Grupo Latinoamericano
de Emisores de Normas
de Información Financiera

Group of Latin-american
Accounting Standard Setters

December 11, 2018

International Accounting Standards Board
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

RE: Discussion Paper 2018/01, financial Instruments with Characteristics of Equity

Dear Board Members:

The "Group of Latin American Accounting Standard Setters"[1] – GLASS welcomes the opportunity to comment on the Discussion Paper 2018/1, Financial Instruments with Characteristics of Equity (the "DP").

Due process
The discussions regarding the DP were held within a specified Technical Working Group (TWG) created in September 2018. All country-members had the opportunity to appoint at least one member to participate in this TWG. Each standard setter represented in the TWG has undertaken different tasks in their respective countries (e.g. surveys, internal working groups). All results were summarized, and this summary was the platform for the TWG discussion process.

The TWG discussed the different points of view included in the summary during several conference calls. In those calls the TWG developed a final document on the basis of the agreed-upon responses and the technical points of view of its members. Finally, the TWG document was submitted to and approved by the GLASS Board.

Overall Comments
We agree it is necessary to establish a principle to recognize financial instruments with characteristics of equity. As new financial instruments appear constantly, each time more complex, rules are not enough and it is necessary to establish a clear principle that encompasses all possibilities.

The Discussion Paper is very complex and in some cases it was difficult to understand what was purported to be established. The modifications to be made to IAS 32, *Financial Instruments: Presentation*, should be drafted in terms that are simple and easily understandable, even for people that are not experts in financial instrument accounting.

Specific Comments
Attached please find our specific responses to the questions presented in the DP.

Contact
If you have any questions about our comments, please contact glenif@glenif.org.

Sincerely yours,

Eduardo Pocetti
Chairman

[1] The overall objective of the Group of Latin American Accounting Standard Setters (GLASS) is to present technical contributions with respect to all Exposure Drafts issued by the IASB. Therefore, GLASS aims to have a single regional voice before the IASB. GLASS is constituted by: Argentina (Vice Chairman), Bolivia, Brazil (Chairman), Chile, Colombia (Board), Costa Rica (Board), Dominican Republic, Ecuador, Guatemala, Honduras, Mexico (Board), Panama, Paraguay, Peru (Board), Uruguay (Board) y Venezuela (Board).

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Exhibit

GLASS Comment Letter on the IASB discussion Paper on Financial Instruments with Characteristics of Equity

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? (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?

We agree with the description of the challenges and their causes, because there are a growing number of financial instruments with different features, which complicates the determination of their classification. A correct classification of a financial instrument as equity or as a liability is important for users to properly understand the financial position of the entity, since an incorrect classification would make them misleading, and therefore, establishing a clear principle for their classification is necessary. Establishing a clear principle is important to contemplate new and future instruments in the standard. For example, increasingly there are more debt instruments that, despite requiring cash disbursements, include conditions that result in the investors assuming risks related to the equity of the entity.

If the Board's objective is not to fundamentally change the classification criteria of IAS 32, we agree the criteria established in that standard are not sufficiently solid to address certain complex contractual agreements that are essentially identical in different jurisdictions and require a similar accounting treatment.

One member country believes it is important to include guidance as to whether a shareholder acts as an investor or as a representative of the entity and whether the liabilities derived from contingencies should be measured for the full amount or whether the probability of resolution of the contingency should be considered (e.g. IAS 32, BC12).

In summary, we agree that the challenges identified by the IASB are important to financial statement users and are sufficiently pervasive so as to require standard setting so that information provided on financial liabilities and equity instruments is useful and relevant. The classification is critical since it impacts financial indicators such as solvency, leverage and others such as the regulatory capital of a bank.

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 summarised 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?

We agree that a claim with the features indicated in (a) and/or (b) above should be classified as a liability because either economic resources will flow out of the entity at a specified time other than liquidation, creating therefore an obligation to pay, or the economic resources are for an amount unrelated to the entity's equity and the entity has to pay them no matter whether the equity has increased or decreased in the period. Therefore, none of these claims have the features of equity since the holder of the financial instrument is not affected by the risks and rewards inherent in the operation of the business. The financial instrument will be paid before the end of the life of the business and will be paid at an amount unrelated to the operating results of the business. The Board's view responds to the need for clear classification criteria for debt and equity instruments in the two described situations.

One member country believes the Board should issue guidance for the evaluation of instruments with certain characteristics, such as perpetual bonds.

Another member country believes that the characteristic of "an amount independent of the economic resources available to the entity" should be clarified since as is it could create problems with inconsistent application in practice. The member country believes the concept utilized in the DP differs from that used in the Conceptual Framework since paragraph 3.17 expands the concept of available economic resources as compared to those defined in the Conceptual Framework as it more closely resembles a residual amount (i.e. net assets). The member country also believes that an economic resource as a function of time may not be aligned with the concept used as a function of quantity, since the former addresses the economic resource dealt with in the Conceptual Framework and the latter is a residual value. As a result the member country believes these concepts must be clarified.

Question 3 -

The Board's preliminary view is that a non-derivative financial instrument should be classified as a financial liability if it contains:

(a) an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation; and/or

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

This 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.

Do you agree? Why, or why not?

We agree that a non-derivative financial instrument should be classified as a liability if it has the features described in (a) and (b) above, for the same reasons as we indicated in our response to question 2. It should be considered that they deal with liabilities that will be paid independent of the equity. Additionally, classification as a liability addresses the circumstance of having an unavoidable obligation to transfer resources prior to liquidation or having an obligation independent of the entity's available economic resources. The procedure proposed by the Board eliminates the classification discrepancies that currently exist when applying IAS 32 to instruments with options to liquidate with a fixed amount of the entity's equity.

One member country believes that subordination is not essential to classify an instrument as equity, since some liabilities may be subordinated to others. On the other hand, it believes that economic compulsion, such as an excessive increase in interest rates, should be considered since an entity would be compelled to repurchase the debt. Similarly, deferral of the payment of interest could create economic compulsion since the increase in the liability would make the debt more burdensome. As a result the concept of economic compulsion should be considered in the classification principle.

The member country also believes the lack of coherency between the concepts of an economic resource as a function of time and as a function of quantity would create doubts and challenges with the application of the classification principle.

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?

We agree that the puttable exception included in paragraphs 16A through 16F of IAS 32 would be required under the Board's preferred approach because at least one claim should be recognized and measured as a residual. Applying the preferred approach should not have the effect that all the claims analyzed through that approach should be classified as a liability; at least one, even if it is a puttable instrument, should be classified as equity if it is the most subordinated. This "puttable exception" should therefore be carried forward along with the Board's preferred approach.

In some countries there are mutual funds in which owners constantly come and go and their investments bear the risks of the fund. Although redeemable, the equity of the mutual fund cannot be presented as a liability, since that would be misleading as far as the liquidation value is based on the equity of the entity and it is a reduction of such and not the settlement of a liability.

One member country believes that the presentation of these instruments as liabilities would present more relevant information on the cash flow perspectives to meet obligations, although the characteristics of these items are separately disclosed. Additionally, it believes that measuring the liability at fair value through OCI would provide updated information on the transaction.

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 a 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?

We agree that a derivative on own equity should be classified in its entirety as an equity instrument, a financial asset or a financial liability, without separation of the individual legs of the exchange, due to the interdependency of the components of the instrument. This proposal better represents the economic characteristics of the instrument, which would provide more useful information.

We agree that a derivative on own equity be classified as a financial asset or a financial liability, and not as equity, if it is net-cash settled at a specified time other than liquidation, because the derivative's term is specified and the term of an equity instrument is indefinite. Also, we agree that if the net amount of a derivative is affected by a variable that is independent of the entity's available economic resources (its equity), it should be classified as an asset or a liability, such as in the case of an exchange of shares for an amount of foreign currency that could result in receiving more (an asset) or less (a liability) than the amount originally determined as the fair value of the shares to be issued.

Classification as a financial asset or liability allows financial information users to identify the obligations and anticipate the impact on the cash flows of the entity.

We noticed that there is no reference to the situation explained in paragraph 16(b)(ii) of IAS 32 which states that "For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all its existing owners of the same class of its own non-derivative equity instruments". We wonder if this will be eliminated on the basis that such item is for an amount independent of the entity's available economic resources, being in a foreign currency, or will be kept since it will be part of the equity, being an amount based on own equity, and thus a residual.

One member country believes that the wording of paragraphs 4.26, 4.36 and 4.37 is confusing. Additionally, paragraph 4.37 refers to chapter 5 of the DP which addresses the topic in paragraphs 5.15 to 5.18 and could represent a conflict between these paragraphs, which appear to completely exclude derivatives to extinguish a financial liability through the delivery of its own equity. This country believes that the reasoning for the criteria to be applied in the classification of derivatives for the exchange of liabilities and equity should be clarified. It also believes that the terms hybrid and compound instruments are interchangeably and inconsistently used (see paragraphs 4.7 and 5.3). Additionally, in this regard paragraph 4.3.6 of IFRS 9 is inconsistent with paragraph 5.12 of the DP.

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. 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?

We agree with the preliminary views set out in paragraphs 5.48(a) and (b), insofar as the final outcome of a convertible bond and a written put option (both at the option of the holder) will be the same in the case of equity settlement or liability settlement, respectively. This is because if the convertible option is exercised the liability created when the convertible bond was issued ends up as equity, and if the written option is not exercised the liability generated by the option returns to equity. Conversely, if the bond is not converted or the written put option is exercised, the liability remains in both cases, and there will be an outflow of cash from the entity. When the concept of same accounting outcome is exposed, it may seem to be counterintuitive since the objective of one of the transactions could be to increase equity and that of the other to reduce equity.

A reverse convertible bond is not a common financial instrument, since for it to be an attractive investment the interest rate would have to be high or the conversion rate to equity would have to be favorable, and the potential holder is uncertain whether he will receive cash or equity instruments. We are not sure if under the Board's preferred approach the instrument would be classified as equity, which would be the case if the bond is converted to equity to avoid paying a high interest rate thereby improving the debt-equity ratio and facilitating obtaining additional finance at a better rate. However, the shareholders may not like being diluted with shares issued at a low price and could force management to settle the bond in cash. The most likely outcome should be determined at the date the reverse convertible bond is issued and consistently followed thereafter.

Once classified as equity, if that is the most likely outcome, separating the embedded derivative from equity and presenting it as a liability could be confusing since it would not represent an unavoidable obligation to be satisfied. Separating the embedded derivative within equity would also be confusing, since it could mean there is a class in equity that is less subordinated and, hence, should be a liability. We believe that the best approach would be through adequate disclosure.

We believe this classification approach is more objective than that in IAS 32, which is based on fixed or variable payment with an entity's own shares, because the proposed classification provides clear guidance that allows properly classifying equity derivatives.

One member country believes that the principle for dealing with derivatives for the exchange of debt and equity should be better explained, since there are certain difficulties with understanding the basis of the separation for applying the classification requirements for derivatives to extinguish a financial liability with the delivery of equity instruments and those that include the obligation to extinguish an entity's own equity instruments. The country also believes that the inconsistencies with the use of certain terms, as previously mentioned, must be clarified.

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?

We agree with the separation of the carrying amounts of financial liabilities that contain no obligation for an amount that is independent of the entity's available financial resources, derivative financial assets and derivative financial liabilities that have net amounts that are unaffected by any independent variable and partly independent derivatives that meet the criteria in paragraph 6.34.

Remeasuring the amount of these obligations through profit and loss may lead to what some consider counterintuitive accounting, and its presentation in OCI, without subsequent reclassification, of income and expenses arising from financial liabilities described above, is recommended by the DP. We understand these cases arise when the entity makes an offer to buy its own shares from existing shareholders at the market price at the date they put the shares back to the entity or when debt is converted to equity at the market price at the date the holder of the debt converts it to equity. These are rare cases, since generally the price at which shares will be redeemed or liabilities will be converted to equity are fixed when the offer to buy shares or the liability is assumed. We recommend that the effect of these transactions be recognized directly in equity, either as an adjustment to retained earnings when the shares are purchased or as paid-in capital when the shares are issued in a conversion of liabilities. We believe this would be more appropriate than using a non-recyclable OCI, as far as these are transactions with existing shareholders or with potential shareholders that became so at the conversion date, and transactions with shareholders should be recognized directly in equity accounts.

We also recommend clearly explaining this transaction, indicating that it is a purchase of shares or a conversion of liabilities instead of "a derivative of an amount that is not independent of the entity's available economic resources". The wording used in the DP is very difficult to understand.

In the event the entity is unable to bifurcate the embedded derivatives, it should thoroughly disclose the transactions to allow financial statement users to understand the impact. This would provide balance between the benefits of providing useful information and the costs of applying the standard.

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?

We believe the initiative to separate equity instruments based on the difference between rights and obligations is appropriate, as this could result in the allocation of different amounts to different classes of equity instruments based on their characteristics.

We agree that information about the attribution of profit or loss to equity instruments other than ordinary shares would be useful, since these equity instruments may become ordinary shares and have a direct interest in the entity's profit or loss in the future.

We believe that the attribution should be based on the existing requirements of IAS 33, *Earnings per Share*, because it will not require a significant additional effort to prepare such information. Also, the disclosure of the attribution of profit or loss to other financial instruments will be based on a methodology that is familiar to the preparers and the users of financial statements. We believe that using two different basis for the attribution of profits will create confusion, since users will question which is the correct one.

Regarding the attribution approaches mentioned in the DP for derivative equity instruments, there are two questions. One refers to the use of fair values to determine the attribution, and the other is if such attribution will provide sound information or just theoretical information that will not be reliable.

We believe that the information obtained from any of the three approaches indicated in the DP would give theoretical information that may not be very useful, as the actual attribution of profit and loss once the equity derivatives are exercised will most likely be different since it will be based on different assumptions. Additionally, the cost of preparing such information could exceed the benefits. In the respect one Member country believes that the average-of-period approach is the one that would provide the best information, although it is also the approach that would require the most effort. Another country prefers the period-end approach and still another believes either approach is acceptable.

Therefore, we believe that only the attribution based on IAS 33 should be retained to avoid creating a procedure that would be contradictory.

One member country agrees with providing more information, since financial instruments and other contracts that give rise to potential ordinary shares may include terms and conditions that affect the determination of basic and diluted EPS. These terms and conditions could determine whether the potential ordinary shares are dilutive and the related impact on the weighted average number of shares outstanding and the results of the period.

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?

We agree with the Board's preliminary view on the disclosures to be made. These are presently provided to a large extent, since it is information required either by IAS 1 or by IAS 33. When there are equity instruments issued with special characteristics and when there are equity derivatives, we find there is generally disclosure of useful information. Therefore, we caution the Board not to require an overload of information. For this purpose the Board needs to first establish the objectives of the disclosures and, based on these objectives, establish the necessary requirements.

Paragraph 72 of IAS 33 currently requires the disclosure of the impact of financial instruments on the weighted average number of shares outstanding, as well as on the resulting adjustments to the results of the period attributable to the holders of ordinary shares of net equity.

We agree with the disclosure of the priority of financial liabilities and equity instruments on liquidation. Trying to address this matter in the statement of financial position would make such statement very confusing.

One of our member countries appreciates the proposed increased disclosures regarding equity instruments, especially for non-derivative instruments with characteristics of equity and liabilities, in which the entity should consider whether repurchase is more likely than not.

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?

We agree that 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 equity instrument, since the economic incentives for the holder of the instrument may change when economic conditions are modified due to reasons beyond the control of the issuer. Classification should be based on the rights and obligations established by the contract, including any obligation established indirectly by the contract. The Board might consider if a subsequent event could be evidence of the final outcome that must be recognized in the financial statements.

We therefore agree that the requirements in paragraph 20 of IAS 32 for indirect obligations should be retained.

One member country agrees that the economic incentives for the classification of an instrument as a liability or as equity should be considered, since understanding the economic incentives is essential to align the accounting treatment with the essence of the transaction. In this respect, the concept of economic compulsion should be defined and clarified.

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?

We agree that the entity should apply the Board's preferred approach to the contractual terms of a financial instrument consistent with the existing scope of IAS 32. However, in certain countries where laws cover an extensive part of the terms that are inherent in the contract, even if not specifically indicated, what is indicated in the laws should also be considered as terms of the contract. Therefore, if there are changes in the laws that affect the contract, such change must be considered to determine if there could be a modification in the classification, considering the new terms, as modified by law, to apply the Board's preferred approach to the financial instrument. This can happen, even if it is rare, in countries where statutory law takes precedence, as in many countries in Latin America.

Additionally, one should consider that the contractual terms may not represent the substance of the transaction.

On the other hand, with the accelerating development of financial instruments it is possible that existing laws do not contemplate the specific characteristics of new instruments, thereby always requiring consideration of the substance of the transaction. This is critical when the conditions of new instruments do not match the contractual terms, in which case for appropriate accounting the substance of the transaction must be determined.

In some cases, if there are changes in laws that impact existing contracts, it is necessary to consider amending the contract so that it aligns with the substance of the transaction. In any case, the laws should provide a framework for interpretation of the contract.