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

Topic **Potential short-term solution: a scope exclusion from IAS 32 *Financial Instruments: Presentation* for some NCI puts**

Background

1. Over the course of several meetings, the IFRS Interpretations Committee (the Committee) has discussed the accounting for put options written on shares held by non-controlling interest shareholders (NCI puts) in the consolidated financial statements of the controlling shareholder.[1] Some constituents have expressed concerns to the Committee about the diversity in accounting for the subsequent measurement of the financial liability that is recognized for those NCI puts.

2. At the November 2010 IASB meeting, the Board expressed support for the Committee to work with the staff of the Financial Instruments with Characteristics of Equity (FICE) project to develop a short-term solution to this issue. Thus, at the January 2011 Committee meeting, the Committee received an education session from the staff on the FICE project to learn about their views on the possible direction and timing of the FICE project.

3. Also at that meeting, the Committee discussed possible short-term solutions for this issue, including a scope exclusion from IAS 32 *Financial Instruments: Presentation* for NCI puts. That scope exclusion would change the measurement basis of NCI puts to that used for other derivative contracts.

[1] The Committee has discussed this issue at five previous meetings—May, July, September and November 2010 and January 2011. If Committee members would like copies of previous agenda papers or other background information, please let us know.

Specifically, NCI puts would be initially and subsequently measured on a 'net' basis at fair value—rather than being measured on a 'gross' basis at the present value of the option exercise price as is currently required by IAS 32. The Committee asked us to explore the viability of such a scope exclusion.

Purpose of this paper

4. As requested by the Committee, we have analyzed that short-term solution. This paper discusses:
   (a) how a scope exclusion might work;
   (b) which NCI puts would be scoped out of IAS 32 (ie the 'scope of the scope exclusion'); and
   (c) advantages and disadvantages of a scope exclusion.
5. The appendix of this paper contains draft amendments to IAS 32 that would be necessary if a scope exclusion was made for NCI puts.
6. Based on the Committee's discussion at the January 2011 meeting, some constituents have expressed their support for a scope exclusion for NCI puts. They provided us with a detailed analysis of that and other possible short-term solutions. Their work was very helpful and we are extremely appreciative of their efforts. A lot of their input is reflected in this paper.

How a scope exclusion might work

The effect on IAS 32

7. The scope of IAS 32 (paragraph 4) would be amended to exclude particular NCI puts. Thus **none** of the requirements in IAS 32 would apply to those instruments. The amendments to IAS 32 also would describe clearly which NCI puts were subject to that scope exclusion (the scope of the scope exclusion is discussed later in this paper).

8. As a result, the requirements in paragraph 23 of IAS 32 to recognize a financial liability at the present value of the option exercise price would not apply to NCI puts. Instead, the relevant measurement requirements in IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments* would apply (both initially and subsequently)—and the NCI put would be measured on a 'net' basis at fair value with all changes in fair value recognized in profit or loss.[2]

9. It would be unnecessary to make any further amendments to IAS 32. The existing requirements would remain unchanged for the contracts within its scope.

The effect on other IFRSs

10. The scope exclusion would not affect any other IFRSs (other than some possible minor editorial changes to reflect the change in the scope of IAS 32).

IAS 27

11. The scope exclusion would only affect the accounting for the NCI **put**. It would not affect the accounting for the non-controlling interest itself; therefore, it would be unnecessary to make any amendments to IAS 27 *Consolidated and Separate Financial Statements*.

IAS 39 and IFRS 9

12. NCI puts are financial instruments and already are within the scope of IAS 39 and IFRS 9.

13. If NCI puts were excluded from the scope of IAS 32 (and thus excluded from the 'specialized' requirements in paragraph 23), those financial instruments would fall automatically within the measurement requirements in IAS 39 or

[2] For simplicity, this paper assumes that the 'cost exception' described in paragraph 47(a) of IAS 39 for derivatives on unquoted equity instruments is not applied.

IFRS 9 for derivative contracts and thus would be measured at fair value through profit or loss.

14. Therefore it would be unnecessary to make any amendments to IAS 39 or IFRS 9.

Further interpretations

15. Since the scope exclusion in IAS 32 would clearly explain that NCI puts are measured in accordance with IAS 39 or IFRS 9 and the requirements in those Standards for derivative contracts are clear, we think it would be unnecessary to make any interpretations.

The 'scope of the scope exclusion'

16. We think the scope exclusion should be as narrow and straight-forward as possible. Otherwise it could add significant complexity to IAS 32 and cause confusion in practice. Moreover if the objective is to ask the Board to deliberate (and potentially finalize) this issue quickly, we think it is imperative that the potential amendments are as uncomplicated as possible.

Limiting the scope exclusion

17. As mentioned at the beginning of this paper, the scope exclusion would apply only to the consolidated financial statements of the controlling shareholder. It would **not** apply to the separate financial statements of the controlling shareholder or to the separate financial statements of any of the subsidiaries (ie there is not a potential conflict between IAS 32 and IAS 27 in those separate financial statements). In those separate financial statements, IAS 32 would continue to apply to the put.

18. We think the scope exclusion should be further limited as follows:

    (a) The NCI put is not embedded in another contract. For example, we think that the Board should not re-consider the accounting in IAS 32 for puttable instruments (eg puttable shares).

(b) The NCI put obliges an entity in the consolidated group to settle the derivative by delivering cash or another financial asset in exchange for the interest in the subsidiary (ie 'gross physical settlement'). In other words, the scope exclusion would apply only to those NCI puts that otherwise would be measured on a 'gross' basis pursuant to the requirements in paragraph 23 of IAS 32. The concerns raised by constituents relate only to those NCI puts; therefore we see no compelling reason to create a larger scope exclusion than necessary and 'tinker' with requirements in IAS 32 that are not troublesome or problematic.

We note that if the requirements in paragraph 23 do not apply to the NCI put, it is measured on a 'net' basis at fair value in accordance with IAS 32 and IAS 39 or IFRS 9. There does not seem to be confusion, concern or diversity in practice related to those requirements; therefore, we think they should remain unchanged.

Further limitations?

19. We think the scope exclusion should **not** be any narrower than we have described in paragraphs 17 and 18. We acknowledge that for the purposes of simplifying prior discussions, the Committee focused on a very specific fact pattern (set out in paragraph 6 of agenda paper 6 for the January 2011 meeting). However, we understand that the Committee did not necessarily intend to limit its consideration to that simplified instrument.

20. We acknowledge that further narrowing the scope exclusion would have one noteworthy advantage—it would limit the exception to IAS 32. However, other than that, there does not seem to be any basis for a narrower scope exclusion. Moreover creating a narrower scope exclusion would require a detailed list of rules to set out which NCI puts qualify for the exclusion, which is inconsistent with our objective of proposing a straight-forward and uncomplicated short-term solution.

A final observation

21. If the scope of IAS 32 was amended as we have described, all NCI puts would be measured on a 'net' basis at fair value with changes recognized in profit or loss in the consolidated financial statements of the controlling shareholder. Said differently, the requirements in paragraph 23 of IAS 32 would no longer apply to any NCI put in the consolidated financial statements of the controlling shareholder.

Examples

22. The following table illustrates the scope exclusion described above. As we discussed in paragraphs 17 and 18, our analysis is limited to the consolidated financial statements of the controlling shareholder and we have assumed that the NCI put is not embedded in another contract and that it obliges an entity in the consolidated group to deliver cash or another financial asset in exchange for the interest in the subsidiary.

	Instrument	Excluded from IAS 32?	Notes
1	Put options written by the parent on some or all of the shares held by the non-controlling interest shareholder(s), regardless of exercise price (fixed or variable)	Yes	
2	Put options written by any subsidiary in the consolidated group on some or all of the shares held by the non-controlling interest shareholder(s), regardless of the exercise price (fixed or variable)	Yes	In the consolidated financial statements of the controlling shareholder, this includes put options written by a subsidiary on its own shares. That is because the scope exclusion focuses on the NCI put at the consolidated level. At the consolidated level, the NCI put 'looks the same' regardless of who in the group writes it.
3	Forward contracts written by the parent or any other entity in the consolidated group to purchase shares held by non-controlling interest shareholder(s)	No	The concerns raised to the Committee were related to put contracts, not forward contracts. Therefore we see no compelling reason to broaden the scope exclusion to include forward contracts.

	Instrument	Excluded from IAS 32?	Notes
4	Put options written by the parent on its own shares	No	This would require a fundamental change to IAS 32. Moreover, the concerns raised to the Committee were related to the potential conflict between IAS 27 and IAS 32 for NCI puts. Those concerns are not relevant to a put option written by the parent on its own shares.
5	Puttable instruments (eg puttable shares) issued by the parent or any other entity in the consolidated group	No	The Board spent a considerable amount of time in 2007 and 2008 deliberating the classification of puttable instruments. We do not think that debate should be re-opened.

Advantages and disadvantages of a scope exclusion

23. There are several **advantages** of the scope exclusion described in this paper:

It addresses the concern that was originally raised to the Committee—ie that a potential conflict between IAS 32 and IAS 27 has resulted in diversity in accounting for the subsequent measurement of the 'gross' liability that is recognized for NCI puts. Moreover, this possible short-term solution avoids the 'knock on' questions that were discussed in previous Committee meetings (eg how to account for the receipt of dividends, what component of equity should be debited when the 'gross' liability is initially recognized, how to account for the expiry of the NCI put). That is because those 'knock on' questions arise only if the liability for the NCI put is measured on a 'gross' basis.

(a) It responds to criticisms about the usefulness of the information provided by the current measurement basis. Some constituents have told the Committee that measuring NCI puts on a 'gross' basis results in counterintuitive information that does not reflect the economics of the instrument. For example, if a NCI put is exercisable at (or close to) fair value, there likely will be significant volatility in the measurement of the liability over its life even though the instrument's fair value will always be close to zero.

(b) It is a non-invasive solution that would require limited changes to IAS 32.

(c) It is directionally consistent with the boards' discussions in the FICE project. In that project the boards preliminarily decided that all puts written on an entity's own shares should be accounted for on a 'net' basis as a derivative contract.

24. However, there are several **disadvantages** of a scope exclusion:

(a) It creates another exception to IAS 32. The issue of how to measure these types of obligations was thoroughly debated when IAS 32 was revised in 2003, as illustrated by the dissenting opinion to that revision. The scope exclusion discussed in this paper would be a direct reversal of the IASB's decision at the time.

(b) Criticisms about the usefulness of the information provided by the current measurement basis (ie measuring the liability on a 'gross' basis) are applicable to all put options and forward purchase contracts written on an entity's own equity—not just NCI puts. There is little or no conceptual basis for accounting for NCI puts differently than other put options written on the group's own equity.

(c) IAS 32 and IAS 39/IFRS 9 set out the primary requirements for accounting for financial instruments—and create a natural 'two step' process for classifying and measuring financial instruments. In the first step, an entity uses IAS 32 to determine whether an instrument meets the definition of an asset, a liability or equity. In the second step, the entity applies IAS 39/IFRS 9 to all non-equity instruments. This scope exclusion would create an exception to that two-step process. Unlike all other financial instruments, NCI puts would skip the first step—and would only be within the scope of IAS 39/IFRS 9.

(d) The FICE project is still on the boards' active agendas and amendments to IAS 32 could risk pre-empting the discussions in that project. While the boards could reach a different conclusion in that project, we think changing direction would be more difficult following an amendment to IAS 32 as proposed. As the IASB has seen with its other recent amendments to IAS 32 (for puttable instruments and rights issues), there is significant pressure to come to the same conclusion to avoid requiring practice to change twice in a short period.

Conclusion and staff recommendation

25. We think a scope exclusion from IAS 32 for NCI puts is a viable short-term solution—and we think it is preferable to other solutions that the Committee has discussed at prior meetings (such as amending the presentation requirements in IAS 32, IAS 39 and IFRS 9 to require the re-measurement of NCI puts to be presented in equity rather than profit or loss). While we have concerns about addressing these instruments in isolation (ie separately from other derivatives on the group's own equity), we acknowledge that there are complexities in the accounting for derivatives written on shares held by non-controlling interest shareholders as a result of the interaction between the requirements for consolidated financial statements (IAS 27) and the requirements for measuring financial instruments (IAS 32, IAS 39, and IFRS 9).

26. If the Committee supports a scope exclusion from IAS 32 for NCI puts, we recommend that the Committee refer this issue and potential short-term solution to the Board for its consideration.

27. We would aim to present this to the Board at its April 2011 meeting, if possible. If the Board decides to pursue this scope exclusion, our goal would be to prepare the exposure draft in April or early May. We think that timing would be the most convenient (and least disruptive) to the Board's full agenda.

Question – Scope exclusion to IAS 32 for NCI puts
Does Committee support the scope exclusion from IAS 32 for the NCI puts described in paragraphs 17 and 18 of this paper? If so, does the Committee want to refer this issue and potential short-term solution to the Board? If not, what does the Committee want to do instead and why?

Appendix – Draft amendments to IAS 32

A1. This appendix sets out the draft amendments to IAS 32 that would be necessary if a scope exclusion was made. Paragraph 4 has been amended (new text is underlined) and paragraphs 4A, AG2A and AG2B have been added.

Scope

4 **This Standard shall be applied by all entities to all types of financial instruments except:**

(a) those interests in subsidiaries, associates or joint ventures that are accounted for in accordance with IAS 27 *Consolidated and Separate Financial Statements*, IAS 28 *Investments in Associates* or IAS 31 *Interests in Joint Ventures*. However, in some cases, IAS 27, IAS 28 or IAS 31 permits an entity to account for an interest in a subsidiary, associate or joint venture using IFRS 9; in those cases, entities shall apply the requirements of this Standard. Entities shall also apply this Standard to all derivatives linked to interests in subsidiaries, associates or joint ventures <u>except for, in the consolidated financial statements of the controlling shareholder, the derivatives described in paragraph 4A</u>.

(b) ...

4A **In the consolidated financial statements of the controlling shareholder, a derivative that gives the counterparty the right to sell an interest in a subsidiary of the controlling shareholder to any entity in the consolidated group is not within the scope of this Standard if the derivative:**

(a) does not oblige the counterparty to sell the interest;

(b) is not embedded in another contract; and

(c) obliges the entity in the consolidated group to settle the derivative by delivering cash or another financial asset in exchange for the interest in the subsidiary.

Derivatives that have all the features described above are within the scope of IAS 39 or IFRS 9 and shall be measured accordingly.

...

AG2A An example of a derivative that has the features described in paragraph 4A is a put option written by a controlling shareholder on the shares held by a non-controlling interest shareholder that obliges the controlling shareholder to deliver cash (or another financial asset) in exchange for the shares. In the consolidated financial statements of the controlling shareholder, this Standard is not applied to that put option. However in the separate financial statements of the controlling shareholder, this Standard is applied to the put option. The same analysis applies if another entity in the consolidated group (ie a subsidiary) writes a put option on shares held by the non-controlling interest shareholder that obliges the entity in the consolidated group to deliver cash (or another financial asset) in exchange for the shares. In the consolidated financial statements, this Standard is not applied to that put option.

AG2B The following are examples of financial instruments that do not have the features described in paragraph 4A:

(a) *A forward contract on shares held by a non-controlling interest holder*. This derivative obliges the counterparty to sell the interest and therefore fails to meet the requirement in paragraph 4A(a).

(b) *Puttable share issued by a subsidiary*. The derivative is embedded in another contract and therefore fails to meet the requirement in paragraph 4A(b).

(c) *Put option on shares held by a non-controlling interest holder that will be settled net in cash.* This derivative does not oblige the entity in the consolidated group to settle the derivative by delivering cash or another financial asset in exchange for the interest in the subsidiary and therefore fails to meet the requirement in paragraph 4A(c).