

Convertibles and IAS

Part 2: Position of the Holder

In a previous article (see *The Tax Journal*, 14 March 2005, Issue 780) we provided a basic introduction to the accounting and tax treatments that would apply to an issuer of convertible bonds issuing such bonds in a period beginning on or after 1 January 2005 and accounting for them under international accounting standards¹ (IAS).

This article, which draws heavily on our first article, concludes the general overview of recent changes to the accounting and tax treatment of convertibles by turning to the position of a corporate holder of such bonds also accounting for them under IAS.²

As with the ground covered in our first article, the tax analysis is not entirely straightforward and further changes to the regime are understood to be likely. The accounting treatment discussed represents our understanding of the relevant standards, which are comparatively new and the precise application of which is, in a number of areas, uncertain.

EXAMPLE

The example considered in the first article was that of a UK-incorporated and listed company (the issuer) issuing 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. Interest is payable annually in arrears at a nominal annual interest rate of 6% but the prevailing interest rate for bonds without a conversion option is 9% (the difference reflecting the value to holders of the conversion right). At the holder's option, each bond is convertible at maturity into 1 ordinary share in the issuer. The conversion right cannot be separately transferred.

This article considers the position of a hypothetical holder of a number of the above convertibles (the holder), which is a UK-resident company (but is not a financial trader) and which adopts IAS

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

for periods of account beginning on or after 1 January 2005, when the convertibles are assumed to have been issued to it. It is further assumed that the fair value of the conversion right attaching to each of the bonds is as set out in Table 1.

Before turning to the example we begin with a brief reminder of the accounting and tax treatments which apply for periods of account beginning before 1 January 2005 for holders who are corporation taxpayers applying old UK GAAP (meaning in this context UK GAAP excluding FRS 26).

PERIODS OF ACCOUNT BEGINNING BEFORE 1 JANUARY 2005

Holder accounting treatment

There is no one standard under old UK GAAP dealing comprehensively with the position of holders of financial instruments. In particular FRS 4 would apply to the issuer, but not the holder, of convertibles. Ignoring the interest accrual, a convertible would, however, generally be shown as a single asset on

the balance sheet of the holder at historical cost (adjusted for payments of principal) or the recoverable amount, if lower. Accruing interest would be recognised as income in the profit and loss account. On conversion at maturity the double entries might typically be:

- Cr Convertible (balance sheet);
- Dr Investment in equities (balance sheet).

Holder tax treatment

As the value of a convertible will depend in part on the value of the shares into which it converts, special rules in Finance Act (FA) 1996, s 92 provide, broadly speaking, that if certain conditions are met (the purpose of the conditions being, in part, to ensure that the convertible debt genuinely provides the holder with an equity-type return), the only amounts to be brought into account by the holder under the loan relationships regime in FA 1996 are interest and any exchange gains and losses (using an authorised accruals basis of accounting). Any other amounts (for example, a profit on transfer of the convertibles) are to be dealt with under the, usually more favourable, chargeable gains rules.

If a corporate holder elected to convert, the original cost of the convertible would generally be treated as the base cost of the shares acquired by virtue of FA 1996, s 92(4) and the reorganisation rules in the Taxation of Chargeable Gains Act 1992 (TCGA).

PERIODS OF ACCOUNT BEGINNING ON OR AFTER 1 JANUARY 2005 FA 1996, s 94A

Prior to FA 2005 (see our first article), s 94A was to have applied, both to issuer

Table 1: Fair value of the conversion right

Year	FV of embedded derivative (per bond) at end of period	Change in FV in period (per bond)
Issue	£97	
1	£105	£8
2	£110	£5
3	£115	£5
4	£97	£(18)
Total		Nil

and holder, where a company was *permitted or required* in accordance with generally accepted accounting practice to treat the rights and liabilities under a loan relationship as divided between rights and liabilities under a loan relationship (referred to in s 94A as the host contract) and rights and liabilities under one or more derivative financial instruments or equity instruments (referred to in s 94A as embedded derivatives).

Following FA 2005, s 94A applies where, in accordance with generally accepted accounting practice, a company *does* in fact treat the rights and liabilities under a loan relationship as so divided (subject to a transitional rule discussed further below).

The accounting treatment therefore forms the starting point to the application of s 94A. What is the accounting treatment to which s 94A is referring and how does it apply to a holder of convertibles?

Holder accounting treatment

Split accounting under IAS 39

IAS 39 provides that if certain conditions are met the ‘embedded derivative’ in a ‘hybrid (combined) financial instrument’ (that is, a financial instrument which includes a non-derivative ‘host contract’ as well as an

embedded derivative) must be accounted for separately from the ‘host contract’. An ‘embedded derivative’ is a component of a financial instrument which causes some of the cash flows of the combined instrument to vary in a way similar to a stand-alone derivative. The conversion right in the example is likely to constitute an embedded derivative and the loan element of the convertibles the ‘host contract’.

For separate recognition of an embedded derivative to be required under IAS 39 the three conditions below must be satisfied, *provided* that the embedded derivative is in fact ‘embedded’. A derivative attached to a financial instrument but which is independently transferable or has a different counterparty is not ‘embedded’. If it is not embedded, the three conditions need not be satisfied for separate recognition to be required.

The three conditions are as follows and, subject to the point made below, will all likely be satisfied in our example.

- Condition 1: The economic characteristics and risks of the embedded derivative must not be closely related to the economic characteristics and risks of the host contract.

- Condition 2: A separate instrument with the same terms as the embedded

derivative would meet the definition of a derivative.

- Condition 3: The hybrid (combined) instrument (here the entirety of each convertible) is not itself measured at fair value with changes in fair value taken though profit and loss.³

There are many points that could be made in relation to each of these but a key aspect to note is that the third condition could be failed electively by the holder designating the convertibles as ‘financial assets at fair value through profit or loss’ (on exercise of the so-called ‘fair value option’).⁴

IAS 39 prescribes a number of categories of financial instruments. Which category a financial instrument falls into determines how it will be measured (as summarised in Table 2 in relation to financial assets).

An important theme of IAS 39 is that derivatives are to be measured at fair value with fair value gains and losses recognised in profit or loss and therefore should always (subject to hedge accounting) fall within the category of ‘financial assets at fair value through profit or loss’.

The rationale for separate recognition of embedded derivatives is that an entity should not be able to circumvent the recognition and measurement requirements applicable to derivatives merely by embedding a derivative in a non-derivative financial instrument or other contract which is not accounted for as at fair value through profit or loss (thus potentially circumventing the need so to account for the derivative). If, however, the combined instrument is already being accounted for as at fair value through profit or loss, separate recognition is not required.

The exercise of the fair value option in relation to the combined instrument therefore provides a simple route to ensure that split accounting under IAS 39 is avoided.⁵

It is assumed on the facts that the convertibles would fall to be accounted for by the holder as within the held-to-maturity category and that the holder does not, as would be possible, exercise the fair value option in relation to the convertibles. Accordingly the holder would be required to account for the embedded derivative separately from the host contract. (Note that the holder would still be required so to account were it to elect to treat the convertibles as within the available-for-sale category of financial assets.)

Table 2: Categories and measurement of financial assets under IAS 39

IAS 39 categories of financial assets	Measurement
Financial assets at fair value through profit or loss. (Includes assets designated as such on exercise of the ‘fair value option’ and derivatives (subject to hedging rules).)	Asset is measured at fair value with changes in fair value recognised in profit or loss.
Held-to-maturity investments. (Would not generally apply to the convertibles if the conversion right were exercisable before maturity.)	Asset is measured at amortised cost.
Loans and receivables. (Not available <i>inter alia</i> where asset quoted in an active market as assumed in example.)	Asset is measured at amortised cost.
Available-for-sale financial assets. (Category is residual but it is also possible to designate a non-derivative financial asset as within this category.)	Asset is measured at fair value with changes in fair value generally recognised directly in equity until financial asset is derecognised (previous changes in fair value then recognised in profit or loss).

Contrast to split accounting under IAS 32

Our first article, dealing with the position of the issuer, explained how the convertibles in the example would under IAS 32 be treated by the issuer as comprising both an equity component (the conversion right) and a financial instrument component (the loan element of the convertibles). IAS 39 would accordingly not apply to the issuer.⁶

Unlike the issuer, the holder of the convertibles in the example would not treat the convertibles acquired as comprising an equity instrument. Accordingly, although the holder will, on the facts, adopt ‘split accounting’ (see above), this will not be the same form of ‘split accounting’ as that adopted by the issuer under IAS 32. This is because, whilst the conversion right represents an equity component from the perspective of the issuer, it is equivalent to a (derivative) financial instrument, not an equity instrument, for the holder – since a financial asset includes an equity instrument of another entity.⁷ Split accounting under IAS 32 (which requires an equity component from the perspective of the relevant entity) is therefore not appropriate to the holder on the facts.

Initial recognition

IAS 39 provides that the embedded derivative is to be measured on initial recognition at fair value. The initial carrying amount of the host instrument is the residual amount after separating out the embedded derivative. This, however, represents a different approach from the measurement of the equity and financial components for the issuer under IAS 32, where it was the amount allocated to the equity component which was residual.

The same result is, however, assumed on the facts, since £97 (see Table 1) is equal to the amount recognised by the issuer as the equity component of each

bond before deduction of issue costs (see our first article).

The host contract is accordingly initially recognised by the holder at £903. The double entries are (per convertible):

Cr Cash (balance sheet)	£1,000
Dr Embedded derivative (balance sheet)	£97
Dr Host contract loan (balance sheet)	£903

Subsequent measurement

Because it is treated as if it were a derivative, the embedded derivative must (ignoring hedge accounting) be remeasured at fair value, with fair value gains and losses recognised in profit or loss. This would give rise to the fair value movements per convertible listed in Table 1 being reflected in the income statement. The accounting entries in, for example, year 3 would be (per convertible):

Dr Embedded derivative (balance sheet)	£5
Cr Fair value gains (income statement)	£5

Since the convertibles fall within the held-to-maturity category of financial assets, the host contract will be accounted for at amortised cost. Revenue from the host contract should, under IAS 18, be calculated using the effective interest method (see our first article) and recognised in profit or loss.

Although the application of the effective interest method in this context is not explained by IAS 39, it is thought that, as applied to the holder, it would give rise to income of £337 per convertible as shown in Table 3 (the difference of £97 between the £337 and the £240 interest paid being equal to the amount initially recognised in respect of the embedded derivative).

Following this approach the result would be to increase the income recognised in respect of the host contract by the amount allocated to the embedded derivative.

Conversion

On conversion, assuming that the conversion right is in the money (as on the facts), one might expect the carrying amount of the embedded derivative at the conversion date and the principal owed under the convertible to approximate to the fair value of the equities into which the convertibles convert. The expected accounting in such a case (although IAS 39 is silent on this point) would be for the carrying amounts of the host contract (which should, ignoring interest payable at maturity, at such point be equal to the principal amount of the convertible) and of the embedded derivative to be reversed out and a corresponding amount shown as the initial carrying amount of the equities.

Accordingly the double entries would be (per convertible):

Dr Investment in equities (balance sheet)	£1,097
Cr Embedded derivative (balance sheet)	£97
Cr Host contract loan (balance sheet)	£1,000

Holder tax treatment

If, as is assumed, the holder does not exercise the fair value option in relation to the convertibles, s 94A should be satisfied. Accordingly the host contract and the embedded derivative would fall to be taxed under the loan relationships regime and the derivative contracts regime, respectively. Each of these aspects is considered below.

Taxation of host contract

The loan relationship host contract will fall to be taxed under the loan relationships regime in FA 1996. It will be noted that, in the application of the effective interest method, the income recognised in respect of the host contract comprises not only the interest actually receivable by the holder but also a further amount equal in aggregate to the amount initially recognised in respect of the embedded derivative and which is thought to be taxable.

Taxation of embedded derivative

As to the taxation of the embedded derivative, credits and debits representing fair value movements in the embedded derivative will be brought into account as capital gains and losses under FA 2002, Schedule 26, paragraphs 45A and 45B by virtue of paragraph 45D.⁸ The conditions for capital treatment are similar (although not identical⁹) to those contained in FA 1996, 92 (which is repealed for periods beginning on or after 1 January 2005) and should be satisfied here.

Table 3: Effective interest

Year	Initial amount recognised	Effective interest (9% x closing liability)	Payment	Closing liability
	£903			
1		£81	£(60)	£924
2		£83	£(60)	£947
3		£85	£(60)	£972
4		£88	£(60)	£1,000
Total		£337	£(240)	

However, the effect of paragraphs 45A and 45B is quite different from that of s 92. The effect of s 92 is that capital gains are only brought into charge to tax once realised; under paragraphs 45A and 45B fair value gains are taxed in the period in which they are recognised for accounting purposes.

The new rules allow paragraph 45A losses to be carried back and set against paragraph 45A gains in the previous 24-month period.

In the example therefore, and assuming no other capital gains or losses in the relevant years, the loss of £18 in year 4 could be carried back against the gain of £5 in each of years 3 and 2 but not the gain of £8 in year 1, despite the absence of an overall fair value gain taking into account all years. The holder will, however, have an unrelieved paragraph 45A loss of £5 in year 4 available to carry forward to set against gains in future periods.

It should be noted that no chargeable gain or allowable loss arises where the substantial shareholdings exemption would have applied to the conversion right had it been contained in a separate option contract (paragraph 45A(6)).

Capital gains treatment under paragraphs 45A and 45B would not apply if the holder in the example exercised the fair value option such that s 94A did not apply. Nor would such treatment apply if s 94A applied but paragraph 45D did not.

Further, had capital treatment not applied as a result of the holder and the issuer being connected (this being one of the relevant conditions), debits in respect of the embedded derivative would not have been relieved, even on an income basis (see paragraph 48A). Under the rules as currently drafted the fair value increases in years 1 to 3 would still have been taxed in their entirety.

Conversion

The technical analysis on conversion is not straightforward. However, it is thought that the intended effect of paragraph 45D(8) is that the base cost in each share should, as it would have been in a period beginning before 1 January 2005, be equal to the amount paid for the convertible as a result of the reorganisation rules in the TCGA. (Note, however, that paragraph 45D(8) would not apply to secure the above treatment where s 94A did not apply – for example, where split accounting was not adopted in respect of the convertibles. This would currently be the case even if the other relevant conditions of paragraph 45D

were otherwise satisfied. A further consequence, in circumstances where paragraph 45D(8) does not apply, would appear to be that a deemed market value disposal on conversion would arise for the purposes of the loan relationships rules by virtue of TCGA, s 116(8A).)

The rules do not, as they should, currently provide for the base cost of the shares to be increased to reflect any fair value gains in respect of the embedded derivative which have already been taxed. The Revenue did, however, announce in the 2005 Budget that they would reintroduce a provision to this effect.¹⁰ As previously drafted, however, this provision would not affect the treatment of the holder in the example, notwithstanding that the holder will, even assuming maximum carry back of the £18 loss in year 4, have been taxed on the £8 increase in fair value per convertible in year 1 (see above).

What about new UK GAAP?

Suppose the holder in the example was accounting under UK GAAP and not IAS. FRS 26 (the UK equivalent of IAS 39), which only applies to certain companies (see first article), may not apply to the holder, such that s 94A would not *prima facie* be satisfied. The convertibles would be taxed entirely under the loan relationships regime but without the benefit of s 92.

FA 2005 contains a transitional rule, which could allow a holder to elect to treat s 94A as satisfied. However, this only applies to convertibles held immediately before the end of the holder's last period of account beginning

before 1 January 2005 – it would not therefore apply to the holder on the facts.

Further impact of FA 2005

FA 2005, s 83 provides that for periods of account of a 'securitisation company' beginning on or after 1 January 2005 and ending before 1 January 2007, generally accepted accounting practice is to be taken to mean UK GAAP as it applies for periods of account ending on 31 December 2004. The definition of 'securitisation company' is, however, widely cast (in particular the definition of a 'note-issuing company') and would potentially prevent s 94A applying in a number of cases which do not involve what would typically be thought of as a securitisation, including not only to the issuer in the example (depending on the facts) but also to the holder if it happened itself to be a 'note-issuing company'.

Notes

¹ Used here loosely to include International Financial Reporting Standards.

² The article does not consider the position of traders in relation to such bonds. Deferred tax and exchange gains and losses are also not considered, nor are the transitional rules covered in this article. It is also generally assumed that the holder is not connected to the issuer.

³ See IAS 39, paragraph 11.

⁴ Note that there are proposals to amend the availability of the fair value option.

⁵ One of the purposes of the fair value option is to reduce the burden of separating out embedded derivatives from combined instruments. See IAS 39, BC 76.

⁶ IAS 39, paragraph 2(d).

⁷ Although note that, as per the 'revised facts' in the first article, a conversion right may not always represent an equity component for an issuer of convertibles.

⁸ Inserted 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).

⁹ For instance, in contrast to s 92, paragraph 45D may in principle be satisfied where the conversion right can be cash settled for an amount corresponding to the market value of the shares, as per the 'revised facts' in our first article (see paragraph 45E(4)).

¹⁰ Paragraph 45H inserted by the Finance Act 2002, Schedule 26, Parts 2 and 9 (Amendment) Order 2004 (SI 2004 No 2201) but repealed by the No 2 Amendment Order (SI 2004 No 3270). See Rev BN 13.

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 or Stuart Collins of PKF at stuart.collins@uk.pkf.com who is acting as our adviser on *Accounting Concepts*.

Topics already covered in the Accounting Concepts series are: *Convertibles & IAS Part 1* (Issue 780); *IRFS & GAAP* (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).