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MFRS Hot Topics

Convertible debt and the effect of the changes to the conversion ratio on equity or liability classification

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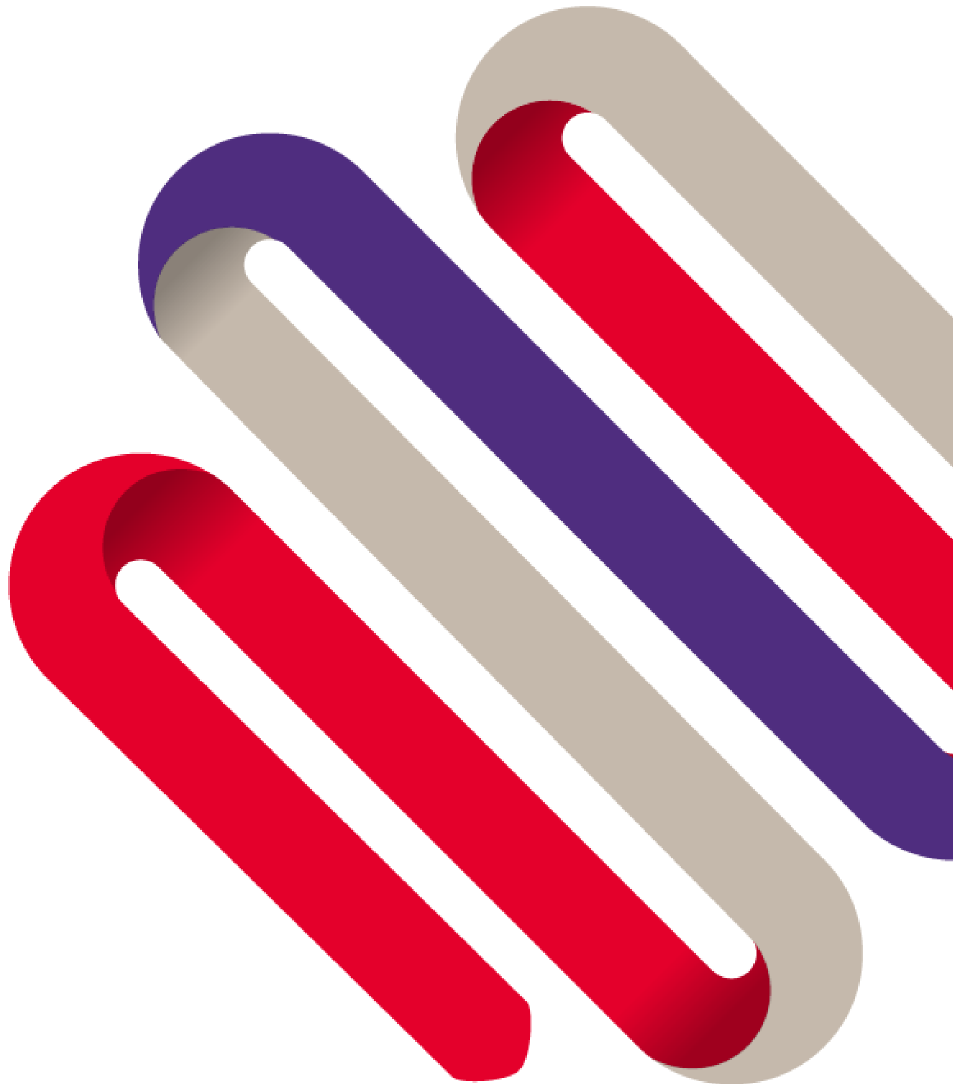

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Issue

In what circumstances does the issuer of a debt instrument which is convertible into equity shares treat the conversion feature as:

- an equity component; or
- an embedded derivative at fair value through profit or loss?

Relevant MFRS
MFRS 132 Financial Instruments: Presentation
MFRS 139 Financial Instruments: Recognition and Measurement

Guidance

General

The conversion option in a convertible debt instrument is an embedded derivative. The conversion option is therefore an equity component if, and only if, it satisfies the MFRS 132 definition of equity as applicable to derivatives. In particular, a derivative is equity if (and only if):

- it is settled only by issuing a **fixed number of shares** for a **fixed amount of cash or another financial asset** - the so-called "fixed for fixed" rule (MFRS 132.16(b)(ii)); and
- it contains no "non-equity" **settlement alternatives** such as an issuer's or holder's option to pay or take cash equal to the fair value of the conversion option as an alternative to delivering shares (MFRS 132.26).

The conversion option in a convertible debt instrument might include terms that vary the number of shares to be issued per bond (the "conversion ratio") in certain circumstances. This is sometimes expressed as a change to the exercise price. Changes to the conversion ratio that are purely "anti-dilutive" do not in our view breach the fixed for fixed requirement.

Anti-dilutive changes to the conversion ratio

In our view, the MFRS 132.16(b)(ii) fixed for fixed rule should be applied based on the substance of the arrangement. If the conversion ratio varies in certain circumstances, the fixed for fixed requirement may be breached. However, the factors that cause the conversion ratio to vary should be analysed. We consider that:

- adjustments to the conversion ratio whose effect is simply to preserve the rights of the bondholders to the entity's equity relative to other equity shareholders do not breach the fixed for fixed requirement. This type of adjustment is often referred to as "anti-dilutive";
- other adjustments, for example those that link the number or value of the shares to be received on exercise to the entity's share price or some other price or index, breach the fixed for fixed requirement. These conversion options are not equity components.

An adjustment to the conversion ratio preserves the rights of the bondholders relative to other equity shareholders if its effect is to ensure that all classes of equity interest are treated equally.

The practical application of this approach for various common types of adjustment is set out in the Examples section.

Consequences of failing "fixed for fixed"

If the conversion option is not equity, it is an embedded derivative within the scope of MFRS 139. The embedded conversion option is accounted for as a derivative at fair value through profit or loss. Alternatively, the entire (hybrid or combined) instrument can be designated at fair value through profit or loss (MFRS 139.11A).

Discussion

General

Convertible debt is a popular type of financing arrangement. The inclusion of a written conversion option in a debt instrument enables the issuer to reduce its cash interest payments compared to issuing "straight" (ie non-convertible) debt.

An option to convert a debt instrument into shares is a type of embedded derivative. Most embedded derivatives are within the scope of MFRS 139. Embedded derivatives within the scope of MFRS 139 need to be separated from the host contract and accounted for at fair value through profit or loss unless they are assessed to be closely related to the host. However, financial instruments issued by an entity that are equity in accordance with MFRS 132 are outside the scope of MFRS 139 (MFRS 139.2(d)). This includes derivatives and embedded derivatives. Accordingly, the embedded conversion option in a convertible debt instrument needs to be assessed to determine if it is equity.

MFRS 132 sets out the requirements on distinguishing debt and equity. This Standard also establishes the concept of a "compound instrument" - an instrument that contains both an equity and a liability component. The issuer of a compound instrument presents the equity and liability components separately (MFRS 132.28). MFRS 132.29 goes on to explain that a bond convertible by the holder into a fixed number of ordinary shares of the issuer is a compound instrument [emphasis added]. MFRS 132 also includes extensive guidance on accounting for the issuance, repurchase and conversion of convertible debt (MFRS 132.AG30-35 and IE34-50).

The "fixed for fixed" rule

Although MFRS 132 addresses convertible debt in the context of compound instruments, it is important to note that not every convertible debt instrument is a compound instrument. This is because a convertible debt instrument contains an equity component only if the conversion option meets the definition of equity.

This point is demonstrated by:

- the reference to a "fixed number of ordinary shares" in MFRS 132.29 (see above); and
- by the IFRIC's discussion of foreign currency convertible bonds in IFRIC Update (April 2005):

> "The IFRIC discussed … the classification of the written option in a convertible bond denominated in a foreign currency (a currency other than the functional currency of the entity issuing the bond) ie a written option to exchange a fixed number of its own equity instruments for a fixed amount of cash that is denominated in a foreign currency. The IFRIC noted that although the issue has been raised in the context of a convertible bond it applies equally to freestanding instruments, ie to all contracts entered into by an entity to exchange a fixed number of its own equity instruments for a fixed amount of cash that is denominated in a foreign currency. The IFRIC also noted that the question of determining classification of such instruments as liabilities or equity depends upon whether a fixed amount of a foreign currency represents a fixed amount of cash or other financial asset.
>
> The IFRIC noted that although this matter is not directly addressed in MFRS 132, it is clear that when the question is considered in conjunction with guidance in other Standards, particularly MFRS 139 *Financial Instruments: Recognition and Measurement*, any obligation denominated in a foreign currency represents a variable amount of cash …
>
> Consequently, the IFRIC noted that contracts that will be settled by an entity by delivering a fixed number of its own equity instruments in exchange for a fixed amount of foreign currency should be classified as liabilities. The IFRIC decided that it would not take this submission onto its agenda …"

These references in particular demonstrate the importance of the so-called fixed for fixed rule in MFRS 132.16(b)(ii). This states that a derivative instrument is equity only if it will be settled "by the issuer exchanging a **fixed amount of cash or another financial asset for a fixed number of its own equity instruments** …" [emphasis added].

Applying the fixed for fixed rule to convertible debt with variable conversion terms

Many convertible bonds include conversion options in which the number of ordinary shares received in exchange for each bond (or conversion price) varies in some circumstances. Common types of variation provision include adjustments in the event of:

- a share split, share consolidation, bonus issue or rights issue
- rights issue dividend payments in excess of a certain level
- a change of control of the issuer.

The first two types of adjustments are often described as "anti-dilution provisions".

A very narrow or mechanical reading of the fixed for fixed requirement would imply that any such adjustment would result in the conversion option failing the definition of equity. In practice, this interpretation would result in very few convertible bonds being treated as compound instruments (because anti-dilution provisions are included in most convertible bonds). In our view, the fixed for fixed requirement should be interpreted in a slightly broader way, taking account of the economic substance of the arrangement. For example, if the entity subdivides each issued share into two shares (a share split), it seems obvious that the bondholders should be entitled to double the number of shares on exercise. In substance, the bondholders are receiving exactly the same assets in exchange for the same amount of cash. The adjustment to the conversion rate simply preserves the rights of the bondholders to the entity's equity relative to other equity shareholders.

By contrast, the IASB clearly intends that the equity definition is "failed" for instruments in which the issuer is using its own shares as a "currency" to settle what is, in substance, a monetary obligation. This will be the case when:

- the number of shares to be issued is adjusted so that the value of the shares is maintained at a fixed amount; or
- the number of shares or exercise price is indexed to an underlying variable such as a commodity price (MFRS 132.AG27(d) and BC10(b)).

By contrast a genuine anti-dilution provision does not underwrite the **value** of the conversion option. It merely preserves the value of the option **relative to the other ordinary shares** in specified circumstances.

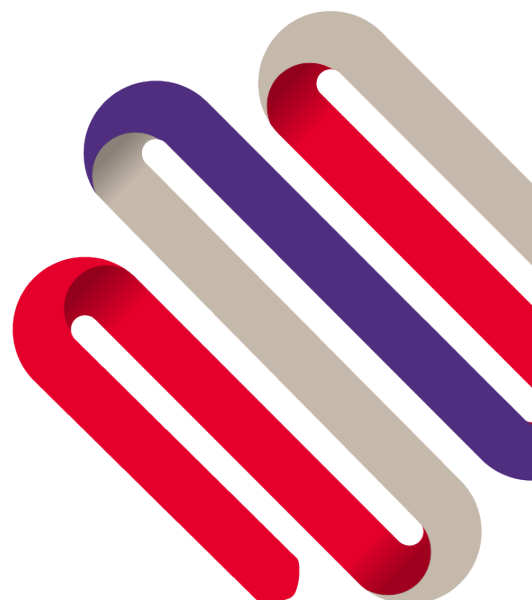
In practice, the terms of convertible bond must be analysed carefully to determine the substance of the conversion feature. Judgement will be required to decide whether a conversion option is fixed in economic terms.

Conversion features that are not equity components

If a conversion option or other feature "fails" the definition of equity, it is an embedded derivative within the scope of MFRS 139. As with any other embedded derivative, an assessment is then required of whether the embedded feature is "closely-related" to the host (debt) instrument.

MFRS 132.28 establishes that principle of separation when the conversion feature is equity. Moreover, MFRS 139.AG30(f) explains that an embedded equity conversion feature in a convertible debt instrument is not closely related to the host debt instrument from the holder's perspective. Although MFRS 139 does not directly address the closely related test for the issuer when the conversion feature is not equity, we consider that such a feature cannot be closely related (based both on these analogies and on the economic differences between a debt contract and a share warrant).

Accordingly, the embedded conversion option must be separated and accounted for as a derivative at fair value through profit or loss. Alternatively, the entire convertible debt instrument can be designated at fair value through profit or loss on initial recognition in accordance with MFRS 139.11A.



Examples

The following two tables set out our analysis of whether or not specific contract terms create an equity instrument or component. The first table focuses on the conversion feature in a convertible bond. The second table indicates our views on certain types of standalone share options and warrants. This division is made on the basis of the types of arrangement commonly encountered in practice. The underlying technical analysis applies equally to embedded conversion options and to standalone options and warrants.

Convertible bonds

Nature of conversion feature	Is the conversion feature an equity component?
Different exercise dates - conversion ratio is a fixed amount per bond, but the conversion option can be exercised on various dates.	**Yes.** Example 9 to MFRS 132 (MFRS 132.IE34-36) makes clear that a conversion option for a fixed number of shares that is exercisable at any time is an equity component. This is the case even through the carrying value (eg amortised cost) of the host debt typically varies over its expected life.
Conversion ratio changes from one exercise date to another on a predetermined basis - the conversion ratio is adjusted on different dates by an amount that is predetermined at inception.	**Yes.** This is a point of interpretation. In our view it is reasonable to regard a conversion feature as meeting the “fixed for fixed rule” if the conversion ratio changes only with time, but is fixed and predetermined (ie known in advance) at any point in time.
Issuer conversion option - the issuer rather than the holder has the right to convert the instrument into a fixed number of shares	**Yes.** Although MFRS 132 mainly discusses options written by the issuer to the holder, the same principles apply to issuer call options. An issuer call option will have a positive value to the issuer and will therefore result in recording a debit within equity. The liability to be recorded on initial recognition will exceed the proceeds received on issuing the compound instrument.
Conversion ratio or exercise price changes based on entity’s share price - the conversion option contains a clause or formula that varies the conversion ratio or exercise price depending on the issuer’s share price (based either on a “stepped” or continuous formula).	**No.** This breaches the fixed for fixed requirement. The effect is normally to guarantee the value of the shares the bondholders are entitled to. This is similar to the entity using its shares as currency. Further, this does not preserve the rights of bondholders relative to other equity shareholders (other shareholders do not receive extra shares if the share price falls).
Conversion ratio changes upon a share split or bonus issue - the conversion ratio is expressed as a fixed number of shares but is increased proportionately if the issuer sub-divides its shares or issues new shares without consideration (bonus shares).	**Yes.** The effect of a proportionate adjustment in these circumstances is to preserve the rights of the bondholders relative to other equity shareholders.

Nature of conversion feature	Is the conversion feature an equity component?
Conversion ratio changes upon a rights issue - a convertible bond provides for a change to the conversion ratio upon a rights issue.	**Possibly.** A rights issue can be analysed into: • a bonus issue of "free" ordinary shares; and • an issue of new shares at market price. An adjustment for the bonus issue component of a rights issue does not in our view breach the fixed for fixed requirement. An adjustment that alters the conversion terms based on changes in the market price (ie the second element) does not comply with the fixed for fixed requirement.
Conversion ratio changes upon a dividend payment - convertible bond contains a clause that adjusts the conversion ratio or price if the issuer pays dividends to existing shareholders.	**Probably.** If no dividends were expected to be payable on the underlying shares at the time of setting the conversion price, then clauses which adjust the conversion ratio to take account of subsequent dividend payments can generally be considered anti-dilutive and therefore consistent with the fixed for fixed test. This is on the basis that the subsequent adjustments to the conversion ratio maintain the relative rights of the convertible bondholder and the existing shareholders. A similar logic would apply if a specified level of dividends were anticipated at the time of setting the conversion price – a special dividend in excess of that specified level of dividends, which is in effect a return of excess capital, would not breach the fixed for fixed test as it would maintain relative rights. Adjustments that take place for dividends that were anticipated at the time of setting the conversion price are likely to fail the fixed for fixed rule, however, as they would benefit the convertible bondholder to the detriment of the existing ordinary shareholders. Such situations are likely to be relatively rare however.
Conversion ratio changes upon a change of control - entity issues a convertible bond that is convertible at an improved ratio if the issuer is acquired by another entity (ie undergoes a change of control) before the maturity date of the bonds.	**Possibly.** The holder of a convertible bond issued by a quoted company will be disadvantaged if that company is acquired and ceases to be listed (because their option is then to acquire "illiquid" shares in a private company). It is therefore common to allow or require bondholders to convert their bonds immediately on acquisition. Bondholders who convert can then sell shares to the acquirer. However, as a result of early conversion the holders have sacrificed the time value component of the conversion option's total value. An adjustment whose effect is purely to compensate for this loss of time value does not in our view fail the fixed for fixed requirement.

Nature of conversion feature	Is the conversion feature an equity component?
Conversion ratio changes if the entity issues shares at a lower share price - entity issues a convertible bond for which the conversion ratio is improved if the entity subsequently issues new shares at a lower valuation than the share price when the bonds where issued.	**Probably not.** The effect of such an adjustment is to increase the conversion ratio if the entity's share price declines and new shares are issued at the lower price. This does not preserve the rights of bondholders relative to other shareholders. Rather, it underwrites (wholly or in part) the value of the conversion option. This favours the bondholders at the expense of other shareholders. Such a provision might however be argued to be anti-dilutive if it enhances the conversion ratio only if new shares are issued at below market value (including in a bonus or rights issue - see above).
Contingently convertible bond - entity issues a convertible bond for which the conversion option is for a fixed number of shares but becomes exercisable only if a contingent event occurs or fails to occur.	**Yes.** The fact that the conversion option is exercisable only in certain circumstances does not cause the option to fail the definition of equity (provided the conversion terms are fixed if the conversion option becomes exercisable). Similarly, a conversion option that "knocks-out" (ie ceases to be exercisable) if the entity's share price exceeds a set amount does not fail the fixed for fixed requirement. Put another way, in our view a "binary" type option (ie one for which the number of shares is either zero or a fixed number) is still fixed for fixed.
Convertible bond with variable conversion rate subject to a cap or floor - an entity issues an instrument that is settled in a variable number of shares but is subject to a cap to prevent excessive dilution of the existing shareholders through the issue of new shares.	**No.** This instrument includes a provision to issue a variable number of shares. It therefore fails the fixed for fixed requirement unless the factors that vary the conversion terms are anti-dilutive.
Foreign currency convertible bonds - convertible bond is issued in a currency that is not the functional currency of the issuer.	**No*.** At its meeting in April 2005, the IFRIC concluded that derivative contracts that may be settled by an entity by delivering a fixed number of its own equity instruments in exchange for a fixed amount of foreign currency are financial liabilities. A convertible bond denominated in a foreign currency therefore has no equity component - the fixed amount of the foreign currency liability that can be exchanged for shares is a variable amount of cash in the functional currency of the issuer. The convertible bond is therefore a host debt instrument and an embedded foreign currency derivative. *** Note:** Refer to the project update box regarding Amendments to MFRS 132 made in October 2009. If certain conditions are met, rights, options or warrants to acquire a fixed number of an entity's own equity instruments for a fixed amount of any currency should be treated as equity. This is an exception to the above rule.

Standalone options and warrants

Nature of arrangement	Equity instrument?
Option entitling holder to acquire a fixed percentage of share capital at a fixed price per share - an entity issues an option or warrant entitling the holder to acquire (say) 10% of the company's issued share capital (or fully diluted share capital) at a fixed price per share.	**Probably.** Although the number of shares does potentially vary in such circumstances (in that the number of shares that will be issued is not known until the date of conversion), this feature is typically designed to preserve the relative economic rights of the various equity shareholders. If however the feature is designed so as to benefit the holder relative to other equity shareholders, the fixed for fixed criteria would be breached.
Contracts to exchange a fixed number of equity instruments for a specified non-controlling interest - a parent entity issues an option for a minority shareholder to exchange its holding of shares in a subsidiary for a fixed number of equity shares in the parent	**Yes - at consolidated level.** Non-controlling interest shares are a form of equity in the parent entity's consolidated financial statements. A contract to exchange one type of equity for another on fixed terms is an equity instrument.
Options and warrants that can be cash-settled - an option or warrant entitling the holder to shares but a further option for the issuer to settle the difference between the exercise price and the value of the share on the exercise date in cash.	**No.** An instrument that includes settlement alternatives is equity only if all of those alternatives would result in equity classification (MFRS 132.26).
Written put options - an option written by the entity that entitles the holder to sell shares back to the entity in exchange for cash.	**No.** This contract includes an obligation to transfer cash to the holder. A liability must be recognised equal to the present value of the amount payable on exercise, with the corresponding credit recognised in equity (MFRS 132.23). This accounting therefore differs from the normal accounting for a derivative, which records the asset or liability on a net fair value basis. The "gross" accounting for a written put over own shares reflects the fact that own shares are not an asset in IFRS.

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