Better communication —A table is worth 1,000 words

Pat Finnegan

Pat Finnegan, a member of the International Accounting Standards Board® (the Board), offers his perspective on the need to improve the disclosure effectiveness about a company's capital structure and some thoughts about how companies might do so. Investor input into this issue will be useful for the IASB's ongoing projects dealing with improving the effectiveness of disclosure and with Financial Instruments with Characteristics of Equity.

Where do investors find detailed information about liability and equity claims comprising a company's capital structure? Some may say the annual or interim report. Others say it depends on whether a company is involved in a pending transaction, such as a sale of bonds, equities—or a recapitalisation or a merger.

In the case of pending transactions, it is common for companies to provide a table—known as a capitalisation table or 'cap table' in a prospectus or proxy statement to reflect the 'before and after' effects of such transactions on the capital structure. Even though such a table is not required by IFRS, it is often required by securities regulations[1]. The purpose of such a table is to disclose the liability and equity claims of a company that comprise its capital structure along with key terms about those claims and how the claims are expected to change following a transaction.

Table 1 illustrates a company's capital structure without the effect of any transactions. Later in this discussion, a more detailed format of a cap table is illustrated that might be used to display the components of, and changes in, a company's capital structure.

Table 1—Example of a capitalisation table

	As of 1 Jan 20XX
Senior secured loan	2,500
Junior secured loan	1,500
Subordinated note(s)	1,000
Finance leases	450
Pension plan deficit	500
Other financial liabilities*	500
Liabilities	**6,450**
Other equity instruments*	1,000
Non-controlling interest	415
Shareholders' equity	1,350
Group equity	**2,765**
Total capitalisation	**9,215**

* The total amounts aggregated within 'Other financial liabilities' and 'Other equity instruments' correspond to the total amount of instruments labelled 'Contingent capital notes' and 'Cumulative preference shares' presented in Table 2.

1 The US Securities and Exchange Commission published a Concept Release on 13 April, 2016 seeking comments on whether to revise the business and financial disclosure requirements in Regulation S-K, which is the SEC's principal regulation for both business and financial disclosure, albeit with an emphasis on non-financial disclosure matters. See discussion under Section IV, D of the Concept Release for questions related to this discussion.

IFRS®

IFRS® Standards currently include some disclosure requirements about a company's capital structure. For example, IFRS 7 *Financial Instruments: Disclosure* requires some specific disclosures about financial liabilities, however it does not have similar requirements for equity instruments. Also, IAS 1 *Presentation of Financial Statements* requires a company to disclose information in the financial statements to evaluate a company's objectives, policies and processes for managing capital (See paragraphs 134–138). The notion of capital in this context is often just focused on equity or share capital, however, some companies include debt instruments in their description of capital. For investors, assessing what companies consider to be capital and the changes in capital is challenging because the information is rarely prepared with financial details. Because there is no overall requirement, disclosures about a company's capital structure are often spread across management commentary and the notes to financial statements and include broad statements about the goal of optimising the weighted average cost of capital without providing the details to support or to evaluate such statements.

Investors expect management to exercise stewardship when making capital structure decisions dealing with the mix of equity and debt, the relative costs of each, the relative returns to each holder and the implications on the company's liquidity and solvency.

Why is information about the capital structure important?

The two broad classes of capital reported on the balance sheet are debt[2] and equity. However, even within these broad classes there are a variety of debt and equity claims with different levels of seniority and subordination, each with its own rights, benefits, costs and risks. Investors expect management to exercise stewardship when making capital structure decisions dealing with the mix of equity and debt, the relative costs of each, the relative returns to each holder and the implications on the company's liquidity and solvency. Hence, the details underlying a company's capital structure are absolutely essential to assessing the prospects for changes in a company's financial flexibility, and ultimately, its value.

What information is available today?

If a company is not involved in a pending transaction, it is uncommon to find cap tables in periodic reports to shareholders. While the information on the face of the balance sheet and disclosures in the notes furnish some details about a company's liability and equity claims, those disclosures are fragmented and frequently lack the details that creditors and shareholders seek.[3]

While some regulated entities, for example, bank holding companies, provide reconciliations between reported IFRS equity and regulatory capital, those tables do not provide the kind of comprehensive information investors need to understand the rights and obligations relating to liability and equity claims at either a consolidated group level or on a legal-entity level. As a result, current and prospective investors and lenders must review a number of documents, for example, annual reports, interim reports, proxy statements, indentures, credit agreements and prospectuses to piece together the details of a company's capital structure.

2 IFRS Standards do not define debt. My use of the term 'debt' in this context is meant to include all forms of a company's short and long-term liabilities whether they arise from a company's operating decisions (sale of goods or services) or its financing decisions (receipt of cash for later payments of cash).

3 A wide range of information is of interest to creditors and shareholders. The following is a 'brief' list of issues developed from my discussions with investors that have a bearing on a company's liquidity position, solvency, reported profit or loss, or distribution of returns: a) comprehensive list of all claims (on or off balance sheet in order of priority of claim in bankruptcy), b) cross-default provisions, c) key terms dealing with seniority of claims—both contractual and structural, d) legal entity identity of obligations, e) acceleration of claim clauses, f) terms of variable interest rates, g) credit ratings and events tied to credit ratings, h) rating agency treatment of hybrid instruments, i) key covenants and 'headroom' under financial covenants, j) existence of upstream and downstream guarantees (senior or subordinated in nature), k) hedging policies for risks such as interest rates and foreign exchange, l) seniority of other obligations such as trade payables, environmental liabilities or pensions, m) voting rights of various classes of stock and restricted sale provisions, n) conversion features, 'bail-in' features, and regulatory approvals for payments, o) dividend restrictions, p) share repurchase plans.

Two related projects—the Conceptual Framework and Financial Instruments with Characteristics of Equity

For the past two years, the International Accounting Standards Board (the Board) has been consulting stakeholders about the definitions of elements to financial statements—how IFRS Standards should define assets, liabilities, equity, income and expenses in the context of the Board's *Conceptual Framework*.

In conjunction with this work, the Board has a research project underway which is investigating the challenges of, and improvements to, accounting for financial instruments that have characteristics of both liabilities and equity. Recent innovations in the development of financial instruments (for example, contingent convertible, or CoCo bonds) have added more layers to capital structures making them more difficult to explain to investors. Determining the best way to report the effects of recent innovations in capital structure is one of the challenges the Board is considering.

Collectively, this work is expected to help the Board to decide whether it should add a project to its standards-setting agenda. Such a project would consider how to distinguish liability claims from equity claims, as well as changes to the presentation and disclosure requirements within liabilities and equity to provide better information about an entity's capital structure.

There are a host of issues that the Board will need to resolve in this area. These include how the competing objectives of the information about claims (for example, effects on liquidity, solvency, performance and returns to holders of a particular class) affect classification of claims as liabilities or equity and, ultimately, how changes in the measurement of such claims affect the reporting of financial performance. The discussion of those issues will likely be challenging and lengthy. However, the Board has accepted that regardless of how it decides to address the distinction between liabilities and equity, additional information will be required about other differences between various types of liabilities and equity. This additional information will be needed to provide an understanding about the characteristics of complex instruments regardless of how such instruments are classified.

Soon the Board will consider improvements to the disclosure requirements to assist in providing this information to investors. I believe that one of the disclosures that the Board could consider would include the information suggested by Tables 1 and 2 along with relevant footnotes to explain the key terms of instruments and changes during periods presented – in a tabular format. Such information would help to meet the various information needs of both current and prospective investors and lenders in a clear, concise and relevant way.

It is really no surprise that many of the respondents to the Board's consultation on its future agenda (Request for Views) reinforce the need and the urgency for more comprehensive information about the issues discussed above. (IASB April 2016 Board Paper – 5C).

1 IAS 32 *Financial Instruments: Presentation*

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What do you think?

Should there be a more efficient and effective way for investors and lenders to obtain a comprehensive picture of the rights and obligations created by a company's liability and equity claims? It would be useful to hear your views about how such information might be designed or displayed. An example is provided below for your consideration. What other disclosures might be useful?

By disaggregating the components of financial capital, and providing information about the key characteristics of different classes of instruments, investors will see a more clear and consistent picture of a company's capital structure from period to period. I understand that some may question the value of repeating information that may already be disclosed; I agree that repetition should be avoided and so, I would favour the disclosure of capital structure information in one place in accordance with one set of standards. Context matters greatly to investors; so a single place for such information would be a more effective way to communicate compared to existing practice.

Raising the bar on disclosures

In the past several years there has been heightened discussion about the issue of 'disclosure effectiveness' in corporate reporting. Standards setters, regulators, accounting firms, investors and companies alike have been focused on the issue of how to deliver more concise and relevant information to investors. Links to three recent examples are included below for your reference.

Examples of work on disclosure effectiveness:

Link to US Securities and Exchange Commission's April 2016 Concept Release:

Business and Financial Disclosure Required by Regulation S–K

Link to European Securities and Markets Authority's October 2015 Statement:

Improving the quality of disclosures in the financial statements

Link to the Board's Snapshot on IFRS Practice Statement: *Application of Materiality to Financial Statements*.

Snapshot: IFRS Practice Statement

Table 2—Example of a capitalisation table and reconciliation of changes (summary version of table with changes)

	As of 1 Jan 20XX	Total changes during period	As of 31 Dec 20XX
Senior secured loan	2,500		2,500
Junior secured loan	1,500	75	1,575
Subordinated note(s)	1,000	(75)	925
Finance leases	450		450
Pension plan deficit	500	50	550
Liabilities	**5,950**	**50**	**6,000**
Contingent capital notes**	750		750
Cumulative preference shares**	750		750
Instruments with characteristics of both liabilities and equity	**1,500**		**1,500**
Non-controlling Interest	415	27	442
Shareholders equity	1,350	165	1,515
Group equity	**1,765**	**192**	**1,957**
Total capitalisation	**9,215**	**242**	**9,457**

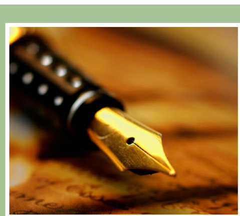
** The total amounts aggregated within 'Other financial liabilities' and 'Other equity instruments' correspond to the total amount of instruments labelled 'Contingent capital notes' and 'Cumulative preference shares' presented in Table 1.

Table 3—Disaggregation of changes presented in table 2

	As of 1 Jan 20XX	New issuance	Redemption	Change in OCI	Net Profit	Share Re-purchase	Exec Compensation	Dividends	Total Changes During Period	As of 31 Dec 20XX
Senior secured loan	2,500									2,500
Junior secured loan	1,500	75							75	1,575
Subordinated note(s)	1,000		(75)						(75)	925
Finance leases	450									450
Pension plan deficit	500			50					50	550
Liabilities	**5,950**								**50**	**6,000**
Contingent capital notes**	750									750
Cumulative preference shares**	750									750
Instruments with characteristics of both liabilities and equity	**1,500**								**0**	**1,500**
Non-controlling Interest	415				42			(15)	27	442
Shareholders equity	1,350				238	(50)	60	(83)	165	1,515
Group equity	**1,765**				**280**	**(50)**	**60**	**(98)**	**192**	**1,957**
Total capitalisation	**9,215**	**75**	**(75)**	**50**	**280**	**(50)**	**60**	**(98)**	**242**	**9,457**

Get in touch

If you would like to discuss this topic or other areas of accounting, please contact: Patrick Finnegan at pfinnegan@ifrs.org



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