

IFRS News

Shedding light on the IASB's activities*

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IAS 32 from the issuer's perspective – part 3

This is the final instalment in a series of three supplements in IAS 32. We highlight some of the more common financial instruments terms and conditions and explain how they affect the classification of an instrument. This edition looks at the linkage of two or more contracts, reclassification between liabilities and equity and the separation of a compound instrument into its components, among other issues.

Linkage of two or more contracts

Question 1 – Linked transactions

Where an entity issues two or more instruments at (or nearly at) the same time to the same counterparty, are these instruments considered as linked and viewed as a single instrument, or as two separate contracts?

Answer 1

The indicators outlined in IAS 39.AG51(e) and IAS 39.IGB.6 must be considered when determining whether the contracts are linked and viewed as a single arrangement or as two separate contracts. Indicators that the contracts are linked include:

- they are entered into at the same time and in contemplation to one another;
- they have the same counterparty;
- they relate to the same risk;
- there is no apparent economic need or substantive business purpose for structuring the transaction separately that would not also have been accomplished in a single transaction; and
- they cannot be transferred or redeemed separately (IAS 39.10)

Reclassification between debt and equity

Question 2 – Settlement of a financial liability with a new equity instrument

A company exchanges its existing debt instruments for equity shares through renegotiations with their holders to reduce an excessive interest burden. How is the exchange accounted for?

- Option 1: the accounting treatment is the same as where an existing convertible debt is converted into shares – that is, the carrying amount of the existing debt instrument is transferred to equity and no gain or loss arises on the conversion (IAS32.AG32); or
- Option 2: the exchange of an existing debt instrument of the issuer with new equity instruments is, in substance, an extinguishment of the existing financial liability. The

original debt instrument is therefore derecognised in accordance with IAS 39.39; the new equity instruments issued are recognised at fair value, with the difference between this amount and the carrying amount of the derecognised financial liability recognised as a gain or loss in profit or loss in accordance with IAS 39.41.

Answer 2

Either treatment is acceptable. IAS 32 does not specifically deal with a transfer from debt to equity; the issuer can therefore choose either Option 1 or Option 2. This is an accounting policy choice. The chosen treatment is therefore applied on a consistent basis.

Question 3 – How should a transfer from equity to debt be accounted for when the transfer is a result of a change in contractual terms?

A company has in issue a perpetual debt instrument that is classified as equity, as the company has the discretion not to make any payments. The company changes the contractual terms of the instrument subsequent to its issue in such a way that the instrument is now classified as debt. This might be achieved, for example, through changing the terms to require the coupon to be paid on the occurrence of a genuine contingent settlement event. Can the transfer from equity to debt be accounted for as a continuation of an existing instrument – that is, the carrying amount of the instrument is transferred to liabilities with no gain or loss being recognised?

Answer 3

No. The IFRIC issued rejection wording in November 2006 that clarified that a financial liability is initially recognised at the time when the contractual terms are changed, irrespective of whether the change affects cash flows under the contract. The new liability is measured at its fair value in accordance with IAS 39.43.

The IFRIC also observed that the change in the terms of the instrument gave rise to derecognition of the original equity instrument. IAS 32.33 states that no gain or loss is recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instrument. The difference between the carrying amount of the equity instrument and the fair value of the newly recognised financial liability is recognised in equity at the time when the terms are changed. This applies even if the change has no impact on the expected cash flows of the instrument.

Separation of a compound instrument into its components

Question 4 – Convertible debt with embedded puts and calls

A company issues a convertible debt instrument that contains both an equity conversion option and embedded written puts and purchased calls. The debt component is initially measured at the fair value of a vanilla debt with the same contractual maturity, plus the value of the written puts less value of the purchased calls, in accordance with IAS 32.31 and as illustrated in IAS 32.IE37 and IE38 (example 10). If the puts and calls are

not required to be separated from the debt host, are they taken into account when determining the expected life of the debt component and hence its effective interest rate?

Answer 4

Yes. The debt component is measured at amortised cost using the effective interest rate method as defined in IAS 39.9. The puts and calls are considered in determining the expected future life of the instrument and therefore the expected interest rate.

Other issues

Question 5 – Issue costs

Company A incurs IPO costs that relate to both newly issued shares and the listing of existing shares. Can all the costs be recognised in equity?

Answer 5

No. Transaction costs that relate jointly to more than one transaction (for example, costs of a concurrent offering of some shares and a stock exchange listing of other shares) are allocated to those transactions using a basis of allocation that is rational and consistent with similar transactions (IAS 32.38). Only the costs associated with the listing of the new shares and not those attributed to the existing shares are recognised in equity. Company A allocates the IPO costs between the new shares and the existing shares. Where a cost relates to both the newly issued shares and the listing of existing shares, the allocation is made using a rational and consistent method. If costs (such as an underwriting fee) relate solely to the issue of new shares, they are accounted for as a deduction in equity if they are incremental and directly attributable to the issue of new shares. The costs allocated to the listing of existing shares are expensed in profit or loss.

Question 6 – Do marketing costs meet the definition of equity issue costs?

Company A undergoes an IPO that includes the issue of new shares. The costs include costs for marketing the IPO, including the 'road show'. Are all these costs incremental and directly attributable to the issue of new shares?

Answer 6

Generally, no. These costs must be 'directly attributable' to the shares being issued in order to meet the definition of 'transaction costs' (IAS 39.9 and IAS 39.AG13). Marketing costs relate to the marketing of the entity itself. Therefore, in most situations, these costs do not meet the definition of 'directly attributable' and are expensed through profit or loss.

Question 7 – Partly paid instruments – discretionary call dates

A company that is currently in an expansion phase issues some partly paid shares in November 20X5. A call to further pay up the partly paid shares may be made by the issuer on or after 1 January 20X6. Is the element of share capital not yet called recognised in the balance sheet at the date the partly paid shares are initially issued together with a receivable?

Answer 7

No. If the call for further monies may be made by the issuer at a future point in time at its discretion, this element of share capital is not recognised in the balance sheet and no receivable is recognised until the call is made. A receivable is only recognised when it meets the definition of a financial asset – that is, the issuer has a contractual right to receive cash from the shareholder. The past event of issuing the partly paid shares gives the company the right to make future calls, but there is no contractual right to force the issuer to make the calls and there is no contractual obligation on the shareholder to deliver cash until the call is made; it cannot therefore be a financial asset of the issuer, as it is not a financial liability of the other party.

The issue of partly paid shares and calls for further payment may be subject to legislation; due regard must also be paid to the requirements of the law under which the company is incorporated.

Question 8 – Partly paid instruments – fixed call dates

A company that is currently in an expansion phase issues some partly paid shares. The share agreement contains a fixed schedule of definite call dates that the company and the shareholders have no ability to avoid. Is the element of share capital not yet called recognised in the balance sheet at the date the partly paid shares are initially issued together with a receivable?

Answer 8

It depends. It will be a matter of law of the territory in which the company is incorporated as to whether such a schedule of calls has the effect that the calls are legally obliged to be made. If the shares are deemed to be called and ‘paid up’ – that is, where the effect is that the shareholder is legally obliged to make payments as a result of the agreement and the fixed schedule of payments – a receivable is recognised for the outstanding proceeds of issue. This receivable is measured at fair value on initial recognition and subsequently at amortised cost in accordance with IAS 39 (unless designated as at FVTPL). The amortised cost will be calculated using an effective interest rate such that the receivable is measured at the net present value of the future receipts. The guidance in Question 8 applies if the instrument is not deemed to be called and ‘paid up’.

Question 9 – Short sales of own equity

Bank A trades in its own equity securities. This includes short sales where the bank borrows its own equity securities from others and therefore has an obligation to buy back shares from the market to deliver to third parties. The bank operates in a jurisdiction where short sales in its own equity securities are legal. Are these trades recognised in equity or as trading liabilities under IAS 39 and measured at fair value through profit or loss?

Answer 9

The requirement for own equity transactions in IAS 32.16 is no different for short sales. The trades and any gains and losses on them are recognised in equity in accordance with IAS 32.23.

Question 10 – Before maturity conversion of a convertible bond with a US conversion option

Convertible bonds with a US conversion option are regularly converted before the original maturity date of the loan.

1. To the extent the carrying amount at the date of conversion is not equal to the principal amount converted, is the difference recognised as a gain or loss on conversion?
2. Does the expected life of the host liability that is used to determine its effective interest rate include any expectations of early conversion?

Answer 10

1. No. The meaning of ‘maturity’ in IAS 32.AG32 is any date when a holder converts the bond according to its contractual terms.
2. No. IAS 32.IE9 illustrates the accounting for such a convertible on initial recognition. It illustrates that the early conversion option is a characteristic of the equity component and not of the host liability, and that the expected life of the liability is determined without considering possible early conversion. The estimated cash flows used to apply the effective interest rate method are therefore the contractual cash flows based on the contractual maturity.

Question 11 – Own share buy-back programme

During certain times of the year (for example, before an entity releases its results), a listed company is prohibited by local listing rules from buying its own shares in the market. The local listing rules may permit other arrangements to be entered into with independent third parties that result in the listed entity’s shares being purchased on behalf of the listed company.

For example, a listed company has entered into a contract with a bank that mandates the bank to buy the company’s shares from the market during the prohibition period. The contract requires the company to buy the shares the bank has purchased immediately after the prohibition period. The number of shares to be bought is not fixed (but depends on the daily turnover of the shares in the market) but is subject to a cap set by the entity so as to meet the company’s objective and avoid breaching the listing rules. The shares will be bought by the bank at their market price, and the price that the company will pay the bank is that same market price plus a fee or spread. The contract is structured so that the bank is not acting as an agent for the company, and the bank acts independently in deciding how many shares to buy and on what dates.

Does the company have an obligation to acquire its own equity instruments under IAS 32.23? If so, how is this financial liability measured under IAS 39?

Answer 11

Yes. The company is contractually obliged to buy the shares the bank has purchased. IAS 32.23 requires the company to

recognise a financial liability at the present value of the redemption/repurchase amount. The corresponding debit is to equity under IAS 32.23, as the underlying is the company's own shares.

The financial liability is measured on initial recognition based on the

maximum number of shares that may be purchased (ie, the cap) and a best estimate of share price. Subsequent changes in the estimated repurchase amount arising from changes in share price are accounted for in accordance with IAS 39.AG8. However, if the total number of shares actually bought is less than the cap, the difference is

accounted for in the same way as an option that expires unexercised by a corresponding reclassification from liabilities to equity.

The company must ensure it meets any local listing requirements for notification of such transactions to the relevant regulators.

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