IFRS

IASB Meeting | Agenda reference **18**

Staff Paper | Date **September 2010**

Project **IAS 32 *Financial Instruments: Presentation***

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

Purpose of this paper

1. This paper provides an overview of the discussions held by the IFRS Interpretations Committee (the Interpretations Committee) about a request that they received for guidance about the accounting for changes in the carrying amount of a financial liability for a put option, written over shares held by a non-controlling interest shareholder ('NCI put'), in the consolidated financial statements of a parent entity.

2. These discussions, which began in the May 2010 Interpretations Committee meeting, have resulted in the following being included as a tentative agenda decision in the September 2010 IFRIC Update:

> The Committee received a request for guidance on how an entity should account for changes in the carrying amount of a financial liability for a put option, written over shares held by a non-controlling interest shareholder ('NCI put'), in the consolidated financial statements of a parent entity. The request focuses on the accounting for a NCI put after the 2008 amendments were made to IFRS 3 *Business Combinations*, IAS 27 *Consolidated and Separate Financial Statements* and IAS 39 *Financial Instruments: Recognition and Measurement*.
>
> The Committee observed that paragraph 23 of IAS 32 requires the financial liability recognised for a NCI put to be subsequently measured in accordance with IAS 39. The Committee also observed that paragraphs 55 and 56 of IAS 39 require changes in the carrying amount of financial liabilities to be recognised in profit or loss. However, the Committee noted that additional accounting concerns exist relating to the accounting for NCI puts.

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

> Therefore, the Committee [decided] not to add this issue to its agenda but to ***recommend that the Board address these additional accounting concerns as part of the Financial Instruments with Characteristics of Equity (FICE) project***. The Committee observed that it would expect entities to apply the guidance in IAS 1 *Presentation of Financial Statements* in determining whether additional information relating to the accounting for NCI puts should be disclosed in the financial statements, including a description of the accounting policy used. (Emphasis added)

3. This paper:

   (a) provides background information on the request received;

   (b) summarises the main issues and concerns raised by the Interpretations Committee during their deliberations; and

   (c) notifies the Board of the recommendations made by the Interpretations Committee in their tentative agenda decision.

Background information

4. The request received by the Interpretations Committee focuses on the accounting for an NCI put written after the 2008 amendments were made to IFRS 3 *Business Combinations*, IAS 27 *Consolidated and Separate Financial Statements* and IAS 39 *Financial Instruments: Recognition and Measurement*.

5. The issue arises because of a perceived conflict between the financial instruments guidance in IAS 32 *Financial Instruments: Presentation* and IAS 39 and the guidance in IAS 27.

6. The Interpretations Committee observed that some constituents believe, in conformity with the guidance in IAS 32 and IAS 39, that because a financial liability is initially recognised for the NCI put, subsequent changes in its carrying amount should be recognised in profit and loss.

7. However, the Interpretations Committee noted that other constituents believe that, in conformity with the guidance in IAS 27 on transactions with non-controlling interests (NCI), changes in the carrying amount of the NCI put should be recognised in equity.

Main issues and concerns raised by the Interpretations Committee during their deliberations

8. The Interpretations Committee observed that paragraph 23 of IAS 32 requires the financial liability recognised for a NCI put to be subsequently measured in accordance with IAS 39. The Interpretations Committee also observed that paragraphs 55 and 56 of IAS 39 require changes in the carrying amount of financial liabilities to be recognised in profit or loss. However, the Interpretations Committee noted that additional concerns exist relating to the accounting for NCI puts.

9. These additional concerns included, but were not limited to, the following matters.

Requirements in IAS 32 to present a liability on a 'gross' rather than 'net' basis

10. Some of the Interpretations Committee expressed concerns with the current requirements in IAS 32 to recognise a financial liability for the NCI put that would be measured on a 'gross basis'.

11. Instead, they favoured the approach that has been tentatively decided by the Board in the Financial Instruments with Characteristics of Equity (FICE) project to recognise the NCI put as a derivative liability which would be measured on a 'net basis'.

Rationale for recognising changes in profit or loss when they relate to NCI

12. Other Interpretations Committee members acknowledged the concerns in the request relating to the perceived conflict between IAS 27 and the financial instruments guidance.

13. In addition to concerns relating to the requirement to recognise changes in the carrying amount of the NCI put financial liability in profit or loss, given the guidance in IAS 27 on transactions with owners in their capacity as owners,

these Interpretations Committee members were concerned about the economic rationale behind this requirement and whether it provides useful information.

14. For example, they questioned whether it is appropriate that the accounting for a put that is exercisable at, or close to, fair value should create significant profit and loss volatility when the fair value of the put derivative instrument itself is expected to be close to zero throughout the life of the instrument, and the put transfers limited risk to the parent until exercised?

15. In considering these profit or loss implications, Interpretations Committee members broadly acknowledged that the approach tentatively agreed by the Board in the FICE project to recognise the NCI put as a derivative liability, rather than a financial liability, would address some of these concerns.

Guidance on the initial recognition of NCI puts

16. The Interpretations Committee also identified that many of the subsequent accounting concerns relating to the measurement of changes in the carrying amount of a financial liability recognised for an NCI put arise because of uncertainty in how the NCI put should be initially recognised.

17. Specifically, different approaches exist in practice in determining, in accordance with paragraph 23 of IAS 32, from which component of equity the financial liability recognised for the NCI put should be reclassified.

Economic benefits approach

18. Some Interpretations Committee members favoured an '**economic benefits approach**'. This would require an entity to determine, when considering all other relevant facts and circumstances, whether the put, in substance, provides the holder with the economic benefit from the NCI shares subject to the put.

19. If the issuer determines that the put, in substance, provides it with the economic benefit from the NCI shares subject to the put, it de-recognises NCI and accounts for the NCI shares as though they have been purchased, recognising a financial liability for the NCI put.

20. If the issuer determines that the put, in substance, does not provide it with the economic benefit from the NCI shares subject to the put, the entity will continue to recognise NCI as a component of equity, but will also recognise a separate financial liability for the carrying amount of the NCI put. In this situation, the 'debit entry' for initial recognition of the financial liability for the NCI put is recognised against controlling interest equity.

21. However, the Interpretations Committee noted that some double counting issues exist if the put does not, in substance, provide the issuer with access to the economic benefit from the NCI shares subject to the put.

22. Specifically, on the statement of financial position, two 'credit entries' are recognised. One is recognised for NCI in equity and one is recognised for the financial liability. As a result, total equity is reduced when the NCI put is written.

23. Furthermore, profit attributed to equity holders of the parent of a profitable subsidiary is reduced by both the share of subsidiary profits attributed to the NCI shares and, when the NCI put is exercisable at a price that is at, or close to, fair value, by changes in the carrying amount of the financial liability recognised for the NCI put. In this situation, there is a reduction in the parent's profits when the value of the subsidiary shares increases and an increase in the parent's profits when the value of the subsidiary shares decreases.

Reclassification of NCI approach

24. As an alternative to the economic benefits approach, the Interpretations Committee considered a '**reclassification of NCI approach**'.

25. In accordance with the reclassification of NCI approach, the financial liability initially recognised for the NCI put is always accounted for as a reclassification of NCI.

26. The Interpretations Committee noted that this significantly addresses the double counting issues that exist with the economic benefits approach. However the Interpretations Committee expressed concerns as to whether:

(a) it was **always** appropriate to reclassify NCI from equity when an NCI put is written; and

(b) IAS 32 should be interpreted as providing guidance on **which component of equity** the financial liability for the NCI put should be reclassified from, and the Interpretations Committee has concerns as to whether such an interpretation should also be applied to the initial recognition of other instruments.

Other issues and concerns

27. Other issues and concerns identified by the Interpretations Committee relating to the accounting for NCI puts included:

(a) whether changes in the carrying amount of an NCI put should be accounted for as contingent consideration, if the NCI put is issued as part of a business combination;

(b) the accounting for expiration, or expiry, of an NCI put: specifically, when the put expires without being exercised, but NCI was reclassified from equity when the NCI put was initially recognised and is not recognised as equity during the life of the NCI put;

(c) how any premium received for a NCI put should be accounted for; and

(d) the treatment of dividends paid to NCI shareholders that relate to shares subject to an NCI put.

Recommendations made by the Interpretations Committee

28. As noted in the September 2010 IFRIC Update, the Committee tentatively decided not to add the issue of accounting for NCI puts to its agenda, but to instead recommend that the Board should address these additional accounting concerns as part of the *Financial Instruments with Characteristics of Equity* (FICE) project.