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International Accounting Standards Board

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Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **September 2007, London**

Project: **How should an entity *measure* non-cash distributions and the corresponding dividends payable? (Agenda Paper 2A)**

INTRODUCTION

1. When an entity declares non-cash distributions to its equity holders (ie when distributions are appropriately authorised and no longer at discretion of the entity), it has an obligation to deliver non-cash assets to its equity holders. Hence, the entity has to record the following journal entry when it declares the distributions:

   DR Distributable reserves (eg retained earnings)
   CR Dividends payable

2. This journal entry is required regardless of how close the date of declaration and the date of distributions are (ie even when distributions are declared and distributed in the same accounting period).

THE PURPOSE OF THIS PAPER

3. In addressing the measurement issue, a question arises as to whether the IFRIC should focus on the debit side or the credit side of the journal entry described in paragraph 1.

4. [Paragraph omitted from observer note].

5. Current IFRSs do not provide any guidance on how an entity should measure non-cash distributions. However, there are a number of IFRSs that address how an entity should measure liabilities. Consequently, some suggest that the IFRIC should focus on the credit side of the journal entry.

6. Therefore, to measure non-cash distributions, this paper considers how the corresponding dividends payable should be measured in accordance with IFRSs. This paper discusses the principle measurement. Paper 2C then discusses any possible exceptions to the proposed measurement principle.

7. This paper focuses on distributions whose purpose is to transfer 'something' valuable from an entity to its equity holders acting in their capacity as equity holders. The staff notes that some 'distributions' are for the purpose of group restructurings. Paper 2C also discusses those 'distributions' and asks whether the IFRIC would like to address them in the project.

WHICH IFRSs ARE RELEVANT IN MEASURING DIVIDENDS PAYABLE?

8. There is no IFRS that specifically addresses the measurement of dividends payable. Therefore, it is necessary to look for a relevant analogy. There are a number of IFRSs that address how an entity measure its liabilities that are set out below:

    - IAS 12 *Income Taxes* prescribes the accounting treatment for income taxes.
    - IAS 17 *Leases* prescribes the accounting treatment for leases. IAS 17 requires lessees of finance leases, at the commencement of the lease term, to recognise finance leases as assets and liabilities at amounts equal to the

fair value of the leased property or, if lower, the present value of the minimum lease payments.

- IAS 19 *Employee Benefits* prescribes the accounting and disclosures by employers for employee benefits.
- IFRS 2 *Share-based Payment* prescribes the accounting by an entity when it undertakes share-based payment transactions. For cash-settled share-based payment transactions, IFRS 2 requires an entity to measure goods or services acquired and the liability incurred at the fair value of the liability.
- IFRS 4 *Insurance Contracts* prescribes the accounting for insurance contracts by an entity that issues such contracts.
- IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* prescribes the accounting for provisions, contingent liabilities and contingent assets. IAS 37 covers all provisions except for those arising from executory contracts and those that are specifically dealt with by other standards.
- *IAS 39 Financial Instruments: Recognition and Measurement* prescribes the accounting for financial instruments including financial assets and financial liabilities.

9. The staff believes that, although IAS 12 does not address an exchange transaction, it is not relevant as it applies only to accounting for income taxes and it adopts a model that is different from that those generally used in other IFRSs. The next four IFRSs described in paragraph 8 might ***not*** be relevant because they primarily address exchange contracts. At the July 2007 IFRIC meeting, the IFRIC agreed that the project should define distributions as unconditional non-reciprocal transfers of assets by an entity to its equity holders.

10. The staff believes that the most relevant IFRSs in respect of measuring dividends payable are IAS 37 and IAS 39.

11. Some believe that IAS 37 might not be relevant because a dividend payable might not meet the definition of a provision. IAS 37 defines a provision as a liability of uncertain timing or amount (see paragraph 10 of IAS 37). They note that an entity usually knows the amount and timing of the distribution at the time it declares the distribution. However, others believe that the objective of IAS 37 is to cover all liabilities other than those arising from executory contracts and those addressed

by other standards. Such a view is supported by an exposure draft of *Proposed Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits* issued in June 2005 (the Exposure Draft). Paragraph 2 of the Exposure Draft states: 'An entity shall apply this [draft] Standard in accounting for ***all non-financial liabilities***, except: (a) those resulting from executory contracts, unless the contract is onerous; and (b) those within the scope of another Standard.'

12. IAS 39 covers both delivery and exchange contracts. Paragraph 11 of IAS 32 *Financial Instrument: Presentation* defines a financial liability as any liability that is a contractual obligation to (i) ***deliver*** cash or another financial asset to another entity or (ii) ***exchange*** financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity. Some argue that IAS 39 might not be relevant because dividends payable are not contractual obligations while others argue that they are because the entity no longer has the discretion to avoid making the distributions once it declares the distributions.

13. Even if a dividend payable might not exactly meet the definition of a provision and a financial liability in IAS 37 and IAS 39 respectively, the staff believes that the IFRIC could still apply IAS 37 and/or IAS 39 by analogy.

14. This paper discusses the following three alternatives in respect of how an entity should measure its dividends payable:

- ***Alternative 1*** **–** All dividends payable should be measured in accordance with IAS 39; and
- ***Alternative 2*** **–** All dividends payable should be measured in accordance with IAS 37; and
- ***Alternative 3*** **–** Dividends payable should be measured in accordance with IAS 37 or IAS 39 depending on the type of asset to be distributed.

15. Under both Alternative 1 and Alternative 2, all dividends payable are addressed by one single standard. Some believe that all dividends payable, regardless of the types of the assets to be distributed, should be accounted for in the same way. This is because the purpose of all distributions is the same – that is, to distribute 'something' valuable to the equity holders.

Alternative 1 – All dividends payable should be measured in accordance with IAS 39

16. An entity's dividends payable represent its obligations to deliver its assets to its equity holders.

17. IAS 39 covers contracts that require one party to deliver financial assets to another party.

18. Consequently, supporters of Alternative 1 believe that an entity should apply IAS 39 to measure its dividends payable when:

    - the dividends payable require an entity to deliver financial assets to its equity holders; and
    - the dividends payable meet the definition of contractual obligations. Supporters of Alternative 1 believe that the fact that the entity no longer has the discretion to avoid making the distributions meets the definition of a contract in accordance with Paragraph 13 of IAS 32[1].

19. Supporters of Alternative 1 believe that this view is consistent with the following requirements:

    - F.2.7 of the Guidance on Implementing IAS 39 states: 'a declared dividend that has not yet paid and is recognised as ***a financial liability*** may qualify as a hedged item, for example, for foreign currency risk if it is denominated in a foreign currency.'
    - AG13 of IAS 32 states: 'if such a contract contains an obligation for the entity to pay cash or another financial asset, it also gives rise to a liability for the present value of the redemption amount. An issuer of non-puttable ordinary shares assumes ***a liability*** when it formally acts to make a distribution and becomes legally obligated to the shareholders to do so.'

[1] Paragraph 13 of IAS 32 states: 'In this Standard, 'contract' and 'contractual' refer to ***an agreement*** between two or more parties that has clear economic consequences that the parties ***have little, if any, discretion to avoid***, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.'

20. Moreover, proponents of Alternative 1 believe that all dividends payable should be addressed by one single standard to ensure that all dividends payable are accounted for in the same way. Consequently, they believe that an entity should also apply IAS 39 by analogy to dividends payable other than those described in paragraph 18.

Initial measurement in accordance with IAS 39

21. Paragraph 43 of IAS 39 requires an entity to ***initially measure a financial liability at its fair value***. Applying this requirement to a dividend payable means that the dividend payable should initially be measured at its fair value.

22. In determining the fair value of a dividend payable, the staff believes that an entity inevitably has to consider the fair value of the assets to be distributed.

Subsequent measurement in accordance with IAS 39

23. Paragraph 47 of IAS 39 requires an entity to measure all financial liabilities at amortised cost using the effective interest method except for certain circumstances.

24. Paragraph 9 of IAS 39 defines the amortised cost of a financial asset or a financial liability as the amount at which the financial asset or financial liability is measured at initial recognition minus principal payments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectability.

25. AG8 of IAS 39 requires an entity to recalculate the carrying amount of a financial liability measured at amortised cost based on the financial liability's ***original effective interest rate***. The adjustment is recognised ***as income or expense in profit or loss immediately***.

26. Some raise the following questions:

- Whether it is appropriate to recognise any differences in the carrying amount of the dividends payable in profit or loss. They note that the carrying amount of dividends payable is adjusted to reflect the most up-to-date 'values' of the distributions. In their view, adjustments to the carrying amount of dividends payable should be recognised in equity (ie the place where the distributions are initially debited).
- When an entity declares that it will deliver non-financial assets to its equity holders, how it could subsequently measure its dividends payable based on the amortised cost method. The amortised cost method in IAS 39 is specifically designed for financial assets and financial liabilities.

Alternative 2 – All dividends payable should be measured in accordance with IAS 37

27. Similar to Alternative 1, supporters of Alternative 2 believe that all dividends payable, regardless of the type of asset to be distributed, should be addressed by one single standard to ensure that all dividends payable are accounted for in the same way.

28. Proponents of Alternative 2 believe that dividends payables are **not** contractual obligations because of the nature of the distributions – that is, non-reciprocal transfers of assets by an entity to its equity holders.

29. Supporters of Alternative 2 do ***not*** believe that the requirements set out in paragraph 19 require dividends payable to be within the scope of IAS 39. They note that the primary purpose of IG F.2.7 is to prohibit a forecast transaction in the entity's own equity instruments or forecast dividend payments to be designated as hedged items. In addition, IG F.2.7 does not say that a dividend payable must be a financial liability. It merely states that, if a dividend payable is recognised as a financial liability, it could be a hedged item. Moreover, they note that AG13 of IAS 32 merely states that a dividend payable is a liability (ie AG13 of IAS 32 does not specify whether a dividend payable should be within the scope of IAS 37 or IAS 39).

Initial measurement in accordance with IAS 37

30. Paragraph 36 of IAS 37 requires the amount recognised as a provision to be the best estimate of the expenditure required to settle the present obligation at the balance sheet date (hereinafter referred to as ‘the best estimate’).

31. Paragraph 37 of IAS 37 states that the best estimate of an obligation is either:

    - the amount that an entity would ***rationally pay to settle*** the obligation at the balance sheet date; or
    - the amount that an entity would pay to ***transfer*** the obligation to a third party at the balance sheet date.

32. The purpose of this paper is ***not*** to discuss whether there are any differences between the amounts determined in accordance with the first and second bullets.

33. It is obvious that an entity would have to consider the fair value of the assets to be distributed when it determines the best estimate of the dividends payable based on the second bullet in paragraph 31.

34. Even if an entity uses the first bullet in paragraph 31 to determine the best estimate of the dividends payable, supporters of Alternative 2 believe that the entity should take into account the fair value of the assets to be distributed. In their view, the first bullet requires an entity to consider the cash-price equivalent of the assets to be distributed as if the dividends payable were settled in cash.

35. Some might argue that an entity can determine the best estimate of the dividends payable based on the carrying amount of the assets to be distributed (if they use the first bullet described in paragraph 31). Supporters of Alternative 2 disagree with such a measurement basis. They note that current IFRS literature never allows an entity to estimate the value of a liability based on the carrying amount of a related asset. Current IFRS literature requires an entity to consider the fair value of the related asset (rather than the carrying amount of the related asset) to determine the carrying amount of the liability. For example, IAS 19 requires an entity to consider the present value of other long-term employee benefits and the

fair value of plan assets separately to determine the amount recognised as a liability for other long-term employee benefits.

36. In addition, there are some additional questions that must be addressed if an entity uses the carrying amount of the assets to be distributed to measure its dividends payable:

    - How to apply such a measurement basis when equity holders are allowed to choose either (i) non-cash assets or (ii) cash in an amount that is equivalent to the fair value of the non-cash assets?
    - Whether the carrying amount of the dividends payable should be adjusted when the carrying amount of the assets to be distributed changes? If so, how should any adjustments to the carrying amount of the dividends payable be accounted for?

Subsequent measurement in accordance with IAS 37

37. Paragraph 59 of IAS 37 requires provisions to be reviewed at each balance sheet date and to be adjusted to reflect the current best estimate.

38. Paragraph 45 of IAS 37 states that, when the effect of time is material, the amount of a provision should be the present value of the expenditure expected to be required to settle the obligation. Paragraph 47 of IAS 37 requires the discount rate to be a pre-tax rate that reflects ***current market assessments*** of the time value of money and the risks specific to the liability.

39. IAS 37 does ***not*** specify how any changes in the best estimate of a liability should be recognised. Paragraph 8 of IAS 37 states: ‘Other standards specify whether expenditures are treated as assets or expenses. These issues are not addressed in this Standard. Accordingly, this Standard neither prohibits nor requires capitalization of the costs recognised when a provision is made.’

40. Supporters of Alternative 2 believe that any adjustments to the best estimate of dividends payable to reflect the most ‘up-to-date’ values of the distributions should be recognised in equity (ie the place where the distributions are initially debited).

Alternative 3 – Dividends payable should be measured in accordance with IAS 37 or IAS 39 depending on the types of the assets to be distributed

41. Alternative 3 is a mixture of Alternative 1 and Alternative 2.

42. To include a liability within the scope of IAS 39, the liability must be a contractual obligation. Paragraph 11 of IAS 32 *Financial Instruments: Presentation* defines a financial liability as a liability that is a contractual obligation to (i) deliver cash or another financial asset to another entity; or (ii) exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.

43. Paragraph 13 of IAS 32 states: 'In this Standard, 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.'

44. Consequently, Alternative 3 suggests that an entity should apply IAS 39 to measure its dividends payable when:

    - the dividends payable require an entity to deliver financial assets to its equity holders; and
    - the dividends payable meet the definition of contractual obligations. Supporters of Alternative 3 believe that the fact that the entity no longer has the discretion to avoid making the distributions meets the definition of a contract in accordance with Paragraph 13 of IAS 32.

45. Alternative 3 requires dividends payable other than those described in paragraph 44 to be within the scope of IAS 37. Like those who support Alternative 2, supporters of Alternative 3 believe that IAS 37 covers all liabilities other than those arising from executory contracts and those that are addressed by other standards.

Initial measurement under Alternative 3

46. Paragraphs 21 and 30 specify how an entity should apply IAS 37 and IAS 39 to initially measure its dividends payable. This section does not discuss them further.

47. Supporters of Alternative 3 believe that an entity should consider the fair value of the assets to be distributed, regardless of whether it uses IAS 37 or IAS 39 to initially measure its dividends payable. This is because the entity has an obligation to deliver non-cash assets to its equity holders.

48. In addition, proponents of Alternative 3 note that there are some similarities between how an entity determines the fair value of a liability under IAS 39 and how the entity determines the best estimate of a liability under IAS 37:

    - When an entity uses a valuation technique to determine the fair value of a financial instrument, IAS 39 requires an entity to consider all possible outcomes (eg all observable factors that a market participant would take into account in setting the price of a financial instrument)[2].
    - IAS 37 requires an entity to consider the same three measurement building blocks that IAS 39 uses to estimate the fair value of a financial liability in accordance with IAS 39. The three measurement building blocks are: (i) an estimate of the amount to be paid; (ii) an estimate of for the time value of money; and (iii) an adjustment for the risk and uncertainty surrounding the estimate.

Subsequent measurement under Alternative 3

49. Paragraphs 23 and 37 specify how an entity should apply IAS 37 and IAS 39 to subsequently measure its dividends payable. This section does not discuss them further.

50. Given that IAS 39 requires any changes in the carrying amount of a liability determined using the amortised cost method to be recognised in profit or loss immediately, supporters of Alternative 3 believe that such a requirement should also be applied to dividends payable within the scope of IAS 37 (ie any changes in the carrying amount of dividends payable within the scope of IAS 37 should also be recognised in profit or loss immediately).

[2] See AG82 of IAS 39.

APPLICATION OF ALTERNATIVES 1 – 3

51. The table below summaries how an entity applies Alternatives 1 – 3 to the following three situations to measure its dividends payable:

- **Situation 1 –** An entity declares that it will distribute ***financial assets*** to its equity holders. Financial assets include receivables and ownership interests in another entity.
- **Situation 2 –** An entity declares that it will distribute ***non-financial assets*** to its equity holders.
- **Situation 3 –** An entity declares that it will distribute ***non-financial assets*** to its equity holders. The equity holders ***have a choice*** to receive either the non-financial assets or cash with an amount that is equal to the cash price equivalent of the non-financial assets.

	Situation 1	**Situation 2**	**Situation 3**
***Initial* measurement of dividends payable**			
Alternative 1	Based on the fair value of the dividends payable in accordance with IAS 39.		
Alternative 2	Based on the best estimate of the dividends payable. In determining the best estimate of the dividends payable, an entity should consider the fair value of the financial assets to be distributed.	Based on the best estimate of the dividends payable. In determining the best estimate of the dividends payable, an entity should consider the fair value of the non-financial assets to be distributed.	Based on the best estimate of the dividends payable (ie the cash-price equivalent of the non-financial assets to be distributed).
Alternative 3	Based on the fair value of the dividends payable in accordance with IAS 39.	Based on the best estimate of the dividends payable in accordance with IAS 37.	Some believe that dividends payable arising from Situation 3 are within the scope of IAS 39 because (i) the dividends payable could be settled in cash and (ii) the entity has an obligation to deliver cash if the equity holders choose cash.

	Situation 1	**Situation 2**	**Situation 3**
***Subsequent* measurement of dividends payable**			
Alternative 1	Generally based on the amortised cost of the dividends payable. Any changes in the carrying amounts of the dividends payable are recognised ***in profit or loss*** immediately. When an entity declares that it will distribute non-financial assets to its equity holders, a question arises as to how the entity should determine the amortised cost of such dividends payable.		
Alternative 2	Based on the best estimate of the dividends payable. Any changes in the carrying amounts of the dividends payable are recognised ***in equity*** (ie the place where the distributions are initially debited).		
Alternative 3	Generally based on the amortised cost of the dividends payable in accordance with IAS 39. Any changes in the carrying amount of the dividends payable are recognised in profit or loss immediately in accordance with IAS 39.	Based on the best estimate of the dividends payable in accordance with IAS 37. Alternative 3 suggests that any changes in the carrying amount of the dividends payables should be recognised in profit or loss immediately by analogy to the requirements in IAS 39.	Generally based on the amortised cost of the dividends payable (assuming that dividend payables arising from Situation 3 are within the scope of IAS 39). Any changes in the carrying amount of the dividends payable are recognised in profit or loss immediately in accordance with IAS 39.

STAFF RECOMMENDATION

52. Under Alternative 1 and Alternative 3, any changes in the carrying amounts of dividends payable, until they are settled, are recognised in profit or loss immediately. Such an accounting treatment is based on the requirement in IAS 39 that any changes in the carrying amount of a liability determined using the amortised cost approach should be recognised in profit or loss immediately.

53. However, the staff questions whether it is appropriate to recognise any differences in the carrying amount of the dividends payable in profit or loss. Any adjustments to the carrying amount of dividends payable are to reflect the most up-to-date 'values' of the distributions. The staff believes that such adjustments should be recognised in equity (ie the place where the distributions are initially debited).

54. In addition, if any changes in the carrying amount of the dividends payable are recognised immediately in profit or loss, and any changes in the carrying amount of the non-cash assets to be distributed are not recognised in profit or loss, there will be an accounting mismatch in profit or loss.

55. The staff agrees with supporters of Alternatives 1 and 2 that all dividends payable, regardless of the types of the assets to be distributed should be addressed by one single standard.

56. However, the staff is concerned with Alternative 1 regarding how an entity can determine the amortised cost of dividends payable that require the entity to deliver non-financial assets to its equity holders.

57. For the above reasons, the staff recommends Alternative 2.

QUESTIONS FOR THE IFRIC

58. The staff would like to remind the IFRIC that this paper only addresses how an entity should ***in principle*** measure its dividends payable. Paper 2C discusses possible exceptions to the principle measurement requirement.

59. Which Alternative do you prefer? Why?

60. If you prefer Alternative 1 (ie all dividends payable should be measured in accordance with IAS 39),

    - Do you have any comments regarding how any changes in the carrying amount of the dividends payable should be accounted for?
    - Do you have any comments regarding how an entity can determine the amortised cost of dividends payable that require it to deliver non-financial assets to its equity holders?

61. If you prefer Alternative 2 (ie all dividends payable should be measured in accordance with IAS 37),

    - Do you agree that an entity should consider the fair value of the assets to be distributed in determining the best estimate of the dividends payable?

- Do you agree that any changes in the carrying amount of the dividends payable should be recognised in equity (ie the place where the distributions are initially debited)?

62. If you believe that none of the alternatives set out in the paper are not appropriate, what other alternatives do you prefer? Why? What is the implication of your suggested approach to Situations 1 – 3?