IFRS Interpretations Committee Meeting

Agenda reference **4C**

Staff Paper

Date **July 2010**

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

Topic **Subsequent measurement – NCI put financial liability**

Purpose of this paper

1. Agenda paper 4B discussed the initial recognition of NCI puts.

2. It identifies that on initial recognition, a financial liability is recognised for the fair value (present value of the redemption amount) of the NCI put and that this financial liability is reclassified from equity.

3. Subsequent to initial recognition, the carrying amount of the NCI put financial liability may change.

4. Constituents have different views on how these subsequent changes in the carrying amount of the NCI put financial liability should be recognised in the financial statements.

5. These views typically reflect the rationale for the accounting of the initial recognition, specifically, which component of equity the financial liability for the NCI puts is considered to be reclassified from.

6. This paper:

   (a) identifies how changes in the carrying amount of a financial liability for a NCI put should be recognised;

   (b) discusses specific subsequent measurement issues relating to changes in the carrying amount of a financial liability for a NCI put;

(c) considers the implications of the *Financial Instruments with Characteristics of Equity* (FICE) project for the subsequent measurement of the NCI put;

(d) makes a staff recommendation on:

  (i) whether the accounting for changes in the carrying amount of a financial liability for a NCI put should be included in the scope of the proposed Interpretation; and

  (ii) if so, how those changes should be recognised; and

(e) asks the Committee whether they agree with the staff recommendation.

Background information

7. As noted in agenda paper 11 that was presented at the May 2010 Committee meeting[1], the issue of how an entity should account for changes in the carrying amount of a financial liability recognised for an NCI put was the subject of a request received by the Committee.

8. The requested noted that in November 2006 the Committee published two agenda decisions relating to these issues.

9. In these agenda decisions, the Committee concluded 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. (emphasis added)

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

10. However, the request observes significant diversity in practice, both existing and emerging, in accounting for changes in the carrying amount of a financial liability recognised for an NCI put issued after the 2008 amendments were made to IFRS 3 *Business Combinations*, IAS 27 *Consolidated and Separate Financial Statements* and IAS 39 *Financial Instruments: Recognition and Measurement* (collectively, the 2008 Amendments).

11. The request notes that some constituents believe that these changes should be recognised in profit or loss in accordance with the financial instruments guidance in IFRSs.

12. Others believe that subsequent changes in the carrying amount of the NCI put should be recognised in equity (either in NCI or as a separate component of equity). They believe that this position is supported by the 2008 Amendments, specifically by the amendments to IAS 27.

13. These different views were highlighted in recent public observations reported by a regulator in one IFRS jurisdiction (refer to Appendix A of the May 2010 agenda paper for details).

Staff analysis

How should changes in the carrying amount of a financial liability for a NCI put be recognised?

14. The question of how changes in the carrying amount of a financial liability for a NCI put should be recognised was the main issue identified in the request received by the Committee.

15. As a result, the May 2010 agenda paper included a detailed analysis of the issue, and two alternative views. These alternative views are summarised below.

Changes in the carrying amount of a financial liability for a NCI put are recognised in profit or loss in accordance with IAS 32 and IAS 39

16. Some believe that changes in the carrying amount of NCI puts should always be recognised in profit or loss (the **'profit or loss view'**).

17. Supporters of the profit or loss view note that the NCI put is initially recognised as a financial liability in accordance with IAS 32 *Financial Instruments: Presentation*. In conformity with the requirements of IAS 32.23, changes in the carrying amount of the NCI put financial liability should be recognised in accordance with IAS 39.

18. In accordance with IAS 39.55 and IAS 39.56, changes in the carrying amount of a financial liability should be recognised in profit or loss.

19. This profit or loss view is consistent with the accounting for the initial recognition of a NCI put when the NCI put:

    (a) transfers, in substance, a present access to the economic benefits associated with the ownership interest from the NCI shareholder to the parent (Situation 1 in agenda paper 4B); or

(b) does not transfer, in substance, a present access to the economic benefits associated with the ownership interest from the NCI shareholder to the parent, but an entity applies View A[2] or View B[3] in agenda paper 4B when initially recognising the NCI put.

20. This is because only the writing of the NCI put, and consequently the initial recognition of the NCI put as a financial liability, is considered to be a transaction with owners in their capacity as owners in accordance with IAS 27.30 and paragraph 109 of IAS 1 *Presentation of Financial Statements*.

21. The subsequent measurement of the NCI put reflects the subsequent measurement of a financial liability. It is not viewed as a further transaction with owners in their capacity as owners, but instead as a change in the carrying amount of a financial liability. Consequently, these changes are required to be recognised in profit or loss in accordance with IAS 39, and they cannot be accounted for as equity transactions.

22. They believe that this is consistent with the:

(a) rationale that these changes relate to the measurement of an instrument that is now classified as a financial liability, and is no longer an equity instrument;

(b) identification that other transactions between the parent and the NCI shareholder are not considered to be transactions with owners in their capacity as owners (eg the sale of inventory by the parent to the NCI shareholder);

(c) accounting for other measurement changes associated with non-equity instruments where the counterparty is the NCI shareholder (eg when the NCI shareholder holds an interest-bearing debt instrument issued by the parent); and

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[2] View A in agenda paper 4B is that the NCI shareholder retains, in substance, present access to the economic benefits associated with the shares of the NCI. The NCI component of equity continues to exist and a financial liability is recognised for the NCI put.

[3] View B in agenda paper 4B is that the financial liability initially recognised for the NCI put reflects the reclassification of the NCI shares subject to the put from equity to a financial liability.

(d) Board's conclusions in paragraph 58 (b) of IFRS 3 *Business Combinations* that, in circumstances when changes in the carrying amount of the NCI put are considered to reflect contingent consideration that the liability:

> is a financial instrument and is within the scope of IFRS 9 or IAS 39 shall be measured at fair value, with any resulting gain or loss *recognised either in profit or loss or in other comprehensive income in accordance with IFRS 9 or IAS 39* as applicable. (emphasis added.)

Changes in the carrying amount of a financial liability for a NCI put are recognised in equity in accordance with IAS 27

23. In contrast, others believe that changes in the carrying amount of NCI put financial liability should always be recognised in equity (the '**equity view**').

24. They believe recognising changes in the carrying amount of the financial liability for the NCI put in profit or loss is inappropriate when the risks and rewards of ownership of the shares subject to the NCI put have not transferred to the parent.

25. In this scenario, the parent should not be recognising profit or loss for the changes in the carrying amount of the financial liability, because it:

    (a) does not have a present ownership interest in the shares that are subject to the NCI put; and

    (b) is inconsistent with the accounting for the purchase of the remaining shares subject to the NCI put. This would be reflected as an equity transaction.

26. This view is supported by some in the case when the NCI put does not transfer, in substance, a present ownership interest from the NCI shareholder to the parent and an entity applies View C in agenda paper 4B.

27. In applying View C in agenda paper 4B, on initial recognition an entity:

    (a) reclassifies the financial liability from the NCI component of equity. This reclassification is considered equivalent to a change in the parent's interest in the subsidiary; and

(b) transforms some, or all, of its NCI into a financial liability. However, in substance, this financial liability still reflects NCI.

28. Consequently, proponents of the equity view believe that changes in the carrying amount of NCI put financial liability should be recognised in equity, because it is consistent with:

(a) initial recognition of the financial liability reflecting a reclassification from NCI. Consequently, subsequent changes in the carrying amount should also be considered equivalent to reflecting a change in the parent's interest in the subsidiary; and

(b) the rationale for believing that the NCI is no longer recognised as a financial liability, but continues to reflect the NCI shareholder's interest.

29. Supporters of the equity view think that recognition of these changes in the carrying amount of the NCI put in equity is consistent with the guidance in:

(a) IAS 27 relating to transactions with owners in their capacity as owners; and

(b) IFRIC 17 *Distributions of Non-cash Assets to Owners*.

Guidance in IAS 27

30. Proponents of the equity view think that it reflects the 'economic entity' principle of IFRS 3 and IAS 27.

31. They believe changes in the carrying amount of the NCI put financial liability reflect a transaction with owners in their capacity as owners and is recognised within equity, not profit or loss, 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).
>
> 31 In such circumstances the carrying amounts of the controlling and non-controlling interests shall be adjusted to reflect the changes in their relative interests in the subsidiary. Any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received shall be

> *recognised directly in equity* and attributed to the owners of the parent. (emphasis added)

32. Proponents of View C in agenda paper 4B believe that this is the case even if, in substance, a present ownership interest in the shares subject to the NCI put has not transferred from the NCI shareholder to the parent.

33. They note that, on initial recognition of the NCI put, an entity reclassifies a financial liability from the NCI component of equity. This is because the initial recognition of the NCI put is considered to be a transaction with owners in their capacity as owners.

34. Consequently, they argue that subsequent changes in the carrying amount of the financial liability recognised for the NCI put should also be considered to relate to NCI, and that they are also transactions with the NCI shareholder (transactions with owners in their capacity as owners).

35. In applying this view, they believe that changes in the carrying amount of the financial liability relating to an NCI put are equivalent to a change in the parent's ownership of the shares subject to the NCI put.

36. The remeasurements are re-estimations of the initial transaction, which was a reclassification of NCI from equity to a financial liability. These changes reflect the remeasurement of the NCI, which was characterised as a financial liability when the NCI put was initially recognised.

Guidance in IFRIC 17

37. Supporters of the equity view also believe that it is analogous to the guidance in IFRIC 17, which requires changes in the carrying amount of a financial liability for a dividend payable to be recognised in equity, not profit or loss.

38. IFRIC 17 requires:

> 13 At the end of each reporting period and at the date of settlement, the entity shall review and *adjust the carrying amount of the dividend payable, with any changes in the carrying amount of the dividend payable recognised in equity* as adjustments to the amount of the distribution. (emphasis added)

The rationale for this approach is discussed in the Basis for Conclusions in IFRIC 17:

> BC36 The IFRIC concluded that, because any adjustments to the best estimate of the dividend payable reflect changes in the estimated value of the distribution, they should be recognised as adjustments to the amount of the distribution. *In accordance with IAS 1 Presentation of Financial Statements (as revised in 2007), distributions to owners are required to be recognised directly in the statement of changes in equity.* Similarly, adjustments to the amount of the distribution are also recognised directly in the statement of changes in equity.
>
> BC37 Some commentators argued that the changes in the estimated value of the distribution should be recognised in profit or loss because changes in liabilities meet the definition of income or expenses in the Framework. However, the IFRIC decided that the gain or loss on the assets to be distributed should be recognised in profit or loss when the dividend payable is settled. This is consistent with other IFRSs (IAS 16, IAS 38, IAS 39) that require an entity to recognise in profit or loss any gain or loss arising from derecognition of an asset. The IFRIC concluded that the *changes in the dividend payable before settlement related to changes in the estimate of the distribution and should be accounted for in equity* (ie adjustments to the amount of the distribution) until settlement of the dividend payable. (emphasis added)

39. However, opponents to this analogy observe that IFRIC 17 applies when an entity is required to recognise a financial liability because of an obligation to make a distribution of equity, although the amount to be distributed in relation to the obligation is uncertain.

40. In contrast, the NCI put requires a contractual amount to be paid to settle a potential obligation, but the potential obligation may not require settlement (eg if the NCI put expires unexercised).

41. Consequently, changes in the carrying amount of a NCI put financial liability reflect potential transfers of value (both positive and negative) between the NCI shareholder and the parent. These potential value transfers would only become distributions if the NCI put is exercised.

42. To the extent that the NCI put has an exercise price of fair value, there may not be a transfer of value between the NCI shareholder and the parent. Instead, there is merely an exchange of instruments of equal value.

Specific subsequent measurement issues relating to NCI put financial liabilities

43. As noted in agenda paper 4B, the NCI put financial liability is presented on a 'gross' basis in accordance with IAS 32, and is measured at fair value (the present value of the redemption amount).

44. In considering whether changes in the carrying amount of NCI puts should be recognised in profit or loss or within equity, staff think that it is important to consider what the nature of these changes may be.

Subsequent measurement of a NCI put exercisable at fair value

45. When the NCI put is exercisable at fair value, the carrying amount of the financial liability will be remeasured to reflect changes in the fair value of the NCI put.

46. These fair value changes may reflect, for example, changes in the fair value of the shares of the subsidiary.

Subsequent measurement of a NCI put exercisable at a fixed price

47. When the NCI put is exercisable at a fixed price, the carrying amount of the financial liability will be remeasured to reflect the present value of the redemption amount.

48. As a result, the carrying amount of the NCI put financial liability will change as the NCI put is accreted, using an effective rate of interest, to the present value of the fixed payment due on exercise.

49. In addition to the guidance noted above, IAS 39 specifically indicates that measurement changes relating to application of the effective rate of interest are recognised in profit or loss:

> AG8 If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate or, when applicable, the revised effective interest rate calculated in accordance with paragraph 92. *The adjustment is recognised in profit or loss as income or expense.* (emphasis added)

50. This reflects the view that accretion is considered to be a finance charge that should be recognised in profit or loss.

51. If the equity view above is applied, the question arises as to whether changes in the carrying amount of the financial liability that relate to accretion should be recognised in equity, rather than in profit or loss. This would be consistent with the proposals for recognition of other changes in the carrying amount of the financial liability relating to a NCI put.

52. An alternative would be, when applying the equity view, to determine that these changes relating to the accretion of the financial liability should be separately identified and recognised as a finance cost in profit or loss. All other changes in the carrying amount of the NCI put financial liability would be recognised in equity.

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

53. As noted in the May 2010 Committee Agenda Papers, on the basis of the Board's tentative decisions to date, the FICE exposure draft (the ED) is expected to propose that a NCI put financial liability should be presented on a 'net' basis, in conformity with the accounting for derivative instruments in accordance with IAS 32.

54. It is anticipated that the ED would then require the NCI put derivative liability to be measured in accordance with IAS 39, to be consistent with other derivatives. This would be at fair value at each reporting period, with changes in fair value being recognised in profit or loss.

Staff recommendation

How should changes in the carrying amount of a financial liability for a NCI put be recognised?

55. In conformity with the staff conclusions in the May 2010 agenda paper, the staff think that **all** changes in the carrying amount of a financial liability for a NCI put should be recognised in profit or loss. This includes changes in the estimated exercise price of the NCI put, and also accretion relating to the NCI put financial liability.

56. This reflects the staff view that changes in the carrying amount of the NCI put financial liability should:

    (a) be recognised in profit or loss, in accordance with the current guidance in IAS 32 and IAS 39, including the guidance relating to the accretion of financial liabilities, and also in accordance with the Board's tentative decisions in the FICE project,;

    (b) not be considered as transactions with owners in their capacity as owners as they relate to the NCI put, which is an instrument that is presented as a liability, not as equity;

    (c) not be bifurcated between the profit and loss (eg for changes relating to accretion) and equity (for other changes in the carrying amount of the financial liability); and

    (d) reflect the requirements in the *Framework* that:

        (i) changes in a liability are recognised in profit or loss, rather than equity; and

        (ii) equity is a residual interest and is not subsequently remeasured after initial recognition.

Should guidance on how the changes in the carrying amount of a financial liability for a NCI put are recognised be within the scope of the proposed Interpretation?

57. The staff believe that guidance on how the changes in the carrying amount of a financial liability for a NCI put are recognised should be within the scope of the proposed Interpretation.

58. This is because the question of how changes in the carrying amount of a financial liability for a NCI put should be recognised was the main issue identified in the request received by the Committee. It is also considered to be the component of the accounting for NCI puts that leads to the most significant diversity in practice.

Question 1 for the Committee
Does the Committee agree with the staff's recommendation that: i) changes in the carrying amount of a financial liability for a NCI put should be recognised in profit or loss in accordance with the guidance in IAS 39? ii) the proposed Interpretation should address the accounting for changes in the carrying amount of a financial liability for a NCI put? If not, what does the Committee recommend?

Agenda paper 4C - Subsequent measurement - NCI put financial liability journal entries

Instrument	Present access to economic benefits?	Initial recognition approach (Agenda paper 4B)	Subsequent measurement of financial liability (Agenda paper 4C)	12 months ending 31 December 20X0 Journal entries				Notes
				Debit	CU	Credit	CU	
Instrument 1 (‘Fixed price NCI put’)	Yes - Situation 1 in agenda paper 4B	Present access to economic benefits	Profit and loss view	Profit or loss	20	Financial liability	20	All changes in the carrying amount of the financial liability are recognised in profit or loss.
Instrument 2 (‘Fair value NCI put’)	No - Situation 2 in agenda paper 4B	View A - No present access to economics	Profit and loss view	Profit or loss	20	Financial liability	20	All changes in the carrying amount of the financial liability are recognised in profit or loss.
		View B - In substance acquisition	Profit and loss view	Profit or loss	20	Financial liability	20	All changes in the carrying amount of the financial liability are recognised in profit or loss.
		View C - Combination of IAS 27 & IAS 32	Equity view	NCI equity (*****) CI equity	10 10	Financial liability	20	All changes in the carrying amount of the financial liability (including accretion) recognised in equity. Changes allocated to NCI until NCI is reduced to zero. Excess changes are allocated to controlling interest equity.

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) Fair value of the Fixed price and Fair value NCI put on 31 December 20X0 is CU220
(iii) The financial liability for the NCI put is subsequently measured at fair value
(iv) Change in fair value of the NCI put is 20 (CU220 - CU200)