Solutions

A – What is meant by 'fixed for fixed' in the determination of an equity instrument?

Question 1

If a convertible bond is issued in a currency that is not the functional currency of the issuer, does this violate the 'fixed for fixed' requirement in IAS 32 paragraph 16b(ii)?

Solution

Answer:

Yes. The IFRIC clarified that a convertible bond issued out of a single entity that is denominated in a foreign currency has no equity component (that is, it is a liability with an embedded derivative). This is because the fixed amount of the foreign currency bond that will be extinguished if the holder converts represents a variable amount of cash in the functional currency of the issuer. It, therefore, fails the 'fixed for fixed' requirement and precludes the conversion option being classified as equity. The whole of the convertible bond is classified as a financial liability under IAS 32 and is subject to IAS 39 for recognition and measurement. Under IAS 39 the convertible bond will be assessed as having a host debt instrument and an embedded foreign exchange equity derivative. The latter is not closely related to the debt host so will need to be separated if the debt host is carried at amortised cost.

Question 2

A subsidiary issues a convertible bond that (if converted) converts into shares of the parent, where the subsidiary and parent have different functional currencies. In the group's consolidated accounts, which currency should be looked to in determining whether the 'fixed for fixed' requirement in IAS 32 is met?

Solution

Answer:

It depends. For the purposes of the group's consolidated accounts, a group must look to either the functional currency of the parent (whose shares the bond is convertible into), or that of the subsidiary (whose liability will be extinguished if the bond is converted). The choice to look to the functional currency of the subsidiary or the parent is a policy choice and should be applied on a consistent basis for all similar instruments. IFRIC considered this issue (November 2006) and decided to give no guidance.

In the individual financial statements of the subsidiary, the convertible is classified completely as a financial liability, as the conversion option relates to the shares of the parent and not the equity of the subsidiary. In the individual financial statements of the subsidiary, under IAS 39 the conversion option is an embedded derivative that must be separated, as it is not closely related to the debt host.

Question 3

An entity issues an option to sell a fixed number of its own equity shares at a specified exercise price. The terms of the option state that the specified exercise price varies with the share price of the entity such that:

Share price	Conversion ratio
0-10 C	10 shares at 1 C per share
11-20 C	10 shares at 1.50 C per share

Does this breach the 'fixed for fixed' settlement requirements in IAS 32 paragraph 16b(ii)?

Solution

Answer: Yes.

The variability in the exercise price, as a function of the share price of the entity, results in a variable amount of cash for a fixed number of shares. The fixed for fixed requirement is, therefore, violated. The option is, therefore, a derivative and not an equity instrument.

Question 4

A convertible bond provides for a change to the conversion ratio upon a bonus issue of the issuer's ordinary shares for nil consideration. Does this bonus issue adjustment violate the 'fixed for fixed' requirement in IAS 32 paragraph 16b(ii)?

Solution

Answer: No.

Where the adjustment to the conversion ratio merely preserves the rights of the convertible bondholders relative to ordinary shareholders, that is, it maintains their relative ownership interests – the adjustment would not violate the fixed for fixed rule.

Question 5

A convertible bond provides for a change to the conversion ratio upon a rights issue. Does an adjustment for a rights issue violate the 'fixed for fixed' requirement in IAS 32 paragraph 16b(ii)?

Solution

Answer: It depends.

A rights issue is typically made up of two components: a bonus issue of nil paid ordinary shares, and the issue of new ordinary shares at market price. An adjustment for the bonus issue component of a rights issue preserves the relative rights of the convertible bondholders relative to the ordinary shareholders (see Question A.4). An adjustment for this bonus issue component does not, therefore, violate the 'fixed for fixed' requirement.

However, an adjustment for the second component – the issue of new ordinary shares at market price – does not preserve the economic position of the convertible bondholders and the ordinary shareholders relative to each other. An adjustment for this new share issue component does not, therefore, meet the 'fixed for fixed' requirement.

Question 6

An entity issues a convertible with a clause that automatically adjusts the conversion ratio to compensate for some or all dividend payments on ordinary shares. Does this change in the conversion ratio upon a dividend payment violate the 'fixed for fixed' requirement in IAS 32 paragraph 16(b)(ii)?

Solution

Answer: No.

A change in the conversion ratio that compensates the bondholders for a dividend payment made to the shareholders does not violate the 'fixed for fixed' requirement. This applies if the adjustment is made as partial compensation for all dividends or compensation for only 'large' or 'exceptional' dividends. Such an adjustment would be viewed as preserving the relative economic rights of the convertible bondholders and the ordinary shareholders.

Question 7

An entity issues an option that allows the holders to exchange a fixed number of one kind of the entity's own equity for a fixed number of a different kind of equity. An example is an option for a minority shareholder to exchange its holding of shares in a subsidiary for a fixed number of equity shares in the parent. Is a contract to exchange one type of equity for another type of equity classified as equity under IAS 32?

Solution

Answer: Yes.

From the perspective of the group in preparing its consolidated accounts, the option is to exchange a fixed amount of one type of equity for a fixed amount of another type of equity. The 'fixed for fixed' requirement in IAS 32 paragraph 16(b)(ii) does not cover this; it only deals with contracts to exchange equity for financial assets. Both legs of the contract are a fixed number of shares, and in both cases the shares are a residual interest in some or all of the entity (that is, are equity). The contract does not violate the part of the definition of a financial liability in IAS 32 paragraph 11(b)(i) because, although it is a non-derivative contract, it does not oblige the entity to deliver a variable number of its own equity instruments. The entity is not, therefore, using its own equity instruments as 'currency'.

From the perspective of the parent in preparing its separate financial statements, the contract is a derivative (as the underlying is a financial asset – the investment in subsidiary) rather than an equity instrument.

Question 8

Company A issues a contingently convertible bond; the debt host becomes convertible into common shares of A at a fixed ratio of 1:1.25 only if the contingent event occurs. The contingent event meets the definition of a contingent settlement event in accordance with IAS 32 paragraph 25 and is 'genuine' – for example, a change in control event (see Question B.4). There are no adjustments to the conversion ratio upon the contingent event occurring, and there are no other put or call options. Is the conversion option an equity component since it meets the 'fixed for fixed' criteria, even through it can only be exercised based on the occurrence of a contingent event?

Solution

Answer: Yes.

The instrument is first separated into its component parts, namely a debt host and equity conversion option. The fact that the option is only contingently convertible will not cause liability classification of the conversion option under IAS 32 paragraph 25 provided that, upon occurrence of the contingent event, it would be settled in such a way as to require classification as equity. If the contingent event were to occur in the example above, the conversion to own shares would still satisfy the 'fixed for fixed' requirement in IAS 32 paragraph 16(b)(ii). The conversion option would be classified as an equity component, and the entire instrument would be a compound financial instrument.

Question 9

Companies A, B and X are listed companies. Company A purchases an option to buy 5 per cent of the share capital of X from company B, in return for company A delivering its own equity shares to company B. The exchange ratio is fixed when the option is written (for example, company A pays B 0.8 of A's own shares for the purchase of 1 share of company X). Does the option violate the 'fixed for fixed' requirement if IAS 32 paragraph 16(b)(ii) for company A?

Solution

Answer: Yes.

The exchange ratio is not 'fixed for fixed'. The fixed number of company A's shares that company A may issue is not equal to a fixed amount of cash, as the value of each share acquired in exchange can vary. Company A must treat its purchased option as a derivative instrument under IAS 39.

Question 10

An entity issues an instrument that is settled at the end of the year by delivering shares to the value of C100 The fair value of the shares at the date of issue is C10 The instrument also contains a cap that limits the number of shares that the entity is required to deliver to 20 shares in order to prevent excessive dilution of the existing shareholders through the issue of new shares.

How should this instrument be accounted for?

Solution

Answer:

There are two acceptable views on how the cap should be accounted which depends on the determination of the host contract:

View 1 – The contract is a non-derivative liability for a fixed monetary amount
The host contract is an obligation to issue a variable number of shares whose *value equals 100* (that is, a fixed monetary amount) The entire instrument is a liability on the grounds that the 'fixed for fixed' requirement in IAS 32 para 16(b)(ii) is not met for the instrument as a whole (that is, the instrument is settled in a variable number of shares) IAS 32 paragraph 25 further supports this view because the movement in share price that determines the number of shares to be delivered under the contract (that is, to the fixed monetary amount of 100) is outside the control of the issuer and the holder

View 2 – Contract contains a debt host with a purchased put
The host is an obligation to deliver a *variable number of shares* which is a liability The instrument also contains an embedded derivative whose effect is to cap the amount of shares the entity will have to deliver according to the debt host, so that, overall, the issuer does not deliver shares in excess of the cap. This embedded derivative can be viewed as a

purchased put that will be net share settled (that is, the number of shares to be delivered under the put will vary depending on the share price so that the overall contract results in the delivery of the capped number of shares)

As the cap is not closely related to the debt host (it is linked to movements in the share price), the embedded cap would need to be bifurcated and accounted for at fair value through profit and loss (assuming the fair value option is not used for the entire contract).

Question 11

An entity issues an instrument that is settled at the end of the year by delivering shares to the value of C100 The fair value of the shares at the date of issue is C10. The instrument also contains:

A cap that limits the number of shares that the entity is required to deliver to 20 shares.

A floor that requires the entity to deliver a minimum of at least 5 shares.

How should this instrument be accounted for?

Solution

Answer:

The host is an obligation to deliver a variable number of shares to the value of C100 which is a liability The instrument also contains two embedded derivatives: a cap and a floor. Because the cap and floor are linked to the same risk exposure (that is, the share price) and are interdependent, they cannot be analysed as two separate instruments. The cap and floor need to be bundled together and treated as a single compound embedded derivative. [IAS 39 para AG 29] Because they need to be accounted for as one derivative, the fixed for fixed rule is not met (that is, the 'compound derivative' does not result in the delivery of a fixed amount of cash for a fixed number of shares) As a result, the embedded derivative is within the scope of IAS 39. Assuming the fair value option is not used for the entire contract, the cap and floor should be bifurcated as a single compound derivative that is not closely related to the debt host (the underlying of the compound derivative is the share price).

Question 12

An entity issues an instrument that is settled in a fixed number of shares except where the share price is in a specified range. Within that range, settlement could be in a variable number of shares to the value of a specified amount, or an adjusted number of shares determined at inception based on a sliding scale. It is unknown at inception whether the share price will be within this range and hence how many shares will be delivered in settlement. Is this instrument a financial liability on the grounds that the fixed for fixed requirement in IAS 32 paragraph 16(b)(ii)is not met?

Solution

Answer: Yes.

The fact that the number of shares varies when the share price is in a specific range means that the fixed for fixed requirement is violated.

Question 13

An entity issues a convertible bond with a fixed conversion ratio. The terms of the instrument state that if a change of control event occurs the fixed conversion ratio will be adjusted by a predetermined amount or a formula.

The purpose of these adjustments is to compensate the bondholder for the loss of optionality. Does this adjustment to the conversion ratio violate the 'fixed for fixed' ratio?

Solution

Answer: No.

The adjustment still maintains the relative rights of the bondholders and shareholders for the settlement of the entity's own equity.

Question 14

An entity writes an option to company B that enables B to buy 1 equity share of the entity on the following terms:

- If the option is exercised in year 1 the strike price is C1.
- If the option is exercised in year 2 the strike price is C2.
- If the option is exercised in year 3 the strike price is C3.

Does the above adjustment to the strike price violate the 'fixed for fixed' requirement in IAS 32 paragraph 16(b)(ii)?

Solution

Answer:

In November 2009, the IFRIC discussed whether this type of instrument, where the exercise price is predetermined at inception and only varies over time, met the fixed for fixed condition. The IFRIC acknowledged there is diversity in practice in accounting for such instruments but rejected issuing interpretive guidance on the fixed for fixed condition due to the longer term debt-equity project (Financial instruments with characteristics of equity – FICE) that is currently underway.

Prior to the IFRIC meeting, our view was that the fixed for fixed condition was not met due to the step up feature. However, in light of the IFRIC discussions and the diversity in practice, we have revised our view to also accept that this instrument may be considered to meet the fixed for fixed condition when the exercise price is predetermined at inception and only varies over time (that is, the price within each time period is fixed). If the strike price is determinable based on variables other than time, such as the share price for example, the fixed for fixed condition would not be met.

An entity's decision to interpret the fixed for fixed condition as being met when the strike price is predetermined at inception as described above is an accounting policy decision that should be applied consistently.

An entity may change its policy to reflect the alternative view by following the guidance for changes in accounting policy in IAS 8. Under IAS 8, a change in accounting policy is appropriate if it results in the financial statements providing reliable and more relevant information about the effects of the transactions, other events or conditions on the entity's financial position, financial performance, or cash flows. [IAS 8 para 14].

Question 15

Company A writes a call option over its own ordinary shares to Bank B. The option grants Bank B the right to subscribe for 2.5% of the fully diluted ordinary share capital of Company A at a strike rate of $1 per share.

At grant date, Company A has 200 shares on issue. If the option were to be exercised, Bank B would obtain 5 shares in Company A (that is, 2.5%). The market share price on this date is $2 per share. Therefore, the option has an intrinsic value of $5 [($2 - $1) x 5 shares]. Subsequent to granting the option, Company A issues an additional 200 shares to existing shareholders at $2 per share (the market price). Company A now has 400 shares in issue, still worth $2 each. The existing shareholders have neither gained nor lost as a result of the issue of additional shares at market price. However, Bank B is now entitled to receive 10 shares (2.5% of 400) under the option, each of which has an intrinsic value of $1. Accordingly, the value of Bank B's option has doubled in value from $5 to $10, while the economic rights of the existing shareholders were unaffected. A buy-back of shares would reduce the value of Bank B's option in a similar manner.

Is the written call option over Company A's own shares considered an equity instrument in the hands of Company A?

Solution

Answer: No.

IAS 32.22 states that for a contract that is settled in the entity's own equity to be an equity instrument in its own right, the contract must be settled by delivery of a fixed number of shares for a fixed amount of cash or other financial assets. In this case, the option to subscribe a fixed percentage of shares at a fixed price per share is at a fixed amount per share, but the number of shares may vary if the issued share capital varies. This variation does not preserve the option-holder's rights relative to those of the equity holders, and hence is not equivalent to granting a right to a fixed absolute number of ordinary shares. Consequently, the option is accounted for as a derivative liability.

B – What is meant by 'contractual obligation'?

Question 1

Does a legal/statutory obligation (an obligation as result of the operation of law) to pay dividends meet the definition of a contractual obligation in IAS 32?

Solution

Answer: No.

A financial liability arises from the existence of a *contractual obligation* of one party to the financial instrument (the issuer) to deliver cash or another financial asset to the other party (the holder). [IAS 32 para 17]. An obligation established from local law or statute is not contractual; it does not, therefore, create a contractual obligation as required by the definition of a financial liability.

Question 2

An entity has issued ordinary shares that have a legal/statutory requirement to pay dividends. The entity has also issued a second class of shares (for example, preference shares) with a fixed dividend that is required to be paid in the event a dividend is paid on the entity's ordinary shares (a dividend pusher). Does the legal/statutory obligation to pay a dividend on the ordinary share create an indirect contractual obligation to pay the dividend on the preference shares?

Solution

Answer: Yes.

The preference share is classified as a liability. This is based on the fact that the entity has no ability to avoid paying a dividend of the preference shares, as it has a contractual obligation to do so when it is legally/statutorily obliged to make a dividend payment on its ordinary shares.

Question 3

What does the term 'liquidation' mean in IAS 32 paragraph 25? Should 'liquidation' be interpreted more broadly to include all kinds of insolvency proceedings (such as receivership, administration etc) that might (or might not) result when the entity is no longer a going concern?

Solution

Answer: No.

The term ‘liquidation’ typically will be met only on a winding up of the entity. If the terms of an instrument state that it is mandatorily redeemable upon the event of insolvency proceedings (for example, initiation of administration which is beyond the control of the entity), such that the entity became obliged to repay it irrespective of whether the insolvency leads to liquidation, these terms do not meet the exception in IAS 32 paragraph 25(b); the instrument is, therefore, classified as a financial liability.

However, a mandatory distribution of all proceeds to shareholders following the sale of all the assets of the entity (such that a shell is all that would remain), would fall within the scope of a 'liquidation' even though the legal process of a winding-up has not been concluded.

Question 4

A contract between company A and a third party contains a requirement for company A to make payments to the third party on a change of control of company A, for example, company A being taken over by company B (where company B is not connected to company A). Is such a change of control outside the control of either party to the contract for the purposes of IAS 32 paragraph 25, such that the contract is a liability (given a change of control is both uncertain and genuine)?

Solution

Answer: Yes.

A change in control is outside the control of both the entity and the counterparty provided that it need not be agreed by the entity in a general meeting. This will be the case if a purchaser could approach individual shareholders and buy their shares. Payments that are contingent on a change of control are, therefore, liabilities when no agreement by a general meeting is required.

Question 5

An undated cumulative convertible bond, whose interest payments are at the discretion of the entity absent an Initial Public Offering (IPO), contains a clause that states that the instrument (including all unpaid cumulative interest) will become mandatorily payable if there is not an IPO. Given the IPO event is both uncertain and genuine, does it also meet the criterion of being outside the control of both issuer and holder thus making it a contingent settlement event in accordance with IAS 32 paragraph 25?

Solution

Answer: Yes.

It may be within the entity's control to determine whether the IPO is attempted, but market and regulatory forces determine whether any attempt is successful (ie, whether the market will accept an IPO and whether all regulatory approvals will be obtained). These forces are beyond the control of the entity. Redemption upon an IPO event not occurring, therefore, meets the definition of a contingent settlement event and results in the bond being classified as a financial liability.

Question 6

Is a financial instrument that includes an obligation to pay out a fixed percentage of profits, (10 per cent of profits) and is mandatorily redeemable at par after 20 years a financial liability of the issuer? If so, how is it measured?

Solution

Answer: Yes.

The instrument has two liability components, a contractual obligation to redeem the instrument at par after 20 years and a contractual obligation to pay 10 per cent of profits until redemption. The latter is a financial liability because, although the payment depends on the entity making profits, future profits are outside the control of both the issuer and holder, and if profits are made the issuer cannot avoid making the payment. [IAS 32 para 25].

The 10 per cent obligation does not meet the definition of an embedded derivative as the entity's profit is a non-financial variable that is specific to a party to the contract. See question C.1. Note: this view may change, as the IASB in its Exposure Draft Of Proposed Improvements To International Financial Reporting Standards is proposing to delete the exclusion in the definition of a derivative for contracts that are linked to a non-financial variable that is specific to a party to the contract, with the effect that only those contracts that meet the definition of insurance contracts would fail to be treated as derivatives.

The instrument is initially measured at fair value and subsequently at amortised cost in accordance with IAS 39 paragraph 47, unless it can be and is designated as at FVTPL.

Question 7

An entity acquires a significant stake in a listed company. The entity is obliged, by local law, to launch a takeover bid for the remaining shares. Does this obligation result in a liability for the present value of the exercise price under IAS 32 paragraph 23 (in the same way as a put option written to a minority interest)?

Solution

Answer: No.

A financial liability arises from the existence of a *contractual obligation* of one party to the financial instrument (the issuer) to deliver cash to the other party (the holder). [IAS 32 para 17]. A statutory requirement to launch a takeover bid is a legal obligation not a contractual obligation; no liability is, therefore, recognised.

Question 8

Entity A ('the issuer') issues an instrument with the following terms:

- The instrument has a stated 5 per cent coupon that is mandatory.
- The issuer has an option to convert the instrument into a fixed number of its own shares at any time. The holder has no conversion option.
- The issuer has an option to redeem in cash the instrument at any time. The redemption price is the fair value of the fixed number of shares into which the instrument would have converted if it had been converted. The holder has no redemption option.
- The instrument has a 30 year stated maturity and, if not converted or redeemed previously, will be repaid in cash at maturity for its par value plus accrued but unpaid interest.

How should the instrument be classified by the issuer?

Solution

Answer:

There are two valid views depending on analysis of the host contract (that is, liability host versus equity host) Therefore, an issuer has a policy choice between the following two treatments.

(1) The host contract can be viewed as an equity instrument, as the issuer has the ability to convert the instrument into a fixed number of its own shares at any time. It, therefore, has the ability to avoid making a cash payment or settling the instrument in a variable number of its own shares. Any feature that may have been considered to be an embedded derivative would not meet the definition of a derivative on a stand-alone basis given the ability to avoid payment (see Question C.6) Hence, the issuer's conversion and redemption options would not be separated and the entire instrument would be classified as equity.

(2) The entity can classify this instrument as a liability, being a hybrid instrument comprised of:

   (a) a host liability component for the obligation to pay the mandatory coupons and to repay the instrument at maturity, and
   (b) an embedded derivative component for the entity's option to settle the instrument early in either a fixed number of its own shares or cash of an equivalent value As these two early settlement mechanisms are interdependent, they are viewed as part of a single embedded derivative rather than as two separate embedded derivatives Furthermore, they are classified as a financial asset or liability (rather than equity) under IAS 32 paragraph 26 which requires that where either party to a derivative financial instrument has a choice over how it is settled, it is a financial asset or liability unless all the settlement alternatives would result in classification as an equity instrument.

The entity can classify the entire contract at FVTPL or value the host liability contract at amortised cost and separate the embedded derivative.
The chosen policy should be applied consistently to all similar instruments.

Question 9

An entity has issued two instruments. The first instrument is mandatorily redeemable and pays a mandatory fixed coupon and is therefore classified as a liability in accordance with IAS 32. The second instrument has no mandatory payments other than it is mandatorily redeemable if there is an event of default on the first instrument.

Is the event of default on the first instrument a contingent settlement provision that would make the second instrument a financial liability of the issuer under IAS 32 paragraph 25?

Solution

Answer: Yes.

Whether or not an entity defaults on the payment related to an instrument depends, in part, on whether it has adequate resources to make the payments when contractually due The availability of adequate resources depends primarily on the future revenue and income of the entity. IAS 32 paragraph 25 is clear that revenues and net income are not within the control of an entity Therefore, mandatory redemption in the event of default meets the definition of a genuine contingent settlement provision which results in the second instrument being classified as a financial liability.

C – Embedded derivatives

Question 1

Company A issues a mandatorily redeemable bond whose coupon payments are based on a multiple of EBITDA. These payments meet the definition of a financial liability under IAS 32 paragraph 25. Does the linkage to EBITDA mean that there is an embedded derivative in the host debt contract?

Solution

Answer: No.

Both sales revenue and EBITDA are non-financial variables that are specific to a party of the contract on the grounds that they are primarily a function of business risk. The definition of a derivative in IAS 39 paragraph 9(a) is not, therefore, met. Management applies IAS 39 paragraph 9 for the calculation of the effective interest rate.

Note: This view may change as the IASB in its exposure draft of proposed improvements to International Financial Reporting Standards is proposing to delete the exclusion in the definition of a derivative for contracts that are linked to a non-financial variable that is specific to a party to the contract, with the effect that only those contracts that meet the definition of insurance contracts would fail to be treated as derivatives.

Question 2

What are the components of a foreign currency denominated convertible instrument? For example, a UK company (functional currency GBP) issues a convertible bond denominated in US dollars and convertible on a number of dates into a fixed number of shares of the parent.

Solution

Answer:

The whole contract is a liability. The host contract is a US dollar bond (whose FX risk is accounted for under IAS 21). The embedded derivative is a written option for the holder to exchange the US dollar bond for a fixed number of GBP-denominated shares.

Question 3

A convertible bond is convertible into a fixed number of warrants on shares in the borrower. Is the conversion option an equity component?

Solution

Answer: No.

In accordance with IAS 32 paragraph 16(b)(ii) the issuer's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the issuer's own equity instruments. The warrant is a contract for the future receipt of the issuer's own equity instruments; the conversion option is not, therefore, an equity component to purchase own shares.

Question 4

A company has issued convertible bonds whose terms include a clause giving the issuer the option to redeem in cash the bonds at their fair market value in the event of the occurrence of an uncertain future event. Does this contingent settlement option prevent the conversion option from being an equity component?

Solution

Answer: Yes.

The conversion option is a derivative. The terms of the convertible bond give the issuer the option to redeem the bonds for cash at their fair market value. There is a settlement alternative for the equity conversion option, as it can be settled at fair value either in shares or in cash, that is, there is a net cash settlement option. An equity conversion option for which either party has a choice of settlement in cash or shares is a financial liability under IAS 32 paragraph 26. IAS 32 paragraph 26 overturns the usual principle that something that is in the control of an issuer is not an obligation. This right of choice of settlement is contingent upon a future event in the example above, but the equity conversion option must still be accounted for as an embedded derivative in accordance with IAS 32 paragraph 26.

Question 5

Company A issues a convertible bond that, if converted, converts into a fixed number of equity shares. The bond also contains a provisional call option that gives the issuer the option to redeem the bonds at par if the shares price is 130 per cent of the conversion price for at least 20 days. How should company A account for the provisional call option?

Solution

Answer:

The convertible bond is a compound financial instrument with a debt host and equity conversion option. As the issuer call option is to redeem the bonds at par, it does not result in the conversion option having a cash settlement alternative. The conversion option is not, therefore, accounted for as an embedded derivative in accordance with IAS 32 paragraph 26.

In respect of the issuer call option, the value of any derivative feature (such as a call option) embedded in a compound financial instrument, other than the equity component is included in the liability component. [IAS 32 para 31]. The call option is, therefore, considered part of the liability and not the equity component. When determining whether the embedded option is closely related, the assessment of whether the call or put option is closely related to the host debt contract from the issuer's perspective is made before separating the equity element under IAS 32. [IAS 39 para AG30(g)].

Question 6

An entity issues an instrument on which all payments are at the entity's discretion. However, if the entity does decide to make a payment, those payments vary with reference to a specified variable, for example, FX rates or commodity prices instead of being a fixed amount or specified fixed rate. Is the entity required to separate out an embedded derivative from the host equity instrument?

Solution

Answer: No.

The instrument meets the definition of an equity instrument in IAS 32 paragraph 16 in that the instrument includes no contractual obligation to pay cash. There is no embedded derivative should be separated. The definition of a derivative in IAS 39 paragraph 9 is not met as the 'derivative' does not have to be settled and is, therefore, not 'within the scope of this standard. [IAS 39]'.

This guidance only relates to embedded derivatives and not to stand-alone derivatives.

Question 7

An entity, with functional currency of HKD, issues a 5 year euro-denominated convertible bond for HKD100. The bond is puttable at the holder's option (holder's put option) after 2 years for the initial amount paid by the investor (that is, the euro amount determined at inception as the equivalent of HKD100). Based on previous IFRIC conclusions (see Question A.1), a foreign currency convertible bond such as this is accounted for as a financial liability by the issuer. The conversion option is an embedded derivative which will require separate accounting treatment. Assuming that the holder's put option meets the 'fixed for fixed' requirement in IAS 32 paragraph 16(b)(ii) it will be accounted for as an equity instrument Based on an option pricing model, the conversion option has a fair value on initial recognition of HKD20. The amortised cost of the host liability would be HKD87,47 after 2 years. Should the put option be viewed as closely related to the host debt instrument under ?

Solution

Answer: No.

In cases where the instrument is puttable by the holder and the conversion feature is treated as an embedded derivative, the put option can never be closely related to the debt host as it involves a put of both the debt host and the derivative conversion feature. Accordingly, the put option and the conversion feature should be treated as a single compound embedded derivative in accordance with IAS 39 paragraph AG29 regarding multiple embedded derivatives.