

IFRS Briefing Sheet

Classification of Rights Issues – Amendment to IAS 32 Financial Instruments: Presentation

October 2009, **Issue 157**

This IFRS Briefing Sheet summarises the International Accounting Standard Board's (IASB or Board) *Classification of Rights Issues – Amendment to IAS 32 Financial Instruments: Presentation*, which was published on 8 October 2009.

The amendment to IAS 32 addresses the accounting for rights issues (rights, options or warrants) that are denominated in a currency other than the functional currency of the issuer.

In particular, when the amendment is applied, rights (and similar derivatives) to acquire a fixed number of an entity's own equity instruments for a fixed price stated in a currency other than the entity's functional currency, would be equity instruments, provided the entity offers the rights *pro rata* to all of its existing owners of the same class of its own non-derivative equity instruments.

criterion). In 2005, the IFRIC concluded that if an equity conversion option in a convertible bond was denominated in a foreign currency, the principal amount of the bond subject to conversion would be variable when measured in the issuer's functional currency. Therefore, the issuer accounts for such a conversion option as a derivative liability with changes in fair value recognised in profit or loss.

As a result of the global financial crisis, an increasing number of entities have undertaken rights issues to raise additional capital. The rights issues are generally offered *pro rata* to all existing holders of a class of equity instruments, and the exercise price is normally below the current market price of the entity's shares. Some entities fix the exercise price of the rights issued in a foreign currency because the entity is listed in one or more jurisdictions where the local currency is not the entity's functional currency.

In 2009, the IFRIC received requests for guidance on whether a rights issue entitling the holder to receive a fixed number of the entity's own equity instruments for a fixed amount of cash in a currency other than the entity's functional currency should be accounted for as a derivative liability. The IFRIC requested that the Board consider an amendment to IAS 32 as

Background

IAS 32 *Financial Instruments: Presentation* states that a derivative instrument relating to an entity's own equity instruments is classified as equity only if it results in the exchange of a fixed number of equity instruments for a fixed amount of cash or another financial asset (the "fixed for fixed"

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it believes that liability classification for such rights issues is not consistent with the overall substance of the transaction.

The IASB decided that if the rights to acquire a fixed number of equity instruments are issued *pro rata* to all existing shareholders of the same class of non-derivative equity instruments and are exercisable for a fixed amount of any currency, then these rights should be classified as equity instruments. *Pro rata* distribution to all existing shareholders is a critical factor in this conclusion.

The IASB therefore amended the definition of a financial liability.

Summary of the Amendments

The amendment requires 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.”

This is a very narrow amendment and does not extend to other instruments that grant the holder the right to purchase the entity’s own equity instruments such as the conversion feature in convertible bonds.

Illustrative Example

Background:

On 1 March 2010, Entity A offered all of its existing shareholders rights to acquire 1 new common share for every 3 common shares held at a price of U.S. dollar (USD) 15 per share. A’s functional currency is the pound sterling (GBP), and A has only one class of shares outstanding. There were a total of 100 rights offered and they initially traded at USD 2 each.

The rights were subject to expiry on 15 March 2010 and were fully subscribed on that date. On 15 March 2010, the common share price was USD 18 per share and the closing fair value of the rights was USD 3 per share (i.e., USD 18 – USD 15).

Accounting Treatment Prior to the Amendment:

The rights offered in USD would have been accounted for as derivative liabilities. On 1 March 2010, a liability of GBP 133 (USD 2 x 100 ÷ 1.5) would have been recognised with a corresponding debit to equity, representing the distribution of the rights to common shareholders. Subsequently, the liability would have been re-measured at fair value, increasing to GBP 200 (100 x USD 3 ÷ 1.5), and a loss of GBP 67 (GBP 200 – GBP 67) would have been recognised

in profit or loss. On exercise of the rights, the cash proceeds of GBP 1,000 (USD 15 x 100 ÷ 1.5) and the closing fair value of the rights of GBP 200 would have been credited to equity.

Accounting Treatment After the Amendment:

The rights offered in US dollars would be classified as equity. Hence, no liability or gain or loss would be recognised in respect of the rights. On exercise of the rights, the cash proceeds of GBP 1,000 would be credited to equity.

Effective Date

The amendment is applicable for annual periods beginning on or after 1 February 2010. Earlier application is permitted.

If you would like further information on any of the matters discussed in this issue of *IFRS Briefing Sheet*, please talk to your usual local KPMG contact or call any of KPMG firms’ offices.

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