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

Topic: **Alternatives to an Interpretation**

Purpose of this paper

1. The purpose of this paper is to consider whether, as an alternative to addressing the issue of accounting for put options written over non-controlling interests (NCI) through an Interpretation, the IFRS Interpretations Committee (Interpretations Committee) should consider recommending that guidance should be provided by the Board.

2. In relation to the accounting for put options written over NCI, this paper:

   (a) provides background on why the Interpretations Committee may determine that the accounting should be addressed by the Board, rather than by the Interpretations Committee;

   (b) analyses how the Board could consider the accounting as part of the *Financial Instruments with Characteristics of Equity* (FICE) project; and

   (c) considers how other current IFRSs could be amended to address some of the concerns noted with interpreting current IFRSs.

Background information

3. At the May and July 2010 meetings the Interpretations Committee discussed the current guidance in IFRSs relating to the accounting for put options written over NCI.

This paper has been prepared by the technical staff of the IFRS Foundation 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*.

4. In discussing this guidance, the Interpretations Committee tentatively decided to develop a draft Interpretation, based primarily on interpreting IAS 32 *Financial Instruments: Presentation*, that includes guidance for the:

   (a) initial recognition of put options written over NCI, 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 the put liability, proposing that changes in the carrying amount of a financial liability for the instrument should be recognised in profit or loss in accordance with the guidance in IAS 39 *Financial Instruments: Recognition and Measurement*.

5. However, in making these tentative agenda decisions, some Interpretations Committee members expressed concerns as to whether the interpretation of current IFRSs (including application of the in substance purchase or reclassification of NCI approach discussed in agenda paper 4B) improves financial reporting.

6. These concerns include whether:

   (a) the subsequent accounting for the puts should impact upon profit or loss. This is because of views that these instruments are considered to be transactions with owners in their capacity as owners, in accordance with the 'single economic entity concept' included in IAS 27 *Consolidated and Separate Financial Statements*;

   (b) NCI should, or should not continue to be recognised after the put option is written; and

   (c) the resulting accounting is intuitive. For example, should the accounting for a put that is exercisable at, or as a proxy to, fair value create significant profit and loss volatility when the fair value of the put derivative instrument itself is expected to be close to zero throughout the life of the instrument, and the put transfers limited risk to the parent?

7. Many of these concerns raised from interpreting current IFRSs to address this issue are similar to those noted when the Board issued an amendment to IAS 32 to address *Puttable Financial Instruments and Obligations Arising on Liquidation* (the 'puttables amendment') in February 2008.

8. In making those amendments, the Board's Basis for Conclusions reflected concerns including:

> BC50 As discussed in paragraphs BC7 and BC8, puttable instruments meet the definition of a financial liability and the Board concluded that all such instruments should be classified as liabilities. However, constituents raised the following concerns about classifying such instruments as financial liabilities if they represent the residual claim to the net assets of the entity:
>
> (a) ….
>
> (b) Changes in the carrying value of the liability are recognised in profit or loss. This results in counter-intuitive accounting (if the redemption value is linked to the performance of the entity) because:
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> (i) when an entity performs well, the present value of the settlement amount of the liabilities increases, and a loss is recognised.
>
> (ii) when the entity performs poorly, the present value of the settlement amount of the liability decreases, and a gain is recognised.

9. Consequently, the staff believe that many of the concerns that exist in interpreting current IFRSs to address the accounting for NCI puts reflect broader issues relating to the guidance in IAS 32, rather than being concerns that are unique to the accounting for NCI puts. In addition, many of these concerns were identified and have been discussed by the Board in previous projects relating to IAS 32.

10. However, in voicing some of these same concerns, some members of the Interpretations Committee question whether greater improvements in financial reporting could be achieved by addressing these concerns, as well as those expressed relating to the current, and emerging, diversity in practice, by:

    (a) providing guidance that reflects the Board's tentative decisions taken in the *Financial Instruments with Characteristics of Equity* (FICE) project; or

(b) recommending that the Board should make amendments to the current requirements in IFRSs (eg IAS 27, IAS 32 or IAS 39).

Staff analysis

Financial Instruments with Characteristics of Equity (FICE) project considerations

Gross versus net financial liability recognition – IAS 32

11. A significant concern raised by the staff and the Interpretations Committee in interpreting the current guidance in IFRSs relates to the requirements in IAS 32.23 to recognise a financial liability for the entire instrument on a 'gross basis':

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

12. The illustrative examples prepared by the staff for the purposes of the July 2010 Interpretations Committee meeting highlighted how this requirement results in an entity recognising a financial liability for the put that **includes** value relating to the shares held by the NCI shareholder. This potentially reduces equity attributable to equity holders of the parent (especially if NCI continues to be recognised).

13. In addition, specifically in the case of put options written based on a fair value (or a proxy to fair value) exercise price, these examples highlighted that application of the guidance in IAS 32 and IAS 39 creates significant changes in the subsequent measurement of the financial liability initially recognised. The tentative decisions taken by the Interpretations Committee indicate that these changes would be recognised in profit or loss, creating volatility that some consider to be counter-intuitive.

Gross versus net financial liability recognition – FICE

14. In contrast, as explained in the July 2010 agenda papers, the staff expressed conceptual support for the approach currently proposed in the Board's FICE project.

15. Based on the Board's tentative decisions to date, the FICE project will propose that the financial liability for a put option written over NCI should be presented on a 'net' basis, consistent with the current accounting for derivative instruments in accordance with IAS 39.

16. This would initially be measured at the fair value of the NCI put instrument (a derivative financial liability), and therefore **excludes** value relating to the shares subject to the put (which remains as NCI in the form of an equity instrument).

17. When the put is exercisable at fair value, or a proxy to fair value, the amount initially, and subsequently, recognised as a financial liability when applying the FICE proposals is expected to be lower than the financial liability recognised in accordance with IAS 32 (and close to zero).

18. Similarly, subsequent changes in the carrying amount of the put financial liability (which the Interpretations Committee has tentatively decided to recognise in profit or loss) are expected to be lower when applying the FICE proposals than those recognised in accordance with IAS 32.

19. Consequently, when these subsequent changes in the carrying amount of the put financial liability are recognised in profit and loss in accordance with the FICE proposals, it is expected that they will create significantly less income statement volatility than is currently recognised in accordance with IAS 32.

20. This is expected to contrast with the increased income statement volatility that is expected to arise when recognising subsequent changes in the fair value of a put, exercisable at a fixed strike price, in accordance with the FICE proposals, rather than with IAS 32.

21. Supporters of the FICE proposals argue that this:

    (a) creates recognition of a financial liability, and subsequent changes in profit or loss, that better reflects the risk that the parent has in relation to the put instrument; and

    (b) allows NCI to continue to be recognised, reflecting the existence of the NCI shareholder's interest in those shares until the put is exercised, consistent with how they would be recognised in the financial statements of the NCI shareholder.

Status of the FICE project

22. Since the staff started to analyse the accounting for put options written over NCI, the IASB and FASB have issued a revised timetable of their Memorandum of Understanding (MoU) projects.

23. As a result, the publication of the FICE exposure draft (FICE ED) is now planned for the **first quarter of 2011**. In the meantime, the staff are currently performing further research and analysis to address issues raised by external reviewers during the project.

24. It is therefore unlikely that the FICE ED will be published (the effective date is yet to be determined) before the current timeline proposed for the issuance of a draft Interpretation addressing the accounting for NCI puts.

25. During meetings in July 2010, the Board discussed the next steps in the project, specifically whether it should continue to pursue the proposed approach, or else retain the requirements in IAS 32 (and perhaps address particular practice problems that have arisen from applying that standard).

26. Consequently, one approach that the Interpretations Committee could take would be to recommend that, as part of the FICE project, the Board should address particular practice problems relating to the accounting for puts written over NCI.

27. The staff discussed this potential recommendation with the FICE project team after the July Board meeting. The FICE project team believes that the September Board meeting (which occurs after the September Interpretations Committee meeting) will provide greater clarity on the next steps in the FICE project, one of which could be to address specific practice issues.

28. However, the FICE project team expressed concern as to whether, even if the Board decided to address specific practice issues as the next step, the accounting for NCI puts would be addressed, noting that it is not currently perceived to be:

    (a) as significant as other practice issues that they are aware of;

    (b) a significant IFRS/US GAAP convergence issue; and

    (c) an issue that the project team would address separately from the accounting for other instruments that are accounted for on a similar basis in accordance with IAS 32 (eg other puttable instruments, puttable shares).

Amendments to current IFRSs

29. Alternatively, the Interpretations Committee could determine that, because of concerns relating to the accounting implications of interpreting current IFRSs in relation to the accounting for put options written over NCI, they should instead recommend that the Board should make amendments to current IFRSs.

30. The staff have identified potential amendments that could be made to IFRSs to address the accounting for NCI puts. These includes amending IFRSs to:

    (a) require the financial liability to be recognised for the NCI put on a different basis.

        This could involve amending the presentation and measurement requirements in IAS 32 to require a net, rather than gross, approach to recognising a financial liability for the put, similar to the tentative agenda decisions taken to date in the FICE project.

    (b) change the subsequent measurement requirements in IAS 39 for put options written over NCI.

        This could include requiring different accounting for the various components of changes in the carrying amount of a financial liability recognised for the put.

        For example, possible proposals could include:

        - approaches similar to the proposals for own credit that were included in the *Fair Value Option for Financial Liabilities* Exposure Draft;
        - the approaches that were discussed at the July 2009 Board meeting in relation to the FICE project[1];
        - an approach for allocating amounts between profit or loss and the NCI component of equity;; or

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[1] IASB / FASB July 2009

(c) require changes in the carrying amount of the NCI put liability to be recognised in equity.

This could be achieved by;

- adding additional guidance in IAS 27 to require the accounting for put options written over NCI to follow the single economic entity concept illustrated in IAS 27.30 and IAS 27.31; or
- amending the scope of IAS 39 to expand the exception for interests in subsidiaries to include puttable instruments relating to an NCI shareholder's interest in subsidiaries.

Implications of amending current IFRSs

31. Concerns may exist over any recommendations made by the Interpretations Committee to amend IFRSs to address the accounting for puts written over NCI.

32. These concerns include whether the Board would want to separately amend IFRSs (and specifically IAS 32) to address the accounting for puts written over NCI, because of the:

(a) staff's expectation that an amendment would not meet the criteria to be included as part of the *Annual Improvements* process;

(b) risk of pre-empting decisions in FICE project;

(c) puttables amendment in 2008 that the Board considered a limited scope exception to the definition of a financial liability;

(d) extent of the Board's current agenda and consequential lack of time available;

(e) implications on the accounting for other puttable instruments (eg puttable instruments issued by a parent, rather than a subsidiary, puttable shares and the accounting in the separate financial statements of the issuer of the instrument); and

(f) alternative approaches previously considered and rejected by the Board, as described in IAS 32.BC21.

Staff recommendation

33. The staff do not believe that the Interpretations Committee should recommend that the Board should make a specific amendment to current IFRSs to address the accounting for put options written over NCI.

34. Consequently, the staff continue to believe that the most effective and efficient way of resolving the current (and emerging) diversity in practice is through an Interpretation.

35. The staff believe that it:

    (a) is not probable that the Interpretations Committee could reach a consensus on the nature of a proposed amendment to IFRSs on a timely basis, because of the number of alternatives that exist in amending, rather than interpreting, IFRSs to address this issue; and

    (b) would not be appropriate for the Interpretations Committee to recommend that the Board should make a specific amendment to address this issue, because of the continuing FICE project.

36. However, the staff are also concerned about a recommendation that the Board should address the accounting for put options written over NCI as part of its deliberations on the next steps in the FICE project. This is because it would:

    (a) significantly delay the timing of any accounting guidance that is issued (and may even lead to no guidance being issued);

    (b) lead to continuation, and potentially an increase, in diversity in practice;

    (c) be unlikely to specifically address the basic issue raised in the request, relating to a perceived conflict between the financial instruments and business combinations/consolidations guidance in IFRSs (including how the 'debit entry' on initial recognition of the put should be recognised); and

    (d) indicate that the issue raised in the request is not sufficiently narrow in scope.

37. However, the staff believe that the specific issue included in the request relating to whether changes in the carrying amount of a financial liability recognised for an NCI put are required to be recognised in profit or loss, because of a perceived conflict between IAS 32/IAS 39 and IAS 27, does meet the IFRIC agenda criteria. This was noted in the May Committee meeting and is reflected in tentative decisions made to date by the Committee.

Question for the Interpretations Committee
Does the Interpretations Committee agree with the staff recommendation that an interpretation remains the most appropriate method of issuing guidance to address the current divergence in practice relating to the accounting for put options written over NCI? If not, what does the Interpretations Committee recommend?