STAFF PAPER

10 May 2016

IFRS Interpretations Committee Meeting

Project	**New items for initial consideration**
Paper topic	IAS 32 *Financial Instruments: Presentation*—Accounting for written puts over non-controlling interests to be settled by the variable number of parent's shares

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Introduction

1. The IFRS Interpretations Committee ('the Interpretations Committee') received a request from two submitters regarding how an entity should account for a written put option over non-controlling interests (a NCI put) in its consolidated financial statements. The NCI put has a strike price that will, or may, be settled by the exchange of a variable number of the parent's own equity instruments.

2. The question relates to whether the parent should account for the NCI put as a financial liability for the present value of the option's strike price on a gross basis, or as a derivative liability on a net basis.

3. The paper is structured as follows:

   (a) summary of the submission;

   (b) summary of past discussions related to NCI puts;

   (c) assessment against the Interpretations Committee's agenda criteria;

   (d) staff recommendation;

   (e) questions for the Interpretations Committee;

   (f) Appendix A— Tentative agenda decision;

(g) Appendix B—Relevant Extracts from IAS 32

(h) Appendix C— Submissions.

Summary of the submission

4. The submitters describe an arrangement in which a parent grants non-controlling interest shareholders the right to sell the equity shares they hold in the subsidiary to the parent. If exercised, the parent will (Issue 1) or may (Issue 2) settle the obligation to acquire the subsidiary's shares by delivering a variable number of its own equity instruments, rather than in cash. The formula for determining the number of shares to be delivered might be one of the following:

   (a) shares to a fixed monetary value;

   (b) shares to the fair value of the subsidiary's shares that are subject to the put at the time of exercise; or

   (c) shares to a value based on a multiple of the subsidiary's earnings, which may be intended to approximate the fair value of its shares.

5. For both Issue 1 and Issue 2, the submitters acknowledge that the NCI put gives rise to an obligation for the parent that meets the definition of a liability. However, the question is whether the parent accounts for the NCI put as a financial liability for the present value of the option's strike price on a gross basis, or as a derivative liability on a net basis. Paragraphs 6–13 reproduce the arguments for and against each treatment as identified by the submitters.

Issue 1—NCI puts to be settled in exchange for a variable number of the parent's equity instruments

6. The question is whether the parent recognises a financial liability representing the present value of the option's strike price, for example, as a gross liability in its consolidated financial statements, applying IAS 32 *Financial Instruments: Presentation*.

7. The submitter has identified that there is currently diversity in practice relating to this matter and identifies the following three views.

View 1—Account for the NCI puts as a financial liability on a gross basis

8. According to the submitter, proponents of this view note that:

(a) although from the perspective of the reporting entity (the parent) the contract appears to contain no obligation to deliver cash or other financial asset, the non-controlling interest shareholder has a right to receive what, from its perspective, is a financial asset.

(b) IAS 32, paragraph 21[1] contains a clear principle that an obligation to deliver a variable number of equity instruments based on the fair value of the entity's own equity instruments does not meet the definition of equity, and should be accounted for as if the contractual right or obligation is settled in cash.

(c) IAS 32, paragraph 23 states that 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. This principle does not contain any requirement for the obligation to be 'for cash or another financial asset', suggesting that the entity recognises a liability even if the strike price is payable in the entity's equity instruments.

(d) IAS 32, paragraph BC11also notes that, without a requirement to recognise a financial liability for the present value of the share-redemption amount, entities with an identical obligation 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. This clearly indicates the Board's intention to achieve similar treatment for similar obligations.

[1] The staff note that an obligation to deliver a variable number of equity instruments meets the definition of a financial liability in IAS 32, paragraph 11.

View 2—Account for the NCI puts as a derivative financial liability on a net basis

9. According to the submitter, proponents of this view note that:

   (a) from the perspective of the reporting entity, the contract contains no obligation to deliver cash or another financial asset, only an obligation to deliver its equity instruments. Accordingly, the requirements of IAS 32, paragraph 23 do not apply and, instead, the requirements of IAS 32 for derivatives on own equity instruments apply.

   (b) this view would be consistent with the principle of IAS 32, articulated, for example, in paragraphs BC6(b), BC10(b) and BC13, that a contract containing a right to issue or receive a variable number of equity instruments is not itself an equity instrument but is instead a financial liability.

   (c) the value of the put changes in response to the changes in, at least, the value of the shares of the subsidiary, requires no or only a small initial net investment and it is settled at a future date.

View 3—Account for the NCI puts applying an appropriate accounting policy

10. According to the submitter, proponents of this view note that both of the analyses above have merit and, therefore, entities apply judgement to select an appropriate accounting policy.

Issue 2—When the parent has an option to settle by paying cash rather than delivering its own equity instruments

11. As in Issue 1, a parent grants to non-controlling interest shareholders the right to put to the parent the shares they hold in a subsidiary of the parent. However, if the option is exercised, the parent will have the choice to settle the exercise price (which could be fixed or variable in monetary terms) either in cash or a variable number of its own equity instruments.

12. The question raised is the same as that in Issue 1—does the parent recognise a financial liability representing the present value of the option's strike price in its consolidated financial statements applying IAS 32?

13. The three options introduced for Issue 1 apply equally to Issue 2. However, proponents of View 1 also note that Example 6 of the Illustrative Examples to IAS 32 includes an instrument that provides settlement alternatives for the parent. In that example, because one alternative is an exchange of cash for equity shares, the parent presents its obligation arising from the instrument as a gross financial liability.

Similarity to past discussions related to NCI puts

14. The Interpretations Committee and the Board have considered issues arising from NCI puts on a number of occasions. These previous discussions were limited to NCI puts that are required to be settled *in cash*. The only difference with the NCI puts in the new submission is that the parent is required, or permitted, to settle the obligation to acquire shares in a variable number of its own equity instruments.

15. The question raised in the previous submissions for cash-settled NCI puts was about the subsequent accounting for the liability. However, as we discuss further in paragraphs 17-29, that question led to a discussion of whether the parent accounts for the NCI puts as a financial liability on a gross basis at the present value of the redemption amount, or as a derivative liability on a net basis. That is, the Interpretations Committee debated the same question that is the subject of the new submission.

16. We will summarise those previous discussions in the next section.

Summary of past discussions related to NCI puts

17. This section summarises:

    (a) The Interpretations Committee's discussions on previous submissions (paragraphs 18-21); and

    (b) The Board's discussions after the issue was referred to the Board by the Interpretations Committee (paragraphs 22-29).

The Interpretations Committee's discussions

18. In 2006, the Interpretations Committee discussed a request for clarification of the accounting related to NCI puts or NCI forwards to be settled *for cash*. The Interpretations Committee did not add this issue to its agenda [2] because:

    (a) IAS 32, paragraph 23 states that a parent recognises a financial liability when it has an obligation to pay cash in the future to purchase the non-controlling interest's shares, even if the payment is conditional on the option being exercised by the holder;

    (b) after initial recognition, any liability to which IFRS 3 *Business Combinations* is not applied will be accounted for applying IAS 39 *Financial Instruments: Recognition and Measurement*; and

    (c) there is likely to be divergence in practice in how an entity classifies the related equity. However, the Interpretations Committee did not think that it could reach a consensus on this matter on a timely basis.

19. In 2010, the Interpretations Committee received a request for guidance on how a parent accounts for changes in the carrying amount of a financial liability for NCI puts to be settled *for cash* in the consolidated financial statements. The submission considered whether there was a potential conflict between the amendments to IFRS 3 and IAS 27 *Consolidated and Separate Financial Statements* in 2008 and IAS 39.

20. Although the request focused on subsequent measurement, the issue necessarily led to a discussion on initial recognition—whether the parent recognises a financial liability for the present value of the option exercise price (on a gross basis) or a derivative liability (on a net basis).

21. The Interpretations Committee and the Board discussed this issue over the period from May 2010 to March 2013. The summary of those meetings follows:

    (a) the Interpretations Committee issued a tentative agenda decision in September 2010, which explained that:

[2] Refer to the agenda decision entitled '*IAS 32 Financial Instruments: Presentation–Puts and forwards held by minority interests*' and '*IFRS 3 Business Combinations–Are puts or forwards received by minority interests in a business combination contingent consideration*' in IFRIC Update from November 2006.

(i) IAS 32, paragraph 23 requires an entity to subsequently measure the financial liability recognised for a NCI put applying IAS 39; and

(ii) additional accounting concerns relating to the accounting for NCI puts would be best addressed as part of the Financial Instruments with Characteristics of Equity (FICE) project.

(b) the Interpretations Committee received a significant number of comments on the September 2010 tentative agenda decision, which highlighted significant diversity in practice in the accounting for NCI puts. Accordingly, at its March 2011 meeting, the Interpretations Committee recommended that the Board issue a scope exclusion from IAS 32 for NCI puts as a short-term solution. As a result of that proposal the requirements in IAS 39 (IFRS 9 *Financial Instruments*) for derivative contracts would have applied to NCI puts.

(c) at its September 2011 meeting, however, the Board voted not to amend the scope of IAS 32 before deciding how to proceed with the FICE project. The Board was concerned about treating NCI puts differently from other derivatives on an entity's own equity instruments. Instead, the Board asked the Interpretations Committee to clarify the accounting for subsequent changes in the measurement of NCI puts.

(d) the Interpretations Committee published Draft IFRIC Interpretation DI/2012/2 *Put Options Written on Non-controlling Interests* in May 2012, which explained the following:

(i) an entity must remeasure the financial liability that is recognised for an NCI put applying IAS 39 (IFRS 9), which requires the entity to recognise changes in the measurement in profit or loss; and

(ii) the changes in the measurement of that financial liability do not change the relative interests in the subsidiary held by the parent and the non-controlling-interest shareholder, and therefore are not equity transactions.

(e) at its January 2013 meeting[3], the Interpretations Committee discussed the analysis of the comments on the draft Interpretation, and reaffirmed that the draft consensus published in May 2012 is the correct interpretation of existing Standards. However, the Interpretations Committee expressed the view that an entity would provide better information if NCI puts were measured on a net basis at fair value, consistently with derivatives that are within the scope of IAS 39 (IFRS 9). It also noted that:

(i) many respondents to the draft Interpretation think that either the Interpretations Committee or the Board should address the accounting for NCI puts—or all derivatives written on an entity's own equity—more comprehensively. Those respondents said that many aspects of the accounting for those contracts have resulted in diversity in practice; and

(ii) some of the respondents believe that the requirements—to measure particular derivatives written on an entity's own equity instruments on a gross basis at the present value of the redemption amount—do not result in useful information.

(f) consequently, at the January 2013 meeting, the Interpretations Committee decided to ask the Board to reconsider the requirements in IAS 32, paragraph 23 for put options and forward contracts written on an entity's own equity. The Interpretations Committee noted that such work should consider whether an entity should account for NCI puts and NCI forwards differently from other derivatives written on an entity's equity.

[3] Refer to *IAS 32 Financial Instruments: Presentation–Put options written on non-controlling interests* in IFRIC Update from January 2013.

The Board's discussions on NCI puts

22. In March 2013[4], the Board discussed the Interpretations Committee's views and the feedback received on the draft Interpretation published in May 2012. At that meeting, the Board decided to reconsider the requirements in IAS 32, paragraph 23, including whether an entity should measure put options and forward contracts written on an entity's own equity on a net basis at fair value.

23. At its October 2014 meeting, the Board discussed the scope of the FICE project, and decided that it will consider derivatives that may or must result in buying back own equity as part of the FICE project, amongst other issues (see paragraphs 24-29).

The FICE project related to NCI puts

24. In the Agenda Consultation Feedback Statement published in December 2012, the Board identified the FICE project as a priority on the basis of the views received.

25. The Board is currently investigating potential improvements to:

    (a) the classification of liabilities and equity in IAS 32, including investigating potential amendments to the definitions of liabilities and equity in the Conceptual Framework; and

    (b) the presentation and disclosure requirements for financial instruments with characteristics of equity, irrespective of whether they are classified as liabilities or equity.

26. With regard to derivatives on 'own equity', at its October 2015 meeting, the Board discussed an analysis of:

    (a) the challenges associated with accounting for derivatives on own equity, (including put options written on own equity); and

    (b) how IAS 32 deals with those challenges (including the redemption obligation requirements in paragraph 23 of IAS 32).

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[4] Refer to *Put options written on non-controlling-interests* in IASB Update from March 2013.

27. The Board directed the staff to:

    (a) consider how the existing requirements for classifying derivatives on own equity in IAS 32 would fit with the underlying rationale of various approaches to the distinction between liabilities and equity that it has identified; and

    (b) identify potential areas in which the existing requirements might be improved.

28. As a part of the FICE project, the Board will discuss an analysis of the application of the existing requirements, and the proposed approaches to various types of derivatives including NCI puts, at its future meetings. Given its complexity and its breadth, the topic will be presented over a number of meetings.

29. The Board is continuing those discussions in 2016. The Board has also begun to consider the priority of projects on its agenda in the light of the feedback received to its Agenda Consultation 2015. The staff expect to be able to give a better indication of its expected timeline for a potential Discussion Paper following those discussions.

Assessment against the Interpretations Committee's agenda criteria

30. The issue raised in the submission is about whether IAS 32, paragraph 23 applies to obligations to deliver a variable number of equity instruments. However, the underlying questions are the same as those in the Interpretations Committee's previous discussions on NCI puts. That is, whether an entity measures *all or particular* put options and forward contracts written on an entity's own equity on a gross basis or a net basis at fair value.

31. After several meetings over the period from May 2010 to January 2013 (paragraphs 19 to 21), those discussions culminated in the Interpretations Committee referring the issues to the Board, with a recommendation to reconsider the requirements in IAS 32, paragraph 23. This was because, in the Interpretations Committee's view, an entity would provide better information if NCI puts were measured on a net basis at fair value, notwithstanding its view that the draft consensus published in May 2012 is the correct interpretation of existing Standards (paragraph 21(d) of this paper).

32. Therefore, the following assessment of the Interpretations Committee's agenda criteria has also been informed by those previous discussions, and on the basis of that assessment

below, we do not think that further outreach and technical analysis on this issue is required.

33. Our assessment of the Interpretations Committee's agenda criteria is as follows:[5]

Paragraph 5.16 of the Due Process Handbook states that the Interpretations Committee should address issues:	Agenda criteria satisfied?
that have widespread effect and have, or are expected to have, a material effect on those affected;	**Met.** We have received questions on this issue from two submitters. Although additional outreach has not been conducted, the submissions and the previous discussions on NCI puts indicate that the issue has widespread effect, and that the accounting for NCI puts is expected to have a material effect on the financial statements. This is because an entity recognises either a financial liability on a gross basis or a derivative financial liability on a net basis, depending on the views.
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and	**Met.** It was acknowledged in the FICE project and previous discussions that IAS 32 could be improved to address the diversity in practice arising from NCI puts.
that can be resolved efficiently within the confines of existing IFRS Standards and the *Conceptual Framework for Financial Reporting*.	**Not met.** As described in its comment letter on Request for Views on 2015 Agenda Consultation, the Interpretations Committee found it difficult to identify a clear and consistent classification principle in IAS 32. The Interpretations Committee's past discussions on NCI puts suggest that this issue cannot be resolved efficiently within the confines of existing IFRS Standards. Those discussions culminated in the Interpretations Committee referring the issues to the Board, with a recommendation to reconsider requirements in IAS 32, paragraph 23.

[5] These criteria can be found in the *IFRS Foundation Due Process Handbook* .

Paragraph 5.16 of the Due Process Handbook states that the Interpretations Committee should address issues:	Agenda criteria satisfied?
In addition:	
Can the Interpretations Committee address this issue in an efficient manner (paragraph 5.17)?	**Not met.** Given the history of past discussions on NCI puts, we think that the scope of this issue is likely to be expanded to a broader range of similar arrangements that contain an obligation to deliver a variable number of equity instruments—for example, a preference share that includes a variable parent ordinary share conversion option. Accordingly, we think the scope of the issue is too broad for the Interpretations Committee to deal with in an efficient manner.
The solution developed should be effective for a reasonable time period (paragraph 5.21).	**Not met.** The Interpretations Committee developed a draft Interpretation on cash-settled NCI puts in May 2012. However, at its March 2013 meeting, the Board decided to reconsider the requirements in IAS 32, paragraph 23, including whether an entity should measure *all or particular* put options and forward contracts written on an entity's own equity on a net basis at fair value. In October 2014, the Board confirmed that it will reconsider paragraph 23 of IAS 32 within the scope of the FICE project. Consequently, because the FICE project will specifically address the issue (and even though the time frame for a specific solution is uncertain), we think that a short-term solution by the Interpretations Committee is not justified.

Staff recommendation

34. Previous discussions on cash-settled NCI puts culminated in the Interpretations Committee referring the issues to the Board, with a recommendation to reconsider the requirements in IAS 32, paragraph 23.

35. This was because, notwithstanding its view that the draft consensus published in May 2012 is the correct interpretation of existing Standards, in the Interpretations Committee's view:

    (a) an entity would provide better information if NCI puts were measured on a net basis at fair value; and

    (b) the Board should address all derivatives written on an entity's own equity, including the NCI puts, more comprehensively.

36. In October 2014, the Board confirmed that it will reconsider NCI puts within the scope of the FICE project.

37. In the staff's view:

    (a) the issue regarding equity-settled NCI puts would lead to the same discussions as in the past on cash-settled NCI puts.

    (b) the Interpretations Committee's past discussions on NCI puts suggest that:

        (i) the scope of this issue is likely to be expanded to a broader range of similar arrangements that contain an obligation to deliver a variable number of equity instruments.

        (ii) this issue cannot be resolved efficiently within the confines of existing IFRS Standards and the Conceptual Framework.

    (c) this issue would be better considered within the FICE project, which will consider derivatives on an entity's own equity comprehensively, including cash-settled and equity-settled NCI puts (paragraphs 24 to 29).

38. Consequently, on the basis of the assessment of the Interpretations Committee's agenda criteria, we recommend that the Interpretations Committee does not add this issue to its agenda.

39. We have set out proposed wording for the tentative agenda decision in **Appendix A** to this paper.

Questions for the Interpretations Committee

Questions to the Interpretations Committee
1. Does the Interpretations Committee agree with the staff recommendation not to add this issue to its agenda?
2. Does the Interpretations Committee have any comments on the proposed wording of the tentative agenda decision set out in Appendix A to this paper?

Appendix A—Tentative agenda decision

A1. We propose the following wording for the tentative agenda decision.

IAS 32 *Financial Instruments: Presentation*—Accounting for written puts over non-controlling interests to be settled by a variable number of the parent's equity instruments

The Interpretations Committee received a request regarding how an entity accounts for a written put option over non-controlling interests ('NCI puts') in its consolidated financial statements. The NCI put has a strike price that will, or may, be settled by the exchange of a variable number of the parent's own equity instruments.

Specifically, the Interpretations Committee was asked to consider whether, in its consolidated financial statements, the parent recognises:

(a) a financial liability representing the present value of the option's strike price—in other words, a gross liability; or

(b) a derivative financial liability presented on a net basis measured at fair value.

The Interpretations Committee was also asked whether the parent applies the same accounting for NCI puts for which the parent has the choice to settle the exercise price either in cash or a variable number of its own equity instruments to the same value.

The Interpretations Committee observed that the issue regarding equity-settled NCI puts would lead to the same issues discussed by the Interpretations Committee in the past on similar NCI puts that are settled in cash.

On the basis of its previous discussions, the Interpretations Committee noted that:

(a) it would be unable to resolve the issue without expanding the scope of the issue to a broader range of similar arrangements. Consequently, the issue is too broad for it to address efficiently within the confines of existing IFRS Standards and the Conceptual Framework.

(b) the scope of the Financial Instruments with Characteristics of Equity (FICE) project includes derivatives on an entity's own equity including NCI puts.

For these reasons, the Interpretations Committee [decided] not to add this issue to its agenda.

Appendix B—Relevant Extracts from IAS 32

21 A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. An entity may have a contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity's own equity instruments to be received or delivered equals the amount of the contractual right or obligation. Such a contractual right or obligation may be for a fixed amount or an amount that fluctuates in part or in full in response to changes in a variable other than the market price of the entity's own equity instruments (eg an interest rate, a commodity price or a financial instrument price). Two examples are (a) a contract to deliver as many of the entity's own equity instruments as are equal in value to CU100, and (b) a contract to deliver as many of the entity's own equity instruments as are equal in value to the value of 100 ounces of gold. Such a contract is a financial liability of the entity even though the entity must or can settle it by delivering its own equity instruments. It is not an equity instrument because the entity uses a variable number of its own equity instruments as a means to settle the contract. Accordingly, the contract does not evidence a residual interest in the entity's assets after deducting all of its liabilities.

[….]

23 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. The financial liability is recognised initially at the present value of the redemption amount, and is reclassified from equity. Subsequently, the financial liability is measured in accordance with IFRS 9. 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).

[….]

BC6 The approach agreed by the Board can be summarised as follows:

A contract on an entity's own equity is an equity instrument if, and only if:

(a) it contains no contractual obligation to transfer cash or another financial asset, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; and

(b) if the instrument will or may be settled in the entity's own equity instruments, it is either (i) a non-derivative that includes no contractual obligation for the entity to deliver a variable number of its own equity instruments, or (ii) a derivative that will be settled by the entity exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments.

[….]

BC10 The approach taken in the revised IAS 32 includes two main conclusions:

(a) When an entity has an obligation to purchase its own shares for cash (such as under a forward contract to purchase its own shares), there is a financial liability for the amount of cash that the entity has an obligation to pay.

(b) When an entity uses its own equity instruments 'as currency' in a contract to receive or deliver a variable number of shares whose value equals a fixed amount or an amount based on changes in an underlying variable (eg a commodity price), the contract is not an equity instrument, but is a financial asset or a financial liability. In other words, when a contract is settled in a variable number of the entity's own equity instruments, or by the entity exchanging a fixed number of its own equity instruments for a variable amount of cash or another financial asset, the contract is not an equity instrument but is a financial asset or a financial liability.

When an entity has an obligation to purchase its own shares for cash, there is a financial liability for the amount of cash that the entity has an obligation to pay.

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.

[….]

BC13 The Board agreed that it would be inappropriate to account for a contract as an equity instrument when an entity's own equity instruments are used as currency in a contract to receive or deliver a variable number of shares whose value equals a fixed amount or an amount based on changes in an underlying variable (eg a net share-settled derivative contract on gold or an obligation to deliver as many shares as are equal in value to CU10,000). Such a contract represents a right or obligation of a specified amount rather than a specified equity interest. A contract to pay or receive a specified amount (rather than a specified equity interest) is not an equity instrument. For such a contract, the entity does not know, before the transaction is settled, how many of its own shares (or how much cash) it will receive or deliver and the entity may not even know whether it will receive or deliver its own shares.

Appendix C—Submissions

C1. The submissions have been reproduced below. We have deleted details that would identify the submitter of this request.

…

Submission 1

IFRIC POTENTIAL AGENDA ITEM REQUEST
The IFRS Interpretations Committee (the Interpretations Committee) is requested to address the following issue related to IAS 32 *Financial Instruments: Presentation.*

Issue:

We are asking the Interpretations Committee to clarify an issue in respect of the accounting for written put options over a non-controlling interest (NCI) in which the strike price will or may, at the option of the reporting entity, be settled by exchange of a variable number of the parent's own equity instruments rather than in cash. [6]
We illustrate the issue using a number of scenarios for the exercise price of the put option over NCI, including:

A. The exercise price is a fixed price
B. The exercise price is an amount based on a formula (for example, an EBITDA[7] multiple, net asset value of the subsidiary, average fair value of the shares of the subsidiary over a period of time), often intended to be a proxy for the fair value of the subsidiary's shares at the date of exercise
C. The exercise price is equal to the fair value of the shares of the subsidiary that are subject to the put at the time of exercise

However, the principle issue under consideration does not depend on how the amount of the exercise price is determined.

Current practice

This issue has arisen in practice because of what some would see as an ambiguity in paragraph 23 of IAS 32. Views appear to be mixed between views 1 and 2 with some supporting an accounting policy choice between the two alternatives.

[6] The entity uses its shares as currency, i.e. the amount of shares required for settlement is variable even if the exercise price is fixed.
[7] Earnings before taxes, depreciation and amortisation

View 1

The written put option over NCI that will be settled by exchange of equity instruments is accounted for as a financial liability representing the net present value (NPV) of the option's strike price in accordance with IAS 32.23.

IAS 32.23 states that *'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'*.

Although from the perspective of the reporting entity the contract appears to contain no obligation to deliver cash or another financial asset, the counterparty has a right to receive what from its perspective is a financial asset.

Apart from this, IAS 32 contains a clear principle that an obligation to deliver a variable number of shares is equivalent to an obligation to pay cash and IAS 32.23 should be read in this light. That principle is first spelled out in paragraph IN9 of IAS 32 which states that *"[t]he classification of derivative and non-derivative contracts indexed to, or settled in, an entity's own equity instruments has been clarified consistently [..]. In particular, when an entity uses its own equity instruments 'as currency' in a contract to receive or deliver a variable number of shares whose value equals a fixed amount or an amount based on changes in an underlying variable (eg a commodity price), the contract is not an equity instrument, but is a financial asset or a financial liability."* The principle is further explained in BC10(b) of IAS 32.

Further, paragraph 11 says: *'A financial liability is any liability that is: […] a contract that will or may be settled in the entity's own equity instruments and is: (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.'*

In addition, paragraph 21 states that *'[a] contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. An entity may have a contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity's own equity instruments to be received or delivered equals the amount of the contractual right or obligation. Such a contractual right or obligation may be for a fixed amount or an amount that fluctuates in part or in full in response to changes in a variable other than the market price of the entity's own equity instruments (eg an interest rate, a commodity price or a financial instrument price). Two examples are (a) a contract to deliver as many of the entity's own equity instruments as are equal in value to CU100, and (b) a contract to deliver as many of the entity's own equity instruments as are equal in value to the value of 100 ounces of gold. Such a contract is a financial liability of the entity even though the entity must or can settle it by delivering its own equity instruments. It is not an equity instrument because the entity uses a variable number of its own equity instruments as a means to settle the contract. Accordingly, the contract does not evidence a residual interest in the entity's assets after deducting all of its liabilities.'*

Finally, IAS 32.23 concludes: *'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).'* This contains no requirement for the obligation to be *'for cash or another financial asset'*, suggesting that a liability should be recognised even if the strike price is payable in the reporting entity's equity instruments.

Paragraph BC11 of IAS 32 notes in addition that *'[…] 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.'* This clearly indicates the intention of the IASB to achieve similar treatment for similar obligations. Allowing an accounting policy choice does not seem to reflect the intent of the standard.

Under scenario A, the financial liability is measured at amortised cost and remains fixed apart from unwinding the discount by applying the effective interest method. Under payments change in respect to the variable exercise price, it is remeasured by applying paragraph AG8 of IAS 39.[8]

<u>View 2</u>

The written put option over NCI that will be settled by exchange of equity instruments of the parent is accounted for as a derivative financial liability.

IAS 32.23 states that *'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'*.

From the perspective of the reporting entity the contract in question contains no obligation to deliver cash or another financial asset, only an obligation to deliver equity instruments of the reporting entity. Therefore the requirements of IAS 32.23 do not apply.

Whilst the accounting required by IAS 32 is often consistent with viewing an obligation to deliver a variable number of shares as equivalent to an obligation to deliver cash, the principle of IAS 32, articulated for example in paragraphs BC6(b), BC10(b), and BC13 to BC15, is simply that a contract containing a right to issue or receive a variable number of equity instruments is not itself an equity instrument but a financial asset or financial liability. Accounting for the contract in question as a derivative liability would be consistent with this principle.

Further, when the issue of accounting for put options over NCI was first addressed by the IFRIC, it is clear from the IFRIC staff papers that the debate excluded those contracts where the strike price was to be settled by the parent issuing equity instrument. For example, the paper presented to the May 2006 meeting says:

> *'In the scenarios described by the submitter, the obligation is to settle the purchase of a fixed number of shares with a fixed or variable amount of cash. The analysis presented here is limited to this type of arrangement. The analysis does not cover, for example,*

[8] This assumes that the entity did not designate the financial liability as measured at fair value through profit or loss in accordance with paragraph 9 of IAS 39.

> *settlement of the forward or put by the issue of a fixed or variable number of shares in the parent.*
>
> *The staff accept that, although there are other types of put and forward arrangements, the request was in relation to this subset only—presumably because of their prevalence. The staff believe that the scope of this interpretation, or rejection, should be limited to this sub-set of possible settlement methods.'*

Following this view, the contract would be treated as a derivative financial liability as per paragraph 9 of IAS 39 and accounted for at fair value through profit or loss. That is because its value changes in response to the change in at least one underlying (i.e. the value of the shares of the subsidiary), requires no or only a small initial net investment and it is settled at a future date. [9]

The fair value of the derivative financial liability will be a function of the (sometimes variable) strike price, the fair value of the shares of the subsidiary and other variables common in option pricing models such as the volatility of the underlying and the risk free interest rate. As a consequence, the fair value of the derivative financial liability could potentially be very small under scenario B, depending on how close the applied proxy is to the fair value of the shares of the subsidiary (with scenario C as the theoretical extreme case of scenario B in which the proxy is perfect).

<u>View 3</u>

Both of the analyses above have merit and therefore entities should apply judgement to select an appropriate accounting policy.

[9] Under scenario C, an argument can be made that the instrument is not a derivative because a contract to buy an asset at its exact fair value has always a value of zero. Therefore, the value of the contract does not change in response to the change in an underlying. However, following this argument it would not make a difference as to whether the contract is classified as a derivative or not because its value would be zero in any case.

Appendix

The tables below illustrate the accounting for the NCI put either as a gross financial liability (view 1) or as a derivative financial liability (view 2). The assumed fair value of the derivative financial liability only represents the intrinsic value and ignores the time value of the option for simplicity.

The assumed value of the NCI put liability under view 1 equals the strike price of the option at the measurement date. The assumed value of the derivate financial liability under view 2 equals the difference between the fair value of the shares of the subsidiary and the strike price. Movements in the statement of comprehensive income reflect the remeasurement of the values on the statement of financial position.

The example assumes that the NCI put is contracted on 1.7.20x0 and the end of the first reporting period is 31.12.20x0. The entries in the table only concern the liability and gain/loss recognised in respect of the NCI put and are not intended to be double-entries. Numbers in brackets in the statement of financial position represent a liability while in the statement of comprehensive income they represent a profit or loss.

1.7.20x0:
(a) Scenario A: strike = CU 100 (fixed strike)
(b) Scenario B: strike = CU 99 (value of proxy)
(c) Scenario C: strike = CU 97 (fair value of the shares of the subsidiary)
(d) Fair value of the shares of the subsidiary: 97

	View 1		**View 2**	
	Statement of financial position	Statement of comprehensive income	Statement of financial position	Statement of comprehensive income
A	(a) = CU (100)	-	(d) – (a) CU (3)	-
B	(b) = CU (99)	-	(d) – (b) CU (2)	-
C	(c) = CU (97)	-	(d) – (c) = -	-

31.12.20x0:
(a) Scenario A: strike = CU 100 (fixed strike)
(b) Scenario B: strike = CU 78 (value of proxy)
(c) Scenario C: strike = CU 77 (fair value of the shares of the subsidiary)
(d) Fair value of the shares of the subsidiary: 77

	View 1		**View 2**	
	Statement of financial position	Statement of comprehensive income[1]	Statement of financial position	Statement of comprehensive income
A	(a) = CU (100)	-	(d) – (a) CU (23)	CU (20)
B	(b) = CU (78)	CU 21	(d) – (b) CU (1)	CU (1)
C	(c) = CU (77)	CU 20	(d) – (b) = -	-

[1] This assumes movements in the liability are accounted for under AG8 in profit and loss. If other methods are applied to account for the (movements in the) liability, such as the method whereby at each reporting date the balance sheet the liability is recognised against NCI with the remainder adjusted to parent's equity, there may be no effect on the statement of comprehensive income.

Reasons for the Interpretation Committee to address the issues:

(a) The issue is widespread and has practical relevance	The issue applies to all consolidated groups that have written put options over NCI where the strike price will or may at the option of the entity be settled using a variable number of shares rather than in cash. In our experience these contracts are reasonably widespread. The accounting for such written put options over NCI as either a gross liability or (net) derivative financial liability has wide implications on ratios as the difference between the views could potentially be very large in the statement of financial position.
(b) The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice).	We have come across instances in practice in recent months where this was an issue and have become aware of different interpretations of the requirements in IAS 32.23. We have not investigated whether further diversity in practice exists. View 2 seems to give in practice an advantage to public companies whose shares are readily marketable, as the NCI holder will be more likely to agree to receipt of shares rather than cash. In practice, it is hard for a private company to do this due to the absence of a Level 1 valuation and lack of liquidity.
(c) Would financial reporting be improved through the elimination of the diversity?	Yes, financial reporting would be improved; specifically with respect to comparability between entities. Not only do the two views result in a potentially very different picture on the statement of financial position, the treatment in the statement of comprehensive income is different as well. Ignoring the unwinding of discount, Under view 1 an entity would remeasure a financial liability for the changes in the fair value of the subsidiary (or changes in the proxy) in scenario B and C, but not in scenario A. Under view 2 it would fully remeasure the liability for changes in the fair value of the subsidiary

	in scenario A, would partially remeasure it in scenario B (only with regards to the difference between the fair value of the shares and the proxy) but not remeasure it in scenario C. In addition, if view 2 is allowed, it is reasonable to expect that the terms of some NCI puts could be amended to allow a settlement in the parent's own shares so as to exclude the liabilities under these puts from net debt computations.
(d) Is the issue a narrow implementation or application issue that can be resolved using existing IFRSs?	We consider that this issue can be resolved by clarifying whether or not the requirements in IAS 32.23 apply to situations where an entity delivers a variable number of shares to settle a put option over NCI.
(e) If the issue is related to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project?	We would expect that the issue will be addressed by the project Financial Instruments with Characteristics of Equity. However, this project is currently in the research phase and we believe that there is a pressing need that this issue is resolved sooner than would be expected from the IASB project.

Submission 2

Suggested agenda item: Accounting for written puts over non-controlling interests to be settled by the remittance of a variable number of the parent's shares

It has come to our attention that there are diverse views on how to account for written puts over non-controlling interests ('NCI puts') to be settled by remittance of a variable number of the parent company's equity shares, specifically on the question of whether such NCI puts result in a financial liability to be recognised initially at the present value of the redemption price in accordance with paragraph 23 of IAS 32 *Financial Instruments: Presentation*. As a result, we are seeking clarification of the issues detailed below by the Committee.

Issue 1

A parent company grants to non-controlling interests shareholders the right to put to the parent the shares they hold in a subsidiary of the parent. If exercised, the obligation to acquire the subsidiary's shares will be settled by the parent delivering a variable number of its own shares (instead of a payment of cash). The formula for determining the number of shares to be delivered might frequently be one of:

- shares to a fixed monetary value;
- shares to the fair value at exercise date of the subsidiary's shares; or
- shares to a value based on a multiple of the subsidiary's earnings (which may be intended to approximate the fair value of its shares).

In its consolidated financial statements, should the parent company recognise a financial liability representing the net present value of the option's strike price (i.e. a gross liability), in accordance with IAS 32.23?

Views

View 1: No. The contract should be classified as a derivative financial liability

IAS 32.23 states that "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".

Proponents of this view note that from the perspective of the reporting entity the contract in question contains no obligation to deliver cash or another financial asset, only an obligation to deliver equity instruments of the reporting entity.

Therefore they believe that the requirements of IAS 32.23 do not apply and that, instead, the requirements of IAS 32 for derivatives on equity instruments (including the Illustrative Examples of IAS 32) should apply. This would result in the contract being treated as a derivative liability accounted for at fair value through profit or loss.

View 2: Yes. A financial liability representing the net present value of the option's strike price (which may be fixed or variable in monetary terms) should be recognised in accordance with IAS 32.23

Proponents of this view note that, although from the perspective of the reporting entity the contract appears to contain no obligation to deliver cash or another financial asset, the counterparty has a right to receive what, from its perspective, is a financial asset.

Further, they note that IAS 32:21 contains a clear principle that an obligation to deliver a variable number of shares so that the number of shares varies so that the fair value of the entity's own equity instruments to be received or delivered equals the amount of the contractual right or obligations does not meet the definition of equity, and should be accounted as if the right or obligation is settled in cash. This is commonly referred to as "shares to the value of". IAS 32.23 should be read in this light.

Finally, proponents of this view highlight the last sentence of IAS 32.23: "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 (e.g. 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)". They note that this sentence does not contain any requirement for the obligation to be "for cash or another financial asset", suggesting that a liability should be recognised even if the strike price is payable in the reporting entity's equity instruments.

Issue 2

Similar to in issue 1, a parent company grants to non-controlling interest shareholders the right to put to the parent the shares they hold in a subsidiary of the parent. However, if the option is exercised, the parent company will have the choice to settle the exercise price (which, as in issue 1, could be fixed or variable in monetary terms) either in cash or a variable number of its own shares to the same value.

In its consolidated financial statements, should the parent company recognise a financial liability representing the net present value of the option's strike price, in accordance with IAS 32.23?

Views

The two views expressed in Issue 1 equally apply to Issue 2, but in addition those that support View 2 (i.e. IAS 32:23 applies) also note IAS 32:IE 31 (Example 6 of the Illustrative Examples to IAS 32) includes an instrument that provides settlement alternatives for the issuer with one of the alternatives being an exchange of cash for equity shares and in this case it is presented as a gross financial liability.

Reasons for the Committee to address the issue

NCI puts are common instruments. Both accounting treatments described above are encountered in practice and can have significantly different results on consolidated financial statements. Indeed, for NCI puts with an exercise price set at the fair value of the subsidiary's shares on the date of exercise, the requirement (or the option) of the parent to settle its obligation by remittance of a variable number of its own shares would either lead to recognition of a financial liability measured based on the fair value of the underlying subsidiary's shares (under View 2) or of a derivative instrument with a nil fair value (under View 1).

We acknowledge that issues relating to NCI puts were previously brought to the attention of the IFRS Interpretations Committee and that the draft Interpretation DI/2012/2 *Put Options Written on Non-controlling Interests* published in May 2012 was not finalised. However, we note that these previous issues related to the diversity in accounting for the subsequent measurement of financial liabilities recognised for NCI puts whereas the issues exposed above relate to the scope of instruments to which IAS 32.23 applies.

In addition, the issues are not related to a Board project that is expected to be completed in the near future.

For these reasons, we believe that these issues meet the criteria for acceptance onto the Committee's agenda.