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Debt vs Equity

Accounting, Companies Act and everything inbetween…

Introduction

Definition of Liability vs Equity

- Liability
  - A present obligation of the entity
  - As a result of past events
  - The settlement of which is expected to result in an outflow of resources from the enterprise

- Equity
  - = Assets – Liabilities

- Current vs Non current
- Terms and conditions

Why have preference shares become so popular?

- Companies Act
- Looking for finance
- Turning debt into equity
- Tax planning....

Companies Act and Accounting

Companies Act definitions

“securities” means any shares, debentures or other instruments, irrespective of their form or title, issued or authorised to be issued by a profit company;

“share” means one of the units into which the proprietary interest in a profit company is divided;

“shareholder”, subject to section 57 (1), means the holder of a share issued by a company and who is entered as such in the certificated or uncertificated securities register, as the case may be;

“shareholders meeting”, with respect to any particular matter concerning a company, means a meeting of those holders of that company’s issued securities who are entitled to exercise voting rights in relation to that matter;

43. Securities other than shares

(1) In this section—

(*a*) “debt instrument”—

(i) includes any securities other than the shares of a company, irrespective of whether or not issued in terms of a security document, such as a trust deed; but

(ii) does not include promissory notes and loans, whether constituting an encumbrance on the assets of the company or not; and

b) “security document” includes any document by which a debt instrument is offered or proposed to be offered, embodying the terms and conditions of the debt instrument including, but not limited to, a trust deed or certificate.

(**2) The board of a company—**

(a) may authorise the company to issue a secured or unsecured debt instrument at any time, except to the extent provided otherwise by the company’s Memorandum of Incorporation; and

(b) must determine whether each such debt instrument is secured or unsecured.

(3) Except to the extent that a company's Memorandum of Incorporation provides otherwise, a debt instrument issued by the company may grant special privileges regarding—

(*a*) attending and voting at general meetings and the appointment of directors; or

(*b*) allotment of securities, redemption by the company, or substitution of the debt instrument for shares of the company, provided that the securities to be allotted or substituted in terms of any such privilege, are authorised by or in terms of the company's Memorandum of Incorporation in accordance with section 36.

(4) Every security document must clearly indicate, on its first page, whether the relevant debt instrument is secured or unsecured.

(5) A company may appoint any person, including a juristic person, as trustee for the holders of the company's debt instruments, if—

(*a*) the person—

(i) is not a director or prescribed officer of the company, or a person related or interrelated to the company, a director or a prescribed officer; and

(ii) does not have any interest in, or relationship with, the company that might conflict with the duties of a trustee; and

(*b*) the board is satisfied that the person has the requisite knowledge and experience to carry out the duties of a trustee.

(6) Any new trustee appointed for the purpose of this section must—

(*a*) satisfy the requirements of subsection (5) (*a*); and

(*b*) be approved by the holders of at least 75% by value of debt instruments present at a meeting called for that purpose.

<u>(7) Any provision contained in a trust deed for securing any debt instruments, or in any agreement with the holders of any debt instruments secured by a trust deed, is void to the extent that it would exempt a trustee from, or indemnify a trustee against, liability for breach of trust, or failure to exercise the degree of care and diligence required of the prudent and careful person, having regard to the provisions of the trust deed respecting the powers, authorities or discretions of the trustee.</u>

(8) Subsection (7) does not invalidate—

(*a*) any release validly given in respect of anything done or omitted to be done by a trustee before the giving of the release; or

(*b*) any provision of a debt instrument—

(i) enabling a release to be given with the consent of the majority of not less than three fourths (75%) in value of the holders of debt instruments present and voting at a meeting called for the purpose; and

(ii) with respect to a specific act or omission, or of the trustee dying or ceasing to act.

Points to note

- Companies Act follows IFRS/IFRS for SMEs
- Therefore:
  - Debt or equity instruments
  - Won’t see reference to ordinary share, preference share, or debenture in Companies Act
  - Needs to be defined in MOI
- Shareholder
  - Instrument that holds the right to vote
- Build a Bear workshop…..

Pref shares - Are they equity?

- Depends on terms and conditions
- Terminology of Preference Share vs Debenture has little to no impact per IFRS/IFRS for SME's or Companies Act
- Could be:
  - Equity
  - Debt
  - Compound Financial Instrument

S45 Financial Assistance and IFRS 9

S45 Loans or other financial assistance to directors

(1) In this section, “financial assistance”—

(*a*) includes lending money, guaranteeing a loan or other obligation, and securing any debt or obligation; but

(*b*) does not include—

(i) lending money in the ordinary course of business by a company whose primary business is the lending of money;

(ii) an accountable advance to meet—

(*aa*) legal expenses in relation to a matter concerning the company; or

(*bb*) anticipated expenses to be incurred by the person on behalf of the company; or

(iii) an amount to defray the person’s expenses for removal at the company’s request.

(2) Except to the extent that the Memorandum of Incorporation of a company provides otherwise,

the board may authorise the company to provide direct or indirect financial assistance to a director or prescribed officer of the company or of a related or inter-related company, or to a related or inter-related company or corporation, or to a member of a related or inter-related corporation, or to a person related to any such company, corporation, director, prescribed officer or member, **subject to subsections (3) and (4).**

(5) If the **board of a company adopts a resolution** to do anything contemplated in subsection (2), the company **must provide written notice of that resolution to all shareholders**, unless every shareholder is also a director of the company, **and to any trade union representing its employees**—

(*a*) **within 10 business days** after the board adopts the resolution, **if the total value of all loans, debts, obligations or assistance** contemplated in that resolution, together with any previous such resolution during the financial year, **exceeds one-tenth of 1% of the company's net worth at the time of the resolution**; or

(*b*) **within 30 business days after the end of the financial year**, in any other case.

(6) A **resolution by the board** of a company to provide financial assistance contemplated in subsection (2), or an agreement with respect to the provision of any such assistance, **is void to the extent that the provision of that assistance would be inconsistent** with—

(*a*) this section; or

(*b*) a prohibition, condition or requirement contemplated in subsection (4).

(7) **If a resolution or an agreement is void** in terms of subsection (6) a **director of a company is liable** to the extent set out in section 77 (3) (*e*) (v) if the director—

(*a*) **was present at the meeting** when the board approved the resolution or agreement, **or participated in the making of such a decision** in terms of section 74; and

(*b*) **failed to vote against the resolution or agreement, despite knowing that the provision of financial assistance was inconsistent** with this section or a prohibition, condition or requirement contemplated in subsection (4).

IFRS and IFRS for SME's

Definition of a Liability

- A present obligation of the entity
- As a result of past events
- The settlement of which is expected to result in an outflow of resources from the enterprise

- Debate – Liabilities vs. Provisions, contingent liabilities
  - Probable vs possible vs remote

Equity instrument

- Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities
- E = A-L
- When assessing liabilities vs. equity
  - Need to look at substance over form
  - Compound financial instruments

What rights and obligations do you have?

- Right to call in instrument
  - Holder vs Issuer
- Additional promises
  - Contingent conditions
- Instruments issues under what intentions?
  - As “currency” ???

Accounting for Financial Instruments

- Focus on loans
- Definition of a Financial instrument
  - Any contract (verbal or written) that
  - Gives rise to a both a financial asset of one entity
  - and a financial liability or equity instrument of another entity (Investments)
- Financial Asset
- Financial Liability vs Equity
  - Obligation
- Terms and conditions and effective interest

Accounting for Financial Instruments

- IFRS for SMEs
  - Amortised cost
  - Cost
  - FV through P&L
  - Transaction costs
  - Hedging
- IFRS
  - IFRS 9
  - FV through P&L
  - FV through Equity
  - Amortised cost
    - Expected Credit loss

Amortisation Schedule (arrears)

	Opening Balance	Interest (10%)	Payment	Closing Balance
Year 1	31 700	3 170	(10 000)	24 870
Year 2	24 870	2 487	(10 000)	17 357
Year 3	17 357	1 738	(10 000)	9 095
Year 4	9 095	910	(10 000)	-

Complications

- Financial Guarantee contracts
- Trade Finance
- Primary vs derivative financial instruments
- Embedded derivatives
- Compound financial instruments
- Debentures vs preference shares
- Hedging

Preference shares

- Standard “non redeemable” = equity, why?
- Cumulative vs. non cumulative
  - At issuer’s discretion = equity
  - Because of their intention
- Redeemable non cumulative pref shares
  - Equity + liability
  - Dividend = equity,
  - notional interest PV of redemption

Methods used to divide compound instruments

- Determine the amount of one instrument (debt) and allocate the balance to the other
- Determine the amount of each portion independently and balance the difference on a pro-rata basis
- Prefer the first approach

- Academically easy to calculate, but problematic in reality
  - Discount rate – need identical pure redeemable debenture in another listed Co
    - Adjust for risks
    - Adjust for differences in tradability
  - Flexible conversion dates
    - Option to convert at different dates under different conditions
    - Compulsory based upon future contingent event

Illustrative example

- 10% cumulative pref shares compulsorily redeemable at par 31/12/2020
  - Liability
- 10% Non cumulative non redeemable preference share
  - Equity
- Cumulative pref share redeemable at par, at the option of the holder at any time (Dividend 10% now, thereafter 20%)
  - Liability
- 10% cumulative pref shares compulsorily redeemable at par upon the death of the holder
  - Liability

- 10% cumulative pref shares convertible into ordinary shares a the option of the holder between 2019 and 2020
  - Split
- 10% convertible debentures convertible into ordinary shares a the option of the holder between 2019 and 2020
  - Split
- 10% cumulative pref shares compulsorily convertible into 20% redeemable debentures in Jan 2020
  - Liability
- Interest free non redeemable debenture
  - Equity

Interest and Dividends

- Mirrors the balance sheet classification
  - Finance costs vs. Dividends

Example

- Directors issue a 10% compulsory Pref share to be converted into ordinary shares in 5 years time for R100 000
  - Annual payment R10000
  - Return of similar debts instruments 10%

- PV(n= 5, i= 10%, pmt = R10000)
  - R37 908 debt element
  - R100 000 – R37 908 = R62 092 equity element

  - Therefore, “dividend” should be split 38 interest:62 dividend

National Credit Act

The National Credit Act, 2005

- National Credit Act, 2005

  Amended by the National Credit Amendment Act 2014 on 13 March 2015

  Affordability assessment regulations applicable from 13 March 2015

Key points

- Scope
- Registration
- Reckless credit
- Incidental credit
- In Duplum
- Debt Enforcement
- Prescription

Scope of the Act

- **Credit providers**
  - Banks
  - Micro lenders
  - Retailers such as clothing and furniture stores
  - All businesses, companies, close corporations and individuals who do business on credit, provide loans, or charge interest on overdue accounts
- **Credit agreements**
  - Mortgage bonds
  - Credit facilities like store cards, bank overdrafts, credit cards, garage cards, personal loans, instalment sales, leases, pawn and discount transactions
  - Developmental credit
  - Incidental credit
  - Credit guarantees

Excluded transactions

- Agreements which are not covered by the Act:
  - Juristic persons whose asset value or turnover > R 1 000 000
  - Small business that enters into a large agreement
  - Agreements where the credit provider and the consumer are related, for example where a husband lends money to his wife (Careful employees)
  - Member of a stokvel borrows money from the stokvel
  - Director of a company lends money to his company
  - Government institution lends or borrows money from any source. For example if a bank borrows money from the South African Reserve Bank

- Levies charged by body corporates??

Incidental Credit Agreement

- An agreement, irrespective of its form, in terms of which an account was tendered for goods or services that have been provided to the consumer, or goods or services that are to be provided to a consumer over a period of time and either or both of the following conditions apply:
  - A fee, charge or interest became payable when payment of an amount charged in terms of that account was not made on or before a determined period or date; or
  - Two prices were quoted for settlement of the account, the lower price being applicable if the account is paid on or before a determined date, and the higher price being applicable due to the account not having been paid by that date
- Only specific portions of the Act are applicable to incidental credit agreements
- The provisions dealing with the registration criteria are not applicable to incidental credit agreements
- If a Credit Provider **only supplies incidental credit**, they **do not need to register**

Types of agreements

- **Small:**
  - Pawn transaction
  - Up to R 15 000
  - Excluding a mortgage
- **Intermediate:**
  - Between R 15 001 and R 250 000
  - Excluding a pawn transaction and mortgage
- **Large:**
  - More than R 250 000
  - Mortgage

Registration requirements

- The NCA only required credit providers with at least 100 credit agreements or a total principal debt of R 500 000 to be registered credit providers
- The Amendment Act removed both requirements
- **New:** On **11 May 2016**, the Department of Trade and Industry announced in Government Gazette 39981 that the new credit provider registration threshold will be **Nil (R0)**
- The essence of the newly set threshold is that **any person who grants credit** within the ambit of the National Credit Act (NCA), irrespective of the principal debt, **must apply to be a registered credit provide**r with the National Credit Regulator (NCR) before giving a loan or granting credit
- Warning: The Act applies to ALL credit providers – whether they are required to be registered or not

- **Effective 6 months after gazetted – therefore 11 November 2016**

Effect of new registration threshold

- Any person providing **more than one loan** bearing interest at commercial rates must register as a credit provider
- The person must follow the registration process
  - Providing the NCR with CIPC documents, auditor details, details of the total value (principal debt) of all credit agreements entered into during the most recent financial year, and signed resolutions and criminal name clearance certificates for all directors
- Pay an application fee of R 550, an initial registration fee, branch fee of R 250 and annual renewal fee
- Possible administrative fines may be handed down by the National Consumer Tribunal for a failure to register as a credit provider

Impact on employers

- Interest free **salary advances** which must be repaid within a specified period of time
  - Because no compensatory interest is levied the transaction falls outside the ambit of the Act
- Provision of **loans to employees** where there is a maximum amount of time prescribed for repayment and where interest is charged at a nominal rate or linked to prime
  - Loans carry some level of commercial significance and/or advantage to the company
  - Transaction indeed concluded at arm's length
  - View of the NCR that any interest (even a nominal rate) applied to a transaction will render that transaction liable to the effects and protections of the Act
- Provision of **share schemes** where interest-bearing loans are made available to employees
  - Regardless of the intention and purpose the transaction is regarded as credit agreement

Unlawful agreements

- Unlawful:
  - Minors
  - Mentally unfit
  - Under administration
  - Negative option marketing
  - Unregistered providers

Reckless credit

- **New:** Debt counsellors are bound by the Act to investigate whether an over indebted consumer is the victim of reckless lending and to report it to the NCR
- In the past only a court could declare a credit agreement reckless
- **New:** Amendments to the Act now empower the National Consumer tribunal to make findings of reckless lending. This will result in swifter action against errant lenders

Reckless credit (cont.)

- Agreement is reckless if, at the time the agreement was made:
  - Credit provider failed to take reasonable steps to assess:
    - General understanding/appreciation of risks and costs of credit and his rights and obligations
    - Debt re-payment history under credit agreements
    - Existing financial means, prospects and obligations
    - Whether there is a reasonable basis to conclude that any commercial purpose may be successful, if the consumer has such a purpose for applying for credit
  - Or credit provider made such assessment and entered into agreement, despite the fact that:
    - Consumer did not understand/appreciate the risks, costs or obligations

Pre-agreement statements

- **New: Credit cost multiple**: The ratio of the total cost of credit to the advanced principal debt, that is, the total cost of credit divided by the advanced principal debt expressed as a number to two decimal places
- **Disclose** the credit cost multiple and total cost of credit in the pre-agreement statement and quotation
- Ensure that the **attention** of the prospective consumer is drawn to the credit cost multiple
- Ensure that the cost of credit is **understoo**d by the prospective consumer
- Disclose a total cost of credit that **includes** the following items:
    - The principal debt
    - Interest
    - Initiation fee, if any
    - Service fee aggregated to the life of a loan
    - Credit insurance aggregated to the life of a loan

Fees and interest rates

- **New:** On **6 May 2016**, the **Limitations on Fees and Interest Rates** Regulations (Final Regulations) in terms of the National Credit Act, 2005 (NCA) came into effect
- The maximum interest rates based on the current repo rate of 7%, which may be levied by credit providers in respect of:
  - Home loans will be 19% (18,75%) per year;
  - Credit cards and store cards will be 21% (21,48%) per year; and
  - Unsecured credit transactions will be 28% (26,48%) per year.
  - Incidental credit will be 2% (2%) per year.
- The maximum initiation fees which credit providers may levy on in respect of:
  - Home loans are R 5 250
  - Credit cards and store cards are R 1 050
  - Unsecured credit transactions, short term credit transactions and other credit agreements are R 1 050

In duplum rule

- Means “double the amount”
- Common law rule
  - Provides that interest on a debt will cease to run where the total amount of arrear interest has accrued to an amount equal to the outstanding principal debt
- Statutory *in duplum rule: Section 103(5)*
  - Refer to amounts contemplated in section 101(1)(b) to (g)
    - Initiation fees
    - Service fees
    - Interest
    - Insurance
    - Default administration charges
    - Collection costs

Credit insurance

- Credit insurance:
  - May not exceed the outstanding obligation
  - Reduce cover as the outstanding balance reduces
  - Home loan: May not exceed the value of the property
  - May not be forced to take insurance offered by the credit provider
  - Premiums may not be capitalised upfront
  - May require credit life insurance

Debt enforcement

- Debt enforcement
  - Not allowed to retain:
    - ID, Debit or credit card, ATM card, PIN number
- Notify in writing (Section 129 letter by registered post)
- Options:
    - Consult a debt counsellor
    - Contact credit provider for alternative payment arrangements within 10 days
- Automatic removal of adverse consumer credit information
  - Previous amnesty
- Release of information for credit checks??
- Debt Counselling
  - Debt Clearance certificate
  - Payment distribution agent
- Affordability assessment

Necessary Expenses table

Minimum	Maximum	Minimum monthly Fixed Factor	Monthly Fixed Factor = % of Income Above Band minimum
R 0,00	R 800,00	R 0,00	100%
R 800,01	R 6 250,00	R 800,00	6,75%
R 6 250,01	R 25 000,00	R 1 167,88	9,00%
R 25 000,01	R 50 000,00	R 2 855,38	8,20%
R 50 000,01	Unlimited	R 4 905,38	6,75%

New Child Maintenance Bill

- Parents who default on child maintenance:
    - Be prevented from accessing more credit
    - Details will be handed to the credit bureau
- If a defaulter cannot be traced, **the cour**t will now be able to give **an order to cellphone service providers** to give the **contact details** of the defaulter to the courts

Prescription

- **Debt prescribed if:**
  - No knowledge for > 3 years (verbally or in writing)
  - Not acknowledged to pay
  - No promises to pay
  - No summons issued
  - Onus was always on consumer to claim prescription
- **Types of debts that can prescribe after 3 years:**
  - Retail accounts
  - Credit card accounts
  - Telkom accounts
  - Personal loans
  - Gym membership
  - Cellphone accounts
  - Monies owed on vehicle finance

Prescription (cont.)

- **Debt that only prescribes after 30 years**
  - Mortgage
  - Tax (now 15)
  - Municipality debt e.g. rates
  - TV License
- **New:** It is now unlawful for a credit provider to attempt to collect a debt that has prescribed or to sell debt that has prescribed
- **New:** No more selling of book debts
- **New**: Consumer don’t have to raise prescription
- Credit providers are also urged to notify consumers when they decide to sell their debt to another company

QUESTIONS

THANK YOU FOR YOUR PARTICIPATION

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