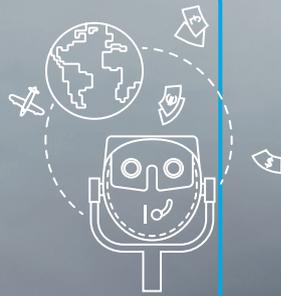


# Financial INSIGHT

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## HOW TO ACCOUNT FOR CONVERTIBLE DEBT

Convertible debt continues to be a challenging area for financial statement preparers. It involves navigating technically complex accounting standards, and small differences to the wording of a contract can result in a significantly different accounting treatment. This paper aims to explain the principles involved in accounting for convertible debt, and also to highlight some common challenges.

This paper is based upon the requirements of IAS 32 *Financial Instruments: Presentation*, and IAS 39 *Financial Instruments: Recognition and Measurement*, which have been issued in Australia as AASB 132 and AASB 139 respectively. A new standard, AASB 9 *Financial Instruments*, replaces the two existing standards for periods beginning on or after 1 January 2018, but the accounting for convertible debt by issuers will remain unchanged.

## ACCOUNTING FOR CONVERTIBLE DEBT

### Accounting Treatment

Convertible debt is treated as a compound financial instrument. This means that a 'split accounting' approach is adopted, where the debt component and the conversion option are accounted for separately.

The debt component is initially recognised at its fair value. It is then amortised over its life using the *effective interest method*.

The conversion option may be treated as either equity or as a financial liability. Its treatment will depend on whether it meets what is called the "fixed for fixed" test. In order to be classified as equity, a conversion option must involve a fixed amount of cash being exchanged for a fixed number of equity instruments. If it does not meet this test, it will be classified as a financial liability.

### Determining whether the "Fixed for Fixed" requirement is met

Assessing whether the "fixed for fixed" test is met may be complex or judgmental. Agreements for convertible debt will usually have a "conversion ratio" or similar feature setting out how the number of equity instruments to be issued on conversion is calculated. Where the number of equity instruments to be issued on conversion is fixed relative to the amount of cash, the conversion option will be treated as an equity instrument.

Some arrangements clearly fail the "fixed for fixed" test. For example, a conversion option that entitles the holder to a variable number of shares equal to a fixed dollar value will fail this test, as the number of shares to be issued will vary inversely with the entity's share price. Similarly, an arrangement where the number of shares is variable, but which is subject to a cap and/or a floor in the number of shares issued would also breach this requirement.

Any arrangement with a cash-settlement alternative, where cash or another non-equity instrument may be issued in settlement of the conversion option, cannot be classified as equity. This applies regardless of whether the option to issue cash is held by the holder or the issuer.

However, arrangements which change the number of shares to be issued may not breach the "fixed for fixed" test if they maintain the rights of the convertible bondholders relative to those of existing shareholders. Examples of this would be conversion ratios that increase the number of shares to be issued in the event of a share split or bonus issue.

## Accounting Treatment for the Debt Component

The debt component must be recognised at its fair value at inception. This will usually be different to its face value. The debt component should be valued based on discounting the contractual cash flows by the interest rate that would apply to an otherwise identical debt instrument with no conversion feature. Determining this valuation usually involves significant judgment, particularly since convertible debt is often issued by entities in the start-up phase, who may not have ready access to comparable "vanilla" debt.

This approach will usually result in some level of discount of the debt component when compared with the face value of the debt. This discount should be recognised over the term of the loan using the effective interest method such that the book value and face value are equal by the repayment date. The unwinding of the discount will be recognised as a notional interest charge.

## Accounting Treatment for the Conversion Option

Where the "fixed for fixed" test is met, the conversion option is classified as an equity instrument. This means that its value is determined at inception, and it is never subsequently revalued. Its value is calculated as the residual difference between the consideration received for the convertible debt, and the fair value of the debt component as determined above.

Where the conversion option is not "fixed for fixed," it is treated as a financial liability. Its value at inception is determined in the same way as for an equity-classified conversion option. However, it is recorded as a financial liability, not as equity. Under AASB 139 *Financial Instruments: Recognition and Measurement* it meets the definition of a derivative, and therefore must be measured at "fair value through profit and loss." This means a fair value must be determined at each reporting date, with any gain or loss being recognised in the income statement.

## Conversion

On conversion of convertible debt, the debt component is derecognised as a financial liability and recognised as equity. If the conversion option had been treated as a financial liability, and therefore held at fair value, it would also be transferred to equity. No gain or loss is recognised on the conversion itself.

If the conversion option had previously been recognised within equity, it must not be revalued, but may be reallocated at this time. For example, an amount previously recognised in a separate convertible instrument reserve may be transferred to issued capital.

## EXAMPLE

XYZ Limited issues a convertible note with a face value of \$1 million. The note has a term of four years, and pays interest of 8% each year. After four years, the holder has the option either to receive repayment of the sum of \$1m in cash, or to receive 25,000 shares in XYZ Limited. In this example, the holder elected to convert the notes to equity.

If XYZ Limited had issued a similar note without a conversion option, the market rate of interest would have been 13.5%.

Applying the principles set out above, the following would apply:

1. XYZ has a potential obligation to repay \$1m of cash at the end of the instrument's life. This represents a debt component that must be treated as a financial liability
2. The conversion option is for a fixed number of shares in XYZ Limited, in return for a fixed amount of cash. The conversion option should therefore be treated as equity
3. The accounting at inception is determined by fair-valuing the debt component and allocating the residual to equity. The debt component's fair value may be determined by discounting the cash flows of the instrument back to present value, using the discount rate based on a comparable non-convertible instrument. In this case, that gives the following result:

Period	Event	Cash Paid	Discount at 13.5% rate	Present Value
Year 1	Interest paid	\$80,000	0.881	\$70,480
Year 2	Interest paid	\$80,000	0.776	\$62,080
Year 3	Interest paid	\$80,000	0.684	\$54,720
Year 4	Interest and Principal paid	\$1,080,000	0.603	\$651,240
				\$838,520

4. A financial liability of \$838,520 would be recognised at inception. The remaining balance of \$161,480 is then allocated directly to equity. The journal recognised at inception is therefore:

Dr	Cash	\$1,000,000
Cr	Financial Liability	\$838,520
Cr	Equity	\$161,480

5. The equity is never remeasured. However, the discount on the financial liability is unwound each year, and recognised as an interest expense, as shown below. Note that the interest expense is greater than the cash interest paid, reflecting the difference between the coupon rate, and the market rate for a similar instrument with no conversion option.

Period	Opening Balance	Interest Expense	Interest Paid	Closing Balance
Year 1	\$838,520	\$113,062	(\$80,000)	\$871,582
Year 2	\$871,582	\$117,520	(\$80,000)	\$909,102
Year 3	\$909,102	\$122,579	(\$80,000)	\$951,680
Year 4	\$951,680	\$128,320	(\$80,000)	\$1,000,000

6. Had the holder chosen to receive cash, then XYZ would simply have paid the sum of \$1m, and debited it against the financial liability. However, since, in this example, conversion was chosen, the following entry would be recognised:

Dr	Financial Liability	\$1m
Cr	Issued Capital	\$1m

If the conversion option was initially recognised within a separate reserve within equity, then the following entry may also be recognised as a transfer within equity:

Dr	Convertible instrument reserve (equity)	\$1m
Cr	Issued Capital	\$1m

## COMMON ISSUES

### Convertible Debt in a Foreign Currency

When convertible debt is issued in a currency other than the functional currency of the issuer, then the conversion option will not meet the definition of equity. Even if the amount of currency to be paid is fixed in the country of issue, foreign exchange movements will mean that it is a variable amount in the functional currency of the issuer. The "fixed for fixed" test is not met.

Therefore, the conversion option of a convertible debt in a foreign currency must be treated as a derivative financial liability, and shown at fair value through the income statement.

### Debt with Mandatory Conversion

Some debt instruments do not have an option to convert, but instead convert automatically into shares at a specified time in the future. The treatment depends on the terms of conversion, and on whether there is a requirement to pay interest

If the note is interest-free and converts into a fixed number of shares, then the whole balance may be treated as equity from inception, as there is no contractual obligation for the issuer to deliver cash. If there are interest payments, these must be recognised as a financial liability at their present value, with the residual balance of capital being treated as equity from inception.

If the note is mandatorily convertible into a variable number of shares, then the "fixed for fixed" test is not met, and the whole note would be classified as a financial liability.

### Changes in the Conversion Ratio

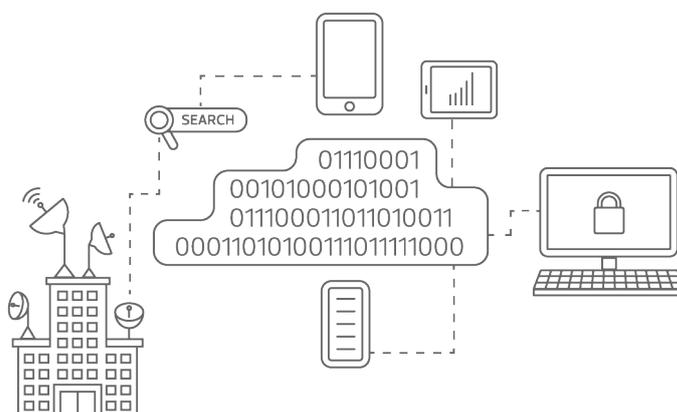
In some instances, the conversion ratio may be a set amount, but that ratio may change if an agreed milestone is hit, for example to the entity's share price, commodity prices, or a stock exchange index. Alternatively, it may change if the issuing entity issues shares at a lower price. The clauses will usually represent a breach of the "fixed for fixed" requirement of AASB 132, and therefore the conversion option will be treated as a derivative financial liability.

### Contingently Convertible Debt

Some debt instruments become convertible only if a specified future event occurs. A common example of this is debt that becomes convertible only in the event of successful completion of a stock exchange listing. Such instruments should still be treated as convertible debt, and the conversion option would still usually be expected to have a value, which must be recognised as a derivative financial instrument or as equity depending on the nature of the conversion option.

### Conversion is at the Option of the Issuer

Some convertible debt contains terms where it is the issuer rather than the holder who has the right to determine whether they are converted into equity. Such arrangements are known as "issuer call options." Since they confer additional rights on the issuer, the conversion option represents an asset, rather than a liability, from the issuer's perspective.



For further information or advice on the treatment of convertible debt, please contact Ralph Martin, National Technical Director, or your local RSM adviser.

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