

FRC’s statement of observations on the accounting treatment of equity conversion options of convertible bonds with anti-dilutive clauses

1 Background

- 1.1 Convertible bonds are compound financial instruments, commonly used by listed entities as means of raising capital. There are two components in convertible bonds, namely, the debt instrument and the equity conversion option. The equity conversion option allows bondholders to elect converting the bonds into equity of the issuing entities in accordance with provisions in the subscription agreements. The debt instrument component will be classified as a financial liability and the equity conversion option can be classified either as a financial liability or an equity instrument.
- 1.2 Paragraph 15 of Hong Kong Accounting Standard 32 *Financial Instruments: Presentation* (“HKAS 32”) requires the issuer of a financial instrument to “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”.
- 1.3 Paragraph 11 of HKAS 32 defines an equity instrument as “any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities”.
- 1.4 Paragraph 16 of HKAS 32 further specifies conditions for classifying a financial instrument as an equity instrument. One of the conditions, commonly known as the “fixed-for-fixed” criterion, is that “a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments.” There has been criticism of this “fixed-for-fixed” criterion as it is not clear what “fixed” means.
- 1.5 Virtually all convertible bonds in the market nowadays include anti-dilutive clauses in their subscription agreements. Anti-dilutive clauses aim to protect the bondholders’ interest from certain specified events of the issuing entities, such as bonus issue, share splits, buy back of its own shares, dividend payments or issue of shares below market value, etc. By virtual of these anti-dilutive clauses, the conversion price of the convertible bonds will be adjusted if one of these events takes place. HKAS 32 is silent on the accounting treatment of financial instruments with anti-dilutive clauses and there are variations of accounting treatments in the market.
- 1.6 The classification of an equity conversion option as a financial liability and not an equity instrument does not only affect the presentation in the balance sheet but may also have a significant impact on the profit or loss of the issuer through its subsequent measurement. It may also have an impact on financial ratios.

2 Published literature

- 2.1 In the absence of explicit provision or application guidance on financial instruments with anti-dilutive clauses in HKAS 32, major accounting firms have published certain guidance on this topic.
- 2.2 From these published literature, it appears that there is a consensus in the accountancy profession that conversion price adjustments as a result of bonus issues, share splits, dividend payments and issues of share below market value, etc., which preserve the relative rights of the bondholders are not viewed as a violation of the “fixed-for-fixed” criterion. The equity conversion option of the convertible bonds, the subscription agreements of which contain such anti-dilutive clauses, should be classified as an equity instrument, if the “fixed-for-fixed” criterion would otherwise be met.

3 Observation

- 3.1 There are different anti-dilutive clauses in the market, some of which may not fully preserve the relative rights of the bondholders. Each case needs to be considered in its own merits.
- 3.2 For example, there are provisions in some anti-dilutive clauses that the adjustment to the conversion price will not take place if new shares are issued at a discount of not more than a certain percentage to market price. Therefore, one may argue that the relative rights of the bondholders are not preserved when shares are issued at a discount of that percentage or less, and as a result, it violates the “fixed-for-fixed” criterion (the “percentage exemption” provisions).
- 3.3 There may be a practical need to provide for exemption to conversion price adjustment in anti-dilutive clause if the discount to market price is within a certain percentage. The issue price of new shares is determined in advance. The market price of the shares continues to fluctuate after the determination of the issue price. With the “percentage exemption” provisions, there is no need to adjust the conversion price of the convertible bonds if the issue price differs from the eventual market price by not more than that percentage.
- 3.4 If applying the concept of materiality to the matter, the issue of new shares which is equal in number to the shares in issue at a 10% discount to market price without anti-dilutive adjustments to the conversion price will dilute the relative rights of the bondholders by 5%. Whether the “percentage exemption” provisions in a convertible bonds subscription agreement would materially affect the relative right of the bondholders depends on the likelihood of the issue of a large number of new shares and the extent of discount to market price which would cause a material dilution of the rights of the bondholders. The management of the entity concerned would need to take a judgement in this connection. If the dilution effect caused by the “percentage exemption” provisions is immaterial, the

equity conversion option of convertible bonds can be considered as meeting the definition of an equity instrument.

- 3.5 Published literature of the accountancy profession is silent on these “percentage exemption” provisions.

4 Enforceability

- 4.1 The analyses above provide a view on what are the reasonable accounting treatments of convertible bonds with anti-dilutive clauses under the existing standards.
- 4.2 Notwithstanding the analyses above, it is doubtful if the interpretation is enforceable. This is because the above interpretation involves the extension of the “fixed-for-fixed” criterion beyond its literal meaning and there is considerable professional view in the extension.
- 4.3 As a result, there are variations in the accounting treatments of the equity conversion options of convertible bonds in the market.

5 Impact of accounting treatment

- 5.1 Whether or not the equity conversion option of convertible bonds meet the “fixed-for-fixed” criterion and other conditions as set out in paragraph 16 of HKAS 32 will determine if the equity conversion option of convertible bonds should be classified as an equity instrument or a financial liability.

No violation of the “fixed-for-fixed” criterion

- 5.2 If there is no violation of the “fixed-for-fixed” criterion and the equity conversion option is classified as an equity instrument, its carrying amount after initial recognition will not be re-measured. There will be no fair value gain or loss arises on and after the initial recognition. (Paragraph 31 of HKAS 32)
- 5.3 The debt component shall be subsequently measured at amortised cost using the effective interest method.

Violation of the “fixed-for-fixed” criterion

- 5.4 If there is violation of the “fixed-for-fixed” criterion, the equity conversion option is classified as a financial liability and the initial carrying amount would be at its fair value.
- 5.5 After initial recognition, the equity conversion option shall be subsequently measured at its fair value. Changes in fair value would be recognised directly as profit or loss in the

income statement in the period in which they arise. The debt component shall be subsequently measured at amortised cost using the effective interest method. (Paragraph 47 of Hong Kong Accounting Standard 39 *Financial Instruments: Recognition and Measurement* (“HKAS 39”))

- 5.6 Alternatively, the entire financial instrument may be designated as a financial liability at fair value through profit or loss upon initial recognition (Paragraph 11A of HKAS 39). The changes in fair value of the entire financial instrument shall be recognised directly as profit or loss in the income statement in the period in which they arise.

Comparison of accounting treatment

- 5.7 If the equity conversion option is classified as an equity instrument, it will not be re-measured subsequent to initial recognition and there will be no fair value gain or loss. If the equity conversion option is classified as a financial liability, it will be measured at its fair value separately or together with the debt component. There can be significant fair value gains or losses in the accounting periods subsequent to initial recognition.

6 Development of International Accounting Standard 32 (“IAS 32”)

- 6.1 Since 2005, the International Accounting Standard Board (the “IASB”) and the US Financial Accounting Standards Board (the “FASB”)(collectively the “Boards”) have had a long-term objective to improve and simplify the reporting for financial instruments.
- 6.2 On 28 February 2008, the IASB published for comment a discussion paper (“DP”) on *Financial Instruments with Characteristics of Equity*, which includes the FASB Preliminary Views document *Financial Instruments with Characteristics of Equity* issued in November 2007. The DP is the first stage of the IASB’s project to improve and simplify the requirements in IAS 32 to address worldwide stakeholders’ criticism of the current requirements. In general, there are two broad classes of criticisms of the distinction set out in IAS 32 between equity instruments and non-equity instruments:
- (a) the principles in IAS 32 are difficult to apply; and
 - (b) the application of those principles can result in inappropriate classification of some financial instruments.
- 6.3 The DP mentioned that the application of the principle in IAS 32 can be problematic and cited the application of the ‘fixed for fixed’ principle as one of the examples, as questions have been raised of what “fixed” means.
- 6.4 The FASB Preliminary Views document describes three approaches to distinguish equity instruments and non-equity instruments, namely, basic ownership, ownership-settlement, and reassessed expected outcomes (“REO”). The FASB reached a preliminary view that the basic ownership approach was the appropriate approach for determining which

instruments should be classified as equity. The IASB's DP describes implications of the three approaches for IFRS but the IASB did not deliberate on any of the three approaches at the time the DP was published. The table below summarizes the classification of convertible debt for fixed number of shares under different approaches:

Current US GAAP	Basic Ownership	Ownership-Settlement	REO	IAS 32
Liability	Liability	Equity and liability	Equity and liability	Equity and liability

- 6.5 During the October 2008 IASB meeting, the Boards decided to begin deliberations using the principle underlying the perpetual and basic ownership approaches. The perpetual approach was introduced after receipt of comments from the DP issued in February 2008. The perpetual approach would classify an instrument as equity if it (a) lacks a settlement requirement and (b) entitles the holder to a share of the entity's net assets in liquidation. This approach was similar to the classification approach in IAS 32 except that derivatives over an entity's own equity would not be classified by the issuer as equity.
- 6.6 Under the basic ownership approach, an instrument would be classified as equity if it (a) is the most subordinated claim and (b) entitles the holder to a share of the entity's net assets.
- 6.7 During the May 2009 IASB meeting, the general principles and decision rules for distinguishing between equity and non-equity instruments was presented.
- 6.8 Under the proposed general principles, a convertible bond would not contain an equity component because both outcomes were liabilities: firstly, if the conversion option was not exercised the outcome would be liability; and secondly, the conversion option is by default a liability under the principle as the option meets the definition of a derivative and the IASB's previous decision (reflected in the decision rules) was to treat all derivatives as liability instruments regardless of whether equity is delivered under them.
- 6.9 A majority of the IASB agreed with the general principles and decision rules described above and agreed to proceed to build on the current platform with additional changes to deal with undesirable outcomes of applying the proposed principles. The IASB expected to issue an exposure draft in the fourth quarter of 2009 or first quarter of 2010.
- 6.10 Because of the convergence policy as set out in paragraphs 5 and 26 of the *Preface to Hong Kong Financial Reporting Standard*, the wordings of HKAS 32 are expected to be exactly the same as that of IAS 32.

7 Summary

- 7.1 The equity conversion option of convertible bonds meeting the “fixed-for-fixed” criterion should be classified as equity instruments under the current financial reporting standards.
- 7.2 The accountancy profession generally considers that anti-dilutive clauses that preserve the rights of the convertible bond holders do not violate the “fixed-for-fixed” criterion.
- 7.3 There is no consensus yet on the accounting treatment in relation to “percentage exemption” provisions. The Financial Reporting Council considers that the concept of materiality should apply in determining the appropriate accounting treatment.
- 7.4 It is likely that in the near future, there will be changes in the financial reporting standards which require all convertible bonds to be classified as financial liabilities.

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