THE STANDARD STANCE

Shareholders' Agreement: The Big Three Accounting Puzzles

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A Shareholders' Agreement (SHA) is an important legal document outlining the rights, responsibilities and decision-making rules for a company and its shareholders/ investors. It works alongside the Articles of Association of the company and is customised to meet the specific needs of the different investors. It is particularly useful for start-ups with multiple investors, as it helps set clear rules for managing and running the business while establishing a clear framework for governance, decision-making, and dispute resolution. It serves to protect the interests of the founders and outlines strategies for future fundraising, and is equally critical for investors, providing safeguards such as rights to board representation, veto powers, mechanisms for protecting investments and plans for exit.

Companies and investors usually take the assistance of lawyers while drafting the SHA. However, they often fail to fully appreciate the accounting complexities arising from the specific provisions of the SHA. While there could be various accounting implications arising from the SHA, there are three common areas where companies often face specific challenges. These big three accounting areas or the accounting puzzles that companies need to crack while reviewing the SHA are summarised below.

1. FINANCIAL INSTRUMENTS - DEBT-VERSUS-EQUITY CLASSIFICATION

Companies should begin the SHA analysis by identifying the financial instruments issued. Companies must read the SHA and any related agreements thoroughly to identify all the terms that may require recognition in the financial statements.

Debt-versus-equity determination can be challenging under Ind AS and unusual contractual terms in the financial instruments may have complex accounting consequences. Additionally, there are specific accounting rules for derivatives (or embedded derivatives) components in the financial instruments which must be fair-valued and can cause significant volatility in profit and loss.

While reviewing the SHA, it is critical to analyse the various rights provided to investors/ shareholders to determine the appropriate classification and accounting of the related financial instruments under Ind AS.

#	Rights	Key accounting implications
1	Redemption and dividend rights	Financial instruments that give rise to a contractual obligation to deliver cash or other financial assets are generally classified as financial liabilities. As regards dividend rights, some key terms to keep in mind specifically for accounting purposes are (a) whether the dividends are mandatory or discretionary; (b) what is the basis on which the dividends are determined (e.g., to be distributed, if the company earns profits) and (c) whether the dividends are cumulative or non-cumulative.
2	Conversion rights	Conversion features in convertible instruments (e.g., optionally convertible preference shares or debentures) often meet the definition of a derivative. Some convertible instruments can be complex, with several features, which can significantly impact their classification. They can only be classified as equity if they meet the 'fixed-for-fixed criterion' as per Ind AS. This is a complex area, and hence, specialist advice may help assess complex terms from an accounting perspective. The conversion terms usually also have anti-dilution and down-round provisions. The anti-dilution provisions are usually inserted in the SHA as a protective clause for the investor and adjust the conversion ratio in the event of a new share issue, a stock split or for the payment of dividends to existing shareholders. A down-round feature is an anti-dilution provision that adjusts the conversion ratio if, after a convertible instrument is issued, there is an issue of shares at a price less than the conversion price. Clauses relating to anti-dilution and down-round provisions in the SHA need to be reviewed carefully to evaluate, inter-alia, whether these are added to maintain the relative rights of shareholders and investors, as this would impact its classification and subsequent accounting treatment.
3	Exit rights (e.g., buy-back)	The SHA typically provides for an exit mechanism for the investors. These exit rights might be in the form of an initial public offering (IPO) requirement. If the IPO is not completed by the company within the said timeline, the company may be required to provide an exit to the investors in the form of a share buy-back. This effectively means that the investors' instrument might become mandatorily payable if the IPO is not completed by the specified time period. Although it might be within the company's control to determine whether the IPO is attempted, the success of the IPO is determined by market and regulatory forces. These forces are beyond the company's control, so redemption or buy-back obligation on an IPO event not occurring meets the definition of a contingent settlement event, and it could result in the underlying instrument being classified as a financial liability from inception. Similarly, the SHA could provide rights to the investors, to put the instruments back into the company. The existence of such rights could potentially result in such instruments subject to the put, being classified as a liability.

#	Rights	Key accounting implications
4	Termination rights (e.g., events of default)	Some instruments may have no mandatory payments, except that they are mandatorily redeemable if there is an event of default defined in the SHA. The events of default may include default on existing financial instruments. Whether or not a company defaults on the payment related to an instrument depends, in part, on whether it has adequate resources to make the payments when contractually due. This is not within the company's control, and hence, may result in the instrument being classified as a financial liability.

2. CONTROL ASSESSMENT

Ind AS contains a single control model whereby an investor is required to consolidate an investee if it has all of the following:

- Power over the investee
- Exposure, or rights, to variable returns from its involvement with the investee
- The ability to use its power to affect the amount of the investor's returns.

Under Ind AS, an investor can have power even if it holds less than the majority of voting rights in certain scenarios. Accordingly, it is imperative to review the provisions of the SHA for the various rights provided to different classes of shareholders/ investors and accordingly determine if the company is under the control of any investor.

#	Rights	Key accounting implications
1	Voting and potential voting rights	An investor concludes that it has control over an investee if it owns the majority of shares of its investee that have equal voting rights attached, and those shares have a proportionate entitlement to a share of the returns of the investee. However, this is subject to whether another party holds potential voting rights which, if acquired, would result in that other party having control. Potential voting rights are the rights to obtain voting rights of an investee (e.g. convertible instruments, options and forward contracts). Potential voting rights always affect at least two parties and could result in one investor (that currently holds less than the majority of voting rights and would otherwise conclude that it does not control the investee) consolidating the investee and another investor (that currently holds the majority of voting rights and would otherwise conclude that it does control the investee) not consolidating the investee. Apart from convertible instruments, the following types of rights included in the SHA to acquire or dispose of shares represent potential voting rights (unless no voting rights are attached to the associated shares). ▪ Call options – These provide the holder with the right to acquire shares held by the writer of the option at a price specified by the terms of the option. ▪ Put options – These provide the holder with the right to sell their shares to the writer of the option at a price specified by the terms of the option. Specific facts and circumstances should be assessed to determine whether the potential voting rights are substantive and provide power.

#	Rights	Key accounting implications
2	Substantive versus protective rights	An investor has power over an investee if it has existing rights that give it the current ability to direct the relevant activities. Only substantive rights are considered, with protective rights being disregarded. The distinction between substantive and protective rights can be significant in the analysis of which investor (if any) has the unilateral power to control an investee. Ind AS acknowledges the assessment of whether rights are substantive requires judgment. Protective rights relate to fundamental changes to the activities of an investee or apply in exceptional circumstances. Examples of protective rights are: ▪ A lender's right to restrict borrower's activities (if these could change credit risk significantly to the detriment of the lender) ▪ Capital expenditure greater than that required in the ordinary course of business requiring approval by non-controlling interest holders ▪ Issue of debt or equity instruments requiring approval by non-controlling interest holders ▪ A lender's right to seize assets of a borrower in the event of default The SHA might restrict the investor's ability to exercise all the voting rights that it holds. It might reserve the right to appoint the board of directors to the holders of a certain class of voting shares or restrict the circumstances in which the investor could exercise its voting rights. The SHA might also require unanimous agreement among the shareholders over all major decisions relating to the investee (including things such as paying a dividend, significantly changing the investee's business activities, incurring capital expenditure over a specified level, changing the pay of its directors and other employees, or changing other major relevant activities). In such a situation, if these matters were deemed to be the investee's relevant activities, the investor holding more than 50% of the share capital would not control the investee. However, it might still have joint control or significant influence.
3	Drag-along and tag-along rights	Drag-along rights allow majority shareholders to compel minority shareholders to join in the sale of the company, ensuring a complete transfer of ownership. These rights simplify the sale process by preventing minority shareholders from blocking a deal, making the company more attractive to potential buyers. Tag-along rights give minority shareholders the option to join a sale initiated by majority shareholders, ensuring they can sell their shares under the same terms. These rights protect minority shareholders from being left behind when a significant stake is sold, maintaining fairness in exit opportunities. Both rights aim to balance the interests of shareholders and promote smoother ownership transitions. The 'drag-along' and 'tag-along' rights represent symmetrical exit rights and generally do not give either party the ability to obtain the voting rights of the other. Therefore, these rights do not usually impact the assessment of power over the investee.
4	Other rights	The SHA may include other rights that, either individually or in combination, can give an investor powers that include but are not limited to: ▪ Rights to appoint, reassign or remove members of an investee's key management, who have the ability to direct the relevant activities ▪ Rights to appoint or remove another company that directs the relevant activities ▪ Rights to direct the investee to enter into, or veto any changes to, transactions ▪ Decision-making rights specified in a management contract These rights link to decisions that need to be taken on an investee's operating and financing activities on an ongoing basis, and often it is those rights in combination with voting rights that are likely to give an investor power.

3. SHARE-BASED PAYMENTS

Share-based payment arrangements are arrangements where entities receive or acquire goods or services in exchange for equity instruments or cash amounts based on equity instrument prices. The SHA sometimes includes complex and innovative terms indicating share-based payment arrangements and considerable care needs to be applied in evaluating the requirements in this regard.

The following table provides some key accounting challenges for share-based payments and some accounting considerations to be kept in mind while reviewing certain conditions in this regard.

#	Conditions	Key accounting implications
1	Contingent vesting conditions	Sometimes the SHA includes terms for grant of certain share-based payments that are to be cash-settled only on the occurrence or non-occurrence of a contingent event such as IPOs and changes in control of the company. Where an award is conditional on an IPO occurring, but employee service up to the IPO date is not required (or perhaps service is only required for part of the period), the IPO condition becomes a non-vesting condition. However, in the case of a share-based payment whose settlement is contingent on an IPO (or similar exit event), the award will generally not vest until the IPO occurs (and employees are still employed by the company at that time). In such cases, the vesting period will be expected to commence no later than the grant date and end on the expected IPO date, thereby resulting in the need for the company to assess the requirements of variable vesting periods. The more puzzling question concerns how the date of a future IPO can be estimated reliably in such a situation for accounting purposes. Where the length of the vesting period varies (depending on when a performance condition is satisfied), an estimate is made on the basis of the most likely outcome. In practice, it might be difficult to estimate the date of an IPO; but a reasonable estimate should be made, although it might need to be revised.
2	Reverse vesting conditions	Reverse vesting is a concept which discourages the founders from terminating their association with their company by providing an option to the company to buy back founders' shares in the event they decide to leave the organisation prematurely. Such a clause protects the interests of the company, shareholders, and investors, in the event a founder (who is also an employee of the company) decides to quit the company and take away a substantial number of shares as well as control. The accounting evaluation of such conditions is often puzzling. The presence of reverse vesting conditions usually results in the underlying shares being covered in the scope of share-based payments accounting under Ind AS.
3	Good and bad leaver conditions	The SHA often includes good and bad leaver provisions. A good leaver is often defined as an individual who leaves the company due to injury, disability, death, redundancy or on reaching normal retirement age. A bad leaver is usually defined as anyone other than a good leaver. A bad leaver would not generally be entitled to receive the share-based payment. In this situation, employees could lose their rights to shares if they leave the company, and the shares are repurchased or cancelled. So, employees might only earn their right to the shares if they stay with the company for a particular period or, for example, in the event of a trade sale or an IPO. The inclusion of good and bad leaver provisions in the SHA typically results in the underlying shares coming within the purview of share-based payments accounting under Ind AS.
4	Redemption conditions	The SHA may also include terms specifying the grant of equity instruments to the promoters and/ or employees and an obligation to pay cash at a later date once the shares are vested. Although such terms result in the issue of equity instruments, the shares issued are not accounted as equity-settled share-based payments if the shares are redeemable mandatorily or at the option of the employee. This could result in cash-settled share-based payments for accounting purposes.

CONCLUDING REMARKS

The aforementioned rights and conditions relating to the SHA are illustrative in nature but increasingly becoming common in discussions and negotiations among the stakeholders for the execution of the SHA. As highlighted, the accounting implications of such terms and conditions are often puzzling, and hence, greater care is required to understand the accounting nuances of such provisions in the SHA and effectively manage any surprises from the financial reporting perspective.

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