Stage 3–
Financial Instruments with Characteristics of Equity: the BuildItYourself case study
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BuildItYourself Case Study

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BuildItYourself\(^1\) is a web-based home improvement retailer, which is listed on the Latrican Stock Exchange. It prepares its financial statements in accordance with IFRS. BuildItYourself’s functional currency is the Latrican dollar (L$).

BuildItYourself has only one class of shares—ordinary shares. Each share carries equal voting rights. Dividends are declared to the ordinary shareholders periodically at the sole discretion of the company. In the event of liquidation, the holders of the ordinary shares have the only interest in the residual assets of the company.

BuildItYourself operates out of a single warehouse in Capitol (the capital city of Latrica). To expand its operations to other major Latrican cities, management is planning to acquire five new warehouses, one located in each of the five targeted cities.

Management is considering how to raise the L$20 million needed to finance the acquisition of the five new warehouses. It has identified the following alternatives available to the company:

**Alternative 1: fresh issue of ordinary shares**

On 1 January 20x0 BuildItYourself receives L$20 million in exchange for issuing 2 million new ordinary shares of the same class that its existing shareholders currently hold.

**Alternative 2: mandatorily redeemable fixed-term variable-rate debentures**

On 1 January 20x0 BuildItYourself receives L$20 million in exchange for 1 million L$20 ten-year debentures that, collectively, contractually oblige BuildItYourself to pay:

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variable ‘interest’ cash flows calculated as follows: L$20 million × (a specified observable variable interest rate + 1.5 per cent)\(^2\) on 31 December each year for 10 consecutive years; and

- a final payment of L$20 million (ie L$20 for each debenture) in full and final settlement of the obligation to the debenture holders (ie fixed redemption at par) on 31 December 20x9.

On 1 January 20x0 the specified observable variable interest rate for the year was paying 2.5 per cent. Consequently, at that time, BuildItYourself incurred interest at 4 per cent per year (ie 2.5 per cent observed + 1.5 per cent premium).\(^3\)

If BuildItYourself were to be liquidated, the debentures holders’ claims rank higher than those of the ordinary shareholders (ie the debenture holders’ claims would be settled in full before settling the claims of the ordinary shareholders).

**Alternative 3: mandatorily redeemable fixed-term fixed-rate debentures**

On 1 January 20x0 BuildItYourself receives L$20 million in exchange for 1 million L$20 ten-year debentures that, collectively, contractually oblige BuildItYourself to pay:

- L$1 million (ie 5 per cent fixed interest) on 31 December each year for 10 consecutive years; and

- a final payment of L$20 million (ie L$20 for each debenture) in full and final settlement of the obligation to the debenture holders (ie fixed redemption at par) on 31 December 20x9.

**Alternative 4: mandatorily redeemable debentures with holder-held early redemption feature**

The facts are the same as Alternative 3 except, in this case (Alternative 4), interest payments are L$900,000 (ie 4.5 per cent) per year. In addition, the debenture holders can, at their sole discretion, require redemption of the debentures after 1 January 20x3 but before maturity (ie any time after 1 January 20x3 the debenture holders can require BuildItYourself to redeem). The amount due on redemption is L$20 million (the face

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\(^2\) The contractual cash flows in all Alternatives reflect market rates that apply to BuildItYourself at 1 January 20X0. In other words, the interest rates in all Alternatives are market interest rates.

\(^3\) The features in this instrument and those in the other financing alternatives presented in this case study have not been priced accurately. Nevertheless, the authors believe that the inaccurate pricing adjustments are directionally correct—indicate whether a higher or a lower ‘interest rate’ would apply to the instrument as a whole as a result of including such features.
amount) plus interest accrued at the rate of 4.5 per cent per year since the last interest payment date to the early redemption date.

**Alternative 5: mandatorily redeemable debentures with issuer-held early redemption feature**

The facts are the same as Alternative 3 except, in this case (Alternative 5), interest payments are L$1.2 million (ie 6 per cent) per year and BuildItYourself may after 1 January 20x3 but before maturity, at its sole discretion, redeem the debentures by paying them L$20 million (the face amount) plus interest accrued at the rate of 6 per cent per year since the last interest payment date to the early redemption date.

**Alternative 6: mandatorily redeemable fixed term preference shares—with fixed dividends but without voting rights**

On 1 January 20x0 BuildItYourself receives L$20 million in exchange for issuing preference shares that have no voting rights and have the contractual obligation to pay:

- L$1.15 million (ie 5.75 per cent per year fixed non-discretionary dividend) on 31 December each year for 10 consecutive years; and
- a final payment of L$20 million in full and final settlement of the obligation to the preference-shareholders (ie fixed redemption at par) on 31 December 20x9.

On liquidation only the ordinary shareholders’ claims are more subordinate than the claims of the non-voting preference shares against BuildItYourself’s net assets.

**Alternative 7: convertible debentures—exercisable only at maturity**

The facts are the same as Alternative 3 except, in this case (Alternative 7), interest payments are L$700,000 (ie 3.5 per cent) per year and the debenture holders may at 30 December 20x9, at their sole discretion and in lieu of receiving L$20 for each debenture held, require BuildItYourself to convert each debenture into one BuildItYourself ordinary share. Any debentures not converted into ordinary shares at 30 December 20x9 must be redeemed at their par value (ie L$20).

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4 In Latrica such preference shares never gain voting rights.
Alternative 8: convertible debentures—exercisable during the 6 years before maturity

The facts are the same as Alternative 3 except, in this case (Alternative 8), interest payments are L$600,000 (ie 3 per cent) per year and the debenture holders may any time after 1 January 20x4 but before maturity, at their sole discretion require BuildItYourself to convert each debenture held into one BuildItYourself ordinary share. Any debentures not converted into ordinary shares by 31 December 20x9 must be redeemed at their face value (ie L$20).

Alternative 9: mandatorily redeemable debentures with conditional early redemption feature

The facts are the same as Alternative 3 except, in this case (Alternative 9), interest payments are L$1.1 million (ie 5.5 per cent per year) per year and BuildItYourself may any time after 1 January 20x7 but before maturity, at its sole discretion, redeem all of the outstanding debentures at par (L$20) plus interest accrued since the last interest payment date, provided that (ie conditional upon) the market price of BuildItYourself ordinary shares exceeds L$26 for longer than seven consecutive working days immediately before the election is made.

Alternative 10: convertible debentures with conditional early redemption feature

These debentures combine the features of the debentures in Alternatives 8 and 9 except, in this case (Alternative 10), ‘interest’ cash flows are L$700,000 (ie 3.5 per cent) per year. In other words:

- BuildItYourself may any time after 1 January 20x7 but before maturity, at its sole discretion, redeem all of the outstanding debentures at par (L$20) plus interest accrued since the last interest payment date, provided that (ie conditional upon) the market price of BuildItYourself ordinary shares exceeds L$26 for longer than seven consecutive working days immediately before the election is made.
- the debenture holders may any time after 1 January 20x4 but before maturity, at their sole discretion and in lieu of receiving any future interest and (on 31 December 20x9) L$20 for each debenture held, require BuildItYourself to convert each debenture held into one BuildItYourself ordinary share.
### Some IFRS issues for class discussion

Explain the economics of each of the instruments being considered by management to raise finance for BuildItYourself (for example, identify the financial risks of the alternatives and explain why interest rates and the contractual cash flows differ for each of the instruments being considered).

Which elements (for example, asset, liability, equity), as set out in the Conceptual Framework, would arise from BuildItYourself contracting with the counterparties in each of the financing alternatives that management are considering for financing the acquisition of the new warehouses?

For each of the financing alternatives being considered by management how, in accordance with IFRS, would the contracts be accounted for by BuildItYourself when first recognised?

For each of the financing alternatives being considered by management how, in accordance with IFRS, would the contracts be accounted for by BuildItYourself after initial recognition?

For each instance in which the classification (ie asset, liability or equity, or a combination thereof) in accordance with IFRS, differs from classification in accordance with the Conceptual Framework definitions of ‘elements’, discuss why the IFRS classification requirement differs from the Conceptual Framework element definitions.

### Some suggestions for extending the class discussion to other related areas of study

- If the jurisdiction in which you teach IFRS has dual reporting using also a local GAAP which is based on similar concepts, the teaching of both sets of financial reporting requirements using this case study could be integrated. In other words, class discussion would, for each of the financing alternatives being considered by management, include both IFRS and local GAAP and students could evaluate which best satisfies the shared objective of financial reporting?
- By assuming that BuildItYourself is subject to the income taxation laws of a particular jurisdiction the class discussion could be extended to include:
  - accounting, in accordance with IAS 12 Income Tax, for the tax effects for BuildItYourself for each of the financing alternatives being considered; and
  - possible tax planning issues.
- From the perspective of the counterparty, explore the economics/pricing/finance of the range of financing alternatives being considered by BuildItYourself.
- From the perspective of the audit partner, discuss implications for the audit of BuildItYourself’s annual financial statements for each of the financing alternatives being considered by management.