



IFRS IN PRACTICE

Accounting for convertible notes

TABLE OF CONTENTS

Introduction	3
The basic requirements of IFRSs	4
Example 1 – Convertible note in its simplest form	7
Transaction costs	8
Deferred taxes	9
Early conversion	9
Early repurchase	9
Modification to encourage early conversion	9
Example 2 – Convertible notes with an embedded derivative liability	10
Transaction costs	12
Derivative liability	12
Scenarios where the conversion feature fails equity classification	13
'Ratchet' feature	13
Convertible note denominated in a foreign currency	13
Variable conversion price limited to 'cap' and/or a 'floor'	13
Scenarios where the conversion feature still meets equity classification	14
'Loyalty bonus' issues	14
Adjustments from a stock split or bonus issue	14
Other common practice issues	15
Conversion price based on the issuer's share price at conversion date	15
Fair value of the note is more than the transaction price	15
Callable convertible note	15
Convertible notes issued to management	16
Mandatorily convertible notes	16
Contingently convertible notes	16
Control of the issuer – shareholder votes	17
Cancellation clauses	17
Additional examples	18
Example 3: Convertible into a variable number of shares	18
Example 4: Bonds issued in a currency other than the entity's functional currency	19
Example 5: Callable convertible note	20
Example 6: Early repurchase of bonds	21
Example 7: Mandatorily convertible note	22

INTRODUCTION

The current economic climate has resulted in many companies having to offer increasingly attractive returns in order to obtain funds from lenders and investors. In many cases, investors are requiring entities to issue convertible notes with a cash settlement option instead of issuing equity shares, as a convertible has only upside returns and the cash settlement feature protects the investor from losses. Increasingly, issuers are being forced to add enhancements to conversion features in order to attract investors. There are advantages for the issuer, because in comparison with a straightforward interest bearing loan the issue of a convertible can result in lower cash outflows, with the lender accepting a lower interest rate on the funds advanced. This is because the conversion feature will, potentially, provide a significant enhancement to the overall return.

The increasing number of these instruments being issued with more complex conversion features has led to questions being raised about the appropriate accounting treatment from the perspective of the issuer. In their simplest form, convertible instruments consist of a loan (the liability host contract) and an embedded derivative (the conversion feature) which gives the holder of the convertible instrument the option to convert it into a specified number of shares of the borrower.

However, other convertible instruments are more complex, and contain a number of features which can have a significant effect on the appropriate accounting approach. In particular, although a conversion option may be settled through the issue of equity shares, that option will not always be classified as an equity instrument. Instead, depending on the precise terms and conditions, it may instead be classified as a financial liability (a derivative) that is measured at fair value, with changes in value recorded in profit or loss.

Consequently, the classification of a conversion feature as either an equity instrument or as a derivative liability can have a significant effect on an entity's financial statements. If it is classified as a derivative liability, this will be measured at fair value with changes in value recorded in profit or loss, which will give rise to what can be significant net asset and profit or loss volatility. This means that the effect on a number of related arrangements needs to be considered, including:

- Other lending agreements, including the effect on key ratios and covenants
- Employee remuneration arrangements, including bonus schemes linked to reported profits and share-based payments
- Investor communications.

This publication highlights a number of practical issues that need to be considered when determining the appropriate accounting approach for convertible instruments.

THE BASIC REQUIREMENTS OF IFRSS

Convertible notes are financial instruments that fall within the scope of IAS 32 *Financial Instruments: Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement* (or IFRS 9 *Financial Instruments* if that standard has been adopted early). The scope and basic accounting requirements of IFRS 9 are the same as IAS 39 for the purposes of the issuer's accounting for the convertible instruments discussed below, and so future references in this document are to IAS 32 and IAS 39.

IAS 32 contains the definitions of financial liabilities, financial assets and equity. Therefore, whether a financial instrument should be classified as liability or equity is dealt with under IAS 32. As noted above, the standard approach in IFRS requires that a convertible instrument is dealt with by an issuer as having two 'components', being a liability host contract plus a separate conversion feature which may or may not qualify for classification as an equity instrument.

The definitions set out in IAS 32 for financial liabilities and equity are detailed and appear complex (see extracts below). However, for the purposes of accounting for convertible instruments by an issuer they can be summarised in two key principles:

- Does an entity have a contractual obligation to deliver cash or another financial asset that it cannot avoid? If the entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability
- A financial instrument can only be classified as equity if the 'fixed-for-fixed' criterion is met, 'a contract that will be settled by the entity delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash' (IAS 32.22) is an equity instrument.

A financial liability is defined under IAS 32 as:

- '... (a) A contractual obligation
- (i) to deliver cash or another financial asset to add another entity, or
 - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
- (b) A contract that will or may be settled in the entity's own equity instruments and is:
- (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
 - (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments.' (IAS 32.11).

Where an entity has a contractual obligation to deliver cash or another financial asset or a contract that requires settlement in a variable number of the entity's own shares, that contract is a financial liability. A key criterion for liability classification is when the entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation (IAS 32.19).

IAS 32 defines equity 'any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities' (IAS 32.11). The definition of an equity instrument is the opposite of the financial liability definition above:

'... (a) The instrument includes no contractual obligation

- (i) to deliver cash or another financial asset to another entity; or
- (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.

(b) If the instrument will or may be settled in the issuer's own equity instruments, it is:

- (i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
- (ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments....' (IAS 32.16).

The following flow chart summarises the accounting requirements in IAS 32 in relation to the evaluation of liability and equity classification of financial instruments.

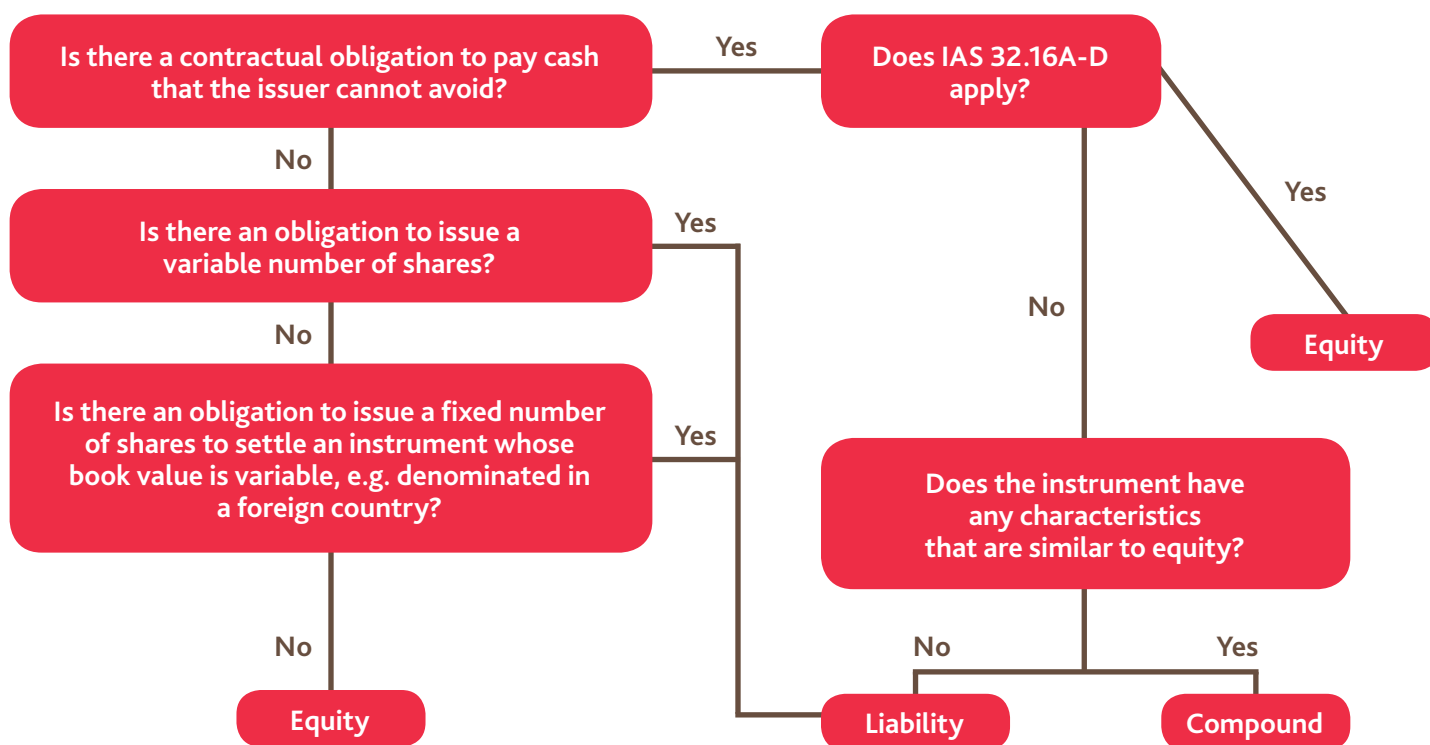


Figure 1: Liability and equity classification in IAS 32

The flowchart has been designed to enable an analysis of financial instruments as a whole (i.e. both the host liability and conversion feature together for convertible instruments) and also, as ultimately required by IFRS, by individual component parts. The operation of the flowchart is included in the illustrative examples below.

Once the appropriate classification of a financial instrument has been determined (including, where applicable – such as for certain convertible instruments – identification of the liability and equity components), it is then necessary to determine the measurement of the individual components.

When a convertible instrument, such as the instrument illustrated below in example 1, has been determined to contain a host liability and embedded equity conversion feature, the fair value of the liability component is determined first. This is established by using a present value calculation, i.e. the contractual stream of future cash flows is discounted at the rate of interest that would apply to an identical financial instrument without the conversion option (that is, a stand-alone loan or debt instrument). The equity component is then assigned as the residual amount, by deducting the amount calculated for the liability component from the fair value of the instrument as a whole. This is consistent with the definition of equity under which an equity instrument is a residual interest.

$$\text{Fair value of convertible note} - \text{Fair value of the liability} = \text{Equity residual component}$$

Figure 2: Determining the fair value components of a simple convertible note with a liability and an equity component

Although it might be thought that a valuation exercise needs to be carried out of the entire convertible note, this is not the case. IAS 39 is clear that, except where a financial instrument is quoted on an active market (such as a listed share), the transaction price for the instrument is its fair value.

EXAMPLE 1 – CONVERTIBLE NOTE IN ITS SIMPLEST FORM

This example sets out the accounting approach for a convertible note in its simplest form, in which it contains a financial liability and a fixed-for-fixed equity conversion feature.

Entity A issues a note with face value of CU1,000 which has a maturity of three years from its date of issue. The note pays a 10% annual coupon and, on maturity, the holder has an option either to receive a cash repayment of CU1,000 or 10,000 of the issuer's shares. The market interest rate for a note without a conversion feature would have been 12% at the date of issue.

Entity A incurred transaction costs of CU100 in issuing the convertible note.

Analysis

Using the flowchart above for the entire instrument, it is assessed as being a compound financial instrument:

- Step 1 is to consider whether there is a contractual obligation to pay cash that the issuer cannot avoid. The answer is yes, as the issuer has to pay an annual cash coupon and could be required to repay the capital amount at the end of three years if the holder chooses not to exercise the conversion option
- Step 2 is to consider whether IAS 32.16A-D apply. These paragraphs set out a specific and specialist exception from the requirement to classify certain financial instruments, which the issuer has an obligation (or potential obligation) to repurchase, as financial liabilities. This exception does not typically apply to convertible instruments and is not applicable in this example
- Step 3 is to consider whether the instrument has any characteristics that are similar to equity. The answer is yes as the instrument contains an option to be converted into equity instruments.

Each component of the compound financial instrument needs to be assessed separately. The host debt component will be classified as a financial liability in its entirety. This is because there is an obligation to pay cash that the issuer cannot avoid (see above) and, for this component on a stand-alone basis, there is no feature that is similar to equity. The conversion feature is then assessed, again on a stand-alone basis. Starting with the box at the top left hand side of the diagram:

- There is no contractual obligation to pay cash that the issuer cannot avoid. The equity conversion feature can only be settled through the issue of equity shares, otherwise it will simply expire unexercised
- There is no obligation to issue a variable number of shares. If exercised, the option will result in the issue of 10,000 shares
- There is no foreign currency element, as the issuer's functional currency and the currency of the convertible instrument are the same.

Consequently, the conversion feature is classified as an equity component.

This means that the note contains the following liability and equity components:

- Contractual cash flows of 10% annual coupons and a cash repayment of CU1,000 (liability)
- The conversion feature to convert the liability to equity of the issuer (equity).

On initial recognition, the contractual cash flows are discounted at the interest rate that would apply to a note without a conversion feature (12%). This is in order to calculate the fair value of the liability component of the compound financial instrument.

Year	Cash flow	Amount	Discount factor at 12 %	Net present value (NPV) of cash flow
1	Coupon	CU100	1/1.12	CU89
2	Coupon	CU100	1/1.12 ²	CU80
3	Coupon and principal	CU1,100	1/1.12 ³	CU783
Fair value of liability component				CU952

Figure 3: Calculation for the fair value of the liability component with a liability and an equity component

The fair value of the liability component is then deducted from the fair value of the compound financial instrument as a whole, with the balance being taken directly to equity.

	Amount
Transaction price (fair value)	CU1,000
Less: liability component	CU(952)
Equity component (residual)	CU48

Figure 4: Calculation of the residual equity component

Transaction costs

For compound financial instruments, IAS 32.38 requires these costs to be allocated to the liability and the equity components.

- For equity, transaction costs of an equity transaction are accounted for as a deduction from equity (IAS 32.37)
- For financial liabilities that are not measured at fair value through profit or loss, transaction costs are added to the carrying amount of the financial liability (IAS 39.43)

Entity A adjusts the carrying amount of the components for the CU100 incurred in transaction costs as follows:

	Transaction price	Transaction costs	Carrying amount
Liability	CU952	CU(95)	CU857
Equity	CU48	CU(5)	CU43
Total	CU1,000	CU(100)	CU900

Figure 5: Allocation of transaction costs

The effective interest rate is recalculated after adjusting the carrying amount of the host liability for the transaction costs. This results in the transaction costs being amortised over the term of the convertible note through an adjustment to the effective interest rate, which increases the rate to 16.41%. Entity A will therefore record interest expense at the effective interest rate (16.41%). The difference between the total interest expense (16.41%) and the cash coupon actually paid (10%) increases the carrying amount of the liability so that, on maturity, the carrying amount is equal to the capital cash repayment that might be required to be made. The following table shows the balance of the liability component over the life of the loan.

Year	Beginning balance	Interest expense (16.41%)	Cash coupon (10%)	Closing balance
1	CU857	CU141	CU(100)	CU898
2	CU898	CU147	CU(100)	CU945
3	CU945	CU155	CU(100)	CU1,000

Figure 6: Liability amortisation table

Assume that, at the end of Year 3, the holder elects to receive shares. Entity A would derecognise the liability (CU1,000) and recognises an increase in equity of the same amount; no gain or loss would be recorded on conversion. Conversely, if the holder elects to receive cash, Entity A would simply derecognise the liability CU1,000 and recognises a corresponding decrease in cash of CU1,000.

It can be seen from this that, when the conversion feature is classified as equity, it is not remeasured. In addition, even if the conversion option is not exercised, the amount recorded in equity is not reclassified (or 'recycled'), although it could be transferred from one equity reserve to another. The only item that affects profit or loss is the recognition of interest expense at the effective interest rate for the liability component.

Deferred taxes

In most jurisdictions, only the coupon cash payment (10% in this example) and transaction costs would be tax deductible and it is unlikely that a tax deduction will be received for the interest expense (16.41% in this example) recorded under additional the effective interest method. Therefore, a deferred tax arises from the temporary difference between the carrying value of the liability component and the tax base of the liability for tax purposes. If the Entity A is subject to a 30% tax rate and assuming that transaction costs are also deductible over the life of the loan (that is, the element of the interest expense in profit or loss that represents transaction costs is tax deductible rather than the transaction costs being deductible in full when they are incurred), then a deferred tax liability of CU13 $((\text{CU}900 - \text{CU}857) \times 30\%)$ should be recognised on initial recognition with a corresponding entry to equity. The effect of deferred tax is recognised in equity because IAS 12 *Income Taxes* requires that the recognition of deferred tax must follow the underlying transaction it relates to, and the temporary difference relates to the amount attributed to the equity conversion option.

The carrying amounts of the liability component, and the associated tax effects over the life of the note, are summarised below:

	0	Year 1	Year 2	Year 3
Carrying value of liability	CU857	CU898	CU945	CU1,000
Tax base of liability	CU900	CU932	CU965	CU1,000
Temporary difference	CU43	CU34	CU20	0
Deferred tax liability (30%)	CU13	CU11	CU6	0

Figure 7: Deferred tax effects

Early conversion

Some convertible notes contain 'American type' conversion features where the holder is allowed to convert the note for shares at any time before the note's maturity date. In practice, it has been widely interpreted that for such a conversion feature, the conversion date (regardless of what that date happens to be) is the instrument's maturity date. This is because 'maturity' means any date on which the holder exercises the conversion option in accordance with the convertible note's contractual terms. Consequently, the accounting described at maturity date also applies to 'American type' options regardless of when the holder elects to convert, and no gain or loss is recognised on settlement.

Early repurchase

Some convertible notes allow the issuer to repurchase the note before its stated maturity date, if certain events occur. If the issuer does elect to repurchase the note before its stated maturity date, IAS 32 requires the consideration paid (i.e. repurchase price) to be allocated to the liability and equity components. This is achieved by determining the fair value of the liability at the repurchase date; the residual amount attributed to the equity component. The difference between the carrying amount and the fair value of the liability at the repurchase date is accounted for as the cost of redeeming the liability (example 6 below outlines the appropriate accounting approach in more detail).

Modification to encourage early conversion

In some situations, to encourage early conversion an entity may amend the terms to induce the holder to convert the notes immediately. In these cases, IAS 32 requires that that:

'the difference, between the fair value of the consideration the holder receives on conversion under the revised terms and the fair value of the consideration the holder would have received under the original terms is recognised as a loss in profit or loss' (IAS 32.AG35)

As an example, assume that at the end of year 2 Entity A is struggling to pay interest and will not be able to redeem a note for cash, so it offers an additional 10,000 shares to the holders to encourage early conversion. At the time of the offer of early conversion the share price is CU0.70. Entity A would recognise CU7,000 $(10,000 \times \text{CU}0.70)$ as an expense with a corresponding increase in equity. This means that the accounting effect is the same as if Entity A had granted a share-based payment of 10,000 shares with immediate vesting; IFRS 2 *Share-based Payment* would require an immediate charge of CU7,000.

EXAMPLE 2 – CONVERTIBLE NOTES WITH AN EMBEDDED DERIVATIVE LIABILITY

In practice, many conversion features in convertible notes fail equity classification, which means that the conversion feature is a financial liability.

The reason that many conversion features fail equity classification is that they contain contractual terms that result in the holder of the conversion feature having rights that are different to those of existing shareholders. This is because the contractual terms mean that either:

- The number of shares to be issued varies
- The amount of cash (or carrying amount of the liability) converted into shares varies
- Both the number of shares and the amount of cash (the carrying amount of the liability) vary.

The commercial effect of this is that the holder of the conversion feature obtains a different return in comparison with an investor that holds equity shares.

Conversion features that fail equity classification are derivatives because they are either written options (that is, options that provide the holder with a choice over whether the convertible note is exchanged for shares or cash) or forward contracts under which an entity will issue shares in order to extinguish an obligation, with no cash settlement alternative.

This links to the definition of a derivative in IAS 39, with all three of the characteristics of a derivative being met. These characteristics are:

- The value of the conversion feature changes in response to the share price of the issuer
- The investment required to purchase the option (which is the present value of the reduction in interest rate that is paid on the convertible note in comparison with an loan note with no conversion feature) is less than would be required to purchase the equivalent number of shares (the comparison that is made is to compare the cost of acquiring the conversion feature with the cost of acquiring other instruments that would have a similar response to future changes in the fair value of the issuer's shares – which would be an investment in the shares themselves)
- The conversion feature can or will be exercised at a future date.

Conversion features that fail equity classification and are accounted for as derivative liabilities are typically accounted for separately from the host instruments. This is because the fair value of the conversion feature is affected by changes in the fair value of the issuer's shares, and the fair value of the host loan is not. This means that the conversion feature (an embedded derivative) is not what IAS 39 refers to as being 'closely related' to the host contract.

The effect of this is that for many convertible notes, a host loan will be accounted for at amortised cost, with an embedded derivative liability being measured at fair value with changes in value being recorded in profit or loss.

The terms of some convertible notes which contain conversion features that are required to be accounted for as derivative liabilities can mean that the accounting for each of the separate components can become complex. One approach which can simplify the accounting is to use the IAS 39 'fair value option'. Under this approach, a contract that contains one or more embedded derivatives that would normally be required to be accounted for separately can instead be accounted for in its entirety at fair value through profit or loss. Although this may appear to be an attractive option, it can give rise to additional volatility in amounts reported in profit or loss. This is because not only the embedded derivative(s), but also the host loan, will be measured at fair value with this being affected by factors which include changes in interest rates, and changes in the issuer's own credit rating (because this affects the rate of interest that the issuer would have to pay for new borrowings).

The remainder of this section illustrates the accounting approach to be followed where the IAS 39 'fair value option' is not used. This means that the host contract will be accounted for at amortised cost.

The accounting for a convertible note with an embedded derivative liability is set out in IAS 39. The embedded derivative liability is calculated first and the residual value is assigned to the debt host liability component (IAS 39.AG28). This is in contrast to where a convertible note is a compound instrument with an equity component, where the fair value of the liability component is calculated first with the equity being residual.

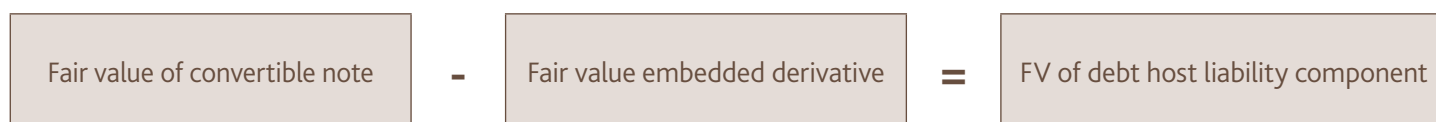


Figure 8: Determining the fair value components of a convertible note with a liability and an embedded derivative component

Example

Entity B issues a note with a face value of CU1,000 which has a maturity of three years from its date of issue. The note pays a 10% annual coupon and, on maturity at the end of three years, the holder has an option either to receive a cash repayment of CU1,000 or to convert the note into the Entity B's shares. The note would be converted into Entity B's shares using the average of the lowest five days value weighted average price (VWAP) in the previous 30 days prior to maturity. The conversion feature is determined to have a fair value of CU20 at issue date.

Entity B incurred transaction costs of CU100 in issuing the convertible note.

Analysis

Using the flowchart above for the entire instrument, it is assessed as being a financial liability with an embedded derivative liability. The analysis is as follows:

- Step 1 is to consider whether there is a contractual obligation to pay cash that the issuer cannot avoid. The answer is yes, as the issuer has to pay an annual cash coupon and could be required to repay the capital amount at the end of three years if the holder chooses not to exercise the conversion option
- Step 2 is to consider whether IAS 32.16A-D apply. These paragraphs set out a specific and specialist exception from the requirement to classify certain financial instruments, which the issuer has an obligation (or potential obligation) to repurchase, as financial liabilities. This exception does not typically apply to convertible instruments and is not applicable in this example
- Step 3 is to consider whether the instrument has any characteristics that are similar to equity. The answer is yes as the instrument contains an option to be converted into equity instruments. The question of whether the conversion feature meets the criteria to be classified as equity is dealt with separately.

For the purposes of the compound instrument, the host debt component will be classified as a financial liability in its entirety. This is because there is an obligation to pay cash that the issuer cannot avoid (see above) and, for this component on a stand-alone basis there is no feature that is similar to equity.

The conversion feature is then assessed, again on a stand-alone basis. Starting with the box at the top left hand side of the diagram:

- There is no contractual obligation to pay cash that the issuer cannot avoid. The equity conversion feature can only be settled through the issue of equity shares, otherwise it will simply expire unexercised
- However, there is an obligation to issue a variable number of shares – the number of shares to be issued is based on the lowest 5 day VWAP in the last 30 days prior to maturity.

Consequently, the conversion feature is classified also classified as liability.

This means that the note contains the following components:

- Contractual cash flows of 10% annual coupons and a cash repayment of CU1,000 (liability)
- The conversion feature to convert the liability to in to equity of the issuer at the lowest five day share price in the previous 30 days prior to maturity (an embedded derivative liability).

For convertible notes with embedded derivative liabilities, the embedded derivative liability is determined first and the residual value is assigned to the debt host liability. Therefore, the debt host liability is initially recognised at CU980 being the residual value from deducting the fair value of the derivative liability from the transaction price (i.e. CU1,000 less CU20).

Transaction costs

Transaction costs are to be apportioned to the debt liability and the embedded derivative. The portion attributed the conversion feature is immediately expensed, because the embedded derivative liability is accounted for at fair value through profit or loss. For the portion of transaction costs that are attributed to the loan, these are added to the carrying amount of the financial liability and amortised as part of the effective interest rate.

Entity B adjusts the carrying amount of the liability component for transaction costs incurred as follows:

	Transaction price	Transaction costs	Carrying amount
Liability	CU980	CU(98)	CU882
Derivative liability	CU20	CU(2) – profit or loss*	CU20
Total	CU1,000	CU(100)	

*CU2 of transaction costs in relation to the derivative liability component is expensed immediately in profit or loss.

Figure 9: Allocation of transaction costs

The effective interest rate is recalculated after adjusting for the transaction costs, and for the host liability component it is 15.18 % (this is determined by establishing the rate that is required to discount the contractual cash flows back to the carrying amount, as adjusted for transaction costs). Entity B will therefore record interest expense at the effective interest rate (15.18%). The difference between interest expense (15.18%) and the cash coupon (10%) increases the carrying amount of the liability so that, on maturity, the carrying amount is equal to the cash payment that might be required to be made. The following table shows the balance of liability component over the life of the loan.

Year	Beginning balance	Interest expense (15.18%)	Cash coupon (10%)	Closing balance
1	CU882	CU134	CU(100)	CU916
2	CU916	CU139	CU(100)	CU955
3	CU955	CU145	CU(100)	CU1,000

Figure 10: Liability amortisation table

Derivative liability

The fair value of the conversion feature would have to be determined at each reporting date and the fair value changes would be recognised in profit or loss. The following table sets out the effect on profit or loss assuming the following fair values at each year end:

Year	Fair value of conversion feature	Profit or loss effect
1	CU(100)	CU(80)
2	CU0	CU100
3	CU(300)	CU(300)

Figure 11: Fair value changes and the profit or loss impact

Thus, if the conversion feature is classified as a derivative liability, this will often lead to a significantly higher and more volatile expense pattern in trading profit or loss. This is because a derivative liability is remeasured to fair value at each reporting date, whereas if the conversion feature is classified as equity, because if equity classification is met, no re-measurement of the conversion feature is required.

SCENARIOS WHERE THE CONVERSION FEATURE FAILS EQUITY CLASSIFICATION

In addition to the example above, there are many other scenarios in practice where the conversion feature can fail equity classification. This is often because the 'fixed for fixed' criterion in IAS 32, under which equity classification only applies for instruments where a fixed amount of cash (or liability) is exchanged for a fixed number of shares. This section highlights some of the most common scenarios that are encountered in practice.

'Ratchet' feature

A 'ratchet' feature is an anti-dilution provision that adjusts the conversion ratio if there are subsequent new issues of shares.

As an example, Entity C issues a face value CU1,000 note which has a maturity of three years from its date of issue. The note pays a 10% annual coupon and, unless converted into shares, will be repaid in cash on maturity. The holder has an option exercisable at any point to convert the note into the issuer's shares, at CU1.00 per share. However, if shares are issued for less than CU1.00 during the outstanding term of the note, then the conversion price is reset to the new share issue price. The purpose of such a clause is to protect the note holder from dilution in the value of its conversion option at CU1.00 per share.

When accounting for this type of the note, the existence of the 'ratchet' feature has modified the potential number of shares to be issued to a variable number and therefore as a whole, the conversion feature has violated the 'fixed-for-fixed' criterion for equity classification and instead contains two embedded derivative features, being:

- 1) CU1.00 conversion option and
- 2) The ratchet feature.

These two features are accounted for as a single instrument, as the exercise of one of them automatically results in the lapse of the other.

Convertible note denominated in a foreign currency

It is common for international companies to raise funds via convertible notes issued in a currency other than their functional currency. Although the issue and repayment amount in foreign currency may be fixed, when converted back to the entity's functional currency it results in a variable amount of cash (that is, a variable carrying amount for the financial liability that arises from changes in exchange rates), and hence failure of the 'fixed-for-fixed' criteria for equity classification. The conversion feature is therefore a derivative liability, with the value of the conversion feature is dependent on foreign exchange rates. This means that the foreign exchange feature is an embedded derivative that must be accounted for separately accounted for under IAS 39 (an example of this type of convertible note and the details of the accounting approach is set out in example 4 below).

Variable conversion price limited to 'cap' and/or a 'floor'

Some convertible notes contain provisions that limit the variability of the conversion price within a certain range. These provisions can set an upper/lower limit to the conversion price (cap/floor), or it can set both an upper and a lower limit to the conversion price (often refer to as a collar). These notes have a potential to convert at either a variable or a fixed number of shares dependent on the share price, and this violates the fixed-for-fixed criterion for equity classification. The options embedded in these conversion features are accounted for as embedded derivative liabilities.

SCENARIOS WHERE THE CONVERSION FEATURE STILL MEETS EQUITY CLASSIFICATION

Some conversion terms initially appear to have breached the 'fixed-for-fixed' criterion. However, in practice equity classification may still apply. This chapter highlights some of the more common convertible notes to which this applies.

'Loyalty bonus' issues

In addition to granting the holder the option to convert the principal amount into a fixed number of shares, some conversion features:

- Grant the holder the option to receive a fixed coupon payment in cash or to convert the 'accrued' interest into additional shares at a fixed rate of exchange, or
- Grant the holder a set number of additional shares at on each anniversary date of the note being issued.

There is a debate as to whether these terms fail the 'fixed-for-fixed' criterion, since the number of shares to be converted is variable dependent on the passage of time. In practice the usual treatment for these terms is to assume that the 'fixed-for-fixed' criterion is met because the number of shares is predetermined at the outset and the only variable is the passage of time. The additional shares issued at each anniversary date are considered as a series of predetermined fixed issues.

In contrast, an arrangement in which the coupon payment was at a variable rate would fail equity classification. This is because the arrangement contains an additional variable feature (the variable interest rate) which means that the number of shares to be issued in future will vary in response to changes in benchmark interest rates.

Adjustments from a stock split or bonus issue

The terms of a convertible note may include an anti-dilution protective clause for the note holder that adjusts the conversion ratio in the event of a flotation, a stock split or for the payment of dividends to existing shareholders. Prima facie, the inclusion of such clause would violate the 'fixed-for-fixed' principle in that the clause would result in a variable number of shares to be issued. However, a widely held view in practice is that such variability does not necessarily result in a violation 'fixed-for-fixed' criteria provided the following conditions are met:

- 1) The instrument would otherwise meet the 'fixed-for-fixed' requirement, and
- 2) The anti-dilution clause was added only to maintain the relative rights of the shareholders and note holders, and its effect is that those relative rights remain exactly the same immediately before and immediately after the event that gives rise to the anti-dilution adjustment.

OTHER COMMON PRACTICE ISSUES

In addition to the issues that have been discussed in this publication, accounting issues can arise from the myriad of different conversion terms that exists in practice. Some of the more common arrangements that arise in practice are set out below.

Conversion price based on the issuer's share price at conversion date

Conversion terms that allow the holder to convert a convertible note into the number of shares equal, on maturity date, to the face value of the note at their market price fails the 'fixed-for-fixed' criterion. This is because a variable number of shares will be issued to extinguish a fixed liability amount.

Such a conversion feature is a derivative liability but, as the conversion price is set at the conversion date market share price, the derivative liability has no value; the holder simply receives shares equal in value to the cash payment that would otherwise be made. These types of notes typically only contain a liability component, being the fair value of the cash coupon and the face value of the note (an example of this type of convertible note is set out in example 3 below).

Fair value of the note is more than the transaction price

In practice, some convertible notes have been issued where it would appear that, on conversion, the holder is always going to realise a profit.

For example, the terms of a convertible note may mean that the holder has an option on maturity of the convertible note to convert it into the number of the issuer's shares equal to the face value (say, CU1,000) of the note at a 20% discount to their quoted market price. This means that, if the issuer's share price is CU1 on maturity, the shares will convert at CU0.80. The issuer has the obligation to deliver 1,250 shares (fair value CU1,250) with the holder realising a CU250 profit.

Because the number of shares issued on maturity will vary, depending on the share price at that point, the conversion feature gives rise to a derivative liability. Consequently, the fair value of the derivative liability will be determined first, with the residual being allocated to the host liability. The host liability will then have a correspondingly higher effective interest rate, which will result in an increased charge being made during the term of the convertible note.

Callable convertible note

Some convertible notes also contain a call option which allows the issuer to repay the principal plus any outstanding accrued interest at anytime during the life of the note. From the issuer's perspective, this call feature is a derivative because future changes in interest rates could mean that the redemption amount of the loan is less than its fair value.

However, this derivative is not accounted for as a separate embedded derivative. This is because the repayment price is equal to the amortised cost of the host debt instrument and therefore under one of the exceptions in IAS 39 it is to be considered to be 'closely related' to the debt host contract. Consequently, no separate accounting is required for the call option (See example 5 below for more details on the accounting approach).

Convertible notes issued to management

In practice, it is not uncommon for convertible notes to be issued to executives or directors. If the price paid for the convertible notes is less than fair value, the embedded equity option in these convertible notes typically constitute an embedded share-based payment. This is because the entity is receiving the benefit of services from its executives/directors, with payment being made through the issue of a convertible note at a discount from its total fair value.

In practice, embedded share-based payments in convertible notes may not be immediately apparent, as the coupon rate typically matches the market discount rate. This means that the fair value of the liability component is typically equal to the transaction price which gives a nil residual value on the equity conversion feature. However, the fair value of the convertible note is more than the transaction price as the convertible note is both paying a market coupon and contains an embedded share-based payment.

Assume that a convertible note is issued to a director for CU100, and the fair value is CU109. The equity component therefore is CU9. This would be recorded as a share-based payment. This does not contradict the basic principle of IAS 39 which is that there should be no day 1 gain or loss on initial recognition of a financial instrument. This is because there are situations where the note contains both a financial instrument (the host loan) and an embedded share-based payment. In these cases, it is necessary to obtain a fair value for the convertible note as a whole, and not simply deduct the fair value of the debt component from the transaction price.

Mandatorily convertible notes

In some circumstances, convertible notes mandatorily convert after a fixed period of time, but pay a contractual coupon up to the point of conversion. Provided that the conversion feature results in the conversion of a fixed functional currency amount of the notes into a fixed number shares, the conversion feature of the mandatorily convertible component is classified as equity. The liability component consists only of the cash flows associated with the contractually required coupon payments. This treats the note effectively as prepaid equity and results in significantly more equity upon initial recognition than would be the case with a conventional convertible note with a conversion option. Interest expense recognised at the effective interest rate would also be significantly lower than a conventional convertible note (see example 7 below for further details of the accounting approach).

Contingently convertible notes

It is not uncommon in practice for new start-up companies to raise convertible capital (commonly known as 'seed' capital) to fund the initial start-up phase of its business operations. When convertible notes are issued under such situation, the notes often mandatorily convert to equity if the start-up company successfully lists on the stock exchange within a set time frame.

A key principle in IAS 32 for equity classification is whether an entity has unconditional right to avoid the obligation, if not then it is liability. Whether an IPO would be successful is not within the control of the issuer. This is because other factors such as regulatory approval and the economic environment can influence whether the IPO would be successful or not. Therefore the existence of such clauses would mean that the note still contains a liability component (face value of the note and coupon) and an equity component (conversion feature) even though the note is mandatorily convertible into a fixed number of shares (without this type of clause, only the coupon component of the liability, and the residual would be classified as equity).

Control of the issuer – shareholder votes

Some convertible notes, such as the contingently convertible notes illustrated above, convert into shares or require repayment in cash in the event of contingent events, such as the sale or change in control of the issuer. In determining the appropriate liability or equity classification for these instruments, the question of whether certain events are within the control of the issuer may be relevant.

A key test is whether the issuer can control whether the sale or change of control takes place. In principle, the following approach is appropriate:

- If the owners of the issuer can sell their shares at any point, without any reference to the company, then the transaction that gives rise to the sale or change of control is not within the control of the company
- If the owners of the issuer can only sell their shares after approval of the related transaction in general meeting of the company, then the transaction that gives rise to the sale or change of control is within the control of the company. This is because shareholders are viewed as having two roles, being holders of the shares and a membership of the governance structure of the entity. It is common for corporate law to specify that shareholder general meetings form part of the governing process of entities, and specify how these meetings are to be conducted and the rights that can be exercised. Consequently, because the transaction is considered and approved at a shareholder general meeting, at the point at which the vote in general meeting is taken, the shareholders are viewed as being part of the entity itself.

Cancellation clauses

In certain circumstances, an issuer and investor may agree that the investor will subscribe for a specified number of shares at a predetermined price on a number of future dates. The contractual terms may permit the issuer to cancel the subscription arrangement by paying a penalty fee. For example, a convertible note may include a clause that states '...arrangement can be cancelled at anytime by paying CU100,000'.

The cancellation clause is an option that is embedded within the convertible note and its effect should be taken into account when determining either the fair value of the derivative liability.

ADDITIONAL EXAMPLES

The rest of this section contains additional examples.

Example 3: Convertible into a variable number of shares

An entity issues a note with a face value of CU1,000. The note has a maturity of three years from its date of issue. The note pays a 10% annual coupon and, at any point up to its maturity, the holder can convert the note into the number of shares equal, at their quoted market price, to CU1,000. Assume there are no transaction costs.

Analysis

Using the liability versus equity flowchart for the entire instrument, it is assessed as being a financial liability with embedded derivative liability having a zero fair value:

- There is a contractual obligation to pay cash that the issuer cannot avoid – the issuer has to pay an annual cash coupon and could be required to repay the capital amount at the end of three years if the holder chooses not to exercise the conversion option
- The exceptions in paragraphs IAS 32.16A-D do not apply
- The instrument has characteristics that are similar to equity – the instrument contains an option to be converted into equity instruments.

The host debt component will be classified as a financial liability in its entirety. This is because there is an obligation to pay cash that the issuer cannot avoid and, for this component on a stand-alone basis there is no feature that is similar to equity. The conversion feature is then assessed, again on a stand-alone basis. Starting with the box at the top left hand side of the diagram:

- There is no contractual obligation to pay cash that the issuer cannot avoid. The equity conversion feature can only be settled through the issue of equity shares, otherwise it will simply expire unexercised
- However, there is an obligation to issue a variable number of shares – the number of shares to be issued is based on quoted market price on conversion.

Consequently, the conversion feature is classified as a derivative liability.

This means that the note contains the following components:

- Contractual cash flows of 10% annual coupons and a cash repayment of CU1,000 (liability)
- The conversion feature to convert the liability to in to equity of the issuer at the market price on conversion date (an embedded derivative liability).

For convertible notes with embedded derivative liabilities, the embedded derivative liability is determined first and the residual value is assigned to the debt host liability. However, in this case, the embedded derivative liability has a zero fair value, therefore the debt host liability's initial carrying value equals its transaction price.

Entry on initial recognition:

Dr Cash	CU1,000	
Cr Debt liability		CU1,000

Being cash proceeds received in exchange for the issue of the convertible note

Example 4: Bonds issued in a currency other than the entity's functional currency

An entity issues a bond in foreign currency (FC) with a face value FC500,000. FC is not the entity's functional currency (LC). The note has a maturity of three years from its date of issue. The note pays a 10% annual coupon in foreign currency and on maturity; the holder has an option either to receive a cash payment in FC500,000 or 500,000 of the issuer's shares.

Assume that the derivative liability has a fair value of LC10,000 at the time of issue.

Assume also that the exchange rate is FC1.00:LC1.10.

Analysis

Using the liability versus equity flowchart for the entire instrument, it is assessed as being a financial liability with embedded foreign exchange (FX) derivative liability:

- There is a contractual obligation to pay cash that the issuer cannot avoid – the issuer has to pay an annual cash coupon and could be required to repay the capital amount at the end of three years if the holder chooses not to exercise the conversion option
- The exceptions in paragraphs IAS 32.16A-D do not apply
- The instrument has characteristics that are similar to equity – the instrument contains an option to be converted into equity instruments.

The host debt component will be classified as a financial liability in its entirety. This is because there is an obligation to pay cash that the issuer cannot avoid (see above) and, for this component on a stand-alone basis there is no feature that is similar to equity.

The conversion feature is then assessed, again on a stand-alone basis. Starting with the box at the top left hand side of the diagram:

- There is no contractual obligation to pay cash that the issuer cannot avoid. The equity conversion feature can only be settled through the issue of equity shares, otherwise it will simply expire unexercised
- However, there is an obligation to issue a fixed number of shares for a variable amount of liability – the amount of liability to be settled depends on the foreign exchange rate at the date of settlement.

Consequently, the conversion feature is classified as a derivative liability.

This means that the note contains the following components:

- Contractual cash flows of 10% annual coupons and a cash repayment of CU1,000 (liability)
- The conversion feature to convert a variable amount of liability in the functional currency into a fixed number of shares (an embedded FX derivative liability).

Therefore, the embedded FX derivative liability is determined first and the residual value is assigned to the debt host liability.

On initial recognition, entity receives LC550,000 in its local (functional) currency (at a rate of Foreign Currency (FC)1.00:Local Currency(LC)1.10). Since it has been determined that the FX derivative liability has a fair value of LC10,000, the carrying amount of the debt host liability on initial recognition is therefore LC540,000.

Subsequently, the FX derivative host liability is measured at fair value with changes recognised in profit or loss. The debt liability will be translated at the exchange rate at that reporting date as per paragraphs 23 and 28 of IAS 21 *The Effects of Changes in Foreign Exchange Rates* with differences recognised in profit or loss. Interest expense, calculated on an effective interest rate basis, is translated at the average exchange rate for the period.

Example 5: Callable convertible note

An entity issues a face value CU1,000 note which has a maturity of three years from its date of issue. The note pays a 10% annual coupon and, on maturity, the holder has an option either to receive cash of CU1,000 or 10,000 of the issuer's shares. The value of a similar bond without the equity conversion option feature is CU950. In addition, the bond also has a call feature which allows the issuer to repay the principal plus any outstanding accrued interest at anytime during the life of the note. The additional call feature is determined to be worth CU10 to the issuer.

Analysis

Using the liability versus equity flowchart for the entire instrument, it is assessed as being a compound financial instrument with two embedded derivatives:

- There is a contractual obligation to pay cash that the issuer cannot avoid – the issuer has to pay an annual cash coupon and could be required to repay the capital amount at the end of three years if the holder chooses not to exercise the conversion option
- The exceptions in paragraphs IAS 32.16A-D do not apply
- The instrument has characteristics that are similar to equity – the instrument contains an option to be converted into equity instruments.

Therefore, the host debt component will be classified as a financial liability in its entirety.

The conversion feature is then assessed, again on a stand-alone basis. Starting with the box at the top left hand side of the diagram:

- There is no contractual obligation to pay cash that the issuer cannot avoid. The equity conversion feature can only be settled through the issue of equity shares, otherwise it will simply expire unexercised
- There is no obligation to issue a variable number of shares. If exercised, the option will result in the issue of 10,000 shares.

Consequently, the conversion feature is classified as an equity component.

In addition, the bond also has a call feature which allows the issuer to repay the principal plus any outstanding accrued interest at anytime during the life of the note. However, as discussed above, this derivative is not accounted for as a separate embedded derivative (because it is to be considered to be 'closely related' to the debt host contract).

This means that the note contains the following liability and equity components:

- Contractual cash flows of 10% annual coupons and a cash repayment of CU1,000 (liability)
- The conversion feature to convert the liability to equity of the issuer (equity)
- The call feature (an embedded derivative that is not separated and recognised separately from the host liability)

The fair value of the liability component is CU940 which is the sum of the fair value of the debt host contract (CU950) and the non-separable embedded derivative (CU(10)). The equity component would be the residual i.e. CU60.

Example 6: Early repurchase of bonds

An entity issues a face value CU1,000 note which has a maturity date of three years from date of issue. The note pays a 10% annual coupon and, on maturity, the holder has an option either to receive cash of CU1,000 or 10,000 of the issuer's shares. At the end of Year 2, the issuer is subject to a takeover offer and elects to repurchase the note for CU1,100.

Assume the following:

- Carrying value of the note at the end of Year 2 is CU984
- The market interest rate for a note without conversion feature at the end of Year 2 is 10%.

Analysis

IAS 32.AG33 requires an entity to allocate the consideration paid for the repurchase to the liability and equity components using the same allocation method as the method for allocating the initial transaction price, i.e. determine the fair value the liability component, with the residual amount being allocated to equity.

The fair value of the outstanding liability at the end of Year 2, after payment of interest for that year is set out in Figure 12. This is the present value of outstanding cash flows at the market interest rate at the end of Year 2 (i.e. 10%).

	Discount	Cash flow	Fair value
Interest	1/1.1	CU100	CU91
Principal	1/1.1	CU1,000	CU909
			CU1,000

Figure 12: Calculation for the fair value of the liability component

The repurchase consideration paid to the holder is CU1,100, and the fair value of the liability component is CU1,000 as determined above, therefore the value assigned to the equity component is CU100.

The difference between the carrying value and the fair value of the debt liability at the end of Year 2 is accounted for as the cost of redeeming the debt.

	Debt liability
Carrying value	CU984
Fair value	CU1,000
Difference – debt settlement expense	CU16

Figure 13: Calculation for the debt settlement expense

Entry on note repurchase at the end of Year 2:

Dr Debt liability	CU984	
Dr Debt settlement expense	CU16	
Dr Equity	CU100	
	Cr Cash	CU1,100

Being cash paid for note repurchase, derecognition of the debt liability and equity, and the associated expense

Example 7: Mandatorily convertible note

An entity issues a face value CU1,000 note which has a maturity of three years from its date of issue. The note pays a 10% annual coupon and, on maturity, the note mandatorily converts into 10,000 of the issuer's shares. The market interest rate for a note without a conversion feature would have been 12% at the date of issue.

Analysis

Using the liability versus equity flowchart for the entire instrument, it is assessed as being a compound financial instrument:

- There is a contractual obligation to pay cash that the issuer cannot avoid – the issuer has to pay an annual cash coupon
- The exceptions in paragraphs IAS 32.16A-D do not apply
- The instrument has characteristics that are similar to equity – the instrument contains an option to be converted into equity instruments.

Therefore, only the cash coupon will be classified as a financial liability.

The mandatory conversion feature is then assessed, on a stand-alone basis. Starting with the box at the top left hand side of the diagram:

- There is no contractual obligation to pay cash that the issuer cannot avoid. The equity conversion feature can only be settled through the issue of equity shares, otherwise it will simply expire unexercised
- There is no obligation to issue a variable number of shares. The note mandatorily converts into 10,000 of issuer's shares on maturity.

Consequently, the conversion feature is classified as an equity component.

Year	Cash flow (interest)	Discount factor at 12 %	Net present value (NPV) of cash flow
1	CU100	1/1.12	CU89
2	CU100	1/1.12 ²	CU80
3	CU100	1/1.12 ³	CU71
Liability component			CU240

Figure 14: Calculation for the fair value of the liability component

	Amount
Transaction price	CU1,000
Less: liability component	CU(240)
Equity element (residual amount)	CU760

Figure 15: Calculation of the residual equity component

Year	Beginning balance	Interest expense (12%)	Cash coupon	Closing balance
1	CU240	CU29	CU(100)	CU169
2	CU169	CU20	CU(100)	CU89
3	CU89	CU11	CU(100)	CU0

Figure 16: Liability amortisation table

The accounting for a mandatorily convertible note results in significantly more equity than a conventional convertible note with a convertible option and effectively treats the note as prepaid equity. Interest expense recognised at the effective interest rate is significantly lower than a conventional convertible note, as interest is only calculated based on a substantially lower liability balance.

CONTACT

For further information about how BDO can assist you and your organisation, please get in touch with one of our key contacts listed below. Alternatively, please visit our IFRS page at www.bdointernational.com where you can find full lists of regional and country contacts.

EUROPE

Alain Frydlender	France	alain.frydlender@bdo.fr
Jens Freiberg	Germany	jens.freiberg@bdo.de
Nils Borcharding	Germany	nils.borcharding@bdo.de
Ellen Simon-Heckroth	Germany	ellen.simon_heckroth@bdo.de
Teresa Morahan	Ireland	tmorahan@bdo.ie
Ehud Greenberg	Israel	ehudg@bdo.co.il
Avi Oz	Israel	avio@bdo.co.il
Bart Kamp	Netherlands	bart.kamp@bdo.nl
Oscar van Agthoven	Netherlands	oscar.van.agthoven@bdo.nl
Reidar Jensen	Norway	reidar.jensen@bdo.no
Terje Tvedt	Norway	terje.tvedt@bdo.no
Ignacio Algas	Spain	ignacio.algas@bdo.es
René Krügel	Switzerland	rene.kruegel@bdo.ch
Pauline McGeer	United Kingdom	pauline.mcgee@bdo.co.uk
Juliet Ward	United Kingdom	juliet.ward@bdo.co.uk

ASIA PACIFIC

Wayne Basford	Australia	wayne.basford@bdo.com.au
Fanny Hsiang	Hong Kong	fannyhsiang@bdo.com.hk
Stephen Chan	Hong Kong	stephanchan@bdo.com.hk
Manoj Daga	India	manoj.daga@bdoindia.co.in
Paul Gough	India	paul.gough@bdoindia.co.in
Khoo Yeow Tan	Malaysia	tanky@bdo.my

LATIN AMERICA

Marcelo Canetti	Argentina	mcanetti@bdoargentina.com
Ernesto Bartesaghi	Uruguay	ebartesaghi@bdo.com.uy

NORTH AMERICA & CARIBBEAN

Wendy Hambleton	USA	whambleton@bdo.com
Carlos Ancira	USA	cancira@bdo.com
Armand Capisciolto	Canada	acapisciolto@bdo.ca

MIDDLE EAST

Antoine Gholam	Lebanon	agholam@bdo-lb.com
Rupert Dodds	Bahrain	rupert.dodds@bdo.bh

SUB SAHARAN AFRICA

Nigel Griffith	South Africa	ngriffith@bdo.co.za
Japie Schoeman	South Africa	jschoeman@bdo.co.za

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