Accounting issues for the Holy Grail

Nigel Dealy of PricewaterhouseCoopers explains the interaction of FRS 4 and 5 and addresses the accounting issues behind hybrids and convertibles.

For much of the last century accountants thought they understood the distinction between shares and debt. However, by the 1980s this certainty had diminished as innovative instruments began to appear that have rights which are structured to blur the distinction. The much-sought Holy Grail is an instrument that ranks as equity for accounting purposes, but whose servicing costs are tax deductible.

As the Inland Revenue looks increasingly to the accounting to determine whether or not to tax and to the timing of that taxation, users of capital instruments need also to understand the accounting to determine their usefulness in tax planning.

This article therefore considers the instruments and structures that my colleague Mohammed Amin deals with in his article on the 'Taxation of convertibles and other hybrids' on page 36.

FIGURE 1

The 'rules'

- Any finance-raising instrument must be classified as either shares or debt of the issuer.
- If the instrument takes the form of shares (including preference shares) it must be carried within the issuer's shareholders' funds to comply with Company Law.
- Any non-share instrument that contains an obligation to make cash payments or transfer other assets in settlement of either principal or investment return must be reported as a liability.
- Where the holder of an instrument has the option to require settlement in cash or the issuer's shares, the instrument is a liability and must be reported as such in its entirety.
- An instrument that contains no obligation to transfer economic benefits should be reported in shareholders' funds.
- Conversion of instruments in to the issuer's shares should not be presumed in advance, even if it is thought highly likely.
- A share that carries a preference over the issuer's equity shares or some restrictions on dividends or capital on a winding up is classified as non-equity share capital.
- All instruments are required to be reported at their net issue proceeds plus finance costs less amounts paid. This involves some convoluted disclosure requirements in the case of shares in order to comply with FRS 4 and Company Law.
- Finance costs in relation to debt instruments are all reported within interest and similar items on the face of the profit and loss account, whilst in relation to non-equity shares such amounts must be reported within the 'dividend' caption. ■

What are the accounting rules?

Figure 1 sets out the rules embodied in the 1993 Financial Reporting Standard (FRS) 4 Capital instruments. This standard, together with Urgent Issues Task Force (UITF) Abstract 11 Capital instruments: issuer call options, provides the detailed criteria for the recognition and measurement of liabilities, within the constraints of Company Law, and their servicing costs. For foreign currency-denominated instruments, the 1983 standard SSAP 20 Foreign currency translation supplements the accounting requirements.

Many complex instruments are in fact structured not just as one transaction, but as a series of transactions that are undertaken at the same time and sometimes with the same counterparty. Others feature the use of detailed contractual arrangements with special purpose vehicles (SPVs), such as orphan companies, trusts and partnerships. These structures generally have banks, or their nominees as registered owners, or are structured, with the ultimate beneficiaries being charities.

FRS 5 Reporting the substance of transactions requires that a series of linked transactions should be accounted for in relation to their overall commercial effect. This can often be demonstrated where the combined product is contemplated, designed and promoted as one integral item. FRS 5 tends to have a significant impact on structured products that involve SPVs – they often fall to be treated as subsidiaries or 'quasi subsidiaries'.

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An issuer's group financial statements are generally prepared from the perspective that SPVs are treated on a look-through basis.

Together FRSs 4 and 5 ensure that companies adopt uniform accounting treatment for debt and equity instruments and thus report a more detailed and cautious picture of their shareholders' funds.

Applying the accounting rules

Convertible debt. Such instruments come in many varieties, ranging from the plain vanilla to those with a premium put option. As shown in *Figure 1*, conversion cannot be anticipated and therefore all variants must be reported as debt in the issuer's balance sheet because they have an obligation to pay interest. Similarly, bonds issued by subsidiaries with conversion or exchange rights into equity shares of the parent must be reported as debt in the group balance sheet.

What is a convertible debt's finance cost? Under FRS 4, redemption always should be considered to be the eventual outcome. Hence, the finance cost calculated as described in *Figure 2* includes issue costs, interest, discounts and redemption premium, and is spread on a constant yield basis in to the profit and loss account over the period to the earliest date that the holder has the option to demand redemption.

There is no charge to the profit and loss account for the 'equity kicker', as FRS 4 does not permit split accounting for convertible debt. This can be contrasted with debt with detachable warrants, where split accounting is required because the warrants can be transferred, cancelled or redeemed independently of the debt. Over time, the carrying amount of the convertible debt increases by the unpaid element of the finance cost. On conversion, the proceeds for the shares issued is the carrying amount of the debt immediately prior to conversion.

Euro-denominated convertible debt. The currency of a convertible debt does not alter either its classification as a liability or the basic calculation of its finance cost. But the foreign exchange differences that arise in translating the debt and its interest into sterling results in additional complexities.

Consider a euro-convertible debt that hedges an investment in euro-land. Within SSAP 20's parameters for hedge accounting for foreign net investments, the exchange differences arising on the debt are taken to reserves (via the statement of total recognised gains and losses (STRGL) to match the differences on the hedged investment. Foreign exchange differences on the interest are included in the finance charge to the profit and loss account. Where the euro convertible is not a hedge, the exchange differences on both capital and interest are taken to the income statement.

> From 2005 all EU-domiciled-listed firms will have to prepare their consolidated accounts in accordance with International Accounting Standards (IAS)

If the issuer is averse to euro risk, it may hedge that risk using a cross-currency swap or forward exchange contract. But for what period, since the conversion to shares is uncertain?

One strategy might be to hedge the debt to the earliest date on which conversion is possible and thereafter roll the swap or forward contract to the next conversion anniversary. The debt is accounted for as a synthetic sterling debt and therefore no foreign exchange differences are reported on the hedging instrument or the hedged debt.

Exchangeable bonds. Exchangeable bonds differ from a convertible in that settlement is not effected using the issuer's own equity shares. Instead, settlement may be effected by transferring an asset held by the issuer, such as shares in another company, to the bondholders.

As discussed in Mohammed Amin's tax article on page 36, exchangeable bonds typically defer the disposal of the shareholding for tax purposes until the exchange option is exercised. The accounting considerations can be complex and will depend on the bonds' actual terms.

It would be rare for the transaction to be accounted for as a sale when the bonds are issued. Usually the issuer has not transferred substantially all risks and rewards of the asset to the bondholders and neither do they accept that the asset will necessarily extinguish all of their entitlements, such as their option for cash settlement and payment of coupons in cash.

Consequently, the bonds are reported as liabilities because there is an obligation to transfer cash or the asset in exchange.

What is the carrying amount of the debt? Should it be restated at each balance sheet date to the market value of the corresponding asset into which it is exchangeable, with the difference taken to the profit and loss account as part of its finance cost?

Or should the difference between the fair value of the asset and the 'cost' of the debt be recognised as an additional finance expense in the period that the exchange occurs? Furthermore, is the accounting for the asset impacted by the fact that it is now under option through the exchange mechanism?

A definitive solution is beyond the scope of this article, but suffice to say that the few examples that exist tend to show the liability and asset accounted for in the conventional manner, which would suggest that the alternative treatment is being followed.

Tax efficient capital. The structure illustrated in the tax article on page 37

FIGURE 2

Calculation of finance costs

Finance costs for debt and non-equity shares are calculated by deducting the net proceeds received on issue from the total payments (capital, interest, redemption premium) that may be made over the term of the instrument. Such costs are allocated to accounting periods so as to achieve a constant rate on the carrying value (that is, inclusive of compounding interest).

Special provisions apply where the amount of the total payment (or component) is dependent upon an index or some other feature that is dependent upon an underlying item. Such effects are only taken into account when they occur. For example, the increase in the capital obligation of a bond that is linked to say the FTSE 100 index is reflected as the index increases and is neither deferred over the remaining life of the instrument nor accrued in advance. ■

can achieve servicing costs that are tax deductible and the instruments not shown as liabilities in the group balance sheet. Is this the Holy Grail? However, the sting is that in UKPLC's own accounts the perpetual subordinated debenture is a liability, which perhaps diminishes the structure's usefulness.

To achieve the desired group non-liability objective, the limited partnership must be a subsidiary, its preferred securities must be deemed as 'shares' under the provisions of the Companies Act 1985, and their terms and conditions must be such that they qualify as non-equity minority interests in UKPLC's group accounts. FRS 4 only permits such treatment where it is clear that the holders of the preferred securities have equivalent rights and remedies against the group in the same way as holders of the parent's preference shares against the parent. It is important that such rights and remedies are actually attained.

Consequently, much of the cost of using this structure is incurred in the lawyers crafting tightly drawn contractual arrangements, to the satisfaction of the auditors, which simulate the capital maintenance requirements of UK Company Law and prevent cheating.

Simply, there must be no payments (coupon or redemption) to the holders of the preferred securities when payments could not be made on equivalent preference shares of the parent. This would occur should the parent have insufficient distributable profits at the relevant dates.

In no circumstances can the preferred securities ever be included in the group's shareholders' funds. In the group profit and loss account the finance costs of the preferred securities are reported as minority interests net of the tax relief obtained by the parent.

Use of this structure is comparatively more expensive than debt or preference share issues made directly by the parent, as investors need to be sweetened because of the complex structure.

Accounting for tax effects

The following standards, FRS 16 Current taxation and SSAP 15 Deferred tax (and when implemented its replacement the newly issued FRS 19 Deferred tax) and UITF Abstract 19 Tax on gains and losses on foreign currency borrowings that hedge an investment in a foreign enterprise need to be considered in accounting for the tax effects of capital instruments and tax structures. The basic rule is that tax effects (current or deferred) should be recognised in the profit and loss account, except to the extent that they are attributable to a gain or loss that is, or has been, recognised directly in the STRGL. In the latter case, the tax is also reported in the STRGL. UITF 19's interpretation of the hedging rules in SSAP 20, and so the amount taken to reserves via the STRGL, offers some interesting tax planning opportunities, because it is now possible to gross up the hedging instrument for the tax effects on the exchange differences.

> When there is a difference between the timing of a transaction for accounting and tax purposes, a deferred tax liability (or asset) should be provided

Generally, when there is a difference between the timing of a transaction for accounting and tax purposes, a deferred tax liability (or asset) should be provided. The new deferred tax standard is more relaxed about deferred tax assets as they can be recognised where it is more likely than not that they will be recovered. The test allows for recoverability to be assessed through tax planning opportunities.

Disclosures

The ever-increasing demands for transparency means more disclosures that can be intrusive to tax planning opportunities. There are the disclosures required by FRSs 4 and 5, which broadly deal with the terms and conditions of the instruments. In addition, companies with listed capital instruments have to provide details in compliance with FRS 13 Derivatives and other financial instruments: disclosures. For directors and treasury teams, this is especially challenging, as this information has to be subject to audit, wherever it is given, and should ensure that their explanations of objectives, policies and strategies cope with the use of complex instruments and details of any key features.

The accounting future

The only certainty is that there will be change. In response to some recent tax efficient capital structures, the ASB has begun a high priority review of the rules in FRS 4. Expect a further clampdown.

Furthermore, from 2005 all EU-domiciled-listed companies will have to prepare their consolidated accounts in accordance with International Accounting Standards (IAS). Even before then, the EC intends to amend the EU Company Law directives to allow certain financial liabilities (basically derivatives and trading items) to be fair valued.

Both of these initiatives will cause interesting challenges, not least if the UK requires company's own accounts to continue to be prepared in accordance with UK GAAP. This could introduce anomalies such as the use of split accounting (a requirement of IAS) in an issuer's consolidated accounts for an instrument where such accounting is not permitted its own accounts by the present FRS 4.

And the standard setters want to go further. The international Joint Working Group issued its proposals in December 2000. They would require all financial instruments to be fair valued with their gains and losses reported in the income statement. Hedge accounting would not be permitted, not even that for net investments in foreign entities.

Conclusion

When using tax-efficient hybrid structures the skills of the treasury, tax and finance teams should be marshalled at the same time. Failure to do so can lead to unnecessary complications.

For example, an instrument that may require settlement in the form of a listed issuer's own equity shares has to be factored into the issuer's diluted earnings per share (EPS) calculation in accordance with FRS 14. The group finance director will not be best-pleased if, after the event, he has to explain to the chairman that the group's diluted EPS is diverging significantly from the basic EPS because the latest tax-efficient financing was not congruous with the ever upwards march in the group's EPS. ■

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