Accounting for rights to subscribe for convertible bonds

Introduction

In today's business world, convertible bonds are commonly used by listed entities to raise funds. A conventional convertible bond issued by an entity is usually defined as a fixed-rate bond whose terms require or allow the bond holder to convert the bond into a certain number of ordinary shares of the entity at a prescribed conversion price within a prescribed conversion period. Until HKFRS 9 *Financial Instruments* becomes effective in 2018 and replaces HKAS 39 *Financial Instruments: Recognition and Measurement*, the accounting for convertible bonds is governed by HKAS 32 *Financial Instruments: Presentation* and HKAS 39. Since HKAS 32 and HKAS 39 have been effective for some time, preparers of financial statements should have a good grasp of the application of HKAS 32 and HKAS 39 in accounting for basic convertible bonds. However, dealings in convertible bonds are becoming more complicated nowadays and accounting issues may arise even before the convertible bonds are issued.

In recent reviews of published financial statements by the Institute's Quality Assurance Department, we noted instances where the listed companies accounted for agreements to subscribe for convertible bonds to be issued by them (subject to the fulfillment of certain preconditions some time in future) as financial assets carried at fair value. These transactions gave rise to substantial fair value gains being recognized within a short period of time even before the preconditions were fulfilled and the convertible bonds were issued. The disclosures described these subscription agreements as "put options" held by the listed companies as the listed companies were considered to have rights under the agreements to request the other parties ("other parties") to subscribe for the convertible bonds when the bonds are issued. Although it is arguable as to whether these agreements are in fact put options or other types of derivatives as the underlying convertible bonds did not exist at the time of entering into the agreements, these instruments are still referred to in this article as put options for ease of reference.

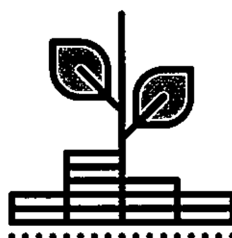
Since the above transactions are likely to fall outside the normal course of business for an entity, it is important to consider all facts and circumstances before determining an appropriate accounting treatment. This article highlights matters for which preparers and auditors should watch out in accounting for and auditing the transactions, particularly on recognition and measurement of the put options and the resulting gains. The discussion below is made on the assumption that the put options are contracts that fall within the scope of HKAS 39.

Understanding the business rationale and assessing the substance of the transaction – related party transaction?

First and foremost, it is important to obtain a clear understanding of the business rationale to assess the substance of the transaction in relation to the put options. The terms of the transaction, including terms of the underlying convertible bonds, should provide some insights into its substance.

In one listed company's financial statements, the terms of the underlying convertible bonds provided that the listed company (the bond issuer) was allowed to redeem the convertible bonds at 100 percent of the outstanding principal amount at any time prior to the maturity date of the bonds whereas the other parties (the holders of the bonds) were required to mandatorily convert the outstanding convertible bonds into shares of the listed company at the prescribed conversion price on the maturity date. Under the above circumstance, it would appear that the other parties, by entering into the subscription agreements, could have little chance of a subsequent upside gain when the share price exceeded the conversion price as the listed company could redeem the convertible bonds at their principal amount at any time before the maturity date. On the other hand, the other parties had to bear the downside risks arising when the conversion price exceeded the share price as they were required to mandatorily convert the underlying outstanding convertible bonds into shares at the conversion price on the maturity date.

In the above case, one would expect that a significant amount of money should have been paid by the listed company (bond issuer) in order to attract the other parties to enter into the subscription agreements given the lopsided risks required to be borne by the other parties as discussed above. Therefore, if there was nil payment involved upfront, then why did the other parties agree to enter into the deal? What was the commercial substance of the deal? Could the other parties be related parties of the listed company, e.g. the controlling shareholder or an equity participant of the listed company? The nature and the purpose of



the transaction have to be well thought through, in particular in cases similar to the above where there are indications that the transaction might not have been entered into on an arm's length basis that might give rise to different accounting implications. For example, if the other parties were in fact the controlling shareholder of the listed company and the deal was determined to have been entered by that shareholder in the capacity of an equity participant, the Day 1 gain or loss arising from the transaction should be recorded in equity as a deemed capital contribution or distribution.

Mandatory conversion

Convertible bonds are compound financial instruments when their terms determine that they contain both a liability and an equity component (HKAS 32 paragraph 28). However, if the conversion of the convertible bonds is "mandatory" at a fixed conversion price into a fixed number of shares of the bond issuers on the maturity date and the bonds pay no interest, the "convertible bonds" would contain only an equity component and therefore be considered as solely an equity instrument (assuming the bonds do not contain any liability features).

An illustrative example provided in HKAS 32 paragraph IE25 (example 5) shows an entity that enters into a contract with another party that gives the entity a right to sell (i.e. put option) and the other party an obligation to buy the shares (i.e. an equity instrument) of the entity. In that example, the entity (put option holder) accounts for the put option in its financial statements as an equity instrument at initial recognition with the consideration paid to purchase the put option being deducted from equity. Changes in fair value of the put option are not recognized in the financial statements as it is an equity instrument.

By analogy, the same accounting would be applied if the underlying instruments are not shares but convertible bonds that consist solely of an equity component, in which case, the put options would have to be accounted for as an equity instrument with no re-measurement permitted. Since the nature of the underlying convertible bonds would affect the accounting treatment of the put options, careful examination of the terms of the underlying convertible bonds is required to determine the appropriate accounting treatment of the put options.

Day 1 gain or loss

HKAS 39 paragraph 43 states that "When a financial asset or financial liability is recognized initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability." Therefore, the put options, if they are determined to be financial assets, should be recognized at their fair value on Day 1. But what if the fair value differs from the transaction price?

HKAS 39 paragraph AG76 acknowledges that the best evidence of the fair value of a financial instrument at initial recognition in an arm's length transaction is normally the transaction price (i.e. the fair value of the consideration given or received) unless its fair value is determined otherwise wholly based on observable market data (including Level 1 inputs). In cases where the fair value cannot be determined wholly based on observable market data (which is more likely in the scenarios described in this article), an entity shall recognize the instrument at fair value duly determined, adjusted to defer the difference between the fair value at initial recognition and the transaction price.

After initial recognition, the entity shall recognize the deferred difference as a gain or loss only to the extent that it arises from a change in a factor (including time) that market participants would consider in setting a price. In other words, effectively, Day 1 gain or loss can only be recognized immediately when the fair value is evidenced by observable market data whereas in all other cases the transaction price gives evidence of fair value and immediately recognizing the Day 1 gain or loss is precluded (HKAS 39 paragraph BC104). In respect of subsequent measurement of the instrument, HKAS 39 paragraph AG76A requires that the subsequent recognition of gains and losses shall be consistent with the requirements of HKAS 39.

Based on the above requirements, if the transaction price of the put options was automatically taken as their fair value in the case that their fair value could not have been determined wholly based on observable market data, their real fair value and the resulting Day 1 gain or loss might not have been carefully considered at the point of initial recognition. However, when a subsequent re-measurement of the put options gives rise to a substantial change in their fair value over a short period of time (e.g. a few months from initial recognition to the first year end after initial recognition), questions would arise as to whether the substantial change in

fair value could have consisted of some material Day 1 gain or loss that should have been deferred due to the provision in HKAS 39 paragraph AG76. Therefore careful consideration of the implication of HKAS 39 paragraphs AG76 and AG76A is needed in determining the fair value of the put options, in particular in the first re-measurement required to be recognized.

As a reminder, HKFRS 13 *Fair Value Measurement* paragraph 64 provides that if the transaction price is fair value at initial recognition and a valuation technique that uses unobservable inputs will be used to measure fair value in subsequent periods, the valuation technique shall be calibrated so that at initial recognition the result of the valuation technique equals the transaction price. Accordingly, if work had been done according to HKFRS 13 paragraph 64, the Day 1 gain or loss should have been identified at initial recognition rather than being included in subsequent measurement.

Fair value measurement

As discussed above, fair value measurement is applied in determining the fair value of the put options at initial recognition and where appropriate, also in the subsequent measurement. HKFRS 13 provides guidance on how to determine fair value for financial reporting. It should be noted that fair value is a market-based measurement, rather than an entity-specific measurement (HKFRS 13 paragraph 2). As fair value is a market-based measurement, it is measured using the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk (HKFRS 13 paragraph 3). As a result, relevant risk factors of the deal (such as the likelihood of fulfilling the preconditions before the convertible bonds can be issued, the credit risk of the other parties and the volatility of the share price) and the risk inherent in the valuation technique used and its inputs should be factored into the fair value of the put options.

It is worth noting that HKAS 39 paragraph 46 provides a fair value exemption to subsequent measurement of unquoted equity instruments and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments if their fair value cannot be measured reliably. If the preconditions set out in the subscription agreements are not within the control of contracting parties and are substantive rather than a formality or there are other factors causing the fair value of the put options falling within the scope of the exemption under HKAS 39 not to be able to be estimated with a reasonable degree of reliability, considerations might be given to applying the exemption by analogy to the subsequent measurement of the put options. However, it is important to bear in mind that the exemption does not apply to initial recognition of the put options.

Auditor's perspective – exercise professional scepticism

There are a lot of matters which should be considered in determining an appropriate accounting treatment of the put options. The matters described above are not exhaustive and the accounting should be determined based on all relevant facts and circumstances. After all, from the auditor's perspective, before it draws its audit conclusion on the client's accounting treatment and fair value measurement, a thorough study of the terms of the contract and understanding of the business rationale is necessary. Such work should enable the auditor to assess the substance of the transaction to arrive at an appropriate audit conclusion. Professional scepticism is the key to satisfactory audit outcomes. The auditor should heighten its professional scepticism and perform adequate work to challenge the appropriateness of the client accounting treatment when the results of the accounting for the put options are critical to the financial statements (e.g. representing a substantial part of the net assets or giving rise to a substantial profit).

As a reminder, to identify transactions which actually are related party transactions, auditors should carry out the steps set out in HKSA 550 *Related Parties*. Auditors should also carry out sufficient appropriate audit procedures as required by HKSA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* to verify whether the fair value of the put options recognized by their client is appropriate. The procedures to be performed shall include evaluation of appropriateness of the assumptions used and the valuation method applied by the client, in particular, whether those assumptions and valuation method are reasonable and supportable.

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