



IFRS IN PRACTICE 2021/2022

Accounting for convertible notes

BDO

1 Contents

2. Introduction	4	5 Example 2 – Convertible notes with an embedded derivative liability	21
3. The basic requirements	5	5.1 Transaction costs	22
3.1 Overview.....	5	5.2 Accounting for the host debt liability	23
3.2 Definition of a financial liability.....	6	5.3 Accounting for the derivative liability	23
3.3 Definition of equity.....	6	5.4 Accounting for the contract as a whole at fair value through profit or loss	23
3.4 Definition of a derivative	7	5.5 Current or non-current classification	24
3.5 Classification flow chart	8	5.6 Early conversion	24
3.6 Measurement principles	11	6 Further scenarios where the conversion feature fails equity classification	25
3.6.1 Compound financial instrument	11	6.1 Conversion price based on the issuer's share price at conversion date	25
3.6.2 Convertible note with an embedded derivative liability.....	11	6.2 Variable conversion price limited to a 'cap' and/or a 'floor'	25
3.7 Presentation and disclosure considerations ...	12	6.3 Issuer's option to settle in a fixed number of shares is not substantive.....	26
4 Example 1 – Convertible into a fixed number of shares	14	6.4 Down round features	27
4.1 Transaction costs.....	15	6.5 Convertible note denominated in a foreign currency	29
4.2 Current or non-current classification	16	6.6 Conversion into a fixed percentage of the issuer's shares	29
4.3 Conversion on maturity	17	6.7 Issuer settlement options on conversion	29
4.4 Deferred taxes	17		
4.5 Early conversion	19		
4.5.1 Additional consideration offered to encourage early conversion.....	19		
4.6 Early repurchase.....	20		



clickable

7 Scenarios where the conversion feature may still meet equity classification	30
7.1 Principal amount plus accrued interest	30
7.2 Anti-dilution features	31
7.2.1 Adjustments from a stock split or bonus issue	31
7.2.2 Adjustment to the conversion ratio upon a rights issue	31
7.2.3 Anti-dilution features that fail 'fixed for fixed'	32
8 Other common practice issues	33
8.1 Fair value of the note is more than the transaction price	33
8.2 Callable compound convertible notes	34
8.2.1 Early redemption of a callable compound convertible note	34
8.3 Convertible notes issued to management	35
8.4 Mandatorily convertible notes	36
8.5 Contingently convertible notes	36
8.6 Reverse convertible notes - convertible at the issuer's option	38
8.7 Convertible notes / loans with attaching 'free' warrants	38
8.7.1 Subsequent modification to the terms of the warrants/options	39
8.8 Subsequent modifications and replacements	40
8.8.1 Modification of contractual terms	40
8.8.2 Modifications without change to the contractual terms	42
9 Additional examples	44
9.1 Example 3: Convertible into a variable number of shares	44
9.2 Example 4: Bonds issued in a currency other than the entity's functional currency	45
9.3 Example 5: Callable convertible note	47
9.4 Example 6: Early repurchase of bonds	49
9.5 Example 7: Mandatorily convertible note	50
9.6 Example 8: Settlement options on conversion	52
9.7 Example 9: Reverse convertible note – convertible at the issuer's option	52
9.8 Example 10: Loan with attached warrants ...	56
9.9 Example 11: Convertible note with attached warrants	57
9.10 Example 12: Instrument with a share settlement alternative	60
Appendix A – Financial asset vs equity classification flow chart	61
Appendix B – Summary diagrams of the subsequent accounting of convertible notes	62



clickable

2 Introduction

Convertible notes have often been used as a source for entities to obtain financing for their operations. They are appealing from an issuer perspective because they typically involve lower cash out flows, with the lender / investor accepting a lower rate of interest on the funds advanced. They are also usually easier to issue in comparison with obtaining bank financing. A lender / investor is willing to accept a lower rate of interest because the conversion feature will, potentially, provide a significant enhancement to the overall return through participation in the upside equity returns.

Many issuers are adding enhancements to conversion features in order to attract investors, and questions continue to arise in relation to the appropriate accounting treatment by an issuer of instruments with more complex conversion features.

As the name implies, 'convertible notes' can result in debt funding being converted into equity, providing the investor with upside returns. However, convertible notes typically also have a cash settlement feature which protects the investor from any downside losses when the option conversion feature is 'out of the money'.

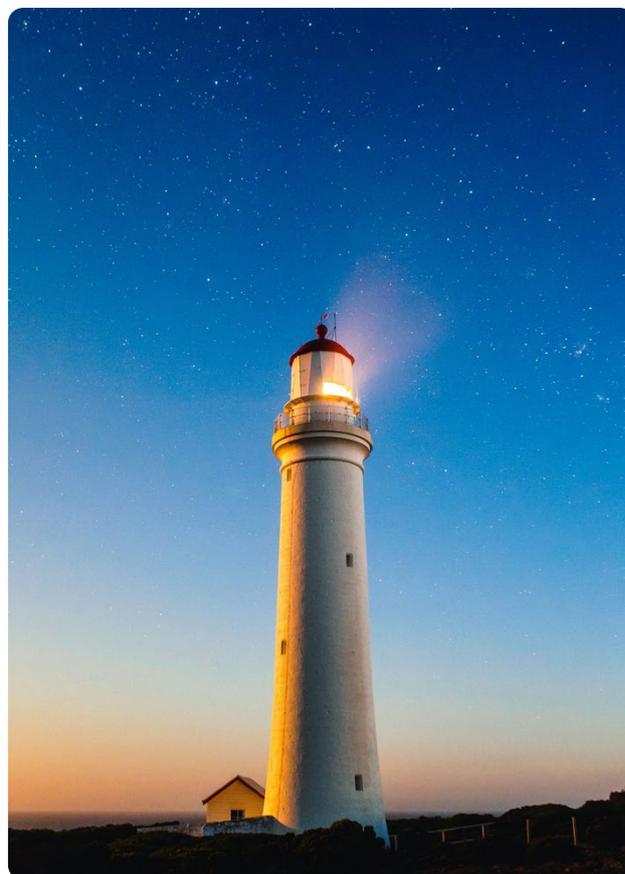
From an accounting perspective, in their simplest form, convertible instruments consist of a loan and an equity conversion feature that gives the holder an option to convert the loan into a specified number of shares of the borrower. However, some convertible instruments can be complex, containing a number of features which can have a significant effect on the appropriate accounting approach. In particular, although a conversion option may be settled through the issue of equity shares, that option may not always be classified as an equity instrument. Depending on the precise terms and conditions, the conversion option may instead be classified as a derivative that is measured at fair value, with changes in fair value recorded in profit or loss.

The accounting classification of a conversion feature as either an equity instrument or as a derivative can have a significant effect on an entity's financial statements. This is because if the conversion feature is classified as a derivative, it can give rise to volatility in reported net assets and profit or loss. This can in turn have an effect on a number of related arrangements, including:

- Other lending agreements, including the effect on key ratios and covenants
- Employee remuneration arrangements, including bonus schemes and share-based payments linked to reported profits, and
- Investor communications.

In addition, when a convertible note is close to or has reached maturity, it may be replaced or modified, which requires further consideration as to the appropriate accounting requirements.

This publication highlights a number of practical issues that need to be considered when determining the appropriate accounting for convertible instruments from the issuer's perspective.¹



¹ Different accounting requirements apply when accounting for convertible notes from the holder's perspective. This publication does not address issues relating to accounting for convertible notes from the perspective of the holder.

3 The basic requirements

3.1 Overview

When accounting for convertible notes from the issuer's perspective², convertible notes are financial instruments that fall within the scope of IAS 32 *Financial Instruments: Presentation and IFRS 9 Financial Instruments*³.

IFRS requires that the terms of a convertible instrument are analysed and each component separately accounted for according to the definitions of a financial liability and equity. Whether a financial instrument should be classified as a financial liability or as equity is dealt with by IAS 32. IAS 32 requires that a convertible instrument is dealt with by an issuer as having two 'components', being a liability host contract plus a separate conversion feature which may or may not qualify for classification as an equity instrument. If a financial instrument has multiple components, each of these components is required to be analysed separately in order to determine the appropriate classification.

The definitions set out in IAS 32 for a financial liability and equity are detailed and appear complex (see extracts below). However, for the purposes of accounting for convertible instruments by an issuer, they can be summarised in two key principles:

Does an entity have a contractual obligation to deliver cash or another financial asset that it cannot avoid?



If the entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability

Is the contract to be settled by exchanging a fixed number of the entity's own equity instruments for a fixed amount of cash (the 'fixed for fixed' criterion)



A financial instrument can only be classified as equity if the 'fixed for fixed' criterion is met*

Illustration 1: Key principles for classifying financial liability vs equity

² Different accounting requirements apply when accounting for convertible notes from the perspective of a holder. This publication does not address issues relating to accounting for convertible notes from the perspective of the holder.

³ However, financial instruments issued under share-based payment transactions are to be accounted for under IFRS 2 Share-based Payment (IFRS 9.2.1(h)).

3.2 Definition of a financial liability

A financial liability is defined by IAS 32⁴ as:

(a) a contractual obligation:

(i) to deliver cash or another financial asset to another entity, or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity, or

(b) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments, or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. ...

Liability classification applies to a contract when the entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation (i.e. (a)(i) and a(ii) above).

Where an entity has a contractual obligation that will or may require settlement in the entity's own equity instruments, the liability classification requirements are different for non-derivatives and derivatives.

- For non-derivatives, the contract⁵ is a financial liability if the contract will or may be settled by delivery a variable number of an entity's own equity instruments.
- For derivatives, a derivative contract⁶ meets the definition of a financial liability if it requires or may require settlement in the entity's own equity instruments, unless it is settled by the entity's issuing a fixed number of shares to settle a fixed amount of cash (commonly referred to as the fixed-for-fixed criterion).

3.3 Definition of equity

IAS 32⁷ defines equity as:

any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities

The definition of an equity instrument is the opposite of the financial liability definition in section 3.2 above.

An equity instrument is defined⁸ as:

(a) The instrument includes no contractual obligation:

(i) to deliver cash or another financial asset to another entity, or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.

(b) If the instrument will or may be settled in the issuer's own equity instruments, it is:

(i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments, or

(ii) 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...

⁴ Extracts from IAS 32.11

⁷ IAS 32.11

⁵ Or a component of the contract

⁸ IAS 32.16

⁶ Or a component of the contract that meets the definition of a derivative

Conversion features in convertible notes often meet the definition of a derivative; this is discussed in section 3.4 below. Therefore, they can only be classified as equity if they meet (b)(ii) in the definition of equity above, commonly referred to as the fixed for fixed criterion.

Notwithstanding the strict fixed for fixed criterion for equity classification, in practice, it has been accepted that some terms still qualify for equity classification despite prima facie⁹ failing the fixed for fixed criterion. These include where:

- The number of shares is predetermined at the outset and the only variable is the passage of time, or
- Where anti-dilution clauses are added to maintain the relative rights of shareholders and noteholders.

3.4 Definition of a derivative

Conversion features in many convertible notes typically meet the definition of a derivative. The definition of a derivative is set out in IFRS 9¹⁰:

A financial instrument ... with all three of the following characteristics.

(a) its value changes in response to the change in a specified ..., financial instrument price, commodity price, foreign exchange rate, ...

(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

(c) it is settled at a future date.

Conversion features in convertible notes typically meet the definition of a derivative because:

- The value of the conversion feature changes in response to the share price of the issuer
- The investment required to purchase the conversion feature is the present value of the reduction in interest rate that is paid on the convertible note in comparison with a loan with no conversion feature. This amount is less than the amount that would be required to purchase the equivalent number of shares upfront, and
- The conversion feature can or will be exercised at a future date (either at maturity of the convertible note or during its life).

Therefore, when determining the classification of a conversion feature, paragraph (b)(ii) of the definition of an equity instrument is relevant. In practice, many conversion features in convertible notes are not settled by the issuer exchanging a fixed amount of cash for a fixed number of the issuer's own equity instruments, i.e. they fail the fixed for fixed criterion for equity classification and are instead derivatives.



⁹ i.e. on first impression

¹⁰ IFRS 9, Appendix A

Conversion features in convertible notes that fail the fixed for fixed criterion contain contractual terms that result in the holder having rights that are different to those of existing shareholders. The commercial effect of these contractual terms is that the holder of the conversion feature is exposed to a different return profile compared to an equity investor.

As noted above, equity is defined as 'any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities' and it is only when the fixed for fixed criterion is met that this residual interest exists. This is because the holder would benefit from any potential upside movement and suffer from downside movements in this residual interest.

When a conversion feature, which is a derivative, fails equity classification, it is typically classified as a derivative liability.¹¹ However, in some circumstances, a conversion feature may not meet the definition of a derivative. To illustrate, two examples of convertible notes where the conversion feature does not meet the definition of a derivative:

- If the conversion feature results in a financial liability at maturity being converted into the number of shares equal to the value of the amount that would otherwise be repayable in cash, the value of that conversion feature does not vary in response to changes in the issuer's share price, and therefore does not meet the definition of a derivative (an example is set out in section 9.1), or
- A note that mandatorily converts into a fixed number of shares. The conversion feature is not a derivative because the initial investment is the entire cash amount received on initial recognition. The entire principal amount of the note is classified as equity (see section 8.4 and Example 7 in section 9.5).

Equity conversion features in convertible notes that are derivative liabilities are required to be accounted for separately from the debt host contract as a standalone derivative¹². This is because they often do not have economic characteristics and risks that are closely related to the debt host. The value of the conversion features is typically driven by different variables (e.g. equity price risk) compared to the host debt contract¹³.

Other derivatives, in addition to the conversion feature, may also exist in convertible notes, such as an issuer call option that allows the issuer to repay the note before its maturity. Entities would need to determine whether the derivatives are closely related to the debt host contract, and account for them accordingly.

When there are multiple embedded derivatives in a convertible note, they are treated as a single compound embedded derivative unless they relate to different risks exposures and are independent of each other. However, embedded derivatives that are classified as equity are accounted for separately from those classified as assets or liabilities.¹⁴

3.5 Classification flow chart

The following flow chart summarises the accounting requirements in IAS 32 in relation to the evaluation of liability and equity classification of financial instruments. It has been designed to enable an analysis of financial instruments by individual component parts as required by IFRS¹⁵. The following points should be noted in using the flow chart:

1. The flow chart assumes that an entity does not elect to designate a financial liability as measured at fair value through profit or loss in its entirety¹⁶.
2. The flow chart does not address instruments with settlement options. If a derivative financial instrument gives one party a choice over how it is settled (e.g. the issuer or the holder can choose settlement net in cash or by exchanging equity instruments for cash), then the instrument is a financial liability unless all of the settlement alternatives would result in it being an equity instrument¹⁷.

¹¹ In some cases, the derivative could be a derivative asset, e.g. if the issuer has the right to convert a note into a variable number of its own equity instruments.

¹² Under IFRS 9, embedded derivatives found in a host liability contract are to be separated and accounted for as standalone derivatives if the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host liability contract. (IFRS 9.4.3.3)

¹³ The value of a debt contract is usually determined by interest rates, which is usually driven by factors such as the risk free rate, credit risk, expected maturity and liquidity risk.

¹⁴ IFRS 9.B4.3.4

¹⁵ IAS 32.28

¹⁶ IFRS 9.4.2.2

¹⁷ IAS 32.26

3. Question 3 asks whether the component 'is a derivative other than a put over an entity's own equity within the scope of IAS 32.23?' IAS 32.23 requires a put over an entity's own equity to be accounted for as a 'gross' financial liability at the present value of the redemption amount rather than as a derivative (i.e. FVTPL). When answering question 3:

(a) If the component is not a derivative, then the answer is No.

(b) If the component is a derivative, but the derivative is a put over an entity's own equity, then the answer is No.

(c) If the component is a derivative other than (b), then the answer is Yes.

The operation of the flowchart is also included in the illustrative examples below.

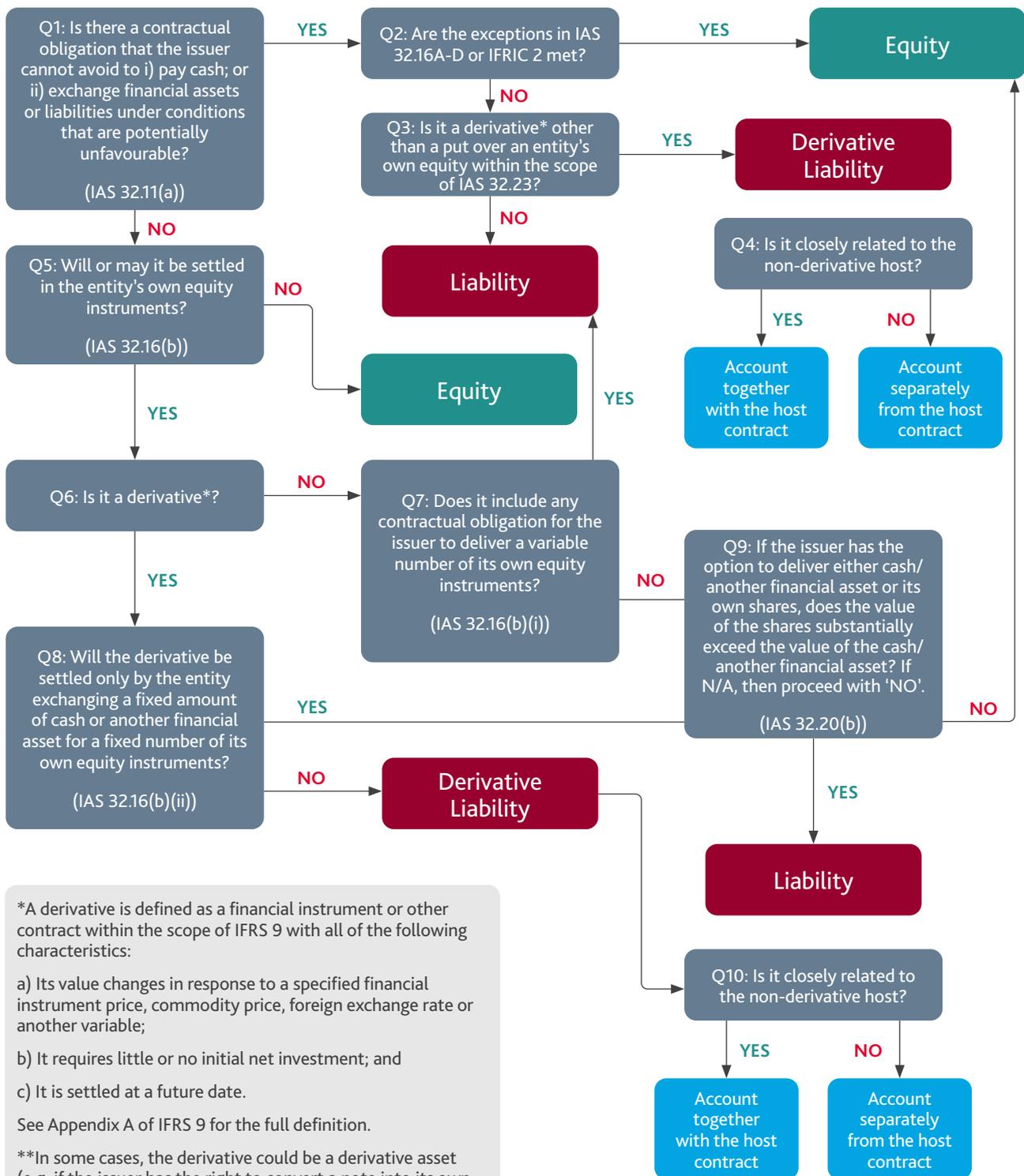
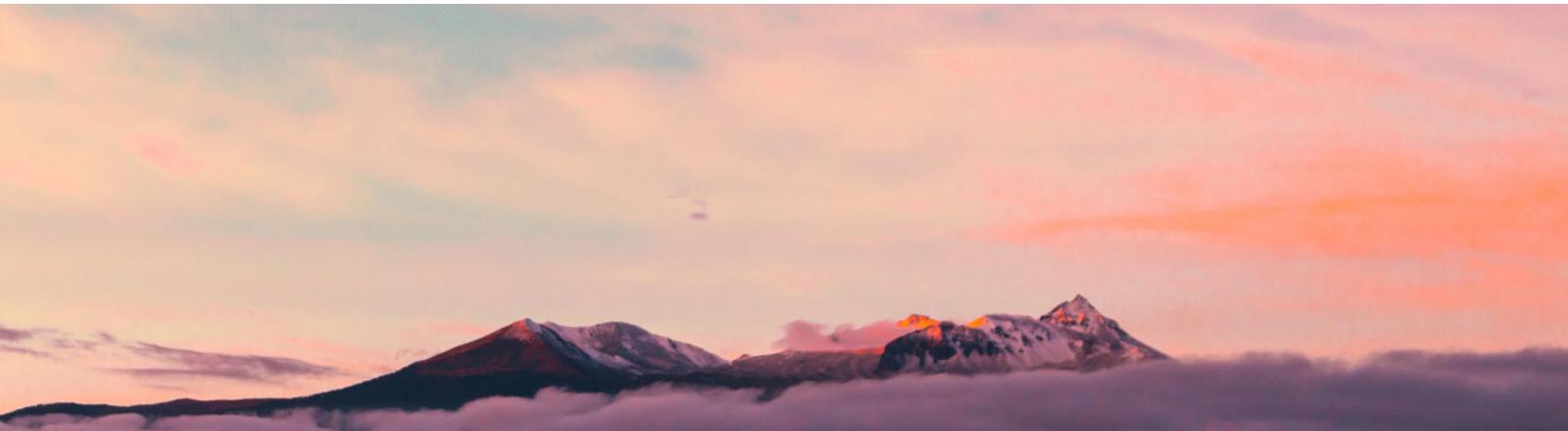


Illustration 2: Equity and liability classification flow chart

This flowchart applies to each component of a compound or hybrid financial instrument separately. Note that the flow chart above does not focus on terms that give rise to a derivative asset. A separate flow chart for equity and financial asset classification is set out in Appendix A.

In the flow chart, Question 2 refers to the exceptions in paragraphs IAS 32.16A-D and IFRIC 2. The IAS 32.16A-D exceptions apply to puttable financial instruments and instruments with an obligation to deliver a pro rata share of an entity's net assets on liquidation.

An example of a puttable financial instrument is when an entity that is a mutual fund issues units. The units are redeemable / can be put back to the fund in cash at any time. These units do not meet the definition of equity under IAS 32 because the fund has an obligation to deliver cash if the investors put their units back to the fund. However, paragraphs 16A-B provides an exception for these units to be presented as equity despite not meeting the definition of equity. IAS 32.16C-D provides an exception for certain financial instruments which contain an obligation to deliver a pro rata share of an entity's net assets only on liquidation to be classified as equity. This publication does not discuss these exceptions further as they do not usually apply to convertible notes.

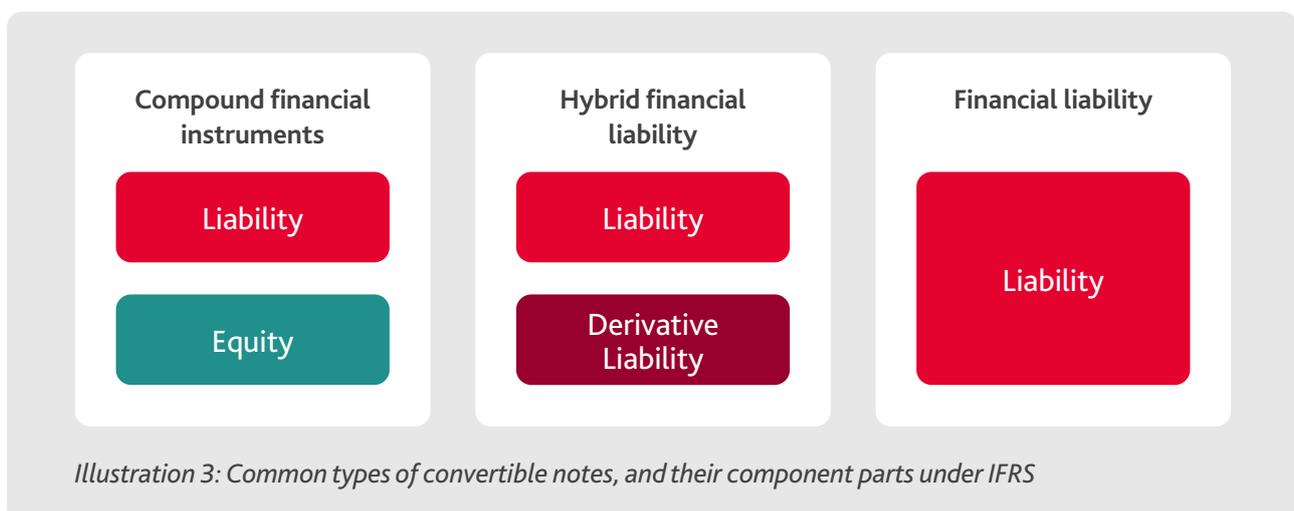


The exception in IFRIC 2 relate to members' shares in co-operative entities and similar instruments. This publication does not discuss these exceptions further as they do not usually apply to convertible notes.

Convertible notes are typically analysed as giving rise to one of the following three types of financial instruments under IFRS:

- A compound financial instrument (consisting of liability and equity components)
- A hybrid financial liability (consisting of a host liability and a derivative), or
- A financial liability in its entirety.

These three types of financial instruments and their components are also set out in the diagram below:



3.6 Measurement principles

Once the appropriate classification of the component parts of a financial instrument have been determined, it is then necessary to determine the measurement of each component.

3.6.1 Compound financial instrument

When a convertible instrument has been determined to contain a host liability and an equity component, the fair value of the liability component is determined first. This is established by using a present value calculation, i.e. the contractual stream of future cash flows is discounted at the rate of interest that would apply to an identical financial instrument without the conversion option (that is, a stand-alone loan or debt instrument). The equity component is then measured at the residual amount, by deducting the amount calculated for the liability component from the fair value of the instrument as a whole¹⁸. This is consistent with the definition of equity under which an equity instrument is a residual interest.

Although it might be thought that a valuation exercise needs to be carried out on the entire convertible note, this is not always the case. On initial recognition, except where a financial instrument is quoted on an active market (such as a listed share), the fair value of the instrument is generally its transaction price¹⁹. However, in cases where convertible notes are issued for non-monetary consideration, an entity may need to determine the value of the convertible note as a whole.

Subsequently, the financial liability is accounted for at amortised cost. The equity residual component is not remeasured.



Illustration 4: Determining the fair value components of a simple convertible note with a liability and an equity component

3.6.2 Convertible note with an embedded derivative liability²⁰

Conversion features that are derivative liabilities are typically accounted for separately from the host instrument. This is because under IFRS 9, when the economic characteristics and risks of an embedded derivative are not regarded as closely related to the economic characteristics and risks of the host debt instrument, the embedded derivative is required to be separated and accounted for separately from the host debt instrument²¹ unless the entire contract is accounted for at FVTPL.²²

In contrast to the accounting for a compound financial instrument, on initial recognition, IFRS 9 requires entities to calculate the fair value of the embedded derivative first with the residual value being assigned to the host financial liability²³.



Illustration 5: Determining the fair value components of a convertible note with a liability and an embedded derivative component

Subsequently, a conversion feature which is a derivative liability is accounted for at fair value through profit or loss (FVTPL) while the host debt liability component is accounted for at amortised cost. Section 5 sets out a detailed worked example of a convertible note with an embedded derivative liability.²⁴

¹⁸ IAS 32.31 and 32

¹⁹ IFRS 9.B5.1.1

²⁰ In some cases, the derivative could be a derivative asset, e.g. if the issuer has the right to convert a note into a variable number of its equity instruments.

²¹ IFRS 9.4.3.3

²² IFRS 9.4.3.5

²³ IFRS 9.B4.3.3

²⁴ In some cases, the derivative could be a derivative asset, e.g. if the issuer has the right to convert a note into a variable number of its own equity instruments.

One approach which can simplify the accounting is to use the fair value option in accordance with IFRS 9²⁵. Under this approach, a contract that contains one or more embedded derivatives can be accounted for in its entirety at fair value through profit or loss. Although the fair value option may appear to be attractive to avoid the complexity of accounting for components separately, it can give rise to additional volatility in amounts reported in profit or loss and OCI²⁶. This is because not only the embedded derivative(s), but also the host loan, will be measured at fair value, meaning that the fair value would be affected by factors such as changes in interest rates and the issuer's own credit rating.

3.7 Presentation and disclosure considerations

Entities also need to give consideration as to how convertible notes should be presented and disclosed in their financial statements. This section highlights the key presentation and disclosure issues that arise in practice for convertible notes.

In January 2020, the International Accounting Standards Board (IASB) issued amendments to IAS 1 *Presentation of Financial Statements*²⁷.

The amendments clarify that a liability is classified as current if it is due to be settled within 12 months after reporting period, or the entity does not have the right to defer settlement of the liability for at least 12 months after the reporting period.²⁸ The amendments further clarify that settlement refers to a transfer that results in the extinguishment of the liability, and the transfer could be of cash or the entity's own equity instruments²⁹.

However, if the contractual terms are such that, at the option of the counterparty, the liability can be settled by the entity issuing its own equity instruments, such contractual terms do not affect the current or non-current classification if the option is classified as equity under IAS 32, i.e. that settlement mechanism is disregarded for the purposes of current or non-current classification if the option to convert meets the 'fixed for fixed' equity criterion. This clarification means that if the conversion feature fails equity classification, the timing of when the holder conversion option can be exercised is relevant to the current or non-current classification. These amendments are effective for annual reporting periods beginning on or after 1 January 2023.

Embedded derivative liabilities that exist in convertible notes are subject to the requirements in IFRS 13 *Fair Value Measurement* (as well as convertible notes with embedded derivative liabilities where the issuer has elected to account for the entire instrument at FVTPL under the 'fair value option' in IFRS 9). IFRS 13 requires entities to take into account the effects of their own non-performance or credit risk when measuring the fair value of a liability³⁰. This includes the effect of both the entity's 'own credit' risk and any credit enhancements such as collateral³¹.

²⁵ IFRS 9.4.3.5

²⁶ For entities that elect to use the 'fair value option' referred to above, IFRS 9 requires fair value changes attributable to 'credit risk' to be recognised in other comprehensive income (OCI) rather than profit or loss

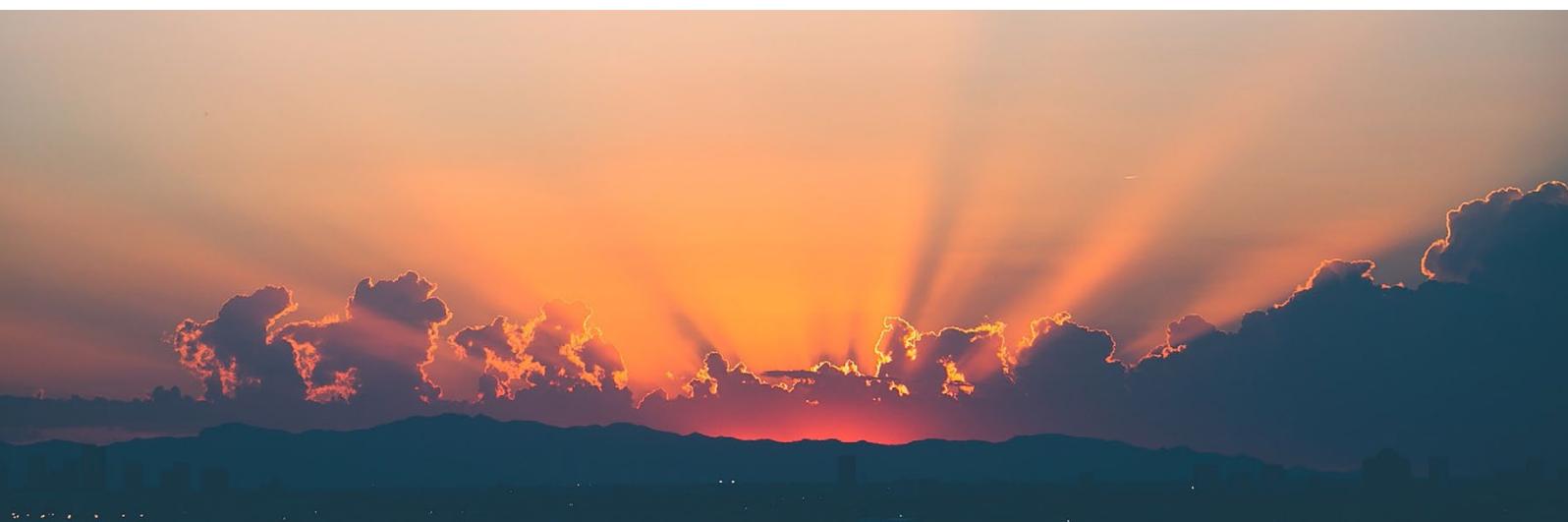
²⁷ Amendments to IAS 1 – Classification of Liabilities as Current or Non-current

²⁸ IAS 1.69(c) and (d)

²⁹ IAS 1.76A

³⁰ IFRS 13.42

³¹ IFRS 13.43



IFRS 13 also requires extensive disclosures regarding fair value. The standard establishes a three-level hierarchy for categorising inputs used to measure fair value, with the extent of disclosure differing between each level:

- Level 1: Quoted prices (unadjusted) in active markets³²
- Level 2: Inputs other than quoted that are either directly or indirectly observable³³
- Level 3: Unobservable inputs³⁴.

Measurements with level 1 inputs require less disclosure while those with level 3 inputs require the most disclosure, e.g. for level 3 fair value measurements IFRS 13 requires entities to quantify all significant unobservable inputs, as well as having to provide sensitivity analyses in narrative format³⁵.

For a convertible note that contains an embedded derivative liability feature, consideration needs to be given to whether the embedded derivative liability falls within the level 2 or level 3 fair value hierarchy. This would depend on the terms of the conversion feature and the valuation model and inputs used. Consideration also needs to be given to the source of the data (i.e. whether observable or not) and the significance of those inputs. Situations where the measurement will be classified as level 3 are:

- Where there are significant adjustments being made to market observable data
- Where valuation requires significant unobservable inputs (e.g. share price of an unlisted entity)
- Where valuation requires Monte Carlo simulations and other calibrations.

A significant input to the valuation of options is expected volatility, which is usually not observable especially for unlisted entities, so many conversion features that are derivatives are level 3 fair values. An example of where an embedded conversion feature is a level 2 fair value is where a warrant with similar terms is traded on an active exchange, and implied volatility can be observed from the listed warrants.

For entities that elect to use the fair value option referred to above, fair value changes attributable to credit risk are normally required to be recognised in other comprehensive income (OCI) rather than profit or loss in accordance with IFRS 9,³⁶

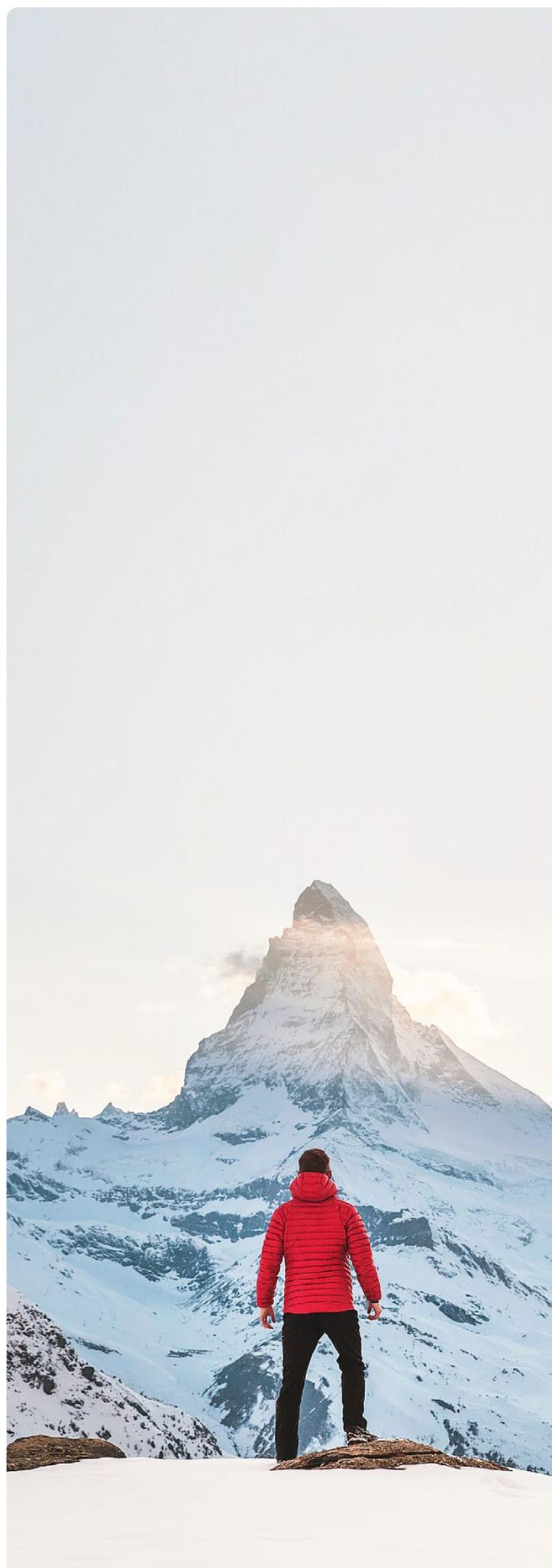
³² IFRS 13.76

³³ IFRS 13.81

³⁴ IFRS 13.86

³⁵ IFRS 13.93

³⁶ IFRS 9.5.7.7



4 Example 1 – Convertible into a fixed number of shares

This example sets out the accounting approach for a convertible note in its simplest form, which contains a financial liability and a fixed for fixed equity conversion feature.



Background

Entity A issues a CU1,000 convertible note in return for the same amount of cash consideration. The note has a maturity of three years from its date of issue. The note pays a 10% annual coupon in arrears, and, on maturity, the holder has an option either to receive a cash repayment of CU1,000 or 10,000 of the issuer's shares. The market interest rate for a note without a conversion feature would have been 12% at the date of issue.

Entity A incurred transaction costs of CU100 when it issued the convertible note.



Analysis

Each component of the convertible note needs to be assessed separately. Using the classification flow chart in Illustration 2 in section 3.5 above, each of the components and their respective classification are as follows:

Component	Analysis using the classification flow chart (Illustration 2)	Classification
Cash payment of 10% annual coupon and principal repayment of CU1,000	<p>This component is a liability because:</p> <ul style="list-style-type: none"> • There is a contractual obligation to pay cash that the issuer cannot avoid, so the answer to Question 1 is yes • The exceptions in IAS 32.16A-D and IFRIC 2 do not apply, so the answer to Question 2 is no, and • This component is not a derivative (other than a put over an entity's own equity), so the answer to Question 3 is no. 	Liability
Conversion feature to convert CU1,000 into 10,000 of the Entity A's shares	<p>Firstly, there is no contractual obligation to pay cash, so the answer to Question 1 is no, and we move on to Question 5 in the flow chart.</p> <p>This component may be settled by the entity issuing its own equity instruments if the option is exercised by the holder, so the answer to Question 5 is yes.</p> <p>This component is a derivative because:</p> <ul style="list-style-type: none"> • Its value changes in response to the Entity A's share price • It requires a net investment that is smaller than otherwise would be required (see section 3.4), and • It is settled on maturity date. <p>So the answer to Question 6 is yes.</p> <p>The derivative may be settled by Entity A exchanging a fixed amount of cash (i.e. CU1,000) for a fixed number of its own equity instruments (10,000 shares), so the answer to Question 8 is yes.</p> <p>Question 9 is N/A because the issuer does not have the option described in that question.</p> <p>Therefore, this component is equity.</p>	Equity

Illustration 5: Analysis of the terms of the financial instrument in Example 1

The above analysis of each component part means that the note is a compound instrument containing both liability and equity components.

On initial recognition, the contractual cash flows are discounted at the interest rate that would apply to a note without a conversion feature (12%)³⁷. This is in order to calculate the fair value of the liability component of the compound financial instrument.

Year	Cash flow	Amount	Discount factor at 12 %	Present value (PV) of cash flow
1	Coupon	CU100	1/1.12	CU89
2	Coupon	CU100	1/1.12 ²	CU80
3	Coupon and principal	CU1,100	1/1.12 ³	CU783
			Fair value of liability component	CU952

Illustration 6: Calculation of the present value of the liability component on initial recognition

The fair value of the financial liability component is CU952.

The fair value of the liability component is then deducted from the fair value of the compound financial instrument as a whole, with the balance being taken directly to equity³⁸.

Transaction price (fair value)	CU1,000
Less: liability component	CU(952)
Equity component (residual)	CU48

Illustration 7: Calculation of the equity component on initial recognition

The fair value of the equity component on initial recognition is therefore CU48.

4.1 Transaction costs

For compound financial instruments, IAS 32 *Financial Instruments: Presentation* requires transaction costs to be allocated to the liability and the equity components in proportion to the allocation proceeds³⁹.

- For equity: Transaction costs of an equity transaction are accounted for as a deduction from equity⁴⁰
- For financial liabilities that are not measured at fair value through profit or loss: Transaction costs are subtracted from the carrying amount of the financial liability⁴¹.

Entity A adjusts the carrying amount of the components for the CU100 incurred in transaction costs as follows:

	Transaction price (CU) (A)	Transaction costs (B)	Measurement at initial recognition (A) – (B)
Liability	CU952	CU(95)	CU857
Equity	CU48	CU(5)	CU43
Total	CU1,000	CU(100)	CU900

Illustration 8: Allocation of the transaction costs

³⁷ IAS 32.AG31

³⁸ IAS 32.31

³⁹ IAS 32.38

⁴⁰ IAS 32.37

⁴¹ IFRS 9.5.1.1

The effective interest rate is recalculated⁴² after adjusting the carrying amount of the host liability for the transaction costs. This results in the transaction costs being amortised over the term of the convertible note through an adjustment to the effective interest rate, which increases the rate to 16.41%. Entity A therefore records interest expense at the effective interest rate of 16.41%.

The difference between the total interest expense (16.41%) and the cash coupon actually paid (10%) increases the carrying amount of the liability so that, on maturity, the carrying amount is equal to the cash repayment that might be required to be made.

The following table shows the balance of the liability component over the life of the loan, and immediately prior to settlement.

	Beginning balance	Interest expense @ 16.41%	Cash coupon @ 10%	Closing balance
Year 1	CU857	CU141	CU(100)	CU898
Year 2	CU898	CU147	CU(100)	CU945
Year 3	CU945	CU155	CU(100)	CU1,000

Illustration 9: Amortised cost table for the liability component of the financial instrument in Example 1 after taking into account transaction costs

4.2 Current or non-current classification

Under the amendments to IAS 1 (see section 3.7), the components of the compound financial instrument are classified as follows:

Component	Classification	Rationale
Financial liability (principal amount)	Non-current liability	Applying IAS 1.76B, the conversion feature, which may be exercised by the holder at any time, does not affect the note's classification as current or non-current because the conversion feature is classified as an equity instrument. The principal and accrued interest are not due for 5 years, therefore, Entity A has the right to defer settlement for at least twelve months ⁴³ .
Financial liability – accrued but unpaid coupon due in the next 12 months	Current liability	Accrued but unpaid coupon is not convertible into shares, therefore, its classification is unaffected by the conversion feature. The coupon is payable annually in arrears, therefore, Entity A does not have the right to defer settlement for at least twelve months ⁴⁴ .
Equity component – conversion feature	N/A – equity	Equity is not classified as current or non-current.

Illustration 10: Current and non-current classification of the compound convertible note in Example 1

The amendments to IAS 1 are effective for annual reporting periods beginning on or after 1 January 2023.

⁴² The effective interest is the discount rate that exactly discounts future cash flows to the initial carrying amount of the host liability. (IFRS 9.Appendix A)

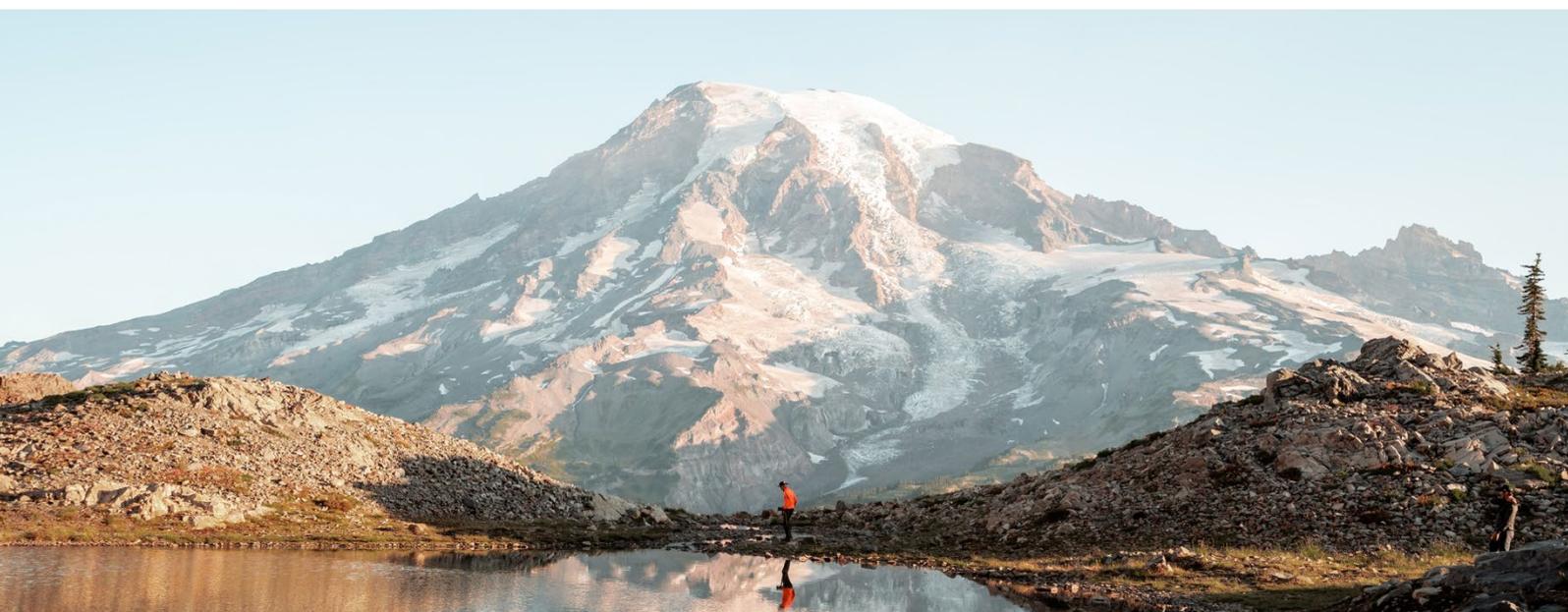
⁴³ IAS 1.69(d)

⁴⁴ IAS 1.69(d)

4.3 Conversion on maturity

Assume that, at the end of Year 3, the holder elects to receive shares. Entity A derecognises the liability (CU1,000) and recognises an increase in equity of the same amount. No gain or loss would be recorded on conversion⁴⁵. Conversely, if the holder elects to receive cash, Entity A simply derecognises the liability CU1,000 and recognises a corresponding decrease in cash of CU1,000.

It can be seen from this example that, when the conversion feature is classified as equity, it is not remeasured. In addition, even if the conversion option is not exercised, the amount recorded in equity is not reclassified (or 'recycled'), although it can be transferred from one equity reserve to another. The only item that affects profit or loss is the recognition of interest expense at the effective interest rate for the liability component.



4.4 Deferred taxes

In most jurisdictions, only the coupon cash payment (10% in this example) and transaction costs would be tax deductible and it is unlikely that a tax deduction will be received for the total interest expense recorded under the effective interest method (16.41% in this example)⁴⁶. Therefore, deferred tax arises from the temporary difference between the carrying value of the liability component and the tax base of the liability for tax purposes.

If Entity A is subject to a 30% tax rate and assuming that transaction costs of CU100 are also deductible evenly over the life of the loan, then a deferred tax liability of CU13 ((CU900-CU857) *30%) should be recognised on initial recognition with a corresponding entry to equity⁴⁷.

Under IAS 12 *Income Taxes*, the tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods.⁴⁸

	Inception	Year 1	Year 2	Year 3
Amount of liability	CU1,000	CU1,000	CU1,000	CU1,000
Amount deductible in future periods	CU100	CU67	CU33	0
Tax base of liability	CU900	CU933	CU967	CU1,000

Illustration 11: Tax base of the liability component

⁴⁵ IAS 32.AG32

⁴⁶ Note that the deferred taxes effects will depend on the tax treatment in the relevant jurisdiction and may not be the same as described.

⁴⁷ The initial recognition exemption in IAS 12 does not apply because the resulting taxable temporary difference arises from the initial recognition of the equity component separately from the liability component. (IAS 12.23)

⁴⁸ IAS 12.8

The carrying amounts of the liability component, and the associated tax effects over the life of the note, are summarised below:

	Inception	Year 1	Year 2	Year 3
Carrying value of liability	CU857	CU898	CU945	CU1,000
Tax base of liability	CU900	CU933	CU967	CU1,000
Temporary difference	CU43	CU35	CU22	0
Deferred tax liability (30%)	CU13	CU11	CU7	0

Illustration 12: Carrying amount, tax base and the deferred tax liability of the liability component

The journal entries on initial recognition to account for the effects of deferred tax are therefore:

Dr Equity CU13
 Cr Deferred tax liability CU13

To recognise deferred tax effects due to the difference in carrying amount of the liability and its tax base

Subsequent changes in the deferred tax liability are recognised in profit or loss as deferred tax expense (income)⁴⁹. So for example, the journal entries at the end of year 1 are:

Dr Deferred tax liability CU2
 Cr Tax expense CU2

To recognise the changes in the deferred tax liability as tax income



4.5 Early conversion

Some convertible notes contain 'American type' conversion features where the holder is allowed to convert the note for shares at any time before the note's maturity date.

In practice, it has been widely interpreted that for such a conversion feature, the conversion date (regardless of what that date happens to be) is the instrument's maturity date. This is because 'maturity' means any date on which the holder can exercise the conversion option in accordance with the convertible note's contractual terms.

Consequently, the accounting described at maturity date also applies to 'American type' options regardless of when the holder elects to convert, with the carrying value of the liability component being transferred to equity, and no gain or loss is recognised on conversion i.e. the issuer would not recognise an acceleration of interest and accrete the carrying amount of the liability to its face value / redemption amount.

Assume that in Example 1, the holder can exercise its option to convert the note into shares at any time before the note's maturity date, and the holder elects to convert early at the end of year 2. The carrying amount of the liability is CU945 at the end of year 2. The journal entries are

Dr Equity	CU945	
	Cr Liability	CU945

To transfer the carrying amount of liability to equity for the early conversion of the note into shares

4.5.1 Additional consideration offered to encourage early conversion

In some situations, to encourage early conversion, an entity may amend the terms to induce the holder to convert the notes immediately. IAS 32⁵⁰ states:

An entity may amend the terms of a convertible instrument to induce early conversion, for example by offering a more favourable conversion ratio or paying other additional consideration in the event of conversion before a specified date. The difference, between the fair value of the consideration the holder receives on conversion under the revised terms and the fair value of the consideration the holder would have received under the original terms is recognised as a loss in profit or loss.

Offering additional shares to encourage early conversion

Following on from Example 1 above, assume that at the end of Year 2, Entity A is struggling to pay interest and will not be able to redeem the note for cash. It offers an additional 10,000 shares to the holder to encourage early conversion, i.e. the holder will receive an additional 10,000 shares if it agrees to convert the convertible note immediately rather than at the predetermined conversion option date. At the time of the offer of early conversion the share price is CU0.70.

Entity A would recognise CU7,000 (10,000 × CU0.70) as an expense with a corresponding increase in equity (because the entity has entered into an obligation to deliver a fixed number of shares). This means that the accounting effect is the same as if Entity A had granted a share-based payment of 10,000 shares with immediate vesting. IFRS 2 *Share-based Payment* would require an immediate charge of CU7,000.

Offering additional cash to encourage early conversion

Instead of offering additional shares to encourage early conversion, an entity may offer additional cash payment to encourage the holder to convert the note into shares early (for example, because the entity will have difficulty in paying future coupon interest payments and will not be able to repay the note for cash on its maturity).

Following on from Example 1, assume that at the end of Year 2, Entity A amends the terms of the note to pay an additional CU100 if the holder chooses to convert early. To account for the amendment, Entity A would recognise an expense of CU100 and an additional financial liability of CU100 at the time of the amendment⁵¹. The journal entry is:

Dr Expense	CU100	
	Cr Liability	CU100

To account for the additional cash offered to encourage early conversion

If the holder chooses to convert the note to shares, the carrying amount of the host liability would be transferred to equity with no gain or loss. Entity A would also pay CU100 to the holder and derecognise the related financial liability which arose from the additional compensation for the early conversion.

If the holder subsequently did not exercise its option to convert early, the entity would derecognise the liability and recognise a gain for the elimination of the obligation to pay the inducement.

4.6 Early repurchase

If an issuer repurchases a compound convertible note before maturity date, the consideration paid (i.e. the repurchase price) is allocated to the liability and equity components⁵². This is achieved by determining the fair value of the liability at the repurchase date, and the residual amount is attributed to the equity component.

The difference between the carrying amount and the fair value of the liability at the repurchase date is accounted for as the cost of redeeming the liability

Note that, if the option to repurchase the loan early is included in the original terms of the note at inception, on initial recognition, the issuer needs to consider whether this early repurchase option is closely related to the liability component, and the accounting may be different on redemption.

⁵¹ Any required discounting has been ignored

⁵² IAS 32.AG33



5 Example 2 – Convertible notes with an embedded derivative liability



Background

Entity B issues a CU1,000 note in return for the same amount of cash consideration. The note has a maturity of three years from its date of issue. The note pays a 10% annual coupon and, the holder has an option either to receive a cash repayment of CU1,000 or to convert the note into Entity B's shares, at any time. Entity B incurs transaction costs of CU100 on issue of the notes.

If the conversion option is exercised, the note will convert into Entity B's shares using the average of the lowest five days' volume weighted average price (VWAP) in the previous 30 days prior to maturity or conversion.

The conversion feature is determined to have a fair value of CU20 at issue date.



Analysis

Each component of the convertible note needs to be assessed separately. Using the classification flow chart in Illustration 2 in section 3.5 above.

Component	Analysis using the classification flow chart (Illustration 2)	Classification
Cash payment of 10% annual coupon and principal repayment of CU1,000	<p>This component is a liability because:</p> <ul style="list-style-type: none"> • There is a contractual obligation to pay cash that the issuer cannot avoid, so the answer to Question 1 is yes • The exceptions in IAS 32.16A-D and IFRIC 2 do not apply, so the answer to Question 2 is no, and • This component is not a derivative (other than a put over an entity's own equity), so the answer to Question 3 is no. 	Liability
Conversion feature to convert CU1,000 into Entity B's shares based on the average of the lowest 5 days VWAP in the previous 30 days	<p>Firstly, there is no contractual obligation to pay cash, so the answer to Question 1 is no, and we move on to Question 5 in the flow chart.</p> <p>This component may be settled by the entity issuing its own equity instruments, if the conversion option is exercised by the holder, so the answer to Question 5 is yes.</p> <p>This component is a derivative because:</p> <ul style="list-style-type: none"> • Its value changes in response to Entity B's share price and the lowest 5 day VWAP in the previous 30 days • It requires a net investment that is smaller than otherwise would be required (see section 3.4), and • It is settled at a future date. <p>So the answer to Question 6 is yes.</p> <p>The derivative may be settled by Entity A exchanging a fixed amount of cash (i.e. CU1,000) but for a variable number of its own equity instruments. The number of shares to be issued will depend on the lowest 5 day VWAP in the last 30 days prior to maturity so the answer to Question 8 is therefore no. This component is a derivative liability, and we move on to Question 10.</p> <p><i>continuation</i></p>	Derivative liability

continuation

Component	Analysis using the classification flow chart (Illustration 2)	Classification
Conversion feature to convert CU1,000 into Entity B's shares based on the average of the lowest 5 days VWAP in the previous 30 days	The derivative liability is not closely related because the value of the derivative is driven by Entity B's share price and the lowest 5 day VWAP in the previous 30 days, whereas the value of the liability host is driven by market interest rates and Entity B's credit risk, so the answer to Question 10 is no . The derivative liability is therefore accounted for separately from the host liability contract.	Derivative liability

Illustration 13: Analysis of the terms of the financial instrument in Example 2

The above analysis of each component parts means that the note is a hybrid financial instrument containing a debt host liability and an embedded derivative liability that is separately accounted for.

For convertible notes with embedded derivative liabilities, the fair value of the embedded derivative liability is determined first and the residual amount is assigned to the debt host liability⁵³. Therefore, the debt host liability is initially recognised at CU980 being the residual amount derived by deducting the fair value of the derivative liability from the transaction price (i.e. CU1,000 less CU20).

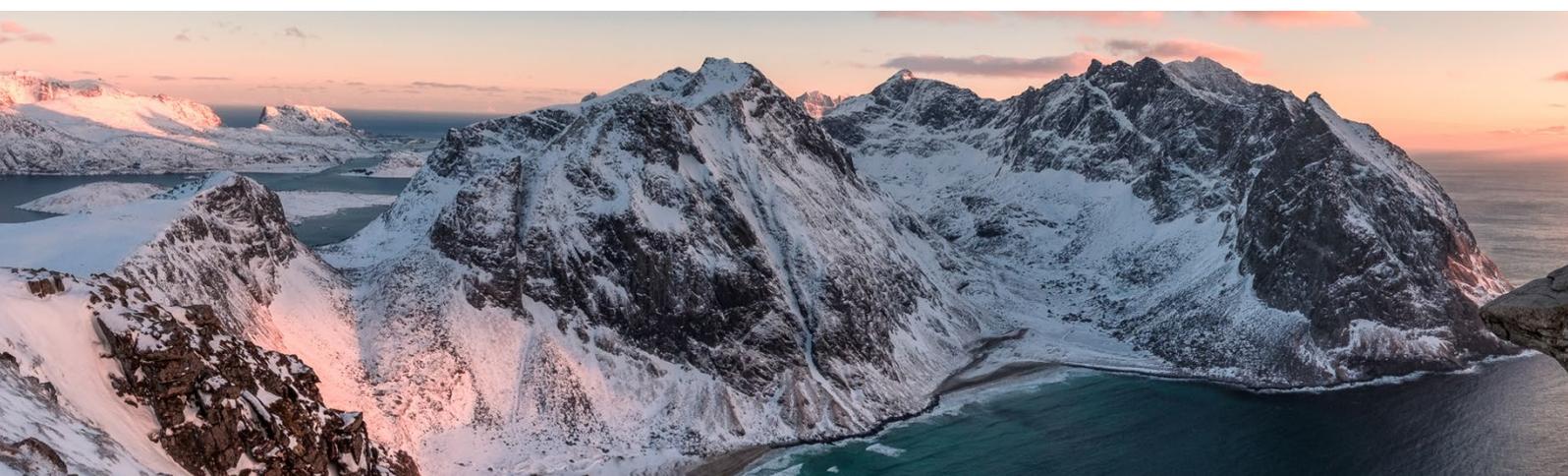
5.1 Transaction costs

Transaction costs are required to be apportioned to the debt liability and the embedded derivative in proportion to the allocation proceeds. The portion attributed to the conversion feature is expensed immediately, because transaction costs are expensed immediately for all financial instruments measured at fair value through profit or loss including derivatives⁵⁴. For the portion of transaction costs that are attributed to the loan (which will be measured at amortised cost), these are subtracted from the carrying amount of the financial liability and amortised as part of the effective interest rate⁵⁵.

Entity B adjusts the carrying amount of the liability component for transaction costs incurred as follows:

	Transaction price	Transaction costs	Carrying amount
Liability	CU980	CU(98)	CU882
Derivative liability	CU20	CU(2) – profit or loss ⁵⁶	CU20
Total	CU1,000	CU(100)	CU902

Illustration 14: Allocation of transaction costs



⁵³ IFRS 9.B4.3.3

⁵⁴ IFRS 9.5.1.1

⁵⁵ IFRS 9.5.1.1

⁵⁶ CU2 of transaction costs in relation to the derivative liability component are expensed immediately in profit or loss.

5.2 Accounting for the host debt liability

The effective interest rate is recalculated after adjusting for the transaction costs, and for the host liability component it is 15.18 %⁵⁷. Entity B will therefore record interest expense at the effective interest rate (15.18%). The difference between interest expense (15.18%) and the cash coupon (10%) increases the carrying amount of the liability so that, on maturity, the carrying amount is equal to the cash payment that might be required to be made. The following table shows the balance of the liability component over the life of the loan, and immediately prior to settlement.

	Beginning balance	Interest expense (15.18%)	Cash coupon (10%)	Closing balance
Year 1	CU882	CU134	CU(100)	CU916
Year 2	CU916	CU139	CU(100)	CU955
Year 3	CU955	CU145	CU(100)	CU1,000

Illustration 15: Amortised cost table for the liability component of the financial instrument in Example 2 after deducting for transaction costs.

5.3 Accounting for the derivative liability

The fair value of the conversion feature would have to be determined at each reporting date and the changes in fair value would be recognised in profit or loss. The following table sets out the effect on profit or loss assuming the following fair values at each year end:

	Fair value of conversion feature	Profit or loss effect (Dr) / Cr
Year 1	CU(100)	CU(80)
Year 2	CU(10)	CU90
Year 3	CU(300)	CU(290)

Illustration 16: Fair value of the derivative liability and the amount recognised in profit or loss at end of Years 1, 2 and 3.

Thus, if the conversion feature is classified as a derivative liability, this will often lead to a significantly higher and more volatile expense pattern in profit or loss. This is because a derivative liability is remeasured to fair value at each reporting date, whereas if the conversion feature is classified as equity, no re-measurement of the conversion feature is required or permitted.

5.4 Accounting for the contract as a whole at fair value through profit or loss

As noted in section 3.6.2, one approach which can simplify the accounting is to use the 'fair value option' under IFRS 9⁵⁸.

Under this approach, a contract that contains one or more embedded derivatives, can be accounted for in its entirety at fair value through profit or loss. This means that on initial recognition there would be no need to separate the convertible note into a host liability component (accounted for at amortised cost) and a derivative liability component (accounted for at fair value through profit or loss).

If the election is made, all transaction costs incurred in relation to the note would be recognised in profit or loss immediately, rather than a portion being offset against the host liability component⁵⁹. Subsequent changes in fair value of the combined financial instrument are recognised in profit or loss, with the exception of changes in fair value attributable to changes in the credit risk, which are typically recognised in other comprehensive income (OCI)⁶⁰.

⁵⁷ Determined by establishing the rate that is required to discount the contractual cash flows back to the carrying amount, as adjusted for transaction costs. See IFRS 9, Appendix A for definition of effective interest rate.

⁵⁸ IFRS 9.4.3.5

⁵⁹ IFRS 9.5.1.1

⁶⁰ IFRS 9.5.7.7

5.5 Current or non-current classification

In accordance with the amendments to IAS 1 (see section 3.7), which are effective for annual reporting periods beginning on or after 1 January 2023, the components of the hybrid note would be classified as follows:

Component	Classification	Rationale
Financial liability at amortised cost	Current liability	Applying IAS 1.76B, the conversion feature, which may be exercised by the holder at any time, does affect the note's classification as current or non-current because the conversion feature is not classified as an equity instrument. As the option may be exercised at any time, the entity does not have the right to defer settlement of the liability for at least twelve months ⁶¹ .
Financial liability – accrued but unpaid coupon due in the next 12 months	Current liability	Accrued but unpaid coupon is not convertible into shares, therefore, its classification is unaffected by the conversion feature. Coupon is payable annually in arrears, therefore, Entity A does not have the right to defer settlement for at least twelve months ⁶² .
Derivative liability – conversion feature	Current liability	The conversion feature may be exercised by the holder at any time, and therefore, Entity B does not have the right to defer its settlement for at least twelve months. ⁶³

Illustration 17: Current and non-current classification of the hybrid convertible note in Example 2

5.6 Early conversion

Early conversion for hybrid convertibles notes

Where the original terms of the note permit the holder to convert at any time before maturity, and the note is subsequently converted early at the holder's option, the conversion date is deemed to be the instrument's maturity date as discussed in section 4.5 above. Consequently, the carrying amount of the host liability (at amortised cost, updated to the date of conversion) together with carrying amount of the derivative liability, which is remeasured to fair value immediately before conversion, is transferred to equity such that no gain or loss is recognised on settlement.

Early conversion for hybrid convertibles notes accounted for at fair value through profit or loss

If the issuer has elected to account for the entire convertible note at fair value through profit or loss, then the entire note is remeasured to fair value as at the date of conversion (with the difference between the existing carrying amount and the fair value on conversion date being recognised in profit or loss). The fair value of the note is then transferred to equity.

⁶¹ IAS 1.69(d)

⁶² IAS 1.69(d)

⁶³ IAS 1.69(d)

6 Further scenarios where the conversion feature fails equity classification

In addition to the example in section 5 above, there are many other scenarios in practice where the conversion feature fails equity classification. This is often because the 'fixed for fixed' criterion in IAS 32 *Financial Instruments: Presentation* is not met. This section highlights some of the more common scenarios that are encountered in practice.

6.1 Conversion price based on the issuer's share price at conversion date

Conversion terms that allow the holder to convert a convertible note into the number of shares equal to the carrying amount of the note at maturity results in a contractual obligation to deliver a variable number of its own equity instruments and therefore it is a financial liability (IAS 32.11(b)(i)).

In this case a variable number of shares will be issued to extinguish a fixed liability amount. The definition of a financial liability in 11(b)(i) of IAS 32 states that a non-derivative for which the entity is or may be obliged to deliver a variable number of shares is a financial liability. The conversion feature is not a derivative because its value does not vary in response to changes in the issuer's share price. Instead, the issuer is using its shares as a 'currency' to settle the obligation.

These types of notes typically only contain a liability component, being the fair value of the cash coupon and the carrying amount of the note (an example of this type of convertible note is set out in section 9.1 below).

6.2 Variable conversion price limited to a 'cap' and/or a 'floor'

Some convertible notes contain provisions that limit the variability of the conversion price within a certain range. These provisions can set an upper or lower limit to the conversion price ('cap' or 'floor'), or they can set both an upper and a lower limit to the conversion price (often referred to as a 'collar').

These notes have a potential to convert to either a variable or a fixed number of shares depending on the share price, and this violates the 'fixed for fixed' criterion for equity classification. The options embedded in these conversion features are accounted for as embedded derivative liabilities.

In May 2014 the IFRS Interpretations Committee discussed how an issuer would account for a convertible note where the note mandatorily converts into a variable number of shares subject to a cap and a floor.

The Interpretations Committee considered an example where an entity issues a convertible note for CU1,000 with a stated maturity date of three years. The instrument has a fixed interest rate and interest is payable annually (in cash). At maturity, the issuer must deliver a variable number of its own equity instruments equal in value to CU1000 - subject to a maximum of 130 shares and a minimum of 80 shares. This means that the holder is guaranteed a fixed minimum number of shares to be delivered (i.e. 80 shares). The holder of the instrument is not exposed to equity price risk if the share price is between CU7.70 and CU12.50 per share at maturity (because the note will always convert to the value of CU1,000 when the share price is within this range).



The Interpretations Committee noted that the issuer's obligation to deliver a variable number of its own equity instruments is a non-derivative that meets the definition of a financial liability in paragraph 11(b)(i) of IAS 32 in its entirety. Paragraph 11(b)(i) states that 'a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments' is a financial liability. The Committee further noted that paragraph 11(b)(i) does not have any limits or thresholds regarding the degree of variability that is required. Therefore, the contractual substance of the instrument is a single obligation to deliver a variable number of equity instruments at maturity, with the variation based on the value of those equity instruments. Such a single obligation to deliver a variable number of own equity instruments cannot be subdivided into components for the purposes of evaluating whether the instrument contains a component that meets the definition of equity. Even though the number of equity instruments to be delivered is limited and guaranteed by the cap and the floor, the overall number of equity instruments that the issuer is obliged to deliver is not fixed and therefore the entire obligation meets the definition of a financial liability.

Furthermore, the Interpretations Committee noted that the cap and the floor are embedded derivative features whose values change in response to the price of the issuer's shares. Therefore, assuming that the issuer has not elected to designate the entire instrument under the fair value option, the issuer must separate those features and account for them separately from the host liability contract at fair value through profit or loss.

6.3 Issuer's option to settle in a fixed number of shares is not substantive

Even if the terms of the convertible note contain an option for the issuer to issue a fixed number of shares to settle the obligation, which therefore prima facie meets the criteria for equity classification, the issuer cannot simply assume that those criteria are met. Consideration needs to be given as to whether such a settlement option is substantive.

In January 2014, the IFRS Interpretations Committee discussed a fact pattern where a convertible note is mandatorily convertible into a variable number of shares (subject to a cap and a floor) but gives the issuer the option to settle by delivering the maximum (fixed) number of shares. The terms of the convertible note considered are the same as those discussed in section 6.2 above. However, in addition to those terms, the issuer also has the contractual right to settle the instrument at any time before maturity by:

- Delivering the maximum number of shares specified in the contract (i.e. 130 shares), and
- Pay (in cash) all of the interest that would have been payable if the instrument had remained outstanding until its maturity date.

The Interpretations Committee noted that the issuer cannot assume that a financial instrument (or its components) meets the definition of an equity instrument simply because the issuer has the contractual right to settle the financial instrument by delivering a fixed number of its own equity instruments.

Judgement will be required to determine whether the issuer's early settlement option is substantive⁶⁴ and thus should be considered in determining how to classify the instrument. If the early settlement option is not substantive, that term would not be considered in determining the classification of the financial instrument.

The Interpretations Committee noted that the guidance in IAS 32.20(b) is relevant because it provides an example of a situation in which one of an instrument's settlement alternatives is excluded from the classification assessment. Specifically, the example in that paragraph describes an instrument that the issuer will settle by delivering either cash or its own equity instruments whose value is determined to exceed substantially the value of the cash. IAS 32.20(b) states that although the entity does not have an explicit contractual obligation to deliver cash or another financial asset, the value of the share settlement alternative is such that the entity will settle in cash. The holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option.

The Interpretations Committee noted that to determine whether the early settlement option is substantive, the issuer will need to understand whether there are actual economic or other business reasons that the issuer would exercise the option.

In making that assessment, the issuer could consider, along with other factors, whether the instrument would have been priced differently, at initial recognition, if the issuer's early settlement option had not been included in the contractual terms. Factors such as the term of the instrument, the range between the cap and the floor, the issuer's share price and the volatility of the share price could be relevant to the assessment of whether the issuer's early settlement option is substantive. For example, the early settlement option may be less likely to have substance especially if the instrument is short-lived, the range between the cap and the floor is wide and the current share price would equate to the delivery of a number of shares that is close to the floor (ie the minimum). That is because the issuer may have to deliver significantly more shares to settle early than it may otherwise be obliged to deliver at maturity.

6.4 Down round features

A down round feature is an anti-dilution provision that adjusts the conversion ratio if, after a convertible instrument is issued, there is an issue of shares at a price that is less than the conversion price. Other anti-dilution provisions are discussed in sections 7.2 and 7.2.2.

Convertible note with a down round provision

As an example, Entity C issues a face value CU1,000 note which has a maturity of three years from its date of issue. The note pays a 10% annual coupon and, unless converted into shares, will be repaid in cash on maturity. The holder has an option exercisable at any point to convert the note into the issuer's shares, at CU1.00 per share. However, if shares are issued for less than CU1.00 during the outstanding term of the note, then the conversion price is reset to the new share issue price. The purpose of such a clause is to protect the noteholder from dilution in the value of its conversion option at CU1.00 per share.

When accounting for this type of the note, the existence of the down round feature modifies the potential number of shares to be issued to a variable number and therefore as a whole, the conversion feature has violated the 'fixed for fixed' criterion for equity classification. The note contains two embedded derivative features, being 1) CU1.00 conversion option and 2) the down round feature. These two features are accounted for as a single instrument, as the two features are linked and the exercise of one of them automatically results in the lapse of the other.⁶⁵

Preference shares with a down round provision

Consider another example where an entity issues 100 preference shares for CU1,000 cash consideration. The preference shares are classified as equity because they contain no contractual obligation to pay cash (i.e. the preference shares are non-redeemable without cumulative or mandatory dividends). The preference shares convert at the option of the holder into ordinary shares on a 1:5 basis. The conversion ratio is adjusted accordingly if there are any subsequent new issuance of shares below the conversion price (i.e. CU2). The issuance of new shares is within the control of the entity. There is no obligation to redeem the preference shares in cash and there are no other features that would cause the preference shares to be classified as financial liabilities.

In our view, two approaches may be adopted by an entity, either of which is acceptable as long as an entity adopts a consistent accounting policy in accordance with the requirements of IAS 8.

Acceptable Approach A – the entire preference share is classified as an equity instrument and no embedded derivative accounting is required

One way to account for the preference share is to take the view that the entire preference share is considered a non-derivative instrument as a whole and that IAS 32.16(b)(i) applies⁶⁶.

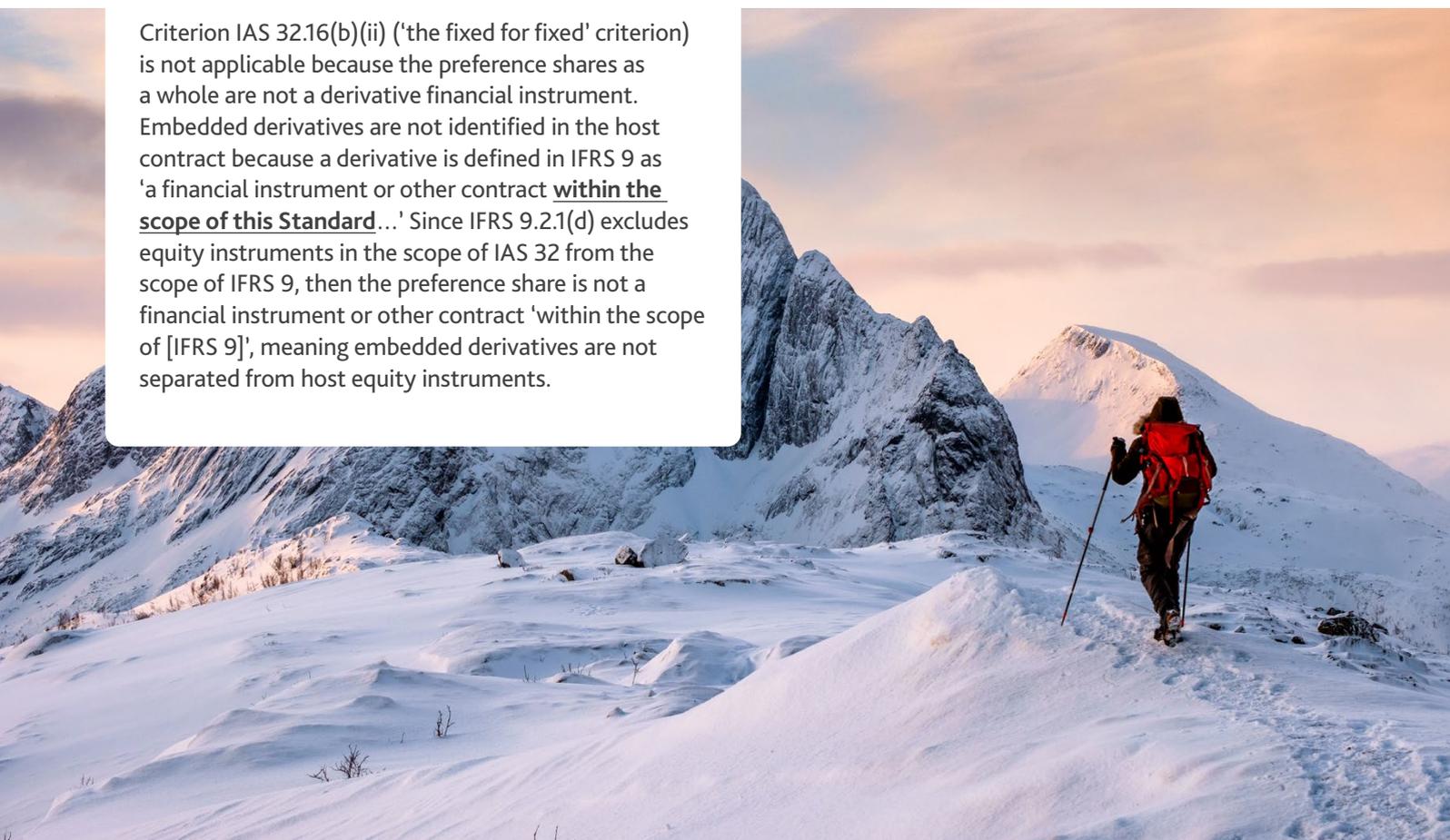
This view argues that the preference shares meet the definition of equity because there is no contractual obligation to issue a variable number of its own equity instruments (i.e. the entity is not obliged to issue a variable number of its own equity instruments i.e. the answer to Questions 7 and 9 in the flow chart in section 3.5 is no). This is because the issuance of the new shares (which would trigger the down round provision) is within the control of the entity, as the entity can decide whether to issue additional preference shares.

It is not relevant whether the entity may be economically compelled to issue additional preference shares because IAS 32.16(b)(i) specifies only a contractual obligation would result in the preference shares failing equity classification.

Criterion IAS 32.16(b)(ii) ('the fixed for fixed' criterion) is not applicable because the preference shares as a whole are not a derivative financial instrument. Embedded derivatives are not identified in the host contract because a derivative is defined in IFRS 9 as 'a financial instrument or other contract within the scope of this Standard...' Since IFRS 9.2.1(d) excludes equity instruments in the scope of IAS 32 from the scope of IFRS 9, then the preference share is not a financial instrument or other contract 'within the scope of [IFRS 9]', meaning embedded derivatives are not separated from host equity instruments.

Acceptable Approach B – the preference share is classified as an equity instrument and an embedded derivative is accounted for separately from the host instrument

An alternative accepted view is that the conversion feature (including the down round provision) is a derivative that violates the 'fixed for fixed' requirement for equity classification because conversion is at the option of the holder and the adjustment to the conversion price results in the potential number of shares to be delivered to be a variable number. The conversion feature is not closely related to the equity instrument, because of the inverse relationship between the share price and the value of the conversion feature, i.e. the lower the share price the greater number of ordinary shares that the preference shareholders will receive. Therefore, the conversion feature should be separately accounted for as an embedded derivative at fair value through profit or loss from the host equity contract (being the preference shares).



⁶⁶ Under IAS 32.16, an instrument is classified as equity if the instrument has (a) no contractual obligation to deliver cash and (b)(i) it is a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments.

6.5 Convertible note denominated in a foreign currency

It is not uncommon for international companies to raise funds via convertible notes issued in a currency other than their functional currency.

Although the amount to be settled may be fixed in the foreign currency, when converted back to the entity's functional currency it results in a variable amount of cash (that is, a variable carrying amount for the financial liability that arises from changes in exchange rates), and hence failure of the 'fixed for fixed' criterion for equity classification. The conversion feature is a derivative liability, with the value of the conversion feature dependent on foreign exchange rates. This means that the foreign exchange conversion option feature is an embedded derivative that must be accounted for separately accounted for in accordance with IFRS 9 (an example of this type of convertible note and the details of the accounting approach is set out in section 9.2 below).

6.6 Conversion into a fixed percentage of the issuer's shares

Some convertible notes may allow conversion into a fixed percentage of the issuer's outstanding shares (albeit for a fixed amount of cash). For example, Entity A issues a convertible note with face value of CU500,000 that is convertible, at the holder's election, into Entity A's shares. The number of shares to be received on conversion represent 20% of the Entity A's outstanding shares at conversion date.

Under such terms, the number of shares to be converted is not fixed and is not known until conversion occurs. This is because the issuer's capital structure could change (due to the new shares being issued or repurchased) during the life of the convertible note. The convertible note holder could be in a better economic position relative to other shareholders, because if there is a new issue of shares, the relative rights of existing shareholders would be diluted whereas the relative rights of the noteholder would be maintained. Consequently, such a clause would fail the 'fixed for fixed' requirement for equity classification.

However, careful review is needed of the precise terms and conditions of this type of anti-dilution clause because the overall terms of the arrangement may in fact simply maintain the relative rights of existing equity shareholders. In such cases, the 'fixed for fixed' requirement is met. (See sections 7.2 and 7.2.2).

6.7 Issuer settlement options on conversion

Some convertible notes give the issuer a choice as to the manner of settlement if the holder elects to convert to shares (i.e. either in shares or in cash to the equivalent value of the shares).

For example, consider a convertible note that contains a provision whereby, if the holder chooses to convert into a fixed number of shares at maturity, the issuer then has a choice of settling the obligation by either delivering the fixed number of shares or delivering cash equal to the fair value of the fixed number of shares on conversion date.

This conversion feature gives rise to an embedded derivative liability because paragraph 26 of IAS 32 states that:

When a derivative financial instrument gives one party a choice over how it is settled ..., it is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument.

In the example, because there is a cash settlement alternative, this means that the conversion feature is a derivative liability⁶⁷. The conversion feature meets the definition of a derivative because the settlement value changes in response to changes in the share price. Consequently, such convertible notes are hybrid instruments containing a host debt liability component and an embedded derivative liability.

7 Scenarios where the conversion feature may still meet equity classification

Some conversion terms initially appear to have breached the 'fixed for fixed' criterion. However, in some cases, equity classification may still be appropriate. This chapter highlights some of the more common convertible notes to which this applies.

7.1 Principal amount plus accrued interest

In addition to granting the holder the option to convert the principal amount into a fixed number of shares, some conversion features:

- Grant the holder the option to receive a fixed rate coupon payment in cash or to convert the accrued interest into additional shares at a fixed conversion rate, or
- Grant the holder a pre-set number of additional shares on each anniversary date of the note being issued.

Questions arise as to whether these terms result in the instrument failing the 'fixed for fixed' criterion, since the number of shares to be converted is variable dependent on the passage of time.

In practice, the usual treatment for an instrument with these terms is to conclude that the 'fixed for fixed' criterion is met. This is because the number of shares is predetermined at the outset and the only variable is the passage of time. The additional shares issued at each anniversary date are considered as a series of predetermined fixed issues.

In contrast, an arrangement in which the coupon is a benchmark variable interest rate would fail equity classification. This is because the arrangement contains an additional variable feature (the variable interest rate) which means that the number of shares to be issued in the future will vary in response to changes in benchmark variable interest rates.

As an example, Entity A issues two convertible notes with a four-year maturity for cash proceeds of CU 10 million each. Each note is convertible into ordinary shares of the issuer, at the option of the convertible note holder, at the end of years 1, 2, 3 and 4. If the notes are not converted, the principal amount plus accrued interest will be repaid in cash at the end of year 4. The conversion terms of the two notes are:

Note 1:

- End of year 1: 1.10 shares per CU1 of convertible note
- End of year 2: 1.21 shares per CU1 of convertible note
- End of year 3: 1.33 shares per CU1 of convertible note
- End of year 4: 1.46 shares per CU1 of convertible note.

If the convertible note holder does not exercise the conversion option at the end of year 4, Entity A is required to redeem the note for a cash payment of CU 14.6 million.

Note 2:

- End of year 1 $(1 + \text{LIBOR})^1$ shares per CU1 of convertible note
- End of year 2 $(1 + \text{LIBOR})^2$ shares per CU1 of convertible note
- End of year 3 $(1 + \text{LIBOR})^3$ shares per CU1 of convertible note
- End of year 4 $(1 + \text{LIBOR})^4$ shares per CU1 of convertible note.

The LIBOR rate used at the end of each year for the purposes of conversion into shares is the rate as at the reporting date. If the convertible note holder does not exercise the conversion option at the end of year 4, Entity A is required to redeem the note for a cash payment of CU 10 million plus accrued interest.

The conversion feature in note 1 is classified as an equity instrument. This is because, although the arrangement will result in changes in the number of shares that might be issued by Entity A on conversion of the convertible note, the number of shares to be delivered and the amount of the liability extinguished at all of the conversion dates are predetermined at the outset. It is appropriate to view the conversion feature as a series of European options, each of which would result in the delivery of a fixed amount of the financial liability for a fixed number of shares.

The conversion feature in note 2 is classified as a derivative liability. This is because the terms of the conversion feature mean that Entity A may be required to issue a variable number of its own equity instruments, depending on the conversion date. This is because, even though the number of shares is determinable (as it is based on LIBOR), the number of shares is not fixed in advance and changes in response to factors other than the passage of time.

7.2 Anti-dilution features

7.2.1 Adjustments from a stock split or bonus issue

The terms of a convertible note may include an anti-dilution protective clause for the noteholder that adjusts the conversion ratio in the event of a flotation, a stock split or for the payment of dividends to existing shareholders.

Prima facie, the inclusion of such a clause violates the 'fixed for fixed' criterion. This is because it would result in a variable number of shares being issued. However, in practice, such variability does not necessarily result in a violation of 'fixed for fixed' criteria provided the following conditions are met:

- The instrument would otherwise meet the 'fixed for fixed' requirement, and
- The anti-dilution clause was added only to maintain the relative rights of the shareholders and noteholders, and its effect is that those relative rights remain exactly the same immediately before and immediately after the event that gives rise to the anti-dilution adjustment.

As an example, Entity A issues a CU1,000 note which has a maturity of three years from its date of issue. The note pays a 10% annual coupon, and, on maturity, the holder has an option either to receive a cash repayment of CU1,000 or 1,000 of the issuer's equity shares (conversion price is CU1 per share). The terms of a note included a clause such that upon a stock split or a bonus issue of shares for no additional consideration, the conversion price (and hence the conversion ratio) would be adjusted so that the relative rights of the equity shareholders and noteholders are maintained. For example, if a stock split occurred and existing equity shareholders received one additional share for every existing 1 equity share they held, then the conversion price would be adjusted to CU0.50 per equity share to give the holders 2 equity shares for each CU1 converted. This adjustment to the conversion feature does not violate the 'fixed for fixed' criterion for equity classification.

7.2.2 Adjustment to the conversion ratio upon a rights issue

A rights issue is where existing equity shareholders are given the right to subscribe for new equity shares at a price that is typically less than their prevailing market price. If a convertible note is outstanding at that point, its contractual terms will normally include an adjustment to the conversion price (and hence the conversion ratio) to reflect that new equity shares have been issued at less than their fair value. Without this adjustment, the fair value of the conversion feature would be reduced (or 'diluted').

An adjustment to the conversion ratio for the bonus component of the rights issue which maintains the relative rights of the noteholders relative to the existing equity shareholders, and no more or less, is considered to meet the 'fixed for fixed' requirement for equity classification.

The assessment of whether the relative rights have been maintained is carried out by comparing the rights of the convertible note holder and equity shareholders immediately before and after the rights issue. The comparison is with the equity shareholders as a group (i.e., they are treated as a single unit of account). Consequently, if a rights issue is only partially subscribed by existing equity shareholders, provided the adjustment to the conversion price (and hence the conversion ratio) takes only the new equity shares that are actually issued into account, this adjustment would not cause the conversion feature to fail the 'fixed for fixed' test and therefore it would be classified as equity.

However, if the adjustment made to the conversion price does not preserve the relative rights of the equity shareholders and the holder of the convertible note, the conversion feature will fail equity classification and will instead be accounted for as a derivative liability.

As an example, Entity A issues a CU1,000 note in return for the same amount of cash consideration which has a maturity of three years from its date of issue. The note pays a 10% annual coupon, and on maturity, the holder has an option either to receive cash repayment of CU1,000 or 200 of issuer's equity shares (conversion price is CU5 per share). The terms of a note included a clause such that upon a rights issue, the conversion price is adjusted by the following formula

$$\text{New conversion price} = \frac{[\text{Initial conversion price} + (\text{price of rights issue} \times \text{rights issue rate})]}{(1 + \text{rights issue rate})}$$

Assume that Entity A has 10,000 shares on issue and there is a 1 for 1 rights issue to all existing shareholders. All existing shareholders have a right to subscribe for additional shares at CU3, while the market share price is CU4. Assume that 60% of the rights were subscribed, this means that there are now 16,000 shares on issue in total after the rights issue. The conversion price of the convertible note would be adjusted to:

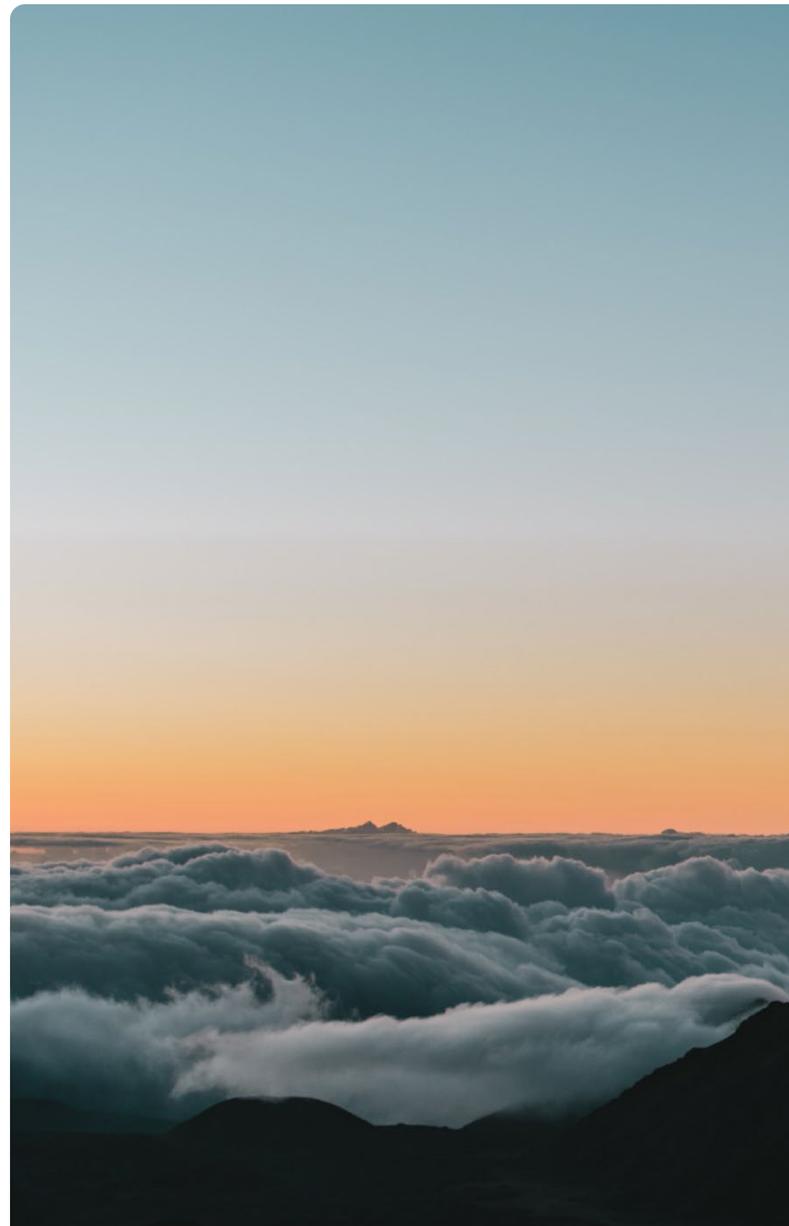
$$\begin{aligned} \text{New conversion price post rights issue} \\ &= [\text{CU5} + (\text{CU3} \times 60\%)] / (1 + 0.6) \\ &= \text{CU4.25} \end{aligned}$$

This adjustment does not violate the 'fixed for fixed' criterion for equity classification, as the purpose of the adjustment is to adjust for the bonus rights issue component so as to maintain the relative rights of the equity shareholders and the noteholders. However, if the conversion price also took into account the changes in the market price of shares, then it would violate the fixed-for-fixed criteria. For example, if the new conversion price in the above example was based on the market price of CU4 rather than the initial conversion price (i.e. $[\text{CU4} + \text{CU3} \times 60\%] / 1.6$) then this would violate the 'fixed for fixed' criterion, as the adjustment also takes into account the change in the market price of the shares and is not limited to maintaining the relative rights of the equity shareholders and the noteholders.

7.2.3 Anti-dilution features that fail 'fixed for fixed'

Examples of adjustments which would fail 'fixed for fixed' and result in a conversion feature being classified as a derivative liability include:

- The conversion price is adjusted if the equity share price falls below a specified level
- If new equity shares are issued at a price which is below the prevailing market price and conversion price, the conversion price is adjusted downwards to that issue price (sometimes referred to as a 'down round' feature. See section 6.4)
- If the adjustment to a bonus issue is based on changes in market price and not just the bonus issue component
- The note is convertible into a fixed percentage of the issuer's outstanding shares (see section 6.6).



8 Other common practice issues

In addition to the accounting issues that have been discussed so far in this publication, other issues can arise from the wide range of different conversion terms that exist in practice. Some of the more common arrangements that arise in practice are discussed below.

8.1 Fair value of the note is more than the transaction price

In practice, some convertible notes are issued where it would appear that, on conversion, the holder is always going to realise a profit.

For example, the terms of a convertible note may mean that the holder has an option, at any time, to convert it into the number of the issuer's shares equal to the face value (say, CU1,000) of the note at a 20% discount to their quoted market price. This means that, if the issuer's share price is CU1 on maturity, the shares will convert at CU0.80. The issuer has the obligation to deliver 1,250 shares (fair value CU1,250) with the holder realising a CU250 profit.

IFRS 9 states that the fair value of the financial instrument is normally its transaction price⁶⁸.

If the fair value at initial recognition differs from the transaction price, an entity recognises the difference between the fair value at initial recognition and the transaction price as an immediate day 1 gain or loss only if the fair value is a level 1 price (i.e. if the fair value of the instrument is evidenced by a quoted price in an active market) or is based on a valuation technique that uses only data from observable markets as input⁶⁹.

In all other cases, the instrument is required to be recognised at its transaction price, and the difference between the transaction price and fair value is deferred and recognised as a gain or loss only to the extent that it arises from a change in factor (including time) that market participants would take into account when pricing the liability⁷⁰.

In our experience, some are of the view that there should generally be no day 1 gain or loss on initial recognition of a convertible note. This is because the fair value of a convertible note is often calculated using data that are unobservable. The difference is therefore either recognised over the life of the note on a systematic basis, or at the end of the life of the note.

However, for the specific scenario described above, an alternative view is that the fair value of the instrument described above is a level 1 valuation, as the share price is the only significant input into the valuation and therefore a day 1 gain or loss should be recognised.

Deferral of day 1 gain/loss for hybrid convertible notes accounted for in accordance with the fair value option (FVO)

If the convertible note is a hybrid, i.e. the conversion feature fails 'fixed for fixed' and is accounted for as a derivative liability, and the issuer has elected to account for the entire convertible note at fair value through profit or loss, but the fair value of the note is greater than the transaction price and the fair value of a note is not a level 1 price, the difference between the transaction price and the fair value of the entire convertible note on initial recognition, is deferred and recognised only as a gain or loss only to extent that it arises from a change in a factor (including time) that market participants would take into account when pricing the liability.⁷¹

For example, Entity A issues a convertible note for CU1,000 for the same amount of cash consideration. The contractual terms of the note include an option for the holder to convert the note on its maturity into Entity A's shares at a 40% discount to the 30 day volume weighted average price of Entity A's shares prior to conversion. Because the note always converts at a discount, the fair value of the note is likely to be greater than the transaction price. In our experience, the difference between the fair value of the note and its transaction price is either recognised over the life of the note on a systematic basis, or at the end of the life of the note.

⁶⁸ IFRS 9.B5.1.1

⁶⁹ IFRS 9.B5.1.2A(a)

⁷⁰ IFRS 9.B5.1.2A(b)

⁷¹ IFRS 9.B5.1.2A(b)

8.2 Callable compound convertible notes

Some compound convertible notes also contain a call option which allows the issuer to repay the principal plus any outstanding accrued interest at any time during the life of the note. From the issuer's perspective, this call feature is a derivative asset. This is because future changes in interest rates could mean that the redemption amount of the loan is less than its fair value.

The issuer would need to determine whether this derivative is required to be separately accounted for by considering whether this derivative is 'closely related' to the debt host contract⁷². If the derivative is considered to be closely related, no separate accounting is required for the call option (See Example 5 in section 9.3 below). This would be the case if the redemption amount on each date on which the call option can be exercised is approximately equal to the amortised cost of the convertible note before separating the equity component.

If the call option is not closely related to the debt host contract, then the call option needs to be accounted for as a separate embedded derivative or the issuer can elect to account for the entire callable convertible note at fair value through profit or loss⁷³. If the conversion feature is also a derivative liability, the call and conversion features are accounted for as a single embedded derivative, as the exercise of one of the embedded derivatives automatically results in the lapse of the other.

8.2.1 Early redemption of a callable compound convertible note

For a compound convertible note that contains an issuer call option, where the issuer has the option to repay the note early at any time and the call option is considered closely related in accordance with IFRS 9, the following accounting approaches could be followed when the issuer subsequently exercises its option to call the note early.

One approach of accounting for the early repayment is to apply the accounting for re-estimation of future cash flows in accordance with IFRS 9 *Financial Instruments* for an amortised cost instrument (the remeasurement approach). This is because the host liability (including the embedded call option) is accounted for at

amortised cost under IFRS 9. Under this approach, the amortised cost of the financial liability component is remeasured (based on the present value of the revised estimate future cash flow at the financial liability's original effective interest rate) and the difference between the new amount and the previous amortised cost carrying amount is recorded in profit or loss⁷⁴.

An alternative approach is to apply the same accounting approach as an early repurchase as set out in Example 6 of this document (see section 9.4) in accordance with paragraph AG33 of IAS 32 *Financial Instruments: Presentation*. Under this approach, an entity would allocate the redemption amount to the financial liability and equity components using the same allocation method as that used to allocate the initial transaction price between the financial liability and equity components on initial recognition. However, once the issuer has elected to exercise its option to redeem early, the fair value of the financial liability component is likely to equal to the redemption price, meaning that this method of allocation would allocate all the redemption price to the financial liability component. Consequently, the effect of applying this approach would be likely to be the same as applying the first approach (the remeasurement approach) above.

Holder has an option to elect to receive shares or cash upon the issuer exercising its call option

Building on the example discussed in 8.2.1 above, in some cases, upon the issuer electing to exercise its call option to call the note early, the holder might have an option to elect to receive shares or cash (i.e. the holder's conversion option to convert the note into shares is exercisable during a short period following the announcement of the issuer call option).

⁷² IFRS 9.4.3.3, IFRS 9.B4.3.5(e)

⁷³ IFRS 9.4.3.3 & 5

⁷⁴ IFRS9.B5.4.6

One way of accounting for this exercise of the call option is to apply the IFRS 9.B5.4.6 remeasurement approach as described in the section above i.e. adjust the carrying amount of the liability based on the repayment amount. An alternative approach is that, if the note is expected to be converted into shares, then no adjustments to the carrying amount are made on the announcement of the early redemption. The entity simply derecognises the liability component and recognises a corresponding entry as equity without any gain or loss recognised in profit or loss.



8.3 Convertible notes issued to management

In practice, convertibles notes are often issued to executives or directors.

If the price paid for the convertible notes is less than fair value, the embedded equity option in these convertible notes typically constitutes an embedded share-based payment, which means that the requirements of IFRS 2 *Share-based Payment* apply. This is because the entity is receiving the benefit of services from its executives / directors, with payment being made through the issue of a convertible note at a discount from its total fair value.

In practice, embedded share-based payments in convertible notes may not be immediately apparent, as the coupon rate typically matches the market discount rate. This means that the fair value of the liability component is typically equal to the transaction price which gives a nil residual value on the equity conversion feature. However, the fair value of the convertible note is more than the transaction price as the convertible note is both paying a market coupon and contains an embedded share-based payment.

If the convertible note is issued to the entity's executives, directors or other employee, and the fair value of the note is greater than the transaction price⁷⁵, additional analysis needs to be taken as to determine whether the note contains a share-based payment that is to be accounted for under IFRS 2 *Share-based Payment*.

Assume that a convertible note which bears a market rate of interest is issued to a director for CU100, and the fair value is CU109. The fair value of the conversion feature is therefore CU9. This would be accounted for as a share-based payment in accordance with the requirements in IFRS 2, with the expense being recognised in profit or loss over the vesting period.

This does not contradict the basic principle of IFRS 9 *Financial Instruments* which is that there should be no day 1 gain or loss on initial recognition of a financial instrument. This is because there are situations where the note contains both a financial instrument (the host loan) and an embedded share-based payment.

In these cases, it is necessary to obtain a fair value for the convertible note as a whole, and not simply deduct the fair value of the liability component from the transaction price.

⁷⁵ The fair value of a convertible note is likely to be greater than the transaction price (assuming the note is issued at par), if the note converts into a fixed number of shares at the holder's option and the note is paying a market coupon rate.

8.4 Mandatorily convertible notes

In some circumstances, convertible notes mandatorily convert after a fixed period of time, but pay a contractual coupon up to the point of conversion.

Provided that the conversion feature results in the conversion of a fixed functional currency amount of the notes into a fixed number of shares, the conversion feature of the mandatorily convertible component is classified as equity⁷⁶. The liability component consists only of the cash flows associated with the contractually required coupon payments.

This treats the note effectively as prepaid equity and results in significantly more equity upon initial recognition than would be the case with a conventional convertible note with a conversion option. Interest expense recognised at the effective interest rate would also be significantly lower than a conventional convertible note (see Example 7 in section 9.5 below). This is another example of a compound convertible note with a financial liability and equity component, with no embedded derivative features.

If a mandatorily convertible note is denominated in a currency other than the functional currency of the issuer, the conversion feature might meet the criteria to be classified as equity. Provided the issue of the note and settlement of the amount due occur simultaneously, no variability in the amount receivable will arise from variations in exchange rates.

8.5 Contingently convertible notes

In some cases, convertible notes only convert upon an uncertain event occurring or not occurring (e.g. a successful initial public offering (IPO) taking place). A key principle in IAS 32 for equity classification is whether an entity has an unconditional right to avoid its obligations to deliver cash⁷⁷ or issue a variable number of its own equity instruments⁷⁸. Under IAS 32, if the entity does not have such unconditional right, then the instrument / component is classified as a liability. In other words, if the note is required to be settled in a way that meets the definition of a financial liability based on the outcome of an uncertain future event, and that event is beyond the control of the issuer and holder⁷⁹, then that instrument / component is classified as a financial liability.

Mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event

In January 2014, the Committee discussed the classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event. The financial instrument did not have a stated maturity date but was mandatorily convertible into a variable number of the issuer's own equity instruments when a 'non-viability event' occurs. Interest payments on the instrument are payable at the discretion of the issuer. A 'non-viability' event occurs when the prudential regulator notifies the issuer that it believes it is necessary for the issuer to either convert the note into shares or raise additional equity, because without it, the issuer would become non-viable. So the right to convert the note into shares is at the discretion of the regulator and not the issuer or the holder.

The Committee noted that the contingent non-viability event is beyond the control of both the issuer and the holder. In accordance with IAS 32, a financial liability exists if the settlement of the obligation is contingent upon the occurrence of an uncertain future event that is beyond the control of both the issuer and the holder, and that settlement mechanism results in liability classification⁸⁰.

In its discussion the Interpretations Committee considered two views:

- View 1: The instrument meets the definition of a financial liability in its entirety. This is because the issuer has a contractual obligation to deliver a variable number of its own equity instruments if the contingent event occurs.
- View 2: The instrument is a compound instrument comprised of a liability and an equity component. The obligation to deliver a variable number of its own equity instruments results in the liability component. The equity component consists of the issuer's discretion to pay interest payments.

The Interpretations Committee did not express a preferred view but noted that the scope of the issues raised in the submission is too broad for it to address in an efficient manner.

⁷⁶ IAS 32.AG27

⁷⁷ or another financial instrument

⁷⁸ And in the case of derivatives, an unconditional right to settle a variable amount by delivering fixed number of shares.

⁷⁹ IAS 32.25

⁸⁰ IAS 32.25

Note converting into equity upon IPO

Start-up companies may raise convertible capital (commonly known as 'seed' capital) to fund the initial start-up phase of their business operations. When convertible notes are issued in such situations, the notes often mandatorily convert to equity if the start-up company successfully lists on a stock exchange within a set period of time.

A note might automatically convert into a fixed number of shares upon a successful initial public offering (IPO), but the principal amount and accrued interest is repayable in cash if the issuer does not successfully complete an IPO within three years. While the decision to launch an IPO is within the control of the issuer, the question of whether an IPO would be successfully completed within three years is not within the control of the issuer. This is because other factors such as regulatory approval and the economic environment can influence the outcome. Therefore, the existence of such clauses would mean that the note contains a liability component (an obligation to pay principal and interest) and an equity component (the conversion feature) even though the note might mandatorily convert into a fixed number of shares upon successful completion of an IPO.

However, consider a variation to the above fact pattern, where the note is repayable in cash if an IPO takes place at any time during the term of the note, but mandatorily converts into fixed number of shares e.g. 100 shares on maturity of the note if an IPO has not taken place. Assuming the note is non-interest bearing, the entire note is classified as equity. This is because, while the success of the IPO is not within the control of the entity, the decision about whether to launch an IPO process or complete the IPO is, and the entity can avoid the obligation to pay cash by not entering into the process or, or not completing, an IPO.

Contingently convertible into a fixed number of shares

The fact that conversion is contingent on an event outside the issuer's control does not automatically mean that the entire financial instrument is a financial liability. If the conversion feature still meets the 'fixed for fixed' criterion on occurrence of the contingent event, the conversion option would meet the definition of an equity instrument.

As an example, Entity A announces a share issue to take place over a set period of time, at a predetermined fixed price. At the same time, the entity announces a separate note issue. If the share issue is successful, the note holders have the option to convert the note into shares at the fixed share issue price (which is set

at the time of the note issue). If the share issue is not successful, then the principal and interest on the note will be repaid in cash. Although, whether the share issue is successful or not is not within the control of the issuer, the conversion feature still meets equity classification as the amount and the number of shares that the note will convert to is fixed and known at the outset. Therefore, the note is a compound instrument (i.e. a host liability with a conversion feature classified as equity) since the conversion option meets the 'fixed for fixed' criterion.

Contingent on change of control of the issuer subject to shareholder approval

Some convertible notes convert into shares or require repayment in cash in the event of a sale or change in control of the issuer. In determining the appropriate liability or equity classification for these instruments, the question of whether certain events are within the control of the issuer may be relevant.

A key test is whether the issuer can control whether the sale or change of control takes place. In principle, the following approach is appropriate:

- If the owners of the issuer can sell their shares at any point, without any reference to the company, then the transaction that gives rise to the sale or change of control is not within the control of the company. In this case, the owners are acting in their capacity as investors, and not in their capacity as part of the governance structure of the company.
- If the owners of the issuer can only sell their shares after approval of the related transaction in general meeting of the company, then the transaction that gives rise to the sale or change of control is within the control of the company. This is because shareholders are viewed as having two roles, being holders of the shares as investors and membership of the governance structure of the entity. It is common for corporate law to specify that general meetings of shareholders form part of the governing process of entities, how these meetings are to be conducted and the rights that can be exercised. Consequently, because the transaction is considered and approved at a general meeting of shareholders, at the point at which the vote in general meeting is taken the shareholders are viewed as being part of the entity itself.

8.6 Reverse convertible notes - convertible at the issuer's option

IAS 32 contains no specific guidance where the conversion option is at the issuer's discretion. This type of convertible note is also referred to as a reverse convertible note. When a note is convertible at the issuer's discretion for a fixed number of shares, there are two acceptable approaches in practice which depend on whether the instrument is analysed as having an equity or liability host. The issuer has an accounting policy choice between the two approaches, to be applied consistently.

One approach is to account for the note on the basis that there is a host liability component which consists of the contractual cash flows (mandatory coupons and repayment of principal). The embedded derivative is an equity component arising from the conversion option to exchange a fixed amount of cash (the principal amount due on maturity) for a fixed number of shares. This means following the same accounting approach as Example 1 as set out in section 4.

An alternative approach is to view the host contract as an equity instrument because the issuer can avoid payment in cash (or another financial asset) by issuing a fixed number of shares (provided such conversion term is substantive - refer to section 6.3 for further discussion). The embedded liability component would be the coupon payments to the extent that they are required to be paid in cash throughout the life of the instrument.

An example of a reverse convertible note is set out in section 9.7.

8.7 Convertible notes / loans with attaching 'free' warrants

In some instances, the terms of a loan agreement provide for 'free' warrants or options being issued to the lender / investor, making the financing arrangement more attractive to the lender / investor.

A warrant is an instrument that entitles the holder to buy shares from the issuer at a specified exercise price within a certain time frame.

It is inappropriate to account for these free options or warrants as a share-based payment expense under IFRS 2 when they are not issued in exchanged for goods or services. The 'free' warrants or options issued as part of a financing arrangement are required to be accounted for together with the loan under IAS 32 as one transaction.

The terms of the warrants or options should be analysed to determine whether the warrants or options are equity instruments (i.e. if the 'fixed for fixed' requirement is met) or whether the warrants are derivative liabilities. (See Examples 10 and 11 in sections 9.8 and 9.9, respectively)

Once all the components are identified and appropriately classified the proceeds should be allocated between all the components. The proceeds should first be allocated to the fair value of any derivative liabilities as specified under IFRS 9⁸¹. Then, IAS 32 states that where an instrument contains a liability and equity component, the liability component should be determined first, and the residual amount is equity. Therefore, the fair value of the host liability also needs to be determined and the residual value is assigned to the equity component. If both the warrants and the conversion are equity instruments, then the fair value of the debt liability is determined first and the residual is assigned to the equity instruments. If there are two equity components, the residual amount could be allocated to the two equity components based on their relative fair values.



8.7.1 Subsequent modification to the terms of the warrants/options

Warrants or options may be modified after they have been issued. For example, the exercise price might subsequently be reduced because the issuer's share price has fallen and the warrants are 'out of the money', or the expiry date of the warrants might be extended, or both. The accounting for modification of warrants depends on their initial classification:

Initial classification	Accounting for subsequent modification
Equity	<p>Approach 1: The modification could be viewed as a cancellation of the old warrants followed by the issue of new warrants. No accounting entries would be made for the difference between the fair value of the old warrants and the fair value of the new warrants.</p> <p>Approach 2: IAS 32.AG35 could be applied by analogy using the hierarchy in IAS 8.10-12, on the basis that the modification to the term and/or exercise price is intended to induce the holders to retain and exercise the warrants. Any difference between the fair value of the warrants immediately before modification, and the fair value of the warrants immediately after modification, would be recognised in profit or loss at the date of modification.</p> <p>The approach followed is an accounting policy choice to be applied consistently to all similar transactions.</p>
Derivative liability	Re-measure the derivative liability at fair value based on the contractual terms of the new warrants with any loss recorded in profit or loss

Illustration 18: Accounting for subsequent modification of warrants



8.8 Subsequent modifications and replacements

The terms of convertible notes may be subsequently modified and renegotiated, e.g. extending the maturity date and / or amending the conversion terms of the instrument. When a note is nearing its maturity, the issuer may also negotiate with the holder for the issue of a new convertible note to replace the existing note that is due to expire. The accounting for the modification of a convertible note can be complex.

8.8.1 Modification of contractual terms

IAS 32 does not provide specific guidance on accounting for the modification of convertible notes, except where the terms of a convertible note are amended to induce early conversion (see IAS 32.AG35). This is because, after the initial recognition of a convertible instrument, each component of that instrument is accounted for separately.

IFRS 9 contains requirements for modifications of financial liabilities at amortised cost. The accounting treatment for the modification of financial liabilities measured at amortised cost is different depending on whether there is a substantial modification.

8.8.1.1 Substantial modification assessment for financial liabilities at amortised cost

Under IFRS 9, the terms of a modified financial liability at amortised cost are substantially different if the discounted present value of the cash flows under the new terms including any fees paid net of any fees received discounted using the original effective interest rate is at least 10% different from the discounted present value of the remaining cash flows of the original financial liability⁸².

IFRS 9 is not explicit about whether a modified financial liability is or can be considered to be substantially different when if the difference in present value is less than 10%.. Our view is that in addition to the 10% test, qualitative factors should also be considered to determine whether the loan modification is substantial. That is, even if the difference in the present value of cash flows is less than 10%, the modification might still be considered to result in the modified financial liability being substantially different from the pre-modification financial liability if there has been (for example):

- A change in currency of the loan
- A change from floating interest rates to fixed interest rates or vice versa
- A significant change in covenants, or
- The introduction of an equity conversion feature.

However, if the difference in the present value of cash flows is more than 10%, that factor by itself is considered conclusive of a substantial modification.

In some cases, it may be clear that a change in contractual terms results in a qualitatively substantial modification for the purposes of IFRS. In such cases, it may not be necessary for a quantitative test to be carried out.

8.8.1.2 Accounting requirement for modifications

The table below summarises the accounting approach for the difference between the carrying amount of an existing instrument / component and the fair value of a new instrument/component upon a modification or replacement.

Classification of 'old' instrument/component	Classification of 'new' instrument/component	Location of the adjustment
Financial liability at amortised cost	Financial liability at amortised cost (substantial modification)	Profit or loss – 'old' instrument/component is derecognised
Financial liability at amortised cost	Financial liability at amortised cost (non-substantial)	Profit or loss – carrying amount is recalculated ⁸³
Financial liability at amortised cost	Equity	Profit or loss for transactions within the scope of IFRIC 19
Derivative	Derivative	Profit or loss ⁸⁴
Derivative	Financial liability at amortised cost	Profit or loss
Derivative	Equity	Profit or loss
Equity	Financial liability at amortised cost	Equity
Equity	Derivative	Equity
Equity	Equity	Accounting policy choice unless within the scope of IAS 32.AG35

Illustration 18: Accounting for modifications

- **Modification to a financial liability component measured at amortised cost**

Under IFRS 9, a substantial modification of an existing financial liability is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability, with the difference between the carrying amount of the original financial liability and the fair value of the new financial liability being recognised in profit or loss⁸⁵.

When the modification is non-substantial, the carrying amount of the existing liability is recalculated as the present value of the revised future cash flows discounted at the original effective interest rate. The adjustment is recognised in profit or loss as income or expense at the date of modification.

- **Modification to the equity component**

IAS 32.33 requires that that no gain or loss is recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. If there is derecognition of an existing equity instrument and a recognition of a new equity instrument, no gain or loss results. Consideration paid or received is recognised in equity.

Alternatively, if a modification results in an increase in the fair value of the equity component, IAS 32.AG35 could be applied by analogy using the hierarchy in IAS 8.10-12 on the basis that the modification to the term and / or exercise price is intended to induce a particular behaviour by the holder (e.g. converting the note into shares instead of receiving repayment in cash). Any difference between the fair value of the equity component immediately before and after the modification would be recognised in profit or loss at the date of modification.

The approach followed is an accounting policy choice, to be applied consistently to all similar transactions.

There is no distinction between a substantial and a non-substantial modification.

- **Modification to an embedded derivative**

All derivatives are required to be measured at fair value with changes recognised in profit or loss. Consequently, any change in the carrying amounts of derivative liabilities is recognised in profit or loss.

⁸³ For a financial liability component with a non-substantial modification the carrying amount of the existing liability is recalculated as the present value of the revised future cash flows discounted at the original effective interest rate), rather than resulting in the derecognition of the existing instrument and the recognition of a new instrument.

⁸⁴ This is because derivatives are always measured at fair value through profit or loss.

⁸⁵ Refer to IFRS 9.3.3.2

- Modification resulting in equity component being replaced by liability

In November 2006, the IFRS Interpretations Committee noted that if a change in the terms of the instrument gives rise to the derecognition of the original equity instrument and the recognition of a new financial liability, the difference between the carrying amount of the equity instrument and the fair value of the newly recognised financial liability is recognised in equity. In practice, the same accounting applies when an equity component is replaced by a derivative component.

- Modification resulting in a liability component being replaced by equity

For modifications within the scope of IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments*, when equity instruments are issued to extinguish all or part of a financial liability, the entity derecognises the financial liability extinguished and recognises the equity instruments issued at their fair value. The difference between the carrying amount of the financial liability extinguished, and the fair value of the equity instruments is required to be recognised in profit or loss. In practice, the same accounting applies when a derivative liability component is replaced by an equity component because the derivative liability is remeasured to fair value at the point at which the modification takes place.

8.8.1.3 Modification to hybrid convertible notes measured at FVTPL

For a hybrid convertible note where the entity has elected to account for the entire note at FVTPL, the difference in the carrying value of the existing hybrid instrument (at fair value) and the fair value of the new hybrid or the total fair value of its component parts (if the entity elects to account for the components separately after modification), is recognised in profit or loss.

8.8.2 Modifications without change to the contractual terms

The classification of the conversion feature of a convertible note as equity or a derivative liability could change without any amendments or modification to the actual terms of the contract (see examples below).

The guidance in IFRS is not clear about whether an entity should reclassify a financial instrument if the contractual terms have not changed. IAS 32.15 requires an issuer to classify the financial instrument, or its component parts, on initial recognition in accordance with the substance of the contractual arrangement and

the definitions as set out in IAS 32. This could be read to mean that classification is only assessed on initial recognition and is not subsequently reconsidered. However, IFRS 9.3.3.1 states that an entity shall remove a financial liability (or a part of a financial liability) when the obligation specified in the contract is discharged or cancelled or expires. In our view, in examples A and B, there is an accounting policy choice for either the classification at initial recognition to be maintained, or for reclassification between equity and liabilities.



Example A: Variable to fixed exercise price

Entity A issues a convertible note that matures in four years' time. The note holder has the option to convert the note into the issuer's shares at the end of Year 1, at which point the conversion price is based on the lower of CU10 and 120% of Entity A's share price. However, after the end of Year 1, under the contract's original terms, the conversion price is fixed at CU8.

On initial recognition, because the number of shares into which the notes could be converted is variable, the conversion option is an embedded derivative liability. However, at the end of Year 1, when the conversion price becomes fixed, the conversion feature no longer meets the definition of a derivative liability.

There are two views. The first view argues that reclassification is not appropriate because IAS 32.15 requires an assessment to be carried out based on the terms at inception of the contract and is silent on any reclassification. The alternative view considers the guidance in IFRS 9 and argues that the conversion option should be reclassified from a derivative liability to equity, because the obligation to deliver a variable number of shares on conversion expires at the end of Year 1, and the conversion term now meets the definition of equity.



Example B: Change in functional currency

Entity B's functional currency is GBP. Entity B issues a convertible note denominated in GBP that matures in three years' time, the note holder has the option to convert the note at a fixed price denominated in GBP per share. On initial recognition the conversion feature is classified as equity and the note is a compound financial instrument.

At the end of Year 1, Entity B's functional currency changes to EUR. Consequently, the conversion feature has become an embedded derivative liability because the liability now contains a foreign exchange component.



Again, similar to the previous example, there are two views as to the accounting approach that should be followed. One approach is that the classification should not be reconsidered after initial recognition under IAS 32. The second approach is that Entity B should reclassify the conversion feature from equity to a derivative liability because the conversion feature no longer meets the definition of equity.



Example C – Disposal of subsidiary

Entity C issues a convertible note that matures in 3 years' time. The contractual terms include an option for the note holder to convert the note into shares of Entity D (a subsidiary of Entity C) at a fixed price. Entity C has a 70% interest in Entity D. In the consolidated financial statements, the conversion feature meets the definition of equity.

At the end of Year 1, Entity C disposes of half of its interest in Entity D such that following disposal it has a 35% shareholding and Entity D is an associate. The shares to be delivered under the contractual terms of the convertible note no longer meet the definition of equity because Entity C is now required to deliver shares of an entity that is outside the consolidated group.

At the date of disposal, Entity C must reclassify the conversion feature from equity to an embedded derivative liability. This situation is different from the situation in examples A and B above since the equity instrument (shares of the subsidiary) which is forms the basis of the option no longer exists in the consolidated financial statements. Any difference between the fair value at the date of reclassification and the original amount included in equity is recognised in equity because it is analogous to a cancellation of the equity instrument.

Accounting for modification without change of contractual terms – reclassifying from equity to liability

If an entity reclassifies a conversion feature from equity to liability following a change in circumstances such as the examples above, the liability should be recognised at fair value and any difference between the fair value of the liability at the date of reclassification and the original amount recognised in equity is recognised in equity. No gain or loss is recognised because it is analogous to a cancellation of the equity instrument under IAS 32.33.

9 Additional examples

9.1 Example 3: Convertible into a variable number of shares



Background

An entity issues a CU1,000 note in return for the same amount of cash consideration. The note has a maturity of three years from its date of issue. The note pays a 10% annual coupon and, at any point up to its maturity, the holder can convert the note into the number of shares equal, at their quoted market price, to CU1,000 plus a cash payment for any accrued but unpaid interest. Assume there are no transaction costs.



Analysis

Each component of the convertible note is assessed separately using the classification flow chart in Illustration 2 in section 3.5:

Component	Analysis using the classification flow chart (Illustration 2)	Classification
Cash payment of 10% annual coupon and principal repayment of CU1,000	<p>This component is a liability because:</p> <ul style="list-style-type: none"> • There is a contractual obligation to pay cash that the issuer cannot avoid, so the answer to Question 1 is yes • The exceptions in IAS 32.16A-D and IFRIC 2 do not apply, so the answer to Question 2 is no, and • This component is not a derivative (other than a put over an entity's own equity), so the answer to Question 3 is no. 	Liability
Conversion feature to convert CU1,000 into the number of shares at their quoted market price.	<p>Firstly, there is no contractual obligation to pay cash, so the answer to Question 1 is no, and we move on to Question 5.</p> <p>Secondly, the conversion feature may be settled in the entity's own equity instruments, if the holder elects to exercise its option, so the answer to Question 5 is yes.</p> <p>The conversion feature is not a derivative because the value of the conversion feature does not change in response to the share price. If conversion is elected, the investor will always receive the number of shares equal to CU1,000. The answer to Question 6 is no, so we move on to Question 7.</p> <p>The entity may be obliged to issue a variable number of its own equity instruments if the holder exercises the option, therefore the answer to Question 7 is yes, and the conversion feature is a liability.</p>	Liability

Illustration 21: Analysis of the terms of the financial instrument in Example 3

Based on the above analysis, the entire note is classified as a financial liability measured at amortised cost.

Entry on initial recognition:

Dr Cash	CU1,000
Cr Debt liability	CU1,000

Being cash proceeds received in exchange for the issue of the convertible note



9.2 Example 4: Bonds issued in a currency other than the entity's functional currency



Background

An entity issues a foreign currency (FC) FC500,000 bond in return for the same amount of cash consideration. FC is not the entity's functional currency (LC). The note has a maturity of three years from its date of issue. The note pays a 10% annual coupon in foreign currency and on maturity. On maturity, the holder has an option either to receive a cash payment in FC500,000 or 500,000 of the issuer's shares.

Assume that the exchange rate is FC1.00:LC1.10.



Analysis

Each component of the convertible note is assessed separately using the classification flow chart in Illustration 2

Component	Analysis using the classification flow chart (Illustration 2)	Classification
Cash payment of 10% annual coupon in foreign currency and principal repayment of FC500,000 in foreign currency	<p>This component is a liability because:</p> <ul style="list-style-type: none"> • There is a contractual obligation to pay cash that the issuer cannot avoid, so the answer to Question 1 is yes • The exceptions in IAS 32.16A-D and IFRIC 2 do not apply, so the answer to Question 2 is no, and • This component is not a derivative (other than a put over an entity's own equity), so the answer to Question 3 is no. 	Liability
Conversion feature to convert FC500,000 into 500,000 of the issuer's shares	<p>Firstly, there is no contractual obligation to pay cash, so the answer to Question 1 is no, and we move on to Question 5.</p> <p>Secondly, the conversion feature may be settled in the entity's own equity instruments, if the holder elects to exercise its option. So the answer to Question 5 is yes, and we move on to Question 6.</p> <p>For Question 6, the conversion feature meets the definition of a derivative because:</p> <ol style="list-style-type: none"> (a) The value of the conversion feature varies in accordance with the FC/LC exchange rate and the entity's share price (b) It requires a net investment that is smaller than otherwise would be required (see section 3.4), and (c) It is settled on maturity date. <p>So the answer to Question 6 is yes, and we move on to Question 8.</p> <p>The derivative may be settled by the entity issuing a fixed number of shares to settle a variable amount depending on the FC/LC exchange rate. So the answer to Question 8 is no.</p> <p>This component is a derivative liability.</p> <p>The derivative liability is not closely related because the value of the derivative is driven by the entity's share price and the foreign exchange rate whereas the fair value of the liability host is driven by market interest rates and changes in the credit status of the borrower. The answer to Question 10 is no. The derivative liability is accounted for separately from the host liability contract.</p>	Derivative liability

Illustration 22: Analysis of the terms of the financial instrument in Example 4

Based on the above analysis of the note's component parts, the convertible note is a hybrid financial instrument containing a debt host liability and an embedded derivative liability that is the FX equity conversion.

The embedded FX derivative liability is determined first, and the residual value is assigned to the debt host liability.

Assume that the FX derivative liability has a fair value of LC10,000 at the date of issue.

On initial recognition, entity receives LC550,000 in its local (functional) currency (at a rate of Foreign Currency (FC) 1.00 : Local Currency (LC) 1.10). Since it has been determined that the FX derivative liability has a fair value of LC10,000, the carrying amount of the debt host liability on initial recognition is therefore LC540,000.

Subsequently, the FX derivative liability is measured at fair value with changes recognised in profit or loss. The debt liability will be translated at the exchange rate at that reporting date as per paragraphs 23 and 28 of IAS 21 *The Effects of Changes in Foreign Exchange Rates* with differences recognised in profit or loss. Interest expense, calculated on an effective interest rate basis, is translated at the exchange rate determined in accordance with IAS 21.



9.3 Example 5: Callable convertible note



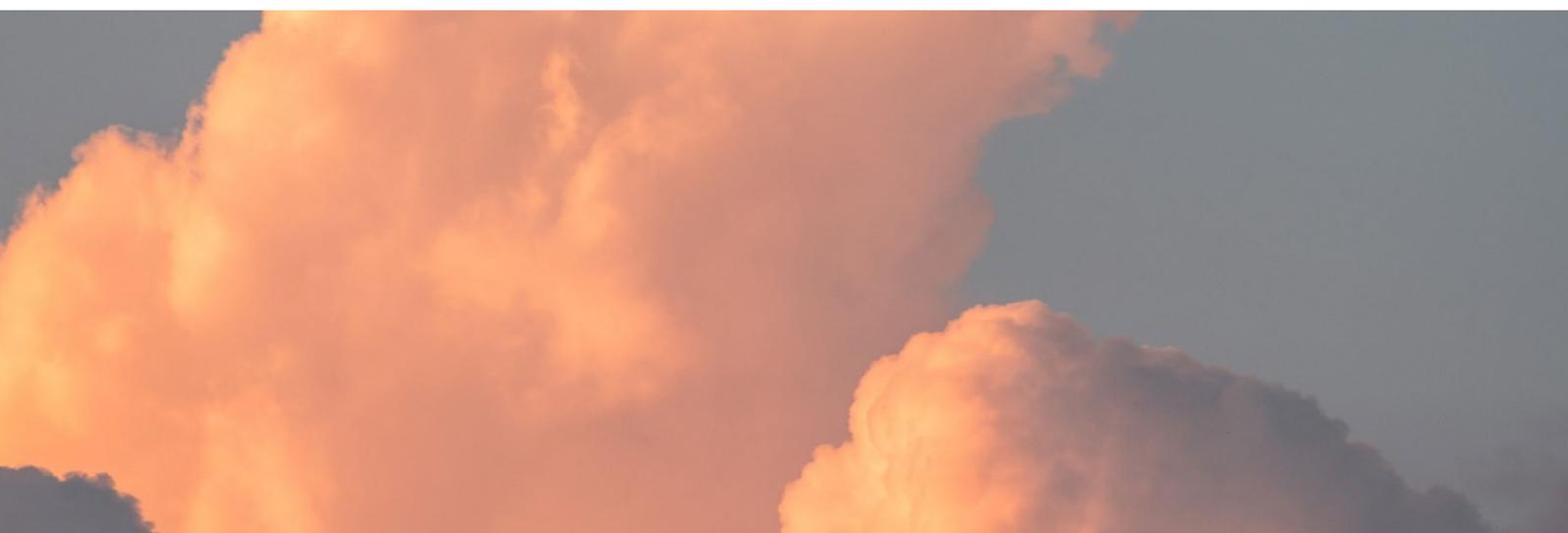
Background

An entity issues a CU1,000 note in return for the same amount of cash consideration which has a maturity of three years from its date of issue. The note pays a 10% annual coupon, and, on maturity, the holder has an option either to receive cash of CU1,000 or 10,000 of the issuer's shares. The fair value of a similar bond without the equity conversion option feature is CU950. In addition, the bond also has a call feature which allows the issuer to repay the principal plus any outstanding accrued interest at any time during the life of the note. The additional call feature is determined to have a fair value of CU10.



Analysis

Component	Analysis using the classification flow chart	Classification
Cash payment of 10% annual coupon and principal repayment of CU1,000	<p>This component is a liability because:</p> <ul style="list-style-type: none"> • There is a contractual obligation to pay cash that the issuer cannot avoid, so the answer to Question 1 is yes • The exceptions in IAS 32.16A-D and IFRIC 2 do not apply, so the answer to Question 2 is no, and • This component is not a derivative (other than a put over an entity's own equity), so the answer to Question 3 is no. 	Liability
Conversion feature to convert CU1,000 into Entity B's shares based on the average of the lowest 5 days VWAP in the previous 30 days	<p>Firstly, there is no contractual obligation to pay cash, so the answer to Question 1 is no, and we move on to Question 5 in the flow chart.</p> <p>The conversion feature may be settled in the entity's own equity instruments, if the holder elects to exercise its option to convert, so the answer to Question 5 is yes.</p> <p>The conversion feature is a derivative because:</p> <ul style="list-style-type: none"> • It value changes in response to the issuer's share price • It requires a net investment that is smaller than otherwise would be required (see section 3.4), and • It is settled on maturity date. <p>So the answer to Question 6 is yes.</p> <p>The derivative may be settled by the entity exchanging a fixed amount of cash (i.e. CU1,000) for a fixed number of its own equity instruments, so the answer to Question 8 is yes.</p> <p>Question 9 is N/A because the issuer does not have the option described in that question.</p> <p>Therefore, this component is equity.</p> <p><i>continuation</i></p>	Equity



continuation

Component	Analysis using the classification flow chart	Classification
<p>Issuer call option (Illustration 51, Appendix A)</p>	<p>Note that this is a call option at the option of the issuer (not the holder), and therefore it is a financial asset. The flow chart in Illustration 51 Appendix A applies, rather than the flow chart in Illustration 2.</p> <p>Using the flow chart in Appendix A, firstly the call option is not cash, so the answer to Question 1 is no.</p> <p>The call option is not an equity instrument of another, so the answer to Question 2 is no.</p> <p>Next, there is a contractual right to exchange financial liability that is potentially favourable to the entity, because if market interest rates decrease, it could be more favourable for the entity to call the bond early and refinance at a lower interest rate. So the answer to Question 3 is yes because this is a derivative other than a put over an entity's own equity. Then we move on to question 4.</p> <p>The issuer call option is a derivative, because:</p> <ul style="list-style-type: none"> • Its value changes based on market interest rates, • It requires little upfront investment, and • It is settled at a future date. <p>Therefore the answer to Question 4 is yes.</p> <p>The call option is a derivative asset.</p> <p>It is then necessary to consider whether the derivative asset is closely related to the host debt contract. The derivative asset is considered to be closely related to the host contract because the exercise price is approximately equal to the amortised cost of the convertible note before separating the equity component (see below). Therefore the answer to Question 5 is yes, and the derivative asset is accounted for as part of the host debt contract.</p>	<p>Derivative asset</p>

Illustration 23: Analysis of the terms of the financial instrument in Example 5

In this example, the call feature allowing issuer to repay early is an embedded derivative asset, but this derivative is not accounted for separately because it is considered to be 'closely related' to the debt host liability contract. This is because the exercise price of the option i.e. principal plus any outstanding accrued interest is approximately equal to the amortised cost of the convertible note before separating the equity component in accordance with IAS 32.⁸⁶ That is, although the reference is to the host debt contract (which would imply only the liability component), the comparison is with the convertible instrument before deducting the conversion feature.

This means that the note contains the following components:

- Contractual cash flows of 10% annual coupons and a cash repayment of CU1,000 (liability)
- The conversion feature to convert the liability to equity of the issuer (equity)
- The call feature (an embedded derivative asset that is not separated and is therefore not recognised and accounted for separately from the host liability).

The fair value of the liability component is CU940 (the combined fair value of the bond and the call option). The equity component is the residual i.e. CU60.

⁸⁶ IFRS 9.B4.3.5(e)

9.4 Example 6: Early repurchase of bonds

An entity issues a CU1,000 note in return for the same amount of cash consideration which has a maturity date of three years from the date of issue. The note pays a 10% annual coupon, and, on maturity, the holder has an option either to receive cash of CU1,000 or 10,000 of the issuer's shares. At the end of Year 2, the issuer is subject to a takeover offer and makes an offer to repurchase the note for CU1,100. The holder accepts the offer. Assume the following:

- Carrying value of the note at the end of Year 2 is CU984
- The market interest rate for a note without conversion feature at the end of Year 2 is 15%.



Analysis

IAS 32.AG33 requires an entity to allocate the consideration paid for the repurchase to the liability and equity components using the same allocation method as the method for allocating the initial transaction price, i.e. determine the fair value of the liability component, with the residual amount being allocated to equity.

The fair value of the outstanding liability at the end of Year 2, after payment of interest for that year is set out in the table below. This is the present value of outstanding cash flows at the market interest rate at the end of Year 2 (i.e. 15%).

	Discount	Cash flow	Fair value
Interest	1/1.15	CU100	CU90
Principal	1/1.15	CU1,000	CU870
			CU960

Illustration 24: Calculation of the fair value the liability component at the end of Year 2

The repurchase consideration paid to the holder is CU1,100, and the fair value of the liability component is CU960 as determined above, therefore the amount of repurchase consideration allocated to the equity component is CU140 (CU1,100 – CU960).

The difference between the carrying value and the fair value of the debt liability component at the end of Year 2 is accounted for as the cost of redeeming the debt liability component. As the fair value of the debt liability is lower than the carrying value at the time of redemption, a gain is recorded rather than an expense.

	Debt liability
Carrying value	CU984
Fair value	CU960
Difference – debt settlement gain	CU24

Illustration 25: Difference between the carrying and fair value of the debt liability component at the end of Year 2

Entry on note repurchase at the end of Year 2:

Dr Debt liability	CU984	
Cr Debt settlement gain		CU24
Dr Equity	CU140	
Cr Cash		CU1,100

Being cash paid for note repurchase, derecognition of the debt liability and equity, and the associated gain.

9.5 Example 7: Mandatorily convertible note

An entity issues a CU1,000 note in return for the same amount of cash consideration which has a maturity of three years from its date of issue. The note pays a 10% annual coupon, and, on maturity, the note mandatorily converts into 10,000 of the issuer's shares. The market interest rate for a note without a conversion feature would have been 12% at the date of issue.

Analysis

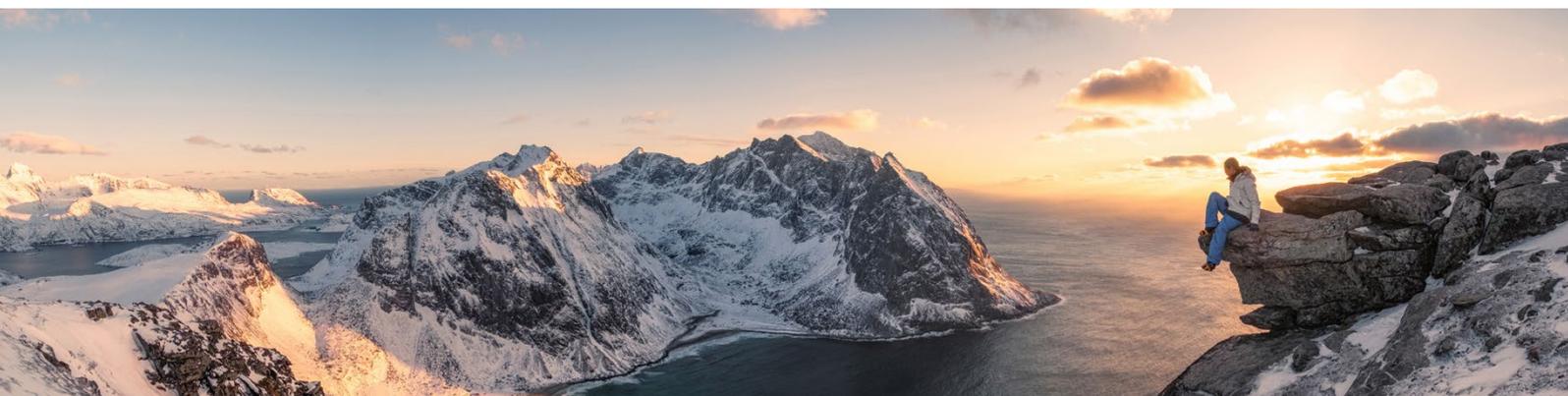
Each component of the convertible note is assessed separately using the classification flow chart in Illustration 2 in section 3.5:

Component	Analysis using the classification flow chart (Illustration 2)	Classification
Cash payment of 10% annual coupon	<p>This component is a liability because:</p> <ul style="list-style-type: none"> • There is a contractual obligation to pay cash that the issuer cannot avoid, so the answer to Question 1 is yes • The exceptions in IAS 32.16A-D and IFRIC 2 do not apply, so the answer to Question 2 is no, and • This component is not a derivative (other than a put over an entity's own equity), so the answer to Question 3 is no. 	Liability
Mandatory conversion feature to convert CU1,000 into 10,000 of the issuer's shares	<p>Firstly, there is no contractual obligation to pay cash, so the answer to Question 1 is no, and we move on to Question 5 in the flow chart.</p> <p>It will be settled in the entity's own equity instruments, because the liability mandatorily converts into the issuer's own equity instruments on maturity. The answer to Question 5 is yes.</p> <p>It is not a derivative because the investment required is the principal amount of CU1,000 and not a nil or lesser amount, so the answer to Question 6 is no.</p> <p>The entity will be issuing a fixed number (10,000) of its own equity instruments, and not a variable number, so the answer to Question 7 is no.</p> <p>Question 9 is N/A because the issuer does not have the option described in that question.</p> <p>Therefore, this component is equity.</p>	Equity

Illustration 26: Analysis of the terms of the financial instrument in Example 7

Based on the above analysis of the note's component parts, this note is a compound financial instrument. However, the liability component only consists of the cash payments of 10% annual coupons. This is because the fixed principal amount mandatorily converts into a fixed number of shares and is classified as equity.⁸⁷

On initial recognition, the contractual cash flows are discounted at the interest rate that would apply to a note without a conversion feature (12%). This is in order to calculate the fair value of the liability component of the compound financial instrument.



⁸⁷ Under IAS 32, a contract that will be settled by exchange a fixed number of its own shares for a fixed amount of cash is an equity instrument (IAS 32.AG27(a)).

Year	Cash flow (interest)	Discount factor at 12 %	PV of cash flow
1	CU100	1/1.12	CU89
2	CU100	1/1.12 ²	CU80
3	CU100	1/1.12 ³	CU71
		Liability component	CU240

Illustration 27: Calculation of the present value of the liability component on initial recognition

Once the liability component is determined, the equity component, being the residual, is determined as follows:

Transaction price	CU1,000
Less: liability component	CU(240)
Equity component (residual amount)	CU760

Illustration 28: Calculation of the equity component on initial recognition

The subsequent balance and interest expense of the liability component in the subsequent years are set out in the below amortisation table:

	Beginning balance	Interest expense (12%)	Cash coupon	Closing balance
Year 1	CU240	CU29	CU(100)	CU169
Year 2	CU169	CU20	CU(100)	CU89
Year 3	CU89	CU11	CU(100)	CU0

Illustration 29: Amortised cost table for the liability component of the financial instrument in Example 7

The accounting for a convertible note that mandatorily converts into a fixed number of equity shares results in significantly more equity than a conventional convertible note (that converts at the option of the holder) and effectively treats the note as prepaid equity. Interest expense recognised at the effective interest rate is significantly lower than a conventional convertible note, as interest is calculated based on a substantially lower liability balance.



9.6 Example 8: Settlement options on conversion

An entity issues a CU1,000 note in return for the same amount of cash consideration which has a maturity of three years from its date of issue. The note pays a 10% annual coupon, and, on maturity, the holder has an option either to receive a cash repayment of CU1,000 or 10,000 of the issuer's shares.

If the holder elects to receive 10,000 of issuer's shares, the issuer has the choice to either:

- Issue 10,000 shares, or
- Pay an amount of cash equal to 10,000 multiplied by Entity A's shares price at date of conversion.



Analysis

Each of the following components of the compound financial instrument needs to be assessed separately:

- Cash payment of 10% annual coupon interest and face value of CU1,000
- Conversion feature into shares – to be settled either by delivering 10,000 shares or cash equal to the value of 10,000 shares multiplied by Entity A's share price.

The cash payment of 10% annual coupon interest and face value of CU1,000 are classified as a financial liability in its entirety. This is because there is an obligation to pay cash that the issuer cannot avoid.

In relation to the conversion feature, IAS 32.26 requires that when a derivative gives either party a choice on how it is settled it is accounted for as a financial liability unless all the settlement alternatives would result in equity. The conversion feature is classified as a derivative liability because one of the settlement alternative results in cash settlement.

9.7 Example 9: Reverse convertible note – convertible at the issuer's option

An entity issues a CU1,000 note in return for the same amount of cash consideration which has a maturity of three years from its date of issue. The note pays a 10% annual coupon, and, on maturity, the issuer has an option either to deliver cash of CU1,000 or issue 10,000 of its own equity instruments. There is no holder conversion option. The issuer's option is considered to be substantive because, if the issuer has insufficient cash on maturity of the note, the issuer can exercise its share settlement option.

The market rate of interest for a note without a conversion feature would have been 8% at the date of issue.



Analysis

There is no specific guidance in IAS 32 in relation to the accounting for a convertible note that is convertible at the issuer's option. There are two acceptable approaches in practice, which depend on whether the instrument is analysed as having an equity or a liability host. The issuer has an accounting policy choice between the two approaches, to be applied consistently.

Approach 1

Approach 1 is to account for the note where:

- There is a host liability component which consists of the cash flows from the mandatory coupons and the principal repayment amount at maturity
- There is an embedded derivative equity component which consists of the conversion option that could result in the entity issuing a fixed number of shares (10,000) for a fixed amount of CU1,000 (i.e. the 'fixed for fixed' criterion is met). The conversion feature is a purchased put option over the entity's own equity instruments.

The coupon is higher than the market interest rate because economically the coupon payment is compensation for:

- The market rate of interest, and
- The option premium on the purchased put option (which is effectively being spread over the life of the note).

On initial recognition, the contractual cash flows are discounted at the interest rate that would apply to a note without a conversion feature (8%). This is in order to calculate the fair value of the debt liability component of the compound financial instrument.

Year	Cash flow	Amount	Discount factor at 8 %	Present value (PV) of cash flow
1	Coupon	CU100	1/1.08	CU93
2	Coupon	CU100	1/1.08 ²	CU86
3	Coupon and principal	CU1,100	1/1.08 ³	CU873
Fair value of liability component				CU1,052

Illustration 30: Calculation of the present value of the liability component on initial recognition under approach 1

The fair value of the liability component is deducted from the total fair value of the compound financial instrument, with the residual being the equity component.

Transaction price	CU1,000
Less: liability component	CU(1,052)
Equity component (balancing figure)	CU(52)

Illustration 31: Calculation of the equity component on initial recognition under approach 1

Entry on initial recognition is:

Dr Cash	CU1,000	
Dr Equity	CU52	
	Cr Liability	CU1,052

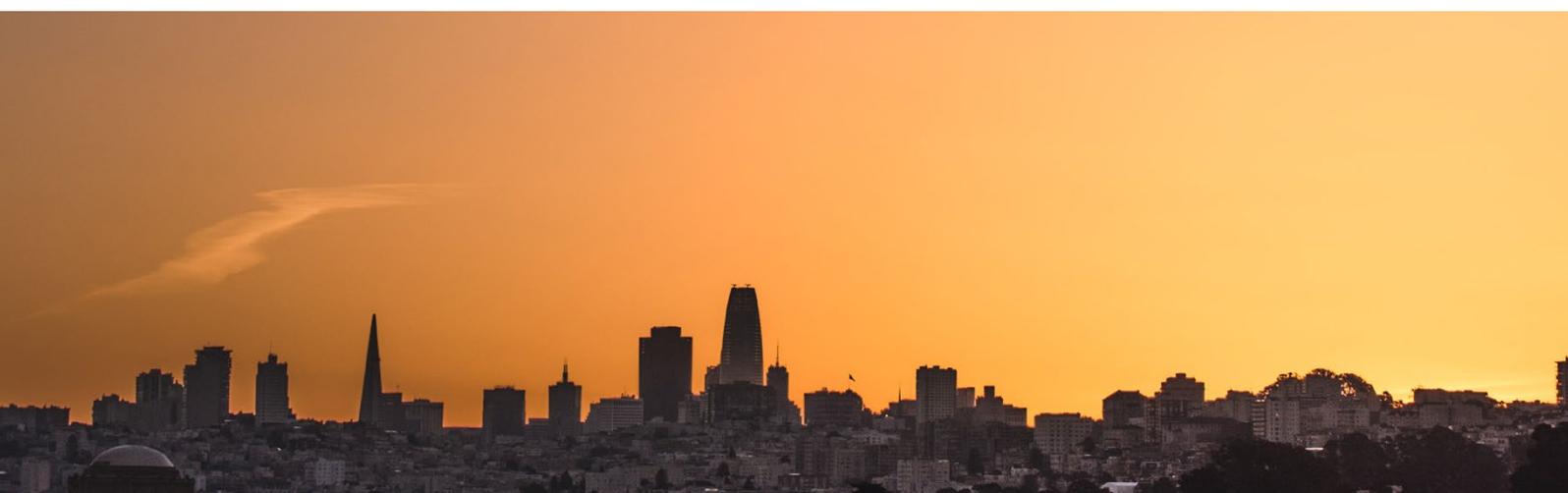
Being the cash proceeds of CU1,000 and its allocation to debt and equity components

Subsequently, the entity would record interest expense at the effective interest rate (8%) and the cash coupon of 10% at the end of each of the three years. The difference between interest expense and the cash coupon adjusts the liability to arrive at its redemption amount at maturity.

This would result in the following balance of the liability component over the life of the note:

	Beginning balance	Interest expense (8%)	Cash coupon (10%)	Closing balance
Year 1	CU1,052	CU84	CU(100)	CU1,036
Year 2	CU1,036	CU83	CU(100)	CU1,019
Year 3	CU1,019	CU81	CU(100)	CU1,000

Illustration 32: Amortised cost table for the liability component of the financial instrument in example 9 under approach 1



Approach 2

An alternative approach is to view the host contract as an equity instrument because the issuer can avoid payment of the principal amount by issuing a fixed number of shares.

Under this approach the note consists of the following components:

- The cash coupons are classified as an embedded liability component because there is a contractual obligation to pay cash that the issuer can avoid, and
- The principal amount is classified as equity because the issuer can avoid delivering cash by delivering a fixed number of shares.

In comparison with Approach 1 above, this results in a larger amount being recognised in equity, with the liability component representing the cash coupons.

Year	Cash flow	Amount	Discount factor at 8 %	Net present value (NPV) of cash flow
1	Coupon	CU100	1/1.08	CU93
2	Coupon	CU100	1/1.08 ²	CU86
3	Coupon	CU100	1/1.08 ³	CU79
Fair value of liability component				CU258

Illustration 33: Calculation of the present value of the liability component on initial recognition under approach 2

Transaction price	1,000
Less: Liability component	(258)
Equity component (residual amount)	742

Illustration 34: Calculation of the equity component on initial recognition under approach 2

The journal entry on initial recognition is:

Dr Cash	CU1,000	
		Cr Liability
		CU258
		Cr Equity
		CU742

Being the cash proceeds of CU1,000 and its allocation to debt and equity components

Subsequently, the entity would record interest expense at the effective interest rate (8%) and the cash coupon of 10% at the end of each of the three years. The difference between interest expense and the cash coupon adjusts the liability to nil on maturity as follows:

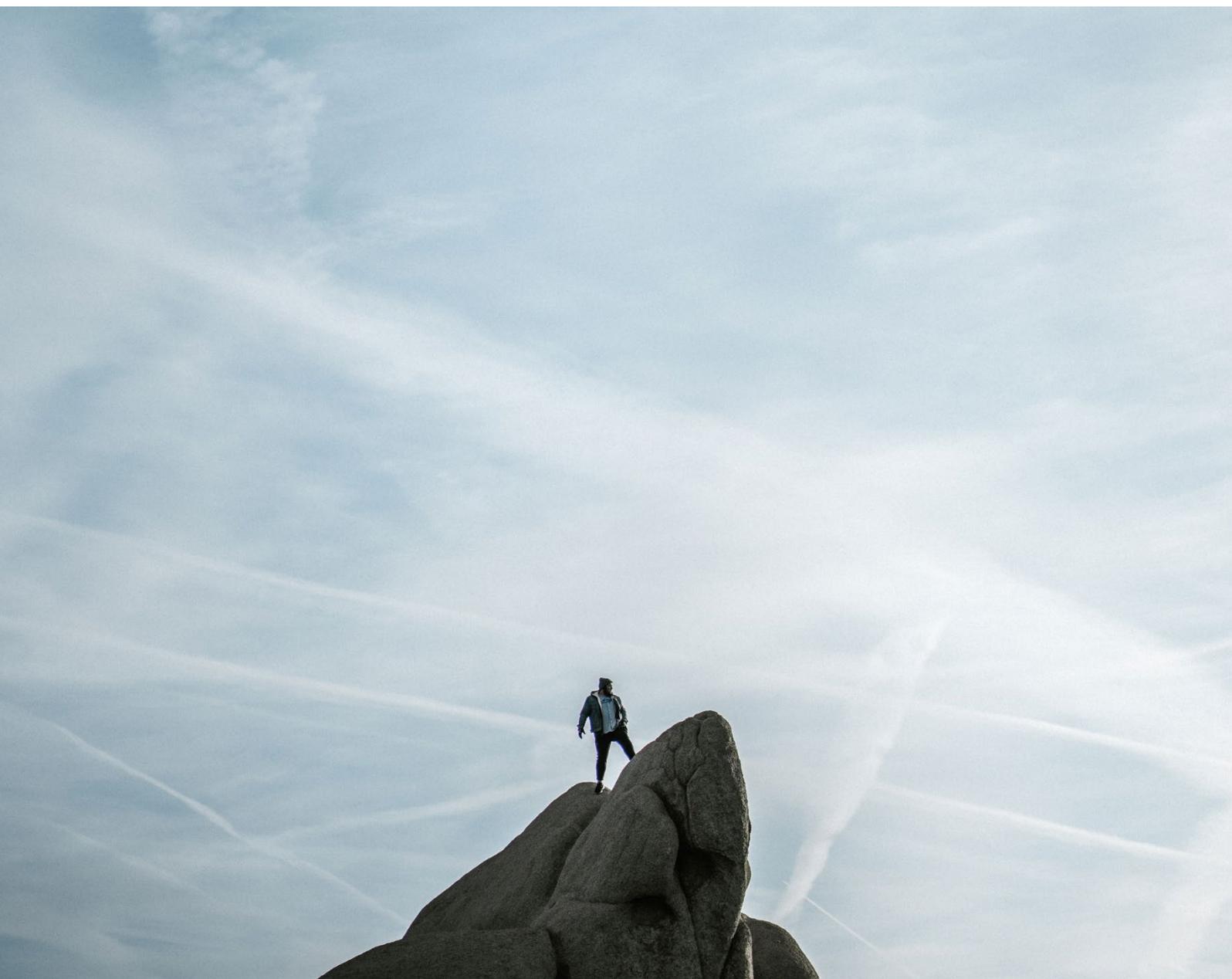
Year	Beginning balance	Interest expense (8%)	Cash coupon (10%)	Closing balance
1	CU258	CU20	CU(100)	CU178
2	CU178	CU14	CU(100)	CU93
3	CU93	CU7	CU(100)	NIL

Illustration 35: Amortised cost table for the liability component of the financial instrument in Example 9 under approach 2

This approach can be supported by IAS 32.20(b) which requires a financial instrument to be classified as a financial liability if, on settlement, the issuer will deliver:

- i. Cash or another financial asset, or
- ii. Its own equity instruments whose value is determined to exceed substantially the fair value of the cash or other financial asset.

Neither of those conditions apply to the host contract which has been classified as an equity instrument.



9.8 Example 10: Loan with attached warrants

An entity issues a CU1,000 note in return for the same amount of cash consideration which has a maturity of three years from its date of issue. The note pays a 10% annual coupon, and, at the same time, the entity issues the noteholder with 100 warrants. Each warrant entitles the noteholder to purchase 1 share of the entity for CU10 at any time from issue date to maturity date of the loan. The market interest rate for a note without the warrants would have been 12% at the date of issue.



Analysis

The following components are identified:

- Repayment of CU1,000 in three years' time
- Cash payment of 10% annual coupon
- 100 warrants.

Each of the above components is assessed separately using the classification flow chart in Illustration 2

Component	Analysis using the classification flow chart (Illustration 2)	Classification
Cash payment of 10% annual coupon and principal repayment of CU1,000	<p>This component is a liability because:</p> <ul style="list-style-type: none"> • There is a contractual obligation to pay cash that the issuer cannot avoid, so the answer to Question 1 is yes • The exceptions in IAS 32.16A-D and IFRIC 2 do not apply, so the answer to Question 2 is no, and • This component is not a derivative (other than a put over an entity's own equity), so the answer to Question 3 is no. 	Liability
100 warrants to purchase 1 share of the entity for CU10	<p>Firstly, there is no contractual obligation to pay cash, so the answer to Question 1 is no, and we move on to Question 5 in the flow chart.</p> <p>The warrants may be settled by the entity issuing its own equity instruments at the option of the holder, so the answer to Question 5 is yes.</p> <p>The warrants are derivatives because</p> <ul style="list-style-type: none"> • There is no initial additional investment required • The value of the warrants will vary based on the issuer's share price, and • The warrants will be settled in the future (anytime between issue date and loan maturity) <p>So the answer to Question 6 is yes.</p> <p>The warrants may be settled by the entity exchanging a fixed amount of cash (i.e. CU1,000) for a fixed number of the issuer's own equity instruments (100 shares), so the answer to Question 8 is yes.</p> <p>Question 9 is N/A because the issuer does not have the option described in that question.</p> <p>Therefore, this component is equity.</p>	Equity

Illustration 36: Analysis of the terms of the financial instrument in Example 10

The above analysis of each of the component parts means that the note is a compound financial instrument. The economic substance of this transaction is the same as if the entity had issued a convertible note that provides the holder with an option to convert part or all the note into up to 100 shares of the entity at any point. The accounting approach to be followed is the same as the compound convertible note in Example 1 as set out in section 4 above.

9.9 Example 11: Convertible note with attached warrants

An entity issues a CU1,000 note in return for the same amount of cash consideration which has a maturity of three years from its date of issue. The note pays a 10% annual coupon and, on maturity at the end of three years, the holder has an option either to receive a cash repayment of CU1,000 or to convert the note into the entity's shares. The note would be converted into the entity's shares using the average of the lowest five days' volume weighted average price (VWAP) in the previous 30 days prior to maturity.

The entity also issues the noteholder 100 warrants. Each warrant provides the noteholder with the option to purchase one share of Entity A for CU10.

The conversion feature based on 30 days VWAP is determined to have a fair value of CU20 at issue date.

The market interest rate for a note without a conversion feature would have been 15% at the date of issue.



Analysis

The following components are identified:

- Repayment of CU1,000 in three years' time
- Cash payment of 10% annual coupon
- Conversion feature to convert CU1,000 into Entity B's shares based on the average of the lowest five days VWAP in the previous 30 days
- 100 warrants.

Each of the above components is assessed separately using the classification flow chart in Illustration 2 in section 3.5.

Component	Analysis using the classification flow chart (Illustration 2)	Classification
Cash payment of 10% annual coupon and principal repayment of CU1,000	<p>This component is a liability because:</p> <ul style="list-style-type: none"> • There is a contractual obligation to pay cash that the issuer cannot avoid, so the answer to Question 1 is yes • The exceptions in IAS 32.16A-D and IFRIC 2 do not apply, so the answer to Question 2 is no, and • This component is not a derivative (other than a put over an entity's own equity), so the answer to Question 3 is no. 	Liability
Conversion feature to convert CU1,000 into Entity B's shares based on the average of the lowest five days VWAP in the previous 30 days	<p>Firstly, there is no contractual obligation to pay cash, so the answer to Question 1 is no, and we move on to Question 5 in the flow chart.</p> <p>It may be settled in entity own equity instruments, if the holder elects to convert, so the answer to Question 5 is yes.</p> <p>It is a derivative because:</p> <ul style="list-style-type: none"> (a) The value of the conversion feature changes depending on the entity's share price on conversion date and the average of the lowest five days VWAP (b) There is no extra outlay by the investors for the conversion feature, and (c) The conversion is to be settled at a future date, if elected by the investor. <p>So the answer to Question 6 is yes.</p> <p>The derivative may be settled by the entity exchanging a fixed amount of cash (i.e. CU1,000) but for a variable number of its own equity instruments. The number of shares to be issued will depend on the lowest 5 day VWAP in the last 30 days prior to maturity, so the answer to Question 8 is no.</p> <p>This component is a derivative liability.</p> <p><i>continuation</i></p>	Derivative liability

continuation

Component	Analysis using the classification flow chart (Illustration 2)	Classification
Conversion feature to convert CU1,000 into Entity B's shares based on the average of the lowest five days VWAP in the previous 30 days	The derivative liability is not closely related to the debt host contract because the value of the derivative is driven by Entity B's share price on conversion date and the average of the lowest five days VWAP, whereas the value of the liability host is driven by market interest rates and the entity's credit risk. The answer to Question 10 is therefore no . The derivative liability is accounted for separately from the host liability contract.	Derivative liability
Warrants to purchase 1 share of the entity for CU10	Same analysis as Example 10 in section 9.8 above	Equity

Illustration 37: Analysis of the terms of the financial instrument in Example 11

The above analysis of each of the component parts means that the note contains the following liability and equity components:

- Contractual cash flows of 10% annual coupons and a cash repayment of CU1,000 - liability
- An option to convert the liability into equity of the issuer at the lowest five day VWAP in the previous 30 days prior to maturity - embedded derivative liability, and
- 100 warrants to purchase one share of the entity for CU10 - equity.

The convertible note contains three components that should be accounted for separately and fair values should be assigned to each of the components on initial recognition.

IFRS 9 requires the fair value of the embedded derivative to be determined first, and the residual amount is the host liability. However, because this instrument also contains an equity component, further consideration is necessary because IAS 32 defines equity as the residual amount and states that where an instrument contains a liability and equity component, the liability component should be determined first, and the residual amount is equity. Therefore, the fair value of the host liability also needs to be determined and the residual value is assigned to the equity component.

The fair value of the host liability component is calculated as follows:

Year	Cash flow	Amount	Discount factor at 15 %	Present value (PV) of cash flow
1	Coupon	CU100	1/1.15	CU87
2	Coupon	CU100	1/1.15 ²	CU76
3	Coupon and principal	CU1,100	1/1.15 ³	CU723
Fair value of liability component				CU886

Illustration 38: Calculation of the present value of the liability component on initial recognition

The fair value of the embedded derivative and the host liability components are deducted from the fair value of the instrument as a whole with the balance being recorded directly in equity.

Transaction price (fair value)	CU1,000
Less: Embedded derivative component	CU(20)
Less: Liability component	CU(886)
Equity component (residual)	CU94

Illustration 39: Calculation of the equity component on initial recognition

Alternatively, the entity could elect to use the 'fair value option' under IFRS 9 where the embedded derivative liability and the host debt liability are accounted for together as one unit of account. Under this approach, the entity would determine the fair value of all its liability components as one component (i.e. the derivative and the host debt liability), and the residual value would be the equity component.



9.10 Example 12: Instrument with a share settlement alternative

An entity issues a CU1,000 note in return for the same amount of cash consideration which has a maturity of three years from its date of issue. The note pays a 10% annual coupon. At maturity, the entity has the option of repaying the principal of CU 1,000 plus unpaid interest or 50,000 shares. The share price at inception of the contract is CU1.

Analysis

Component	Analysis using the classification flow chart (Illustration 2)	Classification
Settlement of the note by the entity choosing to either repay cash or a variable number of shares	<p>Firstly, there is no contractual obligation to pay cash, so the answer to Question 1 is no. This is because the entity may choose to either pay cash or issue shares, therefore, we move on to Question 5 in the flow chart.</p> <p>The note may be settled by the entity issuing its own equity instruments, so the answer to Question 5 is yes.</p> <p>The share settlement feature is a derivative because the value varies over time based on the share price of the entity. So the answer to Question 6 is yes.</p> <p>The derivative may be settled by the entity exchanging a fixed amount of cash (i.e. CU1,000) for a fixed number of its own equity instruments (50,000 shares), so the answer to Question 8 is yes.</p> <p>The issuer has the option to deliver either cash of CU 1,000 or its own equity instruments (50,000 shares) and at inception of the contract the value of shares substantially exceeds the value of the cash, therefore, the answer to Question 9 is yes.</p> <p>Therefore, the entire note is a financial liability.</p>	Liability

Illustration 38: Analysis of the terms of the financial instrument in Example 12

Despite the fact that the note contains no contractual obligation to pay either cash or issue a variable number of its own equity instruments, the entire note is a financial liability. IAS 32.20(b) requires this because although no explicit contractual obligation exists, the value of the share settlement alternative is such that the entity will settle in cash. This is because the value of the share settlement alternative is substantially greater than the value of the cash, meaning the entity will choose to settle the obligation by paying cash. On the basis of the share price at contract inception, if the entity is able to raise CU50,000 by issuing its shares, then it would never decide to issue CU50,000 worth of shares rather than pay CU1,000 of cash.

IAS 32.20(b) is an 'anti-avoidance' type requirement, which results in a financial instrument being classified as a liability despite no contractual obligations existing to pay either cash or issue a variable number of equity instruments. Such an instrument establishes an obligation (i.e. a liability) indirectly through its terms and conditions.



Appendix A – Financial asset vs equity classification flow chart

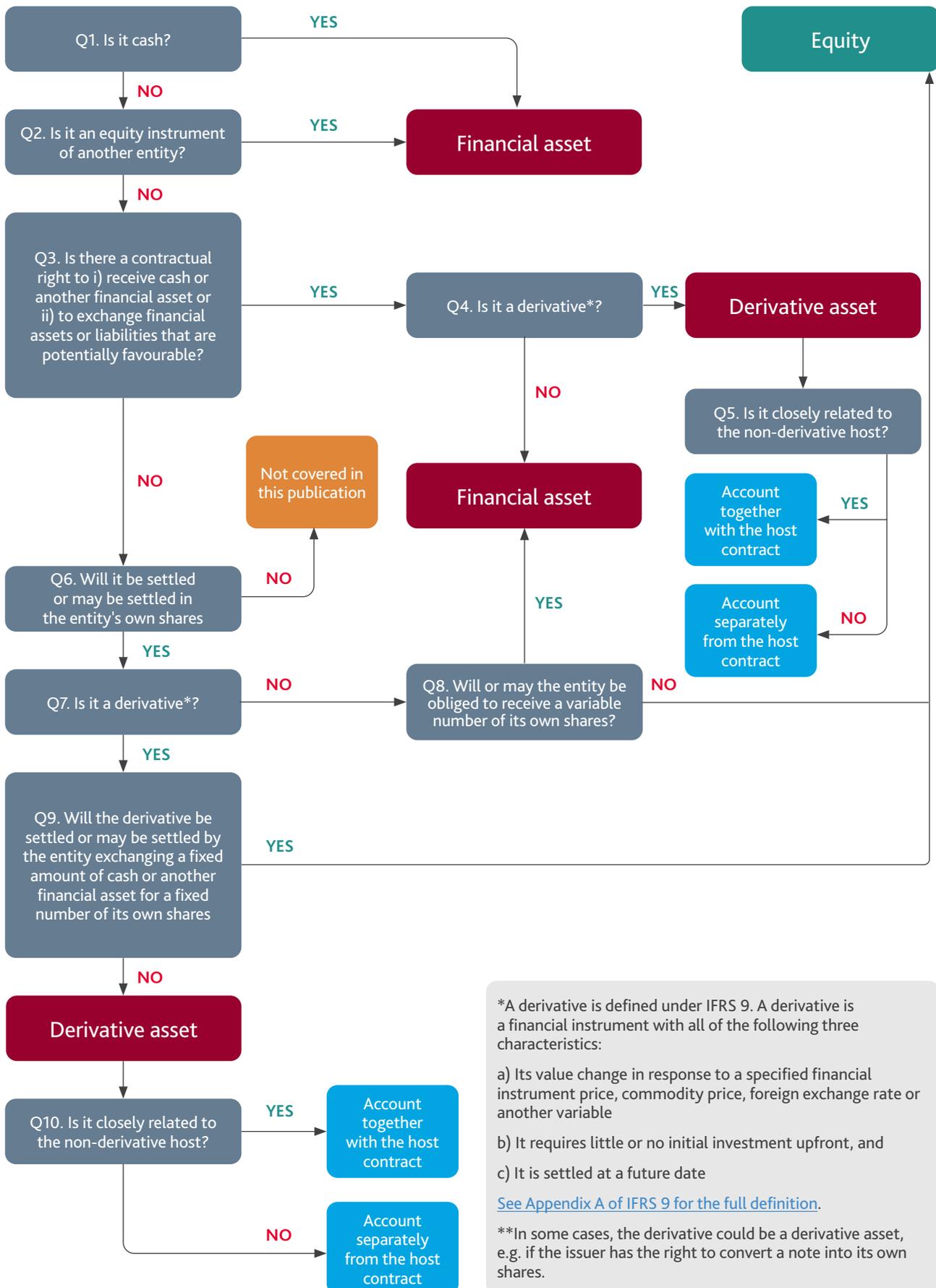


Illustration 51: Financial asset vs equity classification flow chart

Appendix B – Summary diagrams of the subsequent accounting of convertible notes

This section contains summary diagrams to assist in navigating the accounting issues and guidance discussed in this publication around the subsequent accounting for convertible notes after initial classification and recognition.

Conversion in accordance with the original terms

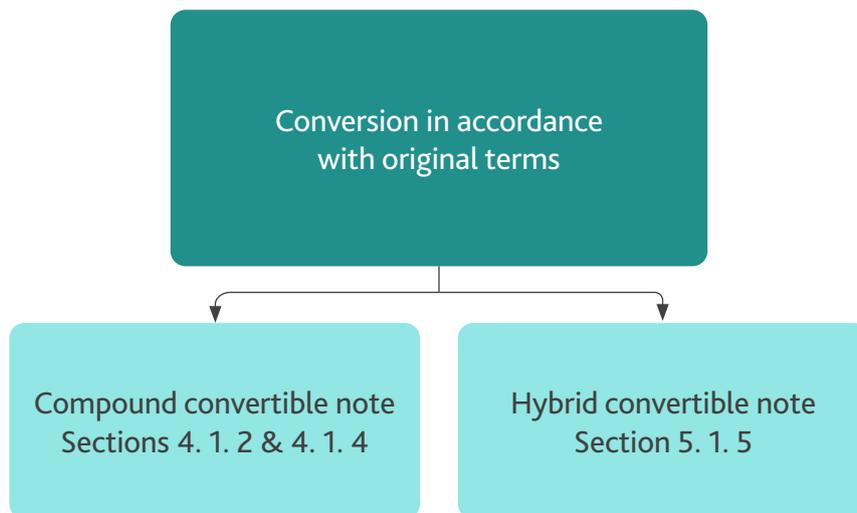


Illustration 52: Guidance on the accounting for the subsequent conversion in accordance with the original terms

Early repurchase/redemption

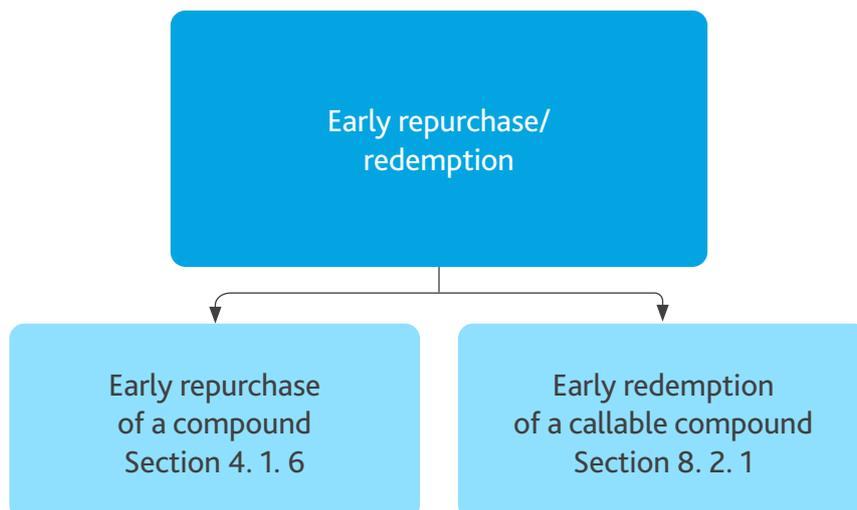


Illustration 53: Summary diagram of the guidance on the accounting for the subsequent early repurchase or redemption of a compound convertible note

CONTACT

For further information about how BDO can assist you and your organisation, please get in touch with one of our key contacts listed below.

Alternatively, please visit www.bdo.global where you can find full lists of regional and country contacts.

EUROPE

Anne Catherine Farlay	 France	annecatherine.farlay@bdo.fr
Jens Freiberg	 Germany	jens.freiberg@bdo.de
Teresa Morahan	 Ireland	tmorahan@bdo.ie
Ehud Greenberg	 Israel	ehudg@bdo.co.il
Stefano Bianchi	 Italy	stefano.bianchi@bdo.it
Roald Beumer	 Netherlands	roald.beumer@bdo.nl
Reidar Jensen	 Norway	reidar.jensen@bdo.no
Leonid Sidelkovskiy	 Russia	L.Sidelkovskiy@bdo.ru
David Cabaleiro	 Spain	david.cabaleiro@bdo.es
René Füglistner	 Switzerland	rene.fueglistner@bdo.ch
Moses Serfaty	 United Kingdom	moses.serfaty@bdo.co.uk

ASIA PACIFIC

Aletta Boshoff	 Australia	aletta.boshoff@bdo.com.au
Hu Jian Fei	 China	hu.jianfei@bdo.com.cn
Fanny Hsiang	 Hong Kong	fannyhsiang@bdo.com.hk
Pradeep Suresh	 India	pradeepsuresh@bdo.in
Khoon Yeow Tan	 Malaysia	tanky@bdo.my
Ng Kian Hui	 Singapore	kianhui@bdo.com.sg

LATIN AMERICA

Marcello Canetti	 Argentina	mcanetti@bdoargentina.com
Victor Ramirez	 Colombia	vramirez@bdo.com.co
Ernesto Bartesaghi	 Uruguay	ebartesaghi@bdo.com.uy

NORTH AMERICA & CARIBBEAN

Armand Capisciolto	 Canada	acapisciolto@bdo.ca
Wendy Hambleton	 USA	whambleton@bdo.com

MIDDLE EAST

Ayez Qureshi	 Bahrain	ayez.qureshi@bdo.bh
Antoine Gholam	 Lebanon	agholam@bdo-lb.com

SUB SAHARAN AFRICA

Theunis Schoeman	 South Africa	tschoeman@bdo.co.za
------------------	--	--



This publication has been carefully prepared, but it has been written in general terms and should be seen as broad guidance only. The publication cannot be relied upon to cover specific situations and you should not act, or refrain from acting, upon the information contained therein without obtaining specific professional advice. Neither BDO IFR Advisory Limited, and/or any other entity of BDO network, nor their respective partners, employees and/or agents accept or assume any liability or duty of care for any loss arising from any action taken or not taken by anyone in reliance on the information in this publication or for any decision based on it.

The BDO network (referred to as the 'BDO network' or the 'Network') is an international network of independent public accounting, tax and advisory firms which are members of BDO International Limited and perform professional services under the name and style of BDO (hereafter 'BDO member firms'). BDO International Limited is a UK company limited by guarantee. It is the governing entity of the BDO network.

Service provision within the BDO network in connection with corporate reporting and IFRS (comprising International Financial Reporting Standards, International Accounting Standards, and Interpretations developed by the IFRS Interpretations Committee and the former Standing Interpretations Committee), and other documents, as issued by the International Accounting Standards Board, is provided by BDO IFR Advisory Limited, a UK registered company limited by guarantee. Service provision within the BDO network is coordinated by Brussels Worldwide Services BV, a limited liability company incorporated in Belgium.

Each of BDO International Limited, Brussels Worldwide Services BV, BDO IFR Advisory Limited and the BDO member firms is a separate legal entity and has no liability for another entity's acts or omissions. Nothing in the arrangements or rules of the BDO network shall constitute or imply an agency relationship or a partnership between BDO International Limited, Brussels Worldwide Services BV, BDO IFR Advisory Limited and/or the BDO member firms. Neither BDO International Limited nor any other central entities of the BDO network provide services to clients.

BDO is the brand name for the BDO network and for each of the BDO member firms.

© 2021 BDO IFR Advisory Limited, a UK registered company limited by guarantee. All rights reserved.