

[by e-mail, 10 July 2008]

Liz

Financial instruments with characteristics of equity

It was good to meet you last night, and I enjoyed your talk.

I would like to take this opportunity to confirm and amplify some of the comments that I made last night, and to respond to some of the questions in the invitations to comment. You will appreciate that my comments are made in a personal capacity and are not those of HSBC.

About me

I am currently a Director in HSBC's Asset and Structured Finance group, where I specialise in accounting issues on leasing and structured finance generally, but am also sometimes called upon to advise colleagues on hybrid capital and financial instruments. Before joining HSBC in November 2004, I spent just over a year as Senior Practice Fellow at the IASB, where I was responsible for its Service Concessions project as well as leasing and property issues.

I worked in KPMG's UK technical accounting group from 1989 to 2003, latterly as a director. For most of that time, my specialist topics included hybrid capital instruments and SPEs, as well as reporting the substance of transactions more generally. While there, I had a big hand in persuading the UK's UITF to take a firm view on the classification of certain types of hybrid capital instrument, and this was instrumental in the FSA (as it is now) agreeing to decouple the regulatory treatment of such instruments from their accounting treatment. So, I have a lot of experience in this area.

Should the FASB/IASB be doing this project?

Something does need to be done for 2011. In my view, the options are:

- converge on a superior new standard - which I think should be the basic ownership approach with some refinements, or
- converge on the better of the existing standards - ie, IAS 32.

Since the latter is not going to happen, the project should go ahead. I think the boards should be able to do a decent job by the end of 2011 if they agree (as soon as politically possible) to concentrate on a single approach.

Why the basic ownership approach?

My initial reaction to the basic ownership approach was negative: "it's too simplistic - FASB is just avoiding the hard questions - what's wrong with what we've got?" But, on reflection, I think it is right.

Mainly, this is because I believe that, although financial statements are used by multiple users, the financial statements of listed entities (which must be our focus) do have a primary user and that is the ordinary shareholder. I therefore believe that anything that represents a cost to (current) ordinary shareholders should be reflected as an expense. An enormous amount of creativity is currently (mis)directed to obscuring this basic truth. The basic ownership approach should fix this.

I appreciate that neither FASB nor the IASB acknowledges the existence of a primary user. However, even if you do not agree that the ordinary shareholder is the primary user, I think that it is impossible to determine how to account for complex financial instruments without agreeing on a perspective to be

applied - and I think the ordinary shareholder perspective is appropriate because (1) it is by far the most relevant perspective for ordinary shareholders; (2) it is a perfectly adequate perspective for other users, including providers of debt capital, regulators, suppliers, employees, and other stakeholders; and (3) it is transparent and easy to understand.

My further comments below address some of the questions in the invitations to comment, in respect of the basic ownership approach only.

FASB questions

Perpetual instruments

I am more than happy for perpetual instruments (both preference shares and debt) to be accounted for as liabilities, if they are not BOIs.

On measurement the usual principles of IAS 39 (or equivalent US GAAP) should apply. This means amortised cost accounting, with the separation of embedded derivatives, unless the fair value option is used.

The only issue then is how to treat those perpetual instruments where distributions/coupons are not mandatory, if amortised cost is adopted. I don't think there is a problem with cumulative instruments - just accrue in the usual way (as interest expense). Accounting for non-cumulative entitlements is more tricky conceptually, but on pragmatic grounds I would just account for them on a paid basis (again as interest expense), which is similar to what FAS 150.22 currently achieves for non-mandatory distributions on mandatorily redeemable instruments.

Separation

I agree with the separation principle in para 25 of FASB's document, although the example there is rather obscure and I am grateful to you for drawing my attention to the dividend example in para 5 of the invitation to comment. Whilst this example is perhaps more important under the ownership-settlement approach, it is still useful to have it under the basic ownership approach.

Substance

It is vitally important to have a substance principle, and I agree with the example given in paragraph 45. But there are other areas where a substance principle needs to be applied. Two that we touched on last night were consolidation, and deferred shares.

Consolidation

Currently, FASB proposes (in para 29) that BOIs of consolidated entities would retain their basic ownership nature in the consolidated financial statements unless their characteristics are different in the context of consolidated financial statements. An example that would lead to the reclassification as a liability on consolidation is the provision of a parent company guarantee. But many other arrangements can be devised to give a similar result.

More generally, I believe that the classification of BOIs of consolidated entities should be based on their substance, as follows:

- a BOI of a substantive business entity (which would need to be defined, which is the hard part!) is an equity minority interest (subject to the caveat in para 29);

- a BOI of any other consolidated entity is a liability (which could be limited recourse and could be asset linked).

If this is thought to be too difficult (and I know that accounting for liabilities linked to non financial assets is difficult and controversial), then as a minimum the substance principle should require BOIs of consolidated entities to be classified as liabilities if the arrangements as a whole are designed to give the BOI holders essentially a lender's return .

Of course, this whole issue interacts with the consolidation project and should not be considered in isolation from it. For example, SPE issuers of trust preferreds generally are not consolidated under FIN46R, which leads to the group reporting the debt owed to the SPEs, whereas such SPEs generally are consolidated under SIC-12 (following the first example in the Appendix), which leads to the group reporting the ownership interests in the SPEs according to their classification under IAS 32 (which is often, but not always, as equity). I think the right answer is to consolidate the SPEs (for the reasons given in SIC-12), but to classify the ownership interests as liabilities on consolidation, which is their substance.

Deferred shares

The existence of relatively worthless deferred shares (which often arises as a result of corporate restructurings) must not preclude equity treatment for the ordinary shares, if they are in substance the true equity.

Measurement

I am quite content that more derivatives would be measured at fair value with changes in their value reported in profit or loss. I can't think of any that should not be.

Presentation

I am not convinced that it is necessary to present redeemable BOIs separately on the face of the statement of financial position, especially as this is only one aspect of liquidity that users will be interested in. For example (and of particular importance for financial institutions) there will also be instruments with discretionary distributions reported as debt. Many of these instruments will be perpetual.

I think liquidity/solvency is best addressed by other disclosures outside of the statement of financial position. In IFRS, this could be addressed through an amendment to IFRS 7.

As regards the income statement, I would just apply the existing rules on presentation, so that all recognised gains and losses in respect of liabilities (or assets) will be in profit or loss, either as interest expense or derivative gains and losses. I would resist the temptation to allow anything to be put in other comprehensive income, as this would be likely to be abused.

IASB questions

Scope

I have no particular problems with the scope and would not wish to carve anything out. However, I would have expressed the scope differently, by saying that all financial instruments would be within the scope of the standard, to the extent that it applies to them. The standard would then:

- specify how to determine whether financial instruments are (or contain) BOIs;
- specify the accounting and disclosure for BOIs;

- require instruments that are not BOIs to be accounted for as financial assets and/or liabilities, and disclosed, in accordance with other relevant standards.

To the extent that other standards currently assume equity treatment for an instrument that is now a liability, there would need to be consequential amendments to them.

Jurisdictions

I deal with a few jurisdictions in my current role and cannot think of any reason why the principles in the FASB document would not be appropriate for them. If there are regulatory problems anywhere, the solution should be to decouple the regulation from the accounting.

Regards

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