IFRIC Meeting

Staff Paper

Agenda reference 14

Date **January 2010**

Project	**Tentative agenda decisions**
Topic	**IAS 32 *Financial Instruments: Presentation* – Shareholder discretion**

Purpose of this paper

1. The purpose of this paper is to document the staff analysis and recommendations relating to a request on whether a financial instrument should be classified as a financial liability or as equity when it has a contractual obligation to deliver cash to the holder at the discretion of the issuer's shareholders.

2. As such, this paper:

   (a) provides background information on this issue;

   (b) analyses the alternatives;

   (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.

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*.

Background information

3. In November 2009, the IFRIC considered a request on how the 'fixed for fixed' condition in paragraph 22 of IAS 32 *Financial Instruments: Presentation* should be assessed in determining whether a financial instrument should be classified as a financial liability or as equity.

4. In response to the request, the IFRIC concluded that the Board's current *Financial Instruments with Characteristics of Equity* (FICE) project is expected to address issues relating to the fixed-for-fixed condition on a timely basis. Therefore, the IFRIC tentatively decided not to add this issue to its agenda.

5. This agenda paper addresses another request, received in July 2009, relating to the interpretation of the terms of financial instruments in scope of IAS 32.

6. This request is to add to the IFRIC agenda the issue of whether a financial instrument including a contractual obligation to deliver cash is a financial liability or equity, when payment is at the discretion of the issuer’s shareholders. These shareholders may, or may not, be party to the instrument.

7. The request is for an interpretation of paragraph 19 of IAS 32 which explains that if:

   > an entity does not have an *unconditional right to avoid delivering cash* or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability … (emphasis added)

8. Specifically the request notes that paragraph AG26 of IAS 32 states:

   > When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the *discretion of the issuer*, the shares are equity instruments. (emphasis added)

9. However, IAS 32 does not provide specific guidance on classification of a financial instrument when the contractual obligation to deliver cash is at the discretion of the issuer’s shareholders.

10. The requestor identifies three situations for consideration. In each of these situations, preference shares have been issued with terms that would require classification as an equity instrument in accordance with IAS 32, prior to consideration of the following additional terms:

    (a) **Example A** – a preferred dividend must be paid in cash in the event that cash dividends are paid on ordinary shares. Local statutory rules require payment of cash dividends on ordinary shares based on a percentage of annual profits **unless** ordinary shareholders vote to waive this requirement at a general meeting by a super majority of 65%.

    (b) **Example B** – the preferred shares must be redeemed by the issuing entity through issuance of a fixed amount of cash if a change in control occurs. A change in control **must be** approved by a simple majority of ordinary shareholders at a general meeting.

    (c) **Example C** – consistent with Example B, the preferred shares must be redeemed by the issuing entity through issuance of a fixed amount of cash if a change in control occurs. However, a new investor could acquire approval by a simple majority of shareholders of the change in control **without** a general meeting (eg where there are two dominant shareholders who hold more than 50% of the voting shares).

11. The submission identifies four views, which the staff believe reflect the divergence existing in published guidance issued by the global accounting firms:

    (a) **View 1** – actions of ordinary shareholders as part of the entity's decision making and corporate governance process (eg decisions at a general meeting) are **within the control** of the issuing entity.

    (b) **View 2** – actions of ordinary shareholders as part of the entity's decision making and corporate governance process (eg decisions at a general meeting) are within the control of the issuing entity only if they reflect **normal** corporate governance (management) decisions and **not** investment decisions.

This view differentiates between decisions where a shareholder is viewed to be approving management decisions (eg a simple majority shareholder approval of a dividend) and those situations requiring more than approval of a simple shareholder majority, or where shareholders are viewed to be acting in their capacity as an investor (eg in a change of control situation).

(c) **View 3** – same as View 1, however **additional** shareholder decisions (eg those outside of a general meeting) are within the control of the issuing entity.

(d) **View 4** – actions of ordinary shareholders are not part of the entity's decision making process and are **outside the control** of the issuing entity.

12. The submission concludes that applying the views in paragraph 11 to the examples in paragraph 10 would result in the following classification of the preferred shares:

	Example A	**Example B**	**Example C**
View 1	Equity	Equity	Liability
View 2	Depends	Liability	Liability
View 3	Equity	Equity	Equity
View 4	Liability	Liability	Liability

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

Staff analysis

14. Although the request relates to applying the guidance in IAS 32, the staff believe that the range of examples and views identified in the submission creates broader questions relating to the:

    (a) distinction between the issuing (reporting) entity and its shareholders (owners);

    (b) the extent to which a reporting entity can control the actions of its owners; and

    (c) the financial statement implications of shareholder actions.

Distinction between the reporting entity and its owners

15. Guidance in IFRS clearly identifies a distinction between a reporting entity and its shareholders. This guidance includes:

    (a) paragraph 7 of IAS1 *Presentation of Financial Statements* which defines owners as being holders of instruments classified as equity;

    (b) paragraph 8 of the *Framework* which identifies that a reporting entity is an entity for which there are users (including present and potential investors) who rely on the financial statements as their major source of financial information about the entity; and

    (c) paragraph 1 of IAS 24 *Related Party Transactions* which identifies that:

    > The objective of this Standard is to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that *its financial position and profit or loss may have been affected by the existence of related parties* and by transactions and outstanding balances with such parties. (emphasis added)

Extent to which a reporting entity can control the actions of its owners

16. In considering the extent a reporting entity can control the actions and decisions of its owners, paragraph 16 of the *Framework* notes that:

> The financial position of an entity is affected by the *economic resources it controls,* its financial structure, its liquidity and solvency, and its capacity to adapt to changes in the environment in which it operates. (emphasis added)

17. Paragraph 49 (a) of the *Framework* goes on to define that:

> An asset is a resource *controlled* by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. (emphasis added)

with paragraph 57 of the *Framework* adding that an item may satisfy the definition of an asset even when there is no legal control.

18. However, neither the *Framework,* nor other IFRSs, provides specific guidance on decisions controlled by a reporting entity and those decisions at the discretion of its owners that are considered to be controlled by those owners.

19. In the absence of specific guidance, the determination of whether a decision is at the discretion of the shareholders should be considered within the control of the reporting entity depends on the specific facts and circumstances of the situation being analysed.

Financial statement implications of shareholder actions

20. Some IFRSs provide specific guidance on how events dependent on shareholder actions and decisions should be reflected in a reporting entity's financial statements in certain situations.

21. For example, paragraph 10 (a) of IFRIC 17 *Distributions of Non-cash Assets to Owners* implies that a reporting entity should only recognise contingent events relating to shareholder actions **after** the shareholders have exercised this discretion. It requires that a dividend is no longer at the discretion of an entity,

and consequently the liability for a dividend obligation can only be recognised, **after** appropriate approval (for example by the shareholders).

22. This guidance implies that an entity cannot control the actions of its shareholders and that a liability can only be recognised **after** the shareholders have exercised their discretion.

23. In contrast, in the following situations IFRSs require a reporting entity to consider a contingent event relating to shareholder actions **before** the shareholders exercise their discretion:

    (a) Paragraphs 34-43 of IFRS 2 *Share-based Payment* requires application of a different measurement model for share-based payment transactions in which the terms of the arrangement provide the counterparty, rather than the issuing entity, with a choice of settlement.

    (b) In the context of determining whether a non-current asset group (or disposal group) should be classified as held for sale, paragraph 8 of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* requires that:

    > The probability of shareholders' approval (if required in the jurisdiction) should be considered as part of the assessment of whether the sale is highly probable.

24. Finally, some IFRS's recognise that the appropriate accounting model for transactions involving actions of an entity's shareholders depends on **how** a shareholder is acting. For example, paragraph BC 18 of IFRS 2 and paragraph 3 (a) of IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments* both clarify that their scope can include transactions with shareholders, but may not apply when a party is acting in their capacity as a shareholder.

25. As a result, the staff believes that IFRS includes guidance in certain situations indicating that the actions of the entity may be subordinate to those of the owners and that shareholder actions do impact the financial statements of a reporting entity. However, IFRSs do not contain an overall principle of how the financial statements should reflect the actions of the shareholders of a reporting entity.

Current Guidance in IAS 32

26. In determining whether an unconditional right to avoid delivering cash to the holder exists, and consequently whether an instrument should be classified as a financial liability or equity, paragraph 19 of IAS 32 considers the *Framework* definitions and makes reference to the following additional guidance in IAS 32:

    (a) Paragraph 25 which addresses contingent settlement provisions. This guidance states that an instrument would be a financial liability:

    > in the event of the occurrence or non-occurrence of uncertain future events … that are *beyond the control* of both the issuer and holder of the instrument. (emphasis added)

    and refers to paragraph AG 28 of IAS 32 which states:

    > if a part of a contingent settlement provision that could require settlement in cash or another financial asset (or in another way that would result in the instrument being a financial liability) *is not genuine*, the settlement provision does not affect the classification of a financial instrument. (emphasis added)

    (b) Paragraph AG 26 of IAS 32 which notes that:

    > The classification of a preference share as an equity instrument or a financial liability *is not affected by*, for example:
    > (a) a history of making distributions; …
    > (e) an issuer's expectation of a profit or loss for a period;
    > (emphasis added)

27. As a result, IAS 32 clearly requires the reporting entity to consider a contingent event relating to shareholder actions **before** the shareholders exercise their discretion.

28. This application guidance in IAS 32 noted above indicates that judgement is required in determining the substance and nature of the terms and conditions of a financial instrument.

Previous IFRIC discussions

IFRIC 2 Members' Shares in Co-operative Entities and Similar Instruments

29. The IFRIC previously assessed similar issues in IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*. Specifically, paragraph 7 of IFRIC 2 identifies that members' shares are equity if the entity has an unconditional right to refuse redemption of the members' shares.

30. In determining if an unconditional right exists, IFRIC 2 recognises that provisions in local law, regulations and an entity's governing charter should all be considered.

31. Analogy of the guidance in IFRIC 2 to the submission would again require an assessment of the specific facts and circumstances in the examples.

Other IFRIC agenda decisions

32. Two previous IFRIC agenda decisions also addressed how the terms and conditions of a financial instrument determine whether an instrument should be classified as a financial liability or equity:

    (a) In November 2006, the IFRIC clarified that the guidance in paragraphs 18 and AG26 of IAS 32 require classification to be <u>**based on an assessment of the substance**</u> of the contractual arrangement, noting that substance and legal form are commonly consistent, but not always.

    (b) In May 2006, the IFRIC noted that:

        (i) a contractual obligation must be established through the terms and conditions of the financial instrument.

        (ii) economic compulsion, by itself, would not result in a financial instrument being classified as a liability.

        (iii) IAS 32 restricts the role of substance to consideration of the contractual terms of an instrument.

33. The staff believes that these previous agenda decisions are consistent with the tentative agenda decision in November 2009 for the IFRIC not to provide interpretations on the range of specific terms and conditions of financial instruments presented in accordance with IAS 32.

US GAAP considerations

34. US GAAP provides specific guidance on determining whether financial instruments should be classified as a financial liability or as equity when the instrument has a contractual obligation to deliver cash at the discretion of the issuer's shareholders.

35. This guidance indicates that in many situations financial instruments **cannot be classified as an equity instrument** when a contractual obligation to deliver cash is at the discretion of the issuer's shareholders. This reflects the general rule that contracts including **any** provision that could require net-cash settlement cannot be accounted for as equity of the reporting entity.

36. Examples of this include guidance in:

    (a) EITF 00-19 *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock* which states in:

        (i) paragraph 19 that if a company could be required to obtain shareholder approval to increase the company's authorized shares, share settlement *is not* controlled by the company. (emphasis added)

        (ii) paragraph 27 that, if an event that is not within the company's control could require net-cash settlement, then the contract must be classified as an asset or a liability… For example, an *event that causes a change in control of a company is not within the company's control* and, therefore, if a contract requires net-cash settlement upon a change in control, the contract *generally must be classified as an asset or a liability.* (emphasis added)

(b) EITF D-98: *Classification and Measurement of Redeemable Securities* which requires in:

   (i) paragraph 7 that any provision that requires approval by the board of directors *cannot* be assumed to be within the control of the issuer. (emphasis added)

   (ii) Paragraph 8 that a change-in-control provision would require a preferred security to be classified outside of permanent equity if a purchaser could acquire a majority of the voting power of the outstanding common stock, *without* company approval, thereby triggering redemption. (emphasis added)

Staff recommendation

Agenda criteria assessment for the IFRIC

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

    (a) *Is the issue widespread and practical?*

    Yes. Significant interpretation questions exist in determining whether an issuing entity should classify, as a financial liability or equity, instruments with an obligation to deliver cash at the discretion of the issuer's shareholders.

    (b) *Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?*

    Yes. The staff understand that significant divergent interpretations exist in practice, as highlighted in the published guidance issued by the global accounting firms.

    (c) *Would financial reporting be improved through elimination of the diversity?*

    Yes. Financial reporting for instruments involving cash settlement at the discretion of the issuer's shareholders would be improved through elimination of the diversity.

    (d) *Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and the Framework for the Preparation and Presentation of Financial Statements, but not so narrow that it is inefficient to apply the interpretation process?*

    No. Constituents have requested interpretation guidance relating to a range of situations where the issuing entity has an obligation to deliver cash to the holder of a financial instrument at the discretion of the issuer's shareholders.

    The staff consider that the different situations identified in relation to this issue indicates that an interpretation would need to address a range of specific contractual terms and conditions that may require the delivery of cash to the holder at the discretion of the issuer's shareholders.

    The staff is concerned that such an interpretation could have broad implications given there is no overall principle of how the financial

statements should reflect the actions of the shareholders of a reporting entity in IFRSs.

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

No. A range of situations where the issuing entity has an obligation to deliver cash to the holder of a financial instrument at the discretion of the issuer's shareholders exist.

The staff believe it is not probable that the IFRIC would be able to reach consensus in interpreting how the guidance should be applied to the range of contractual terms and conditions of financial instruments that exist.

(f) *If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project?*

No. The issues relate to the current FICE project, specifically the distinction between equity and non-equity instruments where there is currently a divergence between the guidance in IFRS and US GAAP.

The staff also consider that it is unlikely that any guidance on the application of this issue could be provided before the issuance of the FICE ED in the second quarter of 2010 and a final standard in the first half of 2011.

38. Based on the assessment of the agenda criteria, the staff recommend that IFRIC does not add the issue to its agenda.

Question 1 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 is 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.

Suggested agenda item: Classification of a Contractual Obligation as a Financial Liability or Equity - Shareholder Discretion

Dear Mr. Garnett,

It has come to our attention that there are significantly diverging interpretations in practice when classifying a financial instrument containing a contractual obligation to pay cash as a financial liability or equity under IAS 32, *Financial Instruments: Presentation*, in circumstances where the obligation is at the discretion of the issuer's shareholders who may or may not be party to the instrument.

The Issue

The issue is whether a financial instrument that includes a contractual obligation to deliver cash is a financial liability or equity if payment is at the discretion of the issuer's shareholders who may or may not be party to the instrument.

Examples

Example A: "Dividend Pusher" Linked to Mandatory Dividend That May Be Waived By Shareholders

Company A has issued preference shares. The contractual terms of the preference shares entitle holders to receive non-cumulative preferential cash dividends in each period that Company A pays dividends on its ordinary shares. The preferred dividend payable for each semi-annual period may be fixed or indexed to a specified interest rate or other variable. The preference shares are perpetual securities and have no fixed redemption date. Investors in the preference shares have no contractual right to put the preference shares back to Company A and there is no mandatory or contingent redemption obligation.

The contractual terms of the preference shares require that if Company A pays cash dividends on the ordinary shares during the period, the issuer is required to pay the preferred dividends on the preference shares in that period. If a dividend on ordinary shares is not paid in the period, the preference shares have no entitlement to receive a dividend for that period.

Company A's ordinary shares are issued within the legal framework of Country X. The contractual terms of the ordinary shares themselves (i.e., the instrument looked at in isolation of the statutory requirement) do not contain an obligation to pay dividends. However, the statutory requirements in Country X require that any company must

declare and distribute a minimum dividend out of its net profits (if any) equal to 35% of the net profits for the year subject to certain adjustments and limitations. A supermajority representing at least 65% of the paid-up share capital may vote to waive this requirement at a General Meeting of the Shareholders.[1]

Note that this agenda submission does not address the classification of Company A's ordinary shares as a financial liability or equity. It is assumed the ordinary shares are appropriately classified as equity as Company A's obligation to pay dividends on its ordinary shares is a statutory obligation and not a contractual obligation and, therefore, is outside the scope of IAS 32.

This agenda submission focuses on the classification of the preference shares issued by Company A.

Example B: "Change-in-Control" Provision Contingent on Shareholder Approval

Company B has issued preference shares. The contractual terms of the preference shares entitle holders to receive non-cumulative preferential cash dividends semi-annually. The preference shares are perpetual securities and dividend payments are at the discretion of Company B. However, the contractual terms of the preference shares require Company B to redeem the shares for a fixed amount of cash if a new investor acquires a majority of the voting power of the outstanding ordinary shares. Before a new investor can acquire a majority of the voting power, the acquisition must be approved by a majority of the existing ordinary shareholders at a General Meeting of the Shareholders.

Example C: "Change-in-Control" Provision Not Contingent on Shareholder Approval

Same fact pattern as Example B, except that a new investor could acquire a majority of the voting power of outstanding ordinary shares without the approval of ordinary shareholders at a General Meeting of the Shareholders.

Alternative Views

Four alternative views are identified below (Views 2 and 3 are variations of View 1). Appendix C to this agenda submission includes extracts from publications issued by the four large global accounting networks that indicate support for variations of one view or the other.

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[1] A variation of Example A is where the statutory obligation to pay a dividend is waived if (1) the Board declares a zero dividend and (2) a supermajority of the shareholders approves the zero dividend. This variation of Example A is not discussed further in this submission. Note, however, that payment of a dividend is outside the control of the Board and management in both the basic fact pattern in Example A and this variation of the fact pattern.

VIEW 1 - The actions of an entity's shareholders as part of the entity's decision-making and corporate governance processes (e.g., decisions at a general meeting of the shareholders) are within the entity's control as the shareholders of the entity are deemed an extension of the entity. Therefore, a financial instrument containing a contractual obligation to deliver cash is an equity instrument if payment is at the discretion of the issuer's shareholders as part of the entity's decision-making and corporate governance processes.

Proponents of View 1 acknowledge that in each of Examples A, B, and C above, (1) the issuer has a contractual obligation to make payments to holders of its preference shares upon the occurrence or non-occurrence of a future event (i.e., a dividend being paid on ordinary shares or a change of control) and (2) the event that triggers payment is outside the control of the issuer's management and board of directors (in Example A because there is a statutory obligation to pay dividends on ordinary shares out of net profits[2] and in Examples B and C because a purchaser could acquire a majority of the voting power of the outstanding ordinary shares without the approval of the issuer's management or board of directors). Proponents of View 1 note, however, that in Example A the issuer's shareholders have the right to waive the obligation to make a dividend payment on ordinary shares at the issuer's general shareholder meeting and in Example B a change of control requires the approval of the issuer's shareholders at a general meeting. Proponents of View 1 believe the shareholders are acting as part of the entity's decision making and corporate governance processes in making any such decision. Therefore, proponents of View 1 believe that the issuer has discretion to avoid a payment to holders of its preference shares as the ordinary shareholders are acting as an extension of the issuer. Accordingly, proponents of View 1 believe the preference shares in Examples A and B should be classified in equity.

Proponents of View 1 distinguish between Example B and Example C on the basis of whether a change of control requires shareholder approval at a general meeting of the shareholders. If the change of control requires shareholder approval at a general meeting, as in Example B, they classify the preference shares as equity. If the change of control does not require shareholder approval at a general meeting, as in Example C, they classify the preference shares as a financial liability.

Proponents of View 1 analogise to paragraph 10(a) of IFRIC 17, Distributions of Non-Cash Assets to Owners, which emphasises that a liability for a dividend arises only after the relevant authority (e.g., shareholders) have approved the declaration of the dividend put forward by management or the board of directors. In Example A, as a supermajority of the shareholders may choose to vote against the dividend, proponents

[2] Paragraph 25 of IAS 32 describes the issuer's future revenues as an example of an uncertain future event that is beyond the control of both the issuer and the holder. In addition, paragraph AG26(f) of IAS 32 specifies that the issuer's ability or inability to influence the amount of its profit or loss for the period does not affect the classification of preference shares as liabilities or equity.

of View 1 believe there is no liability until shareholder approval is obtained. In other words, whether the entity chooses at its discretion to declare a dividend or is forced to declare a dividend by law, it is not an obligation until approved by shareholders. The obligating event is shareholder approval, not the existence of a requirement to pay a dividend. Similarly in Example B as a majority of the shareholders may choose not to approve a change of control, proponents of View 1 believe there is no liability until shareholder approval is obtained.

VIEW 2 - Same as View 1, except that certain shareholder decisions are outside the entity's control even if they are part of the entity's decision making processes. Such decisions are outside the entity's control if they represent investment decisions rather than corporate governance (management) decisions.

Unlike proponents of View 1, proponents of View 2 believe that where shareholders are acting as part of the entity's decision-making processes (e.g., at a general meeting) a distinction should be made between decisions that are clearly corporate governance decisions and those that are clearly investment decisions. Where a payment (e.g., a dividend) requires the approval of a simple majority of the shareholders at the general meeting (based on the shareholders present, i.e., a quorum at the meeting), they believe that such decisions are part of managing the company and in line with other corporate governance type decisions. In this case, the shareholders are being asked to endorse the regular management decision of whether to distribute or retain resources in the entity. This compares with change of control decision which is a decision taken individually by a shareholder as to whether they wish to sell their shares to a new owner.

Where corporate governance type decisions need to be approved by more than a simple majority consideration needs to be given whether this decision is a normal corporate governance action. For example, if the dividend on the ordinary shares can be waived only by 100% of the shareholders (i.e., asking the shareholders to vote against their normal expectation of a return on their investment), then proponents of View 2 believe this is something other than a normal corporate governance decision and that the contractual obligation to pay cash should be classified as a liability.

Proponents of View 2 would argue that Example A is equity if voting on dividend declarations with a super-majority is considered a normal corporate governance decision. If it was not considered a normal corporate governance decision the instrument would be classified as a financial liability. Proponents of View 2 would argue that Example B and C is a financial liability as the decision whether the entity is acquired by a third party is not a normal corporate governance decision as the shareholder is voting in their capacity as an investor.

VIEW 3 - Same as View 1, except that certain shareholder decisions outside the entity's decision making processes are within the entity's control. Such decisions are within the entity's control if it would be a mere formality to make the decision subject to the entity's decision making processes.

Unlike proponents of View 1, proponents of View 3 classify the preference shares in Example C as equity even if the change of control does not require shareholder approval at a general meeting provided approval in a general meeting would be a matter

of form because one or two dominant shareholders would control the vote (e.g., if one shareholder holds 48% and another shareholder holds 42%, it makes little difference whether a agreement to transfer control is subject to shareholder approval or not).

VIEW 4 - An entity does not control the actions of its shareholders either individually or collectively. Therefore, a financial instrument containing a contractual obligation to deliver cash is a financial liability even if payment is at the discretion of the entity's shareholders.

Proponents of View 4 emphasise that, in Example A above, (1) the issuer has a contractual obligation to make payments to holders of its preference shares if a dividend payment is made to holders of its common shares and (2) the issuer is subject to a statutory obligation to make dividend payments to holders of common shares out of its net profits. In response to View 1, proponents of View 4 note that the issuer's management or board of directors does not control the actions of the issuer's shareholders. In particular, the issuer cannot force a supermajority of its shareholders to vote in favour of a waiver of its obligation to make them a dividend payment.

Similarly in Examples B and C, the issuer cannot prevent a new investor from acquiring a controlling interest. Accordingly, proponents of View 4 believe that Company A does not have discretion to avoid a payment to holders of its preference shares. Therefore, proponents of View 4 believe Company A should classify its contractual obligation to make payments to holders of its preference shares in each of Examples A, B, and C as a financial liability.

Proponents of View 4 believe that paragraph 10(a) of IFRIC 17 is relevant in the instance where following a dividend declaration, management or the board of directors has the ability to change its mind regarding the declaration, i.e., the entity has discretion and is not obligated to pay until shareholder approval is obtained. In Example A, management or the board does not have discretion whether to declare the dividend, and therefore the entity has a financial liability, which is either settled by paying the dividend or relieved if a supermajority of the shareholders agrees to vote against the dividend declaration. The obligating event is the existence of a requirement to declare a dividend, not the shareholders voting for the dividend. Similarly, in Examples B and C, management or the board does not have discretion over whether a change of control will occur and therefore the entity has a financial liability.

Proponents of View 4 note that U.S. accounting literature specifies that the actions of shareholders are not within the control of the issuer when determining the appropriate classification of certain contracts (see Appendix B to this submission).

Classification Table

The following table summarises the classification of the instruments described in the three example fact patterns under each of the four views described above.

	Example A	**Example B**	**Example C**
View 1	Equity	Equity	Liability
View 2	Depends	Liability	Liability
View 3	Equity	Equity	Equity
View 4	Liability	Liability	Liability

Reasons for IFRIC to Address the Issue

Preparers, auditors and users of financial statements would benefit if IFRIC provided timely guidance on this issue. As described elsewhere in this agenda submission, significantly diverging interpretations already exist in practice and the difference in accounting treatment is significant. Moreover, the issue has widespread application (e.g., for certain change-in-control and "dividend pusher" features, in particular in jurisdictions with mandatory dividend requirements). Furthermore, the issue is sufficiently narrow and well-defined to be capable of interpretation within the confines of IFRSs and the Framework. We appreciate the IASB's project plan includes a project addressing financial instruments with characteristics of equity but a standard is not expected to be issued until 2011. Shareholder approval and change of control features are pervasive and clarity on this issue in our view is required before the finalisation of that longer-term project.

Appendix A
IFRS ACCOUNTING LITERATURE

Paragraph 19 of IAS 32 states, in part:

> If an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability, except for those instruments classified as equity instruments in accordance with paragraphs 16A and 16B or paragraphs 16C and 16D […]

Paragraph AG26 of IAS 32 states (emphasis added):

> When preference shares are non-redeemable, the appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument. **When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments**. The classification of a preference share as an equity instrument or a financial liability is not affected by, for example:
>
> (a) a history of making distributions;
> (b) an intention to make distributions in the future;
> (c) a possible negative impact on the price of ordinary shares of the issuer if distributions are not made (because of restrictions on paying dividends on the ordinary shares if dividends are not paid on the preference shares);
> (d) the amount of the issuer's reserves;
> (e) an issuer's expectation of a profit or loss for a period; or
> (f) an ability or inability of the issuer to influence the amount of its profit or loss for the period.

Paragraph 10 of IFRIC 17, *Distributions of Non-Cash Assets to Owners*, states (emphasis added):

> **The liability to pay a dividend shall be recognised when the dividend is appropriately authorised and is no longer at the discretion of the entity,** which is the date:
> (a) when declaration of the dividend, eg by management or the board of directors, is approved by the relevant authority, eg the shareholders, if the jurisdiction requires such approval, or
> (b) when the dividend is declared, eg by management or the board of directors, if the jurisdiction does not require further approval.

Appendix B
U.S. ACCOUNTING LITERATURE

EITF Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*, states, in part (emphasis added):

> **If a company could be required to obtain shareholder approval** to increase the company's authorised shares in order to net-share or physically settle a contract, **share settlement is not controlled by the company.** […]
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> Generally, if an event that is not within the company's control could require net-cash settlement, then the contract must be classified as an asset or a liability. […] For example, **an event that causes a change in control of a company is not within the company's control** and, therefore, if a contract requires net-cash settlement upon a change in control, the contract generally must be classified as an asset or a liability.

EITF Topic No. D-98, *Classification and Measurement of Redeemable Securities*, states, in part (emphasis added):

> Assume that a preferred security has a redemption provision that states it may be called by the issuer upon an affirmative vote by the majority of its board of directors. While some might view the decision to call the security as an event that is within the control of the company, the SEC staff believes that if the preferred security holders control a majority of the votes of the board of directors through direct representation on the board of directors or through other rights, the preferred security is redeemable at the option of the holder and its classification outside of permanent equity is required. In other words, **any provision that requires approval by the board of directors cannot be assumed to be within the control of the issuer.** All of the relevant facts and circumstances should be considered.
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> In another example, consider a preferred security with a deemed liquidation clause that provides that the security becomes redeemable if the common stockholders of the issuing company (that is, those immediately prior to a merger or consolidation) hold, immediately after such merger or consolidation, common stock representing less than a majority of the voting power of the outstanding common stock of the surviving corporation. This change-in-control provision would require the preferred security to be classified outside of permanent equity because **a purchaser could acquire a majority of the voting power of the outstanding common stock, without company approval**, thereby triggering redemption.
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> Other events are solely within the control of the issuer, and, accordingly, classification as part of permanent equity would be appropriate. For example, a preferred stock agreement may have a provision that the decision by the issuing company to sell all or substantially all of a company's assets and a subsequent distribution to common stockholders triggers redemption of the preferred equity security.

In this case, the security would be appropriately classified as part of permanent equity if the preferred stockholders cannot trigger or otherwise require the sale of the assets through representation on the board of directors, or through other rights, because the decision to sell all or substantially all of the issuer's assets and the distribution to common stockholders is solely within the issuer's control. In other words, if there could not be a "hostile" asset sale whereby all or substantially all of the issuer's assets are sold, and a dividend or other distribution is declared on the issuer's common stock, without the issuer's approval, then classifying the security as part of permanent equity would be appropriate.

As another example, a preferred stock agreement may have a provision that provides for redemption of the preferred security if the issuing company is merged with or consolidated into another company, and pursuant to state law, approval of the board of directors is required before any merger or consolidation can occur. In that case, assuming the preferred stockholders cannot control the vote of the board of directors through direct representation or through other rights, the security would be appropriately classified as part of permanent equity because the decision to merge with or consolidate into another company is within the control of the issuer. Again, all of the relevant facts and circumstances should be considered when determining whether the preferred stockholders can control the vote of the board of directors.