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Reference: Request for Information – Discussion Paper Financial Instruments with Characteristics of Equity

The Comitê de Pronunciamentos Contábeis - CPC (Brazilian Accounting Pronouncements Committee)¹ welcomes the opportunity to respond to the FICEs DP/2018/1.

We are a standard-setting body engaged in the study, development and issuance of accounting standards, interpretations and guidance for Brazilian companies.

CPC supports the IASB's work to enhance the accounting requirements for the classification of financial instruments, specifically FICEs. We acknowledge that IAS 32 lacks clear and robust classification principles, which might have contributed to divergence in classification outcomes for formally different financial instruments but that have similar economic consequences for the issuer.

As a general comment, it is not clear to us whether the meaning of economic resource is aligned in the articulation of the timing and amount features of the Board's preferred approach. It seems to us that in relation to the timing feature the concept is more linked to the one established in the Conceptual Framework (i.e. assets). However, when dealing with the amount feature the concept is more akin to residual interest (net assets) and performance of the entity. In that respect, we think the IASB's Board should properly clarify the concept, because, apparently, the Board has broadened the definition of available economic resources in the FICE's Discussion Paper (when articulating the amount feature) compared to the concept used in the Conceptual Framework.

Moreover, considering that economic compulsion, economic incentives or implicit obligations might arise from the contractual provisions of the instrument, the Board should consider articulating those concepts into the rationale of the classification principle and not rely only upon the previous requirements of IAS 32.

¹The Brazilian Accounting Pronouncements Committee (CPC) is a standard-setting body engaged in the study, development and issuance of accounting standards, interpretations and guidances for Brazilian companies. Our members are nominated by the following entities: ABRASCA (Brazilian Listed Companies Association), APIMEC (National Association of Capital Market Investment Professionals and Analysts), B3 (Brazilian Stock Exchange and Mercantile & Future Exchange), CFC (Federal Accounting Council), FIPECAFI (Financial and Accounting Research Institute Foundation) and IBRACON (Brazilian Institute of Independent Auditors).



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Yours sincerely,

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Section 1 - Objective, scope and challenge

Question 1

Paragraphs 1.23–1.37 describe the challenges identified and provide an explanation of their causes.

- (a) **Do you agree with this description of the challenges and their causes? Why or why not? Do you think there are other factors contributing to the challenges?**

CPC's response:

CPC agrees with the IASB's description of the challenges and their causes related to FICEs. CPC welcomes the IASB's initiative to develop a more robust, consistent and clearer set of principles to distinguish financial liabilities from equity instruments, thus warranting standard setting activity. Although the Board's objective is not fundamentally changing the classification outcomes of IAS 32, CPC agrees that the current criteria established by that standard are not robust enough to deal with some complex contractual arrangements that are essentially the same, in order to produce a similar accounting classification outcome when applied by different jurisdictions.

In that regard CPC recognizes the existence of divergence in practice when applying the current requirements of IAS 32, specifically when dealing with the so-called perpetual notes/bonds in which the issuer has the contractual right to defer interest payments, and the accounting for NCI put options. The latter is particularly important in our jurisdiction because the lack of consistent requirements might cause differences in non-consolidated financial statements when compared to the consolidated figures, in situations in which jurisdictions require IFRS in non-consolidated financial statements (for instance, Brazil and Italy). Therefore, we believe that for a thorough discussion of the impacts of NCI put options in consolidated financial statements one shall also take into consideration the consequences in non-consolidated financial statements.

CPC also would like to suggest the inclusion in the FICEs' DP some orientation about if the shareholder acts as an independent investor or as a representative of the entity,



for example, when the controlling shareholders exempt themselves of a particular decision in benefit of the non-controlling parties, and if liabilities arising from contingent settlement provisions must be measured by the total amount or has to be considered the likelihood of the contingency resolution (e.g. IAS 32 BC 12).

However, we also believe that some parties believe that the amount feature is a new concept included in the DP, and was not presented in the current version of IAS 32. This feature may lead companies to re-evaluate the accounting treatment of financial instruments issued and, in some situations, may change the current classification

(b) Do you agree that the challenges identified are important to users of financial statements and are pervasive enough to require standard-setting activity? Why or why not?

CPC's response:

CPC agrees that the challenges identified by the IASB are important to users of financial statements and are pervasive enough to require standard-setting activity. Most specifically, because of the amount of debt and equity affect some KPIs calculated by the users of financial statements to evaluate the economic and financial health of companies.

Section 2 – The Board's preferred approach

Question 2

The Board's preferred approach to classification would classify a claim as a liability if it contains:

(a) an unavoidable obligation to transfer economic resources at a specified time other than at liquidation; and/or

(b) an unavoidable obligation for an amount independent of the entity's available economic resources.



This is because, in the Board's view, information about both of these features is relevant to assessments of the entity's financial position and financial performance, as summarized in paragraph 2.50.

The Board's preliminary view is that information about other features of claims should be provided through presentation and disclosure.

Do you agree? Why, or why not?

CPC's response:

CPC generally agrees with the Board's preferred approach to classification of financial instruments between liabilities and equity instruments. In the CPC view, the distinction based on the timing and amount features are paramount elements for the assessment, most specifically because any instrument that has an obligation to pay interests over the time is naturally a financial liability.

Although the CPC generally agrees with the rationale of the principle established by the Board's preferred approach, it also believes that some practical issues might arise in the articulation of the second feature (b), in relation to the interpretation given to "... an amount independent of the entity economic resources".

The first feature (i.e. the timing feature) is clear, understandable and might not cause any difficulties in applying it in practice. Moreover, we understand that it is quite consistent with the definitions of liability established by the Conceptual Framework² and IAS 37³.

In the CPC view, the same cannot be said in relation to the application of the second feature (i.e. the amount feature). Although we understand the rationale behind the

² 4.26 A liability is a present obligation of the entity to transfer an economic resource as a result of past events.

³ 10 A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.



amount feature, the way it is articulated might create some problems of inconsistent application in practice, regarding the concept of “an amount independent of the entity’s available economic resources”, which we find it deserves more clarity in the definition.

CPC highlights that according to the Conceptual Framework economic resources controlled by the entity are assets of that entity (item 4.3), and to our mind all assets of the entity are available to it because the entity controls them. Although the Board’s preferred approach uses the term “an amount independent of the entity’s available economic resources” in the second feature to characterize a financial liability, it seems to us that the concept used in the FICE’s Discussion Paper is different from the same one used in the Conceptual Framework. According to paragraph 3.17 of the FICE’s Discussion Paper, “An entity’s available economic resources are the total recognized and unrecognized assets of the entity that remain after deducting all other recognized and unrecognized claims against the entity (except for the financial instrument in question)”. So, it appears to us that the Board broadened the concept of available economic resources in the FICE’s Discussion Paper, being it more akin to a residual concept (i.e. net assets). Moreover, some parts of the FICE’s Discussion Paper indicate that the concept of available economic resources might be linked to the performance of the entity.

CPC also highlights that the concept of economic resource in the timing feature might not be aligned with the intended concept used in the amount feature. The first concept appears to be aligned with the concept of the economic resource applied by the Conceptual Framework (i.e. an asset), although the second concept might indicate a residual interest in the assets of the entity after deducting all its liabilities (and a performance). So, CPC urges the Board to further clarify both concepts used in the timing and the amount feature, in respect of the meaning of economic resources in both concepts.

Section 3 – Classification of non-derivatives financial instruments

Question 3



First, and as said earlier in response to the previous question, CPC believes that the lack of consistency between the concepts of economic resource in the timing and amount feature would create further challenges in the application of the principle for classification purposes. Therefore, we reaffirm the need for further clarification in this respect.

According to the Brazilian experience, in general, non-derivative financial instruments are characterized by the following features: (a) subordination to other financial liabilities; (b) indefinite maturity; and (c) deferred interests.

It is interesting to note that the subordination to other financial liabilities is not an imperative to determine that a bond is an equity instrument, mainly because, although in corporate liquidations these FICEs assume the last positions when compared to other liabilities, nevertheless their holders would have privileged positions considering the other shareholders (i.e. being subordinated to other liabilities would entail full conditions to compare to equity instruments).

Focusing on indefinite maturity, we observed that non-derivative FICEs are indexed to fixed interest rates that step-up after specific dates whether the issuers do not exercise their right to repurchase the FICEs. In this way, CPC believes that this increase in interest rates can be considered an economic compulsion based on the terms of the contractual provisions of the instrument (i.e. the economic compulsion is deemed to arise from the contract's rights and obligations), because taking into consideration a long-term view, it will be not sustainable keep a FICE increasingly expensive due to the non-exercise of the –repurchase option. In this situation, and taking into consideration only the contractual provisions, CPC considers that the economic incentive to repurchase the instrument is part of the contractual provisions and so should be taken into consideration when analyzing the instrument. Otherwise, the accounting outcome would not portray the economic substance of the instrument.

Regarding deferral interests, it was mentioned that this is an unconditional right of the issuers, which can be exercised continuously, that is, in different fiscal years.



Additionally, the notes that mentioned this case referred to the fact that such rights are conditioned to non-distribution of dividends.

It is important to highlight that deferral interests in a period does not discharge their payment in the future. Additionally, the interests that are not paid in a fiscal year are adjusted with more interested in the subsequent periods, denoting again economic incentive (based on the terms of the instrument) not to defer interest payments.

Thus, considering this context, the CPC agrees with the rationale that will also be the case if the financial instrument has at least one settlement outcome that has the features of a non-derivative financial liability, it should be classified as so.

However, although CPC recognizes the challenges in dealing with the matter, it has the view that the Board should consider articulating the economic compulsion concept into the classification principle, **having regard the contractual provisions of the instrument**. In our understanding, maintain only the requirements of paragraph 20 of IAS 32 is not robust enough to deal with all possible and more complex situations that might arise, which would not reduce the structuring opportunities to achieve a desired outcome. To that end, CPC believes that the Board should attempt to align with the aspects of the definition of a liability established by IAS 37 (i.e. economic compulsion and implicit obligation concepts), that derives from the contractual provisions of the instrument. Besides, we believe that the concept of constructive obligation should also be incorporated into the articulation of the classification principles in order to clarify and highlight that the economic substance must drive the classification of the instrument.

Moreover, CPC points out that according to paragraph 3.5 "... the Board sought to articulate classification principles for financial instruments based on its preferred approach that also: a) are limited to rights and obligations arising from contracts; ...". Hence, economic compulsion and implicit obligations that are derived from the contractual provisions of the instrument should be considered into the articulation principle of the Board's preferred approach and the Board should attempt to clarify that



rationale better and not to rest only upon IAS 32. Differently, the economic substance of the instrument would not have primacy over form.

Question 4

The Board's preliminary view is that the puttable exception would be required under the Board's preferred approach. Do you agree? Why, or why not?

CPC's response:

We understand that the puttable exception would still be required under the Board's preferred approach.

We also think that it is preferable to have a unique set of principles that could encompass all the situations, instead of requiring an exception for accommodating certain types of instruments. Nevertheless, we believe that the exception has its merit.

For instance, in our jurisdiction, this exception is particularly important for certain types of collective investment schemes (i.e. mutual funds). These entities issue shares that grant its holders (pool of investors) to put it back in exchange for cash, based on the entity's net asset value, measured and publicly disclosed on a daily basis. This instrument is the only instrument issued by the fund, meaning that there is no other instrument that is more subordinated than this one. So, if the exception were not available, the investment fund would not present a shareholder's equity (all issued instruments would be classified as a financial liability), in which case we would find the information misleading.

Although the instrument's contractual provision contains an unavoidable obligation for the issuer to transfer cash at a specified time other than at liquidation, depending on the exercise of the holder's option, the redeemable value is based solely on the residual value of the entity (net assets value). Moreover, there is no other classes of instruments issued by the entity. Under these circumstances, we see the rationale behind the classification as equity, considering also the business model of the entity (if



there is not this option for the holder to put the instrument back at any time, the investment mechanism would not be feasible).

Section 4 – Classification of derivative financial instruments

Question 5

The Board's preliminary view for classifying derivatives on own equity—other than derivatives that include an obligation to extinguish an entity's own equity instruments—are as follows:

(a) a derivative on own equity would be classified in its entirety as an equity instrument, a financial asset or a financial liability; the individual legs of the exchange would not be separately classified; and

(b) a derivative on own equity is classified as a financial asset or a financial liability if:

(i) it is net-cash settled—the derivative requires the entity to deliver cash or another financial asset, and/or contains a right to receive cash for the net amount, at specified time other than at liquidation; and/or

(ii) the net amount of the derivative is affected by a variable that is independent of the entity's available economic resources.

Do you agree? Why, or why not?

CPC's response

Committee agrees with the requirement to consider the derivative financial instrument in their entirety when classifying it as a financial asset, financial liability or equity instrument. Moreover, we think that such a proposal would better depict the economic



characteristics of the instrument, thus leading to a more useful information for financial statements' users.

Furthermore, it also appears to us that the Board sometimes uses the terms hybrid and compound instruments interchangeably (see, for instance, paragraph 4.7 and paragraph 5.3), which might lead to inconsistencies in the application of the requirements. In addition, paragraph B4.3.6 of IFRS 9 cites a puttable instrument as an example of a hybrid contract, while paragraph 5.12 of the FICE DP refers to this instrument as a compound instrument.

Section 5 — Compound instruments and redemption obligation arrangements

Question 6

Do you agree with the Board's preliminary views set out in paragraphs 5.48(a)–(b)? Why, or why not? Applying these preliminary views to a derivative that could result in the extinguishment of an entity's own equity instruments, such as a written put option on own shares, would result in the accounting as described in paragraph 5.30 and as illustrated in paragraphs 5.33–5.34.

CPC's response

Although we particularly do not disagree with the Board's preferred approach in dealing with derivatives to extinguish an entity's own equity instruments and compound instruments, we have some concerns in relation to the accounting for NCI put options and the consequences that might arise in the consolidated and non-consolidated financial statements.

Paragraph 5.39 states that the accounting for NCI put options in the consolidated financial statements would be the same as that in Example 2 described in paragraphs 5.33 - 5.34 (i.e. a liability would be recognized at the present value of the redemption amount and the NCI would be derecognized at fair value at the date the written put is issued), except that the underlying equity instruments are shares that represent the



NCI. The equity component would be measured as the difference between the sum of the premium received and the liability recognized, and the fair value of the NCI derecognized. Paragraph 5.42 also adds that if the NCI put is a fair value put, the equity component would be nil.

Derecognizing the NCI at the date the put option is issued might cause some presentation issues in the consolidated financial statements, considering that the instrument's holders continue to be entitled to dividends and have interests in the investee's net assets. Some issues might also arise in respect of how to deal with the liability component in the non-consolidated financial statements (does it make any sense recognizing a liability component in the non-consolidated financial statements?).

Moreover, considering that the NCI put option is frequently issued concomitant with a business combination transaction, we foresee a possible conflict between the Board's proposed approach and paragraph 10 of the IFRS 3, which we find should be clarified.

For financial instruments with alternative settlement outcomes that do not contain an unavoidable contractual obligation that has the feature(s) of a financial liability as described in paragraph 5.48(c), the Board considered possible ways to provide information about the alternative settlement outcomes as described in paragraphs 5.43–5.47.

(a) Do you think the Board should seek to address the issue? Why, or why not?

(b) If so, what approach do you think would be most effective in providing the information, and why?

CPC's response

According to the Board's proposed approach (5.48(c)), financial instruments with alternative settlement outcomes that are controlled by the entity (i.e. reverse convertible bond) would be classified as equity, on the grounds that the entity (issuer)



has the unconditional right to avoid the liability settlement outcome thus avoiding delivering cash. As far as we are concerned, this is not a change from the current requirements of IAS 32.

Since the proposed approach does not take into consideration the intention of the issuer (for instance, changes in economic scenarios), the instrument would never be reclassified to liability during the period at which the option remains effective, even if the issuer intends to settle in cash. We believe this could raise situations in which the accounting would not portray the economic substance of the instrument (liability settlement outcome), as long as conversion features might only be included to allow equity classification.

We have seen situations where some entities declare that they had strengthened its equity with capital increase from the issuance of a reverse convertible bonds that were used to repay outstanding “other” borrowings. The instrument’s contractual provisions gave the entity the right to convert the instrument into equity at a specified time period. At that time (the latest possible date for converting), the entity decided not to exercise its right to convert the instrument. As consequence, the instrument had been classified from equity to other borrowings.

This situation is an important example of the issues that might arise when not considering the economic compulsion in the articulation of the classification principle. Thus, we believe that the economic compulsion is a relevant component to take into consideration when analyzing the classification of financial instruments.

Section 6 – Presentation

Question 7

Do you agree with the Board’s preliminary views stated in paragraphs 6.53–6.54? Why, or why not?



The Board also considered whether or not it should require separation of embedded derivatives from the host contract for the purposes of the presentation requirements as discussed in paragraphs 6.37–6.41. Which alternative in paragraph 6.38 do you think strikes the right balance between the benefits of providing useful information and the costs of application, and why?

CPC's response

Considering that the differences between the disaggregation approach and the criteria-based approach would only matter for partly independent derivatives (i.e. under the criteria-based approach separate presentation requirements would only apply to some partly independent derivatives that meet specific criteria), we are comfortable with the criteria-based approach, because we think it would strike the right balance between the benefits of providing the information for users and the cost of applying the requirements. We also see the rationale of not presenting in profit or loss the changes in the carrying amount of a liability that are due to a variable that is not independent of the entity available economic resources, because this would exacerbate the volatility (and the counter-intuitive accounting) in the income statement in relation to a variable that probably would not be meaningful to investor.

Nonetheless, we have a special concern about the frequent use of OCI (and the no-recycling alternative) by the Board without a thorough theoretical discussion of the reasoning, its definition and use. Considering that the number of situations in which the Board is using the OCI is increasing, the Board should attempt to clarify this compelling issue.

Question 8

The Board's preliminary view is that it would be useful to users of financial statements assessing the distribution of returns among equity instruments to expand the attribution



of income and expenses to some equity instruments other than ordinary shares. Do you agree? Why, or why not?

The Board's preliminary view is that the attribution for non-derivative equity instruments should be based on the existing requirements of IAS 33. Do you agree? Why, or why not?

The Board did not form a preliminary view in relation to the attribution approach for derivative equity instruments. However, the Board considered various approaches, including:

- (a) a full fair value approach (paragraphs 6.74–6.78);
- (b) the average-of-period approach (paragraphs 6.79–6.82);
- (c) the end-of-period approach (paragraphs 6.83–6.86); and
- (d) not requiring attribution, but using disclosure as introduced in paragraphs 6.87, 6.90 and developed in paragraphs 7.13–7.25.

Which approach do you think would best balance the costs and benefits of improving information provided to users of financial statements?

CPC's response

CPC welcomes the Board initiative to split equity instruments according to differences between rights and obligations, specially because these differences may result in the allocation of different amounts of the residual return to different classes of equity instruments based on features that are not reflected by their classification as equity.

According to the CPC views this segregation can be useful for users of financial statements in assessing returns of equity instruments and potential dilutions is shareholders as well.



However, CPC believes that the end of period approach can better reflect the latest position about the equity participants, or potential participants, of an entity and can provide better prospective information for users of financial statements.

Section 7 – Disclosure

Question 9

The Board’s preliminary view is that providing the following information in the notes to the financial statements would be useful to users of financial instruments:

(a) information about the priority of financial liabilities and equity instruments on liquidation (see paragraphs 7.7–7.8). Entities could choose to present financial liabilities and equity instruments in order of priority, either on the statement of financial position, or in the notes (see paragraphs 6.8–6.9).

(b) information about potential dilution of ordinary shares. These disclosures would include potential dilution for all potential issuance of ordinary shares (see paragraphs 7.21–7.22).

(c) information about terms and conditions should be provided for both financial liabilities and equity instruments in the notes to the financial statements (see paragraphs 7.26–7.29).

Do you agree with the Board’s preliminary view? Why, or why not? How would you improve the Board’s suggestions in order to provide useful information to users of financial statements that will overcome the challenges identified in paragraphs 7.10 and 7.29?

Are there other challenges that you think the Board should consider when developing its preliminary views on disclosures?

CPC's response

CPC welcomes the proposed disclosure requirements and concurs with that they would provide useful information to investors and would represent an improvement as compared to the existing requirements. Although we think the proposed requirements to disclose information in the notes is an improvement when compared to the current requirements, we believe that investors would most benefit if the order of priority of components of liabilities and equity is required to be presented on the statement of financial position.

Section 8 – Contractual Terms

Question 10

Do you agree with the Board's preliminary view that:

(a) economic incentives that might influence the issuer's decision to exercise its rights should not be considered when classifying a financial instrument as a financial liability or an equity instrument?

(b) the requirements in paragraph 20 of IAS 32 for indirect obligations should be retained? Why, or why not?

CPC's response

CPC welcomes the Board's consideration of economic incentives to classify a FICE as equity or liability. According to the CPC, the comprehension of the economic incentives is essential to align the accounting treatment with the economic essence of the transaction.



Paragraph 15 of IAS 32 requires that “the issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument **in accordance with the substance of the contractual arrangement** and the definitions of a financial liability, a financial asset and an equity instrument” (*emphasis added*). Paragraph 3.5 of the FICE DP states that the Board sought to articulate classification principles for financial instruments based on its preferred approach **that are limited to rights and obligations arising from the contracts**. Moreover, paragraph 3.6 of the FICE DP adds that the scope would remain unchanged from those that are within the scope of IAS 32.

We also highlight that there are some aspects of implicit obligations and economic incentives that can be derived from the contractual provisions of the instruments and as such should be included in the rationale of the articulation principle of the Board’s preferred approach, otherwise it would not be consistent with the declaration of the Board regarding the scope of the FICE DP.

We faced in the past some issues regarding issuer’s economic compulsion not to defer coupon payments, based on the provisions of the instrument that would trigger a relevant raise in interest rate in case of the issuer’s option to defer interest payment. That raise of interest rate might be understood as an economic compulsion or economic incentive not to defer payment, because doing so would certainly put the company in a serious financial condition.

So, we again ask the Board to revisit the preliminary view not to consider the economic incentives for classifications purposes. In doing so, we believe the Board’s decision is not being consistent with the previous statement that the scope of the preferred approach is limited to right and obligations arising from the contracts in the DP, more important, the Board’s decision is no being consistent with IAS 32 itself, in which requires the issuer to classify the instrument in accordance with the substance of the contractual arrangement. Not considering economic compulsion and economic incentives that are derived from the contractual provisions of the instrument does not help accounting portray the economic substance of the arrangement.



In our view, the Board should consider articulating the economic compulsion/economic incentive concept in the classification principle, having regard the contractual provisions of the instrument. To our mind, retaining the requirement of paragraph 20 of IAS 32 is not robust enough to deal with more complex situations that might arise. The Board should attempt to articulate the principle, having in mind the substance of the contractual arrangement, in a clearer, more robust form. To that end, we find important to consider and align the definition of liability with IAS 37.

Question 11

The Board's preliminary view is that an entity shall apply the Board's preferred approach to the contractual terms of a financial instrument consistently with the existing scope of IAS 32. Do you agree? Why, or why not?

CPC's response

CPC agrees with the Board's preliminary view applied with IAS 32, except for the need to clarify the economic compulsion issue described in the previous responses.

Appendix - Academic Literature Review

There are several academic papers showing the FICEs, sometimes called as hybrid financial instruments, convertible bonds or other similar labels, impacts on the financial statements and markets' response. We are listing below some papers related to this academic field aiming to support a deeper and structured discussion of why FICEs are potentially issued and how can they affect financial statements.

(a.1) Tax avoidance with cross-border hybrid instruments

Reference: Johannesen, N. (2014). Tax avoidance with cross-border hybrid instruments. *Journal of Public Economics*, 112 pp. 40-52.



Abstract: The rules demarcating debt and equity for tax purposes differ between countries, hence the possibility that a hybrid financial instrument is treated as equity in one country and debt in another. This may create a scope for tax avoidance by allowing firms that invest in foreign countries to combine tax deductible interest expenses in the host country and tax favored dividend income in the home country. In this paper, we first develop a formal model of hybrid instruments and show, for a given pair of countries, firms in at least one country and sometimes in both can avoid taxes on investment in the other country with a cross-border hybrid instrument. We then investigate why countries tend to allow the use of hybrid instruments for tax avoidance and show that even if effective anti-avoidance rules are available, there exists a global policy equilibrium in which no country uses such rules.

(a.2) Are convertible bonds underpriced? An analysis of the French market

Reference: Ammann, M.; Kind, A.; Wilde, C. (2003). Are convertible bonds underpriced? An analysis of the French market. *Journal of Banking and Finance*, 27 pp. 635-653.

Abstract: We investigate the pricing of convertible bonds on the French convertible bond market using daily market prices for a period of 18 months. Instead of a firm-value model as used in previous studies, we use a stock-based binomial-tree model with exogenous credit risk that accounts for all important convertible bond specifications and is therefore well suited for pricing convertible bonds. The empirical analysis shows that the theoretical values for the analyzed convertible bonds are on average more than 3% higher than the observed market prices. This result applies to both the standard convertibles and the exchangeable bonds in our sample. The difference between market and model prices is greater for out-of-the-money convertibles than for at- or in-the-money convertibles. A partition of the sample according to maturity indicates that there is a positive relationship between underpricing and maturity with decreasing mispricing for bonds with shorter time to maturity.

(a.3) Characteristics of firms that issue convertible debt versus convertible preferred stock

Reference: Lee, H. W.; Figlewicz, R. E. (1999) Characteristics of firms that issue convertible debt versus convertible preferred stock. *The Quarterly Review of Economics and Finance*, 39 pp. 547-563.

Abstract: This study examines the characteristics of firms that issue convertible debt versus firms that issue convertible preferred stock. The findings are consistent with the agency, information asymmetry, optimal capital structure, financial distress, and tax benefits hypotheses. The findings also indicate that these two types of convertible securities are used to raise external capital by distinctively different groups of firms. First, convertible preferred stock issuing firms have larger nondebt tax shields and higher levels of financial, operating, and bankruptcy risks than convertible debt issuing firms. Second, firms that issue convertible debt have greater free cash flow (financial slack) and growth potential than firms that issue convertible preferred stock.



(a.4) Convertible bonds as backdoor equity financing

Reference: Stein, J. (1992). Convertible bonds as backdoor equity financing. *Journal of Financial Economics*, 32 pp. 3-21.

Abstract: This paper argues that corporations may use convertible bonds as an indirect way to get equity into their capital structures when adverse-selection problems make a conventional stock issue unattractive. Unlike other theories of convertible bond issuance, the model here highlights: 1) the importance of call provisions on convertibles and 2) the significance of costs of financial distress to the information content of a convertible issue.

(a.5) Financial Instruments with Characteristics of Equity Determinants and Consequences

Reference: Flores, E.; Broedel Lopes, A.; and Carvalho, N.; Fasan, M. (2017) *Financial Instruments with Characteristics of Equity Determinants and Consequences*. Available at SSRN: <https://ssrn.com/abstract=2976331>.

Abstract: The purpose of this study was to evaluate the effects of hybrid financial instruments in market-based accounting research. The methodological approach was composed of two samples: (1) the treatment group, formed by 39 companies that issued hybrid instruments in 10 different jurisdictions; and (2) the control group, comprised of 107 organizations domiciled in the same jurisdictions and having a similar equity composition to the interest group. The findings indicated that the hybrid financial instruments affected the stock prices and returns of the issuers in a positive and statistically significant way, much like other equity elements (e.g., book value per share and earnings per share). Concerning the determinant factors for the issuance of these bonds, it was found that the issuers had a higher cost of capital, more financial leverage, and a lower effective tax rate than the non-issuers. Therefore, it can be concluded that, while new forms of contracts for obtaining resources, such as hybrid financial instruments, are relevant for the financing of business activities, it is essential that accounting models faithfully represent the economic nature of these instruments in order to prevent biases from occurring among the users of financial statements.

(a.6) Industry conditions, growth opportunities and market reactions to convertible debt financing decisions

Reference: Lewis, C. M.; Rogalski, R. J.; Seward, J. K. (2003). Industry conditions, growth opportunities and market reactions to convertible debt financing decisions. *Journal of Banking & Finance*, 27 pp. 153-181.

Abstract: Firms that issue convertible debt have high debt- and equity-related costs of external finance. Existing theories of convertible debt finance differ primarily in their identification of the specific causes of the debt- and equity-related costs of external finance. To assess the theoretical issuance motives separately, we propose a simple framework that characterizes how issuers should design convertible debt to efficiently mitigate specific debt- and equity-related costs of external finance. We provide evidence from 588 security offer announcements that supports the hypotheses that:



(1) convertible debt can be designed to mitigate different combinations of debt- and equity-related costs of external finance and (2) share price reactions depend on the security design decisions. The results also illustrate that the relations between firm value, financial leverage, investment opportunities, and the rate of future growth are more complex among convertible debt issuers than situations where firms issue standard financial securities.

(a.7) The determinants of the hybrid security issuance decision for Australian firms

Reference: Suchard, J.; Singh, M. (2006). The determinants of the hybrid security issuance decision for Australian firms. *Pacific-Basin Finance Journal*, 14 pp. 269-290.

Abstract: The Australian capital market has a number of distinct characteristics that distinguish it from typical U.S. and European markets. There is a limited listed debt market where most firms use bank debt, convertible debt is not callable and stand-alone warrants are used to raise capital. This paper examines the determinants of security choice for hybrid issuers in the Australian market. The results support the pecking order model and the impact of financial distress costs and taxation. Alternatively, the results provide support for the sequential financing model where firms with high profitability use convertible debt and firms with low profitability use warrants, to solve the sequential financing problem.