

# Convertibles and IAS

## Part 1: Position of the Issuer

This is the first of two articles on the topic of convertibles, taken here to mean a bond which can be converted into shares of the issuer of the bond. The articles are intended to provide a general overview of recent changes to the corporate taxation of convertibles.<sup>1</sup>

The articles will focus on recent changes to the UK tax legislation to deal with the convergence of UK GAAP with international accounting standards<sup>2</sup> (IAS) and the ability, subject to the relevant provisions of the Companies Act 1985, of an entity to prepare its solus accounts in accordance with IAS for periods of account commencing on or after 1 January 2005.

This first article will focus on the position of the issuer. The position of the holder will be covered in the second article.

In some respects the tax analysis is not entirely clear and further changes to the regime cannot be ruled out. It should also be appreciated that the accounting treatment discussed represents the authors' understanding of the relevant standards, which are comparatively new and the precise application of which is, in a number of areas, uncertain.

However, to summarise some of the more important points in relation to issuers of convertibles:

- issuers may now be able to obtain relief, under the loan relationships regime, for the implicit cost to the issuer of the option right granted to holders of the convertibles;
- where holders elect to convert their bonds into shares, such relief is not clawed back; and
- notwithstanding that holders elect for redemption, the relief obtained by the issuer under the loan relationships regime for the amount attributed to the option right is not necessarily clawed back or is clawed back as a capital gain, depending on the nature of the convertible.

*Jonathan Cooklin, tax partner, and Laurent Sykes, tax associate, Freshfields Bruckhaus Deringer, both solicitors and chartered accountants, discuss recent changes to the taxation of convertibles*

### AN EXAMPLE

It is easiest to consider the changes which are the focus of the present article by way of example: a UK incorporated and resident company (the 'issuer') issues 200,000 convertible bonds into the market at the start of year 1. The bonds have a four-year term and a face value of £1,000 per bond. Issue costs are assumed to be £1 million. Interest is payable annually in arrears at a nominal annual interest rate of 6%. At the holder's option, each bond is convertible at maturity at the end of year 4 into 1 ordinary share in the issuer (and the obligation to issue shares if holders elect to convert cannot be cash-settled). The conversion right cannot be separately transferred. When the bonds are issued, the prevailing market interest rate for similar debt without a conversion option is 9% (the difference between this and the 6% actually payable being acceptable to bondholders as the effective price of the conversion option). Issue costs of delivering the shares on conversion are assumed to be nil. Assume that the issuer adopts IAS in its solus accounts in the relevant periods.

It is worth a quick reminder of the accounting treatment under UK GAAP and the tax treatment which apply for periods of account beginning before 1 January 2005, before considering the position for convertible bonds issued in periods of account beginning on or after that date and accounted for under IAS.

### PERIODS OF ACCOUNT BEGINNING BEFORE 1 JANUARY 2005

#### Issuer accounting treatment

##### Initial recognition

What would be the accounting treatment under FRS 4 for periods of account

beginning before 1 January 2005? Since the bonds impose an obligation on the issuer to transfer economic benefits and since, under FRS 4, conversion is not to be anticipated, the bonds should be accounted for within liabilities as debt (but should be stated separately from other liabilities). The initial carrying amount of the debt will be equal to the net proceeds of issue, being the fair value of the consideration received on issue (£200 million) less the costs incurred directly in connection with the issue (£1 million) – that is, £199 million.

The double entries would accordingly be:

Dr Cash	£199m
Cr Liabilities	£199m

##### Finance costs

Finance costs will be equal to the difference between net proceeds of £199 million and the total payments which the issuer may be required to make in respect of the instrument (£200 million principal and £48 million interest) – that is, £49 million. The finance costs will be allocated to periods over the term of the debt at a constant rate on the carrying amount. On the numbers given that constant rate would be approximately 6.1%, giving the finance costs in Table 1 overleaf for each of the four years. The effect is that the issue costs are spread over the term of the notes. The finance costs of £49 million will typically be charged to the profit and loss account.

##### Conversion or redemption

To the extent that on maturity bondholders elect to convert, the amount recognised in shareholders' funds in respect of the shares issued should be the

**Table 1: Finance charges under FRS 4**

Year	Initial liability recognised	Finance costs (6.1% x opening liability)	Payment	Closing liability
	£(199m)			
1		£(12,228,101)	£12,000,000	£(199,228,101)
2		£(12,242,117)	£12,000,000	£(199,470,218)
3		£(12,256,995)	£12,000,000	£(199,727,213)
4		£(12,272,787)	£212,000,000	Nil
<b>Total</b>		<b>£(49,000,000)</b>		

amount at which the liability for the debt is stated as at the date of conversion, with no gain or loss recognised.

Accordingly the double entries (taking into account the accretion of the principal amount of the liability) would be:

Dr Liabilities      £200m  
Cr Equity            £200m

**Issuer taxation treatment**

For periods of account beginning before 1 January 2005, the taxation of the issuer will, broadly speaking, follow the above accounting treatment. The loan relationships regime applies in the normal way with two modifications. First, Finance Act (FA) 1996, s 92A denies relief for any share issue costs – there are none in the example above. Secondly, s 92A provides that any debits to be brought into account are to be brought into account under an authorised accruals basis of accounting (as opposed to an authorised mark to market basis). Again no adjustment should result on the facts. Accordingly, the issuer should in principle be able to obtain relief for the £49 million of finance charges in the periods in which they are debited to profit and loss, with no other amounts being brought into account.

**PERIODS OF ACCOUNT BEGINNING ON OR AFTER 1 JANUARY 2005**

**Issuer accounting treatment**

How does the above change under IAS and what is the impact on the tax treatment?

An important point to note is that the accounting and tax treatment for the issuer will differ depending on whether the option right granted to holders is treated (from the point of view of the issuer) as equity (that is, as a residual interest in the net assets of the entity), or as a derivative financial instrument. The accounting treatment described below assumes that the option right represents equity from the perspective of the issuer (as it should do on the facts assumed in the example) but some of the differences which would arise were the option right to represent a derivative financial instrument are also considered. The difference in tax treatment which would result is also considered. It should be noted that it may be comparatively easy for equity treatment not to be available – for instance, if the conversion right in the example could be cash-settled other than only on the occurrence of a remote contingency (for example, if on exercise of the option the issuer could, instead of

issuing shares, pay holders cash equal to the market value of the shares which it would otherwise have been required to issue), the option right would, it seems, be analysed as a derivative financial instrument and not as equity in relation to the issuer.

*Initial recognition*

Under IAS 32 the first step for the issuer of a non-derivative financial instrument is to determine whether it contains both a liability and an equity component, since these will need to be presented separately. As the bonds are convertible by holders into a fixed number of ordinary shares (and cannot be cash-settled), they comprise two components: a financial liability (being in this case a contractual arrangement to deliver cash) and an equity instrument (a call option element). Accordingly the liability and equity components will be required to be presented separately by the issuer.

The second step is to determine the initial carrying amount of the liability component. This is achieved under IAS 32 by measuring the fair value of a similar liability that does not have an associated equity component, for example a bond issued on the same terms but without the conversion option right.

In practice (and in the illustrative examples which accompany IAS 32) the fair value of the notional financial liability without the equity component on initial recognition is derived by taking the present value of the cash flows payable (assuming no conversion) under the actual convertible but applying a discount rate equal to the implicit interest rate in similar debt without the conversion option (assumed in the example to be 9%). On this basis, the initial carrying amount of the financial liability component (before deduction of issue costs) would be £180,561,681 as illustrated in Table 2.

The carrying amount of the equity component (before deduction of issue costs) is the difference between the fair value of the convertible taken as a whole and the fair value of the similar liability without the equity component, that is, £19,438,319 (being £200 million less £180,561,681).

As to the issue costs of £1 million, these are allocated to the liability and equity components of the instrument in proportion to the allocation of gross proceeds, as shown in Table 2, giving an initial carrying value of the liability component of £179,658,873 and an amount allocated to equity of £19,341,127.

**Table 2: Separation of liability and equity components**

	Gross proceeds	Issue costs	Initial carrying value
PV of £200m principal repayable at year 4 at 9%	£141,685,042		
PV of £12m payable annually in arrears for 4 years at 9%	£38,876,639		
<b>Fair value of liability component</b>	<b>£180,561,681</b>	<b>(£902,808)</b>	<b>£179,658,873</b>
<b>Equity component (balance)</b>	<b>£19,438,319</b>	<b>(£97,192)</b>	<b>£19,341,127</b>
<b>Total</b>	<b>£200,000,000</b>	<b>£(1,000,000)</b>	<b>£199,000,000</b>

The double entries would accordingly be:

Dr Cash	£199m
Cr Liabilities	£180m
Cr Equity	£19m

**Finance costs**

The financial liability will, generally speaking, be measured at amortised cost using the effective interest rate method. The 'effective interest rate' is the rate that exactly discounts estimated future cash payments through the expected life of the financial instrument to the net carrying amount of the financial instrument. Table 3 shows how the financial liability would be measured on initial recognition, and subsequently, following this approach (note the accretion of the principal amount of the liability to £200 million on maturity).

On the facts, the finance costs will be calculated in a manner similar to those under FRS 4 (that is, as the difference between the initial carrying value of the liability and the principal amount of the debt), with the key difference that under IAS 32 the initial carrying value of the financial liability is the fair value of the financial liability component of the convertible only. Finance costs are accordingly £68,341,127, being the interest payable of £48 million plus issue costs of £1 million<sup>3</sup> (as per FRS 4) plus an amount equal to the equity component of £19,341,127 (net of the relevant proportion of issue costs).

The equity component would not be remeasured.

**Conversion or redemption**

To the extent that bondholders elected to convert, the financial liability component would be derecognised and transferred to equity. No gain or loss would be recognised on conversion.

Assuming (for the sake of simplicity) that all of the holders elected to convert,

the double entries (taking into account the accretion of the liability to its principal amount) would be:

Dr Liabilities	£200m
Cr Equity	£200m

(The £19 million recognised in equity on issue would remain there, although it may be reallocated within equity.)

Assuming no holder elected to convert, the double entries would be:

Dr Liabilities	£200m
Cr Cash	£200m

(Although not expressly addressed in IAS 32, there are indications, in the case of bonds which have run to maturity, that the £19 million recognised in equity on issue would be treated in the same manner as on conversion, that is, it would remain in equity.)

**Treatment under IAS 39 where the option right represents an embedded derivative**

Now suppose that the terms of the convertibles were such that the option right was considered to represent an embedded derivative financial instrument for the issuer, rather than equity, for instance because the option right could be cash-settled. This scenario is referred to below as the 'revised facts'. Some of the important differences in the accounting would be as follows:

- The convertible would not on initial recognition be split into two components under IAS 32 as described above.
- However, the convertibles would, if the relevant conditions were satisfied, be separated into two (or perhaps more) components, under IAS 39: an embedded derivative financial instrument and a host contract representing the liability component. Although the application of the effective interest rate method in this context is not explained by IAS 39, it is thought that the result would be once again that finance costs would be increased (as compared to FRS 4 treatment), in this case by the amount

initially recognised in respect of the embedded derivative.

- The fair value of the embedded derivative represented by the option right granted to holders would be derived in the first instance by valuing the embedded derivative, the value of the 'host contract' being the residual amount. This may produce different numbers to those given above.

- The embedded derivative (in contrast to the equity component – see above) would then subsequently be remeasured at fair value with changes in fair value being recognised in profit or loss (unless cash flow hedge accounting applied).

**Issuer taxation treatment**

What would be the tax treatment of the convertibles for the issuer in the light of the accounting treatments above?

For periods of account beginning on or after 1 January 2005, s 92A is repealed. New s 94A<sup>4</sup> applies where a company is permitted or required in accordance with generally accepted accounting practice in the accounting framework which it adopts (in this case IAS) to treat the rights and liabilities under a loan relationship as divided between rights and liabilities under a loan relationship (defined by the legislation as the 'host contract') and those under a derivative financial instrument or equity instrument (both of these are defined as 'embedded derivatives'). (Note the terms 'host contract' and 'embedded derivative' are borrowed from IAS 39 but are extended, confusingly, also to cover concepts derived from IAS 32.) The conditions for s 94A to apply would accordingly be satisfied whether the option right were treated as an equity component under IAS 32 or as an embedded derivative under IAS 39.

Section 94A(2) provides that the company is to be treated:

- for the purposes of the loan relationships code, as party to a loan relationship whose rights and liabilities consist only of the rights and liabilities of the 'host contract' (that is, in the example, the liability component of the compound financial instrument as determined under IAS 32 or, on the revised facts, the (non-derivative) liability as determined under IAS 39); and
- for the purposes of the derivative contracts code in FA 2002, Schedule 26 as party to a relevant contract whose rights and liabilities consist only of those of the 'embedded derivative' (that is, in the example, the equity component of the compound financial instrument as determined under IAS 32 or, on the revised

**Table 3: Finance charges under IAS**

Year	Initial liability recognised	Finance costs (9.1% x opening liability)	Payment	Closing liability
	£(179,658,873)			
1		£(16,438,163)	£12,000,000	£(184,097,036)
2		£(16,844,239)	£12,000,000	£(188,941,275)
3		£(17,287,470)	£12,000,000	£(194,228,745)
4		£(17,771,255)	£212,000,000	Nil
<b>Total</b>		<b>£(68,341,127)</b>		

facts, the embedded derivative as determined under IAS 39). Under s 94A(3) the ‘embedded derivative’ would take the character of an option for the purposes of Schedule 26.

*Financial liability component*

Will the issuer obtain relief for additional finance costs (compared to those which would have been recognised under FRS 4) representing the equity component (as determined under IAS 32 on the example) or the embedded derivative (as determined under IAS 39 on the revised facts)?

It is our understanding that the issuer should in principle be capable of obtaining relief for the additional finance costs (of £19 million) in the example. Accordingly, subject to the detailed provisions of the loan relationships code, the issuer would, in the example, expect to receive relief for the finance charges of £68 million charged to profit or loss over the term of the convertible. This compares to the £49 million of finance costs in respect of which it would have been entitled to tax relief applying FRS 4. We also understand this to be the case in relation to increased finance costs (as compared to FRS 4 treatment) which result in the case where the option right is accounted for as an embedded derivative financial instrument, as on the revised facts.

*Equity component*

The effect of s 94A would appear to be to treat the equity component in the example as distinct from the financial liability, only the latter being taxed as a loan relationship under the loan relationships regime. Accordingly, it is thought that the credit to equity on recognition of the equity component should escape tax and it is understood that this is also the view of the Inland Revenue<sup>5</sup>. (However, the position is, technically, not entirely clear – s 85B and the proposed new paragraph 14A to FA 1996, Schedule 9, as currently drafted, arguably leaving open some room for debate.)

*Embedded derivative*

Suppose that, as per the revised facts, the option right were treated as an embedded derivative financial instrument under IAS 39.

The embedded derivative financial instrument is dealt with in paragraph 45J of Schedule 26.<sup>6</sup> Its effect, subject to the relevant conditions being met – as in principle they should on the facts be – is, very broadly, as follows.

- Fair value movements on the embedded derivative are not brought into account.

- To the extent that holders exercise their right to convert and shares are issued by the issuer of the bonds, the amount treated as the carrying value of the option at the time the company became a party to the loan relationship will also not be taxed.

- To the extent that holders do not exercise their right to convert and the principal amount of the bond is repaid, or that holders exercise their right to convert but the option is cash-settled by the issuer, a capital gain may arise for the issuer.<sup>7</sup>

The above treatment of the embedded derivative is quite close to the treatment which an issuer might expect to receive, even before the legislative amendments discussed above, if it chose to issue a discounted bond with a warrant instead of a convertible. In that case the issuer could expect to receive relief under the loan relationships regime for the discount and interest but to realise an up-front capital gain on the issue of the warrant (provided that the warrant was an option), with the possibility of this being reversed if the option was exercised (so that single transaction treatment under TCGA 1992, s 144(2) applied).

An important difference, however, lies in timing. The capital gain under paragraph 45J would appear to arise, in a case where conversion does not take place, when the convertible is redeemed; and where the holder does elect to convert there is no up-front capital gain to be reversed.

As noted the position may be thought to be even more favourable where the option right is treated as equity, given that the amount credited to equity is not thought to be taxable.

*And what about new UK GAAP?*

Before concluding it is worth noting that s 94A is, it is thought, intended to apply even if the issuer is accounting under new UK GAAP and not IAS. Where the option right is accounted for as equity, the conditions for s 94A to apply are satisfied in the case of an issuer accounting under UK GAAP through the application of FRS 25 (the UK equivalent of IAS 32), the relevant paragraphs of which (like IAS 32) are mandatory for periods of account beginning on or after 1 January 2005.<sup>8</sup>

FRS 26 (the UK equivalent of IAS 39) is currently only capable of applying, for periods of account beginning on or after 1 January 2005, to listed entities or entities which prepare their financial statements in accordance with the fair value accounting rules set out in the Companies Act. However, it is understood that there has been some discussion about the

Revenue amending s 94A so as to ensure that it applies for such periods even if FRS 26 is not in fact being applied by a company accounting under UK GAAP and the company does not bifurcate the instrument in its accounts.

**Notes**

<sup>1</sup> The article does not consider the position of traders in relation to such bonds. Deferred tax is also not considered, nor are the transitional rules covered in this article.

<sup>2</sup> The term is used loosely to include International Financial Reporting Standards.

<sup>3</sup> As can be seen, the amount taken through the income statement in respect of issue costs is the full £1 million, given that such amounts are deducted from the proceeds of issue either directly from the liability component or as part of the equity component deducted from such proceeds.

<sup>4</sup> Inserted by Finance Act 2004, Schedule 10, paragraph 13

<sup>5</sup> Although the equity component is, under s 94A, treated as a ‘relevant contract’ for the purposes of Schedule 26 it is not a ‘derivative contract’ for those purposes and accordingly paragraph 45J does not apply. The explanatory notes to paragraph 45J confirm that the provision is not intended to apply in such cases.

<sup>6</sup> As amended by the Finance Act 2002, Schedule 26, Parts 2 and 9 (Amendment) Order 2004 (SI 2004 No 2201) and the No 2 Amendment Order (SI 2004 No 3270).

<sup>7</sup> Paragraph 45J(6) and (9) Schedule 26.

<sup>8</sup> Although it is not entirely clear from FRS 25 (or FRS 4) how the finance charges would in this context be calculated in a case where FRS 26 is not being applied.

**ACCOUNTING CONCEPTS**

If any readers feel they need guidance at a fairly basic level on accounting topics, or would like to write on a particular subject, could they please get in touch with the Editor at [alison.lovejoy@lexisnexis.co.uk](mailto:alison.lovejoy@lexisnexis.co.uk) or Stuart Collins of PKF at [stuart.collins@uk.pkf.com](mailto:stuart.collins@uk.pkf.com) who is acting as our adviser on *Accounting Concepts*.

Topics already covered in the Accounting Concepts series are: *IRFS & GAAP* (Issue 773); *Limited Liability Partnerships* (757); *UK GAAP & IAS* (Issue 755); *FRS 12* (754); *Application Note G* (749); *IAS & the Impact on Intellectual Property Transactions* (748); *Accounts Based on IFRS* (726).