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

Topic **Business Combination Implications**

Purpose of this paper

1. The purpose of this paper is to analyse the accounting for put options written over non-controlling interests (NCI) that are issued as part of a business combination.

2. This paper:

   (a) analyses the initial recognition of put options written over NCI that are issued as part of a business combination;

   (b) analyses the subsequent measurement of put options written over NCI that are issued as part of a business combination;

   (c) makes a staff recommendation on whether the initial recognition and subsequent measurement of put options written over NCI that are issued as part of a business combination should be the same as, or different to, the accounting for put options written over NCI that are issued separately from a business combination; and

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

Background information

3. In the July 2010 meeting, the staff analysed the accounting for put options written over NCI using a very narrow definition. This narrow definition[1] defined a NCI put as being free-standing instrument, issued separately from a transaction that is accounted for as a business combination in accordance with IFRS 3 *Business Combinations*.

4. The intention of the staff in using such a narrow definition to analyse the accounting for put options written over NCI was to identify proposed accounting approaches that could be applied to a simple instrument, and then to consider, in subsequent agenda papers, how those approaches would be applied to more complex instruments, for example an instrument issued as part of a business combination.

5. In assessing the implications of the instrument being issued as part of a business combination, rather than as a separate standalone instrument, it is important to note that the request focuses on the accounting for put options written **after** the 2008 amendments were made to IFRS 3, IAS 27 *Consolidated and Separate Financial Statements* and IAS 39 *Financial Instruments: Recognition and Measurement* (collectively, the '2008 Amendments').

6. The staff's agenda paper presented at the May Interpretations Committee[2] meeting provided an overview of the accounting issues that may relate to NCI puts issued **before** the 2008 Amendments.

7. However, this agenda paper focuses only on those instruments issued as part of a business combination with an acquisition date that occurs **after** the parent has applied the 2008 Amendments, in conformity with the scope of the request, and consequently with the scope of the proposed Interpretation.

[1] Refer to paragraph 13 of agenda paper 4A presented at the July 2010 Interpretations Committee meeting Agenda Paper 4A.zip

[2] Refer to agenda paper 11 presented at the May 2010 Interpretations Committee meeting Agenda Paper 11.pdf

Staff analysis

8. The request received by the Interpretations Committee related to the accounting for put options written over NCI that were written **either** as part of, **or** separately from, a business combination.

9. The agenda papers presented in July 2010, and agenda paper 4B, provide an analysis of the accounting, and specifically the initial recognition and subsequent measurement, for instruments written separately from a business combination.

10. This agenda paper provides an analysis of the accounting, and specifically the initial recognition and subsequent measurement, of put options written over NCI as part of a business combination (described as 'Business Combination NCI puts'). It then contrasts the accounting with the analysis on initial recognition and subsequent measurement presented previously in relation to those instruments that are written as a free-standing instrument (described as 'Free-standing NCI puts').

11. In analysing the subsequent measurement implications in this agenda paper, the staff have focused on the accounting for changes in the carrying amount of the financial liability recognised for the put instrument.

12. This is because the staff believe that, in conformity with the accounting for Free-standing NCI puts, the accounting for the exercise or expiry of the instrument, and for dividends that may be paid to the NCI shareholders on shares subject to the put, are dependent upon the approach taken for initial recognition of the instrument.

Example

13. In analysing Business Combination NCI puts, the staff have used the following example:

> Entity A holds 100 per cent of Entity B.
>
> On 1 January 20X0, Entity C acquires 80 per cent of Entity B for CU100 and writes a put option to Entity A over the remaining 20 per cent of Entity B. The premium paid for the put is included within the CU100 of total consideration paid by Entity C.
>
> The put option is exercisable on 31 December 20X2 at CU25 plus an adjustment if Entity B achieves certain performance targets.
>
> The fair value (the present value of the redemption amount) of the put option on 1 January 20X0 is CU32.
>
> The fair value of 100 per cent of Entity B's net assets on 1 January 20X0 is CU90 (fair value of assets of CU300 less fair value of liabilities of CU210).
>
> Entity C measures NCI in Entity B at the proportionate share of net assets acquired.
>
> Entity C applies the 2008 Amendments before 1 January 20X0.

Application of the reclassification of NCI approach

Initial recognition

14. Entity C may apply the reclassification of NCI approach described in agenda paper 4B when accounting for the Business Combination NCI put.

15. In applying this approach, at 1 January 20X0 the staff believe that, in relation to Entity B, Entity C will recognise in the consolidated statement of financial position:

    (a) Total assets of CU242 comprising:

        (i) Goodwill of CU42:

            Total consideration of CU132 (CU100 + CU32)

            Less FV of net assets acquired of CU90 (100%*CU90)

        (ii) Fair value of assets acquired (CU300)

        (iii) Less cash paid (CU100)

    (b) Total liabilities plus equity of CU242 comprising:

        (i) Fair value of liabilities assumed (CU210)

        (ii) NCI put financial liability (CU32)

16. This accounting recognises the 20 per cent of shares held by the NCI shareholder (Entity A) as though they have been acquired by Entity C and reflects the:

    (a) calculation of goodwill in accordance with IFRS 3, with the fair value (the present value of the redemption amount) of the put option being part of the consideration paid to acquire 100 per cent of Entity B; and

    (b) shares held by Entity A as having been acquired by Entity C as part of the business combination. Consequently, NCI is not recognised as a component of equity, and has instead been reclassified as a financial liability recognised for the put instrument in accordance with IAS 32.

17. Consequently, the staff think that the only difference in the initial recognition accounting between Free-standing NCI puts and Business Combination NCI puts in accordance with this approach, relates to the debit entry recorded when a financial liability is recognised for the put. For a:

    (a) Free-standing NCI put, the debit entry eliminates previously-recognised NCI, with any difference between the carrying amount of NCI and the fair value (the present value of the redemption amount) of the put option being recognised in controlling interest equity; however,

    (b) Business Combination NCI put, the debit entry is recognised in goodwill and no NCI is recognised. Consequently, controlling interest equity is not changed on initial recognition of the put instrument.

18. As a result, with both the Free-standing and Business Combination NCI puts, the staff believe that the concerns relating to the potential double counting of the put financial liability and NCI noted in Agenda Paper 4B are avoided.

Subsequent measurement

19. In applying the reclassification of NCI approach, the accounting for the initial recognition of the Business Combination NCI put reflects the 20 per cent of shares held by the NCI shareholder (Entity A) as though they have been acquired by Entity C.

20. Consequently, the fair value (the present value of the redemption amount) of the put option was included in the amount of consideration when calculating goodwill on the business combination transaction.

21. Some therefore consider that changes in the carrying amount of a Business Combination NCI put reflect contingent consideration, and, because the instrument was issued after the 2008 Amendments, they would apply the guidance in IFRS 3.58 (quoted below) to determine how these changes in the carrying amount of the Business Combination NCI put should be recognised:

> Some changes in the fair value of contingent consideration that the acquirer recognises after the acquisition date may be the result of additional information that the acquirer obtained after that date about facts and circumstances that existed at the acquisition date. Such changes are measurement period adjustments in accordance with paragraphs 45–49. However, *changes resulting from events after the acquisition date*, such as meeting an earnings target, reaching a specified share price or reaching a milestone on a research and development project, *are not measurement period adjustments. The acquirer shall account for changes in the fair value of contingent consideration that are not measurement period adjustments as follows:*
>
> (a) Contingent consideration classified as equity shall not be remeasured and its subsequent settlement shall be accounted for within equity.
>
> (b) *Contingent consideration classified as* an asset or *a liability that:*
>
> (i) *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.*
>
> (ii) is not within the scope of IFRS 9 or IAS 39 shall be accounted for in accordance with IAS 37 or other IFRSs as appropriate. (Emphasis added)

22. In applying the guidance in IFRS 3.58, the staff believe that changes in the carrying amount of the Business Combination NCI put reflect contingent consideration. This is because they result from events after the acquisition date that are not measurement period adjustments.

23. This contingent consideration is in the form of the put instrument, which is presented as a financial liability in accordance with IAS 32, and is consequently within the measurement scope of IFRS 9 *Financial Instruments* or IAS 39.

24. Consequently, the staff believe that, changes in the carrying amount of the Business Combination NCI put reflect contingent consideration. In accordance with IFRS 3.58 these changes are recognised in profit or loss attributable to the equity holders of Entity C.

25. As a result, the staff note that in applying the reclassification of NCI approach, the changes in the carrying amount of a Free-standing NCI put and a Business Combination NCI put are **both** recognised in profit or loss.

Application of the economic benefits approach (and the parent does not have, in substance, a present ownership interest in the shares subject to the put)

Initial recognition

26. Alternatively, Entity C may apply the economic benefits approach described in the July Interpretations Committee agenda papers.

27. If it does, it may determine that the shares subject to the put do not, in substance, provide the parent with a present ownership interest.

28. This may be because, for example, Entity C determines that, because the put option is exercisable at a price that is a proxy to fair value, it does not have the risks and rewards associated with the NCI shares that are subject to the put.

29. As a result, in applying the economic benefits approach at 1 January 20X0, the staff believe that Entity C's consolidated statement of financial position will, in relation to Entity B, recognise:

    (a) Total assets of CU228, comprising:

        (i) A residual amount of goodwill (CU28)

        (ii) Fair value of assets acquired (CU300)

        (iii) <u>Less</u> cash paid (CU100)

    (b) Total liabilities plus equity of CU228 comprising:

        (i) Fair value of liabilities assumed (CU210)

        (ii) NCI put financial liability (CU32)

        (iii) NCI of CU18 (20%*CU90) or (refer to paragraph 30(b) below) CU0

        (iv) Reduction of controlling interest equity of CU32 or (refer to paragraph 30(b) below) CU14 (CU32 - CU18)

30. This accounting recognises the 20 per cent of shares subject to the put as still held by the NCI shareholder (Entity A), and reflects the:

(a) calculation of goodwill in accordance with IFRS 3, with the put option being excluded from the consideration paid by Entity C to acquire 80 per cent of Entity B; and

(b) shares held by the NCI shareholder are presented as a component of equity from the date of acquisition date. For equity presentation purposes, this NCI may be presented as CU0 if a view is taken that it is offset by an amount reclassified from equity on initial recognition of the NCI put (refer to the July Interpretations Committee agenda papers for further analysis[3]).

31. Consequently, the staff do not think that there are differences in the initial recognition accounting between Free-standing NCI puts and a Business Combination NCI put when an entity applies the economic benefits approach described in the July Interpretations Committee agenda papers, and determines that the shares subject to the put do not, in substance, provide the parent with a present ownership interest. This is because the same:

(a) financial liability is recognised for the NCI put;

(b) NCI component of equity is recognised; and

(c) the same adjustments are made to controlling interest equity.

32. As a result, with both the Free-standing and Business Combination NCI puts, the staff believe that the double counting concerns noted in Agenda Paper 4B would exist when applying the economic benefits approach in this situation. This is mainly because NCI is recognised within equity and a financial liability is recognised for the fair value (the present value of the redemption amount) of the NCI put.

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[3] Refer specifically to paragraphs 39 to 44 in Agenda Paper 4B presented at the July Interpretations Committee meeting Agenda paper 4B

Subsequent measurement – profit and loss approach

33. The staff believe that, in conformity with the accounting for a Free-standing NCI put in this situation, a financial liability is initially recognised for a Business Combinations NCI put in accordance with the guidance in IAS 32.23.

34. Consequently, the staff think that the arguments discussed in Agenda Paper 4C, presented at the July Interpretations Committee meeting, in relation to the 'profit or loss' view[4], could also be applied when accounting for changes in the carrying amount of a Business Combination NCI put in this situation.

35. Consequently, the Interpretations Committee could determine that all changes in the carrying amount of a Business Combination NCI put are reflected in profit or loss in accordance with IAS 32, regardless of whether the put represents consideration provided in a business combination.

Subsequent measurement – equity approach

36. When Entity C applies the economic benefits approach, and determines that the shares subject to the put do not, in substance, provide the parent with a present ownership interest, some believe the arguments presented in Agenda Paper 4C in relation to the 'equity' view[5] may be applied.

37. These arguments proposed that changes in the carrying amount of a Business Combinations NCI put in equity, rather than profit or loss.

38. Proponents of this view would look to the guidance in IAS 27.30 and IAS 27.31 and argue that the principles supporting recognising the changes in equity are strengthened by the put instrument being issued as part of a Business Combination.

39. The staff note that the Interpretations Committee were previously not supportive of this approach when considering the accounting for a Free-standing NCI put.

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[4] Specifically, refer to paragraphs 14 to 22 in agenda paper 4C presented at the July Interpretations Committee meeting Agenda Paper 4C.

[5] Specifically, refer to paragraphs 23 to 42 in agenda paper 4C presented at the July Interpretations Committee meeting Agenda Paper 4C.

40. However, the Interpretations Committee may consider that a business combination transaction reflects application of the principles in IFRS 3 and IAS 27, rather than the guidance in IAS 32 and IAS 39. Consequently, the equity view may be more supportable when accounting for a Business Combination NCI put.

41. The staff do not believe that the arguments for the equity view are any more persuasive for a Business Combination NCI put than they were for a Free-standing NCI put.

Application of the economic benefits approach (and the parent has, in substance, a present ownership interest in the shares subject to the put)

Initial recognition and subsequent measurement

42. In contrast, Entity C may apply the economic benefits approach described in the July Interpretations Committee agenda papers, and determine that the shares subject to the put, in substance, provide the parent with a present ownership interest.

43. This may be because, for example, in addition to the writing of the NCI put, a call option is also written over the NCI shares.

44. In this situation, the staff believe that the initial recognition and subsequent measurement accounting for Business Combination NCI puts is the same as when Entity C applies the reclassification of NCI approach, described above.

Staff recommendation

45. The staff note that in the July 2010 Interpretations Committee meeting, the Interpretations Committee tentatively decided to include guidance for the:

    (a) initial recognition of Free-standing NCI puts, proposing that a financial liability should be recognised and initially measured at fair value (the present value of the redemption amount) of the put; and

    (b) subsequent measurement of Free-standing NCI puts, proposing that changes in the carrying amount of a financial liability for the put should be recognised in profit or loss, in accordance with the guidance in IAS 39.

46. The staff recommend that both of these tentative agenda decisions should be expanded to include guidance for Business Combination NCI puts, proposing that on:

    (a) initial recognition, a financial liability should be recognised and initially measured at fair value (the present value of the redemption amount) of the put; and

    (b) on subsequent measurement, changes in the carrying amount of a financial liability for the put should be recognised in profit or loss, in accordance with the guidance in IAS 39.

47. This is because the guidance in IFRS 3:

    (a) does not impact upon the requirements to apply IAS 32 to present a financial liability for the put instrument;

    (b) requires that, if the changes in the carrying amount of the put instrument reflect contingent consideration, these changes should be recognised in profit or loss in accordance with the guidance in IAS 39; and

(c) does not change the guidance in IAS 39 to recognise changes in the carrying amount of a financial liability for the put in profit or loss, if these changes do not meet the definition of contingent consideration.

48. The staff do believe that, whether the put instrument is issued as part of, or separately from, a business combination does impact upon the accounting for the debit entry initially recognised in relation to the put instrument.

49. As a consequence, this affects whether subsequent changes in the carrying amount of the financial liability recognised for the put reflect contingent consideration, but does not change the requirement to recognise these subsequent changes in profit or loss.

50. The staff think that, in conformity with the guidance in IFRS 3, if issuance of the Business Combination NCI put leads to the shares held by the NCI shareholder being accounted for as though they have been acquired by the parent (Entity C in this example), that goodwill should be recognised, and subsequent changes in the carrying amount of the financial liability recognised as contingent consideration.

51. However, if the shares held by the NCI shareholder are not accounted for as though they have been acquired by the parent (Entity C), the staff believe that the same financial liability, NCI component of equity and adjustments to controlling interest equity are recognised when a Free-standing NCI put and Business Combination put are written. In addition, the same subsequent measurement accounting will be applied for the NCI and the financial liability that is recognised for the NCI put.

Questions for the Interpretations Committee

1. Does the Interpretations Committee agree with the staff recommendation to expand the tentative decisions relating to Free-standing NCI puts to include Business Combination NCI puts, and that the draft Interpretation should provide guidance on the:

(a) initial recognition of all NCI puts, proposing that a financial liability should be recognised and initially measured at fair value (the present value of the redemption amount) of the put; and

(b) subsequent measurement of all NCI puts, proposing that changes in the carrying amount of a financial liability for the put should be recognised in profit or loss in accordance with the guidance in IAS 39?

2. Does the Interpretations Committee agree with the staff recommendation that, if issuance of the Business Combination NCI put leads to the shares held by the NCI shareholder being accounted for as though they have been acquired by the parent, that:

(a) goodwill should be recognised; and

(b) subsequent changes in the carrying amount of the financial liability reflect contingent consideration?

If not, what does the Interpretations Committee recommend?