THE STANDARD STANCE

An expert insight into key accounting matters

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CONVERTIBLE INSTRUMENTS
LIABILITY OR EQUITY?

In today's fast-growing and ever-evolving business environment, many companies are issuing innovative and complex instruments with increasingly attractive returns to obtain funds from investors.

This issue of the Standard Stance highlights several practical issues that need to be considered when determining the appropriate presentation (liability v/s equity) for convertible instruments.

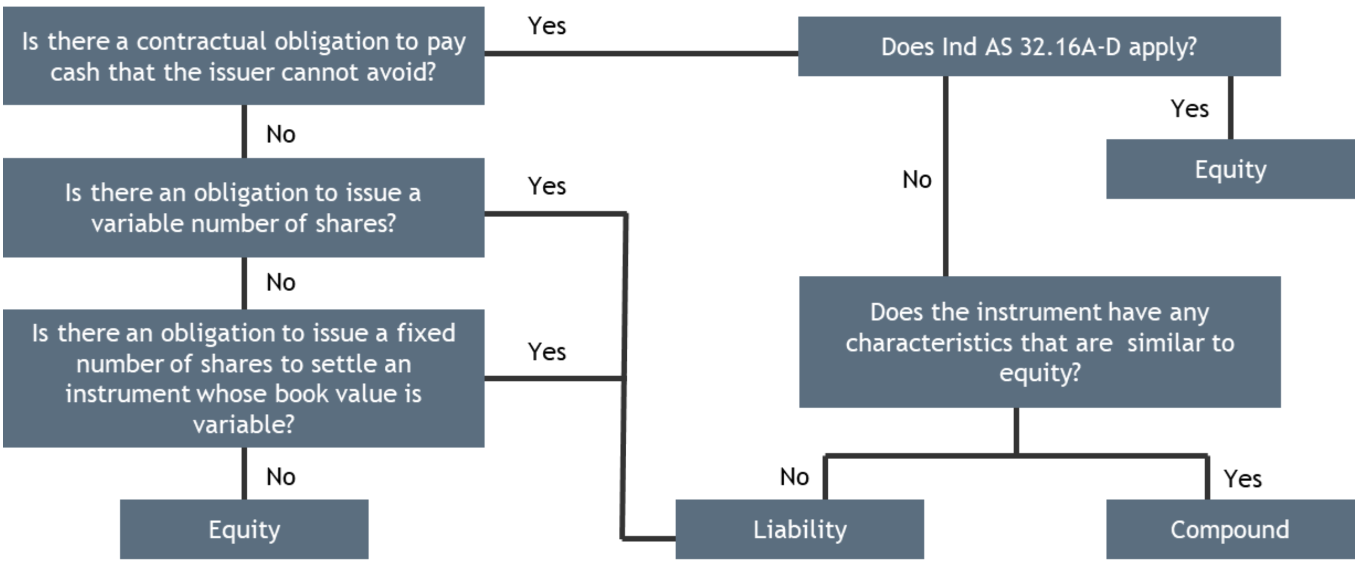
Accounting for convertible instruments is governed by Ind AS 32 'Financial Instruments: Presentation' and Ind AS 109 'Financial Instruments'. Generally, such instruments are either classified as equity or compound instruments or as financial liability or hybrid instruments (liability with embedded derivatives). The classification as liability or equity is important as it directly affects an issuer's reported net profit/ loss and capital structure.

A critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of one party to the financial instrument (the issuer) either to deliver cash or another financial asset to the other party or to exchange financial asset or financial liabilities with holders under conditions that are potentially unfavourable to the issuer.

For an instrument to be classified as an equity instrument under Ind AS 32, the number of equity instruments delivered, and the consideration for them, must be fixed – the so-called 'fixed for fixed' requirement. Contracts that will be settled other than by delivery of a fixed number of shares for a fixed amount of cash do not generally meet the definition of equity.

Instruments with equity conversion features

The flow chart below summarises the requirements of Ind AS 32 relating to the presentation of a financial instrument as a liability and equity, wherein the instrument has equity conversion features which are either mandatory or at the option of the holder or issuer or both.



Let's take an example where the conversion terms result in the classification of an instrument as a 'compound instrument', i.e., the instrument has features of both equity and liability.

Entity A issues a bond with a face value of INR 5,000 which has a maturity of five years from its date of issue. The bond pays a 12% annual interest, and, on maturity, the holder has an option either to receive a cash repayment of INR 5,000 or 1,000 of Entity A's shares. The market interest rate for a bond without a conversion feature would have been 14% at the date of issue.

The transaction cost is ignored for this example.

Analysis:

Analysis of the terms of the convertible bond using the above flowchart is as follows:

1. Step 1: The answer is 'yes' as Entity A has a contractual obligation to pay annual interest in cash and the principal amount in cash if the holder chooses not to exercise the conversion option.
2. Step 2: Ind AS 32.16A-D provides a specific exception from the requirement to classify certain financial instruments as financial liabilities when the issuer has an obligation (or potential obligation) to repurchase those instruments. This exception does not typically apply to convertible instruments and is not applicable in this example.
3. Step 3 is to consider whether the instrument has any characteristics that are like those of equity. The answer is 'yes', as the instrument contains an option to be converted into equity instruments.

Each component of the financial instrument needs to be assessed separately. The host debt component will be classified as a financial liability in its entirety. This is because there is an obligation to pay cash that the issuer cannot avoid (see above), and for this component on a stand-alone basis, there is no feature that is like equity.

The conversion feature is then assessed, again on a stand-alone basis. Starting with the box at the top left-hand side of the diagram:

1. The issuer has no contractual obligation to pay cash as the equity conversion feature can only be settled through the issue of equity shares.
2. There is no obligation to issue a variable number of shares. If exercised, the option will result in the issue of 1,000 shares (a fixed number of shares for a fixed amount).

Consequently, the conversion feature is classified as an equity component. This means that the note contains the following liability and equity components:

- Debt component: Contractual cash flows of 12% annual interest and a cash repayment of INR 5,000 (liability). The fair value would be determined by discounting the contractual cash flows using the market rate of interest (14%).
- Residual equity component: The conversion feature to convert the liability to equity of the issuer (equity). The equity component is then assigned as the residual amount by deducting the amount calculated for the liability component from the instrument's fair value (i.e., proceeds received from the issue of bonds).

However, the answer could be quite different depending on how the instrument features vary. For example:

What if the bond's conversion feature was designed to result in a variable number of shares?

- E.g., Where the bond would be converted into a company's shares using the simple average share price for 30 days before maturity, the 'fixed for fixed' test would not be met. Therefore, the bond would be classified as a financial liability with an embedded derivative liability for the conversion feature.

What if the bond was mandatorily convertible at the end of the term?

- In such situations depending on whether the conversion results is a fixed or variable number of equity shares, the instrument could be classified as a compound instrument or a financial liability instrument in its entirety.

What if the issuer, and not the holder, has the option to convert into a fixed number of its own shares?

- Assuming that the interest payment on such an instrument is also discretionary, the instrument, based on further analysis to determine whether the conversion option is substantive, may be classified as an equity instrument in its entirety as the issuer has no contractual obligation to pay cash for either the principal or the interest component and has the option to convert into a fixed number of its own shares.

Other practical issues

Contingently convertible bonds:

- A contingent convertible bond is a bond that is convertible, at the option of the holder, only on the occurrence of a contingent event outside of the control of the holder or the issuer. If the contingent event occurs then the holder has the option, but not the obligation, to convert. If the contingent event does not occur, then the bond will be settled in cash at maturity.
- The fact that conversion is contingent does not mean the instrument has no equity component. If, on the occurrence of the contingent event, the exercise of the conversion option would result in the exchange of the issuer's own equity instruments for a fixed amount of cash, the conversion option would need to be analysed further to assess whether it leads to the classification of the instrument as a compound financial instrument.

Adjustments to conversion price that preserve the rights of bondholders:

- Adjustments to the conversion ratio whose effect is simply to preserve the rights of the bondholders relative to the entity's other equity shareholders do not generally breach the fixed-for-fixed requirement.
- An adjustment to the conversion ratio will preserve the rights of the bondholders relative to other equity shareholders if its effect is to ensure that all classes of equity interest are treated equally. Such types of adjustments are often referred to as 'anti-dilutive' and do not underwrite the value of the conversion option. Rather they preserve the value of the option relative to the other ordinary shares in specified circumstances. In such a scenario, the fixed-to-fixed criterion is generally not breached.

Bond convertible into fixed percentage of equity:

- The terms of a convertible bond may allow conversion into a fixed percentage of outstanding shares of the issuer at the time of the conversion so that the absolute number of shares to be issued is not fixed and is not known until conversion occurs. This raises the question of whether such a clause violates the 'fixed for fixed' criterion, or whether it can be seen as an anti-dilutive mechanism to always keep the holder in the same economic position relative to other shareholders.
- Such conversion options need to be analysed to see whether classification as equity would be appropriate because the entity's capital structure could change in a way that puts the convertible bond holder into a better economic position relative to other shareholders.

Conclusion

In conclusion, the presentation, classification, and accounting requirements of such instruments are complex and involve the application of significant judgment.

The accounting consequences, e.g., liability v/s equity presentation, identification of embedded derivatives, and measurement of liability could vary depending upon the specific terms of the instrument and the requirements of the Standard. This can have a significant impact on a company's balance sheet and statement of profit and loss account. Before executing such contracts, the management of companies proposing to issue such instruments should carefully evaluate the terms of such instruments, concerning the guidance given under Ind AS. If required, companies may consider approaching an expert to understand the accounting consequences of issuing such instruments.

CONTACT US

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