IAS 32: Cash Settlement Options for Equity-Linked Conversion Features in Convertible Debt

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IAS 32 *Financial Instruments: Presentation* addresses how to classify financial instruments, from the perspective of the issuer, as financial assets, financial liabilities, and equity instruments, including the classification of related interest, dividends, losses and gains, and circumstances in which financial assets and financial liabilities should be offset.

A financial instrument is an equity instrument if, and only if, the conditions specified in paragraph 16 of IAS 32 are met. In addition, paragraph 26 of IAS 32 elaborates on how to address settlement provisions when a financial instrument gives one party a choice over how it is settled. For example, the settlement provision may provide the issuer or the holder with a choice of net settlement in cash or by exchanging shares for cash.

Paragraph 26 of IAS 32 clarifies that when a settlement option exists between settlement in cash or the exchange of shares, the instrument is "a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument."

Example:

- Convertible debt instruments contain conversion features whereby the holder of the debt instrument has an option to settle the debt instrument by requiring the issuer to deliver a fixed number of common equity shares of the issuer. This conversion feature satisfies paragraph 16(b) of IAS 32 and meets the "fixed for fixed" criteria.
- The conversion features also contain an option for the issuer to settle the conversion option by either:
  - paying the holder the market value of the shares in cash; or
  - exchanging its own shares for settlement of the debt instrument (i.e., physical delivery).

The issue for consideration is whether liability or equity treatment is appropriate in this example.

The Group's Discussion

Group members observed that the classification of a financial instrument as a financial liability or an equity instrument can be complex and requires an analysis of the various features of the financial instrument to arrive at a conclusion on the appropriate classification.

For this example, Group members noted that IAS 32 is quite clear but that the accounting result to treat the equity conversion feature as a liability continues to be a surprise in practice. Paragraph 26 of IAS 32 requires the equity conversion feature to be treated as an embedded derivative liability that is not closely related to the debt host contract and, therefore, carried at fair value with changes in fair value recognized in profit or loss. Alternatively, the entire instrument could be accounted for at fair value through profit and loss under paragraph 11A of IAS 39 *Financial Instruments: Recognition and Measurement*. Paragraph 27 of IAS 32 provides a similar example that also requires liability treatment.

Group members noted that there are many ways an entity can include options that result in unintended results that prevent the issuer from classifying a holder conversion option in equity. Group members observed that convertible debentures are complicated and entities issuing these instruments should be prepared to complete the necessary analysis and obtain help when necessary to avoid unexpected accounting consequences.