Project	**Preliminary discussion**
Topic	**IAS 32 *Financial Instruments: Presentation* – Classification of rights and options**

Introduction

1. In May the Board received a request for the IFRIC to reconsider 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, but the conclusion in this case was applied to a rights issue.

2. In June 2009, the IFRIC received a request to provide guidance on the application of IAS 32 *Financial Instruments: Presentation* to conversion obligations to deliver a variable number of own equity instruments subject to a cap and a floor. The issue is whether the variability in the number of own equity instruments requires the entire obligation to be treated as a liability or whether the obligation can or must be analysed into fixed and variable components, with the fixed component(s) classified as equity.

3. The purpose of this paper is to present the issues to the IFRIC for a preliminary discussion. Like the issue discussed in Agenda Paper 3G on debt-equity swaps, the staff understands that financial instruments with the characteristics described in the submissions are frequently being issued in the current economic environment. Constituents have raised concerns that accounting results that do not seem to reflect the substance of transactions provide support for other criticisms of current accounting requirements.

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

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 IFRIC or 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.

Decisions made by the IFRIC are reported in IFRIC *Update*.

Interpretations are published only after the IFRIC and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in IASB *Update*.

4. The purpose of the preliminary discussion is for the staff to obtain the IFRIC's advice on how we should proceed with these issues. We have not included a complete technical analysis at this point and will not be asking the IFRIC to make any decisions.

Submission 1 – Rights issue

Context

5. In order to raise capital, an entity issues rights to purchase additional shares to its existing shareholders. In a conventional offering of this type, the entity issues a right for each specified number of shares an investor 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.
6. 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 are accounted for as a dividend at their fair value. 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.
7. When the rights are exercised, as noted in Agenda Paper 3G, 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

8. Paragraph 7 sets out the accounting result if the exercise price of the rights is in the entity's functional currency. The IFRIC previously concluded that 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.

9. 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 Share capital

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

History

11. As noted above, the IFRIC previously discussed this issue in 2005 in the context of foreign-currency denominated convertible bonds. At that time, the IFRIC decided to recommend that the Board amend IAS 32 to permit a conversion or stand-alone equity 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 amendment.

12. To minimise 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.

Submission 2 – Conversion obligation to deliver a variable number of own equity instruments subject to a cap and a floor

Context

13. An entity issues a financial instrument that will or may be converted into a number of the entity's own equity instruments. The number varies across a range subject to a fixed maximum (cap) amount and a fixed minimum (floor) amount. The obligation to deliver own equity instruments may be mandatory or an option of the holder of the instrument.

14. The issue is whether the variability in the number of own equity instruments requires the entire obligation to be treated as a liability or whether the obligation can or must be analysed into fixed and variable components, with the fixed component(s) classified as equity.

15. For example, an entity issues a preference share at its stated principal amount of CU100 with a maturity of 10 years. The preference share contains no cash redemption right or obligation but is convertible into common shares (equity instruments) of the issuer according to the following terms:

    (a) if the fair value of a common share at the date of conversion is above CU10, the holder receives 10 common shares;

    (b) if the fair value of a common share at the date of conversion is below CU10 but above CU4, the holder receives a number of common shares with a total fair value equal to CU100;

    (c) if the fair value of a common share at the date of conversion is below CU4, the holder receives 25 common shares.

16. The instrument is designed to provide the holder with an equity return plus limited protection against downward price movements. The holder may opt to convert the preference share at any time following issuance. If the preference

share is not converted prior to the maturity date, it is automatically converted on the maturity date. The preference share does not contain a contractual obligation to pay dividends. (Note: The issue does not consider the accounting for any dividends although it is acknowledged that contractual term as to the payment of discretionary or mandatory dividends may represent a separate equity or liability component of an instrument.)

Issue and current views

17. The question is whether (1) a conversion obligation should or may be analysed into further sub-components for the purposes of determining whether it should be classified as liability or as equity or split into liability and equity components and (2) if so, how.

18. In respect of an instrument similar to the example preference share described above, the following views are possible (assuming that there is no designation of any element as at fair value through profit or loss under IAS 39.9 or .11A).

19. **View 1**: The conversion obligation is considered in its entirety as an obligation to deliver a variable number of common shares between 10 and 25. Therefore, the obligation in its entirety is a financial liability. The conversion obligation is a single obligation and cannot be subdivided into further components for the purpose of identifying any equity sub-component(s). However, under IAS 39, the obligation is a hybrid financial instrument that contains a host financial liability to deliver as many common shares as are worth CU100 together with a cap and a floor on the number of common shares deliverable on conversion that are regarded as separable embedded derivative features. The issuer should separate these embedded features and account for them at fair value through profit or loss. Since the embedded features relate to the same risk exposure (i.e. common share price) and are not separately exercisable, then in accordance with IAS 39.AG29 they are treated as a single compound embedded derivative. Although the result is the same, the embedded features may be analysed alternatively as:

(a) **View 1A**: The cap and the floor are net settled derivatives (i.e. the effect of the cap and the floor is that the number of common shares delivered on conversion when the common share price is above CU10 or below CU4 is increased or decreased respectively by the difference between (i) the number of common shares that would have a total value of CU100 as required by the host instrument and (ii) the minimum or maximum number of common shares deliverable under the hybrid instrument of 10 and 25 respectively).

(b) **View 1B**: The cap and the floor are identified as a derivative to exchange the stated principal amount of the host instrument of CU100 (or, alternatively, the cash that would theoretically be payable if the preference share were redeemable at this amount) for either 10 or 25 common shares – which is not a single fixed amount.

20. **View 2**: The conversion obligation comprises two components:

(a) an obligation to deliver a fixed minimum number of 10 common shares in all circumstances that is a residual interest in the entity and qualifies as an equity instrument; and

(b) an obligation to deliver an additional variable number of common shares of between zero and 15 contingent on the issuer's common share price that is accounted for separately as a derivative liability at fair value through profit or loss.

21. Proponents of **View 2** believe that this analysis most appropriately reflects the contractual substance of the arrangement, i.e. a fixed equity interest plus limited protection against downward price movements. They note that View 1 and View 3 effectively require the recognition of increasing derivative liabilities and finance expense as the issuer's common share price increases above CU10, although there is no obligation to deliver cash or other assets or any dilution of (other) equity holders.

22. **View 3**: For the purposes of both IAS 32 and IAS 39, the conversion obligation comprises three components:

    (a) a host financial liability to deliver as many common shares as are worth CU100;

    (b) a derivative to exchange the stated principal amount of CU100 for 10 common shares when the common share price is above CU10;

    (c) a derivative to exchange the stated principal amount of CU100 for 25 common shares when the common share price is below CU4.

23. The two derivatives are both treated as equity components on the basis that each individually satisfies the fixed-for-fixed requirement in IAS 32.11.

24. **View 4**: This is a hybrid of View 1A and View 3 that has the same result as View 1. For the purposes of both IAS 32 and IAS 39, the conversion obligation comprises three components:

    (a) a host financial liability to deliver as many common shares as are worth CU100;

    (b) a derivative to exchange as many common shares as are worth CU100 for 10 common shares when the common share price is above CU10;

    (c) a derivative to exchange as many common shares as are worth CU100 for 25 common shares when the common share price is below CU4.

25. The two derivatives are both accounted for as derivatives at fair value through profit or loss as they do not satisfy the fixed-for-fixed requirement in IAS 32.11.

Reasons for the IFRIC to address the issue

26. The submission notes that a number of instruments with similar or analogous conversion features have been issued in Japan and Europe. The issue may become more widespread as more instruments with these features are issued or as more jurisdictions transition to IFRS.

27. The possible interpretations outlined above may produce significantly divergent results.

Staff discussion

28. The second submission notes that the IASB has a project on Financial Instruments with Characteristics of Equity and another project aimed at replacing IAS 39. It states that the former is not planned to result in the issue of a new standard to replace IAS 32 until 2011. Based on recent Board discussions, there is no indication that the latter would resolve or eliminate the issues discussed above.

29. The staff on the Board's project to replace IAS 32 advises that they have received a large number of questions regarding the application of the 'fixed for fixed' notion in the existing IAS 32. Those questions have not been answered to date given the existence and direction of the Board's project.

Questions for the IFRIC
1. In your experience, are rights issues and other similar forms of capital raising becoming more common in the current environment? 2. Do you agree that the IFRIC should reconsider its conclusion on foreign currency denominated options? 3. Constituents urge the IFRIC to consider instrument classification issues despite the existence of a major Board project. Should any further analysis the staff brings to the IFRIC include the other issues received directly by the project staff? Are there other issues the staff should include? 4. The Board's project is a joint project with the FASB that is intended to result in a common standard for the classification of liability and equity instruments. Current IFRS and US GAAP requirements are significantly different. Given those differences, should further staff analysis include consideration of the accounting conclusions for the instruments in accordance with US GAAP? 5. Does the IFRIC have an other advice for the staff?

Appendix A

A1. 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.