IFRIC Meeting

Staff Paper

Agenda reference **9**

Date **November 2009**

Project **Tentative agenda decisions**

Topic **IAS 18 *Revenue* – Receipt of a dividend of treasury shares**

Purpose of this paper

1. The purpose of this paper is to document the staff's analysis and recommendations relating to a request to consider the recognition as revenue, in the separate financial statements of an investor, of dividends received in the form of the investee's own equity instruments (treasury shares). As such, this paper:
   (a) provides background information on this issue;
   (b) analyses the issue within the context of IFRSs;
   (c) provides preliminary agenda criteria assessment;
   (d) makes a staff recommendation on the tentative agenda decision; and
   (e) asks the IFRIC whether they agree with the staff recommendation.

Background information

2. In October 2009, the staff received a request to add to the IFRIC agenda the issue of how an investor, specifically when accounting for an investment at cost (for example when the investment is in a subsidiary, jointly controlled entity or associate), should record the receipt of a dividend of the investee's treasury shares (dividend of treasury shares).

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IFRIC.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IFRIC or the IASB. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

Decisions made by the IFRIC are reported in IFRIC *Update*.

Interpretations are published only after the IFRIC and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in IASB *Update*.

3. The request is for an interpretation of paragraph 29(a) of IAS 18 *Revenue* which states that revenue arising from dividends shall be recognised when '*it is probable that the economic benefits associated with the transaction will flow to the entity'*.

4. The requester identifies two views of how the investor should reflect a dividend of treasury shares in their separate financial statements:

   (a) **View A** – the dividend of treasury shares **is not** an economic benefit as it does not change the economic situation of the investor or its interest in the investee. The dividend of treasury shares is similar to a bonus or scrip issue and **no revenue is recognised** by the investee for receipt of the dividend.

   (b) **View B** – the dividend of treasury shares **is** an economic benefit to the investor and is similar in substance to a cash dividend. The investor should **recognise revenue** in relation to the dividend.

5. The full text of the agenda request has been included as Appendix B.

Staff analysis

6. In conducting their analysis the staff identified two different situations:

   (a) **Situation 1** – all ordinary shareholders are offered a dividend of treasury shares on a pro-rata basis. There is **no** cash dividend alterative.

   (b) **Situation 2** – all ordinary shareholders are offered a dividend of treasury shares on a pro-rata basis **or** a cash dividend alternative.

7. The staff suggests that these two situations should be analysed separately.

Situation 1

Economics

8. In Situation 1, **all** ordinary shareholders are offered a pro-rata dividend of treasury shares.

9. As a result, the dividend does not change the financial position or economic interest of any of the investors as the value of their investment and the ownership share they hold in the investor remains unchanged.

IFRS Guidance

10. Paragraph 29(a) of IAS 18 *Revenue* states that revenue arising from dividends shall be recognised when '*it is probable that the economic benefits associated with the transaction will flow to the entity*'.

11. In Situation 1, in accordance with paragraph 29 (a) of IAS 18, the staff **does not** consider that the investor would record any revenue as a result of the dividend of treasury shares as it is **not** probable that the economic benefits associated with the transaction will flow to the entity. This is consistent with **View A** in paragraph 4 (a) above.

12. This reflects the economics of the transaction which do not meet the future economic benefit criteria in paragraph 53 of the *Framework* as the dividend does not have '*the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity.*'

13. This is also consistent with the guidance in Paragraph 33 of IAS 32 *Financial Instruments: Presentation* which includes the principle that no 'gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments'.

Question 1 for the IFRIC
Does the IFRIC agree with the staff's analysis in paragraphs 8 - 13 that in Situation 1 the dividend of treasury shares should **not** be recognised as revenue?

Situation 2

Economics

14. In Situation 2, the ordinary shareholders are offered a dividend of treasury shares on a pro-rata basis **or** a cash dividend alternative.

15. As a result, the choice presented impacts the financial position and economic interest of all of the investors.

16. These investors will experience a change in the value of their investment and their ownership share as a result of certain shareholders choosing the dividend of treasury shares and others selecting the cash dividend alternative.

IFRS Guidance

17. Paragraph 29(a) of IAS 18 *Revenue* states that revenue arising from dividends shall be recognised when '*it is probable that the economic benefits associated with the transaction will flow to the entity*'.

18. In Situation 2, in accordance with paragraph 29 (a) of IAS 18, the staff considers that the investor **would** record revenue as a result of the dividend of treasury shares as the dividend it **is** probable that the economic benefits associated with the transaction will flow to the entity. This is consistent with **View B** in paragraph 4 (b) above.

19. Those investors choosing the dividend of treasury shares will see an increase in their ownership share and the potential to receive an increase in future cash flows in accordance with the future economic benefit criteria in paragraph 53 of the *Framework*.

20. Recognition of revenue by investors choosing to receive a dividend of treasury shares will also be consistent with the accounting by those investors choosing to receive the cash dividend alternative.

21. Revenue from the dividend is recognised on a basis consistent with paragraph 30(c) of IAS 18 *Revenue* which states that: *'dividends shall be recognised when the shareholder's right to receive payment is established'* and, where applicable, with the consistent guidance in paragraph 38A of IAS 27 *Consolidated and Separate Financial Statements* which states that '*An entity shall recognise a dividend from a subsidiary, jointly controlled entity or associate in profit or loss in its separate financial statements when its right to receive the dividend is established'*.

Investment impairment considerations

22. The staff notes that in Situation 2, where the investor receives a dividend of treasury shares that is recognised as revenue, that this economic benefit will also be reflected in the recognition of an increase in the financial asset in accordance with paragraph 11(b) of IAS 32.

23. As a result, the investor should assess any impairment impacts relating to the investment as a result of the dividend of treasury shares on the same basis as if a cash dividend had been received.

24. This would require the investor to determine if the dividend is considered a 'loss event' in accordance with paragraph 59 of IAS 39 *Financial Instruments: Recognition and Measurement*.[1]

Question 2 for the IFRIC
Does the IFRIC agree with the staff's analysis in paragraphs 14 -24 that in Situation 2 the dividend of treasury shares should be recognised as revenue?

[1] The staff notes that *Annual Improvements to IFRS – Exposure Draft August 2009* proposes an amendment to IAS 27 to clarify that in its separate financial statements the investor shall apply the provisions of IAS 39 to test its investments in subsidiaries, jointly controlled entities and associates for impairment.

Staff recommendation

Agenda criteria assessment for the IFRIC

25. The staff's preliminary assessment of the agenda criteria is as follows:

    (a) *The issue is widespread and has practical relevance*

    Yes. The issue has been identified as being widespread across different jurisdictions by a national standard setter. The issue also has practical relevance given the impacts of the current environment on the dividend policies of entities.

    (b) *The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The IFRIC will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.*

    No. IFRSs, specifically IAS 18, provide clear guidance on when revenue arising from dividends shall be recognised.

    (c) *Financial reporting would be improved through elimination of the diverse reporting methods.*

    Yes based on (a) above.

    (d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process. The issue should be sufficiently narrow in scope to be capable of interpretation, but not so narrow that it is not cost-effective for the IFRIC and its constituents to undertake the due process associated with an Interpretation.*

    Yes. The issue is sufficiently narrow in scope, but is not so narrow that it would not be cost-effective for the IFRIC and its constituents to undertake the due process associated with an Interpretation.

    (e) *It is probable that the IFRIC will be able to reach a consensus on the issue on a timely basis.*

    Yes. It would be expected that the IFRIC would be able reach a timely consensus.

(f) *If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB's activities. The IFRIC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the IFRIC requires to complete its due process.*

No. The Board is not currently considering the recognition of dividends as part of its project on Revenue Recognition.

26. Based on the assessment of the agenda criteria in paragraph 25, the staff recommends that the IFRIC does not add the issue to its agenda. The proposed wording for the tentative agenda decision is set out in Appendix A.

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Question 3 for the IFRIC
1. Does the IFRIC agree with the staff's recommendation not to add this issue to its agenda? If not, how does the IFRIC recommend the staff to proceed? 2. Does the IFRIC have any comments on the proposed wording for the tentative agenda decision in Appendix A?

[Appendix A has been omitted from this observer note]

Appendix B – Agenda request

B1. The staff received the following IFRIC agenda request. All information has been copied without modification by the staff.

ISSUE

1. The issue concerns the accounting for dividends in the separate financial statement of a shareholder when it receives dividends in the form of investee's own equity instruments ('treasury shares').
2. The issue is especially relevant in the separate financial statement when the investment is carried at cost (i.e. cases in which the investment is a subsidiary, joint venture or associate), but it can be extended to the accounting for available for sale equity instruments in the consolidated financial statements.
3. The case is the following:

   Entity Z controls entity Y and therefore it carries the investment in entity Y at cost in its separate financial statement in accordance with IAS 27. Entity Y purchases its own equity instruments in the capital market and then decides to distribute those treasury shares to its shareholders as dividends.

   The issue concerns what should be reflected in the separate financial statement of Z as a consequence of the distribution.

CURRENT PRACTICE

4. The issue could be addressed following two different views.

<u>VIEW A</u>

5. According to View A, the distribution of treasury shares does not determine economic effects in the accounts of the investor, since it does not modify its economic and financial position.
6. In this view, the distribution is equivalent to a scrip issue, since it assigns shares pro-rata to all the shareholders and does not change the relative interest or the economic benefits of each shareholder. The economic effects produced by the transaction occur at the moment of the purchase of the treasury shares. The distribution does not change the value of the interest in the investee.
7. The position could be supported by this example:

   Entity Y has a 200 CU equity formed by 100 shares (to simplify, book value of equity coincides with its fair value). The investment in Y is carried at a cost of 60 CU in the separate financial statements of Entity Z.

   The equity of the entity Y is owned by entity Z (60%) and other shareholders (40%).

   Y purchases the 20 shares in the capital market at their fair value (40 CU). After this, the value of Z's interest in Y is 120 CU.

   Y distributes the treasury shares purchased as dividends to the shareholders. After the distribution of the 20 treasury shares, the value of Z interest in Y is still 120 CU.

   As clearly evidenced by the example, the position of Z after distribution is equivalent to the position existing at the time of repurchasing.

8. Under view A, the accounting treatment would be the same as for the scrip issue:

   Neither the purchase of treasury shares by Entity Y, nor the distribution of dividends affects the separate financial statements of Entity Z. Under this view the distribution of treasury shares does not give any economic benefit to shareholders, consequently for Entity Z there is no gain to be recognized in accordance with IAS 18. Consistently, no financial asset is recognized in the separate financial statements of Entity Z, even though it has a right to receive equity instruments of Y, that were previously purchased in the capital market by Y.

VIEW B

9. According to View B, the distribution of treasury shares as dividends replicates, in substance, the effects of a usual distribution in cash. This is clearly demonstrated by the following example:

   Entity Y has a 200 CU equity formed by 100 shares (to simplify, book value of equity coincides with its fair value). The investment in Y is carried at a cost of 60 CU in the separate financial statements of Entity Z.

   The equity of the entity Y is owned by entity Z (60%) and other shareholders (40%).

   Y purchases the 20 shares in the capital market at their fair value (40 CU) and distributes them as dividends to the shareholders.

   After the distribution, Z owns 75% of Y's equity, whose fair value is 120 CU, and the book value of the investment in the separate financial statements of Entity Z becomes 84 CU. If Z decides to sell in the market the 15 shares just received as dividends, it would receive 24 CU and the value of the remaining shares would be 96 CU.

   The final position of Z after the distribution and the sale of treasury shares received as dividends would be the following:

24 CU cash,

96 CU fair value of the investment in Y,

60% of the interest in Y equity.

If, instead of purchasing treasury shares and distributing them as dividends, Y had distributed directly 40 CU as dividends in cash, the final position of Z would be the same:

24 CU cash (60% of earnings distributed),

96 CU fair value of the investment in Y (60% of the fair value of Y after the distribution of 40 CU in cash to the shareholders),

60% of the interest in Y.

10. There is not doubt about the fact that the overall value of the investment (original shares plus shares distributed as dividends) does not change after the distribution of treasury shares, but it could be argued that the same happens in every dividend distribution, even if in cash[2]. According to view B, the two operations, distribution of dividends by cash or by treasury shares of the same amount, produce equivalent effects on the economic and financial position of the investor[3].

11. Furthermore, it seems that not allowing recognition of revenue for dividends received would be inconsistent with the general principle for the recognition of financial assets in the financial statement: the investor, after the deliberation of the dividend, has a right to receive equity instruments of another entity. This right allows entity Z to recognize a financial asset, according to the definition given in IAS 32, to which should correspond a revenue. It could be noted that the same happens in the case of scrip issues, which gives rise to an apparent similar right to receive equity instruments from another entity. However, in the

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[2] the value of the investment just before the distribution of dividend is equal to the sum of the value of the shares and the cash received just after the distribution

[3] An exception is represented by the case in which the investor has the burden to sell the shares received as dividends.

case of a scrip issue the investee attributes equity instruments that did not purchase, whose value is equal to the decrease in value of the existing shares at the point of their issue; in this situation it is difficult to admit the existence of an additional financial asset for the investor who receives the shares. Differently, the distribution of treasury shares does not imply direct consequences for the fair value of the other shares.

12. In this view, treasury shares are considered a cash-equivalent, so that these distributions should be treated as distribution in kind. In some circumstances, entities give the choice to their shareholders to receive dividends in the form of cash or in the form of shares of equivalent value of the cash.

13. On the basis of view B, the accounting treatment would be the following:

    when entity Y deliberates the distribution of dividends, entity Z recognize the right to receive financial assets from the associate and a dividend in accordance with IAS 18. At the moment of the distribution, as counterpart entry of the dividends received, entity Z will recognize the equity instruments it received as an increase in the cost of the investment in Y.

REASONS FOR THE IFRIC TO ADDRESS THE ISSUES:

14. The issue described can be potentially treated in different ways due to the different approaches in defining the substance of the transaction.

15. The issue is potentially widespread. It can also be extended to equity instruments accounted for available for sale in accordance with IAS 39, and as a consequence of the credit crunch, it is becoming more common for companies to distribute dividends in the form of treasury shares previously purchased in the market.

16. The issue seems to be very narrow in scope. In term of broadness of scope it is similar to the recent ED 25. We do not think that the IASB's current projects will directly deal with this issue in the short term. For example, the ED on financial instruments seems to be mandatory only in 2012.

17. This is a common issue that could significantly impact the financial statements of many entities. For these reasons, we would request that IFRIC clarify if, and subject to what conditions, a treasury shares distribution should be treated as a cash distribution.