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

Topic **Background for education discussion with FICE project team**

Introduction

1. The purpose of this paper is to provide a summary of the discussions about put options written over non-controlling interests (NCI puts) at the November 2010 meeting of the IFRS Interpretations Committee (the Committee).

2. At the November IASB meeting, a summary of the Committee's work to date on NCI puts was presented to the IASB, together with the offer from the Committee to work with the staff from the Financial Instruments with Characteristics of Equity (FICE) project team to seek a short-term solution to the issues that the Committee has been discussing.

3. IASB members expressed support for the Committee to work with the staff from the FICE project. Details of the Committee's discussions about NCI puts have been shared with the FICE project team staff, including all papers discussed by the Committee.

4. At the January 2011 Committee meeting, staff from the FICE project team will lead an education session for the Committee, to explain some of the FICE team's thinking and approaches that may have a bearing on the direction of a short-term solution to the NCI puts issue.

5. This paper has been prepared by the staff of the IFRS Interpretations Committee to summarise some of the possible paths forward that appeared to emerge from the Committee's discussions in November. It is intended to aid, but not limit,

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

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IFRS Interpretations Committee or the IASB. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*.

Interpretations are published only after the IFRS Interpretations Committee and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in IASB *Update*.

the discussions at the January 2011 Committee meeting. This paper therefore does not necessarily reflect the views of the staff of the FICE project team.

Issue

6. There are a number of variations on the basic fact pattern that share the issues discussed by the Committee. However, for the purposes of discussions to date, the Committee has worked with an NCI put defined as:

   (a) a puttable instrument in accordance with the definition in paragraph 11 of IAS 32 *Financial Instruments: Presentation*.

   (b) providing for gross physical settlement in cash only.

   (c) free-standing.

   (d) issued separately from a transaction that is accounted for as a business combination in accordance with IFRS 3 *Business Combinations* (revised 2008).

   (e) accounted for in the consolidated financial statements of the parent.

   (f) exercisable at fair value **<u>or</u>** at a fixed price at a specified future date.

   (g) written:

      (i) after the 2008 amendments were made to IFRS 3, IAS 27 *Consolidated and Separate Financial Statements* (amended 2008) and IAS 39 *Financial Instruments: Recognition and Measurement*.

      (ii) to one NCI shareholder.

      (iii) to be non-transferable by the NCI shareholder to a different counterparty.

      (iv) over all of the shares in a subsidiary which the parent does not hold a present ownership interest in.

      (v) by the parent.

7. There is little diversity in practice concerning the initial recognition by the parent of the NCI put. The reason for the issue being submitted to the

Committee relates to concerns over diversity in practice for the subsequent accounting.

8. For completeness, the accounting required on initial recognition of the NCI put is to recognise a financial liability for the present value of the expected exercise price of the NCI put. The corresponding accounting entry is a debit to equity. The source of this requirement is paragraph 23 of IAS 32.

9. The primary issue discussed by the Committee relates to the accounting for the subsequent measurement of the NCI put prior to exercise or lapse. The financial liability recognised for an NCI put with a variable exercise price is updated at each reporting date to reflect current estimates of the exercise price. There is agreement over the need to remeasure the financial liability at each reporting date; the issue leading to diversity in practice is whether that remeasurement should be recognised:

   (a) in profit or loss; or

   (b) in equity.

10. Those supporting the view that the remeasurement should be recognised in profit or loss refer to the guidance in paragraph AG 8 of IAS 39. The rationale being that the remeasurement of a financial liability should follow the applicable guidance in IAS 39:

> AG8 If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate or, when applicable, the revised effective interest rate calculated in accordance with paragraph 92. The adjustment is recognised in profit or loss as income or expense.

11. Those supporting the view that the remeasurement should be recognised in equity refer to the guidance in paragraphs 30 and 31 of IAS 27. The rationale being that the put option relates to a transaction between equity owners in their capacity as owners:

30	Changes in a parent’s ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions (ie transactions with owners in their capacity as owners).
31	In such circumstances the carrying amounts of the controlling and non-controlling interests shall be adjusted to reflect the changes in their relative interests in the subsidiary. Any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received shall be recognised directly in equity and attributed to the owners of the parent.

12. An additional observation made in respect of the accounting for NCI puts, is the different measurement basis used compared with that required for other derivatives. The NCI put meets the definition of a derivative set out in paragraph 9 of IAS 39, however the guidance in IAS 32 and IAS 39 requires it to be measured at the present value of the exercise price. The NCI put is a potential obligation on the entity to purchase its own equity instruments (equity instruments of a subsidiary are considered to be own equity instruments from the perspective of the consolidated financial statements). It is because it is a potential obligation to purchase own equity instruments that it is required to be measured on this basis. This contrasts with the “normal” measurement basis of a derivative, which is at the fair value of the instrument itself.

13. The following consequences are observed for the measurement basis required for NCI puts. A change in the fair value of the shares subject to the NCI put will result in a change in the financial liability for an NCI put with a fair value exercise price, even though the fair value of the put option itself will remain at or close to zero. Whereas, the financial liability recognised for a fixed price NCI put will remain unchanged, even though the fair value of the put option itself will have changed to reflect the change in the difference between the fair value of the shares and the exercise price.

14. Some have expressed concerns about whether the current measurement basis provides useful information if, when accounting for an NCI put with an exercise

price at, or close to, fair value, significant profit or loss volatility is recognised when the fair value of the NCI 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. Some argue that a change in the measurement basis of the NCI put from the present value of the exercise price to the fair value of the instrument itself, would give more meaningful information.

Possible solutions

16. Some of the possible short-term solutions raised in discussions at the November 2010 Committee meeting included the following:

17. Solution A: Amend the presentation requirements of IAS 32 and IAS 39 to require the remeasurement of an NCI put to be presented in equity, rather than through profit or loss, whilst retaining the current measurement basis for the NCI put liability.

18. Solution B: Amend IAS 32 to change the measurement basis of NCI puts to that used for other derivative instruments, and to clarify that the remeasurements of that derivative should be presented in profit or loss, consistent with the presentation used for other derivatives.

19. Solution C: Develop an interpretation to address the inconsistency between the guidance in IAS 32/IAS 39 and the guidance in IAS 27. This could focus on the guidance in IAS 32 that requires a financial liability to be recognised for an NCI put and the requirement that financial liabilities should be subsequently measured in accordance with IAS 39. Such an interpretation could require changes in the carrying amount of a financial liability recognised for an NCI put to be recognised in profit or loss in accordance with paragraphs 55 and 56 of IAS 39.

Consideration of solution A

20. Solution A has the appeal of being less invasive than solution B. It does not change the measurement basis of NCI puts and so does not risk pre-empting IASB discussions in the FICE project about the measurement of such instruments. It would address the diversity that has been noted in practice, but it would leave unresolved the concerns raised about the usefulness of the information provided by the current measurement basis.

Consideration of solution B

21. Solution B is a more significant change to the current accounting requirements. It has the appeal of addressing the concerns about the usefulness of the information provided by the current measurement basis, and would address the current inconsistency between the measurement of NCI puts and other derivatives. However, the issue of how to measure such obligations and potential obligations to purchase own equity instruments was thoroughly debated when IAS 32 was revised in 2003, as illustrated by the dissenting opinion on that revision to the standard. Solution B would therefore be a direct reversal of the IASB's decision at that time, and it could also risk pre-empting the IASB's discussions in the FICE project.

Consideration of solution C

22. Solution C could provide interpretive guidance on the question of presentation of the remeasurement of the NCI put liability. Interpretations are largely guidance on current IFRS requirements, although they can include consequential amendments to existing standards. However, discussions among the Committee to date have indicated that there are differences in the views held by Committee members as to what the current IFRSs require. The development of an interpretation would of course require a consensus among the Committee members as to what current IFRSs require, and agreement that the resulting interpretation would lead to an improvement in financial reporting.

Consideration of scope

23. Whichever potential solution is pursued by the Committee, the question of scope will need to be considered. A put option written by a controlling shareholder over shares in a subsidiary held by a non-controlling shareholder, outside of a business combination, has been used as the focus of discussions by the Committee to date. However, other variations on the basic fact pattern exist and the extent to which those variations are seen in practice, will need to be considered when determining scope.

Next steps

24. The discussion at the January 2011 Committee meeting is intended to provide the Committee members with an opportunity to learn more about the FICE team's thinking and direction on matters relevant to the NCI puts issue.

25. The staff plans to bring papers to the March 2011 Committee meeting with detailed proposals for a short-term solution. The staff welcomes direction from the Committee members as it prepares those papers.