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Accounting for financial instruments with characteristics of debt and equity: Finding a way forward

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AASB Academic Forum
24 November 2016

AACSB ACCREDITED

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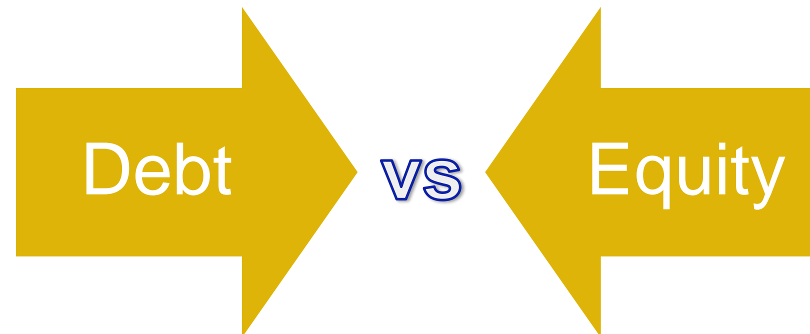
Introduction

- Aim of our study is to inform the standard setting project on accounting for financial instruments with characteristics of equity (FICE).
- Provide an overview of the literature relevant to classification of debt vs equity
- Suggest possible approaches to improving accounting standards



Current accounting standards

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- Conceptual Framework
  - Economic characteristics
  - Defines assets & liabilities
  - Liabilities based on solvency view
  - Equity is residual
- IAS 32
  - CF + ordinary equity valuation view for equity-settled instruments
- IFRS 2
  - Strict solvency approach

Under review as part of conceptual framework and FICE projects

Consult the "Authorities"

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- Google
  - Equity is "the value of the shares issued by a company"
- Wikipedia
  - "**equity** is the difference between the value of the assets and the cost of the liabilities of something owned"
- Investopedia
  - "The value of an asset less the value of all liabilities on that asset."

Problems with current approach

- Classification is important
  - Drives subsequent accounting in balance sheet & income statement
  - Impacts key ratios
    - P / E
    - Debt / Equity
    - EPS
- Practitioners struggling with principles
- Can split in different ways
- Probabilities ignored
- Economic compulsion ignored

Extent of use

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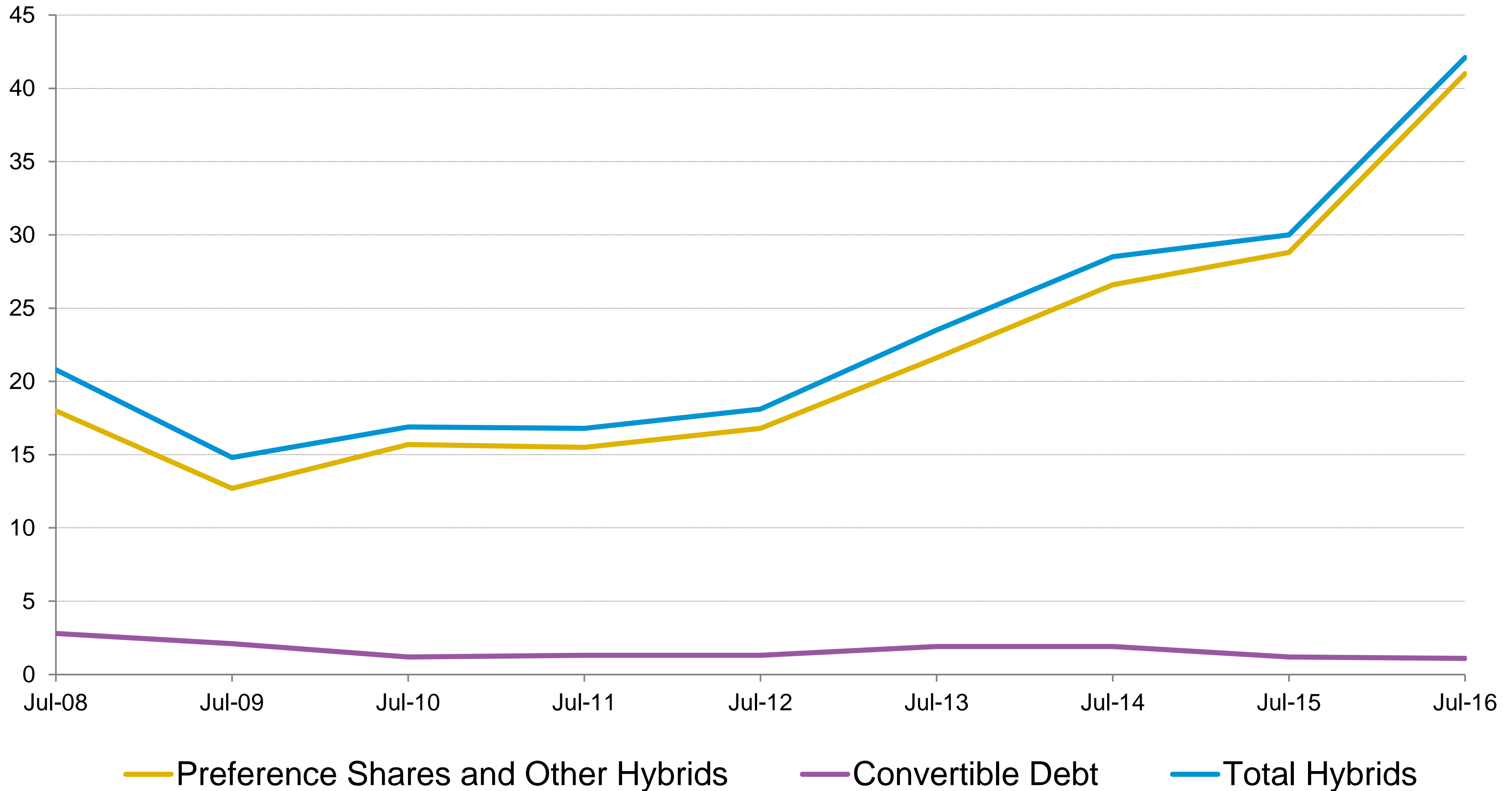

Examples of compound instruments

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Long-dated redeemable preference shares	Short-term convertible notes
Duration – 10 to 20 years	Duration – 12 to 24 months
Dividend based on typical interest benchmark	Converts into fixed number of shares
Dividend blocker + loaded voting rights	No coupon
	Large redemption premium – 20% to 50%

Academic Literature

- Why do firms choose compound instruments?
  - Achieve target D / E ratio
  - Backdoor equity raising
  - Risk-sharing
  - Reduce agency costs
  - Guaranteed equity raising
  - Reduce tax
  - Minimise refinancing
  - Mitigate managerial discretion

What are firms trying to achieve?

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"holy grail" of compound instruments is "an instrument regarded as a liability by the tax authorities (such that costs of servicing it are tax deductible) but treated as equity for accounting and/or regulatory purposes (so that the instrument is not considered as a component of net borrowing)." EY (2016)

'The dream of every finance executive is a hybrid instrument, which is classified as equity when calculating gearing ratios, but does not dilute ordinary shares and share price, is as cheap as debt, and whose return ranks as interest for tax purposes.'

World Accounting Report (1991)

Academic Literature

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- Firms design instruments to obtain equity classification or get tax benefits
  - US (Engel et al.,1999, King & Ortegren, 1998, Levi & Segal, 2015)
  - Canada (Scott, 2011)
  - EU (Seminogovas, 2015)
- Also to obtain favourable DEPS treatment
  - Marquardt & Wiedman (2007b)
  - Lewis & Verwijmeren (2014)
- Standards setters need to be aware of transaction structuring

Academic Literature

- Are users influenced by classification?
  - Hopkins (1996)
    - Analysts predicted different share prices depending on debt / liability classification
    - Liability > Equity
    - Examined attributes more closely if classified in the mezzanine
  - Bispo et al. (2016)
    - Regardless of B / S classification treated as liability

Academic Literature

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- Are users influenced by classification?
  - Clor-Proell et al. (2016)
    - Effect of compound instruments on credit-related judgements
    - Classification not important as rely on underlying features
    - Users vary in views as to what features are important in distinguishing debt from equity

Academic Literature

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- What can we discern from market effects?
  - Market responds differently to B/S classification
    - Kimmel & Warfield (1995), Cheng et al. (2003), Terando et al. (2007)
  - Introduction of new accounting standards improved transparency
    - Godfrey et al. (2010)
  - Disclosure often inadequate despite new accounting standards
    - Marquardt & Wiedman (2007a)

Possible approaches

- Improve definition of a liability
- Improve separation of components approach
- Enhance disclosure requirements
- Introduce mezzanine category

Possible approaches

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- Improve definition of a liability
  - Move to more principles-based approach
  - More rules unlikely to solve problem
  - Focuses on one dimension
  - Where do you place the dividing line?
- Improve separation of components approach
  - Still need to distinguish between liabilities and equity
  - Problems identifying components
  - Difficult to value components

Possible approaches

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- Enhance disclosure requirements
  - Extensive requirements in IAS 32, IAS 39, IFRS7 and IFRS9
  - Limited disclosure for compound instruments
    - Particularly around ordinary equity valuation
  - EPS and DEPS
    - Based on techniques from 1960s
    - Expanded fair value measurement?

Introduce a Mezzanine category

- All compounds in the mezzanine
- Highlight attributes
- No need for split accounting
- Still need category for pure liabilities and equity
- Introduce full fair value accounting for gains and losses in
  - OCI or
  - After EBIT

Mezzanine has been used before

- US
  - Prior to SFAS 150
  - Still used for redeemable preference shares
- UK
  - Non-equity if returns not linked to profits or redeemable
- Supported by
  - Ryan et al. (2001)
  - Wahlen et al. (1999)
  - ASBJ (2015)
  - AOSSG (2015)

FASB and IASB did not consider mezzanine

Areas for future research

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- Determining classification principles
- What attributes are used to distinguish between debt and equity
- Identifying disclosures that meet a variety of needs
- How does classification affect users' assessment of
  - Performance
  - Risk
  - Value

Conclusion

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- Continues to pose challenges to standard setters and researchers
- Significant problems with current approach
- Some research, but mainly in the US
- Limited opportunities in reworking the definitions
- Need to improve disclosure
- Reconsider the mezzanine category

Final thoughts

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- “After many decades of debating how to present claims to the entity’s assets, it seems fair to claim that new thinking may be required.”

Schmidt(2013)