STAFF PAPER

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Project	**Financial Instruments with Characteristics of Equity (FICE)**
Paper topic	Shareholders' discretion

CONTACT(S)	Angie Ah Kun	aahkun@ifrs.org
	Uni Choi	uchoi@ifrs.org
	Riana Wiesner	rwiesner@ifrs.org

Purpose of this paper

1. This paper asks the International Accounting Standards Board (IASB) for tentative decisions on proposed clarifications related to the classification of financial instruments applying IAS 32 *Financial Instruments: Presentation* when payment is at the discretion of the issuer's shareholders. More specifically, it discusses financial instruments that include a contractual obligation to deliver cash (or to settle an instrument in such a way that it would be a financial liability) when such settlement is at the discretion of the issuer's shareholders. These shareholders may or may not be party to the financial instrument.

2. In its September 2021 meeting, the IASB discussed problems that arise in practice in classifying financial instruments with contingent settlement provisions (as described in paragraph 25 of IAS 32). One of the practice issues discussed by the Board related to assessing when an event is within the entity's control and particularly, whether a decision taken by shareholders is within the entity's

control. The IASB directed the staff to develop further the potential clarifications that could resolve such practice problems (Agenda Paper 5C).

3. In this paper, the staff will present further analysis taking into account the feedback from the September IASB meeting. The analysis also considers whether the potential clarifications will result in useful information for users of the financial statements. This paper is structured as follows:

   (a) Summary of the staff recommendation;

   (b) Staff analysis;

      (i) Background;

      (ii) Management and the board of directors;

      (iii) Shareholders' discretion;

      (iv) Staff recommendation; and

   (c) Question for the IASB.

Summary of the staff recommendation

4. When classifying a financial instrument that includes a contractual obligation to deliver cash or settle it in such a way that it would be a financial liability at the discretion of the entity's shareholders, applying IAS 32, an entity is required to assess whether it has the unconditional right to avoid that settlement outcome. Specifically, an entity needs to assess whether the shareholders' discretion to require such settlement is within the entity's control.

5. The staff recommend that the IASB propose including as application guidance in IAS 32, factors that may be relevant for an entity to consider in assessing whether a decision of shareholders is within the control of the entity in classifying financial instruments as financial liabilities or equity. The staff recommend that these factors are provided as examples of potentially relevant factors to consider and not as an exhaustive list.

6. In making the assessment described in paragraphs 4–5, an entity would be required to consider factors that are relevant to the particular financial instrument

and the specific facts and circumstances. The relevant factors may include but are not limited to:

(a) type of decision—whether the decision would be routine in nature and made as part of the entity's operating and corporate governance process;

(b) who would initiate the decision—whether the decision would be initiated by management of the entity and subject to shareholders' approval rather than a decision that would be initiated by shareholders; and

(c) would different shareholders benefit differently from the decision—whether different classes of shareholders would benefit differently from the decision made or whether shareholders are also the holders of the instruments being assessed.

7. Different weightings would be applied to the factors because some factors may be more or less relevant to the assessment depending on the particular facts and circumstances and the terms and conditions of the specific financial instrument. Different factors may provide more persuasive evidence in different circumstances. Where a financial instrument contains more than one obligation that gives the shareholders the rights to require payment of cash or settlement in a way that it would be a financial liability, an entity would perform the analysis for each obligation but consider whether any interdependencies affect the entity's overall right to avoid such settlement.

Staff analysis

Background

8. The underlying principle in IAS 32 for distinguishing a financial liability from an equity instrument is whether an entity has the unconditional right to avoid payment in cash, another financial asset or other types of settlement such as a variable number of own equity instruments.

9. Paragraph 19 of IAS 32 states 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 […].

10. Paragraph AG26 of IAS 32 explains that:

> When preference shares are non-redeemable, the appropriate classification is determined by the other rights that attach to them. […] 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. […].

11. Further, paragraph 25 of IAS 32 requires the issuer to consider whether contingent events are beyond the control of both the issuer and the holder of the instrument. This is because the occurrence or non-occurrence of such uncertain future events may require the entity to deliver cash or another financial asset, or otherwise to settle a financial instrument in such a way that it would be a financial liability (collectively referred to as 'liability-type settlement' in this paper). If such a contingent event is beyond the control of the issuer and the holder, the issuer does not have the unconditional right to avoid liability-type settlement, the instrument is classified as a financial liability unless one of the exceptions in paragraph 25 of IAS 32 applies.

12. In practice, it is generally accepted that judgement is required depending on the specific facts and circumstances when assessing whether an event is within an entity's control. This assessment may not be straightforward, for example in the case where full repayment of a financial instrument is required in the case of fraud in the company. Paragraph 25 of IAS 32 gives examples of future events that are beyond the control of both the issuer and the holder of the instrument, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, or the issuer's future revenues, net income or debt-to-equity ratio.

Management and the board of directors

13. In an entity, it is usually the board of directors (or similar governing body) and management that are responsible for day-to-day decision-making in the normal

course of business. The staff believe the board of directors and management can generally be seen as an extension of the entity. This is consistent with paragraph 9 of IAS 24 *Related Party Disclosures* which defines key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

14. The staff do not believe any clarifications are needed to address what is within or beyond the control of management and the board of directors. Most practice questions that have arisen are in the context of where shareholders have discretion to initiate actions or where decisions made by management and the board of directors are subject to shareholder approval. Developing a principle that focuses specifically on management and the board of directors may implicitly assume that other parties like the entity's shareholders are external to management and the board of directors. To assess whether a decision is within the entity's control and ultimately whether an entity has an unconditional right to avoid delivering cash to settle a contractual obligation this paper therefore focuses on whether shareholders or other parties can be seen to represent the entity when they exercise their discretion.

Shareholders' discretion

15. Based on the feedback on the discussion paper *Financial Instruments with Characteristics of Equity (2018 DP)* and the IASB's other consultations in the past, stakeholders specifically requested clarification and further guidance on classifying financial instruments with liability-type settlement that is subject to shareholders' discretion. In particular, when a decision that results in or prevents liability-type settlement is subject to shareholders' approval, the question arises whether such a decision is beyond the control of the entity and hence the entity does not have the unconditional right to avoid such liability-type settlement.

16. We note that there are proposed and current disclosure requirements which may provide information about the classification of financial instruments with liability-type settlement that is subject to shareholders' discretion. In April 2021, the IASB discussed potential disclosures for financial instruments with features of both

financial liabilities and equity instruments so that users of financial statements can better understand the reason for their classification. In addition, paragraph 122 of IAS 1 requires disclosures of judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

17. Some instruments with cash payments subject to shareholder discretion, may fall in the scope of these disclosures, for example, perpetual equity instruments with fixed cumulative coupons or dividend stopper features. However, because IAS 32 is silent on how shareholder discretion affects the classification assessment, in addition to users of financial statements, other stakeholders such as preparers, auditors and regulators would also benefit from additional clarifications or guidance to IAS 32 in this regard.

18. IAS 32 does not include any specific requirement or application guidance on classifying a financial instrument when the contractual obligation for liability-type settlement is at the discretion of the issuer's shareholders. In its March 2010 agenda decision on shareholder discretion, the IFRS Interpretation Committee acknowledged that there is no overall principle in IFRS Accounting Standards (Accounting Standards) of how the financial statements should reflect the actions of the shareholders of a reporting entity.

19. Some stakeholders that responded to the 2018 DP acknowledged that judgement is required in determining the capacity in which shareholders are acting in because it is not always possible to say with certainty whose interests a shareholder represents when it votes on decisions affecting the entity.

20. As discussed by the IASB in September 2021, there are other Accounting Standards that use the notion of 'owners acting in their capacity as owners' of the entity and if the IASB clarifies this notion, there may be knock-on consequences in applying other Accounting Standards.

21. The underlying principle for making classification decisions in IAS 32 is that an entity has a financial liability if it does not have the unconditional right to avoid delivering cash or another financial asset to settle a contraction obligation. Therefore, by implication, if a contingent event that gives rise to liability-type

settlement is within the control of the entity, the entity has the unconditional right to avoid such settlement.

22. In developing potential approaches to address practice questions on shareholder discretion, the staff exercised caution bearing in mind that the objective of the FICE project is to clarify underlying principles in IAS 32 to resolve existing practice issues rather than to make fundamental changes to classification. Based on the staff's understanding of practice, most stakeholders accept that this is an area of judgement and the conclusion depends on facts and circumstances. However, some stakeholders are of the view that shareholders should always be seen as part of the entity while others are of the view that shareholders should never be seen as part of the entity.

23. The staff are of the view that adopting either of these extreme views and applying it to all financial instruments would represent a fundamental change to the classification requirements in IAS 32. Such fundamental changes would not only be outside the scope of this project, it could cause disruption to practice and result in large effects on the market. If shareholders are always regarded as separate from the entity, the classification for many common instruments would be changed to financial liabilities, which may not necessarily provide more useful information for users of the financial instruments. For example, if ordinary shares in some jurisdictions are issued with terms that allow shareholders to demand the payment of dividends at their discretion, the ordinary shares would contain a financial liability component to pay dividends.

24. The staff therefore acknowledge that assessing when shareholders' decisions are within the entity's control is also subject to the particular legal environment of the jurisdiction and the particular rights attributed to shareholders. In addition, it is not possible to make assumptions about the intention of all shareholders that would apply in all circumstances.

25. The staff considered two potential approaches the IASB could take which are set out below.

Approach A—develop a principle

26. As explained in paragraph 23 of this paper, the staff do not think it is appropriate to adopt an extreme view and apply it to all circumstances, ie either all

shareholder decisions are within the control of the entity (resulting in equity classification) or the decisions are always beyond the control of the entity (resulting in financial liability classification). One potential solution could be to develop a principle to apply as part of the classification assessment. However, such a principle would need to be able to be applied consistently to all financial instruments in various jurisdictions.

27. It is generally accepted in practice that decisions are within the entity's control if they are part of the normal operating and corporate governance process of the entity. The proposed principle could be that routine shareholder decisions made as part of the entity's operating and corporate governance processes, are within the entity's control. It is widely accepted that shareholders rights are generally exercised in an (annual) general shareholders' meeting as part of the entity's corporate governance or due to legal requirements.

28. To be 'routine', the decision would for example, be one that is a recurring item on the agenda of the annual general meeting because it relates to the ordinary year-on-year business matters. Such decisions usually require approval of a simple majority of the shareholders present at the general meeting. Examples include approval of interim and annual dividends and approval of the entity's financial statements. The conclusions under Approach A may depend on the corporate governance structures and requirements in different jurisdictions.

29. Conversely, non-routine decisions would involve special business matters such as changing the entity's founding documents or approving a change of control of the entity. In some of these non-routine decisions, shareholders may be regarded as making investment decisions ie acting as investors in particular instruments even when the decisions require a simple majority vote at an (annual) general meeting of shareholders. For example, if the shareholders need to approve a change of control of the entity, they are likely acting as investors when they vote. This is because a change of control involves individual sales of shares in the entity to the new owner and the change of control event would affect the value of their individual shareholding. Such non-routine decisions would be considered to be beyond the entity's control. Common features of non-routine decisions may include:

(a) requiring a higher level of approval than routine decisions. Decisions dealing with routine business matters usually require a simple majority vote and decisions dealing with non-routine business matters often require higher level of approval eg 75% of the votes.

(b) taking place at special meetings outside those where routine decisions are made.

(c) requiring approval from different classes of shareholders separately.

(d) exercisable in exceptional circumstances such as conditional voting rights which are held by some classes of ordinary shareholders or preference shareholders usually to protect their interests. For example, the preference shareholders may be entitled to vote to declare a preference dividend if the entity skips dividend payments x times. In most cases, routine decisions are made by ordinary shareholders that have unconditional voting rights.

30. The proposed principle focuses on the types of decisions made by shareholders and whether they are routine corporate governance decisions or not. Although a common difference between routine and non-routine decisions may be whether they are made at an annual general meeting or a special meeting, this is not always the case. For example, a decision involving change of control of the entity taken at an annual general meeting by simple majority vote that may still be regarded as non-routine.

31. In practice it may not be so obvious whether a decision is routine and made as part of the operating and corporate governance process or not. This may be the case where a new type of transaction arises which has not been voted on before and cannot be regarded as routine. The proposed principle under Approach A may therefore be too restrictive in some cases. In addition, we note that questions exist in practice even when practice appears to have accepted a principle similar to the proposed principle under Approach A. This suggests that the proposed principle on its own would not significantly reduce the current diversity in practice because it would not cover all scenarios that involve shareholder discretion.

32. To address the concerns discussed in paragraph 31 of this paper, the staff considered an alternative approach. Under the alternative approach, whether a

decision is routine and made as part of an entity's operating and corporate governance process would be one of the factors that may be relevant to consider when determining whether the decision is within the control of the entity but not the sole factor.

Approach B—provide application guidance in the form of factors to consider

33. Under this approach, the IASB could provide application guidance in IAS 32 to help entities apply their judgement when classifying financial instruments where liability-type settlement is at the discretion of shareholders. In developing this approach, the staff note that there are many different contractual terms and facts and circumstances that vary from one instrument to another. Due to the large amount of inherent judgement needed in such classification decisions, the staff think it may be difficult for a single principle to be applied consistently to different financial instruments across all jurisdictions.

34. Similar to Approach A, the ultimate objective of this approach is to assess whether an entity has the unconditional right to avoid liability-type settlement of a financial instrument. In doing so, the entity needs to assess whether shareholders would be making decisions on behalf of the entity such that the decision is seen to be within the entity's control.

35. Under this approach an entity would need to consider all relevant factors in assessing whether a particular decision by shareholders is within the control of the entity. Different weightings would be applied because some factors may be more or less relevant to the assessment of control depending on the particular facts and circumstances and the terms and conditions of the specific contract. Different factors may provide more persuasive evidence in different circumstances. The staff expect that determining whether a decision by shareholders is within the control of the entity would require a case-by-case analysis for each type of financial instrument issued.

36. In some cases, a financial instrument being assessed for classification may contain more than one obligation that gives shareholders the rights to require liability-type settlement. An entity would perform the analysis taking into account the relevant factors for each obligation and any interdependencies which may affect the

entity's overall right to avoid liability-type settlement of the instrument. An entity may be able to avoid a liability-type settlement outcome for one obligation by not taking a particular action but not for the other obligation. For example, consider a financial instrument that pays coupons if the issuer pays dividends on ordinary shares. Management could decide not to propose dividends on ordinary shares and thus avoid paying coupons on the financial instrument. However, the holders of that financial instrument also have the power to force the entity to liquidate, at which point the financial instrument becomes repayable in cash at its par amount. In the staff's view, the entity would need the right to avoid cash redemption in both scenarios to conclude that equity classification is not precluded.

37. Based on the IASB discussions in September 2021 and the staff's further research, the staff believe a number of common factors would often be relevant to this assessment. The factors described in paragraphs 38–46 of this paper are not intended to be an exhaustive list. Each factor might not be determinative on their own but could be an indicator that a decision is or is not within the entity's control. The staff discuss each of the factors below with examples illustrating how that factor could be applied.

Type of decision

38. This factor considers whether a decision is a routine decision that would be made as part of the entity's operating and corporate governance process as discussed under Approach A. See paragraphs 27–30 of this paper for more information. Unlike Approach A, an entity may still need to consider other relevant factors.

> For example, interim and annual dividends on ordinary shares may be subject to shareholders' approval. Such decisions would typically be regarded as routine decisions made as part of the entity's operating and corporate governance process.
>
> The shareholders' discretion to approve ordinary dividends would not result in a liability component. Ordinary shares would be classified as equity instruments.

> Consider preference shares that require the issuer to redeem in cash if a change of control of the entity occurs. Change of control must be approved by a simple majority of ordinary shareholders in a general meeting.
>
> Although the decision is made at a shareholders' general meeting, the nature of the decision would not be considered to be routine in the normal course of business.
>
> The change-of-control event is beyond the entity's control and the obligation to redeem the preference shares would be classified as a financial liability.

Who would initiate a decision

39. In some situations, shareholders may have a right to initiate an action such as the sale of a business or sale of their shares, and in others, they have a right to approve or reject a proposal recommended by management and the board of directors, eg approval of dividends proposed. Furthermore, in some cases, a third party may initiate a transaction that the shareholders need to approve for example, an entity that wants to obtain control of the group. If the liability-type settlement of a financial instrument would be initiated by shareholders or other parties (with liability-type settlement requiring shareholder approval), it is likely that those decisions are beyond the control of the entity.

40. In contrast, shareholders' discretion to approve or reject management's proposals, rather than to initiate an action, may sometimes be an indicator that the decision is within the control of the entity. This would be the case if management, acting on the entity's behalf, can decide not to propose the action requiring shareholder approval and thereby avoid the outflow of cash from the entity. The corporate governance framework in many jurisdictions explicitly requires management to act in a fiduciary capacity in the interest of the entity. Consideration of other factors would still be relevant such as whether the decisions are routine decisions that are made as part of the operating and corporate governance process as explained in paragraphs 27–30 of this paper. The staff expect that routine decisions that are part of the operating and corporate governance process would be initiated by management and the board of directors rather than initiated by shareholders without the involvement of management.

> For example, an entity issues a preference share that requires the entity to pay coupons only if the entity pays dividends on its ordinary shares. The dividend payments on ordinary shares require shareholders' approval via a simple majority vote at a general meeting, which is part of the entity's operating and corporate governance process.
>
> The board of directors can decide not to propose a dividend on ordinary shares. The decision to pay dividends on ordinary shares would be considered to be within the control of the entity.
>
> The shareholders' discretion to approve ordinary dividends would not preclude equity classification of the preference shares because the entity can avoid paying cash to preference shareholders by avoiding paying dividends on ordinary shares.

41. However, it may be inappropriate to assume that all decisions initiated by management and board of directors that are subject to shareholders' approval are within the control of the entity. This is because management and the board of directors may not be able to avoid an outflow of cash from the entity by proposing or not proposing an action. It would always be relevant to consider how shareholders' discretion affects the entity's ability to avoid delivering cash or other liability-type settlement.

> For example, a financial instrument requires settlement in cash or a fixed number of the issuer's shares but the issuance of new shares requires shareholders' approval. Also assume that it is not possible to purchase these shares from the open market.
>
> The only way to avoid the outflow of cash is for the board of directors to propose settlement of the instrument in a fixed number of shares. However, the shareholders could reject the issuance of new shares thus preventing the entity from settling the instrument in shares and requiring cash settlement.
>
> Further analysis would be required considering other factors, eg whether the decision to issue new shares is regarded as routine and part of the operating and corporate governance process.

Would different shareholders benefit differently from a particular decision

42. In some circumstances, different types or classes of voting shareholders stand to benefit differently from a particular decision. Such differences in how a decision

benefits different types of shareholders can be an indicator that particular shareholders are acting as investors in particular instruments when they make the decision and that such a decision is likely to be beyond the control of the entity. Consideration of other factors may still be relevant. For example if shareholders are able to require liability-type settlement of their own instrument for their own benefit through exercising their decision-making power (see paragraphs 45-46 of this paper).

> For example, both preference shareholders and ordinary shareholders may be entitled to vote on the sale of the business but the proceeds are not shared equally among them. The issuer would be required to pay the proceeds as dividends. Preference shareholders are entitled to a specified fixed amount from the sale of the business whereas ordinary shareholders are entitled to the remaining proceeds.
>
> Further analysis would be required, for example as to whether the preference shareholders are able to require the entity to pay them the fixed amount through exercising their decision-making power when voting on the sale of the business or whether the decisions are routine decisions that are made as part of the operating and corporate governance process.

43. In some cases, a decision may require approval from different classes of shareholders for example, ordinary and preference shareholders separately. This could indicate that preference shareholders are voting independently of the ordinary shareholders and independently of the entity. It would be important to understand the reason for requiring separate approval. It may be that different classes of shareholders stand to gain differently from the decision or that the decisions are special business matters of a non-routine nature.

44. Conditional voting rights usually protect particular shareholder interests and could also be an indicator that the shareholders will be acting as investors in particular instruments when they exercise their voting rights.

45. In some cases, the shareholders that vote on the entity's decisions that ultimately affect the payment or settlement of a financial instrument are also holders (ie the investors) of the instrument that is being assessed for classification. In such a case, if they are able to require liability-type settlement of their own instrument for their own benefit through exercising their decision-making power, the staff are of the

view that this is an indicator that the decisions are likely to be beyond the control of the entity. Consideration of other factors may still be relevant such as whether the decisions are routine decisions that are made as part of the operating and corporate governance process as explained in in paragraphs 27–30 of this paper.

> Consider preference shares that give their holders the right to demand redemption in cash if the preference shareholders vote against a specified event such as an acquisition of another business.
>
> In such cases, preference shareholders can require the entity to redeem their instruments through the exercise of their vote on the acquisition. The entity would likely conclude that the decision is beyond the control of the entity and it does not have the unconditional right to avoid cash redemption. These preference shares would likely be classified as financial liabilities.

46. In some cases, ordinary shareholders may hold another financial instrument and are able to require liability-type settlement of that other instrument for their own benefit through exercising their decision-making power.

> For example, an entity issues preference shares that require the entity to pay coupons subject to ordinary shareholders approval via a simple majority vote at a general meeting. Assume the entity has 3 ordinary shareholders holding 55%, 35% and 20% respectively and that the shareholder holding 55% also holds the preference share. In this case the controlling shareholder can require the entity to pay coupons on its preference share investment when voting as an ordinary shareholder. This may indicate that the decision to pay coupons is beyond the control of the entity. However, the entity should consider other relevant factors such as if the decision to pay coupons on preference shares is regarded as a routine decision made as part of the operating and corporate governance process.

It may not be possible to identify whether particular instruments being assessed (the preference shares in the example above) are held by ordinary shareholders on initial recognition. The entity would be required to consider other relevant factors in its analysis.

Staff recommendation

47. The staff recommend Approach B because it would allow an entity to use judgement in determining whether a decision is within an entity's control. This is

because we recognise that assessing control in this context requires consideration of all relevant facts and circumstances specific to each case. The staff believe providing examples of potentially relevant factors will support entities making that assessment in a more consistent manner while still requiring them to exercise judgement. While Approach A has the benefit of providing an overarching principle, the proposed principle on its own it may not resolve all the practice issues or reduce diversity in practice in this regard. The proposed principle may be too loose or too restrictive and Approach A ignores other factors that may be relevant to contracts that involve shareholder discretion. We therefore believe that the principle developed under Approach A would be better incorporated as one of the factors an entity may need to consider when applying Approach B. Approach B would thus result in that more useful information is provided to users of financial statements by helping reduce diversity in practice when entities classify financial instruments where payment is subject to shareholder discretion.

48. The staff therefore recommend that the IASB include as application guidance in IAS 32, factors an entity should consider in analysing whether a decision of shareholders is within the control of the entity as set out in paragraph 6 of this paper. The staff recommend that these factors are provided as examples of potentially relevant factors to consider and not as an exhaustive list. An entity would apply different weightings to the factors depending on the specific facts and circumstances. Where a financial instrument contains more than one obligation that gives the shareholders the rights to require liability-type settlement, an entity would perform the analysis for each obligation but consider whether any interdependencies affect the entity's overall right to avoid liability-type settlement of the instrument.

Question for the IASB

49. The staff would like to ask the IASB the following question.

Question for the IASB
Do IASB members agree with the staff's recommendations summarised in paragraphs 4-7 of this paper?