Common deficiencies in auditing issuers' accounting for convertible bonds

Convertible bonds (CBs) are financial instruments that, in their simplest form, contain a debt component and an option for the bondholders to convert the bonds into equity of the underlying entity. They are often deployed in business combinations, and for specific purposes such as raising funds.

Given there are various ways to structure CBs, and with innovative ways regularly coming to market, accounting for CBs may be complicated. Below are two common deficiencies noted from the Institute's disciplinary cases which demonstrate the need for auditors to carry out sufficient audit procedures when evaluating the specific features of each CB and assessing the relevant accounting impact for ensuring compliance with relevant financial reporting standards.

Measuring fair values upon initial recognition

One of the most common deficiencies arises when auditors do not obtain sufficient evidence to support issuers' use of the CBs' principal amounts as the CBs' fair values.

For example, in one case, the auditor asserted that the fair values of the CBs (issued as part of the purchase consideration for an acquisition) were their principal amounts because the total consideration was arrived at between two knowledgeable and willing buyer and seller on commercial terms and was therefore already a "fair value" consideration – agreed or predetermined in advance. The auditor's argument showed that he lacked the basic understanding of the fundamental concept of fair value of CBs.

The same issuer also issued two CBs for fundraising at conversion prices which were at significant discounts to the issuer's share prices at the bonds' issuance dates. The CBs were share-based payment transactions. However, they were initially measured at values equal to their principal amounts and were not accounted for as share-based payment transactions. In explaining their lack of audit procedures on evaluating the terms and substance of the CBs, the auditor asserted that the deep discount for one of the CBs was due to the undesirable financial performance of the issuer, rather than any unidentifiable goods and services from the subscriber. Regarding the other CB, the auditor asserted that there was no service provided by the subscriber who was an employee of the issuer and that the issuer's financial advisor rendered an opinion that the CB did not contain any service element. These assertions showed a lack of understanding of share-based payment transactions. Furthermore, in respect of the second CB, the subscriber was not an employee of the issuer and there was no such opinion rendered by the financial advisor.

In another case, the issuer issued two CBs as part of the purchase consideration for an acquisition, one of which was subject to adjustment by reference to future profits of the acquiree. The sums of the equity and liability components of the bonds equaled to the bonds' principal amounts. Both CBs were fair valued by a professional valuer engaged by the issuer. The auditor failed to identify that one of the bonds was a contingent consideration payable in nature. The auditor also failed to sufficiently evaluate the assumptions and assess the methodology adopted in the valuation.

In a third case, the purchase consideration for an acquisition was satisfied by the issuance of CBs. The CBs were fair valued by the issuer's valuer. The auditor, having only recalculated the fair value of the equity component of the CBs by using input data of a different acquisition date and adopting a different valuation method, accepted management's assessment that the principal amount of the CBs approximated their acquisition-date fair value, which was materially different from the fair value estimated by the professional valuation.

There are also cases involving auditors who only performed limited audit procedures on the valuation of the liability component of the relevant CBs, or they did not plan properly or carry out any audit procedures assessing the initial measurement of the CBs issued as purchase consideration for acquisitions.

The above are examples showing that the entire CBs were measured at their respective principal amounts upon initial recognition. In those examples, there were indicators that cast doubt on adopting the principal amounts as the CBs' fair values, such as, the conversion price being significantly different from the market price of the entity's shares at issuance date, a significant period of time lapsing from the date of determination of the principal amounts to the issuance date, and a very low coupon rate. In those circumstances, it would be unlikely that the CBs' principal amounts would be representative of their fair values upon issuance.

Recognition of components of CBs

Another common issue relates to auditors' deficient evaluation of the terms of CBs and the resulting lack of audit procedures needed for identification and recognition of different components embedded in the CBs.

In one case, the issuer would repay the outstanding principal amounts to the

holders by issuing new shares at the higher of the then market value or a specific amount per share on the maturity date. Effectively, the issuer was required to issue a variable number of shares to redeem the CB. Thus, the CB did not meet the definition of an equity instrument and should not have been classified as such under Hong Kong Accounting Standard (HKAS) 32 *Financial Instruments: Presentation*. However, the issuer recognized the CB as an equity instrument. There was no evidence showing that the auditor had assessed the terms of the CB and obtained sufficient appropriate audit evidence to support this conclusion.

In another case, a CB was issued as part of the consideration for an acquisition but its amount was subject to adjustment based on the target group's future profit. The CB was in essence a contingent consideration payable as defined in Hong Kong Financial Reporting Standard 3 *Business Combinations*, and the number of shares to be issued upon conversion would vary depending on the target group's future profit. The entire CB should have been recognized as a financial liability. In this case, the auditor failed to carry out audit procedures to evaluate management's assumption that there would be no need to adjust the contingent consideration in the future. The auditor also failed to assess whether the valuation report on the CB had taken into account the relevant terms regarding the adjustment.

A CB may contain early redemption options for either the issuer or the holder to opt for an early repayment. An embedded call option enables the issuer to redeem the whole or part of the principal amount of the CB prior to the maturity date. If the economic characteristics and risks of such an embedded call option are not closely related to the host contract, it is accounted for separately. Otherwise, it is included in the liability component of the CB. There have been situations where the embedded call options were either ignored or wrongly accounted for in the relevant financial statements and the auditors failed to identify the deficiencies.

In one case, the auditor did not perform any work on the embedded call option notwithstanding that the option was identified and fair valued by the issuer's professional valuer. The subsequent auditor of the same issuer also failed to identify the embedded call option despite early redemption of part of the CB by the issuer in the preceding year.

In another case, despite a professional valuation supporting that the embedded call option was capable of being separated from the host contract and fair valued, the auditor concluded that the option was not capable of being fair valued as management had communicated that they had no intention of exercising the option. This position revealed the auditor's lack of understanding of the recognition and measurement requirements under HKAS 32 and HKAS 39 *Financial Instruments: Recognition and Measurement*. Further, HKAS 39 requires that factors and inputs used in a valuation model should be from the market participant's perspective and represent market expectation. An option may have value from the market perspective irrespective of management's intention about whether the option will be exercised.

The next example also demonstrates a lack of understanding regarding recognition and measurement requirements for embedded call options. The financial statements in this case showed that the value of an embedded call option was included in the liability component of a CB; however, the auditor did not perform any work on the embedded call option. In particular, there was no evaluation of the fair value estimated by the professional valuer or assessment of whether it should be accounted for separately. The auditor asserted that the call option should not be included in the CB if the coupon rate is lower than the effective interest rate, as the issuer would have no incentive to redeem the CB. Such an assertion simply could not assist the auditor. Management's expectation or intention about the exercise of the option is not relevant to justify the measurement and the accounting treatment of the option.

As CBs may contain various components, auditors should perform a detailed analysis of the terms and conditions included in the contracts of the CBs to ensure they fully understand the relevant transactions. Then, they should determine which procedures are needed to ensure that the components are properly accounted for in the financial statements. Inappropriate accounting treatment of the components would impact the financial statements of current period as well as subsequent periods.

As a Disciplinary Committee of the Institute stated in an order made against the auditor of a listed entity "The public are entitled to expect that practising accountants and corporate entities discharge their duties and carry out their work to the highest standards of probity, independence and competence. If public confidence is shaken then the price to be paid by the entire accounting profession is very high."

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