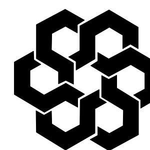

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This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This 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* - Classification of a financial instrument as liability or equity (Agenda Paper 7(xi))**

Tentative agenda decision published in July-2006 IFRIC Update

At its March 2006 meeting, the IFRIC discussed a submission for a possible agenda item relating to the role of contractual and economic obligations in the classification of financial instruments. At that meeting and the following meeting in May, the IFRIC agreed not to take the item onto the agenda but did not agree on reasons to be given for that decision.

At the July IFRIC meeting, the IFRIC Chairman reported the results of the Board's discussions on the subject from its June 2006 meeting. As stated in the June 2006 IASB Update,

> 'The Board discussed whether so-called economic compulsion should affect the classification of a financial instrument (or a component of a financial instrument) under IAS 32 *Financial Instruments: Presentation*. This issue had previously been debated at the IFRIC meetings in March and May 2006.

For a financial instrument (or a component of a financial instrument) to be classified as a financial liability under IAS 32, the issuer must have a contractual obligation either:

- to deliver cash or another financial asset to the holder of the instrument, or
- to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer.

(Different requirements apply to financial instruments that may or will be settled in the issuer's own equity instruments.) The Board confirmed that such a contractual obligation could be established explicitly or indirectly, but it must be established through the terms and conditions of the instrument. Thus, by itself, economic compulsion would not result in a financial instrument being classified as a liability under IAS 32.

The Board also stressed that IAS 32 requires an assessment of the substance of the contractual arrangement. It does not, however, require or permit factors not within the contractual arrangement to be taken into consideration in classifying a financial instrument.'

The IFRIC believed that it would not be able to reach a consensus on this topic on a timely basis and, for that reason and, on the basis that it did not expect significant diversity post publication of the Board's statement, [decided] not to take the issue onto the IFRIC agenda.

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PARIS, 21TH SEPTEMBER 2006

Mr. Robert P. Garnett

IFRIC

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IFRIC tentative agenda decision - *IAS 32 Financial Instruments : Presentation* - Classification of a Financial Instrument as liability or equity

Dear Mr. Garnett,

The Conseil National de la Comptabilité (CNC) examined the IFRIC rejection for a possible agenda item relating to the role of contractual and economic obligations in the classification of financial instruments as liability or equity under IAS 32.

We disagree with the IFRIC decision not to take the issue onto its agenda since we are concerned by the technical merits of the conclusion reached :

- The classification of the two instruments included in the original IFRIC submission discussed in March 2006 raises several key questions on the interpretation of IAS 32 that could lead to diversity in practice. We do not believe that those questions were dealt with by the statement of the Board issued in the June 2006 IASB update.
- Above all, the question of the economic compulsion, that is particularly relevant as far as the classification of "step-up instruments" is concerned, can be interpreted in different ways.

We disagree with the Board's statement which mentions that, by itself, economic compulsion would not result in a financial instrument being classified as a liability under IAS 32.

We consider that the notion of economic compulsion, which was explicitly mentioned in IAS 32 before its revision in 2004, is still present in the revised wording of the Standard. Furthermore,

because this concept is discussed in the works regarding the conceptual framework, the IFRIC cannot ignore the difficulties of an appropriate classification of some instruments and the need of an Interpretation.

The difficulty is that the revised IAS 32 presents a real ambiguity when it mentions that, although the contractual obligation to deliver cash seems to be a critical feature of a liability, the substance of a financial instrument rather than its legal form governs its classification on the entity's balance sheet [1].

Consequently, a need of interpretation is necessary to clarify the following points :

- the notion of "indirect obligation through the terms and conditions" as stated in paragraph 20 ;
- to what extent the example developed in paragraph 20 (b) would not apply to the first category of instruments discussed by the IFRIC in March 2006 (callable financial instruments with dividends payable only if dividends are paid on the ordinary shares of the issuer, and with a "step-up" dividend clause) ;
- to what extent a right to avoid delivering cash on a certain category of instrument is really unconditional (paragraph 19) when the exercise of this right restricts the ability of the entity to pay dividends to its shareholders.

We hope that you consider our point of view on this particular and very important subject worth taking into account, and we are of course available to further discuss any point you may wish to bring up.

Yours sincerely,

Antoine BRACCHI

[1] The Appendix mentions the revised IAS 32 paragraphs which can lead to divergent interpretations, and particularly for the appropriate classification of an undated cumulative subordinated Note with a step-up clause.

APPENDIX :

Paragraphs of the revised IAS 32 which can lead to divergent interpretations for the appropriate classification of an undated cumulative subordinated Note with a step-up clause

1. THE NOTION OF ECONOMIC COMPULSION

In the earlier version of IAS 32 before its revision in 2004, the economic compulsion notion, in which an enterprise elects to settle an obligation, was mentioned in the paragraph 22, through the example of a preferred share with a step-up dividend.

Paragraph 22 of the earlier version of IAS 32 stated that :

> *"(…) A preferred share that does not provide for mandatory redemption or redemption at the option of the holder may have a contractually provided accelerating dividend such that, within the foreseeable future, the dividend yield is scheduled to be so high that the issuer would be* ***economically compelled*** *to redeem the instrument (…)".* (emphasis added).

This example was deleted when IAS 32 was revised in 2004 and replaced notably with paragraph 20 that states that :

> *"A financial instrument that does not explicitly establish a contractual obligation to deliver cash or another financial asset may establish an obligation* ***indirectly through its terms and conditions.*** *For example,*
>
> *(…)*
>
> *(b) a financial instrument is a financial liability if it provides that on settlement the entity will deliver either*
>
> *(i) cash or another financial assets ; or*
>
> *(ii) its own shares whose value is determined to exceed substantially the value of the cash or other financial assets.*
>
> ***Although the entity does not have an explicit contractual obligation to deliver*** *cash or another financial asset,* ***the value of the share settlement alternative is such that the entity will settle in cash****. In any event, the holder* ***has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option*** *(see paragraph 21)."* (emphasis added)

In our opinion, the removal of the example in 2004 does not modify the underlying principle which was maintained in this paragraph 20, and particularly further expanded through the example in paragraph 20 (b).

Furthermore, the fact that the economic compulsion principle could be considered as maintained is reinforced by the paragraph 9 of the basis for conclusions which states that, when revising IAS 32, ***"The Board did not debate whether an obligation can be established implicitly rather than explicitly*** *because this is not within the scope of an improvements project (…) Consequently, the Board retained the existing notion that an instrument may establish an obligation indirectly through its terms and conditions (see paragraph 20)*" (emphasis added).

2. CONSEQUENCES FOR THE ANALYSIS OF A "STEP-UP INSTRUMENT"

For the appropriate classification of an undated cumulative subordinated Note with a step-up clause, the analysis should consider the following questions :

- the obligation for the issuer to redeem the principal amount of the Notes ;
- the obligation for the issuer to pay the interest on the Notes ;
- the right to a residual interest in the assets of the issuer after deducting all its liabilities.

2.1 Obligation for the issuer to redeem the principal amount of the Notes

2.1.1 Estimation of an indirect obligation through call options and step-up clauses

Paragraph 20 does not provide guidance about the type of terms and conditions which could establish an indirect obligation for the issuer. This is a fundamental point which needs to be considered in an interpretation notably as regards call options and step-up clauses.

Call option

The fact the market expects that the call will be exercised is a fundamental point in the analysis, even if this exercise depends upon future market conditions and financial condition of the issuer.
Furthermore, market quotations of these instruments are determined as debt instruments', according to interest rates and credit spreads ; they can also be included in debt index.

Step-up clause

The issuer can be economically compelled to redeem the Notes to avoid a high cost of funding, particularly if the spread resulting from the step-up clause is very high compared to the spread applicable to the issuer for equivalent instruments without step-up clause, even if the decision to redeem the Notes depends upon future market conditions and financial condition of the issuer.

2.1.2 Indirect obligation and unconditional right to avoid delivering cash

On the one hand, according to **paragraph 16**, an instrument is an equity instrument if and only if the instrument includes no contractual obligation to deliver cash. This is further emphasised in **paragraph 17**.

On the other hand, **paragraph 19** states that *"If an entity does not have an unconditional right to avoid delivering cash or another financial assets to settle a contractual obligation, the obligation meets the definition of a financial liability (…)."* The analysis of the right to avoid redeeming the

instrument, and the discretion of the issuer is a fundamental point to be considered in order to classify the instrument as a liability.

Additional explanation is needed to check if all cases can be treated under these two situations. In particular, is a right to avoid delivering cash on a certain category of instrument really unconditional (paragraph 19) when the exercise of this right restricts the ability of the entity to pay dividends to its shareholders.

Paragraph 25 provides examples of uncertain events beyond the control of both the issuer and the holder of the instrument which could rebut the unconditional right to avoid delivering cash or otherwise to settle it in such a way that it would be a financial liability. Furthermore, the fact that the issuer has to redeem the Notes in the case of a liquidation is not sufficient to classify the instrument as a liability. It is consequently necessary to demonstrate the indirect obligation for the issuer to redeem and its absence of unconditional right.

2.1.3 Other remarks

We note the inconsistency between the **paragraph AG 26 c,** and the **paragraph 20 b**,. On the one hand, the paragraph AG 26 mentions that the classification in equity of preference shares for which distributions to holders are at the discretion of the issuer, and particularly those with cumulative dividends, is not affected by a possible negative impact on the price of ordinary shares of the issuer if distributions are not made. On the other hand, the paragraph 20 b, mentions that a financial instrument is a financial liability if it provides that on settlement the entity will deliver cash or a number of its own shares such that its value substantially exceeds the amount of cash, and therefore resulting in a significant dilution for the existing shareholders. In both cases, the entity has the choice between paying cash or being exposed to tremendous consequences on its relation with its shareholders.

2.2 Obligation for the issuer to pay the interest on the Notes

Paragraphs 16 to 20 of the revised IAS 32, relating to the indirect obligation through the terms and conditions of the contract for the issuer to deliver cash and to the unconditional right to avoid delivering cash, are applicable to considering the obligation for the issuer to pay interest.

The question is also to consider whether the payment of interest is at discretion of the issuer or not.

Paragraph AG 26 mentions that when payments are at the discretion of the issuer, the instruments should be classified as equity. The difficulty of this paragraph is relating to the nature of the discretion of the issuer, and to the instruments concerned by this guidance. If the discretion is only the right to defer interest, we consider the issuer cannot avoid the payment of interest.

Paragraph AG 6 is relating to perpetual debt instruments, to be considered as a financial liability, which *"normally provide the holder with the contractual right to receive payments on account of interest at fixed dates extending into indefinite future (…)"*. The question is whether this characteristic should be extended to all perpetual liabilities.

2.3 Right to a residual interest in the assets of the issuer after deducting all its liabilities

In our opinion, subordination should be considered in the classification of a financial instrument between equity and liability and there is a need of interpretation on this subject, the notion of residual interest being even not defined in IAS 32.

Paragraph 11 defines an equity instrument as *"any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities".*

Paragraph 15 also mentions that *"The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset, or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument"*.

Furthermore, **paragraph BC 18** states that *"(…) A contingent settlement provision that provides for payment in cash or another financial instrument only on the liquidation of the entity is similar to an equity instrument that has priority in liquidation and therefore should be ignored in classifying the instrument."*

Subordination is an essential feature of an equity instrument since it balances the right to participate in the earnings and capital appreciation of the entity.

Under this view, paragraph BC18 specifies that an obligation to deliver cash triggered by liquidation does not entail liability classification because it is inconsistent with a going concern assumption. However, this paragraph should not be read as suggesting that subordination should not be considered at all when assessing whether the contract meets the definition of an equity instrument. The subordination feature of an equity instrument is a direct consequence of defining equity as a "residual interest".

This should be clarified in an interpretation.

MAZARS & GUÉRARD

Mr Robert P. Garnett

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Paris, le 25 September 2006

Tentative Agenda Decisions – IAS 32 Financial Instruments: Presentation: Classification of a financial instrument as liability or equity

Dear Sir,
We have examined the IFRIC rejection for a possible agenda item relating to the role of contractual and economic obligations in the classification of a financial instrument as liability or equity.

We disagree with the IFRIC decision not to take the issue onto its agenda. There exist instruments such as those including a "step-up" clause which create divergent interpretations of IAS 32 and may lead to significant diversity in practice.

We believe that IAS 32 is ambiguous. Although it states that a contractual obligation to deliver cash or another financial asset is a critical feature in differentiating a financial liability from an equity instrument, it also mentions that the substance of a financial instrument, rather than its legal form, governs its classification on the entity's balance sheet.

We consider that there are circumstances where the substance resulting from contractual terms creates an economic compulsion that would result in instruments being considered as liabilities by the issuer and classified as such under IAS 32. While having noted the changes in IAS 32 as per 2004 revision, we do not consider that economic compulsion should not be taken into account under IAS 32 in

appreciating whether an instrument is a liability or an equity instrument. Moreover, we are aware that, in some cases, such instruments may be hedged by issuers to protect their fair value against interest rate risk.

Consequently we consider an Interpretation is needed to clarify what the Board has meant by a contractual obligation established indirectly and why indirect obligations do not include economic compulsion. Furthermore, there is a need for clarification on the restatements of past annual accounts that would be necessary for entities having interpreted IAS 32 in a different way.

We hope you will consider our view on this important topic and stay at your disposal to further discuss it. Would you have any request regarding the above comments, please do not hesitate to contact Michel Barbet-Massin (+33 1 49 97 62 27).

Yours faithfully

Michel Barbet-Massin
Head of Accounting Principles Department

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17 August 2006

Robert Garnett, Chairman
International Financial Reporting Interpretations Committee
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Dear Bob,

Proposed rejection wording: IAS 32 *Financial Instruments: Presentation* – Implicit Obligations

Deloitte Touche Tohmatsu is pleased to respond to IFRIC's publication in the July 2006 *IFRIC Update* of the Board's statement relating to IAS 32 *Financial Instruments: Presentation* with respect to implicit obligations in issued financial instruments.

We have grave concerns not only with the technical merits of such a statement, but also the due process that led to the publication of the Board's statement by IFRIC.

We address first the lack of due process. Following the IFRIC meeting in March 2006, the *IFRIC Update* made reference to the accounting treatment for two very highly structured transactions based on a summary fact pattern. However, at that meeting no "rejection notice" was finalised, or even discussed; the staff were asked to draft up a suitable notice for the next meeting. At the time we were left with two concerns. Our first was that any description of such detailed transactions would never adequately convey the complexities, or wide ranging significance, of such arrangements, and that the IFRIC's conclusions would be read as applying to potentially far more extreme variations of these arrangements than those considered thereby leading, in our view, to inappropriate conclusions. Our second was that if the rejection notice sought to describe a transaction and then state the accounting treatment, it would step over the boundary to become an interpretation, but without the due process of a full interpretation. Accordingly, we were not surprised when IFRIC failed to agree a suitable rejection notice at its next meeting.

As a result we understand that the IFRIC Chairman and staff chose to ask the Board its views on 'economic compulsion'. Following its deliberations, the Board issued a statement on this issue which was reproduced in the *IASB Update* for May 2006. This statement was, in turn reported to IFRIC at its July meeting, and has now been reproduced, apparently for comment, in *IFRIC Update* in a rather ambiguous manner which has the characteristics of a rejection notice whilst not being presented in the

normal way for such a notice. Whilst this statement is couched in general terms, it seems to have been presented in a manner which is both intended to support the original comments in the March 2006 *IFRIC Update*, and also to draw on that original *Update* as giving a meaning and a context to the Board's statement. Accordingly, we believe that, in effect, both the Board and IFRIC have now managed to publish a statement which is akin to a full interpretation without even the due process required for a "rejection notice".

Equally importantly, we are concerned that the statement has been made without sufficient consideration of the technical merits of the conclusion. In particular we believe the proposed rejection wording is inconsistent with the standard on two counts. First, it is inconsistent with guidance on indirect obligation in IAS 32.20 which states that an obligation to deliver cash may be established indirectly through its terms and conditions. Secondly, it is inconsistent with IAS 32.25 where contingent settlements provisions that are not considered "genuine" (further clarified in AG28 as being "extremely rare, highly abnormal and very unlikely to occur") are ignored in determining debt/equity classification.

We agree, as indicated in the statement, that an entity must apply substance to the contractual arrangements of an instrument. However, we believe that, at least in some extreme circumstances, even the actual accounting treatments proposed by IFRIC in March may contravene that approach if generalised more widely. If an entity only has to pay cash on an issued instrument if cash is paid on an utterly immaterial instrument issued by another group company, that obligation to pay cash may well lack substance. The linking to such an immaterial instrument may have been structured in a way to achieve a desired accounting result, even though there may well be no substantive obligation for the group. The substance of this may be equity, yet the IFRIC statement could well be read as requiring that it be treated as a liability under all circumstances. There are numerous other possible examples, some of which are, or could well become, common, where we believe the contractual terms may include apparent "options" that in substance provide little or no choice for the issuer. For example, instruments that allow the issuer to call the instrument to avoid suffering an economic loss which is bound to be significantly greater under all potentially likely circumstances. Whilst legally it is merely a call right, the substance of the contractual arrangement is that this is not a substantive option, but a redemption, as the "option" will always be exercised. The substance and pricing of such an instrument is equivalent to straight debt, yet the IASB and IFRIC statement could be read as requiring the substance to be "determined" as equity even in the most extreme of situations.

In summary, we are deeply concerned that the conclusions IFRIC is publishing in this area may be arriving at an inappropriate answer and creating more problems than they solve. By confirming that it is substance of the contractual arrangement that drives classification, and then simply leaving the examples reproduced in the *Update*s which reflect a treatment based on legal form, creates confusion for preparers, and fuels the structuring of instruments to achieve a particular accounting result which is inconsistent with their substance.

Consequently, we strongly urge the IFRIC to take this matter on to its agenda as a full interpretation.

If you have any questions concerning our comments, please contact Ken Wild in London at +44 (0) 207 007 0907.

Sincerely,

Ken Wild
Global IFRS Leader

Cc: Philip A. Laskawy - IASC Foundation, Chairman

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Mr A. Cook
IFRIC Co-ordinator
International Accounting Standards Board
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16 October 2006

IFRIC Meeting, November 2006
Agenda Paper 7(xi), Appendix 4

Dear Allan

Re: Tentative Agenda Decisions: IAS 32 Financial Instruments: Presentation – Classification of a financial instrument as liability or equity

We wish to take up the invitation to respond in the July IFRIC Update and to express our concern over the decision not to include the above issue on the IFRIC agenda.

We have been following the IFRIC discussions on this subject during the first half of 2006 and find the summary conclusions confusing and unhelpful. At the July meeting of the IFRIC, the basis of the IASB Board's decision was addressed and IFRIC reached a tentative decision not to take the issue onto the IFRIC agenda. The reason given in the July IFRIC Update was that the IFRIC would not be able to reach a consensus on this topic on a timely basis and the basis of the tentative decision was that IFRIC did not expect significant diversity post publication of the Board's statement.

This conclusion does not appear to be consistent with the reported draft conclusions reached at earlier meetings and in particular the wording contained in the March IFRIC Update. The reported position of the IFRIC in this document is that the Standard is clear, it would not expect diversity in practice and would not take the item onto its agenda.

At the same time as the IFRIC has produced these statements, the IASB has itself issued the proposed amendment to IAS 32:- *Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation.* Whilst we appreciate that the draft amendment is a specific exception to the general rules on distinguishing debt and equity, we do not believe that its publication assists in clarifying the principles contained in IAS 32.

We believe that there is uncertainty over the application of IAS 32 and in particular the impact of terms within the documentation of some instruments that may result in different accounting treatments emerging.

The admission that IFRIC would not be able to reach a consensus on this topic on a timely basis indicates that this topic is contentious and guidance and interpretation of this will clarify confusion present in the market.

The issue at hand does have a significant impact in the real world. As you will be aware, it remains common practice in certain types of entity, to raise capital through the issue of Perpetual Bonds. Advisors confirm that there remains diversity in the market on the accounting treatment of such bonds under IFRS. The impact of whether these bonds are treated as equity or liability is material in the context of financial statements of the issuing entities.

The Board has decided that economic compulsion would not result in a financial instrument being classified as a liability under IAS 32, notwithstanding economic reality is widely addressed in the IFRS framework. It is the basis of: calculation of impairment, consolidation, leases, fair valuations, offsetting, etc., indeed going concern itself. Observers may find this conclusion confusing particularly because:

- The IFRS Framework paragraph 35 states "If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form……". The IFRIC should review the application of this aspect of the Framework in the classification of these Bonds.

- IAS 1, Presentation of Financial Statements, paragraph 7 states "The objective of general purpose financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions". The users may not be able to make appropriate economic decisions if the financial statements are not based on economic reality.

We strongly urge the IFRIC to address the issue of classification as debt or equity in the context of Perpetual Bonds. We believe that the discussion and the documentation of the IFRIC's position will provide a useful enhancement to IAS 32 that will enable preparers to make consistent judgements over the classification of and accounting for these types of instrument.

Yours sincerely

Doug Logan
Director Group Technical Accounting