



## Solution 85A.2

<b>Component</b>	Classification, recognition and measurement of complex financial liabilities for banks
<b>Index</b>	Obligation to deliver cash or another financial asset
<b>Short title</b>	Undated notes with discretionary dividends

Attention: This guidance is based on the revised standards and interpretations that are mandatory for accounting periods commencing 1 January 2005. A company may early adopt an individual revised standard, but only in its entirety. Guidance based on the previous version of the standards is included in the "Applying IFRS 2004" guidance.

### Issue

A financial liability is any liability that is [\[IAS32R.11\]](#):

- a) a contractual obligation
  - i. to deliver cash or another financial asset to another entity; or
  - ii. to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
- b) a contract that will or may be settled in the entity's own equity instruments and is:
  - i. a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
  - ii. a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

An equity instrument is defined as any contract that evidences a residual interest in an entity's assets after deducting all of its liabilities [\[IAS32R.11\]](#).

Should management classify preference shares that are redeemable at the option of the issuer as debt or equity instruments?

### Background

Bank A has issued perpetual preference shares that can be redeemed at A's option after 10 years. The preference shares carry a fixed coupon of 5% that must be paid if (and only if) A has paid a dividend on its ordinary shares. Management of bank A has complete discretion over the payment of dividends on its ordinary shares.



## Solution

The preference shares should be classified as equity. A critical feature of a liability is that there is a contractual obligation to pay cash [IAS32R.17]. There is no contractual obligation on A's part to make a payment in cash. Bank A has an unconditional right to avoid delivering cash by deciding not to pay a dividend on its ordinary shares and not to redeem the shares.