IAS 32 and IAS 39: Changes to Convertible Debt

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There are situations when an entity would negotiate with lenders to restructure its convertible debt (for example, when an entity is experiencing financial difficulty).

A restructuring of convertible debt may result from a change or modification to the key terms of the convertible debt or through an exchange of old convertible debt with new debt on similar or substantially different terms. An entity needs to determine whether the change in key terms or exchange of the debt represents an extinguishment or modification of the original debt in order to apply the correct accounting treatment in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*.

Paragraph 40 of IAS 39 states:

> "An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability."

Furthermore, paragraph AG62 of IAS 39 states:

> "For the purpose of paragraph 40, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability."

Therefore, if the exchange or modification is accounted for as an extinguishment, the effect is recognized immediately. Otherwise, the effect of the exchange or modification would be recognized prospectively. The challenge around applying this guidance in practice is that it does not explicitly address modifications of debt with conversion options.

Fact Pattern:

- Entity X has issued a convertible debt instrument for $1,000,000. The conversion option meets the "fixed-for-fixed" condition in IAS 32 *Financial Instruments: Presentation* and, thus, is accounted for as an equity component of the instrument. A liability is recognized for the host debt component.

- At the end of year 1, the convertible debt instrument has a fair value of $900,000 and the host debt instrument has a fair value of $860,000. For simplicity, the amount of $860,000 is also assumed to be the present value of the remaining cash flows of the host debt.
- Due to the decrease in Entity X's share price, Entity X and the convertible debt holders renegotiate the terms of the arrangement. The debt holders agree to exchange their convertible debt for new non-convertible debt with a fair value of $900,000. For simplicity, the amount of $900,000 is also assumed to be the present value of the cash flows under the new terms (including any fees paid net of any fees received) discounted using the original effective interest rate.
- The original conversion option feature was substantial (i.e., not of insignificant worth).

Issue 1: When replacing the convertible debt with a non-convertible debt instrument prior to maturity of the original instrument, what approach is Entity X required to use in determining whether the change should be accounted for as a modification or extinguishment?

View 1A – Entity X applies the 10 per cent quantitative test only to the debt component.

Under this view, Entity X determines if the new non-convertible debt is substantially different by applying the derecognition requirements in IAS 39 to the financial liability component only.

Proponents of this view note that IAS 39 does not provide derecognition guidance for the equity component and, thus, there is no requirement to look at any changes to a non-financial liability component of the convertible debt (i.e., the conversion option classified as an equity component). Furthermore, paragraphs 40 and AG62 of IAS 39 do not address considerations related to changes in the instrument that affect the other characteristics or risk profile beyond its cash flows.

In this fact pattern, the change in cash flows does not exceed 10 per cent. Therefore, the change in the terms is accounted for as a modification of the original convertible debt.

View 1B – Entity X applies the 10 per cent quantitative test to the debt component and applies qualitative factors to the whole instrument.

Under this view, Entity X determines if the new non-convertible debt is substantially different by applying the derecognition requirements to the whole instrument.

Proponents of this view note that neither paragraph 40 nor paragraph AG62 of IAS 39 prohibit an entity from looking to qualitative factors in determining whether the change is substantial. Rather, an entity is always required to review the 10 per cent quantitative cash flow test. In addition, if the characteristics or risk profile of the new debt instrument have changed substantially from the original instrument, then the change is accounted for as an extinguishment of the original debt.

In this fact pattern, the original conversion option is removed. Even though the net present value of the cash flows under the new terms is less than 10 per cent different from the discounted present value of the remaining cash flows of the original liability, Entity X would still account for the exchange as an extinguishment. This approach is on the basis that the changes have resulted in the instrument as a whole to be substantially different from the original instrument.

View 1C – Entity X has an accounting policy choice whether to review and apply qualitative factors to the whole instrument.

Under this view, an accounting policy choice exists as to whether the derecognition requirements in IAS 39 are applied on the debt component only or whether testing is performed on the whole instrument.

The Group's Discussion

Most Group members supported the view that both the 10 per cent quantitative test and qualitative factors should be reviewed to determine whether the change would be accounted for as a modification or extinguishment (View 1B). Group members noted that it would be difficult not to consider the removal of the conversion option when assessing whether the characteristics or risk profile have changed substantially. Further, from a holder's perspective, it would be difficult to argue that the original instrument has not changed given the loss of a conversion option.

However, some Group members did not necessarily agree with the conclusion in View 1B in this fact pattern (i.e., that Entity X would account for an exchange of the liability as an extinguishment). They pointed out that although the conversion option is removed, further analysis is required. For example, if the conversion feature was deeply out of the money with no prospect of being of value in the future when the terms of the instrument were amended, then accounting for the change as a modification may be appropriate. In this circumstance, the conversion option would not be a substantive feature at the date of modification.

One Group member supported the view that an accounting policy choice exists (View C) on the basis that guidance in IAS 39 is not explicit on either approach.

Issue 2: If the exchange results in a substantial change in terms and, therefore, is accounted for as an extinguishment of the existing convertible debt (i.e., View 1B), what is the appropriate accounting for allocating the proceeds to the debt and equity components?

View 2A – Gains or losses are allocated to the debt and equity portions.

A gain or loss should be recognized on the extinguishment of the convertible debt in accordance with paragraph AG33 of IAS 32. A part of the new non-convertible instrument replaces the debt component of the convertible debt and a part of the new non-convertible instrument replaces the equity component of the convertible instrument.

Under this view, the consideration paid is allocated to the debt and equity components of the existing convertible debt at the date of the transaction using the same allocation method as on initial recognition. Any difference between the new debt that is allocated to extinguishing the debt component and the carrying value of the host debt is recognized as a gain or loss through profit or loss in accordance with AG34 of IAS 32. The new debt that is allocated to extinguishing the equity conversion component does not result in a gain or loss. Instead, any difference between this amount and the carrying value of the conversion option is taken directly to equity in accordance with AG34 of IAS 32.

View 2B – Gains or losses are allocated to the debt portion only and recognized through profit or loss.

Under this view, if Entity X were to apply the derecognition requirements to the debt component only, any difference between the fair value of the new debt instrument and the carrying value of the existing debt instrument is recognized in profit or loss in accordance with AG34 of IAS 32. The extinguished conversion option does not give rise to a gain or loss. The conversion option continues to be recognized within equity.

The Group's Discussion

Some Group members supported the view that any gain or loss should be allocated to the debt and equity portion (View 2A) because if the change was considered an extinguishment in this fact pattern, this meant that the conversion feature was a substantive feature at the date of modification. Thus, it would be reasonable that a portion of the gain or loss should be allocated to the equity component. However, a few Group members thought it would be difficult to rule out the approach under View 2B because the change is not considered an early redemption of the convertible debt or it could be viewed as analogous to letting the conversion option expire. Therefore, these Group members thought there could potentially be diversity in practice in this area. One Group member pointed out that there could also be earnings per share implications. Another Group member questioned whether there should be symmetry in accounting between the issuer and the holder of such instruments because it is not clear from the guidance in IAS 39.

The Group recommended that the issue be discussed with the AcSB to determine whether it should be referred to the IASB or IFRS Interpretations Committee.

(For a full understanding of the discussions and views expressed, listen to the audio clip).