabilities under IAS 32 (based on the surviving IFRIC 2005 agenda decision). A number of the IASB's constituents have questioned whether such a treatment results in decision-useful information for users of financial statements.*
- 5 *As a result, the IASB has considered the issue and has tentatively decided that, despite its previous decisions not to amend IAS 32, 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. The ED therefore proposes to amend the definition of a financial liability to specify that derivatives that give the right 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 pro rata to all of its existing owners of the same class of its own non-derivative equity instruments.*

EFRAG's response

EFRAG's view

- We broadly agree with the proposal that foreign currency rights issues should be classified as equity.
 - However, we believe 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 these proposals and the thinking underlying earlier agenda decisions. It should also be made clear that the proposals represent an exception to the current equity/liability model in IAS 32.
 - Furthermore, we believe the IASB should provide further guidance on the nature of rights issues. 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.
- 6 We agree with the IASB's tentative conclusion that the application of the existing requirements of IAS 32 (interpreted in the way described in the April 2005 edition of IFRIC Update) to certain rights issues is not appropriate because it would result in them being classified as financial liabilities and such a classification is not consistent with the substance of the transactions. As a result, the accounting information being provided in respect of those transactions currently is not representationally faithful. We agree therefore that an amendment along the lines proposed in the ED is necessary.
 - 7 However, as explained more fully in the paragraphs below, we do have concerns about:
 - (a) the reasoning set out in the Basis for Conclusions for the proposals made and the way the amendment is to be presented within IAS 32's equity/liability model; and
 - (b) the structuring risks arising from the proposal.

Basis for Conclusions and the presentation of the proposed amendment

- 8 The IASB's decision to amend the definition of a financial liability in IAS 32 to specifically exclude foreign currency rights issues is based on the conclusion that these are transactions with owners in their capacity as owners and therefore should be recognised in equity. This conclusion is based primarily on the following:
- (a) Rights that are issued only to existing shareholders on the basis of the number of shares they already own resemble dividends paid in shares;
 - (b) The Framework defines income and expenses as changes in economic benefits that result in changes in equity, other than those relating to contributions by or distribution to equity participants;
 - (c) 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;
 - (d) Paragraph 4 of IFRS 2 *Share Based Payments* explicitly recognises that the holder of a right in a rights issue receives it as a holder of equity instruments.
- 9 Although we are, as we have already said, broadly happy with the amendments proposed, we do not find the above arguments convincing. We think that is because the reasoning is not complete.
- 10 For example, a rights issue that involves existing holders of a class of equity instruments being granted rights to acquire a fixed number of additional shares that is not pro rata to their existing holdings in exchange for a fixed amount of foreign currency would also be a transaction with owners in their capacity as owners, yet under the amendment it would be treated as a financial liability, as would a rights issue that involved only some of the existing holders. This suggests that there are other factors that the IASB has taken into account in scoping its proposals. The Basis for Conclusions should explain what those factors are.
- 11 Furthermore, we think that, although it would not be appropriate to classify a foreign currency rights issue as a financial liability, such rights issues have financial liability features (as well as equity features) and that the most appropriate thing to do would be to split the instrument into equity and liability components. (This view would for example seem to be in line with the IASB's previous decision regarding foreign currency convertible bonds.) Having said that, 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 in the ED (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. We think the Basis for Conclusions should be clearer on this point.
- 12 We think it should also be explained that the proposals will result in some foreign exchange exposures going unreported for the life of these transactions, but the IASB's view is that, given these are transactions with owners in their capacity as owners, full equity presentation better reflects the substance of these transactions.

- 13 Finally, we think it would be helpful if the IASB could provide some additional analysis as to how it differentiates the proposed treatment of foreign currency rights issues from other similar transactions (for example, foreign currency convertible bonds or transactions with a single shareholder within a broader class). Any inconsistencies with prior IASB/IFRIC agenda decisions should also be addressed.

Structuring risks

- 14 If the IASB proceeds with the proposal to classify foreign currency rights issues as equity in their entirety, we think it may need to address the potential exposure any amendment will have to structuring risk, since the proposals will mean foreign exchange exposures are unreported until actual settlement of the new shares.
- 15 In particular, as drafted, the rights that will fall within the scope of the amendment could relate to any non-derivative share provided they are offered pro-rata to all of the existing owners of the same class as that non-derivative share. There is seems to be little to stop an entity issuing a new (and limited) class of non-voting ordinary shares or preference shares that meet the definition of equity in order to provide a population to which to offer long-dated rights that could expose the reporting entity to significant foreign exchange risk.
- 16 In order to address this potential issue, we would suggest including a discussion either in the body of the standard or the application guidance about the nature of rights issues. That discussion should, in particular, make it clear that long-dated foreign currency rights issues (for example those outside the normal market/regulatory/legal conventions for such issues) are not in substance equity in their entirety (or maybe even at all), since they may be more about exposure to foreign currency risk than raising capital. The same could be said for rights issues that are disproportionately large compared to the amount of shares outstanding in any particular class.

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?

Notes for EFRAG's constituents

- 17 *Paragraph BC6 in effect defines a rights issue as the issuance, by an entity to all existing owners of a class of equity instruments of that an entity, rights to acquire a fixed number of additional shares of the same class pro rata to their existing holding in exchange for a fixed amount of cash in any currency.*
- 18 *The proposal in the ED is that the amendment proposed should apply only to those rights issues that involve a fixed amount of cash in a currency other than the entity's functional currency and that are offered pro rata to all existing shareholders in a non-derivative class of shares.*

EFrag's response

EFrag's view

- We agree with the proposal to limit the amendment to 'normal' rights issues (ie rights offered pro rata to all existing owners of the same class of non-derivative equity instruments).
- Subject to the comments made above about the need for more guidance on the nature of rights issues, we believe that the proposals do that.

19 It seems to us that the proposal is in effect that the amendment should apply only to 'normal' rights issues exercisable in a foreign currency. Therefore, in order to answer the question asked, it is necessary to consider both whether it is appropriate to limit the amendment just to 'normal' rights issues and whether the wording proposed achieves that effect.

Should the amendments be limited just to 'normal' rights issues?

20 We agree that the proposed amendments are applicable to 'normal' rights issues. The question is therefore whether it should apply in some other circumstances as well. We find it difficult to reach a view on this issue because, as we explained in paragraph 10 above, the IASB's reasoning is not clear to us so it is difficult to assess that reasoning. In particular, it is not clear why the IASB has concluded that the following types of rights issues should not fall within the scope of the amendment.

- (a) A rights issue that involves existing holders of a class of equity instruments being granted rights to acquire a fixed number of additional shares that are not pro rata to their existing holdings.
- (b) A rights issue that does not involve all existing holders of a class of equity instruments being granted rights.

We also explained in paragraph 13 above that it would be helpful if the IASB could explain why certain rights issues are to be treated differently from, for example, foreign currency convertible bonds.

21 Having said that, our tentative view is that 'normal' rights issues are in substance different from the rights issues described in (a) and (b) and from foreign currency convertible bonds. As we agree that transactions that are different in substance will usually be accounted for differently, we agree with the proposal to limit the amendment to 'normal' rights issues.

Does the wording proposed limit the amendment just to 'normal' rights issues?

22 The second issue is whether, assuming that it is appropriate to limit the amendment just to 'normal' rights issues, the proposed wording in the ED achieves that effect. As we explained in paragraph 16, we think that some types of rights issue that are not in substance entirely equity would fall within the scope of the proposals as currently drafted. (We mentioned in particular long-dated rights issues and rights issues that are disproportionately large compared to the amount of shares outstanding in any particular class.)

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?

Notes for EFRAG's constituents

- 23 *As the question explains, the proposed amendment specifies that the fixed amount of cash the entity will receive can be denominated in any currency that is not the reporting entity's functional currency.*
- 24 *It therefore does not have to be, for example, the currency in which the shares are denominated or the currency of the jurisdiction where the shareholders are located.*

EFRAG's response

EFRAG's view

- We agree with this proposal.

- 25 We recognise that it could be argued that, whilst it might be logical for an entity to issue foreign currency rights denominated in certain currencies (for example, the currency in which the shares are denominated or the currency of the jurisdiction in which the shareholders are located), if the foreign currency rights issue is denominated in another currency then something else is going on and the rights issue might not in substance consist entirely of equity. However, we think in practice it will be impossible to differentiate between those currency denominations that are 'logical' and those where 'something else is going on'. For that reason, we agree that the proposals should apply where the exercise price for the rights issue is denominated in any currency other than the issuing entity's functional currency.
- 26 Finally there appears to be some ambiguity about how the reporting currency relates to the currency of rights issues as this is not addressed in the ED. It would be helpful if the IASB could clarify how the reporting currency relates to the presentation of rights issues issued in any 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?

Notes for EFRAG's constituents

- 27 *The proposal is to apply the amendment retrospectively in all cases.*

EFRAG's response

- 28 Subject to our comments above, we support retrospective application of the proposed amendments.