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

Topic **Initial recognition**

Purpose of this paper

1. The purpose of this paper is to further analyse the accounting for the initial recognition of put options written over non-controlling interests (NCI) following the discussions held by the IFRS Interpretations Committee (the Interpretations Committee) in July 2010[1].

2. Specifically, this paper addresses two requests made by the Interpretations Committee. These were to analyse further, in relation to the accounting for the initial recognition of put options written over NCI:

   (a) potential 'double counting' issues that may exist; and

   (b) View B presented in the July 2010 Interpretations Committee Agenda Paper 4B relating to an 'in substance purchase'. This has been referred to throughout this agenda paper as the 'reclassification of NCI' approach.

[1] Specifically see agenda paper 4B presented at the July 2010 Interpretations Committee meeting at http://www.ifrs.org/NR/rdonlyres/BD93F9DC-F753-428D-ACB9-6C18E5C4DD8D/0/IAS274to4E.zip

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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. In the July 2010 Interpretations Committee meeting, the Interpretations Committee discussed the accounting for put options written over NCI. In these discussions, the Interpretations Committee focused on the accounting for a narrow definition of these instruments, identified as NCI puts[2], noting that this excluded instruments written as part of a business combination.

4. The staff recommended that on initial recognition of a NCI put that, in accordance with the guidance in IAS 32 *Financial Instruments: Presentation*, the entity should recognise a financial liability, and that this financial liability should be initially measured at fair value (the present value of the redemption amount) of the put.

5. The staff also analysed the accounting for the debit entry to be recorded on initial recognition of a NCI put. In this analysis, the staff recommended an approach requiring an entity to determine whether the put option provides the entity, in substance, present access to the economic benefits of the shares subject to the put ('present access approach').

6. In accordance with this approach, an entity would use judgement to determine, if, in substance, it acquires present access to the economic benefits associated with the NCI shares subject to the put.

7. If so, NCI would be reduced to zero and no longer recognised. If not, the debit entry on initial recognition of the NCI put would be to controlling interest equity and NCI would continue to be recognised in full.

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[2] Specifically see paragraph 13 of agenda paper 4B presented at the July 2010 Interpretations Committee meeting http://www.ifrs.org/NR/rdonlyres/BD93F9DC-F753-428D-ACB9-6C18E5C4DD8D/0/IAS274to4E.zip

8. In discussing the staff recommendations, the Interpretations Committee tentatively decided to include guidance for the initial recognition of NCI puts in the draft Interpretation. This would propose that a financial liability should be recognised and initially measured at fair value (the present value of the redemption amount) of the put in accordance with IAS 32.23.

9. However, the Interpretations Committee did not reach any tentative decisions relating to the debit entry relating to initial recognition of the put.

10. Instead, the Interpretations Committee requested that the staff develop papers for discussion at the next meeting that would provide additional analysis of the approach to initial recognition of a put option written over NCI, specifically relating to the debit entry to be recognised.

11. This additional analysis should include:

    (a) the interaction between the accounting for the financial liability and the accounting for NCI after the put option is written.

        Specifically this should include analysis of any perceived double counting within total, and the separate components of, equity, or profit or loss, that is associated with the initial recognition, or subsequent measurement, accounting for the put option; and

    (b) consideration of the implications of applying an initial recognition accounting approach that requires NCI to be reclassified from equity to a financial liability when the put is written.

Staff analysis

12. The staff analysis in this agenda paper continues to focus on the accounting for NCI puts as defined in the July agenda papers. This definition included the assumption that the put was written by the parent as a freestanding instrument, separate from a business combination transaction.

13. In agenda paper 4C, the staff have specifically addressed the accounting for a put option written over NCI as part of a business combination, including how the analysis in this agenda paper would be impacted upon by expanding the definition of NCI puts to include such instruments.

What is the interaction between the accounting for the financial liability and the accounting for NCI after the put option is written?

14. The present access to economic benefits approach presented at the July 2010 meeting highlighted concerns relating to the interaction between the accounting for the financial liability and the accounting for NCI after the put option is written.

15. These concerns reflected the potential to double count the accounting for NCI and NCI puts, both on initial recognition, and on subsequent measurement.

Initial recognition double count

16. The present access to economic benefits approach for the initial recognition accounting of NCI puts creates a double count when the parent has determined, in substance, **not** to have acquired present access to the economic benefits associated with the NCI shares subject to the put. This is because:

    (a) NCI continues to be recognised as a component of equity, reflecting the carrying amount of the share of the subsidiary's net assets attributable to the shares subject to the put. It is not attributable to the equity holders of the parent.

(b) an additional credit balance for the put instrument is recognised as a financial liability, measured at fair value (the present value of the redemption amount) of the NCI put, with an offsetting debit entry recognised to reduce controlling interest equity.

In accordance with IAS 32, this financial liability is measured on a gross basis and includes value attributable to the shares subject to the NCI put.

Implications of initial recognition double count

17. The perceived double count on initial recognition of the NCI put arises from the existence of two credit balances on the parent's consolidated statement of financial position that, although likely to be for different amounts, both include credit balances recognised in relation to shares subject to the put.

18. In addition, the existence of these two credit balances leads to a reduction in controlling interest equity.

19. The economic rationale for this reduction in controlling interest equity is questioned by some, because controlling interest equity appears to be reduced twice: firstly through recognition that part of the total assets of the group are attributable to NCI shareholders, and secondly through the recognition of an additional liability that the group has for acquiring those shares currently held by the NCI shareholders.

Implications of subsequent measurement double count

20. In the July 2010 Interpretations Committee meeting it was also noted that the subsequent measurement elements of the accounting for NCI puts can create a double count.

21. This situation arises when NCI continues to be recognised after a NCI put is written, because profit attributed to equity holders of the parent of a profitable subsidiary:

    (a) is reduced by the share of subsidiary profits attributed to the shares held by the NCI shareholders; and

    (b) includes changes in the carrying amount of the financial liability recognised for the NCI put, including:

        (i) accretion of the financial liability initially recognised (eg interest expense for a fixed price put);

        (ii) changes in the fair value of the shares of the subsidiary (eg because the subsidiary is performing better than expected on the date the put was written) when the put is exercised at a price that is at, or is a proxy to, fair value; and

        (iii) dividends (reflecting distributions of subsidiary profits to NCI shareholders).

Subsequent measurement double count implications

22. The implications of the double count that exists when the NCI put is subsequently measured create some of the counter-intuitive accounting results discussed in the May 2010 and July 2010 Interpretations Committee meetings:

For example, a NCI put is written with an exercise price at, or a proxy to, fair value over the NCI of a subsidiary. The subsidiary earns strong profits and, as a consequence, its value since the date that the put was written has increased. Consequently, profit and earnings per share for the group are decreased in calculating amounts attributed to equity holders of the parent by **both** the: a) deduction for the share of subsidiary profits attributable to the NCI shares; and b) increase in the carrying amount of the financial liability for the put (reflecting the increased obligation that the parent has, if the put was exercised, to purchase the shares subject to the put).

23. This result may seem counter-intuitive. This is because **both** the:

    (a) subsidiary profits attributed to the shares held by the NCI shareholders; and

    (b) changes in the carrying amount of the financial liability (recognised as an expense in profit or loss and attributed entirely to the equity holders of the parent)

    are accounted for, and both are measures, albeit different measures, of value related to the shares subject to the put.

24. The NCI put will either:

    (a) be exercised (and the NCI shares will be acquired by the parent); **or**

    (b) expire (and NCI will continue to exist).

    Consequently, it is counter-intuitive to account for both situations when only one will occur.

25. As a result of the double counting issues noted in the staff analysis, some argue that the parent entity should eliminate these double counting issues by considering the shares subject to the NCI put as either:

    (a) reclassified to a financial liability.

    As a result, NCI is eliminated and a financial liability for the fair value (the present value of the redemption amount) or '**gross**' amount of the put is recognised and subsequently measured.

    This is described as the reclassification of NCI approach (**View 1**); or

    (b) still existing as a component of equity.

    As a result, on initial recognition, only the put instrument would be accounted for as a financial liability and measured as a derivative or '**net**' amount at fair value.

    However, subsequent measurement changes relating to the shares subject to the put reflecting profits attributed to NCI would be allocated to the NCI component of equity.

    This is consistent with the Board's tentative decisions in the *Financial Instruments with Characteristics of Equity* (FICE) project (**View 2**).

View 1 - Does the financial liability recognised for the put option represent a reclassification of NCI?

Overview of approach

26. The reclassification of NCI approach proposes that the financial liability initially recognised for the put reflects that the NCI shares subject to the put are reclassified from equity to a financial liability. This is because, in the staff's opinion, IAS 32.AG29 could be interpreted as implying that the instrument effectively changes the NCI shares from being an equity instrument to being a financial liability:

> 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)

27. Consequently, this approach accounts for the NCI as if it has been acquired (and reduced to zero), on initial recognition of the put, in accordance with View 1 identified in paragraph 25(a) above.

28. There are no subsequent changes in NCI through the attribution of profit relating to the NCI shares because NCI was eliminated when the put was initially recognised. As a result, changes in the gross carrying amount of the financial liability are recognised for the put and presented in profit or loss attributable to equity holders of the parent.

Accounting implications of the approach

29. In analysing the implications of this approach, it is noted that there are no double count issues at initial recognition or during subsequent measurement.

30. This is because the NCI (which was accounted for as an equity instrument) is accounted for as though it is replaced by the NCI put (which is accounted for as a gross financial liability).

31. As a result, on initial recognition of the put, the reclassification of NCI from equity to a financial liability only reduces controlling interest equity on initial recognition to the extent that the fair value (the present value of the redemption amount) of the financial liability for the put is greater than the carrying amount of NCI. The staff understand that this is usually the situation in practice.

32. In reviewing the subsequent measurement implications on the parent's consolidated statement of comprehensive income:

    (a) changes in the carrying amount of the financial liability recognised for the NCI put are included in profit or loss attributed to equity holders of the parent;

    (b) no amount of profit or loss is attributed to the NCI, so profit or loss attributed to equity holders of the parent **includes** (ie does not deduct) amounts relating to shares subject to the NCI put, because these shares are accounted for as though they are owned by the parent;

    (c) total profit or loss attributed to equity holders of the parent (specifically the sum of (a) and (b)) will be different from the amounts recognised if:

        (i) NCI continues to be recognised;

        (ii) NCI continues to be recognised and the put instrument is accounted for as a separate derivative instrument (View 2); or

        (iii) the NCI put is exercised and the NCI is acquired.

    (d) total profit or loss attributed to equity holders of the parent (specifically the sum of (a) and (b)) may be more intuitive than when a double count exists.

For example, when the exercise price of the instrument is issued at, or as a proxy to, fair value, an increase in profits contributed by the subsidiary in (b) may, in part, be offset by increases in the carrying amount of the put financial liability in (a).

33. However, if the Interpretations Committee decide to draft an Interpretation reflecting this reclassification from NCI approach, further analysis may be needed relating to the accounting for:

(a) dividends paid to the NCI shareholders.

> For example, should the dividend payment paid to the NCI shareholders be reflected in consolidated profit or loss (eg as interest expense), as a reduction in the financial liability recognised for the NCI put (eg as a repayment of part of the financial liability) or presented as an equity transaction?

(b) the situation where the put option expires unexercised.

> For example, would this be treated as an 'in substance disposal' of the NCI shares subject to the NCI put? If so, how would NCI be re-recognised?

34. Both of these issues were analysed by the staff in the July 2010 agenda papers[3], but no tentative decisions were made by the Interpretations Committee.

Concerns relating to the assumption of reclassification of NCI

35. The reclassification of NCI approach, accounts for the NCI as being acquired (and reduced to zero) on initial recognition. However, there is no certainty that the put option will be exercised and that the shares held by the NCI shareholder will be acquired by the parent.

36. As a result, the staff have identified two concerns with this approach relating to whether whether it is appropriate to apply this accounting approach because:

    (a) exercise of the instrument is contingent upon the actions of the NCI shareholder, and therefore is outside of the control of the parent.; and

    (b) the intent of IAS 32 is not to specify the component of equity that the financial liability recognise for a NCI put is reclassified from.

37. The first concern is similar to the dissenting opinion on the issue of IAS 32 in December 2003 (IAS 32.DO1-DO3). It further identifies that this approach could lead to potential abuse, as illustrated in the example below:

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[3] Specifically see agenda papers 4D and 4E presented at the July 2010 Interpretations Committee meeting at http://www.ifrs.org/NR/rdonlyres/BD93F9DC-F753-428D-ACB9-C18E5C4DD8D/0/IAS274to4E.zip

Example

An entity may issue a NCI put over the NCI shares in a profitable subsidiary that is not expected to be exercised by the NCI shareholder for a long period of time, or at all because it may:

a) only be exercisable at a fixed point in time (which is far beyond the current reporting period; or

b) exercisable at a fixed price that is significantly out of the money to the NCI shareholder.

However, by applying the reclassification of NCI approach, profit previously attributed to the NCI shareholders is now attributed to equity holders of the parent, because the NCI put is accounted for as though it has been exercised.

Consequently, some believe that, if the subsidiary is profitable, profit attributed to the parent may be overstated.

38. In response to the fact pattern in this example, the staff note that the guidance in IAS 32.AG28 would need to be applied in determining whether the NCI put should be recognised as a financial liability:

> Paragraph 25 requires that *if a part of a contingent settlement provision that could require settlement in cash or another financial asset* (or in another way that would result in the instrument being a financial liability) *is not genuine, the settlement provision does not affect the classification of a financial instrument.* Thus, a contract that requires settlement in cash or a variable number of the entity's own shares only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur is an equity instrument. Similarly, settlement in a fixed number of an entity's own shares may be contractually precluded in circumstances that are outside the control of the entity, but if these circumstances have no genuine possibility of occurring, classification as an equity instrument is appropriate. (Emphasis added)

39. The staff also identify that this outcome is consistent with the approach taken in IAS 32 which requires a written put option to be accounted for as though the option has already been exercised. The rationale for this approach is explained in IAS 32.BC11 and IAS 32.BC12:

> BC11 An entity's obligation to purchase its own shares establishes a maturity date for the shares that are subject to the contract. Therefore, to the extent of the obligation, *those shares cease to be equity instruments when the entity assumes the obligation.* This treatment under IAS 32 is consistent with the treatment of shares that provide for mandatory redemption by the entity. Without a requirement to recognise a financial liability for the present value of the share redemption amount, entities with identical obligations to deliver cash in exchange for their own equity instruments could report different information in their financial statements depending on whether the redemption clause is embedded in the equity instrument or is a free-standing derivative contract.
>
> BC12 Some respondents to the Exposure Draft suggested that when an entity writes an option that, if exercised, will result in the entity paying cash in return for receiving its own shares, it is incorrect to treat the full amount of the exercise price as a financial liability because the obligation is conditional upon the option being exercised. The Board rejected this argument because the *entity has an obligation to pay the full redemption amount and cannot avoid settlement in cash or another financial asset* for the full redemption amount *unless* the counterparty decides not to exercise its redemption right or specified future events or *circumstances beyond the control of the entity occur or do not occur. The Board also noted that a change would require a reconsideration of other provisions in IAS 32 that require liability treatment for obligations that are conditional on events or choices that are beyond the entity's control.* … (Emphasis added)

40. Finally the staff observe that, although the NCI put may lead to profit relating to the NCI shares subject to the put being attributable to equity holders of the parent in the statement of comprehensive income, the profit relating to the NCI shares may be excluded from the calculation of basic earnings per share.

41. This reflects application of the guidance in paragraph 63 and A11 (a) of IAS 33 *Earnings per Share* which, in contrast to IAS 32, can be interpreted as not requiring written put options to be accounted for as though the puts have been exercised. Instead, this guidance can be interpreted as requiring instruments that enable holders to obtain ordinary shares of the subsidiary to be considered when determining diluted earnings per share.

42. The second concern raised relates to whether IAS 32 is intended to specify the component of equity that the financial liability recognise for a NCI put is reclassified from.

43. In discussing this issue with members of the IASB's Financial Instruments team, the staff understand that:

    (a) the staff and Board have mixed views relating to what the equity reclassification represents when recognising a financial liability relating to an instrument to be settled with the entity's own equity instruments;

    (b) some believe that IAS 32 is not intended to provide specific guidance on which component of equity the reclassification of financial liability is from; and

    (c) any interpretation of the reclassification entry should be defined and scoped in a narrow manner to avoid analogy to other instruments where the financial liability recognised is reclassified from equity

44. However, the staff believe that accounting for the NCI put as though it has already been exercised is consistent with the principles of IAS 32 even though it would not be symmetrical with the accounting by the NCI shareholder (who would continue to recognise an interest in the subsidiary until the put is exercised).

Comparison to a put issued over parent's own equity

45. The staff also believe that the reclassification of NCI approach, is consistent with the accounting for a puttable instrument issued over a parent's shares rather than a subsidiary's shares (refer to IAS 32.AG27 (b) for further details).

46. In the situation where the put is issued over a parent's own equity, a gross financial liability is recognised, reflecting the gross amount of the exercise price of the puttable instrument.

View 2 - Implications of the Financial Instruments with Characteristics of Equity *(FICE) proposals*

Overview of approach

47. View 2 is consistent with the Board's current FICE project, and would also eliminate the double count issues noted earlier in the staff analysis.

48. As discussed in previous staff agenda papers on the accounting for NCI puts, based on the Board's tentative decisions to date, the FICE project expects to propose that a written put on an entity's own shares should be presented on a net basis, consistent with the accounting for derivative instruments in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*.

49. This 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).

Accounting implications of the approach

50. Similarly as with View 1, there is no double counting at either initial recognition or subsequent measurement for an NCI put.

51. This is because, on initial recognition of the NCI put, two separate instruments are recognised, one presented in equity (the NCI), and one presented as a financial liability (the put).

52. As a result, on initial recognition of the put, applying View 2 results in equity being reduced by the fair value of the NCI put instrument. As discussed in previous agenda papers, this reduction in equity is expected to be low (and close to zero) in a situation when the exercise price of the NCI put is at, or a proxy to, fair value.

53. In reviewing the subsequent measurement implications on the parent's consolidated statement of comprehensive income, there are no double counting issues because:

(a) changes in the carrying amount of the financial liability recognised for the NCI put are included in profit or loss attributed to equity holders of the parent. These changes are expected to be small if the exercise price of the NCI put is at, or a proxy to, fair value;

(b) profit or loss continues to be attributed to the NCI, and therefore profit or loss attributed to equity holders of the parent **deducts** amounts relating to shares subject to the NCI put, because these shares are accounted for as though they are still held by the NCI shareholders;

(c) total profit or loss attributed to equity holders of the parent (specifically the sum of 3332(a) and 3332(b)) reflects the continued existence of NCI and the existence of a separate put instrument written over the NCI; and

(d) total profit or loss attributed to equity holders of the parent (specifically the sum of 3332(a) and 3332(b)) may be more intuitive than when a double count exists.

For example, when the exercise price of the instrument is issued at, or as a proxy to, fair value, the put instrument will have a limited impact on profit or loss. However, when the exercise price of the instrument is fixed, the put instrument may have a significant impact on profit or loss.

54. However, it should be noted that, in accordance with the FICE proposals, certain issues are likely to remain. These include the:

(a) issue of which component of equity should be 'debited' when the NCI put instrument is recognised as a financial liability;

(b) perceived conflict identified in the Interpretations Committee request relating to IAS 32 and IAS 27; and

(c) requirements to account for a forward contract over shares held by an NCI shareholder to continue to be accounted for on a gross, rather than net, basis. Consequently, the double count issues may continue to exist when accounting for a forward contract over NCI, if the NCI component of equity continues to be recognised after the forward contract is written.

Staff recommendation

55. In the July 2010 staff agenda papers, the staff expressed a preference for a present access to economics benefit approach to the initial accounting for a NCI put. This preference reflected a view that:

    (a) financial reporting would be improved by providing a principles-based approach for entities to determine whether or not they should continue to recognise NCI after writing the put; and

    (b) the approach could be applied in accordance with both the current guidance in IAS 32 and the tentative agenda decisions made by the Board to date in relation to the FICE project.

56. However, the staff acknowledge that the present access to economic benefits approach creates concerns relating to the:

    (a) double count issues discussed in this agenda paper;

    (b) judgement that entities would need to apply in determining whether NCI should, or should not, continue to be recognised after the put is written; and

    (c) reliance on a 'risks and rewards' approach, which is different from the 'control' approach reflected in the tentative decisions taken by the Board in the *Consolidation* project.

57. In contrast, the staff believe that the reclassification of NCI approach:

    (a) is consistent with an interpretation that focuses on the requirements of IAS 32, rather than combining the requirements of IAS 27 *Consolidated and Separate Financial Statements* and IAS 32;

    (b) avoids perceived double count issues;

    (c) provides a clear approach that will eliminate current and emerging divergence in practice; and

(d) by focusing on the guidance in IAS 32 provides a clear basis for the Interpretation Committee's tentative decision that changes in the carrying amount of a financial liability recognised for NCI puts should be recognised in profit or loss.

58. As a result, the staff would recommend, that, because of the double counting concerns discussed at the July Interpretations Committee meeting, the draft Interpretation should propose a reclassification of NCI approach.

Questions for the Interpretations Committee
Does the Interpretations Committee agree with the staff recommendation that if the staff are to continue to develop an Interpretation to address the accounting for put options written over NCI that: i) the accounting model reflects the reclassification of NCI approach? ii) at the next Interpretations Committee meeting, the staff should propose whether additional guidance relating to the lapsing of the put and dividends paid to NCI shareholders should be included? If not, what does the Interpretations Committee recommend?