Project **Put options written over non-controlling interests**

Topic **Cover page**

Purpose of this paper

1. In May 2010, the Committee decided to add the issue of accounting for put options written over non-controlling interests to its agenda.
2. The Committee also directed the staff to develop a paper for discussion at the July 2010 meeting that would:
   (a) include illustrative examples of the issues discussed; and
   (b) assess the proposed scope of the project.
3. The purpose of this agenda paper is to provide an overview of the:
   (a) background to the project;
   (b) the agenda papers to be presented in the July 2010 meeting relating to the accounting for put options written over non-controlling interests;
   (c) staff recommendations for the scope and approach to be included within the proposed Interpretation on the accounting for put options written over non-controlling interests; and
   (d) proposals for the next steps in the project.

Background information

4. As noted in agenda paper 11, which was presented at the May 2010 Committee meeting[1], the Committee received a request for additional guidance on how an entity should account for changes in the carrying amount of a financial liability for a put option, written to a non-controlling interest shareholder (NCI shareholder), in the consolidated financial statements of a parent.

5. The issue arises because of a potential conflict between the guidance in IAS 32 *Financial Instruments: Presentation* / IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 27 *Consolidated and Separate Financial Statements*.

6. Some consider that the guidance in the financial instruments literature is clear. IAS 32 requires a put option written over non-controlling interests to be initially recognised as a financial liability and measured in accordance with IAS 39. IAS 39 requires that changes in the carrying amount of a financial liability must be recognised in profit or loss.

7. Others believe that, consistent with the guidance in IAS 27 on transactions with non-controlling interests (NCI), changes in the carrying amount of a put option written over non-controlling interests should be recognised in equity.

8. The Committee decided to add the issue of accounting for put options written over NCI to its agenda, but requested that the staff consider the scope of the proposed Interpretation when developing the analysis of the issue, and provide the Committee with some illustrative examples of the accounting for these instruments.

[1] http://www.iasb.org/NR/rdonlyres/148401DE-3856-4D10-94A9-AFEB18A3446B/0/1005ap11obsIFRICIAS27NCIPuts.pdf

Overview of July 2010 agenda papers

Overview of scoping issues

9. Two broad scoping questions have been identified by the staff. These relate to, firstly, **which components of the accounting** for put options written over NCI, and secondly, **which put options written over NCI**, should be within the scope of the proposed interpretation.

10. The staff think that it is appropriate to first identify which components of the accounting for a put option written over NCI should be within the scope of proposed interpretation. The analysis relating to this scoping issue will be included in the July 2010 agenda papers.

11. In determining this part of the scope, at a minimum, the issue of accounting for changes in the carrying amount of a financial liability for a put option written over NCI should be included. This is because it was the focus of the agenda request.

12. Once this is determined, and the components of the accounting to be included within the proposed Interpretation are identified, then the staff believe the identification of **which put options written over NCI** should be within scope can be addressed. The analysis relating to this scoping issue will be presented at a future Committee meeting.

13. In determining which put options written over NCI should be within scope, these instruments (**NCI puts**) will at a minimum be defined as:

    (a) a puttable instrument in accordance with the definition in IAS 32.11.

    (b) providing for gross physical settlement in cash only.

    (c) free-standing.

    (d) issued separately from a transaction that is accounted for as a business combination in accordance with IFRS 3 *Business Combinations*.

    (e) accounted for in the consolidated financial statements of the parent.

(f) exercisable at fair value **<u>or</u>** at a fixed price at a specified future date.

(g) written:

(i) after the 2008 amendments were made to IFRS 3, IAS 27 and IAS 39 (collectively, the 2008 Amendments).

(ii) after the effective date of the proposed Interpretation.

(iii) to one NCI shareholder.

(iv) to be non-transferable by the NCI shareholder to a different counterparty.

(v) over all of the shares in a subsidiary which the parent does not hold a present ownership interest in.

(vi) by the parent.

14. This description reflects the staff view of the narrowest set of instruments that should be included within the scope of the proposed Interpretation.

15. Consequently, this description of NCI puts will be used in the first section of the staff analysis addressing which components of the accounting for put options written over NCI should be in scope.

16. In the second section of the staff analysis, when a determination will be made relating to which put options written over NCI should be within scope, the staff will analyse whether this description of NCI puts should be expanded.

17. The staff anticipate presenting this second section of the analysis at the September 2010 Committee meeting.

Which components of the accounting for put options written over non-controlling interests should be within the scope of the proposed interpretation?

18. The staff identified four **<u>components relating to the accounting</u>** for put options written over NCI that could be included within the scope of the proposed Interpretation. These are:

(a) initial recognition (**agenda paper 4B**);

(b) subsequent measurement – NCI put financial liability (**agenda paper 4C**);

(c) subsequent measurement - dividends (**agenda paper 4D**); and

(d) settlement or expiration (**agenda paper 4E**).

19. These agenda papers discuss how NCI puts (as defined above) could be accounted for on initial recognition, on subsequent measurement and on settlement or expiration, in addition to analysing whether each accounting element should be included within the scope of the proposed Interpretation.

20. The request received by the Committee focused upon subsequent measurement, and specifically upon changes in the carrying amount of a financial liability initially recognised for a NCI put.

21. However, the staff believe that in addressing the issue of subsequent measurement, it may be necessary for the proposed Interpretation to address the initial recognition, and settlement and expiration, of NCI puts, because:

(a) some of the rationale and arguments for approaches to subsequent measurement are dependent upon the basis for the initial recognition accounting of the NCI put;

(b) settlement and expiration accounting is impacted upon by the approach to initial recognition and subsequent measurement; and

(c) the staff believe that divergence in practice also exists in relation to the initial recognition and, because of the diversity in initial recognition and subsequent measurement approaches, in the settlement and expiration of NCI puts.

22. In determining which components relating to the accounting for NCI puts could be included within the proposed Interpretation, the staff are most concerned about the scope of guidance to be provided on initial recognition.

23. This concern reflects the November 2006 Committee agenda decisions'[2] conclusion relating to the initial recognition of NCI puts:

> Paragraph 23 of IAS 32 states that a parent must recognise a financial liability when it has an obligation to pay cash in the future to purchase the minority's shares, even if the payment of that cash is conditional on the option being exercised by the holder. After initial recognition any liability to which IFRS 3 is not being applied will be accounted for in accordance with IAS 39. The parent will reclassify the liability to equity if a put expires unexercised.
>
> The IFRIC agreed that there is likely to be *divergence in practice in how the related equity is classified. However, the IFRIC did not believe that it could reach a consensus on this matter on a timely basis.* Accordingly, the IFRIC decided not to add this item to its agenda. (emphasis added)

24. As a result, the staff think the Committee may find it challenging to reach a consensus on how initial recognition of a NCI put should be reflected in the different components of equity (specifically, NCI equity and equity relating to controlling interests).

25. The staff however believe that addressing this component of the accounting for NCI puts should be included within the scope of the proposed Interpretation. This is because it will enable the proposed Interpretation to provide comprehensive and consistent guidance on the accounting for NCI puts.

Illustrative examples of the accounting for put options written over non-controlling interests

26. In response to the Committee's request at the May 2010 meeting, the appendices to agenda papers 4B-4E include illustrative examples of the four separate components of accounting for put options written over NCI as identified by the staff.

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[2] file:///Q:\IFRIC%20Projects\01%20Active\IFRS%203R-6%20-%20NCI%20Put\Related%20Prior%20Board%20Papers\IFRIC%20Update%20on%20Final%20Agenda%20Decision.pdf. Refer to the agenda decisions entitled 'Puts and forwards held by minority interests' and 'Are puts or forwards received by minority interests in a business combination contingent consideration'.

27. These illustrative examples assume that:

    (a) Parent A owns 80 per cent of Subsidiary B's shares;

    (b) the remaining 20 per cent of Subsidiary B's shares are owned by Non-controlling interest holder C;

    (c) an NCI put option is written on 1 January 20X0 allowing the Non-controlling interest holder C to put its 20 per cent interest in Subsidiary B to Parent A on 31 December 20X1;

    (d) exercise of the NCI put would result in Parent A owning 100 per cent of Subsidiary B's shares;

    (e) the NCI put option meets the definition of an NCI put used in this agenda paper;

    (f) Non-controlling interest holder C is retains all dividend rights relating to the shares subject to the NCI put;

    (g) the carrying amount of NCI is as follows:

        (i) 1 January 20X0 - CU210

        (ii) 31 December 20X1 - CU225 (if it continues to be recognised)

    (h) Subsidiary B pays a dividend of CU10 (CU2 relates to the shares subject to the NCI put) on 30 June 20X1; and

    (i) the fair value of the shares of Subsidiary B are as follows:

        (i) 1 January 20X0 - CU1000 (20% = CU200)

        (ii) 31 December 20X0 - CU1100 (20% = CU220)

        (iii) 31 December 20X1 - CU1250 (20% = CU250).

28. In addition, the illustrative examples analyse two NCI puts with the following characteristics:

    (a) Instrument 1 ('Fixed price NCI put'):

        (i) Fixed price NCI put, exercisable on 31 December 20X1 at CU 250;

(ii) Considered to, in substance, provide the parent entity with an ownership interest in the shares subject to the NCI put when assessed with all other factors;

(iii) The present value of the amount payable to exercise the Fixed price NCI put is:

(a) 1 January 20X0 - CU200

(b) 31 December 20X0 - CU220

(c) 31 December 20X1 - CU250.

(b) Instrument 2 (‘Fair value NCI put’):

(i) Fair value NCI put, exercisable on 31 December 20X1 at the fair value of the shares subject to the NCI put;

(ii) Not considered to, in substance, provide the parent entity with an ownership interest in the shares subject to the NCI put when assessed with all other factors.

29. In order to simplify the examples, the impact of income taxes and discounting has been ignored.

Staff recommendations for the scope and approach to be included within the proposed Interpretation

30. Appendix A to this agenda paper includes a summary, based on agenda papers 4B to 4E, of the staff recommendations for which components of the accounting for put options written over NCI should **be within the scope of the proposed** Interpretation.

31. Appendix B includes a summary, based on the staff scope recommendations, of the staff recommendations for the **accounting** for put options written over NCI to be included within the proposed Interpretation.

Proposals for the next steps in the project

32. The staff propose that the next steps in the projects should be presented at the September Committee meeting in the form of agenda papers which would

address the question of **<u>which put options written over NCI</u>** should be within the scope of the proposed interpretation.

33. These agenda papers would analyse:

    (a) how ‘put options written over non-controlling interests’ should be defined.

        For example, should the definition include embedded put options, or those written as part of a business combination?

        The analysis would consider whether the additional instruments that are within scope can be accounted for on a basis consistent with the proposed approach for accounting for NCI puts as narrowly described above, or if they would require an exception to it.

    (b) what transition provisions would be appropriate for the proposed Interpretation?

        For example, should application be limited to NCI puts written after the effective date of the proposed Interpretation, or should guidance be provided for NCI puts written in previous periods? Furthermore, should a distinction be made between NCI puts that have been settled or have expired at the effective date and those that have not?

34. In addition, the staff will continue to provide relevant updates from the *Financial Instruments with Characteristics of Equity* (FICE) project. It should be noted that further discussion is expected with the Board before the FICE Exposure Draft is published.

Appendix A – Summary of scope of proposed Interpretation

A1. Here is a summary of the scope of the proposed Interpretation:

(a) the initial recognition of a put option written over non-controlling interests, including both the ‘debit’ and ‘credit’ entries to be recognised;

(b) the subsequent measurement and recognition of the financial liability, as recognised on initial recognition, of a put option written over non-controlling interests;

(c) the subsequent recognition of dividends paid on the subsidiary shares subject to a put option written over non-controlling interests;

(d) the accounting for the settlement (exercise) of a put option written over non-controlling interests; and

(e) the accounting for the expiration of an unexercised put option written over non-controlling interests.

Appendix B – Summary of accounting for NCI puts included in the scope of the proposed Interpretation, based on the staff recommendations

B1. Here is a summary of the accounting for NCI puts that are included within the scope of the proposed Interpretation, based on the staff recommendations.

The initial recognition of a put option written over non-controlling interests, including both the 'debit' and 'credit' entries to be recognised

B2. On initial recognition of a NCI put, the credit entry is to recognise a financial liability. This financial liability is initially measured at fair value (the present value of the redemption amount).

B3. If, when the NCI put is written, the parent acquires, in substance, a present access to the economic benefits associated with the ownership interest, the debit entry on initial recognition of the NCI put is recognised to reduce NCI to zero. Any difference between the carrying amount of NCI and the credit entry for the financial liability is recognised in controlling interest equity.

B4. If, when the NCI put is written, the parent does not acquire, in substance, a present access to the economic benefits associated with the ownership interest, the debit entry on initial recognition of the NCI put is recognised in controlling interest equity. No adjustment is made to NCI in respect of the put.

The subsequent measurement of the financial liability recognised, on initial recognition, of a put option written over non-controlling interests

B5. After initial recognition, the financial liability recognised for a NCI put is measured at fair value through profit or loss or at amortised cost.

B6. Changes in the carrying amount of the financial liability recognised for a NCI put are recognised in profit or loss.

The subsequent recognition of dividends paid on subsidiary shares subject to a put option written over non-controlling interests

B7. When the parent receives dividends relating to the shares subject to the NCI put, these dividends should be recognised as an equity transaction.

B8. When the NCI shareholder receives dividends relating to shares subject to the NCI put, the accounting depends upon whether the parent continues to recognise the NCI component of equity after initial recognition of the NCI put.

B9. If the parent continues to recognise NCI, these dividends should be recognised as a change in the NCI component of equity.

B10. If the parent does not recognise NCI, an amount equal to the dividends paid to the NCI shareholder is transferred from retained earnings to NCI to “fund” the dividend. The dividend is shown as a distribution from NCI, leaving a zero balance on NCI.

B11. This allocation and appropriation of the dividends shall be clearly identified and presented as an equity transaction within the statement of changes in equity.

The accounting for the settlement (exercise) of a put option written over non-controlling interests

B12. When an NCI put is settled (exercised), the financial liability relating to the NCI put is derecognised, because it has been extinguished, and any remaining NCI relating to the shares subject to the NCI put is reclassified to controlling interest equity.

B13. This reflects the change in the parent’s ownership interest in the subsidiary, and is accounted for as an equity transaction, with no impact on profit or loss.

The accounting for the expiration of an unexercised put option written over non-controlling interests

B14. When an NCI put expires without being exercised, the financial liability relating to the NCI put is derecognised, and reclassified to the same component of equity on expiration to which it was reclassified from on initial recognition.

B15. When an NCI put expires without being exercised, and NCI relating to the shares subject to the NCI put needs to be re-recognised, that NCI is initially measured at fair value.

B16. This reflects a change in the parent’s ownership interest in the subsidiary, and is accounted for as an equity transaction, with no impact on profit or loss.