

Classification of rights issues denominated in a foreign currency

The International Accounting Standards Board (IASB) has issued an amendment to *IAS 32 Financial Instruments: Presentation* (the Amendment) on the classification of rights issues, options or warrants denominated in a foreign currency. The purpose of this publication is to summarise the Amendment and to highlight the potential impact on entities.

Background

In the current economic environment, a number of global organisations have made rights issues to existing shareholders in order to raise additional capital. When listed in more than one jurisdiction, or, if regulatory restrictions so require, some entities have had to make the rights issue in a currency other than their functional currency.

Prior to the Amendment, a financial instrument could only be classified as equity if, *inter alia*, it resulted in an exchange of a fixed amount of cash for a fixed number of shares. In June 2005 the International Financial Reporting Interpretations Committee (IFRIC) decided that, in the context of convertible bonds, an amount denominated in a currency other than the entity's functional currency could not be considered to be 'fixed' for this purpose. Following its 2005 decision, the IFRIC proposed that the IASB amend IAS 32 that, for classification purposes, a fixed amount of foreign currency would be treated as a fixed amount of cash. However, at the time, the IASB decided not to make piecemeal changes to IAS 32.

Accordingly, contracts for the issue of shares in exchange for cash in a foreign currency have continued to be treated as derivative instruments, as the cash to be received in the respective entity's functional currency was not considered to be fixed. Subsequent changes in the fair value of these derivatives were recognised in profit or loss until the rights were exercised and the shares were issued.

As a result, the earnings of a number of entities who have made foreign currency rights issues have been significantly impacted by both volatility in share prices and fluctuating foreign exchange rates. This has been particularly noticeable in recent months.

In July 2009, the IFRIC received a request to consider the treatment of foreign currency rights issues and, due to the decision taken in 2005, the matter was referred to the IASB. In response, the IASB has issued an Amendment to IAS 32, proposing limited changes to the definition of a financial liability.

Summary of the Amendment

The Amendment alters the definition of a financial liability in IAS 32 to classify rights issues and certain options or warrants (together, here termed rights) as equity instruments. This is applicable if the rights are given *pro rata* to all of the existing owners of the same class of an entity's non-derivative equity instruments, in order to acquire a fixed number of the entity's own equity instruments for a fixed amount in any currency.

By changing the definition of a liability, these rights are no longer considered derivative instruments. Their fair value adjustments will no longer impact profit or loss.

When finalising the Amendment, the IASB extended its scope to include financial instruments, such as options or warrants which are, in substance, rights issues (provided all the Amendment's criteria are met). However, the IASB decided not to address foreign currency convertible bonds, as they are not included within the Amendment's limited scope.

Effective date

The Amendment is effective for annual periods beginning on or after 1 February 2010. Early application is permitted. The Amendment, once effective, is to be applied retrospectively.

Business impact

The Amendment will provide relief to entities that issue rights (fixed in a currency other than their functional currency), from treating the rights as derivatives with fair value changes recorded in profit or loss.

Rights issued in foreign currencies that were previously accounted for as derivatives will now be classified as equity instruments. Application of the change will result in the reversal of profits or losses previously recognised, as application of the change will be retrospective. Additionally, the impact on previously reported results would be a reclassification in equity.

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