IFRS

STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	**Put options written over non-controlling interests**
Paper topic	Possible paths forward

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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. 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*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

Background

The issue

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]

2. Some constituents 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. That issue arises because of a potential inconsistency between the requirements for measuring financial liabilities (IAS 32 *Financial Instruments: Presentation*, IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments*) and the requirements for accounting for transactions with owners in their capacity as owners (IAS 27 *Consolidated and Separate Financial Statements* and IFRS 10 *Consolidated Financial Statements*).

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

3. Specifically:

   (a) Some constituents think that subsequent changes in the liability that is recognized for the NCI put should be recognized in **profit or loss** (P&L) pursuant to the guidance in IAS 32, IAS 39 and IFRS 9.

   (b) Other constituents think that subsequent changes in that liability should be recognized in **equity** pursuant to the guidance in IAS 27 and IFRS 10.

A potential short-term solution

4. At the Board's request, the Committee discussed several possible short-term solutions to this issue. The Committee concluded that excluding NCI puts from IAS 32 through a narrow scope amendment was a viable solution. That scope exclusion would have changed the measurement basis of NCI puts to that used for other derivative contracts (ie a net basis at fair value with all changes recognized in P&L[2]).

5. The Board discussed the Committee's recommendation and decided not to proceed with the proposed amendment to the scope of IAS 32. However, the Board expressed support for considering the potential inconsistency that was raised by constituents—not by changing the measurement basis of NCI puts but by clarifying the accounting for subsequent changes in their measurement.

6. The Committee confirmed that it is was willing to continue discussing this issue but asked that the Board provide clear instructions on what matters the Board would like the Committee to discuss.

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

Issues that the Board would like the Committee to discuss

7. At its meeting in November 2011 the Board discussed what guidance to give to the Committee. The Board established the scope for the Committee's discussion by voting to ask the Committee to analyze the following two issues:

   (a) **Whether changes in the measurement of the NCI put should be recognized in**

      (i) **P&L or**

      (ii) **equity**

   Nine Board members expressed a preliminary preference for P&L.

   The Board discussed whether the changes in measurement should be recognized in other comprehensive income (OCI). It decided not to pursue that alternative because using OCI is not consistent with the guidance for measuring financial liabilities or with the guidance for accounting for transactions with owners. Moreover, it would raise difficult questions about whether those amounts should be recycled (and, if so, when).

   (b) **Whether the clarification described in (a) should be applied to**

      (i) **only NCI puts or**

      (ii) **both NCI puts and NCI forwards.**

   Ten Board members expressed a preference for applying the clarification to both NCI puts and NCI forwards.

   The Board discussed whether the clarification should be applied to all derivatives on an entity's own equity that are currently grossed up in accordance with paragraph 23 of IAS 32 but decided not to pursue that alternative. Although several Board members noted that the concerns raised to the Committee about NCI puts are applicable to all derivatives on own equity, the Board noted that this alternative suggests a significantly wider scope than the original submission. The Board also observed that the accounting for derivatives on own equity has been a fundamental issue in the Board's project on financial instruments with

characteristics of equity (FICE) and this alternative likely could not be addressed on a timely basis. Moreover at least one Board member noted that this alternative would raise difficult questions about the requirements for puttable shares and stated that the Board should not address the accounting for puttable shares at this time.

8. In asking the Committee to analyze the two issues set out in paragraph 7, the Board acknowledged that:

   (a) It is willing to discuss this issue (and perhaps clarify IFRSs) before it decides how to proceed in its FICE project and

   (b) It does not want to change the measurement basis of NCI puts at this time—ie NCI puts will continue to be measured as liabilities on a gross basis at the present value of the exercise price.

Purpose of this paper

9. This paper discusses the two issues that the Board asked the Committee to consider. Our objective was to set out a comprehensive analysis of the rationale for each alternative. Our analysis is based largely on the Committee's and the Board's discussions to date.

10. For each issue, we ask the Committee for feedback on whether our analysis is complete and accurate (and, if not, what should be added or changed). We also ask the Committee which alternative it prefers and why.

11. After we incorporate the Committee's feedback from today's meeting, we will bring this analysis and the Committee's preferences to the Board at a future Board meeting. We will ask the Board how it would like to proceed with this issue.

12. At the Committee meeting in November 2011 several members noted that the Committee has discussed the issue of NCI puts at several meetings and expressed the view that it should discuss this issue at only one more meeting. We understand that concern and at this meeting we expect that we will be able to collect all of the information that the Board has requested given that the Board's questions have been discussed at previous Committee meetings.

Issue 1—Recognizing changes in the measurement of NCI puts

13. This was the issue that was submitted to the Committee—ie how to recognize subsequent changes in the measurement of the liability that is recognized for NCI puts. Consistently with the diversity in practice set out in that submission, the Board asked the Committee to analyze whether those changes should be recognized in:

    (a) P&L or

    (b) equity.

14. The rationales for those two alternatives are set out below.

Alternative (a): P&L

15. Supporters of alternative (a) believe that changes in the measurement of the NCI put should be recognized in P&L. They generally do not think that there is a conflict in IFRSs because they believe that the guidance in paragraph 30 of IAS 27 (and paragraph 23 of IFRS 10) is not relevant to the remeasurement of NCI puts.

16. Supporters of alternative (a) put forward the following rationale:

    (a) The NCI put is a financial liability—not an equity instrument. The liability reflects the issuer's obligation to pay the exercise price. Therefore it should be accounted for consistently with all other financial liabilities within the scope of IAS 32, IAS 39 and IFRS 9—ie with changes recognized in P&L. Moreover, paragraph 23 of IAS 32 provides guidance specific to the grossed-up liability that is recognized for derivatives on an entity's own equity—and that paragraph is clear that that liability is subsequently measured in accordance with IAS 39 or IFRS 9.

    (b) Paragraphs 4.47 and 4.49 of the IASB's *Conceptual Framework for Financial Reporting* state that income (or expense) is recognized when a liability balance decreases (or increases).

(c) Only transactions with owners are recognized in equity—and re-measuring an NCI put is not a transaction with an owner. Paragraph 30 in IAS 27 is describing a circumstance in which the controlling shareholder's and the non-controlling interest shareholder's relative ownership of the subsidiary changes—and that is not the case when the NCI put is remeasured.

(d) The controlling shareholder and the non-controlling interest shareholder may enter into a variety of financial instrument contracts that are not transactions with an owner (in the capacity of an owner) and thus are not accounted for by adjusting equity. Just because the NCI put is measured on a gross basis does not mean that remeasuring that liability becomes a transaction with an owner (in the capacity of an owner)—ie when the NCI put is measured on a net basis (eg because it must be net settled in cash), no one has asserted that the changes in that NCI put liability are recognized in equity.

(e) The accounting requirements for NCI puts should be consistent with the requirements for puttable shares (ie if the subsidiary issues puttable shares, those shares are classified as liabilities in the consolidated financial statements and re-measured with changes recognized in P&L). That consistency was the Board's objective when it issued IAS 32 and required physically-settled put options to be measured on a gross basis (please see paragraph BC11 in IAS 32).

(f) Creating another exception to IAS 32 decreases comparability and increases complexity in financial reporting. There is no compelling reason to account for NCI puts differently than other derivatives written on an entity's own equity.

Specifically (and related to (e) above), if changes in the measurement of NCI puts are recognized in equity, that would create a third method for accounting for physically-settled put options on own equity and puttable shares (and, as we noted above, the Board's objective when it issued IAS 32 was to require the same accounting treatment for both types of instruments):

(i) Most puttable shares and physically-settled put options on own equity would be classified as liabilities with changes recognized in P&L.

(ii) As an exception, some puttable shares would be classified as equity and not remeasured (pursuant to the amendments to IAS 32 in February 2008).

(iii) As a second exception, NCI puts would be classified as liabilities with changes recognized in equity.

17. At the Board meeting in November 2011, one Board member noted that it would be inappropriate to recognize changes in the measurement of the NCI put in equity if those changes are caused by a factor **other than** the underlying equity instruments (eg if the ultimate cash pay-out is linked to something other than the fair value of the shares held by the non-controlling interest shareholder). That Board member expressed a preference for recognizing all changes in the measurement of the NCI put in P&L but felt very strongly about NCI puts with such formulaic cash pay-outs. We agree that making an exception for NCI puts could create structuring opportunities or have unintended consequences—and highlights the importance of Issue 2.

Alternative (b)

18. Supporters of alternative (b) believe that changes in the measurement of the NCI put should be recognized directly in equity. They put forward the following two primary views:

(a) <u>Existing IFRSs are not clear</u>. Some supporters of alternative (b) believe that there is a conflict between the requirements for measuring financial liabilities and the requirements for accounting for transactions with owners. Given that conflict, paragraph 30 in IAS 27 (and paragraph 23 in IFRS 10) should 'trump' the requirements for measuring financial liabilities and changes in the measurement of the NCI put should be recognized in equity because:

(i) IAS 27 (and IFRS 10) is clear that the non-controlling interest balance is a component of equity. Recognizing a grossed-up liability to reflect the put option written on

those shares is an accounting construct and should not affect the Board's conclusion that non-controlling interest shareholders are owners at the consolidated level. Therefore all transactions that affect that NCI balance are transactions with owners and should not affect P&L.

(ii) For accounting purposes, the requirements in IAS 32 to gross up the NCI put effectively means that the controlling shareholder has purchased shares held by the non-controlling interest shareholder—ie the controlling shareholder's and the non-controlling interest shareholder's relative ownership of the subsidiary has indeed changed. Any re-measurements are simply re-estimations of that transaction and therefore should be recognized in equity. [Some supporters of alternative (a) agree that the requirement to gross up the NCI put is akin to a transaction with an owner and note that the original entry decreases equity. However, they believe that subsequent changes in the measurement of that grossed-up liability are not further transactions with an owner and thus should not be recognized in equity.]

(iii) The treatment described in (ii) above is analogous to the requirements in IFRIC 17 *Distributions of Non-cash Assets to Owners*, which requires that an entity adjust the carrying amount of the dividend payable and recognize any changes directly in equity as adjustments to the amount of the distribution.

(b) <u>Existing IFRSs do not result in useful information</u>. Some supporters of alternative (b) believe that although existing IFRSs require changes in the measurement of NCI puts to be recognized in P&L, making an exception to recognize such changes directly in equity would be an improvement in financial reporting.

(i) The Board has made exceptions to IFRSs in the past to improve financial reporting. Some argue that recognizing changes in the measurement of NCI puts in P&L does not result in useful information. For example, recognizing volatility in P&L related to a put that is exercisable at the

fair value of the underlying shares (ie a fair value NCI put) is counter-intuitive and results in misleading information. That is because the fair value of that NCI put is close to zero (because if the put is exercised and the issuer is required to deliver cash, it will receive shares in exchange that have an equal value). [We note that this is true only if the ultimate cash pay-out is linked solely to the fair value of the underlying shares. Please refer to the concern described in paragraph 17.]

(ii) The grossed up liability that is recognized for the NCI put is an accounting 'abnormality'. The NCI put is a very different type of liability than a 'plain vanilla' contract to deliver cash to a third party. Therefore, the accounting requirements for NCI puts should not necessarily be driven by the general requirements for financial liabilities. Rather the accounting should be based on the economics of the circumstances, which in this case, have the characteristics of equity (ie the shares are still outstanding and held by the non-controlling interest shareholder).

ISSUE 2—The scope of the clarification (ie the instruments to which the clarification should be applied)

19. The concerns raised to the Committee were related to the accounting for NCI puts. However some Board members have observed that there is no compelling reason to treat NCI puts differently than forward contracts on shares held by non-controlling interest shareholders in the consolidated financial statements of the group (NCI forwards).

20. Therefore, the Board asked the Committee to analyze whether the clarification should be applied to:

    (a) NCI puts; or

    (b) NCI puts and NCI forwards

    As we set out in paragraph 7, some Board members noted that the concerns raised to the Committee about NCI puts are applicable to all derivatives on own equity. However the Board voted that the scope of

the clarification should not be any wider than alternative (b). Therefore, consistent with the Board's direction, we have not analyzed extending the scope to all derivatives on own equity.

21. At least one Board member noted that if the Board decides to clarify that all changes in the measurement of the NCI put must be recognized in P&L—ie the Board decides to pursue alternative (a) in Issue 1—then there is no need to discuss Issue 2. That is because the clarification would be consistent with the existing requirements for all derivative contracts written on own equity. The issue of scope is relevant only if the Board decides to make an exception to existing IFRSs. We agree with that Board member and think that scope should only be discussed in the context of recognizing changes in the measurement of the NCI put directly in equity (alternative (b) in Issue 1).

22. The rationales for the two alternatives are set out below.

Alternative (a)

23. Constituents expressed concerns only about the accounting for NCI puts, not NCI forwards. The primary benefit of alternative (a) is that it would develop a narrow, short-term solution that responds to the specific concerns raised by constituents.

24. Moreover, NCI forwards are different than NCI puts because the cash outflow will definitely occur under the former whereas it will not necessarily occur under the latter. At least one Board member questioned whether widening the scope of the clarification to include NCI forwards could have unintended consequences. Another Board member questioned whether NCI forwards (particularly those that are exercisable at the fair value of the underlying shares) are common in practice.

25. However, while it may be possible to address this population more quickly than alternative (b) because the clarification would affect fewer instruments and presumably have fewer unintended consequences, it may be difficult to explain why NCI puts should be treated differently than NCI forwards. One Board member noted that he did not see why a put option that is deeply 'in the money' should be treated differently than a forward contract.

Alternative (b)

26. Supporters of alternative (b) point out that constituents' concerns are the result of a potential conflict between the requirements for measuring financial liabilities (IAS 32, IAS 39, and IFRS 9) and the requirements for accounting for transactions with owners in their capacity as owners (IAS 27 and IFRS 10) and that potential conflict applies equally to NCI forwards. Therefore, alternative (b) addresses the potential conflict more comprehensively than alternative (a)—and does not raise questions about why the clarification is restricted to one particular group of derivatives written on NCI balances.

27. However, as noted above, forward contracts are different than option contracts and the Committee was asked to address a very specific instrument—an NCI put. Extending the scope to NCI forwards would create a larger exception and some Board members expressed a preference for keeping any exception as narrow as possible. Those Board members questioned the benefits of extending the exception to instruments beyond the population submitted to the Committee.

Question – Issue 1: Clarifying IFRSs
(a) Does the Committee think that the staff's analysis of the two alternatives for Issue 1 is complete and accurate? If not, what would Committee members like to add or change? (b) Does the Committee have a preference for either alternative (a) or alternative (b)? Why?

Question – Issue 2: Scope
(a) Does the Committee think that the staff's analysis of the two alternatives for Issue 2 is complete and accurate? If not, what would Committee members like to add or change? (b) Does the Committee have a preference for either alternative (a) or alternative (b)? Why?