

## Loan relationships - Convertible bonds (Lecture B1257 – 25.20 minutes)

Convertible debt poses multiple issues for the issuer:

1. Initial recognition in the accounts – liability or split between liability and equity?
2. Deductibility of interest expense;
3. Tax implications of conversion to shares or redemption for cash.

CTA 2009 (Part 5 Loan Relationships and Part 7 Derivatives), CTA 2010 (s1015 – special securities) and TCGA 1992 (especially on redemption) are potentially relevant.

The rules are perhaps best explained by using a numerical example and then flexing it for alternative scenarios.

### *Example*

A company has £50 million 5% convertible bonds in issue, issued on 2 January 2019 at par. The issue costs were £1.2 million.

Interest is payable semi-annually on 30 June and 31 December and the bonds are redeemable at par on 31 December 2023 or are convertible into a fixed number of ordinary shares in the company at that date at the option of the holder.

The market rate of interest for a similar but non-convertible 5-year bond would have been 7% per annum on 2 January 2019.

1. How is the bond accounted for under IFRS and FRS 102 up to the point just before it is redeemed or converted?
2. How would the accounting differ if the bond was convertible into a variable number of shares in the company?

### *Analysis*

Split the gross proceeds and issue costs between a debt and equity component. The debt component of the gross proceeds is the present value of the interest and redemption price to be paid, discounted at a market rate of interest.

The equity element is the balance of the gross proceeds.

Issue costs are split between the debt and equity components in the same ratio as the gross proceeds.

| <b>Debt element: PV of interest and redemption amount</b> |                  |  |                    |                   |
|---|------------------|--|--------------------|-------------------|
|   |                  | discount rate 7% per annum , or 3.441% per half year |                    |                   |
|   | <b>Half year</b> | <b>Cash flow</b>                                     | <b>PV factor</b>   | <b>PV</b>         |
|   | <b>1</b>         | 1,250,000  | 0.9667             | 1,208,421         |
|   | <b>2</b>         | 1,250,000  | 0.9346             | 1,168,224         |
|   | <b>3</b>         | 1,250,000  | 0.9035             | 1,129,365         |
|   | <b>4</b>         | 1,250,000  | 0.8734             | 1,091,798         |
|   | <b>5</b>         | 1,250,000  | 0.8444             | 1,055,481         |
|   | <b>6</b>         | 1,250,000  | 0.8163             | 1,020,372         |
|   | <b>7</b>         | 1,250,000  | 0.7891             | 986,431           |
|   | <b>8</b>         | 1,250,000  | 0.7629             | 953,619           |
|   | <b>9</b>         | 1,250,000  | 0.7375             | 921,898           |
|   | <b>10</b>        | 51,250,000   | 0.7130             | <u>36,540,542</u> |
|   |                  |  |                    | <u>46,076,152</u> |
| <u>Analysis of net proceeds:</u>                          |                  | <b>Gross</b>   | <b>Issue costs</b> | <b>Net</b>        |
| Debt element  |                  | 46,076,152   | -1,105,828         | 44,970,325        |
| Equity element (balance)                                  |                  | <u>3,923,848</u>                                     | <u>-94,172</u>     | <u>3,829,675</u>  |
|   |                  | <u>50,000,000</u>                                    | <u>-1,200,000</u>  | <u>48,800,000</u> |



The accounting treatment will differ, depending on whether the company is using FRS 102 or IFRS/FRS 101. The numerical examples use the same data as above.

### FRS 102

The bond would be booked entirely as a liability (FRS 102, Section 22, para 3b(i)), either at fair value (expensing the initial costs), or net proceeds (see below). Because the bonds contain an option for the holder to convert them to shares, their treatment falls within FRS 102, s.12.

Generally, this means booking the bond each period end at fair value through P&L and the initial costs must be expensed immediately. But if the issuer is a small company under UK company law, then FRS 102 requires it to use amortised cost to account for the liability (initial recognition is at net proceeds of £48.8 million). Do not assume the accounts are correct – check the basis on which they have been prepared.

### Small company treatment

There is no splitting of the bond into a liability and equity component, so the bond liability is initially recorded at the net proceeds (£50m minus £1.2m issue costs), i.e. £48.8 million.

| Half year | Cash flow   | B/fwd.     | Amortised cost of debt |             |            |
|-----------|-------------|------------|------------------------|-------------|------------|
|           |             |            | Int exp                | Cash flow   | C/fwd.     |
| 0         | 48,800,000  |            | 2.7782%                |             |            |
| 1         | -1,250,000  | 48,800,000 | 1,355,751              | -1,250,000  | 48,905,751 |
| 2         | -1,250,000  | 48,905,751 | 1,358,689              | -1,250,000  | 49,014,439 |
| 3         | -1,250,000  | 49,014,439 | 1,361,708              | -1,250,000  | 49,126,147 |
| 4         | -1,250,000  | 49,126,147 | 1,364,812              | -1,250,000  | 49,240,959 |
| 5         | -1,250,000  | 49,240,959 | 1,368,001              | -1,250,000  | 49,358,960 |
| 6         | -1,250,000  | 49,358,960 | 1,371,279              | -1,250,000  | 49,480,239 |
| 7         | -1,250,000  | 49,480,239 | 1,374,649              | -1,250,000  | 49,604,888 |
| 8         | -1,250,000  | 49,604,888 | 1,378,112              | -1,250,000  | 49,733,000 |
| 9         | -1,250,000  | 49,733,000 | 1,381,671              | -1,250,000  | 49,864,671 |
| 10        | -51,250,000 | 49,864,671 | 1,385,329              | -51,250,000 | -          |
|           |             |            | <u>13,700,000</u>      |             |            |
| IRR       | 2.7782%     |            |                        |             |            |

### Tax implications

Interest expense each period in the table above will be allowable, subject to any restrictions in CTA2009 or s1000 CTA2010 'special securities' (see later).

If the bonds are redeemed for £5 million at the end there is no tax implication as no profit or loss is recognised

If the bonds are converted to (a variable number of) shares, then again, no profit or loss is recognised, just a derecognition of the bonds replaced by equivalent value of share capital and share premium.

### *Non-small companies*

The bonds should be fair valued at each period end. The change in the fair value should be shown in P&L and will be a taxable LR credit (for gains) or deductible LR debit (for losses) under Part 5 CTA 2009 (unless held by a financial entity as part of its trade when the gains and losses form part of trading profit).

If the bonds are later redeemed, any profit or loss on redemption is also a taxable credit or allowable loss under the LR rules.

If the bonds are converted to (a variable number of) shares in the company, the fair value of the bonds will be replaced by the same value of share capital and share premium, so no impact on P&L and therefore no tax effect.

### **IFRS treatment**

IAS 32, Para 11, financial liability definition (b)(i) initially at fair value, with no equity component.

The conversion option is an 'embedded derivative', and must be split out from the bond

- The bond is accounted for at amortised cost
- The embedded derivative is fair valued with changes taken to P&L

Issue costs must be split between

- The bond – deducted from the initial value and recognised as part of interest expense as seen before
- The embedded derivative – must be recognised immediately in P&L

Do not assume the accounts are correct – check the basis on which they have been prepared as this is not a well understood area in practice.

Ask how the embedded derivative has been valued and how the initial costs have been treated.

### *Tax implications*

The host instrument (the bond) and the embedded derivative must be considered separately (s585).

Interest expense on the loan charged to P&L will be allowable as LR debits, subject to any specific restrictions in CTA 2009 (such as CIR). This will include the effects of the issue costs allocated.

Issue costs relating to the embedded derivative are not specifically addressed by CTA 2009 so will presumably be allowable when expensed (i.e. immediately).

The movement in the fair value of the embedded option must be booked in P&L, but s651 disapplies the normal taxation rules for derivatives for issuers of securities with embedded derivatives where the 5 conditions in s652 are met.

This is very likely for this type of convertible bond unless issuer is a banking business, securities house, authorised unit trust, investment trust, OEIC or VCT).

Tax will only arise on conversion, exchange, cash settlement or redemption of the bonds (ss653 – 655).

#### *Options exercised and shares issued/transferred in exchange for the bonds*

S144(2) TCGA 1992 applies. The deemed consideration for grant of the option = the tax-adjusted carrying value of bond when issued.

But the grant and exercise are considered as a single transaction. If the grantor will settle by issuing shares, there is no disposal for TCGA purposes, so no tax will arise.

If settlement is made in cash or shares in another entity, a gain or loss can arise. This is calculated as the amount paid to settle minus fair value of host contract (bond) minus tax-adjusted carrying value of option when bond was issued.

If the issuer ceases to be a party to the convertible bond where the option is not exercised, a gain or loss arises. For example, where the option lapses or the bondholder required the bond to be redeemed for cash.

The issuer is treated as making a deemed disposal:

- Gain or loss = CV – X
- CV = tax adjusted carrying value of the option when the bond
- X = amount paid to redeem the bond minus fair value of host loan (X cannot be less than zero)

#### *Possible disallowance of interest*

A convertible bond is a 'special security' (s1015 CTA 2010) if

- Not listed on a recognised stock exchange (RSE), or
- Not issued on terms reasonably comparable with similar securities listed on an RSE

S1000 treats interest paid in respect of special securities as a distribution and as such they would be disallowed. But where the interest does not exceed a reasonable commercial return and is paid to another UK company within the scope of CT, it will be allowable (s1032 CTA 2010), as long as the interest received by the other UK company is not exempt from tax.

*Contributed by Malcolm Greenbaum*