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What is meant by 'contractual obligation'?

1. Legal/statutory rights to pay dividends
2. Preference share linkers that link to an ordinary share with a statutory right to pay dividends
3. What is meant by 'liquidation' in IAS 32.25?
4. Is a change in control event within the control of either party to the contract?
5. Is an IPO event within the control of either party to the contract?
6. Shares with an obligation to pay out a percentage of profits
7. Legal obligation to launch a takeover bid

Embedded derivatives

8. Instruments whose payments are linked to EBITDA or sales revenue
9. What are the components of a foreign currency-denominated convertible instrument?
10. Conversion into warrants
11. Contingent settlement options
12. Provisional issuer call option to redeem at par

IAS 32 from the issuer's perspective – part 2

This is the second instalment in a series of three supplements on IAS 32. We highlight some of the more common financial instruments terms and conditions, and explain how they affect the classification of an instrument. This edition looks at what is meant by 'contractual obligation', and accounting for embedded derivatives.

What is meant by 'contractual obligation'?

Question 1 – Legal/statutory obligation to pay dividends

Does a legal/statutory obligation (an obligation as result of the operation of law) to pay dividends meet the definition of a contractual obligation in IAS 32?

Answer 1

No. A financial liability arises from the existence of a contractual obligation of one party to the financial instrument (the issuer) to deliver cash or another financial asset to the other party (the holder) (IAS 32.17). An obligation established from local law or statute is not contractual; it does not therefore create a contractual obligation as required by the definition of a financial liability.

Question 2 – Preference share linkers that link to an ordinary share with a legal/statutory right to pay dividends

An entity has issued ordinary shares that have a legal/statutory requirement to pay dividends. The entity has also issued a second class of shares (for example, preference shares) with a fixed dividend that is required to be paid in the event that a dividend is paid on the entity's ordinary shares (a dividend pusher). Does the legal/statutory obligation to pay a dividend on the ordinary share create an indirect contractual obligation to pay the dividend on the preference shares?

Answer 2

Yes. The preference share is classified as a liability. This is based on the fact that the entity has no ability to avoid paying a dividend of the preference shares, as it has a contractual obligation to do so when it is legally/statutorily obliged to make a dividend payment on its ordinary shares.

Question 3 – What is meant by 'liquidation' in IAS 32.25?

What does the term 'liquidation' mean in IAS 32.25? Should 'liquidation' be interpreted more broadly to include all kinds of insolvency proceedings (such as receivership,

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administration, etc) that might (or might not) result when the entity is no longer a going concern?

Answer 3

No. The term 'liquidation' means only the winding up of the entity. If the terms of an instrument state that it is mandatorily redeemable upon the event of insolvency proceedings, such that the entity became obliged to repay it irrespective of whether the insolvency leads to liquidation, these terms do not meet the exception in IAS 32.25(b); the instrument is therefore classified as a financial liability.

Question 4 – Is a change in control event within the control of either party to the contract?

A contract between Company A and a third party contains a requirement for Company A to make payments to the third party on a change of control of Company A – for example, Company A being taken over by Company B (where Company B is not connected to Company A). Is such a change of control outside the control of either party to the contract for the purposes of IAS 32.25, such that the contract is a liability (given a change of control is both uncertain and genuine)?

Answer 4

Yes. A change in control is outside the control of both the entity and the counterparty provided that it need not be agreed by the entity in a general meeting. This will be the case if a purchaser could approach individual shareholders and buy their shares. Payments that are contingent on a change in control are therefore liabilities when no agreement by a general meeting is required.

Question 5 – Is an IPO event within the control of either party to the contract?

An undated cumulative convertible bond, whose interest payments are at the discretion of the entity absent an Initial Public Offering (IPO), contains a clause that states that the instrument (including all unpaid cumulative interest) will become mandatorily payable if there is not an IPO. Given the IPO event is both uncertain and genuine, does it also meet the criterion of being outside the control of both issuer and holder, thus making it a contingent settlement event in accordance with IAS 32.25?

Answer 5

Yes. It may be within the entity's control to determine whether the IPO is attempted, but market and regulatory forces determine whether any attempt is successful (ie, whether the market will accept an IPO and whether all regulatory approvals will be obtained). These forces are beyond the control of the entity. Redemption upon an IPO event not occurring therefore meets the definition of a contingent settlement event and results in the bond being classified as a financial liability.

Question 6 – Shares with an obligation to pay out a percentage of profits

Is a financial instrument that includes an obligation to pay out a fixed percentage of profits (10% of profits) and is mandatorily redeemable at par after 20 years a financial liability of the issuer? If so, how is it measured?

Answer 6

Yes. The instrument has two liability components, a contractual obligation to redeem the instrument at par after 20 years and a contractual obligation to pay 10% of profits until redemption. The latter is a financial liability because, although the payment depends on the entity making profits, future profits are outside the control of both the issuer and holder, and if profits are made, the issuer cannot avoid making the payment (IAS 32.25).

The 10% obligation does not meet the definition of an embedded derivative, as the entity's profit is a non-financial variable that is specific to a party to the contract. See Question 8. Note: this view may change. The IASB at its February 2007 meeting tentatively agreed to delete the exclusion in the definition of a derivative for contracts that are linked to a non-financial variable that is specific to a party to the contract, with the effect that only those contracts that meet the definition of insurance contracts would fail to be treated as derivatives.

The instrument is initially measured at fair value and subsequently at amortised cost in accordance with IAS 39.47, unless it can be and is designated as at FVTPL.

Question 7 – Legal obligation to launch a takeover bid

An entity acquires a significant stake in a listed company. The entity is obliged by local law to launch a takeover bid for the remaining shares. Does this obligation result in a liability for the present value of the exercise price under IAS 32.23 (in the same way as a put option written to a minority interest)?

Answer 7

No. A financial liability arises from the existence of a contractual obligation of one party to the financial instrument (the issuer) to deliver cash to the other party (the holder) (IAS 32.17). A statutory requirement to launch a takeover bid is a legal obligation not a contractual obligation; no liability is therefore recognised.

Embedded derivatives

Question 8 – Instruments whose payments are linked to EBITDA or sales revenue

Company A issues a mandatorily redeemable bond whose coupon payments are based on a multiple of EBITDA. These payments meet the definition of a financial liability under IAS 32.25. Does the linkage to EBITDA mean that there is an embedded derivative in the host debt contract?

Answer 8

No. Sales revenue and EBITDA are non-financial variables that are specific to a party to the contract on the grounds that they are primarily a function of business risk. The definition of a derivative in IAS 39.9(a) is not therefore met. Management

applies IAS 39.9 for the calculation of the effective interest rate.

Note: this view may change. The IASB at its February 2007 meeting tentatively agreed to delete the exclusion in the definition of a derivative for contracts that are linked to a non-financial variable that is specific to a party to the contract, with the effect that only those contracts that meet the definition of insurance contracts would fail to be treated as derivatives.

Question 9 – What are the components of a foreign currency-denominated convertible instrument?

What are the components of a foreign currency-denominated convertible instrument? For example, a UK company (functional currency GBP) issues a convertible bond denominated in US dollars and convertible on a number of dates into a fixed number of shares of the parent.

Answer 9

The whole contract is a liability. The host contract is a US dollar bond (whose foreign exchange risk is accounted for under IAS 21). The embedded derivative is a written option for the holder to exchange the US dollar bond for a fixed number of GBP-denominated shares.

Question 10 – Conversion into warrants

A convertible bond is convertible into a fixed number of warrants on shares in the borrower. Is the conversion option an equity component?

Answer 10

No. The issuer's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the issuer's own equity instruments, in accordance with IAS 32.16(b)(ii). The warrant is a contract for the future receipt of the issuer's own equity instruments; the conversion option is not therefore an equity component to purchase own shares.

Question 11 – Contingent settlement options

A company has issued convertible bonds whose terms include a clause giving the issuer the option to redeem in cash the bonds at their fair market value in the event of the occurrence of an uncertain future event. Does this contingent settlement option prevent the conversion option from being an equity component?

Answer 11

Yes. The conversion option is a derivative. The terms of the convertible bond give the issuer the option to redeem the bonds for cash at their fair market value. There is a settlement alternative for the equity conversion option, as it can be settled at fair value either in shares or in cash – that is, there is a net cash settlement option. An equity conversion option for which either party has a choice of settlement in cash or shares is a financial liability under IAS 32.26. IAS 32.26 overturns the usual principle that something that is in the control of an issuer is not an obligation. This right of choice of settlement is contingent upon a future event in the example above, but the equity conversion option is still accounted for as an embedded derivative in accordance with IAS 32.26.

Question 12 – Provisional issuer call option to redeem at par

An entity issues a convertible bond that, if converted, converts into a fixed number of equity shares. The bond also contains a provisional call option that gives the issuer the option to redeem the bonds at par if the shares price is 130% of the conversion price for at least 20 days. How should management account for the provisional call option?

Answer 12

The convertible bond is a compound financial instrument with a debt host and equity conversion option. As the issuer call option is to redeem the bonds at par, it does not result in the conversion option having a cash settlement alternative. The conversion option is not therefore accounted for as an embedded derivative in accordance with IAS 32.26.

In respect of the issuer call option, the value of any derivative feature (such as a call option) embedded in a compound financial instrument, other than the equity component, is included in the liability component (IAS 32.31). The call option is therefore considered part of the liability and not the equity component. When determining whether the embedded option is closely related, the assessment of whether the call or put option is closely related to the host debt contract from the issuer's perspective is made before separating the equity element under IAS 32 (IAS 39.AG30(g)).

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