Merger and Acquisition
Financial Instruments

Presented by: Abhishek Pachlangia

Agenda

1. Accounting for issuer of a financial instrument
2. Accounting for holder of financial instrument
3. Case Study
   – Example Quiz
   - Question and Answer format

Accounting for issuer of a financial instrument

Debt vs Equity

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Debt Vs Equity

Financial Liabilities :

A contractual obligation:

-To deliver cash or another financial asset to another entity; or

-To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity.

Equity instrument only if **both** criteria are met:

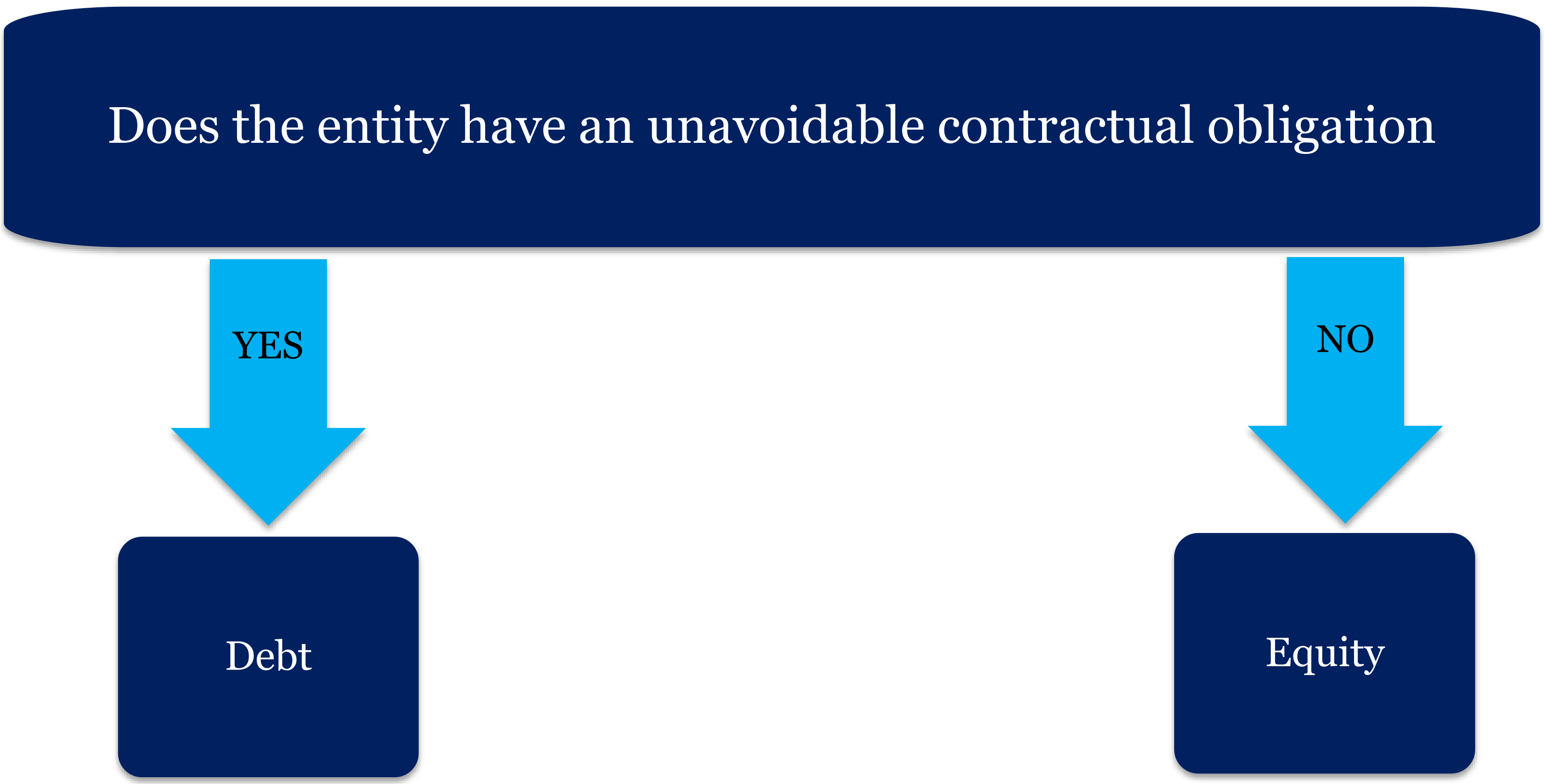
•There is no obligation to deliver cash or another financial asset or to exchange financial assets or financial liability; **and**

•The issuer will exchange:

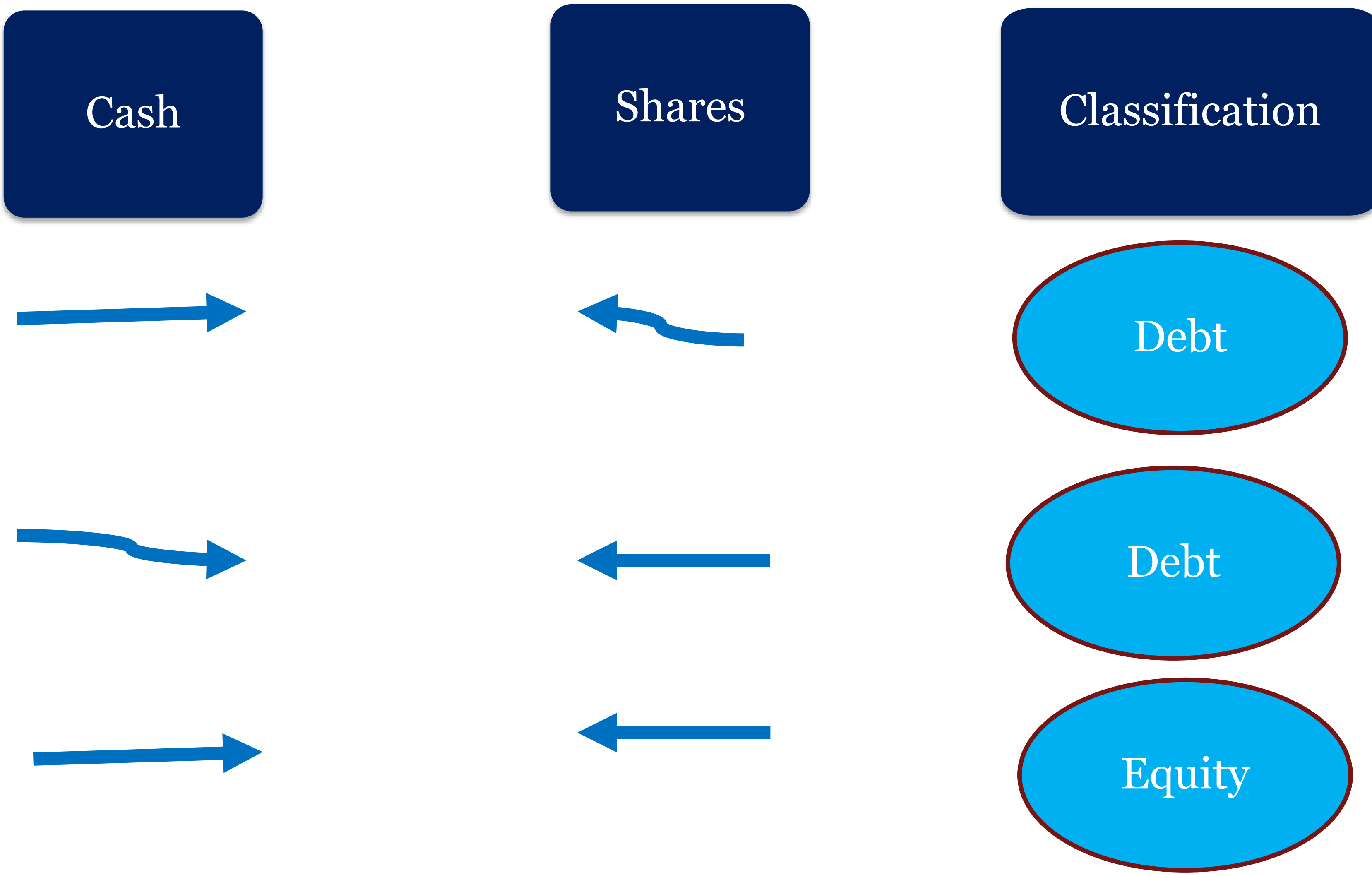
❑ fixed amount of cash; or

❑ another financial asset for a fixed number of its own equity instruments.

Debt Vs Equity



What is fixed for fixed?



Variation due to passage of time

Example:

Entity A (US dollar functional currency) writes an option to entity B (not an employee) that enables entity B to buy 1 share of entity A on the following terms:

- If the option is exercised in year 1 the strike price is $1.
- If the option is exercised in year 2 the strike price is $2.
- If the option is exercised in year 3 the strike price is $3.

Variation due to passage of time

- An instrument's exercise price may be pre-determined at inception and only vary over time.
- The IFRS IC has acknowledged there is diversity in practice in accounting for such instruments, but rejected issuing interpretive guidance due to the longer term debt-equity project that was in progress.

The entity may consider the instrument to be an equity instrument or a derivative liability depending on the 'accounting policy choice' taken by the client

Variations that are contingent settlement provisions

- An event which is outside the control of BOTH the issuer and holder qualifies as a 'contingent settlement provision'
- Such instruments will qualify to be *"Financial liabilities"* as the unconditional right to avoid settlement does not exist
- Common examples:
  - ❖ *Changes in a stock market index or consumer price index.*
  - ❖ *Changes in interest rates or exchange rates.*
  - ❖ *Changes in tax laws or other regulatory requirements.*
  - ❖ *Changes in the issuer's key performance indicators such as revenue, net income or debt-to-equity ratios.*

(i) Non genuine features, (ii) features which trigger only on liquidation of issuer or (iii) puttable instruments in the limited scope exception of Ind AS 32 are not considered as contingent settlement provisions

Compound Financial Instruments

Compound Financial Instrument

Does the instrument terms provide for fixed conversion ratio at the time of inception?

No

Liability

- Convertible into variable number of equity shares – classified as liability in entirety

Yes

Does the instrument carry interest?

Yes

Part Liability and part Equity

- **Liability component** determined basis fair value and reported as 'liability' – this includes
  - principal component of liability; and
  - present value of interest
- Residual amount allocated to **Equity**

No

Entire amount Equity

Financial Instrument with embedded derivatives are financial instruments with an Option either with an issuer or holder need to be recognized as liability or equity

Compound instruments

Split accounting

- *Allocation of fair value of the consideration into debt and equity components on initial recognition.*
- *Embedded non-equity derivative features is included in the liability component.*
- *Assessment of whether the non-equity embedded derivatives are closely related to the host contract.*
- *Equity component does not get remeasured subsequently.*
- *Foreign currency denominated convertible bonds – Conversion option to acquire a fixed number of entity's own equity instruments and at an exercise price which is fixed in a foreign currency.*

Compound financial instrument – Numerical Example

Terms of issue

- 2,000 CCDs of INR 1,000 at par for a three year term aggregating to total proceeds of INR 2,000,000
- Interest is payable annually in arrears at nominal interest rate of 6% p.a.
- Each debenture is convertible at any time up to maturity into 250 equity shares
- When the debentures are issued, the prevailing market interest rate for similar debt without conversion is 9% p.a.

Determination of equity and liability component

- The liability component is measured first, and the difference between the proceeds of the debenture issue and the fair value of the liability is assigned to the equity component.
- The present value of the liability component is calculated using a discount rate of 9%, the market interest rate for similar debentures having no conversion rights

Particulars	INR
Present value of the principal – INR 2,000,000 payable at the end of three years (A)	1,544,367
Present value of the interest – INR 1,20,000 payable annually in arrears of three years (B)	303,755
Total liability component (C = A + B)	1,848,122
Proceeds of the debenture issue (D)	2,000,000
Equity Component (balancing figure) (E = D - C)	151,878

Quiz

Terms	Classification
10% mandatorily redeemable preference shares with mandatory fixed dividend	Liability
Non-redeemable preference shares with mandatory fixed dividend	Compound Financial Instruments
Non-redeemable preference shares with mandatory fixed dividend	Compound Financial Instruments
Zero coupon compulsorily convertible debentures	Liability
Compulsorily convertible preference with no additional consideration	Equity

Reclassifications

Reclassification
Accounting policy choice

Initial recognition

- Paragraph 15 of Ind AS 32
  Classification between debt and equity needs to be made on initial recognition

Subsequent measurement

- Ind AS 32 – Silent on reassessment of classification if terms HAVE NOT CHANGED.
- Paragraph 3.3.1 of Ind AS 109
  an entity shall remove a financial liability when and only when the obligation specified in the contract is discharged or cancelled or expires

Example

An entity issues a 5 year convertible bond where the holder has the option to convert it into the issuer 's equity shares after the first year, but where the conversion ratio is only fixed at the end of the first year at the lower of CU5 and 130% of the equity share price.

As the number of shares the bond could be converted into is variable, on initial recognition the conversion option is recognised as a separate embedded derivative liability. However, at the end of year one, under the contract's original terms, the conversion ratio is fixed and, therefore, no longer meets the definition of a financial liability.

Ind AS 32 - Change in the conversion ratio from variable to fixed at the end of year 1 would not result in reclassification

Ind AS 109 - The obligation to deliver a variable number of shares upon conversion expires and the obligation to then deliver a fixed number of shares meets the definition of equity

Accounting for holder of a financial instrument

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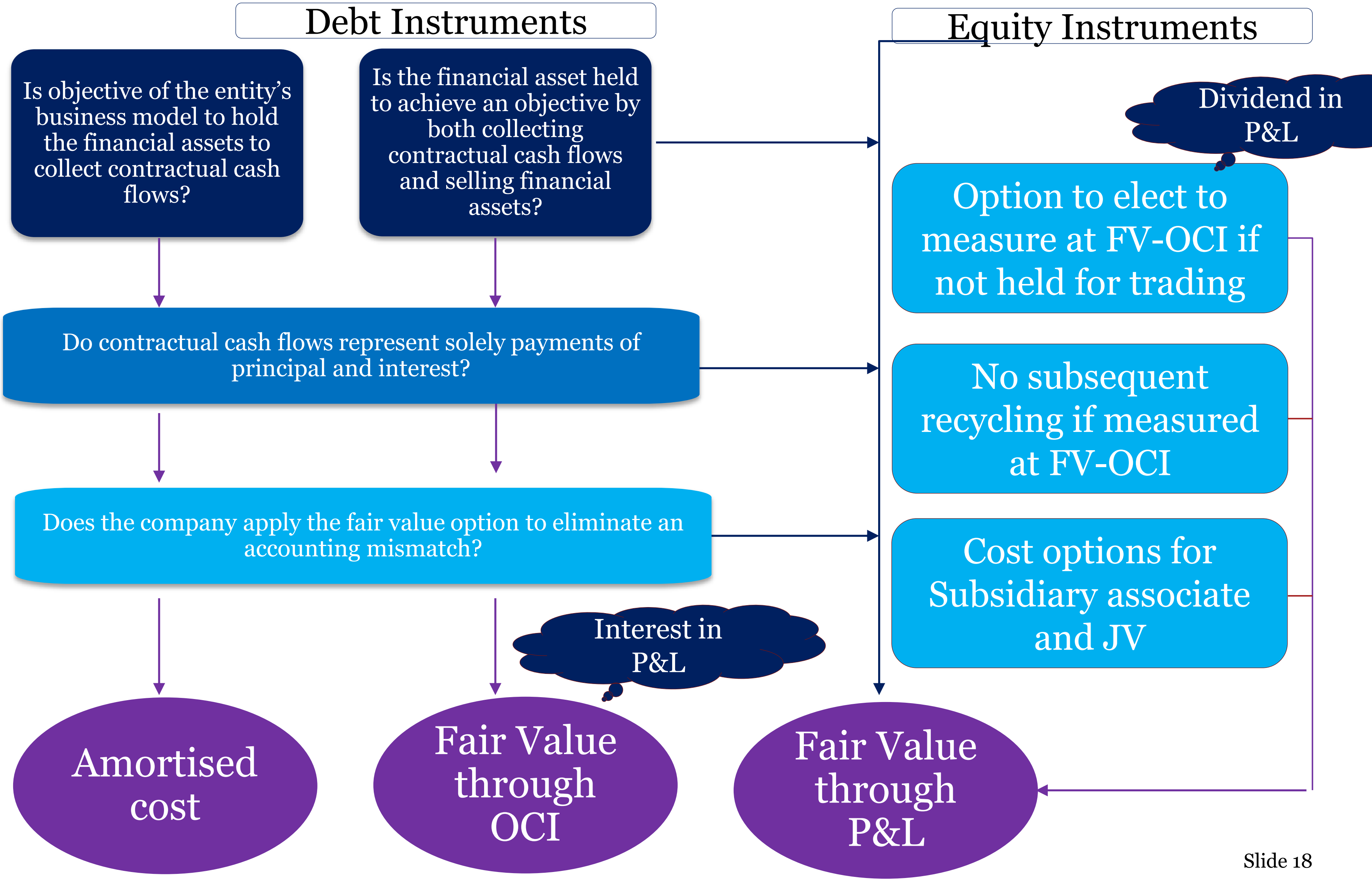
Accounting for Holder of Financial Assets



Thank You

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Profile brief

CA Abhishek Pachlangia is a member of Institute of Chartered Accountants of India , and Commerce Graduate. He has worked in Big 4 chartered accountant firm for 15 years where he was a Director in Capital Markets and Accounting Advisory.

Key Expertise

- IFRS / Ind AS / US GAAP / Indian GAAP accounting advisory and conversion advice
- IFRS trainings

Experience Summary

He has experience on Ind AS convergence for variety of industries which includes: Banks, Non-banking Financial Companies, Insurance Companies, Power and infrastructure Companies and Transportation sector. He has a mix of experience in Audit, Capital markets and accounting advisory space of large listed and unlisted clients. He comes with the expertise of handling complex clients and engagement with GAAP focus. Has got vast experience in the IFRS, US GAAP, UK GAAP and Ind AS convergence and advisory engagements. He has extensive experience in capital market transaction and has been involved with Capital issues, Carve-out of businesses, international bond listing etc.

He has been speaker at various forums of VC Circle, National Institute of Banking Management (NIBM) and National Insurance Academy (NIA).