IFRS Interpretations Committee Meeting

Staff Paper

Agenda reference **4B**

Date **July 2010**

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

Topic **Initial recognition**

Purpose of this paper

1. The purpose of this paper is to address the accounting for the initial recognition of a NCI put (as defined in **agenda paper 4A**) in the consolidated financial statements of the parent.

2. This paper:

   (a) identifies how the 'credit entry' is initially recognised for a NCI put;

   (b) identifies how the 'debit entry' is initially recognised for a NCI put;

   (c) considers the implications of the *Financial Instruments with Characteristics of Equity* (FICE) project on the initial recognition of the NCI put;

   (d) makes a staff recommendation on:

      (i) whether the credit and debit entries recognised on initial recognition of the NCI put should be included in the scope of the proposed Interpretation; and, if so

      (ii) what level of detail should be provided on what those debit and credit entries should be; and

   (e) asks the Committee 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 IFRS Interpretations Committee.

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 IFRS Interpretations Committee 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 IFRS Interpretations Committee or the IASB can make such a determination.

Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*.

Interpretations are published only after the IFRS Interpretations Committee 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. As noted in the May 2009 agenda paper[1], in November 2006 the Committee published two agenda decisions relating to the initial recognition of NCI puts, concluding that:

> 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.)

4. These agenda decisions referenced the guidance in paragraph 23 of IAS 32 *Financial Instruments: Presentation* which states that:

> With the exception of the circumstances described in paragraphs 16A and 16B or paragraphs 16C and 16D, *a contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability for the present value of the redemption amount* (for example, for the present value of the forward repurchase price, option exercise price or other redemption amount). This is the case even if the contract itself is an equity instrument. One example is an entity's obligation under a forward contract to purchase its own equity instruments for cash. *When the financial liability is recognised initially under IAS 39, its fair value (the present value of the redemption amount) is reclassified from equity*. Subsequently, the financial liability is measured in accordance with IAS 39. If the contract expires without delivery, the carrying amount of the financial liability is reclassified to equity. An entity's contractual obligation to purchase its own equity instruments gives rise to a financial liability for the present value of the redemption amount even if the obligation to purchase is conditional on the counterparty exercising a right to redeem (eg a written put option that gives the counterparty the right to sell an

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

entity's own equity instruments to the entity for a fixed price). (emphasis added)

Staff analysis

How should the 'credit entry' initially be recognised for an NCI put?

5. The first issue relating to the initial recognition of NCI puts is how the 'credit' entry should be recognised.
6. In keeping with the previous Committee agenda decision, the staff think that a parent must recognise a financial liability for the NCI put in accordance with IAS 32.23.
7. This is consistent with how a similar free-standing put option written by a parent entity over its own equity instruments, rather than shares in its subsidiary, would initially be recognised. This view reflects the accounting for these instruments in the consolidated financial statements as discussed in IAS 32.AG29.
8. As a result, IAS 32.23 clearly requires that a financial liability is initially recognised at fair value (the present value of the redemption amount). This will reflect the present value of the repurchase price on a fixed price instrument, or the gross amount of a NCI put measured at, or a proxy to, fair value.
9. The staff are not aware of any existing or emerging diversity in practice relating to recognising a financial liability in accordance with IAS 32 on the initial recognition of a NCI put at fair value (the present value of the redemption amount).

How should the 'debit entry' initially be recognised for a NCI put?

Background

10. As noted above, the staff believe that IAS 32.23 is clear that a credit entry for a financial liability for the NCI put is initially recognised. As a result, the staff also think that IAS 32.23 is clear that the 'debit entry' should reflect a reclassification of the financial liability from equity.

11. However conflicts exist within IFRSs, specifically between IAS 32 and IAS 27 *Consolidated and Separate Financial Statements*, in relation to:

    (a) which component of the equity (either NCI, a component of equity other than NCI ('controlling interest equity') or a combination of both) the financial liability should be reclassified from; and

    (b) whether NCI relating to the shares subject to the NCI put should continue to be recognised or should be derecognised after issuance of the NCI put.

12. The staff believe that this conflict is reflected in the existence of divergent interpretations in practice relating to the how the debit entry is initially recognised for an NCI put.

Assessment of present access to the economic benefits

13. The first step in determining which component of equity should reflect the debit entry, and whether NCI should continue to be recognised, is to establish whether the NCI put provides, in substance, the parent with a present ownership interest in the shares held by the NCI shareholder.

14. This assessment is required because, if exercised, the NCI put provides the parent with voting rights in the shares subject to the put. Consequently, before exercise, the NCI put provides the parent with a potential ownership interest and potential voting rights in these shares.

15. This determination of access to the economic benefits reflects application of the guidance in IAS 27.IG6, which states that:

> In some circumstances *an entity has, in substance, a present ownership as a result of a transaction that gives it access to the economic benefits associated with an ownership interest.* In such circumstances, the proportion allocated is determined taking into account the eventual exercise of those potential voting rights and other derivatives that give the entity access to the economic benefits at present. (emphasis added)

16. In applying IAS 27.IG6 to determine whether the parent has, in substance, acquired present access to the economic benefits associated with the ownership interest subject to the NCI put, an assessment is conducted to determine if the risks and rewards associated with the NCI shares have transferred to the parent.

17. In performing this assessment, factors to consider include:

    (a) the exercise price of the NCI put (eg fixed, rather than based on fair value);

    (b) any transfer of rights associated with the shares (eg dividend and voting rights);

    (c) related transactions (eg whether the NCI put is issued together with a call, combining to act similarly to a forward, rather than option contract); and

    (d) participation in any other future changes in the value of the subsidiary (eg earn out clauses or performance conditions).

*Entity, in substance, acquires a present access to the economic benefits associated with the ownership interest (**Situation 1**)*

18. If, in applying IAS 27.IG6, an entity determines that, in substance, it has acquired present access to the economic benefits associated with the ownership interest that is subject to the NCI put (**Situation 1**), then the staff understand that there is limited diversity in the initial recognition of the debit entry relating to a NCI put to reflect the equity reclassification.

19. This is because the ownership interest has, in substance, been transferred from the NCI shareholder to the parent. As a result the:

    (a) reclassification of the financial liability is considered to be from the NCI component of equity;

    (b) NCI is reduced to zero and is no longer recognised; and

    (c) difference between (a) and (b) (eg because NCI was initially measured at the NCI's proportionate share of the acquiree's identifiable net assets, not at fair value) is recognised in controlling interest equity.

20. This accounting considers that the shares subject to the NCI put are effectively acquired by the parent when the NCI put is written.

21. Consequently, when initially recognising a financial liability for the NCI put, the NCI component of equity should be eliminated because the parent entity has, in substance, a present ownership interest of 100 per cent in the subsidiary, and NCI no longer exists.

22. Any difference between the fair value (present value of the redemption amount) of the financial liability, and the carrying amount of the NCI derecognised on initial recognition of the NCI put, is reflected in controlling interest equity. This is because the:

    (a) NCI put has been defined to be an instrument issued separately from a business combination; and consequently

(b) initial recognition of the NCI put is, in substance, a change in the parent's ownership interest in a subsidiary and is recognised in accordance with IAS 27.30:

> Changes in a parent's ownership interest in a subsidiary that do not result in a loss of control are *accounted for as equity transactions* (ie transactions with owners in their capacity as owners). (emphasis added.)

(c) NCI is considered to be eliminated. Consequently, any difference (either positive or negative) should not be attributed to the NCI component of equity.

23. We understand that this is reflected in the consistency of current practice in recognising the debit entry for a NCI put that transfers present access to the economic benefits associated with the ownership interest from the NCI shareholder to the parent.

*Entity, in substance, does not acquire a present access to the economic benefits associated with the ownership interest (**Situation 2**)*

24. In applying IAS 27.IG6, an entity may determine it has, in substance, not acquired present access to the economic benefits associated with the ownership interest that is subject to the NCI put (**Situation 2**).

25. The staff understand that, in Situation 2, significant diversity in practice exists and that a number of different accounting approaches may exist.

26. The staff have analysed three of the more commonly applied approaches that exist in current practice:

(a) Present access to economic benefits - application of IAS 27 (**View A**);

(b) In substance purchase - application of IAS 32 (**View B**); and

(c) Combination of IAS 27 principles and IAS 32 guidance (**View C**).

*Present access to economic benefits - application of IAS 27 (**View A**)*

27. View A applies an approach that corresponds to the situation when the NCI put provides the parent with, in substance, a present ownership interest in the shares held by the NCI shareholder. As a result it continues the 'risks and rewards' approach identified in Situation 1 and focuses on the guidance in IAS 27, rather than the guidance in IAS 32.

28. View A notes that because in Situation 2 the NCI shareholder retains, in substance, present access to the economic benefits associated with the shares of the NCI, the NCI continues to exist. Consequently, this NCI should continue to be recognised and should be accounted for in accordance with IAS 27.

29. View A proponents argue that because a present ownership interest is not, in substance, transferred from the NCI shareholder to the parent, the:

    (a) reclassification of the financial liability (debit entry) is considered to be **all** from controlling interest equity; and

    (b) NCI component of equity remains unchanged and continues to be recognised.

30. In accordance with this approach, NCI continues to exist and is recognised and accounted for in the same manner as it was prior to the NCI put being written.

*In substance purchase - application of IAS 32 (**View B**)*

31. View B supporters believe that if the NCI put does not provide the parent with a present ownership interest in the shares held by the NCI shareholder, the guidance in IAS 32 should take precedence over the guidance in IAS 27.

32. This approach accounts for the NCI as being acquired, and the NCI put exercised, on initial recognition of the NCI put.

33. Proponents of View B believe that it:

    (a) reflects the logic that the NCI put relates to NCI, and consequently that the debit entry relating to the initial recognition of the NCI put liability should be associated with the NCI component of equity; and

(b) avoids a perceived double counting issue of recognising both a gross financial liability (for the NCI put in accordance with IAS 32) and NCI (consistent with the application of IAS 27 before the NCI put was written).

34. Consequently, View B results in the same initial recognition accounting as Situation 1, regardless of whether or not, in substance, a present access to the economic benefits associated with the NCI shares transfers to the parent.

35. View B reflects IAS 27.IG7, which requires application of the financial instruments guidance, rather than IAS 27, when the NCI put does not transfer present access to the economic benefits associated with the NCI shares to the parent:

> IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments* does not apply to interests in subsidiaries, associates and jointly controlled entities that are consolidated, accounted for using the equity method or proportionately consolidated in accordance with IAS 27, IAS 28 and IAS 31 respectively. *When instruments containing potential voting rights in substance currently give access to the economic benefits associated with an ownership interest, and the investment is accounted for in one of the above ways, the instruments are not subject to the requirements of IAS 39 and IFRS 9. In all other cases, instruments containing potential voting rights are accounted for in accordance with IAS 39 and IFRS 9.* (emphasis added)

36. As a result, View B proponents focus on IAS 32.AG29, which states that:

> In consolidated financial statements, an entity presents non-controlling interests—ie the interests of other parties in the equity and income of its subsidiaries—in accordance with IAS 1 and IAS 27. When classifying a financial instrument (or a component of it) in consolidated financial statements, *an entity considers all terms and conditions agreed between members of the group and the holders of the instrument in determining whether the group as a whole has an obligation to deliver cash or another financial asset in respect of the instrument or to settle it in a manner that results in liability classification.* When a subsidiary in a group issues a financial instrument and a parent or other group entity agrees additional terms directly with the holders of the instrument (eg a guarantee), the group may not have discretion over distributions or redemption. Although the subsidiary may appropriately classify the instrument without regard to these additional terms in its individual financial statements, the effect of other agreements between members of the group and the holders of the instrument is considered in order to ensure that consolidated financial statements reflect the contracts and transactions entered into by the group as a

> whole. *To the extent that there is such an obligation or settlement provision, the instrument (or the component of it that is subject to the obligation) is classified as a financial liability in consolidated financial statements.* (emphasis added)

37. As a result, proponents of View B believe that the financial liability initially recognised for the NCI put reflects that the NCI shares subject to the put are reclassified from equity to a financial liability liability. This is because IAS 32.AG29 implies that the NCI put effectively converts the NCI shares from an equity instrument to a financial liability.

38. Consequently the:

    (a) reclassification of the financial liability (debit entry) is considered to be from the NCI component of equity;

    (b) NCI component of equity is reduced to zero and is no longer recognised within equity; and

    (c) difference, if any, between (a) and (b) is recognised as an adjusting entry to controlling interest equity.

*Combination of IAS 27 principles and IAS 32 guidance (**View C**)*

39. View C supporters believe that if the NCI put does not, in substance, provide the parent with a present ownership interest in the shares held by the NCI shareholder, then a combined approach based on the principles of IAS 27 and the guidance in IAS 32.AG29 should be applied.

40. View C proponents believe that on initial recognition the:

    (a) reclassification of the financial liability (debit entry) is considered to be from the NCI component of equity, up to the carrying amount of NCI;

    (b) excess of the amount of the debit entry over the carrying amount of NCI (if any) is recognised in controlling interest equity, rather than NCI becoming negative; and

    (c) NCI continues to be recognised, but this NCI is now classified as a financial liability and not as equity.

41. This approach focuses first on the principles of IAS 27. In applying these principles, View C proponents believe that, because the NCI shareholder retains, in substance, a present ownership interest in the shares subject to the NCI put, that, in agreement with View A, NCI continues to exist and should continue to be recognised.

42. However, in agreement with View B, IAS 32.AG29 requires the portion of NCI relating to the NCI put (but not necessarily all of the NCI) to be reclassified from the NCI component of equity to a financial liability. This is because of the existence of the obligation that the parent has.

43. In combination, the IAS 27 principles and IAS 32.AG29 guidance are interpreted as requiring the NCI to continue to be measured and recognised in accordance with IAS 27 during the reporting period.

44. However this a component (which may or may not represent all of NCI) is now, in accordance with IAS 32, characterised as a financial liability at the end of each reporting period, rather than as an equity instrument.

Implications of the* Financial Instruments with Characteristics of Equity *(FICE) project for the initial recognition of NCI puts

45. As noted in agenda paper 11, which was presented at the May 2010 Committee meeting, based on the Board's tentative decisions to date, the FICE exposure draft (the ED) is expected to propose that a written put on an entity's own shares (eg an NCI put) continues to be classified as a financial liability.

46. Consequently, the FICE project is not expected to change the guidance on where either the debit or the credit entry is initially recognised for a NCI put.

47. However, the ED is expected to change the requirements for presenting and measuring the financial liability recognised as the credit entry.

48. IAS 32 requires a NCI put financial liability to be presented on a 'gross' basis, with a financial liability initially recognised for the entire instrument. This gross financial liability is initially measured at fair value (the present value of the redemption amount).

49. Based on the Board's tentative decisions to date, the ED will propose that a freestanding put option on the NCI should be presented on a 'net' basis, which would be consistent with the accounting for derivative instruments in accordance with IAS 39. This would initially be measured at the fair value of the NCI put instrument, rather than being measured on a gross basis (eg at the present value of the redemption amount of the NCI put).

50. In addition, the ED would require an NCI puttable instrument that does not qualify as equity in its entirety to be separated into a liability component (ie the NCI put instrument) and an equity component (ie shares of the NCI).

Staff recommendation

How should the 'credit entry' initially be recognised for a NCI put?

51. The staff believe that the credit entry initially recognised for a NCI put should be to recognise a financial liability.

52. Additionally, the staff think that IAS 32 provides sufficient guidance on the initial recognition and initial measurement of the NCI put as a financial liability.

Should guidance on the 'credit entry' initially recognised for a NCI put be within the scope of the proposed Interpretation?

53. The staff believe that guidance on the credit entry initially recognised for a NCI put should be within the scope of the proposed Interpretation.

54. Although the staff think that the current guidance in IFRSs is clear, the staff also believe that including this guidance within the proposed Interpretation would be useful in the context of additional issues that the proposed Interpretation is expected to address.

55. However, because of the clarity of the current guidance in IAS 32, the staff do not believe that this guidance needs to provide any further explanation.

56. Instead, the staff believe the proposed Interpretation should merely reflect the current requirements in IAS 32.23 that the:

    (a) credit entry should be to recognise a financial liability; and

    (b) financial liability should be initially measured at fair value (the present value of the redemption amount).

Question 1 for the Committee
Does the Committee agree with the staff recommendation that the: i) credit entry should be to recognise a financial liability, and that this financial liability should be initially measured at fair value (the present value of the redemption amount)? ii) proposed interpretation should address the credit entry recognised on initial recognition of an NCI liability? If not, what does the Committee recommend?

How should the 'debit entry' initially be recognised for an NCI put?

57. The staff believe that the debit entry on initial recognition of an NCI put should be to equity, in conformity with the guidance in IAS 32.

*Entity, in substance, acquires a present access to the economic benefits associated with the ownership interest (**Situation 1**)*

58. The staff believe that when the entity, in substance, acquires a present access to the economic benefits associated with the ownership interest, the debit entry to equity on initial recognition of the NCI put:

    (a) first reduces the NCI component of equity to zero and is no longer recognised; and

    (b) second, that any difference between (a) and the credit entry on initial recognition of the NCI put financial liability, is recognised in controlling interest equity.

59. The staff think that this is consistent with the guidance in IAS 32 and IAS 27 and that a conflict between the two standards does not exist in this situation.

*Entity, in substance, does not acquire a present access to the economic benefits associated with the ownership interest (**Situation 2**)*

60. The staff support the present approach on access to economic benefits, as outlined in View A. As a result, the staff believe that the:

    (a) reclassification of the financial liability (debit entry) is considered to be **all** from controlling interest equity; and

    (b) NCI component of equity remains unchanged and continues to be recognised.

61. The staff think that this reflects:

    (a) consistent application of the guidance in IAS 27 relating to which party has, in substance, a present ownership interest in the NCI shares, and consequently, whether NCI should continue to be recognised;

    (b) the guidance in IAS 32, which specifies that the initial recognition of a financial liability reflects a reclassification from equity, but does not specify from which component of equity the reclassification should be made, or whether an equity instrument should be derecognised.

        This reflects a view that IAS 32 is focused on the presentation and recognition of the instrument as a financial liability, and not on what the other side of this entry represents; and

    (c) an approach that is not expected to conflict with the FICE ED, because of the focus on the principles in IAS 27.

62. In considering the alternative approach in View B, the staff concerns include the:

    (a) rationale for accounting for the NCI put as though it has already been exercised, although the exercise of the NCI put is contingent upon future events, including those that are outside the control of the parent;

    (b) conceptual basis for accounting for the NCI put as a present ownership interest in the subsidiary although, in substance, the parent does not have a present ownership interest; and

(c) potential lack of consistency of View B with the proposed ‘net’ rather than ‘gross’ presentation model expected in the FICE ED.

63. In considering the alternative approach in View C, the staff have concerns that it:

(a) confuses the principles of IAS 27 (specifically that NCI is a component of equity) with the requirements of IAS 32 (that the NCI put instrument is required to be classified as a liability);

(b) is inconsistent with both the accounting for an, in substance, present ownership interest in accordance with IAS 27, and for a financial liability in accordance with IAS 32; and

(c) may create complexity if applied in accordance with the proposed ‘net’ rather than ‘gross’ presentation model expected in the FICE ED.

Should guidance on the 'debit entry' initially recognised for an NCI put be within the scope of the proposed Interpretation?

64. The staff believe that guidance on the 'debit entry' initially recognised for a NCI put should be within the scope of the proposed Interpretation.

65. The staff think this:

    (a) is consistent with the recommendation to include guidance for the credit entry;

    (b) addresses an area of known diversity in practice; and

    (c) is important in providing a rationale and basis for conclusions on other issues relating to the accounting for NCI puts (including the accounting for subsequent changes in the carrying amount of the NCI put financial liability).

66. However, the staff acknowledge that the Committee may have concerns about including guidance on this issue in the proposed Interpretation, because the:

    (a) Committee were previously unable to reach a consensus on the issue;

    (b) current guidance in IFRSs provides few principles relating to the classification of instruments and transactions between the separate components of equity; and

    (c) issue is perceived to be solely a question of 'equity classification'.

67. If the Committee decides that the draft Interpretation should not include full guidance on the debit entry, then the proposed Interpretation could:

    (a) exclude any guidance on the 'debit entry' on initial recognition of a NCI put from its scope, in conformity with the November 2006 IFRIC update;

    (b) reference the current guidance in IAS 32.23, requiring the debit entry to be recorded in equity, but provide no additional clarity relating to the component of equity that the debit entry should be attributed to; or

(c) indicate whether an approach to recognising the debit entry on initial recognition of the NCI put is required, or may be chosen as an optional accounting policy, based on which party to the NCI put has, in substance, a present ownership interest.

This could lead to the inclusion of specific guidance on Situation 1 (because the NCI component is no longer recognised), but also to the inclusion of more limited guidance on the debit entries recorded in Situation 2 (because of the existence of both the NCI and controlling interest components of equity).

Question 2 for the Committee
Does the Committee agree that, when, in substance, an entity: i) acquires a present access to the economic benefits associated with the ownership interest, NCI is reduced to zero and is no longer recognised, with any difference between the carrying amount of NCI and the credit entry being recognised in controlling interest equity? ii) does not acquire a present access to the economic benefits associated with the ownership interest, that the debit entry on initial recognition of the NCI put is to controlling interest equity and NCI continues to be recognised? If not, what does the Committee recommend? Does the Committee agree that the proposed Interpretation should fully address the debit entry recognised on initial recognition of a NCI liability? If not, what does the Committee recommend?

Agenda paper 4B - Initial recognition journal entries

Instrument	Present access to economic benefits?	Initial recognition approach (Agenda paper 4B)	1 January 20X0						Notes
			Journal entries				Statement of financial position		
			Debit	CU	Credit	CU	Debit / (Credit)	CU	
Instrument 1 (‘Fixed price NCI put’)	Yes - Situation 1 in agenda paper 4B	Present access to economic benefits	NCI equity NCI equity	200 10	Financial liability CI equity	200 10	Financial Liability NCI equity CI equity	(200) 0 (10)	NCI is no longer recognised because NCI shareholder no longer has, in substance, present access to economic benefits
Instrument 2 (‘Fair value NCI put’)	No - Situation 2 in agenda paper 4B	View A - No present access to economics	CI equity	200	Financial liability	200	Financial Liability NCI equity CI equity	(200) (210) 200	NCI remains unchanged and continues to be recognised
		View B - In substance acquisition	NCI equity NCI equity	200 10	Financial liability CI equity	200 10	Financial Liability NCI equity CI equity	(200) 0 (10)	NCI is no longer recognised, because it is now presented as a financial liability
		View C - Combination of IAS 27 & IAS 32	NCI equity	200	Financial liability	200	Financial Liability NCI equity CI equity	(200) (10) 0	NCI continues to be recognised, however part of NCI is now reclassified as a financial liability

Key Assumptions

(i) Fair value (present value of the redemption) of the Fixed price and Fair value NCI put on 1 January 20X0 is CU200
(ii) The NCI component of equity is CU210 before the NCI put is written

Note: For the purposes of this illustration, the present value of the redemption amount for the put is assumed to be less than the book value of the NCI. Often the present value of the redemption amount will be greater than the book value of the NCI (because the redemption amount will reflect a current value whereas the book value of the NCI will typically be a histrorical cost value) and the accounting entries will change accordingly, to avoid the NCI balance falling below zero.