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Looking to raise capital?

Don't forget the accounting!

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Is it debt or equity?

You can save a lot of tears and frustration further down the track by including the impact of the accounting outcomes in your due diligence process for raising capital. There can be some surprising accounting outcomes when undertaking what may appear to be straight forward transactions.

When raising equity or debt it is important to consider the key terms of the instruments. For many instruments the answer may be obvious. The issue of ordinary shares for cash will likely be equity. A bank loan will likely be a liability. Where however, there are more complex situations and particularly where there are loans with options to convert to equity, some seemingly innocuous terms may cause:

- an instrument to be classified as a liability rather than equity even if on the face of it there is no obligation to pay out cash
- an instrument to be classified partly as a liability and partly as equity due to mandatory dividend payments or an equity conversion option
- an 'embedded derivative' being created requiring the instrument to be separated into two liabilities with the derivative liability being measured at fair value with the changes in fair value recognised in profit or loss if this is not 'closely related'
- an instrument to be classified as a liability with share price movements effectively being recognised in profit or loss!

Understanding the terms will be key to the classification of the instrument as debt or equity (or both!).

Why does it matter?

Potential outcomes for the treatment of financial instruments on a capital raising include:

Equity	Derivative liability	Non-derivative liability	Compound		Hybrid	
			Non-derivative debt host	Equity	Non-derivative debt/equity host	Embedded derivative liability

The impact of the classification of an arrangement as either debt or equity can have vastly different impacts in the financial statements, on initial recognition and subsequently.

On initial recognition, all financial instruments are measured at fair value, with varying treatment of transaction costs. The process to determine fair value differs depending on the classification. For example, when allocating the fair value of a compound instrument to the debt and equity components, the equity component is the residual after deducting the fair value of the liability from the fair value of the instrument as a whole.

For a hybrid instrument however, the embedded derivative is measured first and the debt or equity host is the residual. Transaction costs will need to be apportioned where there is recognition of debt and equity components.

The classification as debt or equity not only impacts the initial and subsequent measurement, but also drives the recognition of any interest or dividend payments relating to the instrument, either directly in equity or in profit or loss. The following table contains a summary of the impact on the financial statements and other matters.

DEBT	EQUITY
Measured subsequently at amortised cost or at fair value through profit or loss (FVTPL)	Generally not remeasured so no impact on profit or loss
Transaction costs amortised to profit or loss over the life of the instrument (or recognised immediately in profit or loss if FVTPL)	Transaction costs reduce equity directly
Interest and dividends recognised in profit or loss	Dividends reduce equity directly
Decreases reported earnings	No impact on reported earnings
Increases gearing ratios (e.g. debt to equity) and could negatively impact loan covenants	Reduces gearing ratios but can be perceived to dilute existing ownership interests
May impact basic and diluted EPS	May impact basic and diluted EPS

When is an instrument debt?

A financial instrument meets the definition of a financial liability if the instrument:

- contains a contractual obligation where the issuer is/may be required to deliver cash or another financial asset to the holder (which may arise from an obligation to pay interest, dividends and/or the principal)
- is a non-derivative with a contractual obligation where the issuer is/may be required to deliver a variable number of its own equity instruments
- is a derivative where it is possible to settle other than by the issuer exchanging a fixed number of its own equity instruments for a fixed amount of cash ('fixed for fixed'), i.e. not all settlement alternatives meet the 'fixed for fixed' test.

Examples of debt instruments include:

- mandatorily redeemable preference shares
- convertible debt convertible to a variable number of shares based on the market price
- perpetual debt with a mandatory coupon.

When is an instrument equity?

Essentially when it does not meet the financial liability definition.

An equity instrument is any contract that evidences a residual interest in the assets of the entity **after deducting all of its liabilities**.

Examples of equity instruments include:

- non-puttable ordinary shares
- some types of preference shares
- call options that allow the holder to subscribe for, or purchase, a fixed number of non-puttable ordinary shares of the issuing entity in exchange for a fixed amount of cash.

In rare circumstances an instrument which is puttable back to the entity by the holder (a 'puttable instrument') may be classified as equity if it meets specific stringent criteria.

Derivatives that the entity itself holds to purchase or sell its own shares may or may not be equity.

Debt vs. equity – the terms will be critical

The treatment of instruments as debt or equity (or both) under accounting standards is a complex area. Careful analysis will be required to determine the appropriate accounting for particular instruments. Early consideration in your structuring and negotiations is critical.

Some key terms to be aware of:

- anti-dilution clauses
- settlement in a variable number of shares
- options for the holder to convert to equity
- issuer has more than one settlement option
- mandatory dividend payments
- prepayment options
- rights to receive cash in priority to other investors on 'insolvency events'
- foreign currency denominated convertible debt.

This is not a comprehensive list and all the terms, facts and circumstances of any situation will need to be considered in determining the appropriate accounting treatment.

Other matters giving rise to accounting complexity

The following matters may also give rise to accounting complexities or adjustments through profit or loss:

- Modifications to arrangement terms
- Early settlement of debt arrangements
- Treatment of transaction costs
- Off market terms such as low interest rates (typically arise in related party transactions).

In addition, valuation expertise may be required for off-market instruments, such as for embedded derivatives.

How we can help

We have an experienced team of professionals who can assist in all aspects of your capital raising, including:

- Financial modelling for the purposes of determining cash flow and capital requirements
- Capital raising strategy and support
- Form and structure of investment
- Accounting expertise to help you navigate the classification issues
- Valuation for financial reporting purposes.

Contacts

Auckland

Denise Hodgkins
+64 9 303 0918
dhodgkins@deloitte.co.nz

Victoria Turner
+64 9 303 0794
viturner@deloitte.co.nz

Michael Moran
+64 9 306 4301
michaelmoran@deloitte.co.nz

Hamilton

Bruno Dente
+64 7 834 7842
bdente@deloitte.co.nz

Wellington

Jacqueline Robertson
+64 4 470 3561
jacrobertson@deloitte.co.nz

Christchurch

Mike Hoshek
+64 3 363 3744
mhoshek@deloitte.co.nz

Dunedin

Mike Hawken
+64 3 474 8684
mhawken@deloitte.co.nz