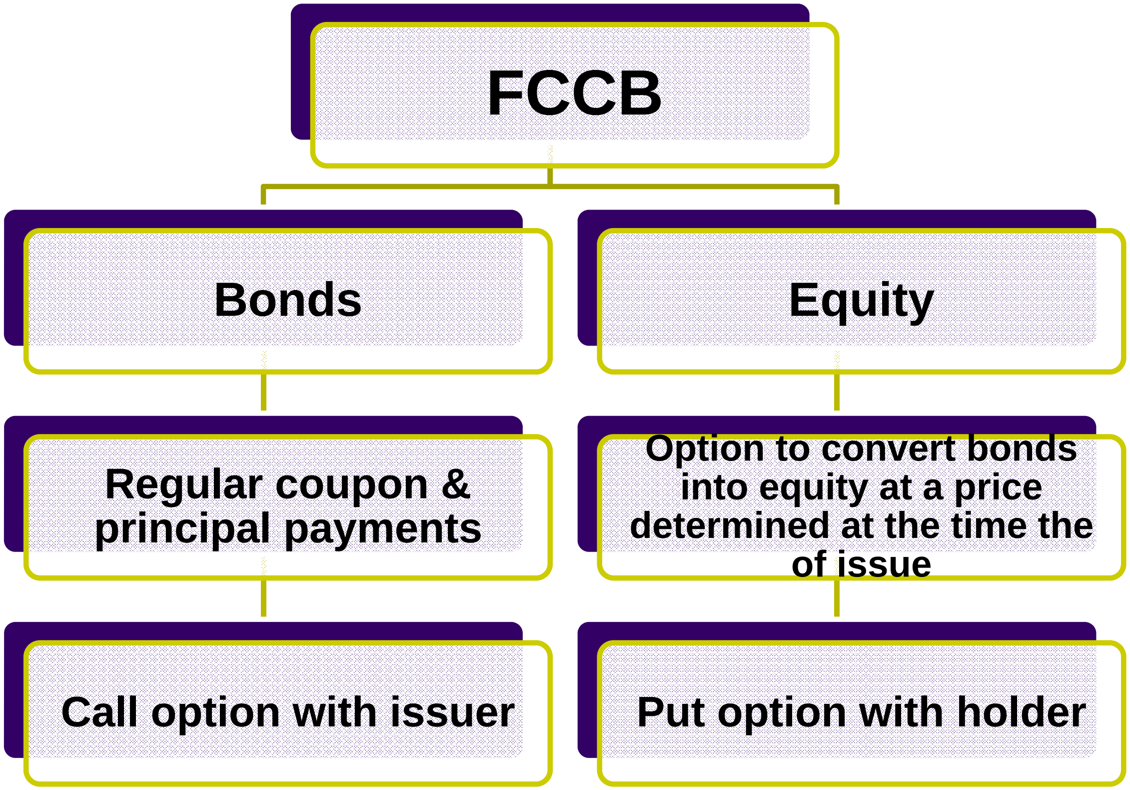
FOREIGN CURRENCY CONVERTIBLE BONDS (FCCBs)

Accounting Standards Board

Features of FCCBs in India- A Summary

- Issued in a currency different than the issuer's domestic currency
- A mix between a debt and equity instrument



- Unless converted, redeemed, purchased and cancelled, the Bonds are to be redeemed on maturity

Why FCCB?

Issuer	Investor
• Coupon payment on bond is lower due to equity conversion feature of bond • Conversion premium adds to the capital reserves • Fewer covenants as compared to a syndicated loan or a debenture • Lower dilution of Equity	• Assured returns in the form of fixed coupon rate payments • Ability to take advantage of price appreciation in the stock by the means of warrants attached to the bonds • Lower tax liability as compared to pure debt instruments due to lower coupon rate

Accounting of Bonds under IFRS

Convertible Bonds	Foreign Currency Convertible Bonds
Convertible Bonds	**Foreign Currency** Convertible Bonds
Debt → Amortised cost	**Financial liability**
Equity → At cost	**At fair value thru' P&L**

Fixed to Fixed Principle

Fixed to Fixed Principle (Para 24 of IAS 32)

Issue of **Fixed** no. of own Equity Instrument → In exchange for **Fixed** amount of cash → Treated as Equity Instrument

Issue of **Fixed** no. of own Equity Instrument → In exchange for **Variable** amount of cash → Treated as Financial Liability

Fixed for Fixed – Applicability on FCCBs

- No. of equity instruments to be issued – Fixed
  * The equity instrument here is the "option" to issue equity share

- The issuer gets debt at a lower effective rate of interest. The saving of "differential" interest constitutes consideration for equity instruments (i.e., equity options) issued. This saving is quantified (fixed amount) at the time of issue of FCCB and doesn't fluctuate thereafter.

- However, this interpretation is not accepted as of now. IASB is of the view that since the amount of cash to be exchanged *at the time of exercise of conversion option* is variable in terms of functional currency (INR), though fixed in USD terms, the consideration for issue of equity instrument is variable.

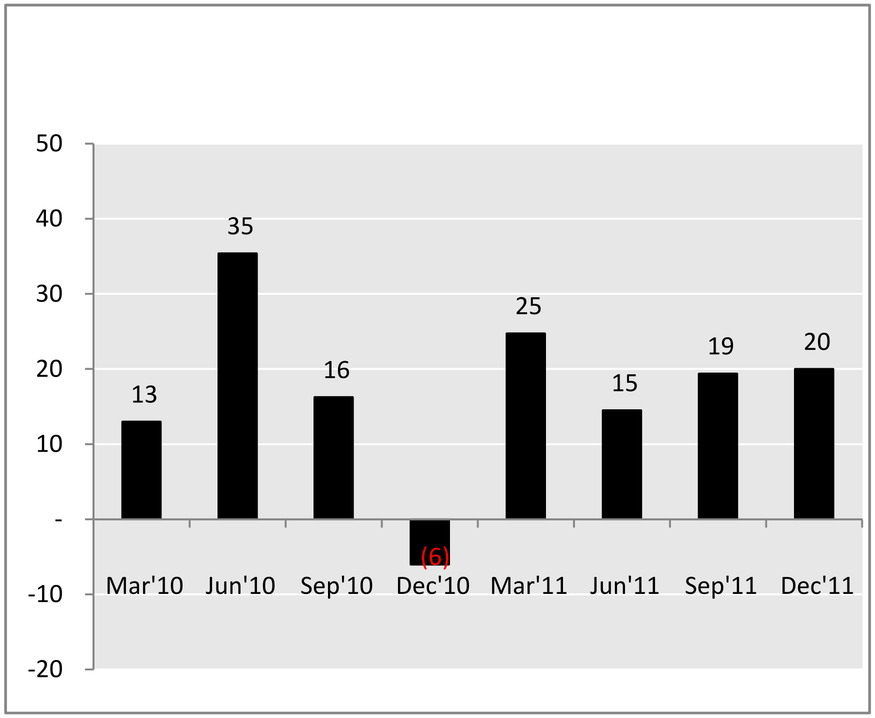
Implications of IASB's view

- No split into debt & equity component allowed
- Entire instrument to be classified as Financial Liability at fair value
- The holder of FCCB has 'option to convert into equity'
- This option is a derivative requiring fair valuation on each balance sheet date
- **Results into volatility in profit or loss**

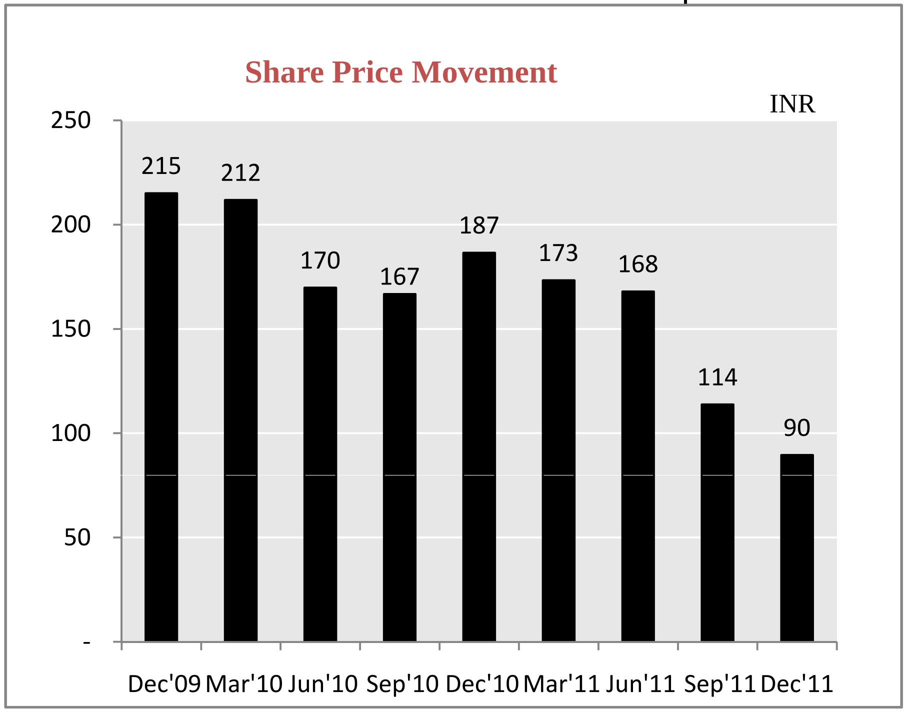
The data in the subsequent slides, though pertains to 2011, illustrates the volatility and other implications

Impact on the financials of Vedanta Resources PLC (Listed on London Stock Exchange)

Gain/(Loss) on MTM of Embedded Derivative

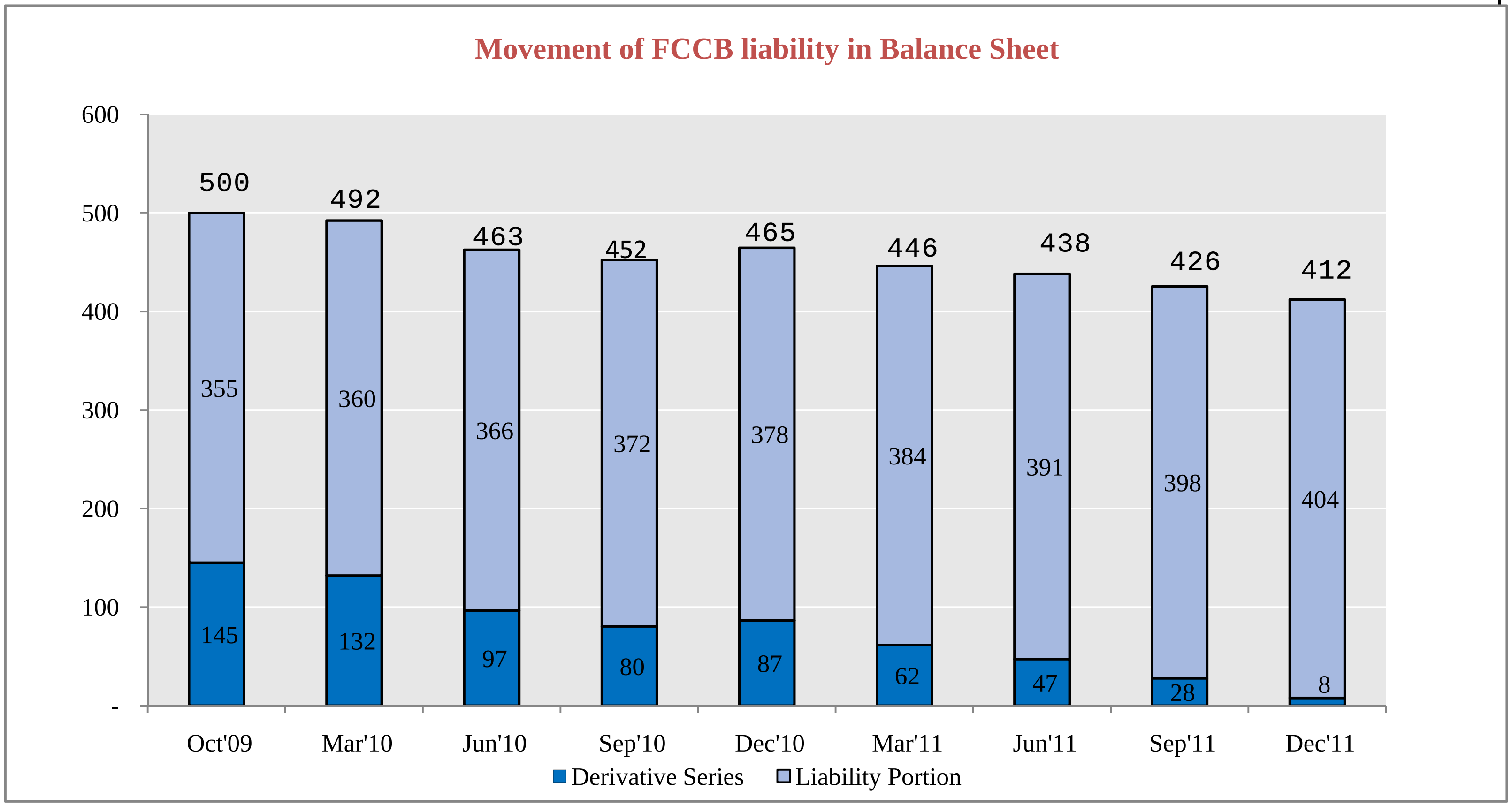


Share Price Movement



- Value of option mainly depends on share price of the issuer.
- With price going down, there is gain in income statement and vice-versa. Cumulative gain of $175 million in FCCB face value of $500 million
- Unintended volatility in income statement due to volatile share price
- Timing mismatch-gain/loss to reverse at time of redemption or conversion

Impact on the financials of Vedanta Resources PLC (Listed on London Stock Exchange)



- Decrease in share price leading to decrease in liability and gain in income statement
- However, it is more unlikely that bond holders will opt for conversion
- Hence, reducing liability further will not reflect true and fair view of liability

Ind AS Carve out

Para 24 of IAS 32

Issue of **Fixed** no. of own Equity Instrument → Exercise price is fixed in currency other than functional currency → Treated as Financial Liability **under IFRS**

Carve out (Para 11 of Ind AS 32)

"The equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of the entity's own equity instruments is an equity instrument if the exercise price is fixed in any currency"

Para 11 of Ind AS 32

Issue of **Fixed** no. of own Equity Instrument → Exercise price is fixed in any currency → Treated as Equity **under Ind AS**

Justification of carve out under Ind AS

- Adherence to principle based accounting
  - Substance over form
- Presents true & fair view
  - Movement in own equity for “equity options” issued should not affect P&L

Extract from Financial Statements

Extract from OAO TMK Financial 2010 :- As disclosed in Note 25 of TMK Consolidated Financial Statements, TMK determined that the convertible bonds represent a combined financial instrument containing two components: (i) a bond liability and (ii) an embedded derivative representing a conversion option in foreign currency combined with an issuer call ("embedded conversion option"). Generally, conversion options are recognised as a part of equity, however, IFRS requires that in the specific case when the conversion option is denominated in currency other than issuing entity's functional currency, no equity component can be recognised prior the conversion of the bond. As a result, in accordance with IFRS, TMK recognised a bond liability of U.S.$368 million (net of transaction costs of U.S.$9 million) and the liability under embedded conversion option of U.S.$35 million at the initial recognition date.The liability component is subsequently carried at amortised cost using the effective interest rate method. The derivative component is subsequently remeasured at fair value at each reporting date.

As of 31 December 2010, the bond liability and the liability under the embedded conversion option were U.S.$378 million and U.S.$48 million, respectively. TMK recorded a loss on changes in the fair valueof the derivative financial instrument in the twelve months of 2010 of U.S.$12 million.

Extract from OAO TMK Financials 2013:- Embedded Conversion Option in foreign currency was classified as financial instrument at fair value through profit or loss. The Embedded Conversion Option was initially recognised at the fair value of 35,455. The Group used binomial options pricing model for initial and subsequent measurement of fair value of this embedded derivative. For the purposes of this model, the Group assessed that the credit spread comprised 410 bps and 673 bps as at December 31, 2013 and December 31, 2012 respectively. As at December 31, 2013 the fair value of the Embedded Conversion Option was 2,080 (December 31, 2012; 10490). The change in the fair value of the embedded derivative during the reporting period resulted in a gain of 8,410 (2012; loss of 7,466),which has been recorded as gain/(loss) on changes in fair value of derivative financial instruments in the income statement.

Recommendation to IASB

- Amendment to IAS 32/IFRS 9
  - In line with amendment in case of “rights” issue
  - Similar to carve out in Ind AS 32

- Address the issue thru’ IFRIC
  - Interpretation of para 24 of IAS 32

THANK YOU