

Macquarie University ResearchOnline

This is the published version of:

Finch, Nigel (2005). Does the use of hybrids cause distortions in financial statement disclosures?. *Journal of law and financial management*, Vol. 4, Issue 2, pp.4-19.

Copyright:

Publisher version archived with the permission of the publisher Macquarie Graduate School of Management, Macquarie University, NSW, Australia. This archived copy is available for individual, non-commercial use. Permission to use this version for other uses must be obtained from the publisher.

Does the Use of Hybrids Cause Financial Statement Disclosure Distortions?

By Nigel Finch

Lecturer in Management, Macquarie Graduate School of Management

Abstract

This paper reports on a study of a sample of hybrid securities issued by large Australian listed corporations between 2002 and 2004. The paper focuses on the key financial reporting impacts of this sample. From a balance sheet perspective these include the frequency with which the securities were classified as equity and the resulting impact on leverage ratios and other traditional risk measures. The impact of these securities on reported earnings and key financial performance metrics is also discussed. Policy implications are drawn from the findings by way of conclusion.

Key Words:

Hybrid Securities, Financial Reporting, Creative Accounting

1. Introduction

In the wake of a global epidemic of revelations of corporate misbehaviour in the beginning years of this decade came a resurgence in interest in and attentiveness towards the objective of improving corporate governance (Carlin & Ford, 2004). A major element of that wave of consciousness was manifested in a heightened focus on the need for improvements in the transparency, consistency, comparability and decision usefulness of corporate financial reports. Failures on one or more of these dimensions more often than not lay at the heart of high profile corporate scandals and collapses such as those epitomised by Enron, WorldCom, Global Crossing¹, HIH² and Parmalat³.

From the time the global wave of governance crises reached its tumult until the present, the Australian market for hybrid financial instruments has burgeoned in size. According to estimates compiled by the Reserve Bank of Australia, the value of outstanding hybrid financial instruments more than doubled between 2001 and 2004, while hybrid issuance as a proportion of non intermediated corporate debt issuance more than tripled over the same period⁴. Yet there are persistent questions as to the legitimacy of hybrid financial instruments, some commentators suggesting that their entire existence rests upon a foundation of regulatory arbitrage and that in consequence they are to be seen as another example of a classic financial reporting mirage. At first glance they appear equity like, but closer inspection reveals a lineage far more dominated by the hallmarks of debt⁵ (Williams, 2005).

Such views are not without foundation. The mandatory requirement for adoption of international accounting standards by listed Australian companies with reporting periods beginning on or after 1 January 2005 has already caused shockwaves. The key reason for this is that IAS 32⁶ has shifted the basis for classification of financial instruments as falling into the categories of debt or equity by requiring that this task be dominated by considerations related to the economic substance, not the legal form, or the instrument. The thin veneer sufficient

to imbue instruments with an equity-like character under the previous regulatory regime appears unlikely to suffice in a changed reporting environment and in consequence corporate Australia has responded with a raft of pre-emptive buybacks⁷, covenant modifications for pre-existing instruments⁸ and continued innovation⁹ in the design and packaging of new security offerings.

This tension between the objectives of greater transparency and accuracy in financial reporting and the regulatory arbitrage laced current which underpins the existence of hybrid securities provides an interesting backdrop for empirical research, of which surprisingly little has been undertaken in the Australian context, though some influential research relating to hybrids has been published internationally (e.g; Hopkins, 1996; Engel et al, 1999; Laurent, 2000.) Consequently, a key motivation of this paper is to provide evidence and analysis to fill that gap. In particular, this paper demonstrates the potentially distorting impacts of the use of hybrid securities as an element of firm capital structure under both historical and forward looking financial reporting regimes.

It is argued that despite the advances in the quality of the financial reporting architecture associated with Australia's adoption of international financial reporting standards, the risks of these distortions remain essentially undiminished. As a result, further development of the reporting framework is argued to be necessary if the goal of greater transparency and accuracy in financial reporting is to be achieved. In supporting these arguments, the paper proceeds as follows.

Section 2 provides background context by describing nature and size of the Australian market for hybrid securities. Section 3 sets out details of the methodology we employed to measure the impact of hybrids on key measures of financial performance and risk for the sample of companies we studied. We set out our results in Section 4, while in Section 5 we briefly outline our conclusions and some suggestions for future research.

Year of Issuance	Domestic Market	Offshore Market	Total Market
1998	1.461	2.203	3.664
1999	6.963	0.490	7.453
2000	1.200	1.002	2.202
2001	3.328	2.112	5.440
2002	5.004	0.787	5.792
2003	4.539	5.345	9.884
2004	4.362	2.993	7.355
2005	1.660	1.640	3.300
TOTAL	28.518	16.571	45.089

Table 1: Gross Issuance in Australia by Market Type (\$b)

Source: Reserve Bank of Australia (2005 data to May 2005 only).

2. The Australian Hybrids Market

Even as recently as the late 1990s bank lending dominated corporate debt raising in Australia. The Reserve Bank of Australia estimates that as at June 1999, only 18% of total corporate debt raising was non intermediated, with hybrids comprising a paltry 1% of total debt raised¹⁰. By June 2004, Australian debt capital markets had changed significantly, with 40% of debt raised in non intermediated form. By this time, hybrid issuance represented 7% of total debt raisings in Australia (RBA, 2005a, p. 54).

Thus not only had Australian corporations increasingly moved towards the creation and issue of their own debt securities rather than relying on traditional bank loan products, the type of instruments used by these organisations to facilitate the raising of capital had also substantially altered. Hybrids in particular, became far more popular than they had been even a short period earlier. This rise in popularity is captured in the data set out in Table 1, which sets out the gross value of hybrid issuance of hybrids by Australian corporations in both domestic and offshore capital markets between 1998 and 2005.

Although the domestic market has been the principal destination for hybrid capital raisings by Australian corporations, the data also reveals a strong capacity on the part of Australian corporations to raise capital by issuing hybrid securities into offshore capital markets. Further, as the data in Table 2 demonstrates, both financial and non financial issuers

have actively participated in hybrid issuance, with non financial corporations playing an increasingly important role in more recent years as Australian financial institutions reached their Tier 1 capital limits for hybrid securities after several years of substantial issuance activity (RBA, 2005b, p.55)

The Australian market for hybrid securities has also been characterised by rapid innovation in instrument design. This echoes experience with hybrid securities in international contexts (Smithson et al, 1993). In the Australian context, a number of factors combine to explain innovation. First, hybrid securities have been targeted far more to a retail investor audience than traditional corporate bond offerings. This has biased the design of many instruments towards the provision of higher yields⁺ than those available on alternative asset classes, or on access to streams of tax credits not normally associated with distributions paid on traditional debt instruments (Moody's, 2001, p. 5).

⁺ One indication of this is evident in the Reserve Bank of Australia's recent estimate that hybrid securities typically cost their issuers between 70 – 100 basis points more than equivalently rated traditional debt instruments (RBA, 2005a, p. 58).

Changes to financial reporting requirements have also been a strong driver of variations in instrument design. The data set out in Table 3 shows clear patterns associated with this phenomenon. It is particularly noteworthy for example, that

Year of Issuance	Financial	Non-financial	Total Issuers
1998	2.444	1.220	3.664
1999	5.295	2.158	7.453
2000	0.295	1.907	2.202
2001	1.035	4.405	5.440
2002	3.464	2.327	5.792
2003	6.470	3.414	9.884
2004	4.489	2.866	7.355
2005	1.375	1.925	3.300
TOTAL	24.867	20.222	45.089

Table 2: Gross Issuance in Australia by Issuer Type (\$b)

Source: Reserve Bank of Australia (2005 data to May 2005 only).

Year of Issuance	Income Security	Convertible Preference Share	Convertible Note	Reset Convertible Preference Share	Reset Convertible Notes	Perpetual Step-up preference share	Other	Total (\$ Billion)
1998	0.261	0.455	2.185	-	-	0.075	0.688	3.664
1999	5.640	0.726	0.586	0.490	-	-	0.011	7.453
2000	-	0.440	1.012	0.740	-	-	0.010	2.202
2001	0.065	0.315	0.978	2.070	0.400	-	1.612	5.440
2002	-	0.016	0.718	4.060	0.210	-	0.787	5.792
2003	-	0.029	0.950	4.394	1.540	2.970	-	9.884
2004	-	-	0.115	0.956	0.851	3.957	1.476	7.355
2005	-	-	-	0.110	-	2.425	0.765	3.300
TOTAL	5.966	1.981	6.544	12.821	3.001	9.427	5.350	45.089

Table 3: Gross Issuance in Australia by Security Type (\$b)

Source: Reserve Bank of Australia (2005 data to May 2005 only).

over recent periods, the single most dominant form of hybrid security issued by Australian corporations falls into a category known as perpetual step up preference shares, while issuance activity of more traditional hybrid forms such as income securities has ceased altogether. As discussed below, step up securities have been designed to satisfy the requirements for classification as equity under international accounting standards, something not possible in relation to traditional income securities given their particular design features.

The degree of security design innovation inherent in the Australian hybrid security market has resulted in considerable fragmentation. Many issues are small in terms of absolute dollars raised and are often unrated. Compared to vanilla debt security offerings they are complex, yet ironically have been most often pitched at a retail investor base which may not fully appreciate the magnitude and nature of risks associated with exposure to them. (Smith, 2003).

Despite the high degree of variation in instrument design

which we have noted characterises the Australian market for hybrid instruments, it is possible to capture the broad parameters of the most important sub-classes of securities which exist within the marketplace. As the data in Table 3 makes clear, the three most significant of these subclasses are hybrids which can be generally described as income securities, reset convertible preference shares and, more recently, perpetual step up preference shares. The essential features of these security sub-classes are summarised in Table 4.

While income securities dominated the Australian market for hybrid securities in the late 1990s, by far the most common form of hybrid found in this jurisdiction at present is the reset convertible instrument. Both are highly vulnerable to reclassification as debt under IFRS, the former because they are essentially indistinguishable from subordinated debt¹¹ and the latter because reset convertibles typically gave investors the right to convert their securities into a variable number of ordinary shares on defined dates or in response to certain defined events¹².

Type	Key Features
Income securities	Perpetual securities with regular interest or coupon payments. They are only redeemable at the option of the issuer.
Perpetual step-up securities	Similar to income securities, except that the interest payment on the security increases if the issuer does not redeem the security on a certain date.
Reset convertible preference shares/notes	The issuer has the option to change the terms or redeem the securities on a predetermined date. The investor has the option to accept the new terms of the security, or to request an exchange. If an exchange is requested, the issuer decides whether it is for ordinary shares or cash.

Table 4: Features of Key Hybrid Security Sub Classes Issued in Australia

Perpetual step up securities have become the most significant form of hybrid issued in Australia since the Australian Accounting Standards Board announced pending Australian Accounting Standard 132¹⁴, pursuant to which most pre-existing forms of hybrid securities would be vulnerable to reclassification from equity to debt for financial reporting purposes. Their popularity is not coincidental, but rather, is based upon the fact that step up securities issued since December 2003 have been designed specifically to avoid being classified as debt for financial reporting purposes. They therefore represent a continuation of the tendency of issuers to design hybrid instruments with a view to achieving regulatory arbitrage – classification as equity while not far beneath the surface lie many of the characteristics of debt.

Thus, far from destroying the inertia of the Australian market for hybrid securities, the introduction of IFRS¹⁵ has merely stimulated further design innovation and greater instrument design complexity¹⁶. Hybrid issuance continues apace, but it is not at all clear that the objectives of greater transparency and accuracy will in fact be engendered by the arrival of a new set of financial reporting rules from 2005 onwards. Thus, IFRS or not, an investigation of the potential impact of hybrids on the quality and accuracy of financial disclosures appears warranted. Section 3 below describes our methodology for investigating the nature and magnitude of the problem.

3. Measuring the Impact of Hybrids

A central contention of this paper is that the regulatory arbitrage upon which the construction of hybrid securities is founded results in the systemic mistreatment of these instruments as equity for financial reporting purposes. It is in turn posited that this has the potential to distort reported financial aggregates such that common measures of financial performance and risk calculated on the basis of those aggregates fail to convey an appropriate image of the underlying organic financial reality of the reporting entity.

Testing these propositions requires the implementation of a two stage methodology. The first component of this methodology goes to acquiring evidence relating to the first contention, that those organisations which use hybrids as an element of their capital structure systemically misclassify

them as equity when categorisation as debt would represent a more appropriate treatment.

The second component relates to acquisition of evidence of the distorting impact (if any) resulting from any detected misclassification. Jointly, this body of evidence provides a composite picture of the impact of the use of hybrid securities by Australian corporations, and by extension, the likely impact in other jurisdictions with similar regulatory structures¹⁷.

We test our first contention by applying a debt/equity characteristics matrix technique against a sample of hybrid securities currently outstanding in Australian capital markets. Specifically, our sample includes all companies which fell within the top 100 Australian corporations ranked by market capitalisation which issued or had outstanding hybrid securities in any of 2002 through 2004.

In order to determine the appropriate classification of each security we examine, we compare its essential characteristics against a six point debt/equity characteristic matrix, and determine, on balance, whether the inherent characteristics of the instrument suggest that the instrument lies closer to “pure debt” or “pure equity”.

In undertaking this analysis, we classify pure debt as having the following characteristics. First, it enjoys contractually defined cashflows. Second, debt enjoys priority claims to the cashflows of the debtor entity while that entity remains a going concern, and to distributions flowing from disposal of assets in the case of liquidation. Finally, pure debt instruments are structured to have a finite, known maturity.

By way of contrast, pure equity instruments do not enjoy contractually defined cashflows, have only residual claims to cashflows (both while the business remains a going concern and in the context of liquidation) and have an indefinite maturity¹⁸.

Our review of hybrid securities issued by the sample of firms we studied using this classification methodology suggested a high degree of financial statement misclassification on the part of hybrid issuers. Our findings on this matter are set out in Table 5. The data suggests that whereas a substance over form approach to the classification of the instruments we studied would almost invariably have led to their classification

HYBRID CLASSIFICATION	2002	2003	2004
Number of hybrids outstanding	19	24	28
Number correctly classified	2	2	2
Number incorrectly classified	17	22	26
Number correctly classified (%)	10.5%	8.3%	7.1%
Number incorrectly classified (%)	89.5%	91.7%	92.9%
Hybrid value correctly classified (\$m)	1,258	1,255	465
Hybrid value incorrectly classified (\$m)	8,094	11,130	17,842
Hybrid value correctly classified (%)	13.5%	10.1%	2.5%
Hybrid value incorrectly classified (%)	86.5%	89.9%	97.5%

Table 5: Hybrid Classification 2002 to 2004

LEVERAGE	2002	2003	2004
DEBT-TO-EQUITY RATIO			
Reported debt-to-equity ratio (times)			
Average financial issuers	12.58	12.32	12.02
Average non-financial issuers	0.93	0.86	0.82
Adjusted debt-to-equity ratio (times)			
Average financial issuers	13.58	13.73	13.18
Average non-financial issuers	1.03	0.94	1.10
Difference upon adjustment			
Average financial issuers	7.96%	11.40%	9.69%
Average non-financial issuers	10.66%	9.15%	35.00%
GEARING			
Reported gearing (times)			
Average financial issuers	13.58	13.32	13.02
Average non-financial issuers	1.93	1.86	1.82
Adjusted gearing (times)			
Average financial issuers	14.58	14.73	14.18
Average non-financial issuers	2.03	1.94	2.10
Difference upon adjustment			
Average financial issuers	7.37%	10.55%	8.95%
Average non-financial issuers	5.15%	4.23%	15.72%

Table 6: Hybrid Issuers Leverage Analysis 2002 to 2004

as debt instruments¹⁹, the actual route to classification of these instruments appears to rest on considerations relating to form, rather than substance.

While the data in Table 5 suggests that the misclassification phenomenon is widespread and systematic amongst those organisations choosing to use hybrids as an element of their capital structure, this begs the question as to the impact this has on the information content of the resulting financial statements.

The most obvious impact of misclassifying a debt instrument as equity is to reduce the apparent leverage of the issuing organisation. Therefore, where necessary, we recast the balance sheet by removing inappropriately classified hybrids from outstanding equity and adding them to the issuing entity's on balance sheet liabilities. We capture any differences by measuring changes in both the debt/equity ratio and the leverage ratio.

In addition to the obvious balance sheet impact however, there remains the possibility of a material profit and loss impact, since cash distributions paid to holders of misclassified hybrid instruments are typically accounted for as distributions of retained earnings rather than treated as expenses²⁰. We make relevant adjustments and measure the impact on earnings per share and return on assets. A detailed review of our process

of adjustment and of the firms which were incorporated into our research sample is reported in Appendices 1–3, at the conclusion of the paper. Our empirical results are reported in Section 4.

4. Results

Our methodology for undertaking this investigation is discussed in section 3. We first tested for impact on key balance sheet based measures of financial position, particularly leverage. Our results are presented in Table 6.

The data demonstrates that the reclassification of hybrid instruments from that adopted by their issuers (equity) to our suggested treatment as debt would have materially impacted both the debt to equity and leverage ratio of each of the organisations we studied. Indeed, the greatest impact flowing from the misclassification of hybrid securities was the significant change this brought to standard measures of gearing. Were a reclassification to occur, this could have potentially significant impacts on both investor perceptions of the degree of risk associated with providing debt or equity capital to the organisations in question, and could also place the organisations studied at greater risk of breaching predefined debt covenants and other similar contractual obligations. This may explain the increase in buyback and instrument redesign behaviour we noted previously, in the wake of the Australian

Accounting Standards Board's release of draft Australian Accounting Standard 132. Viewed in the context of the changing institutional framework, the data suggests a strong element of regulatory arbitrage as a motivating factor for the employment of hybrid financial instruments.

For reasons we set out in the discussion of our methodology, the misclassification of hybrid instruments as equity also has implications for key corporate performance measures, by reason of the treatment of cashflows to security holders as distributions of retained equity rather than as interest expense. Therefore, in addition to recasting gearing measures for the sample of organisations we studied, we also recast earnings where appropriate.

This transformation was undertaken under circumstances where we took the view that a hybrid security which had been classified as equity for balance sheet purposes should have been classified as debt, and jointly, a distribution was paid to holders of the security which, by reason of the security's classification as equity was treated as a distribution of retained earnings rather than as interest expense²¹. We present our results in Table 7.

The data in Table 7 suggests a measurable impact on reported earnings per share when distributions paid to hybrid security holders are treated as interest expenses rather than as payments from retained earnings. Because the treatment hybrid issuers elected to use as a means of accounting for the distributions paid on these securities always conformed to the balance sheet treatment adopted (e.g if the security was classified as equity, the distributions would be treated as flowing direct from retained earnings and not as interest expense²²), our reclassification of instruments as debt invariably also resulted in a reclassification of equity distributions as expenses. This meant that EPS consistently fell after our process of adjustment.

While the magnitude of this change was not large, averaging approximately 4%, the impact on earnings should be taken in context. The decision to inappropriately classify payments to hybrid security holders as distributions of equity even when the underlying characteristics of the securities in question overwhelmingly suggested that they had the character of debt, thus rendering payments to security holders better

seen as interest costs is simply one thread in the complex fabric which is woven together to produce a set of financial statements. Taken together with a range of other potential adjustments, individually small items can rapidly sum to highly material consequences.

In addition to the consequences of security misclassification detected for key metrics such as EPS (as discussed above), we also tested for the impact of this phenomenon on the apparent return on assets of organisations in our sample. We set out the results of this investigation in Table 8.

Consistent with our findings on EPS measures, the effect of misclassifying hybrid securities and the distributions paid to their holders has been to inflate apparent corporate financial performance. The impact of hybrid misclassification resulted in an average overstatement of return on assets (ROA) in the range of 3–5%. Again, we contend that taken in combination with a range of other potential adjustments which lurk within most sets of financial statements, the effect could be far more significant than it appears to be on a standalone basis.

5. Conclusion

The essential premise which motivated this paper was that despite a growing focus on improved transparency, accuracy and consistency in financial reporting evident in the wake of a raft of high profile corporate scandals which broke in the beginning years of the new millennium, significant threats to such ideas still remained unchecked. We examined hybrid securities as an example of a construct which, as the evidence we have discussed above clearly suggests, demonstrates that this threat is not merely conjectural, despite high profile "reform" to financial reporting rules in Australia in the form of the adoption of international financial reporting standards.

In our view, this only adds weight to the calls made by other scholars (e.g; Anthony, 2004; Brilof, 2004; McBarnet & Whelan, 1999) for continued revisions to be made to financial reporting frameworks with a view to further engendering a reporting philosophy and culture founded on the principal that financial statements should reflect economic substance rather than being trapped as the slaves of form.

Our study provides evidence that much territory remains to be covered before such a state of affairs is likely to be

EARNINGS PER SHARE †	2002	2003	2004
Reported earnings per share (\$)			
Average financial issuers	1.15	1.59	1.56
Average non-financial issuers	0.48	0.40	0.46
Adjusted earnings per share (\$)			
Average financial issuers	1.10	1.55	1.51
Average non-financial issuers	0.46	0.38	0.44
Difference upon adjustment			
Average financial issuers	-4.24%	-2.83%	-3.44%
Average non-financial issuers	-5.43%	-4.48%	-3.88%

Table 7: Hybrid Issuers Earnings Per Share 2002 to 2004

reached. In particular, our study reinforces the dynamic nature of regulatory arbitrage, as evidenced by the redesign of hybrid financial instruments to a form amenable to survival under forthcoming financial reporting regulatory regimes before the commencement date of those regimes. In effect, by designing financial reporting standards with a highly technical and detail based bent, regulators appear to have stoked the fires of instrument design creativity and ensured the continued viability of financial reporting practices which, even at best, must be viewed as questionable.

While the case of hybrid financial instruments is of interest treated alone, as we have done here, the better view is that hybrid instruments represent only one of a matrix of phenomena which continue to derogate from the quality of external financial

reporting, including, in particular, off balance sheet financing vehicles, certain forms of lease financing structures and equity linked compensation instruments, including options.

While this may seem an eclectic list, the difficulty inherent in each of its constituent elements is the failure of current financial reporting practices to adhere to a substance based approach. The data we present and discuss in relation to hybrids adds to understanding of the magnitude of the danger inherent with continued adherence to financial reporting rules not firmly embedded on the philosophy of giving precedence to highlighting the underlying economic substance of transactions or positions, above all other objectives. Much room remains for further empirical and theoretical work aimed at providing further illumination in relation to this critical point.

APPENDIX 1

FORMULAE USED IN CALCULATION OF RATIOS

RATIO	FORMULA
Reported debt-to-equity ratio	Average Total Liabilities / Average Shareholder Equity
Adjusted debt-to-equity ratio	(Average Total Liabilities + Average Hybrid Value #) / (Average Shareholder Equity - Average Hybrid Value #)
Reported gearing	Average Total Assets / Average Shareholder Equity
Adjusted gearing	(Average Total Assets) / (Average Shareholder Equity - Average Hybrid Value #)
Reported earnings per share	Average NPAT / Average Weighted Average Number of Shares
Adjusted earnings per share	(Average NPAT - (Average Hybrid Distribution ## x (1-Tax Rate))) / Average Weighted Average Number of Shares
Reported return on assets	Average NPAT / Average Total Assets
Adjusted return on assets	(Average NPAT - (Average Hybrid Distribution ## - (1-Tax Rate))) / Average Total Assets
Reported return on equity	Average NPAT / Average Shareholder Equity
Adjusted return on equity	(Average NPAT - (Average Hybrid Distribution ## - (1-Tax Rate))) / (Average Shareholder Equity - Average Hybrid Value #)

Where hybrid value is incorrectly classified as equity

Where hybrid distribution is incorrectly classified as dividend

APPENDIX 2

SAMPLE OF ASX LISTED COMPANIES

Industry Classification	ASX Code	Company Name
Financials	ADB	Adelaide Bank Limited
	AMP	AMP Limited
	ANZ	ANZ Banking Group Ltd
	BEN	Bendigo Bank Limited
	CBA	Commonwealth Bank of Australia
	MBL	Macquarie Bank Limited
	NAB	National Australia Bank Limited
	QBE	QBE Insurance Group Limited
	SGB	St. George Bank Limited
	WBC	Westpac Banking Corporation
Consumer Discretionary	DJS	David Jones Limited
	FXJ	John Fairfax Holdings Limited
	NWS	News Corporation
	SEV	Seven Network Limited
	VRL	Village Roadshow Limited
Consumer Staples	CML	Coles Myer Limited
	WOW	Woolworths Limited
Energy	STO	Santos Limited
Industrials	CRG	Crane Group Limited
	LEI	Leighton Holdings Limited
Materials	AMC	Amcor Limited
	ORI	Orica Limited

APPENDIX 3
 MARKET CAPITALISATION OF SAMPLE
 OF ASX LISTED COMPANIES (\$ million)

Industry Classification	ASX Code	Company Name	2002	2003	2004
Financials	ADB	Adelaide Bank Limited	638	703	769
	AMP	AMP Limited	12,723	6,944	13,453
	ANZ	ANZ Banking Group Ltd	26,420	27,180	33,743
	BEN	Bendigo Bank Limited	807	1,029	1,249
	CBA	Commonwealth Bank of Australia	41,163	37,026	40,920
	MBL	Macquarie Bank Limited	6,270	4,990	7,590
	NAB	National Australia Bank Limited	51,865	46,689	40,882
	QBE	QBE Insurance Group Limited	4,882	6,773	10,684
	SGB	St. George Bank Limited	8,727	10,292	11,141
	WBC	Westpac Banking Corporation	25,096	29,549	32,730
Sub-total Financials			178,591	171,176	193,160
Consumer Discretionary	DJS	David Jones Limited	410	611	778
	FXJ	John Fairfax Holdings Limited	2,433	2,178	3,306
	NWS	News Corporation	47,829	58,856	79,663
	SEV	Seven Network Limited	1,501	1,220	1,192
	VRL	Village Roadshow Limited	283	285	423
Consumer Staples	CML	Coles Myer Limited	7,317	8,750	10,813
	WOW	Woolworths Limited	13,693	13,136	11,634
Energy	STO	Santos Limited	3,497	4,008	4,960
Industrials	CRG	Crane Group Limited	425	520	486
	LEI	Leighton Holdings Limited	2,785	2,706	2,476
Materials	AMC	Amcor Limited	5,480	6,782	6,044
	ORI	Orica Limited	2,646	3,335	4,731
Sub-total Non-financials			88,298	102,387	126,506
Grand Total			266,889	273,563	319,666

1. These three being in the U.S.A.
2. An Australian example.
3. An Italian example.
4. For the purposes of compiling its statistics, the Reserve Bank of Australia categorises hybrid instruments as debt, irrespective of the accounting or taxation treatment accorded to them.
5. This has led one influential Australian commentator, Tom Ravlic the policy advisor to the Australian National Institute of Accountants to dub hybrids “the transvestites of the accounting world.” In Ravlic’s view, hybrids are made up to look like equity “but once you strip away the lipstick and mini-skirt, you end up with debt.” (Quote drawn from Williams, 2005, p.71).
6. And thus its Australian corollary – AASB 132 *Financial Instruments: - Disclosure and Presentation*.
7. For example the ReCAPS hybrids issued by large Australian retailer Coles Myer. These instruments, through which Coles Myer raised approximately AUD \$700 million were originally issued in December 2000. All were bought back by the company in July 2005. The company explained that its motivation in engaging in the buyback was to “provide a simpler, more efficient capital structure that will benefit the company and shareholders over time.” Given that these were perpetual instruments of no fixed maturity, their survival for so limited a period speaks volumes as to the fragility of the desirability and usefulness of hybrid instruments in the face of regulatory change.
8. For example the “WINS” hybrids issued by Woolworths Limited, another large Australian retailer. Note 24 to the company’s 2004 annual report notes that the trust deed governing these instruments was altered post balance date, in preparation for the changed reporting environment ushered in by the adoption of international financial reporting standards.
9. An important example of this is the arrival of so called “step up” securities into the Australian hybrids market. These are of recent invention and should continue to allow classification as equity for financial reporting purposes. These are discussed in greater detail later in the paper.
10. For the purposes of compiling its statistics, the Reserve Bank of Australia’s standard protocol is to classify hybrids as debt irrespective of accounting or taxation treatment.
11. Though they managed to be classified as equity due to their perpetual maturity and the existence of some degree of conditionality in relation to the right on the part of investors to receive promised cashflow streams.
12. As noted in the introduction to this paper, many organisations have responded to this likely change in classification by engaging in pre-emptive buy-backs of these instruments. As a further example, in August 2004, Computershare Limited notified holders of its reset preference shares that it had opted to invoke an early conversion of the instruments to ordinary equity, in accordance with the terms of issue of the reset preference shares. Its explanation for its decision to do this was that: “The board has made this decision following the release in December 2003 by the Australian Accounting Standards Board with effect from 1 January 2005 of pending Australian Accounting Standard 132: Financial Instruments Disclosure and Presentation (AASB 132). AASB 132 will have the effect of requiring the RPS (currently treated as equity) to be treated as debt for accounting purposes.”
13. In December 2003.
14. AASB 132: Financial Instruments Disclosure and Presentation.
15. Together with changes in prudential regulatory rules relating to the classification of securities as tier 1 capital of financial institutions announced by APRA in April 2004.
16. This applies not only to the actual design features of the instruments, but to the nomenclature of the instruments. A sample of the acronyms used to describe hybrid securities currently outstanding in Australian capital markets includes; CARES, CARS, FIRsTS, FUELS, PARS, PAVERS, PERLS, PINES, POWERS, PRESSES, RENTS, RePS, SAINTS, SHEDS, SITES, TELYS, TICKETS, WINES and WINs. In many cases, the acronyms are designed to in some way reflect the nature of the underlying business of the issuing entity. Thus FUELS (Franked Unsecured Equity Linked Securities) were issued by energy company Santos, PRESSES (Preferred Reset Securities Exchangeable for Shares) were issued by newspaper and media company Fairfax Limited – and so on.
17. An obvious example being other jurisdictions which have adopted or which are moving towards the adoption of IFRS.
18. Albeit with slight modifications to terminology each of Moody’s, Standard & Poor’s and Fitch Ratings use essentially the same approach that we describe above to differentiate between debt and equity securities for the purposes of undertaking credit analysis.
19. Generally, we contend that it would be appropriate to view these instruments as forms of subordinated debt. However, notwithstanding their degree of subordination, in most cases they are clearly distinguishable from equity.
20. That is, interest expense.
21. In making our adjustments to reported EPS, we notionally tax effected the gross cash value of distributions which we recast as interest expenses using the prevailing Australian corporate taxation rate if 30%.
22. Even if, according to the disclosure documents pursuant to which the instruments were issued, these distributions were formally described as “interest” payments.
23. For example, Carlin & Ford (2005) suggest that had Australian listed corporations adopted the practice of expensing executive options, their reported earnings would have decreased by in the order of 2%.