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International
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Note: These notes are based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: July 2006, London

Project: IAS 32 *Financial Instruments: Presentation* – Changes in the contractual terms of an existing equity instrument resulting in it being reclassified to financial liability (Agenda paper 10(viii))

INTRODUCTION

1. The IFRIC has been asked to consider a situation in which an entity makes some genuine¹ amendments to the terms of an existing equity instrument, for example, by inserting a contingent settlement provision. Consequently, the instrument is reclassified from equity to financial liability in accordance with IAS 32 *Financial Instruments: Presentation*.
2. At the date when the instrument is reclassified from equity to financial liability, the fair value of the instrument is different from the carrying amount of the

¹ Paragraph 25 of IAS 32 states that if an entity does not have an unconditional right to avoid delivering cash or another financial asset in the event of the occurrence or non-occurrence of uncertain future events that are beyond the control of both the issuer of the instrument and the holder of the instrument, the instrument should be classified as a financial liability unless (1) the contingent settlement provision is not genuine or (2) the issuer is required to deliver cash or other financial assets only on the liquidation of the issuer of the instrument. AG 28 of IAS 32 states that if the contingent settlement provision is not genuine, the settlement provision does not affect the classification of a financial instrument.

- previously recognised equity instrument. The submission asks how the liability that arises from the change in the terms of the instrument should be measured at the date of reclassification, that is should the liability be measured at the carrying amount in equity immediately before the reclassification or at its fair value at the date of reclassification?
3. An example has been quoted by the submission, which is illustrated in Appendix 1 to this agenda paper.
 4. The staff considers that it is the responsibility of the preparers and auditors of the financial statements to determine whether the contingent settlement provision is genuine or not. The purpose of this agenda paper is NOT to determine whether the contingent settlement provisions are genuine. Nor does this agenda paper address how to measure the fair value of the instrument at the date of reclassification.

SUMMARY OF THE ISSUE

5. Paragraph 15 of IAS 32 states that the issuer of a financial instrument shall classify the instrument on initial recognition in accordance with the substance of the contractual arrangement and the definitions of a financial liability and an equity instrument.
6. Paragraph 43 of IAS 39 *Financial Instruments: Recognition and Measurement* states that, when a financial liability is initially recognised, an entity shall measure it at its fair value plus directly attributable transaction costs in the case of a financial liability not at fair value through profit or loss.
7. Two issues need to be addressed:
 - (1) When an amendment to the contractual terms of an existing instrument results in a reclassification from equity to financial liability, on what basis should the financial liability be measured at the time when the terms of the instrument are changed?
 - (2) If the financial liability is measured at an amount that is different from the carrying amount of the previously recognised equity instrument, where

should the resulting gain or loss be recognised (i.e. in equity or the income statement)?

SUMMARY OF THE RECOMMENDATION

8. The staff believes that, since a financial liability is initially recognised at the time when the terms are changed and financial liabilities are recognised at their fair value on initial recognition in accordance with paragraph 43 of IAS 39, the financial liability recognised at the time when the terms are changed should be measured at its fair value.
9. In addition, since the transaction is entered into with the equity participants of the issuer, the staff believes that the difference between the fair value and the carrying amount should be recognised in equity (see paragraph 28 of this agenda paper).
10. The staff recommends that the issue should not be taken onto the agenda because IAS 39 is clear that a financial liability on initial recognition should be measured at its fair value. Proposed “rejection” wording has been prepared for your consideration (see paragraph 34 of this agenda paper).
11. At its June 2006 meeting, most of the Agenda Committee members agreed with the staff recommendation. They agreed that the issue should not be taken onto the agenda.

QUESTIONS TO THE IFRIC

12. Does the IFRIC agree with the recommendation? Do you have any comments on “rejection” wording?
13. If the IFRIC believes that the issue should be taken onto the agenda, the IFRIC’s views are requested on the following points:
 - Does the issue have practical and widespread relevance?
 - Does the issue involve significant divergent interpretations (emerging or existing)?
 - Would the IFRIC be able to reach a consensus on this issue on a timely basis?

ISSUE 1: When an amendment to the contractual terms of an existing instrument results in a reclassification from equity to financial liability, on what basis should the financial liability be measured at the time of reclassification?

Staff analysis

14. This agenda paper illustrates the following two different views:
- View 1 – The amendment that results in a reclassification should not be treated as a “derecognition/initial recognition” event. The instrument under the revised terms should still be measured at the carrying amount. Hence, no gain or loss arises; and
 - View 2 – Since the financial liability is initially recognised at the date when the terms of the instrument are changed, the financial liability should be measured at its fair value at that date.

View 1 – Measured at the carrying amount

15. Some commentators state that the requirement set out in paragraph 15 of IAS 32 is not clear in respect of a situation in which there is a change in the contractual terms of an existing instrument. They, therefore, refer to the requirements in IAS 39 in respect of the derecognition of a financial liability.
16. Proponents of this view suggest that whether an amendment to the terms of an instrument results in a “derecognition/initial recognition” event depends on whether there is a substantial modification to the terms of an existing instrument.
17. Paragraph 39 of IAS 39 states that an entity shall remove a financial liability from its balance sheet when, and only when it is extinguished. Paragraph 40 of IAS 39 states that a substantial modification² of the terms of an existing financial liability

² AG 62 of IAS 39 provides some guidance on whether there is any substantial modification to the terms. It states that the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability.

shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. For example, an exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Supporters of this view do not believe that the mere addition of the contingent settlement provisions (that may or may not occur in the future) is a substantial modification.

18. Supporters of this view also state that, since the contingent settlement provisions may or may not occur in the future, the addition of the new clause may not have any economic substance. They, therefore, believe that at the time of reclassification, there should not be any remeasurement (i.e. the instrument under the revised terms should still be carried at the carrying amount).

View 2 – Measured at the fair value

19. Paragraph 15 of IAS 32 states that the issuer of a financial instrument shall classify the instrument on initial recognition in accordance with the substance of the contractual arrangement and the definitions of a financial liability and an equity instrument.
20. Supporters of this view believe that, a reclassification from equity to financial liability is a big change in the financial position of an entity. The fact is that the insertion of the new clause results in an initial recognition of a financial liability. According to paragraph 43 of IAS 39, a financial liability on initial recognition should be measured at its fair value.
21. Proponents of this view also note that the following IFRSs address situations that are similar to the illustrated situation:
 - AG 35 of IAS 32 states that, when an entity amends the terms of a convertible instrument to induce early conversion (for example by offering a more favorable conversion ratio or paying other additional consideration in the event of conversion before a specified date), the instrument under the revised terms is measured at its fair value at the time when the amendment is made.

- Example 3 of IFRIC Interpretation 2 *Members' Shares in Co-operative Entities and Similar Instruments* illustrates a situation in which an amendment to the governing charter of the issuer of financial instruments results in a transfer of some existing financial instruments from equity to financial liabilities. Those financial instruments are transferred at an amount which is equal to the maximum amount payable on demand under the redemption provisions, as determined in accordance with paragraph 49 of IAS 39³. Paragraph 18 of the Basis for Conclusions on IFRIC Interpretation 2 headed *Measurement on Initial Recognition* states “when the financial liability for the redemption of members’ shares that are redeemable on demand is initially recognised, the financial liability is measured at its fair value in accordance with paragraph 49 of IAS 39.
22. Supporters of this view note that the recognition of the instrument under the revised terms in those situations (see paragraph 21 of this agenda paper) is treated as an initial recognition. In particular, in Example 3 of IFRIC Interpretation 2, some financial instruments are transferred from equity to financial liability because the issuer of those financial instruments no longer has the unconditional right to avoid delivering cash or other financial assets after the governing charter of the issuer is amended. They state that, in the illustrated situation in this agenda paper, the reclassification from equity to financial liability is also due to the fact that the issuer no longer has the right to avoid delivering cash or other financial assets on the occurrence of uncertain events.
23. Some also suggest that IG 9 of IFRS 2 may be helpful, which illustrates a situation in which an entity modifies the terms of the plan by adding a cash alternative. As a result, a cash-settled obligation is recognised and measured at its fair value at the time when the terms of the plan are changed. Before the modification to the terms, the arrangement was treated as equity-settled. The reason why the liability is measured at its fair value at the time when the terms are changed is that paragraph 30 of IFRS 2 states that obligations under cash-settled share-based payment arrangements should be carried at their fair value. Similarly, in the illustrated situation in this agenda paper, supporters of this view believe that

³ Paragraph 49 of IAS 39 states that the fair value of a financial liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

the financial liability recognised at the time when the terms of the instrument are changed should be measured at its fair value because IAS 39 requires financial liabilities to be recognised at their fair value on initial recognition.

Staff recommendation

24. The staff acknowledges that paragraph 15 of IAS 32 makes no mention of how to deal with the illustrated situation. However, the staff agrees with supporters of View 2 that there are other IFRSs (e.g. AG 35 of IAS 32 as well as Example 3 of IFRIC Interpretation 2 (see paragraph 21 of this agenda paper)) that address similar situations.
25. IAS 39 requires application of the “substantial modification” rule to derecognition of a financial liability. The staff believes that the example in this agenda paper is different from derecognition of a financial liability. The former case involves a reclassification from equity to liability, not an extinguishment of a financial liability. Furthermore, the staff notes that paragraph 40 of IAS 39 focuses on situations in which an original financial liability is derecognised and a new financial liability is derecognised.
26. The staff notes that supporters of View 1 argue that no remeasurement is required at the time when the contractual terms are changed because the change in the terms has little or no economic substance. However, IAS 32 characterises “substance” in terms of the contractual arrangements.
27. Given the fact that the change in the contractual terms results in recognition of a financial liability, and that IAS 39 requires a financial liability on initial recognition to be measured at its fair value, the staff believes that the newly recognised financial liability, at the time when the contractual terms are changed, should be recognised at its fair value.

ISSUE 2: How should the difference between the fair value and the carrying amount at the date of reclassification be accounted for?

28. IAS 32 and IAS 39 do not explicitly address how the difference between the fair value and the carrying amount should be accounted for in a situation where a financial instrument is reclassified from equity to financial liability. Neither does

Example 3 of IFRIC 2 provide any guidance on how the difference should be dealt with. In that example, because the fair value of the liability at the time of transfer is equal to the carrying amount previously recognised in equity, no gain or loss arises.

29. AG 32 of IAS 32 states that, on conversion of a convertible instrument, there is no gain or loss on conversion at maturity. However, AG 32 deals with a reclassification from liability to equity. By contrast, this agenda paper addresses a reclassification from equity to financial liability.
30. One view is that that the difference should be recognised in equity. The rationale is that the additional contingent settlement term is entered into with the equity participants of the issuer of the financial instrument. Supporters of this view suggest that the illustrated situation is similar to a circumstance in which the issuer buys back its equity instruments with the issuance of financial liabilities. In a share buyback situation, the difference between the fair value of the liability and the carrying amount of the equity instrument is recognised in equity. In addition, proponents of this view note that the change in the terms of the instrument gives rise to derecognition of the original equity instrument. Paragraph 33 of IAS 32 states that no gain or loss should be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. Consideration paid is recognised in equity.
31. Alternatively, some argue that the difference should be recognised in profit or loss. They base their argument on paragraph 41 of IAS 39, which states that, when an entity derecognises a financial liability, the difference between the carrying amount of a financial liability derecognised and the consideration paid shall be recognised in profit or loss. They further note AG 35 of IAS 32, which states that, when an entity amends the terms of a convertible instrument to induce early conversion, the difference (at the date the terms are amended) between the fair value of the consideration the holder receives on conversion under the revised terms and the fair value of the consideration the holder would have received under the original terms is recognised in profit or loss.
32. However, the staff does not agree with the view that the difference should be recognised in profit or loss. In the staff's view, the illustrated situation in this agenda paper is different from the situations in paragraph 41 of IAS 39 and AG 35

of IAS 32. Under AG 35 of IAS 32, the purpose of giving additional fair value to the holders of the convertible instruments is to help the entity extinguish liabilities early. In addition, paragraph 41 of IAS 39 relates to the derecognition of a financial liability. By contrast, this agenda paper deals with a situation in which a financial instrument is reclassified from equity to financial liability.

33. For the above reasons, the staff believes that the difference should be recognised in equity.
34. [Paragraph omitted from observer notes]

APPENDIX 1 – EXAMPLE

1. The facts of an example quoted in the submission are as follows:

- On 1 January 20X1, Entity A issues a fixed rate cumulative perpetual instrument with a face value of CU10 million.
- Dividends are discretionary. Therefore, the instrument is classified as equity on 1 January 20X1.
- On 1 January 20X2, Entity A adds a new clause to the instrument – that is, if Entity A is taken over by another party, the instrument will be mandatorily redeemed by Entity A at an amount equivalent to the sum of the face value of the instrument plus any unpaid cumulative dividends.
- The insertion of the new clause results in a reclassification of the instrument from equity to liability. The fair value of the instrument on 1 January 20X2 is CU12 million.