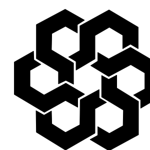

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This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This 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 1 *Presentation of Financial Statements* - Whether the liability component of a convertible instrument should be classified as current or non-current (Agenda Paper 7(viii))**

Tentative agenda decision published in July-2006 IFRIC Update

The IFRIC was asked to consider a situation in which an entity issued convertible financial instruments that, in accordance with IAS 32 *Financial Instruments: Presentation*, were accounted for as two elements – an equity component (ie the holders' rights to convert the instruments into a fixed number of equity instruments of the issuer any time before the maturity date) and a liability component (ie the entity's obligation to deliver cash to holders at the maturity date, which was more than one year after the balance sheet date). The issue was whether the liability component should be presented as current or non-current on the face of the issuer's balance sheet.

The IFRIC observed that both IAS 1 *Presentation of Financial Statements* and the *Framework for the Preparation and Presentation of Financial Statements* (the Framework) state that information about the liquidity and solvency of an entity is useful to users. The IFRIC also noted that the definitions of liquidity and solvency refer to the

availability of cash to the entity. On that basis, the IFRIC believed that the liability component should be classified as non-current.

On the other hand, the IFRIC noted that paragraph 60(d) of IAS 1 states that a liability should be classified as current if the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the balance sheet date. According to paragraph 62 of the Framework, conversion of an obligation into equity is considered as the settlement of a liability. In addition, according to the definition of a financial liability set out in paragraph 16 of IAS 32, a financial liability may be settled through the delivery of a variable number of the issuer's own equity instruments. Settlement of a liability is not confined to delivery of cash or other assets.

The IFRIC believed that the above IFRS requirements appear to be in conflict. In addition, the IFRIC observed that practice, in determining whether the liability component was classified as current or non-current, focused on when the issuer was obliged to deliver cash or other assets. [The IFRIC decided] not to take the issue onto the agenda. Instead, the IFRIC believed that clarification from the Board on this issue was required.

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22 September 2006

Dear Sir

IFRIC Tentative Agenda Decision: IAS 1 – Whether the liability component of a convertible instrument should be classified as current or non-current

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 note that the IFRIC was asked to consider the specific case of a convertible bond that, in accordance with IAS 32, is a compound instrument. This convertible bond contains both an equity component (the holder's right to convert the instrument into a fixed number of the issuer's own equity instruments at any time before the maturity date) and a debt component (the issuer's obligation to deliver cash to the holders at the maturity date that is more than one year after the balance sheet date). We support the IFRIC's tentative conclusion that the classification of this instrument under IFRS is unclear and hence that either a current or a non-current classification can be supported.

However, we do not support the proposed rationale for a non-current classification set out in the second paragraph of the tentative agenda decision. Whilst a non-current classification is acceptable for the compound instrument the IFRIC was asked to address, we support an alternative rationale for such a classification. This alternative rationale is that when classifying an instrument, the first step should be to apply IAS 32 to identify the debt and equity components of the instrument. Any such components that are classified as equity should be ignored for the purposes of a current/non-current classification. The current/non-current classification in IAS 1 applies only to liabilities. Under the principles in IAS 32, any equity components are accounted for in the same way as if they had been issued as separate instruments. It follows that the current/non-current classification under IAS 1 should also be the same as if the components had been issued as separate instruments.

Applying this rationale to convertible debt with no embedded put or call options would result in first the conversion option being analysed as an equity component, which is then excluded from the analysis of whether the liability is current or non-current. This then leaves a debt component that is not repayable within 12 months and hence is non-current. If the convertible debt also includes put or call options these would be assessed in conjunction with the debt component for classification purposes.

The rationale in the 2nd paragraph, being general observations on the application of IAS 1 and the Framework, would have far reaching consequences for transactions other than the one described

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above that we do not think are appropriate. For example, a logical consequence of this paragraph is that a bond which the holder can choose to be settled either by the issuer delivering a variable number of its own shares within 12 months or, alternatively, in cash beyond 12 months would be non-current. In our view, this would not be consistent with the IAS 32 classification of the instrument as being entirely a liability. Furthermore, it offers scope for abuse, by companies specifying that they may settle any amounts due within 12 months in shares 'to the value of' the liability, thereby avoiding a current classification. We believe that, consistent with the classification of such settlement options as liability components (rather than equity components), the issuer has a liability that it can be forced to settle within 12 months and that therefore the instrument should be classified as current.

Applying our proposed rationale to the alternative contract described above would result in a current classification. This instrument contains no equity component. Hence all of its terms – including the option for the holder to demand a variable number of shares within 12 months – are considered to determine whether the instrument is current or non-current. In this case, the share settlement option could cause the entire instrument to be settled within 12 months in a manner that is regarded as a liability under IAS 32. Hence a current classification for the entire instrument is appropriate.

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If you have any questions in relation to this letter please do not hesitate to contact John Brendon, PwC Global Chief Accountant (+44 20 7804 4816), or Pauline Wallace (+44 20 7804 1283).

Yours sincerely

PricewaterhouseCoopers LLP