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Hybrid Financial Instruments, Cost of Capital and Regulatory Arbitrage - An Empirical Investigation

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Data recently published by the Reserve Bank of Australia clearly demonstrates that after a period in abeyance, hybrid financial instruments have again become popular tools for capital raising and management. This raises several questions of practical and theoretical significance, particularly in relation to the motivation for adopting hybrid instruments as an element of firm capital structure, and the impact of putting this choice into effect. In this paper, we examine two key themes. First, we analyse the extent to which the rise of hybrid instruments can be justified on the grounds that the use of these instruments can result in lower firm cost of capital. We also investigate the impact on firm financial reports and key metrics of financial performance of risk which result from the deployment of hybrid financial instruments as components of firm capital structure. We conclude by expressing scepticism as to the proposition that the use of hybrid instruments systematically lowers issuer cost of capital, and argue that the use of hybrid instruments has caused material distortions to emerge within the financial statements of firms which employ them.

1. Introduction

High profile scandals such as those involving Enron, Worldcom, Global Crossing, Parmalat and HIH, to name but a few, have caused widespread recrimination and been the source for much introspection within the accounting profession. While the work of authors such as Clarke, Dean and Oliver (Clarke et al, 1997) reminds us that corporate scandals of significant scale and complexity are best seen as frequent and ancient interlopers, not new fangled products of a nascent millennium, some authors have nonetheless contended that the scale of the accounting profession's complicity in the most recent wave of frauds sets them apart as a separate species of event (Brewster, 2003). That a barrage of regulatory responses has sprung up in the wake of the most recent crop of disasters seems beyond contention (Carlin & Ford, 2004). That the accounting profession has been forced to engage in deep introspection about its continued relevance and legitimacy seems an equally incontrovertible proposition. Some however, have expressed concern that accounting (and related) academics have not understood the significance of these events sufficiently well, or taken appropriate action.

One vigorous promoter of this view is Professor Briloff, of the City University of New York. In a blistering critique of trends in contemporary accounting research, he recently suggested that a tangible means available to the scholarly accounting and finance community for the purpose of better fulfilling its role as a key check and balance on corporate behaviour would be for its constituent members to conduct less "exotic and esoteric" research. Instead, he argued, researchers should spend far more time rolling up their sleeves, dirtying their hands with primary data such as that found in annual financial reports and looking for outcomes capable of more immediately contributing to practice and current policy debates (Briloff, 2004).

In large part, the research reported in this paper reflects an embodiment of the path forward suggested by Professor Briloff. An underlying theme of his work has been the need for accounting scholars and commentators to constantly engage with the world of practice and doggedly apply forensic skills with a view to identifying accounting and reporting practices which debase the value of the accounting profession's product and breach the covenant between society and the profession upon which the profession's legitimacy is based.

A key means of achieving this goal is to highlight deviations from a substance over form approach to reporting towards scenarios in which form dominates all other considerations. We contend in this paper that financial reporting practices in relation to hybrid debt equity securities represent a case in point, and that the consequence of this state of affairs has been (and continues to be) the production of unqualified audited annual financial statements which are potentially seriously misleading.

We noted above the existence of a chain of events linking a raft of corporate financial scandals to a wave of "regulatory reform" - much of which was aimed at improving the content of corporate financial reporting and the credibility of the institutional frameworks within which the reporting cycle transpired. It is interesting to note then, that 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 period¹. 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 debt² (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 32³ has shifted the basis for classification of financial instruments as falling into the categories of debt or equity by changing the parameters on which such a classification is undertaken. 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 buybacks⁴, covenant modifications for pre-existing instruments⁵ and continued innovation⁶ 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. In section 3, we question the common assertion that the key rationale for the use of hybrid debt equity securities is that they allow corporations to source capital at more attractive rates than would be possible using either pure debt or equity. We argue that the lack of a credible cost of capital based argument for the employment of hybrids highlights the likelihood of an alternative motive for their use, based on regulatory arbitrage. In particular, we suggest that hybrids have been employed for the purpose of creating illusions in financial statements. Bearing this argument in mind, in Section 4 of the paper we set out details of our data sample and the methodology we employed to measure the impact of hybrids on key measures of financial performance, risk and firm value. We set out our results of this analysis in Section 5, while in Section 6 we briefly outline our conclusions and some suggestions for future research.

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 raised⁷.

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 (below) 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 yields⁸ 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).

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 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.

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

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

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

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

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

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

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

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

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

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

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.

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 (above) 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, above.

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 debt⁹ 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 events¹⁰.

Perpetual step up securities have become the most significant form of hybrid issued in Australia since the Australian Accounting Standards Board announced¹¹ pending Australian Accounting Standard 132¹², 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 IFRS¹³ has merely stimulated further design innovation and greater instrument design complexity¹⁴. 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. This is particularly so in light of the arguments we present in section 3, below, to the effect that the traditional rationalisation of hybrids as instruments offering attractive capital costs to issuers should be treated with scepticism.

3. Examining the Cost of Hybrid Capital

It is not uncommon for chief financial officers and investment bankers to justify the issuance of hybrid securities by companies on the basis that these instruments allow issuers to achieve a lower cost of capital than would be the case under separate issues of straight equity and straight debt. As a snapshot, consider the following:

“.....hybrid’s flexibility allows issuers to lower the cash cost of debt by introducing exposure to equity upside. A well-structured hybrid may also allow equity to be issued at a premium in the future, thereby lowering the cost of equity”.¹⁵

“In recent times, we have seen the introduction of considerable amounts of hybrid capital onto companies’ balance sheets. These issues all have the same aim of reducing the company’s overall cost of capital”.¹⁶

If we take the case of a simple hybrid structure - a convertible bond under which holders have the right to either convert their notes to ordinary shares at a prespecified date or redeem the notes at their face value - the basis of such claims is that if the share price of the issuing firm falls below the conversion price, the firm will have sold an overvalued option, while if the price of the firm rises above the conversion price, the firm will have issued stock at a premium to the price at the date of issue of the convertible bond. In either case, the firm can achieve a lower cost of capital than would have been the case had the firm issued either straight debt or equity - securing debt finance at a below-market rate should its share price remain stable or fall and securing equity finance at a price premium should its share price rise.

In order to assess the validity of such claims it is necessary to examine the real economic cost of hybrid instruments on the issuing company. If a firm can genuinely achieve a lower cost of capital than would otherwise be the case with the issue of either straight debt or equity, we argue that this is directly linked to regulatory arbitrage, rather than the outcome of some mystical alchemy that arises when debt, equity and option instruments are combined to form a hybrid security. In this regard, we evaluate the argument that hybrid structures lower the cost of capital from two perspectives: opportunity cost and risk. Again, we restrict our focus to a convertible bond, given this instrument forms the structural foundation of most hybrid instruments.

First, we approach the analysis from an opportunity cost perspective. A starting point to this approach is the recognition of the fundamental weakness in the argument that hybrids offer a win-win outcome for issuing firms, being that such statements are typically founded only upon comparison with the performance of the instrument with straight debt when share prices fall, and only with straight equity when prices rise.

To assess the real economic impact of hybrid instruments on the issuing firm it is necessary to incorporate how the instrument compares with straight equity when share prices fall and straight debt when share prices rise. To do otherwise presents only a partial and positively-biased assessment of the impact of hybrids on the cost of capital for the issuing firm.

Consider a scenario under which a convertible bond is issued at a coupon rate of 10% and a conversion premium of 20%. The share price of the issuing firm at the time the bond is issued (P_0) is \$10, and the firm can issue senior debt at the same term as the convertible bond at a coupon rate of 15%. Consider first the outcome if the share price of the firm at the conversion date (P_c) falls to \$5.

Those advocating the cost of capital advantages of hybrids point out that given the fall in share price the debt will be redeemed¹⁷, and the firm has secured debt funding at 500 basis points below the rate that it would have paid had it issued straight debt. This, however, only compares the convertible bond to the issue of straight debt, and ignores the fact the firm could have issued straight equity as an alternative to the convertible bond. What of the opportunity cost of issuing the convertible bond relative to equity?

While it is true that relative to straight debt the firm has achieved a lower cost of capital by issuing the hybrid, compared to equity, the firm has forgone the opportunity to achieve a lower cost of equity by issuing equity at the higher P_0 price. In this sense, the opportunity gain in terms of a lower cost of debt needs to be weighed against the opportunity cost associated with the firm paying a higher cost of equity than might otherwise have been the case.

Subject to relativities associated the size of the price fall, the premium associated with the conversion option and the impact on the cost of equity associated with changes in leverage, it may be the case that the cost of capital of the firm may be unchanged, or even higher, in this setting. It is thus a misconception that a firm is better off having issued convertible securities should its share price subsequently fall. To add further weight to the argument, the firm in question is likely to experience heightened financial pressures associated with servicing the convertible bonds to the extent that the fall in share price at P_c accurately reflects significantly lower future cash flows than were envisaged at the time the bonds were issued. This in itself may impact negatively on the cost of capital of the firm.

Now consider the outcome if the share price of the firm at the conversion date (P_c) instead rises to \$15. Those advocating the cost of capital advantages of hybrids would do so on the basis that the rise in share price will lead holders to convert their bonds to ordinary equity, resulting in the firm issuing stock at a price that is 20% above the price P_0 prevailing at the time the convertible bond were issued. This, however, only compares the convertible bond to the issue of straight equity, and ignores the fact the firm could have issued straight debt as an alternative to the convertible bond. What of the opportunity cost of issuing the convertible bond relative to straight debt?

While it is true that the firm has sold equity at on the conversion date at a price of \$12 compared to the share price at issue of \$10, it is unrealistic to directly compare a certain share price of \$10 with an uncertain sale of shares at some future date at a price of \$12. With respect to straight debt, the convertible bond issue is expensive because conversion results in equity dilution.

If the share price at conversion exceeds the conversion price, the firm is obligated to issue equity at a below market price,

exacerbating the dilution impact. In our example, equity worth \$15 per share is issued to convertible bond holders at \$12 per share. Taken from another perspective, the firm in this case has effectively sold an underpriced option on equity to convertible bond holders - although the cost of the convertible bond is lower than the cost of straight debt, the rate on the convertible bond is not low enough to justify the benefits accruing to convertible bond holders on exercise of their options.

Thus while there is an opportunity gain to equity related to the conversion premium, this is offset by opportunity costs related to the issue of equity at a below-market price. The firm would have been better off issuing straight debt because this would obviate the sale of an underpriced call option to convertible bond holders. Again, it is a misconception that a firm will be better off having issued convertible securities should its share price subsequently rise. The obligation of the firm sell equity to convertible bond holders at a below-market price works to offset the lower coupon rate on the convertible bond.

Our analysis suggests that the principle of 'no free lunch' extends to hybrid securities. In the case of the convertible bond, the hybrid confers greater benefits than straight debt and lower benefits than straight equity if the firm performs poorly, while the reverse holds if the firm prospers. If markets exhibit some degree of efficiency, there should be little or no direct benefit to the cost of capital arising from the issue of a hybrid instrument when straight debt and equity alternatives exist.

Can a better case for issuing hybrids be advanced if markets are not efficient, in the sense that the share price of a firm is underpriced or overpriced from the perspective of better-informed insiders? If insiders perceive the share price of firm to be significantly overvalued, such that bond redemption is highly probable, then the issue of convertible bonds might be justified on the basis of securing low cost debt. If this were the case, however, it may be more efficient for the firm to issue straight equity at the inflated price.

Conversely, if insiders believe the share price of the firm to be significantly undervalued, such that bond conversion is highly probable, then the issue of convertible bonds might be justified on the basis of deferring the issue of stock until the price has risen. If this were the case, however, a similar outcome could be achieved by issuing straight debt in the current period and subsequently issuing equity at the expected higher price at the time of the maturity of the debt, using the proceeds of the equity issue to payout the debt. Again, hybrids appear to provide no significant cost of capital advantage over the use of straight debt and/or equity.

An alternative means of proceeding with the analysis of hybrid instruments is to adopt a risk based perspective. In taking this approach we examine the determination of the cost of capital for a hybrid instrument and we again restrict our focus to a convertible bond given this basic structure captures the essential elements of hybrid instruments. To give a practical dimension to the discussion, we apply the methodology to estimate the cost of capital on convertible notes issued by ERG Limited in Australia in March 2000.

The value of a convertible bond is equal to the value of the straight debt and the value of the call option on embedded in the instrument.¹⁸ Using these values as weights, the before-tax cost of capital on a convertible bond is the weighted average cost of the straight debt and the cost of the embedded call option. The cost of capital for the call option is estimated using the capital asset pricing model and the Black-Scholes option pricing model. The beta on the call option (β_c)

measures the systematic risk of the option, and is measured as follows:¹⁹

$$\beta_c = N(d_1)(S/C)(\beta_s)$$

where S is the market price of the stock of the issuing firm, C is the value of the call option written on the stock, β_s is the beta of the stock, and $N(d_1)$ is the cumulative normal probability for pricing the option. We apply this approach to the ERG Limited convertible notes (ERGG) below.

ERG Limited specialises in automated fare collection equipment and software, smart card systems and services, telecommunications infrastructure, equipment manufacturing and service delivery. In March 2000 it raised AUD \$250 million through the issue of convertible notes.

Terms of Issue

Description	Subordinated unsecured redeemable convertible notes
Size of Issue	AUD \$250 million
Face Value	\$13.50 per note
Coupon	7.5% per annum, semi-annual in arrears
Term	5.5 years
Maturity Date	1 October 2005
Redemption	If not converted notes redeemed at \$13.50

Valuation Assumptions

ERG share price at issue(S)	\$12.50
Dividend yield	0.5% five year average
Risk-free rate	7.20%
Exercise price	\$13.50
Historical volatility	60%
Risk premium to swap	6.00%
Yield on straight debt	13.20%
ERG beta (β_s)	2.090
Beta of ERG call (β_c)	3.014 [where (β_c) = $N(d_1)(S/C)(\beta_s)$]
Equity risk premium	7.00%

The value of a note is the sum of the value of one straight bond and one embedded call option on ERG ordinary shares. Using the CAPM and Black-Scholes option pricing model, the estimated before tax cost of capital on the convertible note issue is the weighted average cost of the straight bond and the cost of the call option.²⁰ Specifically, our analysis suggests that the ERG Convertible notes have the following characteristics:

Value of straight bond	\$10.56	(59.7%)
Value of call option	\$7.14	(40.3%)
Value of ERG convertible note	\$17.70	
Cost of straight bond (before tax)	13.20%	
Cost of capital for call option	28.30%	
Cost of ordinary equity	21.83%	
Before tax cost of ERG convertible note	19.29%	

While the coupon rate on the convertible note was 7.50%, the estimated cost of capital on the convertible note is 19.29% - more than double the coupon rate. The cost of capital on the call option exceeds the cost of equity, reflecting the high systematic risk of the option. Our fair valuation of \$17.70 for the convertible notes issue indicates a considerably undervalued option, bond or combination, given the notes were issued at their face value of \$13.50.²¹

Our example demonstrates how the greater risk associated with the embedded call option in convertible bonds results in a higher cost of capital for convertible notes relative to

equivalent straight debt. It is clearly fallacious to argue that convertible securities offer the issuing firm a lower cost of capital than that which would be achieved by issuing equivalent straight debt.

Of course, convertible notes represent but one element of the broader market for hybrid securities in Australia. As we showed in Table (3) above, the most common form of hybrids issued in Australia over the past several years have been reset preference shares. While measurably different in form from the convertible note we analysed above, a clear factor in common with other hybrids is the consistent tendency of commentators to assert that such instruments carry considerable cost of capital benefits with them.

Reset preference shares have been argued to have this impact by reason of (1) the substantial power they place in the hand of issuers to influence outcomes in their favour, and (2) the ability to use franking credits to pay dividends. Reset preference shares allow the issuer to reset the terms of the instrument as permitted by prospectus on each reset date.

The issuer can make changes to factors such as the distribution rate, the term to next reset, conversion ratios and conversion discounts. The holder may either accept or reject the new terms - if accepted, the instrument rolls over until the next reset date, while if rejected, typically, the issuer can choose to convert the securities into ordinary equity or redeem the securities for cash.

It is apparent that the reset preference share confers considerable power to the issuing firm - in essence the issuer has full control of any decision to convert or redeem the securities at reset dates, and by controlling the new terms of the security at reset date, the issuer is positioned to influence the decision of investors to accept or reject the new terms. The ability to influence the outcome at reset dates confers significant benefits to the issuing firm, which in turn, may positively impact on the cost of capital of the firm.

However if all the benefits appear to accrue to the issuer, surely investors factor this into the price and expected yield on reset preference shares? If this is the case, the expected higher yield may work to offset some or all of the benefits associated with funding flexibility that accrue to the issuing firm under this instrument.

Two arguments might be put forward to suggest that this is not the case. First, in the Australian setting, a large proportion of the holders of reset preference shares have been retail investors. The complicated nature of these instruments, combined with the lower financial sophistication of this segment, may result in issuing firms achieving better prices on reset preference shares than would be the case if investors were better able to assess and price risk into the instruments.

Second, until recently, the ability of issuing firms to recognise these instruments as equity on their balance sheets enabled firms to use franking credits to pay dividends to holders, increasing the after-tax yield for investors. It could be argued that the ability to gross-up yields to reflect the tax benefits of franking credits may compensate investors for the power vested in the hands of issuers at reset dates.

The argument that the payment of franking credits to investors acts to reduce the cost of capital of the firm is, however, not clearcut. The basis of the argument is that faced with two companies of identical systematic risk, one of which pays fully-franked dividends and one which does not, equity investors will accept a lower rate of return on the firm which pays the fully-franked dividends because the imputation credits can

be used to offset their personal tax liability.

While this is plausible, dividend imputation has had a negligible impact on the after-tax cost of capital of Australian firms. Specifically, the value of franking credits is dependent on the tax position of individual shareholders. Foreign investors (who comprise approximately one-third of investors in the Australian market) cannot make use of franking credits.

Further, the unrestricted flow of international capital into and out of the Australian market, combined with its low proportion of global share market capitalisation, implies the cost of capital for Australian issuers is largely set internationally. Lonergan (2003) cites evidence that the majority of independent expert reports (94%) do not make any adjustment to the cost of capital for dividend imputation, and of those that do the majority attribute little or zero net effect on the value of the company being assessed.

Evidence that regulatory arbitrage, rather than sustainable cost of capital advantages, has been a major driver of the decision for Australian firms to issue reset preference shares is demonstrated in the increasing number of issuers who have redeemed their securities or allowed them to convert since the January 2005 introduction International Accounting Standards (IAS32) which reclassify most reset preference shares as debt rather than equity. It is somewhat ironic that reset preference shares which were issued for 'capital management purposes' are now being redeemed, converted or restructured for 'capital management purposes'.

As a case in point, consider the issue of \$700 million in reset preference shares by Coles Myer in 2000. In 2001, the chief financial officer, John Schmoll, is quoted as follows:

"Furthermore, we found that the [hybrid] issue provided us with additional financial flexibility and also the opportunity for a lower cost of capital, both of which should lead to an increase in shareholder value".²²

In July 2005, following the pending reclassification of the reset preference shares as debt, the securities were converted into ordinary shares at the same time that the company completed a \$585 million on-market share buyback. According to the chief financial officer, Fraser MacKenzie:

"Converting the ReCAPS will provide a simpler, more efficient capital structure that will benefit the company and our shareholders over the long term".²³

It can only have been regulatory arbitrage - whereby reset preference shares received easy equity treatment under accounting standards - that explains the colourful but brief life of these instruments. If this argument holds, then it ought to be possible to detect.

4. Sample and Measurement Issues

A central contention of this paper is that the regulatory arbitrage upon which the construction of hybrid securities is founded results in the systemic treatment of these instruments as equity for financial reporting purposes. It is in turn posited that this has the potential 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 methodol-

ogy 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 structures²⁴.

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 consists of those companies which fell within the largest 100 ASX listed corporations (as measured by market capitalisation) which had hybrid securities on issue at any time between 1998 and 2004 (inclusive).

We detected 22 such organisations, details of which are provided in Appendix 1. Since approximately half the 22 organisations we detected as having issued hybrid financial instruments within the timeframe studied were financial institutions (the remainder being drawn from a range of industries including retailing, energy, media and construction), we present our findings for each cluster of firms separately²⁵. Data pertaining to the degree of hybrid issuance activity of firms in our sample, together with data on the relative importance of hybrids

as a funding source for the firms in our sample is set out in tables 5 - 7 below.

The data in Tables 5 - 7 show that questions relating to the classification and financial statement impact of hybrids are non trivial in the context of the sample of firms we examined, with hybrid securities financing approximately 1% of the asset base of the financial institutions we examined and almost 6% of the asset base of the non financial firms in our sample by 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 maturity²⁶. Our review of hybrid securities issued

Table 5: Hybrid Activity for Financial Issuers 1998 to 2004

Year	Hybrids issued (\$m)	Hybrids redeemed (\$m)	Hybrids outstanding (\$m)	Number of issuers	Mean value per issuer (\$m)
1998	-	-	35	1	35
1999	3,650	5	3,680	4	920
2000	390	4	4,066	5	813
2001	2,505	5	6,566	8	821
2002	853	154	7,265	9	807
2003	2,722	183	9,804	10	980
2004	2,311	2,215	9,900	9	1,100

Table 6: Hybrid Activity for Non-financial Issuers 1998 to 2004

Year	Hybrids issued (\$m)	Hybrids redeemed (\$m)	Hybrids outstanding (\$m)	Number of issuers	Mean value per issuer (\$m)
1998	160	-	542	5	108
1999	-	57	485	5	97
2000	583	75	993	5	199
2001	1,412	2	2,403	8	301
2002	510	8	2,905	10	291
2003	315	0	3,220	11	293
2004	440	12	3,648	12	304

Table 7: Hybrid Value as a Percentage of Total Assets 1998 to 2004

Year	Financial Issuers		Non-Financial Issuers	
	Number of issuers	Mean hybrid value as % of total assets	Number of issuers	Mean hybrid value as % of total assets
1998	1	1.11%	5	2.17%
1999	4	0.69%	5	1.43%
2000	5	0.75%	5	3.06%
2001	8	0.61%	8	4.35%
2002	9	0.97%	10	5.34%
2003	10	1.09%	11	5.81%
2004	9	1.01%	12	5.96%

Table 8: Classification of Hybrid Value 1998 to 2004

Year	Financial Issuers		Non-Financial Issuers	
	Value correctly classified (\$m)	Value misclassified (\$m)	Value correctly classified (\$m)	Value misclassified (\$m)
1998	35	-	-	542
1999	1,271	2,410	-	485
2000	1,267	2,800	-	994
2001	1,261	5,305	-	2,404
2002	1,258	6,007	-	2,906
2003	1,255	8,549	-	3,221
2004	265	9,635	200	3,448

Table 9: Accuracy of Hybrid Classification 1998 to 2004

Year	Financial Issuers		Non-Financial Issuers	
	Percentage correctly classified	Percentage misclassified	Percentage correctly classified	Percentage misclassified
1998	100%	-	-	100%
1999	35%	65%	-	100%
2000	31%	69%	-	100%
2001	19%	81%	-	100%
2002	17%	83%	-	100%
2003	13%	87%	-	100%
2004	3%	97%	5%	95%

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 Tables 8 and 9 above. 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 as debt instruments²⁷, the actual route to classification of these instruments appears to rest on considerations relating to form, rather than substance.

The data in Tables 8 and 9 should provide food for considerable thought. Whereas the regulatory backdrop changed measurably between 1998 and 2004, placing greater stated emphasis on transparency and fairness in financial reporting, we estimate that the degree of misclassification of hybrid financial securities actually increased over this same time-frame. Consequently, where we determined that an instrument we reviewed had been misclassified, we undertook the task of recasting selected elements of the raw financial statements released by the organisations which issued the misclassified hybrids we detected in our sample.

For the purposes of this research, we undertook three key sets of adjustments to the raw financial data reported by the firms in our sample. First, where appropriate, we tested the impact of misclassification of hybrid securities by recalculating the debt to equity ratios of firms where we believe a misstatement had taken place. The impact of this process is set out in Table 10.

Second, where a firm had misclassified a hybrid security as equity, it invariably classified cash payments to security holders as distributions of retained earnings rather than as interest costs for the purpose of calculating earnings - thus overstating the profitability of the organisation. We recast firm earnings to take account of this, and set out our findings in Table 11.

Finally, firms which misstated earnings also typically classified cash payments to hybrid security holders as "financing" in nature instead of as "operating" in nature, as would typically be the case if the payments were accounted for as interest, rather than as distributions of retained earnings. Given the im-

portance of a firm's reported net operating cashflows, we also conducted adjustments to this metric, and report the results in Table 12. Formulae describing the process used to generate each of these sets of adjustments are set out in Appendix 2.

5. Results

The data we set out in section 4, above, suggests that while the use of hybrid instruments has been growing, so too has the tendency for these instruments to be classified incorrectly. The vast majority of the instruments we reviewed were structured so that for financial reporting purposes they had a sufficient veneer of equity to be so classified for balance sheet purposes - even though on our approach, they were better viewed as debt than equity.

The tendency of hybrid issuing organisations to misclassify securities which were in substance debt as equity also carried through to the manner in which their profit and loss accounts were configured. Rather than accounting for the cashflows paid to service these obligations as interest expense - as would be the case in the event that instruments had been treated as debt, the payments to security holders were typically treated as distributions of retained earnings.

This also had implications for the presentation of the statement of cashflows, since interest payments are typically classified as cash payments arising from operating activities, whereas distributions of retained earnings are typically classified as cash payments arising from financing activities.

In summary therefore, the root error of balance sheet misclassification led to three key distortions of firm financial statements. The first and most obvious of these was the potential for the emergence of a distorted understatement of the issuing firm's leverage. The second was the potential for an overstatement of earnings and the third an overstatement of net cashflows from operating activities. By carrying out the adjustments we discuss in section 4, above, we measured the mean impact across our sample of these three distortions, and set out the results relating to leverage, earnings and cashflows in tables 10, 11 and 12, respectively, on the following page.

Table 10: Mean Debt-to-Equity Ratio 1998 to 2004

Year	Financial Issuers			Non-Financial Issuers		
	Reported (times)	Adjusted (times)	Difference (%)	Reported (times)	Adjusted (times)	Difference (%)
1998	n/a	n/a	n/a	1.11	1.13	1.3%
1999	13.65	14.88	9.0%	1.09	1.11	1.1%
2000	16.70	20.46	22.6%	1.26	1.60	27.0%
2001	15.58	18.19	16.7%	1.42	1.86	31.2%
2002	12.71	13.94	9.7%	1.10	1.43	30.3%
2003	12.76	14.84	16.3%	1.14	1.49	30.1%
2004	12.92	14.84	14.9%	1.28	1.68	31.0%

Table 11: Size of Overstatement in After Tax Earnings 1998 to 2004

Year	Financial Issuers			Non-Financial Issuers		
	min Δ	max Δ	Mean Δ	Min Δ	max Δ	mean Δ
1998	0.00%	0.00%	n/a	0.02%	1.29%	0.55%
1999	0.38%	0.40%	0.39%	0.02%	2.77%	0.72%
2000	1.75%	3.89%	2.87%	0.04%	5.68%	1.85%
2001	0.26%	7.98%	3.57%	0.03%	13.00%	4.59%
2002	0.90%	7.28%	3.13%	0.03%	10.82%	4.25%
2003	1.25%	5.38%	2.82%	0.03%	14.47%	6.08%
2004	1.93%	6.17%	3.35%	0.02%	16.13%	5.40%

Table 12: Change in Operating Cash flow 1998 to 2004

Year	Financial Issuers			Non-Financial Issuers		
	min Δ	max Δ	Mean Δ	Min Δ	max Δ	mean Δ
1998	0.00%	0.00%	n/a	0.04%	2.16%	0.74%
1999	0.45%	1.60%	1.02%	0.02%	3.33%	0.85%
2000	1.81%	6.01%	3.27%	0.03%	8.44%	2.81%
2001	0.49%	6.44%	3.46%	0.04%	5.90%	2.75%
2002	1.27%	12.89%	4.27%	0.02%	6.10%	2.53%
2003	1.23%	25.36%	5.54%	0.02%	14.42%	4.47%
2004	1.21%	8.87%	3.30%	0.02%	27.41%	5.81%

As predicted, misclassification of hybrid financial securities materially impacted on reported leverage - with leverage for the financial institution issuers in our sample understated by approximately 15% in 2004, and twice that effect for non financial institution issuers. On the data before us, it appears that the capacity to massage apparent leverage is a major attraction of the use of hybrid instruments.

Further, we detected material effects on reported after tax earnings. By 2004, we estimate that the mean magnitude of overstatement in after tax earnings was in the order of 3.5% for financial institution issuers of hybrids, and almost 5.5% for non financial institution issuers. Further, we detected instances where the degree of overstatement in after tax earnings was very substantially larger than this - 25.36% in the case of one financial institution issuer and 27.41% in the case of one non financial institution issuer. This solidifies the proposition that the object of the hybrid regulatory arbitrage is not simply to game apparent leverage, but also to impact on reported earnings.

Since cashflow from operating activities is generally accepted to be a vital metric pertaining to organisational financial health and value generation intensity (e.g see; Naser, 1993; Mulford & Comiskey, 2002), we also tested for the degree of impact on cashflow presentation brought about by hybrid misclassification. As the data set out in Table 12 shows, there were also material impacts here - of a similar magnitude to those detected in relation to after tax earnings.

Our results indicate the presence of the effect of substantial distortions to financial statement numbers arising from material deviations from the ideal of presenting reports on a substance over form basis. Each of the problems we detected could have consequences for shaping the form of investment decisions, apparent conformity with contractual obligations and the measurement of financial performance and risk. We take the view that this represents an unacceptable state of affairs, something we consider in greater detail in our conclusion, below.

6. 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 me 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 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. **JARAF**

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Appendix 1

Sample Companies Categorisation and Market Capitalisation at Start and End of Sample Period

Category	ASX Code	Market Capitalisation (\$ million) 1998	Market Capitalisation (\$ million) 2004
Financial	ADB	394.14	768.77
	AMP	21,949.44	13,452.78
	ANZ	13,779.17	33,743.38
	BEN	189.41	1,248.94
	CBA	17,382.88	40,920.48
	MBL	2,299.44	7,589.61
	NAB	29,720.74	40,881.98
	QBE	2,146.80	10,683.60
	SGB	6,240.80	11,141.24
	WBC	17,975.07	32,729.58
Financial Sub-total (n=10)		112,077.88	193,160.36
Non-financial	AMC	691.90	778.10
	CML	2,251.32	3,305.97
	CRG	51,120.37	79,663.48
	DJS	1,521.85	1,192.42
	FXJ	1,060.40	422.79
	LEI	7,051.78	10,812.55
	NWS	5,945.89	11,633.70
	ORI	2,652.53	4,960.16
	SEV	359.64	486.13
	STO	1,473.78	2,475.70
	VRL	4,519.43	6,043.69
	WOW	2,190.02	4,731.38
Non-financial Sub-total (n=12)		80,838.91	126,506.06
Grand-Total (n=22)		192,916.80	319,666.42

Appendix 2

Formulae Used in Calculation of Ratios

RATIO	FORMULA
Reported debt-to-equity ratio	$[\text{Total Liabilities}] / [\text{Shareholder Equity}]$
Adjusted debt-to-equity ratio	$[\text{Total Liabilities} + \text{Hybrid Value}^{\#}] / [\text{Shareholder Equity} - \text{Hybrid Value}^{\#}]$
Change in operating cash flow	$[\text{Hybrid Distribution}^{\#\#}] / [\text{ABS}(\text{Reported Net Operating Cash Flow})]$
Earnings overstatement	$[\text{Hybrid Distribution}^{\#\#} * (1 - \text{Tax Rate})] / [\text{ABS}(\text{Reported NPAT})]$

[#] Where hybrid value is incorrectly classified as equity

^{\#\#} Where hybrid distribution is incorrectly classified as dividend

Footnotes

1 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.

2 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).

3 And thus its Australian corollary - AASB 132 Financial Instruments: - Disclosure and Presentation.

4 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.

5 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 □ financial reporting standards.

6 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.

7 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.

8 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).

9 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.

10 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, i□ 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.”

11 In December 2003.

12 AASB 132: Financial Instruments Disclosure and Presentation.

13 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.

14 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.

15 Andrew Waddell, National Australia Bank, as quoted in CFO, Boardroom Briefing Supplement, May 2004, p.5.

16 Pittaway, N. (2001), ‘Enhancing Shareholder Value Through Capital Risk Management - An Investor’s Perspective’, Conference Proceedings, Aon Re Australia Limited, p.139.

17 Presumably this will take place on the scheduled maturity date of the instrument.

18 See Benninga and Sarig (1997), chapter 12.

19 See Copeland, Weston and Shastri (2005), chapter 15.

20 Refer Copeland, Weston and Shastri (2005) and Benninga and Sarig (1997).

21 ERG later suffered financial difficulties and its ordinary share price fell significantly below the conversion price. The company became overwhelmed by the servicing costs on the notes and in 2002□

22 INSTO, July 2001, p.17

23 Press Release (2005), ‘Coles Myer converts ReCAPS as part of capital management program’.

24 An obvious example being other jurisdictions which have adopted or which are moving towards the adoption of IFRS.

25 This was necessary, since one of our avenues of enquiry was to establish the degree to which the misclassification of hybrid instruments impacted on measures of gearing. Given the high gearing of financial institutions in comparison to typical non financial firms, combination of all data into one pool for the purposes of analysis would have resulted in lower overall resolution and less capacity to derive robust and meaningful insights from the data.

26 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.

27 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.