Grant Thornton

Technical Accounting Alert

Classification of rights issues –
Amendment to IAS 32 Financial Instruments: Presentation

Introduction

The purpose of this alert is to provide information about the amendment to IAS 32 published by the IASB on 8 October 2009.

Relevant standards

References are made to standards issued by the International Accounting Standards Board. The Australian equivalent to each standard included in this alert is shown below:

International Standard reference	Australian equivalent standard
IAS 32 Financial Instruments: Presentation	AASB 132 Financial Instruments: Presentation

The Amendment

The Amendment alters IAS 32 *Financial Instruments: Presentation* so that rights, options or warrants 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, options or warrants pro rata to all of its existing owners of the same class of its own (non-derivative) equity instruments. Prior to the Amendment, rights issues denominated in a foreign currency 'failed' equity classification and were required to be accounted for as derivative liabilities.

Background

In 2005, the International Financial Reporting Interpretations Committee (IFRIC) was asked whether the equity conversion option in a convertible bond denominated in a foreign currency met IAS 32's requirements to be classified as an equity instrument. IAS 32 states that a derivative instrument settled in an entity's own equity instruments is equity if, and only if, it results in the exchange of a fixed number of equity instruments for a fixed amount of cash or other assets. IFRIC concluded that if the conversion option was denominated in a currency other than the entity'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 measured at its fair value with changes in fair value included in profit or loss.

More recently, IFRIC received requests to consider whether the application of this 2005 conclusion applied to a rights issue in which the exercise price was fixed in a foreign currency. 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. Such rights issues are classified as equity in accordance with IAS 32. An entity may however issue the rights in a currency other than its functional currency, because for example its shares are listed on an overseas stock exchange. Applying IFRIC's 2005 conclusion would lead to these rights being derivative liabilities and re-measured through profit or loss until exercise or expiry. This would result in the entity's profit or loss being affected by changes in its share price and exchange rates. IFRIC referred the issue to the IASB, believing that the Board should consider a narrow, targeted amendment to IAS 32 to address this question.

The IASB agreed a contract with an exercise price denominated in a foreign currency would not result in the entity receiving a fixed amount of cash. However, the IASB also agreed that classifying rights issues as derivative liabilities does not reflect their substance. Rights are issued only to existing shareholders on the basis of their existing shareholdings. The Board therefore decided that a pro rata issue of rights, options or warrants to all existing shareholders to buy additional shares is a transaction with an entity's owners in their capacity as owners. Given that foreign currency rights issues are more common in the current economic environment, and often involve substantial amounts of money, the Board has made a narrow, targeted amendment to IAS 32.

Effective date

The Amendment to IAS 32 is effective for annual periods beginning on or after 1 February 2010. Earlier application is permitted.

Grant Thornton comment

Grant Thornton welcomes the publication of this amendment. The previous classification outcome under which a rights issue with an exercise price denominated in a foreign currency was accounted for as a derivative liability at fair value through profit or loss was counter-intuitive.

Although we would have preferred the amendment to have been a broader one addressing the classification of all instruments denominated in a foreign currency, the fact that rights with these characteristics are being issued by a significant number of entities in the current economic environment justified this urgent amendment of the Standard.

Further information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at NAS@grantthornton.com.au