# Debt vs. equity

## Demystifying classification

May 2023

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An entity could raise funds through a variety of ways, including by issuing new shares. Determining the classification of new instruments issued is important, as it can significantly impact an entity's financial statements, borrowing covenants and solvency. The debt versus equity classification rules are complex and judgement is often required.

## Why is classification important?

Why does it matter whether an instrument issued is classified as debt or equity? Debt represents an obligation of the entity for an outflow of resources at some point in the future, whereas equity represents owners' interests. Debt therefore results in a more 'leveraged' balance sheet. With large amounts of debt – this may impact a borrower's debt covenants, credit rating (which in turn increases the cost of funds), solvency and, in the case of financial institutions, prudential ratios and capital adequacy measures. Debt also results in finance costs impacting various profit or loss measures that are scrutinised by investors and analysts. In the case of equity instruments, these are recognised at the cash consideration received and is never remeasured. Subsequently, dividends paid are recognised in equity rather than profit or loss.

So, when raising funds, the terms offered are a key focus – whether to issue equity, debt, or a hybrid (a mix of both equity and debt features), since the effects are very different. It's worth considering the accounting treatment when an instrument's terms and features are being contemplated by deal teams.

In this publication, we address classification by the entity issuing an instrument (the issuer). The investor applies a different set of considerations not covered here. Further, we do not address instruments issued to employees or suppliers in exchange for goods or services, which may be treated as share-based payments.

## What are the key features of debt?

Several terminologies are commonly used for issuances – notes, loan notes, preference shares, hybrids, bonds, warrants, are a few. The key to understanding the accounting for an instrument is not its name, as features can vary so widely (even when they have the same label) – it is the instrument's contractual terms that are important. In a nutshell, a debt instrument imposes on the issuer a *contractual obligation* to pay cash (or a variable number of the issuer's own shares – more on this in the next section)[1], whereas an equity instrument does not (representing a residual interest after settling all obligations).

It is essential to understand whether the issuer can control the ability to avoid a payment altogether. Merely having the ability to postpone a payment does not negate the existence of a contractual obligation. Put another way, a debt instrument is one that *requires* the issuer at some point in the future or could require the issuer upon an event beyond its control, to pay cash.

An equity instrument, on the other hand, imposes no such obligation – the issuer can pay cash *if it chooses to do so* (e.g., declare a dividend), or it can choose to not act. The existence of 'discretion' by the issuer of whether to pay cash is essential for equity classification.

## Using an issuer's own shares as a settlement currency

A debt classification can arise in other situations beyond where the issuer has a contractual obligation to pay in the form of 'cash'. Where the issuer has the obligation to settle by issuing a variable number of its own shares, that gives rise to debt classification too. One common example is where the issuer is to give an investor a number of its listed shares that are equivalent in value (at the time of the exchange) to the principal amount of the instrument.

In such a case, the issuer is effectively using its shares as currency to settle an obligation. In such an arrangement, the investor bears no share price risk (indifferent to receiving cash or shares), and the instrument is classified as debt.

[1] For the remainder of this publication, 'pay cash' is taken to mean pay cash or deliver a variable number of an issuer's own shares.

## Foreign currency

Issuers should be careful with foreign currency-denominated instruments. For example, if a USD-denominated instrument is required to be settled by the issuance of a *fixed* number of the issuer's own shares that are denominated in AUD, the instrument is classified as debt. While the number of shares may be fixed, the consideration received (relief from paying a foreign amount of cash) is not fixed in terms of the issuer's *functional* currency.

## Economic compulsion

Debt classification arises where the issuer has the *contractual* obligation established through the terms and conditions of the instrument. Terms of an instrument that effectively force the issuer to transfer cash, although it is not legally required to do so, is often referred to as economic compulsion. Economic compulsion, by itself, does not result in debt classification. An example is ordinary shares, where the issuer has discretion over dividends. While dividends may be expected, and the issuer may be economically compelled to pay them to shareholders, it has no contractual obligation to do so. On its own, economic compulsion does not result in debt classification.

## Events of default

Another common feature is a clause covering 'events of default' that give the investor the ability to demand repayment of an outstanding balance before it is due. This is to allow the investor a level of protection when the issuer is in financial difficulty. Events of default are generally beyond the issuer's control, which suggests there exists an obligation that the issuer cannot avoid if the event were to occur. Examples include:

- Default on coupon payments
- Breach of material contracts
- Insolvency
- Court order for claims of a specified amount
- Entering into compromise agreement with creditors
- Commencement of winding up proceedings, with permanent cessation of operations

All of these examples (apart from the last one) may be precursors to liquidation, but do not mean that liquidation will occur. So, in these cases, the instrument is classified as debt, as the issuer *must* stand ready (upon an event beyond its control) to pay cash to settle the arrangement.

In the case of a genuine liquidation, an issuer has the additional obligation to pay 'cash' to shareholders, based on a pro rata of the net assets realised to each shareholder. However, a liquidation obligation is ignored for the purpose of an instrument's classification. Put differently, if an instrument contains features where the only obligation to pay investors is on liquidation and wind-up, that does not cause debt classification.

## Probabilities and contingent events

The *probability* of an event which could trigger a requirement to pay cash is irrelevant in assessing an instrument's classification. The only relevant consideration is the *existence* of the parties' contractual rights and obligations. For example, if an *investor* could redeem an instrument upon a discretionary coupon not being paid, then while missing a coupon might be remote, the issuer still has an *obligation* to meet the investor's *contractual right* to demand redemption. Probability is not ever considered. Equally, the issuer's *expectations* of whether it will choose to redeem an instrument (or not) is irrelevant.

In private equity transactions, it is common for an instrument to be mandatorily redeemable where an initial public offering (IPO) or an exit event does *not* take place. The issuer could well initiate an IPO attempt or an exit event, however , the success of an IPO or exit event often depends on market factors, investor demand and regulatory approvals – matters beyond the issuer's control. In other words, the issuer cannot avoid the existence of the obligation for repayment. The instrument is to be classified as debt.

Contingent settlement events are uncertain events beyond the control of an issuer that, if they occurred or did not occur, could force the issuer to pay cash. Other examples of contingent events are changes in an index such as the stock market index or a consumer price index, changes in an interest rate, achieving or failing to achieve a certain level of future revenues or earnings. An instrument that can require a payment upon any contingent settlement event is a debt instrument.

Also, if the issuer can avoid paying cash only by making good on another promise such as delivering a non-financial asset (e.g., an investment property), that instrument is still classified as a financial liability. Such an arrangement establishes a financial obligation indirectly.

We summarise here some common features of debt instruments:

| Common features of debt instruments |
|---|
| Repayment in cash at a future point or upon events beyond the issuer's control (e.g., events of default, contingent settlement events) |
| Perpetual instrument with mandatory interest |
| Repayment if successful IPO or exit event does not take place |
| Settlement in a variable number of own shares |

## What are the key features of equity?

An instrument is equity if the issuer:

- Has an unconditional right to avoid paying cash
- Settles by paying its own shares on a fixed-for-fixed basis, i.e., a fixed amount of cash for a fixed number of shares

A common example of an equity instrument is ordinary shares. With ordinary shares, an issuer has no obligation (despite expectations) for dividends, as these are discretionary, and it has no obligation to repurchase the shares. In liquidation, shareholders are entitled to a distribution of pro-rata net assets, however the liquidation exemption would apply – such an obligation to pay only on liquidation and wind-up does not cause debt classification (see Events of default section, above).

Another feature, that involves an exchange, is classified as equity if the feature meets the fixed-for-fixed rule. This is a strict test – if there is any variability, then it is not fixed-for-fixed, and the feature would be debt. For example, if the issuer delivers a fixed number of its own shares to settle a fixed amount of an obligation, such a feature would be classified as equity. On the other hand, as discussed earlier (Using an issuer's own shares as settlement currency), if the issuer must give a variable number of its own shares to settle a fixed amount of an obligation, or if there is variability in a foreign currency (see Foreign currency section), then this would be classified as debt.

We summarise here some common features of equity:

| Common features of equity instruments |
| --- |
| Discretionary dividends |
| Repayment at issuer's discretion or upon events wholly within its control |
| Settlement in a fixed number of own shares |

### Warrants

A common misconception is that warrants always meet the fixed-for-fixed rule for equity. The contractual terms do need to be analysed, as certain warrants do not qualify for equity classification. Examples which fail the fixed-for-fixed rule include where: the number of issuer shares to be delivered varies; the warrant's exercise price is based on the issuer's share price at the exercise date; the warrant's exercise price is denominated in a foreign currency; or the warrant is exercisable for another option (or an arrangement that includes an option).

## What if the instrument could be settled in either cash or own shares?

Some instruments have options to settle in either cash or the issuer's shares – the choice could be the issuer's or the investor's. It is important to understand the settlement mechanisms and which party has that choice.

For example, if *the investor*, not the issuer, has the choice to receive cash or the issuer's shares (even if it were a fixed number of shares), because the decision is not within the issuer's control, the right to receive cash is debt. Additionally, the investor's choice to receive the issuer's shares creates an embedded written call option that is to be separately accounted for as a derivative liability (unless the settlement in shares meet fixed-for-fixed criteria). Note that in the case of a hybrid instrument, the entire instrument could be elected as a financial liability carried at fair value).

Alternatively, where *the issuer* has the choice to pay cash or its own shares (assuming settlement in shares meets the fixed-for-fixed rule), then this is equity. This is because the issuer could choose to deliver a fixed number of shares (equity) and avoid paying cash altogether. However, it is important to understand the substance of the arrangement. If the economic value of the shares outcome is expected to substantially exceed the value of cash, this would be debt, because in substance the investor is guaranteed to receive a value that is at least equal to the cash settlement outcome.

## Other complexities

Another complex area is the assessment of embedded derivatives. Where there are debt features, it is also common to see prepayment and term extension features, interest rate caps and floors, conversion features and equity kickers. These are all potential embedded derivatives that may need separate accounting. This a complex area.

When an instrument contains debt and equity features, including embedded derivatives, these need to be accounted for accordingly. Initially measuring the different components (debt, equity and separable embedded derivatives) can be challenging. Generally, the fair value of the instrument as a whole when its issued is allocated to its components at their respective fair values. However, there should be no 'day 1' gain or loss recognised, when comparing the sum of the parts to the cash received from the investors.

An instrument and its features could have a classification for tax purposes which differs from that for accounting. The rules are different. Consequently, there can also be deferred tax implications.

There are certain exceptions to the general definitions of debt and equity. Certain instruments that would otherwise meet the definition of a financial liability are nevertheless classified as equity if very specific criteria are met. Commonly seen in instruments issued by investment funds, unit trusts, co-operative and similar entities, the exception allows equity classification where the only feature in the instrument that creates an obligation is:

- A redemption option exercisable by the most subordinated investors
- Upon establishing the fund/trust, a requirement to liquidate it at a future point in time for a pro-rata share of net assets

## Last words

It is often a balancing act between the issuer and its investors, with each party striving to meet its own commercial objectives. Further, the issuer has several other matters to consider such as regulatory treatment, accounting and tax outcomes. In Australia, certain types of capital raisings require a regulated disclosure statement. A multi-disciplinary approach is needed to involve treasury, legal, accounting and tax specialists early when establishing the terms and features of an instrument.

Eventually the accounting for an instrument will depend on its contractual terms, which is influenced by each party's commercial objectives and risk appetite.

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