IAS 7, IAS 32, and IAS 33: Issuer's Accounting for Subscription Receipts

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A subscription receipt is a financial instrument issued by a company to investors in return for cash consideration and is governed by a subscription receipt agreement. Subscription receipts are converted into a fixed number of a company's common shares upon completing a defined transaction, such as an acquisition of a specific target company or a financing. If the defined transaction is not completed, the company will redeem the subscription receipts and refund the investors' original purchase price plus interest.

Cash received from the issuing subscription receipts is required to be used for the defined transaction and is held in escrow until such time that the conditions for release are either met or the transaction fails to materialize. While held in escrow, the funds are invested in certain specified investments such as short-term obligations guaranteed by the Government of Canada (e.g., guaranteed investment contracts (GICs)), often stipulated by the subscription receipt agreement.

With the increase in acquisitions and market activity in Canada, subscription receipt transactions are becoming a more prevalent form of financing. As a result, several questions have arisen about accounting for such transactions. The Group considered the following fact pattern and discussed questions such as the classification of such subscription receipts on the balance sheet, their measurement, their impact on the cash flow statement, and their impact on earnings per share (EPS).

Fact Pattern 1

- On December 15, 20X2, Company A completed a public offering of 1 million subscription receipts for gross proceeds of CAD$1 million (for simplicity, this example ignores transaction costs). Company A raised funds to complete an acquisition of a target company before January 31, 20X3 (the deadline). Company A's functional currency is CAD and its fiscal year end is December 31, 20X2.
- As at December 31, 20X2, the completion of the business combination was subject to closing conditions, compliance with which is outside Company A's control. In other words, completion of the business combination is not entirely within Company A's control.
- As part of the terms of the subscription receipts, the gross proceeds were placed into escrow and will be released to Company A upon closing of the acquisition. The holder of each subscription receipt is entitled to receive one common share at closing of the acquisition. The common shares are neither puttable by the holder nor of the type described in paragraph 16C of IAS 32 *Financial Instruments: Presentation*.

- If any one of the following events occurs, the escrowed proceeds, together with any interest earned thereon, will be returned on a pro-rata basis to holders of the subscription receipts:

  a) the acquisition does not close by the deadline;

  b) the acquisition agreement is terminated before the deadline; or

  c) Company A announces its intention not to proceed with the acquisition before the deadline.

- While held in escrow, the funds will be invested in various permitted investments specified by the subscription receipts agreement (e.g., GICs). Company A has assessed and concluded that it controls the cash held in escrow and receives the benefits from such cash. Therefore, the cash held in escrow meets the definition of an asset because Company A:

  (i) has discretion in investing the cash held in escrow within the applicable parameters; and

  (ii) retains the funds and the interest earned on the escrowed funds upon the successful completion of the acquisition.

- Company A also concluded it incurs an obligation:

  (i) to pay to the subscription receipt holders the funds held in escrow in the event the transaction does not occur; and

  (ii) to pay any shortfall between the amount owed to subscription receipt holders as described above and the funds held in escrow.

- On January 5, 20X3, Company A completes the acquisition of the target company, the funds are released from escrow and Company A issues the common shares to the holders of the subscription receipts in exchange thereof.

Issue 1: How should Company A's subscription receipts be classified for recognition and measurement purposes in the December 31, 20X2 financial statements?

Analysis

- The terms of the subscription receipts contain two settlement alternatives that depend on whether the specified business combination occurs within the specified time frame. If Company A does not complete the business combination, the subscription receipts will be settled in cash. However, if the business combination is completed, Company A will settle the subscription receipts by issuing its own equity instruments. Furthermore, the closing of the business combination is an uncertain event on December 31, 20X2, which is outside the control of Company A and the subscription receipt holders. Therefore, Company A should consider paragraph 25 of IAS 32 that addresses the issuer's classification of financial instruments with contingent settlement provisions.

- In accordance with paragraph 25 of IAS 32, as Company A does not have the unconditional right to avoid delivering cash and none of the exceptions described in paragraphs 25(a)-(c) are met, Company A should classify the subscription receipts as a financial liability, or at least conclude that there is a liability component.
- Since Company A may have to issue its own equity instruments to settle the subscription receipts outstanding, it should also consider the fixed-for-fixed condition in paragraphs 21- 22 of IAS 32 on contracts that are subject to settlement in its own equity instruments. Given the number of shares to be issued in settlement of the subscription receipts is fixed, Company A concludes that the settlement in shares represents an equity feature and the subscription receipts are therefore a compound instrument.
- At inception of the instrument, Company A allocates the initial proceeds of CAD $1million between the liability and equity components. In accordance with IFRS 9, the liability component is initially recognized at its fair value with any difference between the fair value of the liability component and the proceeds of CAD $1million being allocated to the equity component as described in paragraph 31 of IAS 32. Given the short time frame between the initial issuance of the subscription receipt (December 15) and when the contingency is resolved (January 31), it is reasonable to expect that most of the proceeds would be allocated to the fair value of the liability component.

The Group's Discussion

Group members agreed with the analysis.

One Group member observed that in a few cases, depending on the terms of the escrow agreement, a company may conclude that it does not have control over cash held in escrow and thus, does not recognize cash held in escrow as an asset.

The Group then discussed the following variations to Fact Pattern 1:

Issue 1A: Are there situations different from Fact Pattern 1 where the settlement in shares would not represent an equity component but would instead be an embedded derivative?

Fact Pattern 1A

Instead of Canadian dollars, the gross proceeds for the subscription receipts are USD $1 million. Company A promises to return that amount to the holders if the business combination does not complete. Company A has a CAD functional currency.

Fact Pattern 1B

The subscription receipts will convert into instruments that:

a) could be puttable at the holders' option (as set out in paragraph 16A of IAS 32); or

b) could impose upon Company A an obligation to deliver a pro rata share of net assets as set out in paragraph 16C of IAS 32.

Analysis

- For Fact Pattern 1A, since the monetary amount to be exchanged is not fixed in the entity's CAD functional currency, the fixed-for-fixed condition described in paragraphs 21 and 22 of IAS 32 is not met. Thus, Company A should consider the conversion feature a financial liability.
- For Fact Pattern 1B, Paragraph 22A of IAS 32 notes that any conversion features that result in the types of financial instruments described in (a) and (b) should be considered a financial liability of the issuer, and not equity.
- For both Fact Patterns 1A and 1B, Company A should consider the guidance in IFRS 9 *Financial Instruments* related to embedded derivatives and assess whether the embedded conversion feature is required to be separated from the host liability and accounted for as a derivative. The embedded conversion feature is required to be separated from the host liability and accounted for as a derivative if

  (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host;

  (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

  (c) the hybrid contract is not measured at fair value with changes in fair value recognized in profit or loss (paragraph 4.3.3 of IFRS 9).
- If the conditions in IFRS 9 are met, Company A can also designate the entire subscription receipt contract as at fair value through profit or loss, except for changes in fair value, if any, related to changes in Company A's own credit risk, which would be reported in other comprehensive income (paragraph 4.3.5 of IFRS 9).

The Group's Discussion

Group members agreed with the analysis.

One Group member noted that in Fact Pattern 1A, the gross proceeds of the subscription receipts are denominated in US dollars, but the number of shares Company A will issue to settle the subscription receipts is fixed. Although the number of shares to be issued is fixed, the monetary amount to be exchanged is not fixed in the entity's CAD functional currency. Therefore, the fixed-for-fixed condition is not met, and the conversion feature is a financial liability.

Issue 2: How should Company A present the funds held in escrow in the cash flow statement for the period ended December 31, 20X2?

View 2A– The funds held in escrow should not be excluded from "cash and cash-equivalents" simply due to the existence of the restrictions.

- Proponents of this view think that Company A should first determine whether the investments held in escrow meet the definition of "cash and cash equivalents" in IAS 7 *Statement of Cash Flows*. Specifically, paragraph 6 of IAS 7 defines "cash equivalents" as "short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value."
- Proponents of this view think that if the funds placed into escrow are invested in investments that meet the definition of cash equivalents, then they should be included within "cash and cash equivalents" in the cash flow statement. However, Company A should disclose, with commentary by management, the amount of significant cash and cash equivalents the entity holds that are not available for use by the group in accordance with paragraph 48 of IAS 7.
- Therefore, in the statement of cash flow, Company A should reflect the cash from issuing subscription receipts as a cash inflow from financing activities with a corresponding increase in the closing balance of cash and cash equivalents.

View 2B– The funds held in escrow should be excluded from "cash and cash equivalents" due to the existence of the restrictions that requires the funds to be used for long-term investing purposes.

- Proponents of this view focus on the words in paragraph 7 of IAS 7: "Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes." They think that the nature of the restriction would mean that the amounts held in escrow would not qualify as "cash equivalents" because they are not held for "the purpose of meeting short-term cash commitments", but rather are held for investment or other purposes – specifically, to finance the acquisition of an entity.

View 2C– Accounting policy choice

- Proponents of this view believe the guidance in IAS 7 is unclear. Therefore, Company A has an accounting policy choice between Views 2A and 2B, to be applied consistently.

The Group's Discussion

Most Group members preferred View 2C, recognizing both View 2A and 2B have merit. They noted that because cash will only be held in escrow for a short time until the uncertainty is resolved, this could support the assessment that the funds meet the definition of cash equivalents (View 2A). Alternatively, these Group members considered that the funds held in escrow are held for acquiring an entity, not for short-term cash commitments. Therefore, this could support that the funds do not qualify as "cash equivalents" (View 2B). They highlighted the importance of clear disclosure of this accounting policy and the intended use of the funds so that financial statement users have relevant information regarding these funds.

A few Group members preferred View 2B. They noted that it is important to consider paragraph 7 of IAS 7 to assess the intent for holding the funds in escrow. Given the funds are intended for the acquisition of an entity, these Group members thought the funds do not qualify as "cash equivalents".

Issue 3: If it is concluded that the funds held in escrow do not qualify as "cash and cash equivalents", how should the subscription receipts be reflected in the cash flow statement for the year ended December 31, 20X2?

View 3A– Treat as cash flows from financing and investing activities

- Proponents of this view note that the issuance of the subscription receipts should be presented as a cash inflow from financing activities on Company A's cash flow statement as it changes the size and composition of Company A's borrowings. In addition, Company A should present a corresponding cash outflow from investing activities as the cash received was used to acquire investments not included in cash and cash equivalents.

View 3B– Treat as a non-cash transaction

- Proponents of this view consider paragraph 43 of IAS 7 which states: "Investing and financing transactions that do not require the use of cash or cash equivalents shall be excluded from a statement of cash flows." Given the funds held in escrow do not qualify as "cash and cash equivalents", they think the receipt of cash and the incurrence of the subscription receipts liability would be excluded from the cash flow statement.

View 3C– Accounting policy choice

- Proponents of this view consider the guidance in IAS 7 to be unclear. Therefore, Company A has an accounting policy choice between Views 3A and 3B, to be applied consistently.

The Group's Discussion

Group members offered different views on this issue.

A few Group members preferred View 3A. One Group member noted the issuance of subscription receipts represents a cash inflow to Company A, albeit in escrow, and should be reflected in the cash flow statement. Other Group members noted that this view, along with the note disclosure, better reflects the cash flows behind the transaction whereby the proceeds from the subscription receipts is used to acquire investments.

Some Group members preferred View 3B. They noted that because the funds held in escrow are excluded from cash and cash equivalents, they should be excluded from the cash flow statement. One Group member also considered paragraph 22 of IAS 7 to be relevant, where the cash flows arising from operating, investing and financing activities may be reported on a net basis when "the cash receipts and payments for items in which the turn-over is quick, the amount is large, and the maturities are short."

Other Group members noted the merits in both Views 3A and 3B and therefore, thought an accounting policy choice is appropriate.

Issue 4: How should Company A treat the subscription receipts when calculating basic and diluted EPS as at December 31, 20X2?

Analysis

- IAS 33 *Earnings per Share* does not provide specific guidance regarding the treatment of subscription receipts. However, IAS 33 does provide guidance on "contingently issuable ordinary shares" which are defined as "ordinary shares issuable for little or no cash or other consideration upon the satisfaction of specified conditions in a contingent share agreement" (paragraph 5 of IAS 33). The subscription receipts do not qualify as contingently issuable ordinary shares because the shares are not issuable for little or no consideration – the consideration has been prepaid. Nonetheless, the subscription receipts and contingently issuable shares are similar in that both instruments result in issuing common shares only on the satisfaction of specified conditions. Therefore, it is worth considering the guidance in IAS 33 on contingently issuable shares by analogy.

- With respect to the impact of the subscription receipts on basic EPS, Company A considers paragraph 24 of IAS 33, requiring that the contingently issuable shares be treated as outstanding and included in the calculation of basic EPS only from the date when all necessary conditions have been satisfied (i.e., the events have occurred). Because the acquisition has not occurred by December 31, 20X2, the contingently issuable shares would not be included in basic EPS for the year ended December 31, 20X2. They will be included in basic EPS from the date when all necessary conditions have been met (i.e., the acquisition closes).

- Regarding the computation of diluted EPS, IAS 33 recognizes that contingently issuable ordinary shares may be issued based on conditions relating to future earnings, future market prices or other conditions. Paragraph 56 of IAS 33 explains that:

  "In other cases, the number of ordinary shares contingently issuable depends on a condition other than earnings or market price (for example, the opening of a specific number of retail stores). **In such cases, assuming that the present status of the condition remains unchanged until the end of the contingency period, the contingently issuable ordinary shares are included in the calculation of diluted earnings per share according to the status at the end of the reporting period.**" (**emphasis added**)

- Given that the acquisition has not occurred on December 31, 20X2, the status of the contingently issuable shares is that they are not issuable. Therefore, they would be excluded from diluted EPS for the year ended December 31, 20X2. Once the common shares are issued on January 5, 20X3, they will impact the calculation of diluted EPS from January 1, 20X3.

The Group's Discussion

Group members agreed with the analysis.

Some Group members noted that although subscription receipts do not impact basic and diluted EPS for the year ended December 31, 20X2, there could be a dilutive impact on existing shareholders when the acquisition is completed on January 5, 20X3. These Group members thought that Company A should consider communicating to financial statement users information about this anticipated dilution event and forecasted impact on EPS in its management discussion and analysis.

Overall, the Group's discussion raises awareness on the issuer's accounting for subscription receipts and the related impact on the cash flow statement and EPS. No further action was recommended to the AcSB.