

Earnings Impact of Applying International Accounting Standard 32 to Convertible Debt: Some Evidence for U.S. Firms

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The International Accounting Standards Committee (IASC) recently issued a new accounting standard, International Accounting Standard (IAS) 32, Financial Instruments: Disclosures and Presentations. The new standard calls for issuers of convertible debt to record separate debt and equity components at the date of issuance. In contrast, current U.S. accounting rules for issuers of convertible debt, Accounting Principles Board Opinion No. 14 (APBO 14), Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants, require the "entirely debt until conversion" approach. U.S. issuers of convertible debt are not governed by IAS 32. However, the issuance of IAS 32 shows obvious international consensus for the separate components approach. In addition, there is substantial support among U.S. academic accountants for the components approach used in IAS 32. This article explains and analyzes the potential financial reporting impact of IAS 32 if it were applied to a sample of U.S. issuers of convertible debt. The results of this study show that reclassification of a portion of convertible debt proceeds to equity has the potential to materially increase interest expense and decrease earnings. This study provides important insights which should be of interest to the financial reporting community in the U.S. and internationally.

Key Words: convertible debt; IAS 32; earnings impact.

INTRODUCTION

Financial reporting rules for convertible debt affect the financial position and earnings of issuing firms. Accounting for convertible debt continues to be an

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unsettled issue in the U.S. Current U.S. accounting rules, Accounting Principles Board Opinion No. 14 (APBO 14), *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*, requires that convertible debt be recorded as entirely debt until the instrument is converted by the holder into the issuing firm's common stock.

Recently, the International Accounting Standards Committee (IASC) issued a new International Accounting Standard (IAS) that re-focuses attention on this issue, IAS 32, *Financial Instruments: Disclosures and Presentations* (IASC 1995). The new standard was issued in June, 1995 and is effective January 1, 1996. One motive for the issuance of IAS 32 is that due to the growth in the use of complex financial instruments in recent years, issuers' financial statements often do not fully reflect their financial position or earnings. IAS 32 prescribes that issuers classify financial instruments, including compound or hybrid instruments such as convertible debt, according to their economic substance. With respect to convertible debt, IAS 32 assumes that the economic substance of convertible debt consists of a debt component and an equity component. Accordingly, IAS 32 mandates that at date of issuance, the proceeds from a convertible debt instrument be allocated between debt and equity and be classified as such on the balance sheet. By requiring reporting of separate debt and equity components, IAS 32 contrasts sharply with APBO 14, which requires entirely debt treatment until conversion. The contrast between APBO 14 and IAS 32 frames the main controversy surrounding accounting for convertible debt in the U.S.—“entirely debt until conversion” versus “separate debt and equity components.”

The convertible debt controversy has been addressed by academic accountants. For instance, studies by Brennan and Schwartz (1980), King (1984), Billingsley, Lamy, and Thompson (1986), Dudley and Schadler (1994), and Stevens, Volkan, and Baker (1994) concluded that APBO 14 does not reflect the economic substance of convertible debt and showed that separate debt and equity components, as prescribed by IAS 32, can be measured and therefore classified on issuers' balance sheets. A 1990 Financial Accounting Standards Board (FASB) Discussion Memorandum (DM) entitled “Distinguishing between Liability and Equity Instruments and Accounting for Instruments with Characteristics of Both” discussed reporting separate debt and equity components as an alternative to APBO 14 (FASB 1990). Responding to the DM, the American Accounting Association's Financial Accounting Standards Committee (AAA/FASC) concluded in 1993 that the separate debt and equity components approach should be adopted for convertible debt because it more accurately reflects the economic substance of convertible debt (AAA 1993).

While U.S. issuers are not currently subject to IAS 32 or the conclusions of academic research, the above discussion indicates a consensus internationally and substantial support in the U.S. for changing from APBO 14's “entirely debt until conversion” approach to IAS 32's “separate debt and equity components”

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