Perps as equity: Hyflux saga shows rethink needed

A case can be made to classify perps (especially those with coupon step-up feature) as liability, and to require the cost of equity financing to be charged to income statement

By Ng Eng Juan

THE Hyflux saga has been in the news in recent months. One key area of contention is the accounting treatment for its perpetual securities, or perps. This article examines current accounting practices for perps and suggests a rethinking of the accounting issues.

Should perps be classified as 'equity' or 'liability' in the balance sheet?

The issue of whether a financial instrument should be classified as equity or liability in the balance sheet is governed by International Accounting Standard 32 (IAS 32) and its Singapore equivalents of FRS 32 for non-listed companies and SFRS(I) 1-32 for listed companies.

IAS 32 requires the issuer of a financial instrument to classify the instrument as a financial liability or an equity instrument in accordance with the substance of the contractual arrangement. At the risk of over-simplification, the practical implication of this principle of "substance over form" may be summarised as follows: a financial instrument is to be classified as an equity instrument if and only if there is no contractual obligation to repay.

In compliance with IAS 32, and in accordance with the generally accepted accounting practice in Singapore, Hyflux has appropriately classified its perps as equity in its balance sheet.

However, given that most perps issued in Singapore have a coupon step-up feature (for example, Hyflux's perps issued in May 2016 have an initial coupon rate of 6 per cent, but this coupon will increase in May 2020 to 6.2 per cent plus a four-year swap offer rate), then it may be argued that sometime in the future, the coupon rate is going to be so prohibitively high that the issuer will almost certainly redeem the perps. This coupon step-up feature may therefore, in substance, negate the "if and only if there is no contractual obligation to repay" condition for equity classification. Thus, it may be argued that Hyflux's perps should more appropriately be classified as "liability" in the balance sheet.

Further, in applying the "substance over form" principle in the equity-liability classification, we may have placed too much emphasis on the "contractual obligation to repay" condition. Perhaps some other general conditions or features of "equity" classification should also be considered – for examples, whether the holder is entitled to a pro rata share of the issuer's net assets in the event of liquidation, and whether the instrument is subordinate to all other classes of instruments. When all these other conditions are considered, the conclusion may arguably tilt towards classifying Hyflux's perps as "liability".

Should 'interest' on perps be charged to the income statement?

IAS 32 provides that interest and dividend relating to a financial liability should be recognised in the income statement, whereas distributions to holders of an equity instrument should be recognised in equity.

Thus, whether the "interest" on perps should be recognised in income statement or in equity depends primarily on whether the perps are classified as equity or liability.

Since Hyflux has classified its perps as equity, it has consequently recognised the "interest" on its perps in equity – specifically, in the statement of changes in equity – and not in income statement.

Some investors have rightfully raised the issue of whether it is appropriate not to charge the "interest" on perps to income statement. Some are concerned with the difficulty in interpreting the amount of "profit or loss attributable to Owners of the Company" in the income statement where such "interest" has not been charged.

However, it should be noted that the term "Owners" is a technical term defined (in IAS 1, and its Singapore equivalents of FRS 1 and SFRS(I) 1-1) as "holders of instruments classified as equity" (and not as "the ordinary shareholders").

Perhaps of greater concern is the issue of whether the cost of equity financing should be charged to income statement.

The extant accounting standards only require the cost of debt financing, but not the cost of equity financing, to be accounted for.

Not accounting for the cost of equity financing is one of the main drawbacks of current-day accounting. Investors have to be aware of the implication of this fact to be able to analyse the financial statements correctly for their investment decisions.

The implications of not accounting for the cost of equity financing are illustrated in two simple cases below.

Case 1: Assuming two managers are doing exactly the same things, except Manager A borrows $100 million to run his business, whereas Manager B receives the $100 million from the business owners. In this case, the extant accounting standards require the interest on the bank borrowing to be charged to Manager A's income statement, whereas nothing will be charged to Manager B's income statement relating to the use of the equity financing. Manager B's income statement will therefore show a higher profit, which may mislead investors into believing Manager B performs better than Manager A.

Case 2: Assuming Mr XYZ has $100, and he has two investment options, namely (i) to deposit the money with a bank and receive an interest income of $3 per year, or (ii) to hand his money to his manager to run a business. Assume that Mr XYZ decides to hand the $100 to its manager, and assume also that the manager makes $2 return. It is quite obvious, in this case, that the manager is a bad manager for he is destroying the value for Mr XYZ (Mr XYZ should have deposited the money with the bank and earned $3, instead of handing his money to the manager and receiving only $2 in returns). However, because the cost of equity financing is not accounted for under the extant accounting standards, the manager's income statement will show a profit of $2, which may mislead Mr XYZ into believing the manager is a good manager, creating value for him. In this case, it may be noted that if the cost of equity financing of $3 is charged, then the income statement will show a loss of $1, which will arguably give a more true and fair view of the manager's performance.

The above simple cases illustrate the defects of financial statements when the cost of equity financing is not accounted for, as is the current practice under the extant accounting standards.

So it may be that the accounting standards setting authority should therefore consider requiring the cost of equity financing (besides the cost of debt financing) to be charged to income statements. This will also resolve the issue of whether the "interest" on perps should be charged to income statement, as in Hyflux's case.

Conclusion

The extant accounting standards require perps to be classified as equity (instead of liability) and the "interest" on perps to be charged to equity (instead of the income statement). This has led to much controversy and misunderstanding.

Based on the substance of the instrument, a case could be made to classify perps (especially those with coupon step-up feature) as liability, which is also more in line with the general understanding/perception of the investing community.

A case could also be made to require the cost of equity financing to be charged to income statement. This will resolve the controversy of the current practice of classifying a financial instrument as equity with consequential zero charge to income statement.

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