Own it, or owe it?

The debt/equity conundrum of converting instruments

The recent proliferation of converting financial instruments and the controversy over whether they are debt or equity instruments, or hybrid securities, has important implications for investors and issuers. WAYNE LONERGAN suggests a resolution.

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ASB 1033 Presentation and Disclosure of Financial Instruments deals with the appropriate accounting and disclosure requirements for financial instruments. The standard requires that the issuer of a financial instrument classify the instrument, or its component parts, as debt or equity in accordance with the substance of the contractual arrangements on initial recognition. That classification continues at each subsequent reporting date until a transaction or other specific action by the issuer or the holder alters the substance of the financial instrument, or the financial instrument is removed from the balance sheet of the issuer.

Applied to traditional convertible notes, AASB 1033 requires that the debt element (principal and interest) of the notes be valued at prevailing commercial interest rates for debt instruments without attached equity components and that the equity element be valued at the value of the embedded call option.

CONVERTING FINANCIAL INSTRUMENTS

A converting financial instrument is an instrument that will be settled at a specified date or dates with shares or units of the issuer of the instrument. The issuer usually makes a stream of periodic payments to the holder between the issue date and the settlement date. The amount of these payments, any conditions governing the payments and their security ranking in the event of default are specified in the agreement between the parties.

The number of shares or units to be issued on the settlement date may be:

(a) a fixed number set at the date the converting instrument is issued;
(b) determined by reference to the market price of the issuer's shares or units on a date or dates subsequent to the issue of the converting instrument (for example, the market price on settlement date); or
(c) some combination of (a) and (b).

Whether, and if so to what extent, the financial instrument is classified as debt and/or equity will influence trust-deed and lender requirements on debt-to-total-assets ratios. This also has important implications for reported profitability, EPS calculations, NTA backing, income tax and equity pricing.

The question of the appropriate accounting treatment has been considered by the Urgent Issues Group (UIG). However, in view of the number
of potential permutations and combinations of characteristics of converting instruments, the UIG has decided to narrow the question to instruments where the number of shares to be issued on conversion is specified at the date the instrument is issued.

The accounting treatment of converting instruments is also being considered by the International Accounting Standards Committee (IASC), the Australian Accounting Standards Board (AASB) and the FASB in the United States. The IASC and FASB standard-setters appear to be tending towards the view that converting instruments are generally debt instruments until conversion.

An announcement of the AASB view on this, and the issue of an AASB exposure draft (or amended AASB 1033), is expected in the fourth quarter of this year. If the AASB comes to the view that some of these instruments are in fact substantially debt instruments, any clarification of the operation of AASB 1033 may technically have a retroactive impact on some convertible instruments. That is, if the AASB considers that it is a clarification of an existing standard, rather than a new standard, then the transitional provisions, generally enabling the catch-up adjustments to bypass reported results, will not apply.

ARGUMENTS FOR DEBT CLASSIFICATION

Some commentators argue that converting instruments are liabilities on the basis that: an instrument that converts into a variable number of shares or units does not bear any equity risk until the shares or units are issued; the instruments do not meet the definition of contributions from owners set out in the accounting conceptual framework statement SAC 4; and the holder has no financial interest in the net assets of the issuer until the shares or units are issued.

However, interpretations differ as to whether the whole of the instrument is debt or only some part of it.

For an instrument to be classified as a debt it must satisfy the accounting definition of a liability. In AASB 1033 liabilities are defined as “future sacrifices of economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or events”. On this basis, at least, any (predetermined) periodic payments made between issue date and settlement meet the definition of liabilities.

If the issuer has the right to redeem the instruments on or before conversion date, there is a possibility that the instrument may be settled for cash prior to conversion, in which case both the capital amount and the periodic payments would meet the definition of liabilities.

Statement of Accounting Concepts SAC 4, from which the accounting definition of “liabilities” originated, provides a substantive definition of a characteristic of equity – namely “contributions by owners”. Paragraph 88 of SAC 4 states that equity is increased as a result of contributions by owners or by the excesses of revenues over expenses (ie, profits) from the operations of the entity.

SAC 4 further describes contributions by owners as “future economic benefits that have been contributed to the entity by parties external to the entity, other than those which result in liabilities of the entity, that give rise to a financial interest in the net assets of the entity which: conveys entitlement both to distributions of future economic benefits by the entity during its life, such distributions being at the discretion of the ownership group or its representatives, and to distributions of any excess of assets over liabilities in the event of the entity being wound up; and/or can be sold, transferred or redeemed.”

As the accounting definitions of liabilities and equities are mutually exclusive then, since equity is the residual, the conclusion arises that: an instrument that fails to meet the definition of a liability is equity; and as a slight variation on this theme, an instrument that fails to meet the definition of a liability, and is a contribution by owners, is equity.

While it is relevant that AASB 1033 does not rely on the term liabilities or the definition of liabilities, the definition would not seem to be satisfied until conversion occurs. This could lead to the conclusion that these converting instruments fall outside the definitions of both liabilities and equity.

(In fairness to the AASB, this is one of the many technical problems that have arisen in the pursuit of international harmonisation of accounting standards. AASB 1033 is a harmonisation standard based on an IASC precedent. It is therefore wrong to try to justify an interpretation of AASB 1033 by reference to the Australian conceptual framework and SAC 4 definitions because the IASC framework and definitions are, subtly, but in some case importantly, different.)

ARGUMENTS FOR EQUITY CLASSIFICATION

In the case of investments where conversion is mandatory, the issuer will never have to redeem the notes for cash. Since there will be no payout of assets to settle the principal, it is argued that the definition of “liability” is not satisfied.

Where the number of shares or units to be issued on conversion is fixed at the date the converting instrument is issued, and conversion is mandatory, the instrument provides the holder with a financial interest in the net assets of the issuer and the holder is exposed to the risks and benefits of ownership. Accordingly, the right of the holder to receive shares or units should be classified as equity. (The value of that right is a different issue and this is discussed further below.)

From the perspective of the issuing entity for which the financial statements are being prepared, the converting instruments will always become equity instruments and should be classified as
equity. This view, which holds that the funds are being raised from equity investors, is supported by market experience that purchasers of converting instruments are generally “equity” type investors, not “fixed-interest” type investors.

Conversely, it may be argued that in the case of converting investments in which the issue price is determined at the date of conversion, the instrument, until conversion date, is effectively protected by the existing equity participants. In substance, the risks and rewards of equity ownership do not pass to the holders until conversion occurs. Instead, they experience a risk-and-reward profile similar to that of other liabilities. This argument may be even more persuasive depending on the rights of the instrument holder in the event of a default.

ARGUMENTS FOR HYBRID CLASSIFICATION

There appears to be a majority, but by no means unanimous, view that convertible instruments have characteristics of both debt and equity. Some argue that the present value of the predetermined periodic cash outflows between issue date and settlement should be recognised as a liability, with the balance being equity. Others hold that in substance these are debt instruments with, on maturity, an equity swap or the expiration of an embedded put/call option. Under the equity swap view, the “equity” value of the swap on maturity is very low if the instrument converts into a variable number of shares or units depending on the price at maturity.

TAX TREATMENT

Clearly, the Australian Taxation Office (ATO) is not an uninterested observer of this debate. Unless the ATO is prepared to accept that these instruments are hybrid or compound financial instruments, it faces a dilemma. That is, would it agree that the whole of the periodic payments to service these instruments are tax-deductible interest payments and at the same time accept that issuers account for them on the basis that the core capital component of these instruments is equity and that for accounting purposes only a small proportion of the periodic payments is an interest expense?

SUBSTANCE OVER FORM

In the past, the difference in risk-and-reward profiles enjoyed by different classes of equity – eg, ordinary and preference shares – has not been sufficient to justify a classification of debt for one and equity for the other. The idea that equity might be restricted to the ultimate risk-taker might be suggested by the SAC 4 accounting definition of “contributions by owners”, resulting in a single (last) class of equity, but this has not been explicitly acknowledged in any authoritative accounting literature. It is also contrary to capital-market thinking.

If a debt classification were to be required for converting instruments it would seem a logical next step to require only the ultimate risk class – ordinary shares – to be equity, with all other instruments being classified as debt. This would demand a huge shift in current accounting, financial reporting practice and capital-market thinking and fortunately does not seem to be on anybody’s agenda at present.

The argument comes down to two fundamental questions: Are there layers of equity? In simple terms, is the last person in the queue, or the last two or three or more, the residual equity owner? Although SAC 4 defines equity as the residual of deducting liabilities (as defined) from assets (as defined), SAC 4 is silent on the issue of whether there are layers of equity. What is the value of that equity?

In the view of the writer, the substance of mandatorily converting instruments is that they are merely variations on the concept of traditional convertible notes and that similar valuation principles and accounting treatments should be applied. That is, the embedded call option and/or put option element in the converting instrument should be valued using traditional option valuation techniques and treated as equity; the debt element should be valued on debt instrument principles — ie, on the basis of current interest rate yields of debt instruments with no associated equity components; and where the issuer has an option (over and above the general opportunity to offer equity holders a buy-back) of redeeming the instruments for cash before maturity, the instrument should always be classified as debt.

However, many accountants, including some of my fellow partners, do not share this view. The ATO is also likely to adopt a somewhat toughened stance on the tax-deductibility of any “servicing” costs where conversion is mandatory.

LIKELY UIG CONSENSUS VIEW

The consensus view of the Urgent Issues Group is likely to be that the financial liability component of a converting financial instrument can be measured by discounting the stream of future payments at the prevailing market rate for a similar liability that does not have an associated equity component. The equity component will thus be measured as the residual balance after deducting the financial liability

<table>
<thead>
<tr>
<th>Table 1: Proposed issue</th>
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</thead>
<tbody>
<tr>
<td>Issue value of converting instrument</td>
</tr>
<tr>
<td>Term</td>
</tr>
<tr>
<td>Assumed market price on conversion</td>
</tr>
<tr>
<td>Converts to</td>
</tr>
<tr>
<td>Interest (annually in arrears)</td>
</tr>
<tr>
<td>Purpose of issue</td>
</tr>
</tbody>
</table>
component from the issue price. This is consistent with one of the approaches to measurement of compound instruments identified in paragraph 4.2.6 of AASB 1033. This would also reflect the view that the substance of the transaction is the issue of equity equal in value to the issue price of the instrument less the present value of the expected "dividend" or "interest" stream. The stream of future cashflows compensates the holder for the loss of the dividend/interest stream. The present value of the stream of future cashflows is expected to be the same as the present value of the expected dividend/interest flows, otherwise arbitrage opportunities arise.

**NOT JUST AN ACCOUNTING DEBATE**

The treatment chosen to account for converting instruments has very important financial and equity value implications, as the following hypothetical example in Table 1 demonstrates.

*Alternative 1: Accounted for as a debt instrument*

If the proposed issue is treated as a debt instrument then the accounting is identical to that traditionally applied for any other borrowing.

*Alternative 2: Accounted for as a hybrid instrument*

If the transaction is accounted for as a hybrid financial instrument the $100 million is divided into a debt and equity component. The debt component would be measured by many commentators as the present value of the debt-serving obligation and the balance as equity. This calculation is set out in Table 2.

Interestingly, the annual interest expense recorded in the profit-and-loss account would be the difference between the present value of the annual servicing payment and its face value. For example, in year one the interest expense would be $0.55m ($5.45m + $0.55m equals $6m). However, some promoters of these instruments believe that the whole of the $6 million annual payment should be able to be claimed as a tax-deductible interest payment. (Whether that would be allowed by the ATO remains to be seen). This is demonstrated in Table 3.

It is important to note that if this view is accepted by the ATO, the tax saving will dwarf the interest expenses. Both will be recognised in the profit-and-loss account, resulting in a potentially material increase in reported after-tax profit as a result of the method of accounting for the issue of the financial instrument.

That such an accounting result is, at best, counter-intuitive, is demonstrated by the basic economics and true cashflow of the transaction. That is, $100 million is raised at an annual servicing cost of $6 million to invest in a $100 million building with $6 million of annual income. If the financial instrument is debt it is profit-neutral. If the financial instrument is equity there is no interest and no tax benefit.

It should also be noted that the annual interest expense recognised in the profit-and-loss account increases over the life of the financial instrument. Companies and investors are accustomed to including a premium for growth in the equities price of companies whose reported results reflect above-average growth.

In the first year’s results following the issue of the convertible instrument, reported profit growth will be significant (interest expense of $0.55 million less benefit of tax deduction of 36% of $6 million = $2.16 million, equals increase in after-tax profit of $1.61 million). However in subsequent years, the impact of the increasing
that a large proportion of the distribution made to the holders of the convertible securities can be made yet bypass the profit-and-loss account. For example, in year one $5.45 out of $6m bypasses the profit-and-loss account.

As Table 5 demonstrates, categorisations can also have a significant effect on equity values, particularly in times of high prevailing PERs. The better analysts will argue that the impact on fully diluted EPS is (at least in this example) relatively small and that securities pricing should be focused on fully diluted EPS and not just current reported EPS. However, the following counter-arguments are relevant: Not all investors focus on fully diluted EPS.

This is particularly so in the case of less sophisticated investors and in the case of unit trusts (EPU rather than EPS). Press reporting, and even some brokers’ reports, focus on current EPS and PERs based on current EPS (not fully diluted EPS). In the case of longer-term financial instruments, the present-value effect increases the focus on current EPS rather than fully diluted EPS as the primary determinant of current equity value. The terms of the converting instruments could be tailored to achieve the particular desired reported EPS and fully diluted EPS effects. This is a very simplified example and more complex examples can be financially engineered to generate a wide range of desired results.

**IMPACT ON NTA BACKING**

The categorisation of the financial instrument can also significantly affect reported net asset backing (NTA). It should be noted that reported NTA is normally based on book values. Reported NTA is also particularly relevant to investors in property trusts.

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### Table 4: Reported results (year 1)

<table>
<thead>
<tr>
<th></th>
<th>Before proposed issue</th>
<th>After proposed issue accounted for as a debt instrument</th>
<th>After proposed issue accounted for as a hybrid instrument</th>
<th>After proposed issue accounted for as an equity instrument</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit before tax</td>
<td>$10.0</td>
<td>$10.0</td>
<td>$10.0</td>
<td>$10.0</td>
</tr>
<tr>
<td>Add: Earnings from building acquired from proceeds of new issue</td>
<td>-</td>
<td>$6.0</td>
<td>$6.0</td>
<td>$6.0</td>
</tr>
<tr>
<td>Less interest expense</td>
<td>-</td>
<td>($6.0)</td>
<td>($0.55)</td>
<td>-</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>$10.0</td>
<td>$10.0</td>
<td>$15.45</td>
<td>$16.00</td>
</tr>
<tr>
<td>Less tax at 36%</td>
<td>$3.60</td>
<td>$3.60</td>
<td>$3.60</td>
<td>$5.76</td>
</tr>
<tr>
<td>Reported net profit after tax</td>
<td>$6.40</td>
<td>$6.40</td>
<td>$11.85</td>
<td>$10.24</td>
</tr>
</tbody>
</table>

Note: (1) $100 million at 6%
(2) as set out in Table 3
(3) $16.0 million less $6 million claimed as a tax deduction as set out in Table 3 times 36%.

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### Table 5: Earnings per share (based on 100 million shares)

<table>
<thead>
<tr>
<th></th>
<th>Before proposed issue</th>
<th>After proposed issue accounted for as a debt instrument</th>
<th>After proposed issue accounted for as a hybrid instrument</th>
<th>After proposed issue accounted for as an equity instrument</th>
</tr>
</thead>
<tbody>
<tr>
<td>EPS</td>
<td>6.4¢</td>
<td>6.4¢</td>
<td>11.85¢</td>
<td>6.83¢</td>
</tr>
<tr>
<td>Market value at a PER of 10</td>
<td>64¢</td>
<td>64¢</td>
<td>118¢</td>
<td>68¢</td>
</tr>
<tr>
<td>EPS (fully diluted)</td>
<td>6.4¢</td>
<td>6.4¢</td>
<td>6.83¢</td>
<td>6.83¢</td>
</tr>
</tbody>
</table>

Note: (1) The complication of implied post-conversion earnings in the EPS standard have been ignored in this example for the sake of simplicity.
(2) Assuming market value is calculated by multiplying reported EPS by a constant multiple.
and in equity trusts. The impact on NTA is demonstrated in Table 6.

It is interesting to note that the real value of NTA, as compared to the traditionally reported book value of NTA, is not subject to the same distortions.

**IMPACT ON DIVIDEND POLICY**

The categorisation can also significantly affect the entity's apparent ability to pay dividends. This is demonstrated in Table 7.

Clearly an entity’s dividend distribution policy should be determined by the entity’s underlying cashflow, rather than its accounting reported results. If cashflow is the sole determinant of dividend policy, then no financial disadvantage will be suffered by the entity because the dividend payout will not change. However, even if the dividend payout is unaffected, equity investors who bid up the price of an entity’s equity securities because of the apparently higher dividend cover could still be materially disadvantaged.

Further, in practice, dividend payout is frequently affected by reported profit. In the case of unit trusts the annual distribution may be enshrined in the trust deed. This may result in the whole of the reported profit having to be distributed each year.

**CONCLUSION**

While there are accounting arguments in support of each of the alternative accounting classifications of convertible securities, no particular treatment could be said to be mandatory under the present Australian accounting standards.

This proposition is supported by the fact that the issue has been referred to the Urgent Issues Group. For an issue to be accepted by the UIG there must be different accounting treatments in practice, coupled with a perceived need for requirements to be clarified or interpreted. Additionally, the UIG’s charter requires it to refer accounting standard drafting issues back to the AASB. In this case, if the only reference point is to a strict black-letter or grey-letter interpretation of AASB 1033, then the accounting interpretation is not clear-cut.

Even if one’s preference were to treat the converting instruments as debt, there exist no current mandatory AASB requirement that could be invoked to disallow unequivocally treatment as equity in all cases. Having said this, however, there is every indication that standard-setters throughout the world will soon agree that the appropriate classification for converting instruments such as those discussed above is primarily (if not entirely) debt. This factor alone might, and perhaps should, be influential on directors and auditors in deciding which alternative treatment to adopt.

In the opinion of the writer, a simpler technical solution to this problem lies in valuation theory and practice, and not in the accounting standards and SAC 4. The solution is to value the embedded put and call options as equity, and treat the rest as debt. This is consistent with the economic reality of these instruments. It is also consistent with the treatment of traditional convertible notes, and for this reason is also likely to encounter fewer tax problems.

Unfortunately, the debate on this issue has been focused on accounting rather than valuation considerations. Thus relatively little attention has been given to the correct measurement of embedded option values, and the correct valuation treatment of the numerous permutations and commutations of characteristics of the different convertible securities that have been, or are in the process of being, developed.

The potential for abuse in this area, and for serious securities mispricing, is obvious. The AASB will need to deal with this issue as a matter of urgency.

*The views expressed in this paper are the personal views of the writer. They should not be taken as the views of his firm.*