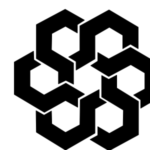

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This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting:	**2 November 2006, London**
Project:	**Review of published tentative agenda decisions**
Subject:	**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 7(vii))**

Tentative agenda decision published in July-2006 IFRIC Update

The IFRIC was asked to consider a situation in which an amendment to the contractual terms of an equity instrument resulted in the instrument being classified as a financial liability of the issuer. Two issues were discussed: (i) on what basis the financial liability should be measured at the date when the terms were changed and (ii) how any difference between the carrying amount of the previously recognised equity instrument and the amount of the financial liability recognised at the date when the terms were changed should be accounted for.

The IFRIC noted that at the time when the contractual terms were changed, a financial liability was initially recognised, and, furthermore, that a financial liability on initial recognition is measured at its fair value in accordance with paragraph 43 of IAS 39 *Financial Instruments: Recognition and Measurement*. The IFRIC observed that Example 3 of IFRIC Interpretation 2 *Members' Shares in Co-operative Entities and Similar Instruments* deals with a similar situation. In that example, at the time when the

financial liabilities are recognised, when the terms are changed, they are recognised at their fair value.

The IFRIC observed that the change in the terms of the instrument gave rise to derecognition of the original equity instrument. The IFRIC noted that paragraph 33 of IAS 32 *Financial Instruments: Presentation* states that no gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. The IFRIC, therefore, believed that, at the time when the terms were changed, the difference between the carrying amount of the equity instrument and the fair value of the newly recognised financial liability should be recognised in equity.

The IFRIC believed that the requirements of IFRS, taken as a whole, were sufficiently clear and that the issue was not expected to have widespread relevance in practice. [The IFRIC, therefore, decided] that the issue should not be taken onto the agenda.

Our ref AWP/MJM
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IAS 32 *Financial Instruments: Presentation* – Changes in the contractual terms of an existing equity instrument resulting in it being reclassified to financial liability

Dear Allan

Legal & General is a major UK investor, and as such, we have been an advocate of high quality financial reporting for shareholders for many years. Consequently, we welcome the opportunity to comment on your recent tentative interpretation of the financial impact of reclassifying an existing equity instrument as a financial liability, as published in the *July 2006 IFRIC Update*.

As an overarching comment, we have a general concern that the definitions of equity and financial liabilities in IAS 32 are highly rules based and therefore have resulted in a number of situations where the commercial substance has been ignored. This approach is not helpful for Directors in drawing up a set of true and fair accounts and I would urge you to reconsider a more principles based approach in your future interpretations.

Turning to the specific issue that was covered in your tentative interpretation, we have concerns with your concluding comment, that the matter is "not expected to have widespread relevance in practice." In fact this matter has had a direct bearing on Legal & General Group Plc and has acted to reduce parent company distributable reserves. Our understanding is that a number of other entities have also been adversely affected.

The specific situation that has affected Legal & General is the accounting treatment of £400m of Sterling undated subordinated notes issued in March 2004. This instrument was raised as debt and Directors believe has had the substance of debt since inception. Indeed Analysts and rating agencies have continued to treat the instrument as debt. Therefore it has caused quite some considerable confusion that this instrument has been reclassified twice; first as equity and then back to debt as a result of the application of IFRS.

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Legal & General

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After Legal & General published its IFRS opening balance sheet restatement and first set of IFRS interim accounts classifying this instrument as a financial liability, our Auditors, in common with their peers, determined that the instrument should be reclassified as equity, owing to the existence of certain remote discretionary terms operating over the coupon. A subsequent minor amendment to these terms removed their discretionary feature and enabled reclassification as a financial liability.

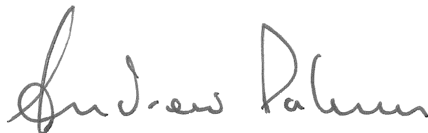
Our analysis at the time of the second reclassification was that the liability should be recognised at book value, a view that was supported by our auditors. It struck us as wholly inappropriate that either a profit or a loss should be generated merely from a balance sheet reclassification.

However, as a result of IFRIC's tentative interpretation, we were obliged to recognise the difference between the fair value of the liability and the carrying value of the equity on the date that the terms of the instrument were changed in our 2006 Interim accounts. This has resulted in a significant loss being charged to reserves. Conversely, had the debt been trading sub par (possibly as a result of weak company performance) we would have booked a profit to reserves. Both these outcomes seem quite inappropriate when nothing of commercial substance has changed.

Legal & General has concluded that our experiences, which have been mirrored in a number of other companies, have been detrimental to the acceptance of International Financial Reporting Standards by the market. As a consequence we would urge you to review your tentative conclusion regarding the reclassification of an equity instrument as a liability on a change in contractual terms and, more generally, to review the very rules based approach that has been taken to defining financial liabilities to recognise the importance of commercial substance.

If you would like to discuss any of these issues in more detail, do not hesitate to contact me.

Yours sincerely



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22 September 2006

Dear Sir

Agenda request - IAS 32 *Financial Instruments: Presentation* - Changes in the contractual terms of an existing equity instrument resulting in it being reclassified to financial liability

We are responding to your invitation to comment on the above Tentative Agenda Decision, published in the July edition of IFRIC Update on behalf of PricewaterhouseCoopers.

Following consultation with members of the PricewaterhouseCoopers network of firms, this response summarises the views of member firms who commented on the agenda decision. 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

We disagree with the IFRIC's conclusions that the requirements of IFRS on this issue are sufficiently clear. There is no explicit guidance in the literature and there are equally valid alternative interpretations which can be applied. Our interpretation is that one can analogise to the modification of the terms of an issued debt instrument between an existing borrower and lender when considering the accounting for the modification of an issued equity instrument. We set out below how we reached our interpretation of IFRS requirements, using an illustrative example. Consequently we do not believe that the IFRIC should reject the issue on this basis. However, we accept that the IFRIC view is one way of interpreting the literature.

Example

An entity has issued a perpetual instrument, with interest step-up and the option to redeem after 15 years. Under the terms of the instrument the entity has the option to defer interest payments indefinitely, except upon liquidation of the entity. The instrument meets the definition of an equity instrument. Although interest payments are discretionary, the entity has historically always made interest payments when due and intends to continue to do so.

In the current year the issuing entity, with the agreement of the holders of the instrument, modifies the contractual terms of the instrument, incorporating a genuine contingent settlement provision. If the prescribed contingent event does occur, the entity is required to pay all deferred interest and loses the right to defer interest in the future. In accordance with IAS 32.25, the modified instrument now meets the definition of a financial liability. The modification involves no payment to the holders of the instrument as compensation nor any change in the expected cash flows from the instrument.

Analysis of relevant IFRS literature

Neither IAS 32 nor IAS 39 addresses the circumstances in which a modification of the terms of an equity instrument constitutes derecognition of that instrument and recognition of a new financial

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instrument. IFRIC 2, which requires reclassification between equity and liabilities in certain circumstances, does not address the measurement basis for such a reclassification.

In the absence of a standard that specifically applies to a transaction, IAS 8.10 requires management to use its judgement to determine an accounting policy that "*results in information that is (a) relevant to the economic decision-making needs of users; and (b) reliable, in that the financial statements: (i) represent faithfully the financial position, financial performance and cash flows of the entity; (ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form; (iii) are neutral, i.e. free from bias; iv) are prudent; and (v) are complete in all material respects".* IAS 8.11 requires management to refer firstly to the requirements and guidance in Standards and Interpretations dealing with similar and related issues and subsequently to the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the *Framework.*

An analogy in accounting literature to the modification of an equity instrument is the treatment of the modification of a financial liability, addressed in IAS 39.40 and IAS 39.AG62. These paragraphs require a substantial modification of the terms of a financial liability to be accounted for as the extinguishment of the original liability and the recognition of a new liability. On the other hand, if the modification of the terms of the original liability are not substantial, IAS 39.AG62 does not permit derecognition. Terms are considered to be substantially different if the discounted present value of the cash flows under the new terms, 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. IFRIC 9 "Reassessment of embedded derivatives" also recognises the relevance of a significant modification of the cash flows in a contract as a trigger for an accounting event.

In the circumstances described in the example above, there is no change in the parties to the contract. The modification of the terms of the instrument has no impact on the expected cash flows under the instrument and the contingent settlement provision, whilst genuine in accordance with the definition in IAS 32.AG28, is not likely to occur. Consequently, there is no change in the present value of the cash flows under the instrument and therefore no substantial modification in terms using the analogy in IAS 39. Following this analogy, the instrument would be reclassified from equity to liabilities at its carrying amount, with no recognition of gain or loss. The effective interest rate of the liability will be based on the expected cash flows at its inception rather than on date of modification. This reflects the economic substance of the transaction as required by IAS 8.10.

Where the amendments to convert an equity instrument to a financial liability significantly change the present value of the expected cash flows of the instrument and thus constitute a substantial modification of its terms, the equity instrument would be derecognised and a new financial liability recorded at fair value in accordance with IAS 39.43. In such circumstances, any gain or loss arising from the transaction would be recognised in equity (IAS 32.33).

Another argument arises from the Exposure Draft (ED) that the Board issued in June 2006 on *Financial instruments Puttable at Fair Value and Obligations Arising on a Liquidation.* Reclassifications between liabilities and equity could arise reasonably often under the proposals in that ED, since classification as equity relies on (a) the instrument being in the most subordinated class and (b) on all of that class being puttable at fair value or redeemable for a pro rata share of asses on a liquidation. Thus if an entity issues a new 'more subordinated' instrument, or one that is not puttable/redeemable, it implicitly changes the terms of its pre-existing instrument and causes it to be reclassified from equity to liabilities.

The possibility of such reclassifications is acknowledged in the disclosure requirements proposed in the ED. The ED (amendment to IAS 1, para 75A) proposes that if an entity has reclassified instruments puttable at fair value or redeemable only on a liquidation between liabilities and equity, it shall disclose the "amount reclassified into and out of each category (financial liabilities or equity), and the timing and reason for that reclassification". This suggests that the Board thinks there can be reclassifications between equity and liabilities (rather than only derecognition of one instrument and recognition of a new one). In addition, the absence of a requirement to disclose any gain or loss arising from reclassification indicates that none is expected to arise.

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If you have any questions in relation to this letter please do not hesitate to contact John Brendon, Global Chief Accountant (+44 207 804 4816), or Pauline Wallace (+44 20 7804 1293).

Yours faithfully

PricewaterhouseCoopers LLP