Brazilian Accounting Standards Board

IASB EMERGING ECONOMIES GROUP December 5th 2012

Issue for discussion: Hybrid/compound financial instruments

Paper Topic: Did EEG members face discussions about the appropriate classification of such instruments between Liabilities and Equity in your respective jurisdictions?

This paper has been prepared for the benefit of those participating in the IASB Emerging Economies Group. Its purpose is to discuss some of the issues arising from the debates in capital markets about classifying such instruments between Liabilities or Equity. More specifically the paper aims to address those issues affecting emerging economies.

Introduction

1. The objective of this paper is to provide participants with an overview of the main arguments, pro and con, dealing with classification of hybrid or compound financial instruments in the Statement of Financial Position (Balance Sheet).

2. In this session we aim to generate the discussion of the topic between participants with the view of: a) detecting whether it is a problem generally identified in various emerging economies, and b) if the answer to a) is YES, to determine whether additional guidance may be needed from the IASB to mitigate the issues thus resulting.

3. This paper is structured as follows:

    a. A brief description of the financial instruments involved in this discussion

b. ; A summary description of two leading (actual) cases (names omitted) that occurred in Brazil, with arguments in favor of one classification (Equity) or the other (Liabilities)

Hybrid/compound financial instruments have a potential dual nature of equity and debt, and they make it possible to businesses to issue debt with the characteristic of an option on the future value of the company's equity.

A "compound" financial instrument is defined as a non-derivative that contains "liability" and "equity" elements. A "hybrid" financial instrument is the one that contains an embedded derivative.

In general (and in Brazil in particular) some of the main restrictions to issuing convertible debt are:

- they cannot include any sort of guarantee to the creditor;
- they must be paid in cash to the issuer;
- they can only be redeemed after all other liabilities of the issuer are met;
- they cannot be redeemed at the issuer's will.

Some or all of the above restrictions may be included in issuance of such instruments.

The creditor has no managerial power of decision on the issuing company's businesses, similarly to the investor in preferred stock.

Some of the most usual hybrid/compound financial instruments are:
- debentures convertible in the issuing company's stock
- debentures exchangeable for another company's stock

Remuneration:
The more usual clauses of remuneration of the debentures are:
- indexation to an exchange rate, price index or some other coefficient;

- interest, that may be paid either based on the nominal or on the adjusted value of the debentures
- profit sharing: cases may be found where the remuneration to be due to the creditor is related to some performance indicator of the issuer, most of the times its net income for a given period
- premiums: they are offered in certain situations, like when revision of terms of issuance are put out for creditors' deliberation

Besides Debentures, it is becoming increasingly common to see hybrid financial instruments in form of notes payable, most of them of a "perpetual" nature.

In a couple of leading cases occurred in Brazil, listed companies attempted to classify such as equity.

First leading case to be exemplified:

One of such cases had to do with a perpetual note where interest payments could be deferred at the company's discretion, provided that a trigger stipulated in contract was not put in motion. The company's arguments were, basically:

- the notes issued had a clause whereby interest due could be "deferred" and would not be due unless the company declared and paid "complementary dividends" over and above the minimum legally required or other business decisions under the control of the company;

- as a consequence, the company believed it was entitled to indefinitely defer interest payment, which made the remuneration of the perpetual notes similar to cumulative priority dividends on preferred stock;

- due to this lack of definition of due date – not only when, but also if it would ever become due - the resulting accounting classification of the perpetual notes thus issued should be, in the company's opinion, as equity.

Arguments contrary to the company's position were:

- to defer interest payment does not mean to avoid them – it is a postponement, not a waiver from paying interest;

- dividends payable are not subject to exchange losses, and interests payable are;

- deferred interest are increased if and when paid, and this does not occur with dividends payable;

- the notes are not "subordinated", meaning that if the company goes bankrupt the creditors would be entitled to any remaining net assets before stockholders could claim any rights. This is, in form and substance, a genuine characteristic of a liability;

- there are no "covenants" on equity instruments, and typically the requirement to pay increased interests if complementary dividends are paid meets the definition of a covenant;

- if the company is and continues to be profitable, there are limited ways for it to avoid paying such complementary dividends in the future – and therefore having to pay the deferred interests.

The resulting accounting treatment was to classify these perpetual notes as a liability rather than as an equity instrument.

IFRSs adopted: IAS 32, §§ 11, 15, 16-16D, 19

<u>Second leading case:</u>

A second leading case occurred in Brazil relates to the issuance of a debenture mandatorily convertible in stock. If the holder of the debenture does not voluntarily requests the conversion, prior to maturity, they will necessarily be converted in common stock at due date (the hypothesis of requesting conversion prior to maturity date depends on default of payment of interest by the issuer) – there is no contractual possibility of these debentures being redeemed in cash by the issuer.

The parameters defined in the formula for conversion of the debentures in stock result, in the Management's opinion, in a very limited range of variability, and practically they believed the holder of the debentures shall get a fixed and determinable quantity of common shares.

As a result of this reasoning, the company is of the opinion that the holder of the debentures is exposed to an equity risk rather than to a liability risk and as consequence these debentures would qualify for classification in the equity section of the statement of financial position.

The opposite view raises the issue that there is a floor, a minimum limit for conversion if the stock of the company becomes traded at decreasing prices – and in this case the existing shareholders may be diluted – if there is a floor for the conversion price, the risk of dilution is reduced.

This opposite view claims that the "compound" instrument – convertible debenture issued – comprises a debt instrument as the "host contract" with two embedded derivatives: (i) a put option to "sell" the shares on maturity of the debenture (mandatory conversion) (European option), and (ii) a call option held by the investor/creditor (American option) that may be exercised if and when the company defaults payment interest.

The economic effect under this understanding would be the same as if the company issued a debt instrument and at the same time it would issue a put option and a call option with the same due date.

This understanding would cause the hybrid financial instrument to be separated and classified in part as debt and in part as equity.

In order to turn this "split accounting" operational the suggestion was to measure it at fair value under the revenue approach, using discounted cash flows. The fair value of the hybrid financial instrument in total, on day zero, equals the cash amount received by the issuer from the debenture holder (the transaction price, or the consideration given or received).

The "split" of the hybrid takes into account that there is the obligation to disburse future cash flows to the holder of the instrument, calculated on the basis of the interest payable plus the principal at maturity. The net premium of the embedded options is computed by difference – that is the portion to be accounted for as equity.

IFRSs adopted: IAS 32, §§16-16D, 28-32, AG30-AG35 and IAS 39, §§13, AG64, AG69, AG70, AG71, AG73, AG77, AG78 and AG82.

QUESTIONS FOR EEG:

1)Did you face any similar issues in the market in your jurisdiction?

2) If yes, are there any characteristics that you encountered that may present substantial differences to those described in the "leading cases" summarized above?

3) Were the financial reporting and disclosure decisions in your jurisdictions similar or substantially different from the ones described in the leading cases above?

4) Do you disagree with the accounting treatment adopted in each of the leading cases above (liability in the first one, splitting embedded derivatives in the second one)?

5) Do you believe additional guidance is needed from the IASB and /or IFRIC to deal with these complex financial instruments?

Staff papers presented at the IASB ́s November 2012 Board Meeting

As of November 19, 2012, the following Papers prepared by the IASB Staff were available to be discussed by the Board at its meeting this week. For further understanding of the underlying arguments supporting this discussion, such papers may be consulted. They are:

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5A

5B

5C

5D

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