

IAS32, IAS39 and IFRS 7 MADE EASY (Part I)

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PRESENTATION, RECOGNITION & MEASUREMENT OF COMPOUND FINANCIAL INSTRUMENTS

Under IAS 32,

- A financial instrument is classified as **financial liability/debt** if there is a contractual obligation on the issuer either;
 - to deliver cash or another financial asset to the holder or
 - to exchange another financial instrument with the holder under conditions that are potentially unfavourable to the issuer(Note- The FL/debt still exists irrespective of the existence of any limitation on the ability of the issuer to settle the obligation e.g. lack of access to foreign currency for foreign currency borrowings)
- A financial instrument is classified as **equity** where the above critical feature is not met(rationale- the holder of the equity instrument is **entitled** to share of any distribution out of the equity but the issuer **does not have a contractual obligation** to make such a distribution)
- In some cases,
 - a financial instrument may have the legal form of equity but are, in substance, liabilities e.g.
 - *preference shares- In addition to the definitions stated above, where the distribution of dividend/dividend payout is not at the discretion of the issuer, then the contractual obligation to pay dividend should be classified as financial liability/debt by the issuer.
 - where the distribution of dividend/dividend payout is at the discretion of the issuer, then the financial instrument should be classified as Equity
 - a financial instrument may have features of both equity and debt (known as **compound instrument**)

Examples

- a) Goodheart Plc issues preference shares which must be redeemed by the company for a fixed amount in 3yrs time and terms of the contract is such that the holder has the right to require the issuer to redeem the shares for a fixed amount at or after a certain date. .
Is the instrument an Equity or Debt?

Solution

The terms of the contract requires that Goodheart Plc, the issuer, redeem the shares in 3yrs time. This constitutes a contractual obligation on the issuer's part and therefore the financial instrument should be classified as Debt/Financial liability at the date of issue

- b) Expert PLC issues 100,000 8% preference shares at par for 1million. However, the terms of the contract stipulate that Directors of Expert plc have true discretion over whether dividends are paid or not.
Is the instrument an equity or debt/financial liability?

Solution

**In this case, the distribution of dividend is at the discretion of the issuer, Expert Plc. The contract terms does not mandate such distribution by Expert plc.
Expert Plc has no contractual obligation to deliver cash to its preference shareholders via dividend payment.
The financial instrument is therefore classified as Equity at the date of issue**

Compound financial instruments

Compound financial instruments are instruments that have both a liability and an equity element.

IAS32 requires that where such is the case, **the component parts be separated from each other with each part accounted for and presented separately according to its substance.**

E.g. - **Convertible debt**

- This creates a primary financial liability/debt of the issuer (the issuer's contractual obligation to pay cash i.e. principal and interest on the bond)
- and also creates an equity instrument as it grants an option to the holder to convert it into equity instrument usually ordinary shares of the issuer.
(i.e. a call option written to the holder to convert the debt security into common shares)

Presentation and accountability of convertible debt

- The separation of the components of such instrument is made at the time of issue and cannot be revised subsequently/in the future as a result of changes in interest rate, share price or other event that changes the likelihood that the conversion option will be exercised.

Method of separating the components of a compound instrument

Balance Sheet

IAS 32 requires the following method for balance sheet amounts;

- 1) calculate the value of the **liability component**

MV / FV of convertible debt/ liability

=PV of coupon interest payments + PV of principal (total proceeds)

- 2) Deduct (1) from the instrument as a whole to leave a residual value that is the **equity component.**

=Total proceeds – PV/FV of liability

The rationale/reasoning behind this is that the equity is the residual interest in its assets amount after deducting all its liabilities.

Note:

The carrying amount of the liability + the carrying amount the equity = the carrying amount of the instrument as a whole

Equity element

- The equity element is not re-measured

C) Redemption or conversion

i) Conversion option exercised

Derecognise FL and recognise as Equity;

Cr (BS) Equity X (amount at which the liability for the debt is stated at date of conversion)

Dr (BS) Liability X

No gain/loss is recognised on conversion

ii) Conversion option not exercised

The convertible debt instrument will be redeemed at the fully accreted amount (£2,000,000) at maturity date

Dr (BS) Liability £2,000,000

Cr (BS) Bank £2,000,000

Working

1) Liability element= MV of debt (using DDM or IVM

= $P_0 \Rightarrow i/r$)

substitute $P_0 = MV$ of debt & $r = kd$ b/4 tax

2) Principal amount (always based on NV) or Total proceeds

£1,000 x 2,000os=£2,000,000

3) Coupon interest payments (i)

£2,000,000w2 x 6%=£120,000

4) Market interest rate for similar FI i.e. discount rate (r or kd b/4 tax)

9%

5) amortised cost or effective rate method- interest paid in arrears

y/end	Bal B/f liability £	finance cost r or kd= 9% £	installments £	Bal C/d liability £
31.12.2006	1,848,140	166,333	-120,000	1,894,473
31.12.2007	1,894,473	170,503	-120,000	1,944,976
31.12.2008	1,944,976	175,024 (bal fig)	-120,000	2,000,000

bal figure- derived by working backwards £(2,000,000 + 120,000 - 1,944,976)

Practise question 2

Logic Plc has issued 10,000 6% convertible bonds at a par value of £100. Interest is payable annually in arrears. The market rate of interest for similar debt without the conversion option is 8%. Each bond is convertible into four shares in 4 years time.

Requirement

Show the accounting treatment for all applicable years assuming:

- i) conversion option is exercised in 4yrs time
- ii) conversion option is not exercised.

Solution

i) conversion exercised in 4yrs time

a) Value of liability element

PV of coupon interest payments = 1-4yrs →	£60,000w6 x 3.3121 (annuity 4yrs/8%) =	198,726	£
PV of principal = yr 4 →	£1,000,000w7 x 0.7350 (pv discount yr 4/8%) =	<u>735,000</u>	
Value of liability element		<u>933,726</u>	

b) Value of equity element

Total proceeds – value of liability element
£1,000,000 w7 – £933,726 a = £66,274

Issue date- initial recognition at FV

	£
Dr (BS) Bank	1,000,000 w7
Cr (BS) Equity	66,274 b
Cr (BS) Liability	933,726 a

Year end 1, 2, 3 and 4

Dr (IS) interest payment	60,000 w6
Cr (BS) bank	60,000

Year end 1

	£
Dr (IS) finance cost	14,698 (£74,698 w8 - £60,000)
Cr (BS) liability	14,698

Year end 2

	£
Dr (IS) finance cost	15,874 (£75,874 w8 - £60,000)
Cr (BS) liability	15,874

Year end 3

	£
Dr (IS) finance cost	17,144 (£77,144 w8 - £60,000)
Cr (BS) liability	17,144

<u>Year end 4</u>	£
Dr (IS) finance cost	18,558 (£78,558 w8 - £60,000)
Cr (BS) liability	18,558
Dr (BS) liability	1,000,000 w8
Cr (BS) Equity	1,000,000

ii conversion option is not exercised

The accounting treatment in this case will be the same as above (i) however, in year 4, on redemption of the bond, bank is credited rather than equity

Dr (BS) liability	£1,000,000 w8
Cr (BS) Bank	£1,000,000

Working

6) Coupon interest payments- $6\% \times (10,000 \text{ bonds} \times £100) = £60,000$

7) Principal or total proceeds= $10,000 \text{ bonds} \times £100 = £1,000,000$

8) amortised cost or effective rate method- interest paid in arrears

y/end	Bal B/f liability	finance cost r or kd= 8%	installments W1	Bal C/d liability
	£	£	£	£
1	933,726 a	74,698	-60,000	948,424
2	948,424	75,874	-60,000	964,298
3	964,298	77,144	-60,000	981,442
4	981,442	78,558 (bal fig)	-60,000	1,000,000

Income Statement

IAS 32 also considers how FIs affect income statement and movements in equity.

The treatment varies according to whether interest, dividends, losses or gains relates to a financial liability/debt or an equity instrument.

(In other words, the classification of FI in the balance sheet determines whether the interest, dividend, losses or gains related to that instrument are reported in the income statement or movement in equity statement).

- 1) Interest, dividends e.g. dividend on preference shares, losses and gains on a FI or its component, classified as **financial liability/debt**, should be recognised as **income or expense** in profit or loss.
- 2) Dividends/Distributions to holders of FI classified as an equity instrument are **debited directly to equity** by the issuer.

- 3) Gains and Losses associated with redemption or re-financings of FIs classified as the issuer's equity should be reported as **movements in equity**.
- 4) **Transaction costs of an equity** transaction shall be accounted for as a **deduction from** equity (unless they are direct costs to cost of investment i.e. directly attributable to the acquisition of a company, in which case should be accounted for under IFRS3)

Practise question 3

Gofigure issues 100,000 £1 equity shares (ordinary shares) which have a fair value of £2.50 per share for cash. Professional fees in respect of share issue are £50,000. The costs are deductible in arriving at the income tax liability. The corporate tax rate is 21%. The management of the Gofigure estimates that costs incurred internally for time incurred working on the share issue were £25,000.

Requirement- How should these transactions be recorded in Gofigure's financial statements

Solution-	£
Dr BS (cash/bank) 100,000es x £2.50	250,000
Cr BS (share capital/equity) 100,000es x £1	100,000
Cr BS (share premium) 100,000es x £ (2.50-1)	150,000
Cr BS- (bank re; profess fees)	50,000
Dr BS (share prem- 79% x £50,000)	39,500
Dr BS (current tax liability-21% x £50,000)	10,500