IASB Meeting

Agenda reference	5

Staff Paper

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

Topic **Guidance for the IFRS Interpretations Committee: possible paths forward**

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 transactions with owners in their

[1] The Committee discussed this issue at seven meetings—May, July, September and November 2010 and January, March and November 2011. At the IASB meetings in September and November 2010 and September 2011, we updated the Board on the Committee's discussions. If Board members would like copies of previous Committee or Board papers, please let us know.

capacity as owners (IAS 27 *Consolidated and Separate Financial Statements* and IFRS 10 *Consolidated Financial Statements*).

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 paragraph 30 of IAS 27 and paragraph 23 of IFRS 10.

A potential short-term solution

4. At the Board's request, the Committee discussed several possible short-term solutions to this issue and, in March 2011, the Committee agreed that excluding NCI puts from IAS 32 through a narrow scope amendment was a viable solution. That scope exclusion would change the measurement basis of NCI puts to that used for other derivative contracts.

5. Under the Committee's proposal, NCI puts would be initially and subsequently measured on a 'net' basis at fair value with all changes in fair value recognized in P&L in accordance with IAS 39 or IFRS 9[2]—rather than being measured on a 'gross' basis at the present value of the option exercise price in accordance with paragraph 23 of IAS 32.

6. Since amending IFRSs is not within the mandate of the Committee, it referred this issue and possible solution to the Board for its consideration. [Agenda paper 6 for the Board's September 2011 meeting describes the background of this issue and the Committee's proposal in more detail.]

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

The Board's discussion in September 2011

7. At its meeting in September 2011 the Board discussed the Committee's recommendation. While some Board members supported the proposal as a practical, targeted solution that was consistent with what it had requested, the Board decided not to proceed with the proposed amendment to the scope of IAS 32. [For the Board's convenience, a summary of Board members' concerns is included in the appendix to this agenda paper.]

8. However the Board expressed support for considering addressing the potential inconsistency that was raised by constituents (described in paragraph 3 of this paper)—not by changing the measurement basis of the NCI put but by clarifying the accounting for the subsequent changes in the measurement of that liability.

9. The Board acknowledged the significant amount of work performed by the Committee on this issue and that the Committee had suggested a solution consistent with the Board's previous request. The Board asked us to obtain feedback from the Committee on whether the Committee wishes to be involved in further considering this issue or whether the Board should consider this potential clarification itself.

The Committee's discussion in November 2011

10. At its meeting earlier this month, we asked the Committee how it would like to proceed with this issue. The Committee confirmed that it is willing to continue to consider this issue. However the Committee asked that the Board provide clear instructions on what matters the Board would like the Committee to discuss.

Purpose of this paper

11. As requested by the Committee, this paper asks the Board for clear instructions on how the Committee should proceed on the issue of NCI puts.

12. On the basis of the Board's discussion in September, we have set out two issues that we think the Board would like the Committee to consider. Specifically:

    (a) Should IFRSs be clarified to address the diversity in accounting for the subsequent measurement of the financial liability that is recognized for NCI puts? If so, how?

    (b) If IFRSs are clarified, to which instruments should the clarification be applied?

13. This paper discusses each issue and sets out several possible solutions for each. We are asking the Board to confirm that we have correctly identified the issues and possible solutions that the Board wants the Committee to discuss. We are **not** asking the Board to make any technical decisions about the issues set out in this paper.

14. However, if the Board has any preliminary thoughts or concerns about the issues or the possible solutions that we have set out in this paper (or has additional possible solutions that it would like the Committee to consider), we think that information would be useful to the Committee.

15. When the Committee has considered these issues (and perhaps developed a recommendation), we will bring the issue of NCI puts back to the Board and ask for a decision on a path forward.

Two matters that this agenda paper does <u>not</u> consider

16. Consistent with the Board's discussion in September, this paper makes two assumptions:

    (a) The Board is willing to discuss this issue (and perhaps clarify IFRSs) before it decides how to proceed in its project on financial instruments with characteristics of equity (FICE). At this point, the timing of the FICE project is uncertain and is subject to the current agenda consultation. The comment deadline on the agenda consultation is 30 November 2011 and we expect the feedback from that consultation to be presented to the Board in the first half of 2012. If the Board would prefer to receive that feedback and decide on the direction of the FICE project before it addresses the issue of NCI puts, we think the Board should ask the Committee to defer any discussion until that time.

(b) The Board does not want to change the measurement basis of NCI puts at this time. In other words, the NCI puts will continue to be measured as liabilities on a gross basis at the present value of the option exercise price in accordance with paragraph 23 of IAS 32.

Issue 1—Clarifying IFRSs to address the diversity in accounting for NCI puts

17. As discussed above, some constituents have told the Committee that there is an apparent inconsistency between the requirements for measuring financial liabilities and the requirements for transactions with owners in their capacity as owners, which has resulted in diversity in accounting for the subsequent measurement of the liability that is recognized for NCI puts. This is the issue that was raised to the Committee.

18. We think there are three alternatives that could be considered for how those changes are recognized. The changes could be recognized in:

(a) P&L;

(b) equity; or

(c) other comprehensive income (OCI).

Observations on the alternatives

19. We have several observations on this issue, which may be useful to the Board as it considers what guidance it wishes to give to the Committee for moving forward on this issue.

Recognizing the changes in P&L or equity (alternatives (a) and (b))

20. As mentioned above, the issue submitted to the Committee asked whether subsequent changes in the measurement of the liability recognized for the NCI put should be recognized in P&L (pursuant to the guidance for measuring financial liabilities) or in equity (pursuant to the guidance for transactions with owners in their capacity as owners). Since May 2010, we have written several papers that set out the rationales for alternatives (a) and (b)—as well as our analysis of those alternatives.

21. In those papers, the staff has expressed the view that subsequent changes in the measurement of NCI puts must be recognized in P&L pursuant to the requirement for measuring financial liabilities (ie alternative (a)). We do not think that subsequent changes in the measurement of the NCI puts are transactions with owners (ie the remeasurements are not changing the parent's and non-controlling interest shareholder's relative ownership in the subsidiary); therefore we do not think the guidance in IAS 27 or IFRS 10 is applicable. As discussed in those papers, we think that alternative (a) is consistent with current IFRS requirements.

22. Consistent with our view, in September 2010 the Committee published a tentative agenda decision, which stated in part (emphasis added):

> 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 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…**

23. The Committee received a significant number of comment letters on that tentative agenda decision that highlighted the diversity in practice that exists related to the subsequent measurement of NCI puts. Those respondents expressed support for either the Committee or the Board to provide additional guidance on a timely basis. The Committee also noted that subsequent to the publication of the tentative agenda decision the Board had acknowledged that it could not devote the time necessary to deliberate the issues related to the FICE project. Consequently the Committee did not finalize the tentative agenda decision and decided to add the issue of NCI puts to its agenda.

24. However, in 2006 the Committee (at that time it was called the IFRIC) discussed an almost identical issue and, in November 2006, it finalized the following agenda decision (emphasis added):

> The IFRIC considered a request for clarification of the accounting when a parent entity has entered into a forward to acquire the shares held by the [non-controlling] minority interest in a subsidiary or the holder of the [non-controlling] minority interest can put its shares to the parent entity.
>
> Paragraph 23 of IAS 32 states that a parent must recognise a financial liability when it has an obligation to pay cash in the future to purchase the minority's shares, even if the payment of that cash is conditional on the option being exercised by the holder. **After initial recognition any liability to which IFRS 3 is not being applied will be accounted for in accordance with IAS 39. The parent will reclassify the liability to equity if a put expires unexercised.**
>
> The IFRIC agreed that there is likely to be divergence in practice in how the related equity is classified. However, the IFRIC did not believe that it could reach a consensus on this matter on a timely basis. Accordingly, the IFRIC decided not to add this item to its agenda.

25. We acknowledge that when IFRS 3 *Business Combinations* was revised in 2008, it added paragraph 30 to IAS 27 to provide guidance for accounting for transactions with owners in their capacity as owners—thus adding the requirements that some believe create the potential conflict that is the subject of the concerns raised to the

Committee about NCI puts. However, we do not think the addition of that paragraph affects IFRIC's observation in its 2006 agenda decision that financial liabilities should be measured in accordance with IAS 39.

26. We agree with the significant amount of discussion and analysis that has been done to date on this issue. Consistent with that work, we think that alternative (a) could be achieved with an Interpretation of existing IFRSs whereas alternative (b) would require an amendment.

Recent discussions about recognizing remeasurements of liabilities directly in equity

27. During the deliberations that resulted in the measurement requirements in IFRS 9 for financial liabilities, the Board discussed how to recognize own credit gains or losses on a financial liability designated under the fair value option. As part of that discussion, the Board considered whether entities ought to be required to recognize the effects of changes in the liability's credit risk directly in equity.

28. The Board rejected that approach and noted in paragraph BC5.44 of IFRS 9 that remeasurements of assets and liabilities are not transactions with owners. If the Board decides that it is appropriate to recognize subsequent changes in the liability recognized for NCI puts in equity, we think it will be important to explain why those financial liabilities are treated differently.

Recognizing changes in OCI (alternative (c))

29. This alternative was mentioned by at least one Board member during the September 2011 IASB meeting. The Committee has not previously focused on this alternative.

30. If the Board wants to the Committee to consider this alternative, we think the Committee would also have to consider consequential 'knock on' questions such as whether amounts recognized in OCI should be subsequent reclassified (recycled) to P&L (and, if so, under what circumstances). The Board has acknowledged that IFRSs do not provide a clear objective for when an item should be recognized in OCI or whether amounts should be recycled to P&L (and if so, when).

Other 'knock on' questions related to Issue 1

31. Over the course of the past 18 months, the Committee has also discussed several 'knock on' questions related to the issue of NCI puts. For example:

    (a) which component of equity should be debited when the grossed-up liability is initially recognized—ie should the non-controlling interest balance be derecognized?

    (b) how should dividends that are paid to the non-controlling interest shareholder be recognized—ie should those amounts be recognized as an expense (rather than a distribution) and should the answer depend on whether the non-controlling interest balance is derecognized when the grossed-up liability is recognized?

32. Some of these knock-on questions were considered in 2006 but, as noted in the agenda decision reproduced above, the IFRIC did not think it could reach a consensus on a timely basis.

33. The request submitted to the Committee did not ask for guidance on these knock-on questions—the submission only asked for guidance on whether subsequent changes in the measurement of the NCI put should be recognized in P&L or equity. However, it may be difficult (or perhaps impossible) to consider that request without also considering the knock-on questions.

34. For example, a Board member's view on whether subsequent changes in the measurement of the NCI put should be recognized in P&L or equity may depend on whether that Board member believes that the NCI balance continues to 'exist' in equity (or has been derecognized and replaced by the grossed-up liability).

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

35. The concerns raised to the Committee were related to the accounting for put options written on shares held by non-controlling interest shareholders in the consolidated financial statements of the controlling shareholder . However at the IASB meeting in September 2011 some Board members said that there was no compelling reason to

treat NCI puts differently from other contracts on an entity's own equity—and to do so would create confusion and 'a maze of questions' from constituents.

36. If the Board decides to clarify IFRSs, we think there are three alternatives that could be considered for the scope of that clarification:

    (a) put options written on shares held by non-controlling interest shareholders in the consolidated financial statements of the controlling shareholder (ie NCI puts, as discussed to date);

    (b) put options **and forward contracts** written on shares held by non-controlling interest shareholders in the consolidated financial statements of the controlling shareholder (ie NCI puts and NCI forwards); or

    (c) **all** put options and forward contracts written on an entity's own equity that are currently grossed up in accordance with paragraph 23 of IAS 32.

Observations on the alternatives

37. We have several observations on this issue, which may be useful to the Board as it considers what guidance it wishes to give to the Committee for moving forward on this issue.

Alternative (a)

38. Constituents expressed concerns only about the instruments described in alternative (a). If the Board wishes to develop a narrow, short-term solution that responds to the specific concerns raised by constituents, alternative (a) might be preferable to the other alternatives.

39. However, while it may be possible to address this population more quickly than the other alternatives because the clarification would affect fewer instruments, it may be difficult to explain why NCI puts should be treated differently than other contracts written on an entity's own equity instruments.

40. At the IASB meeting in September 2011 at least one Board member discussed the possibility of further limiting the scope of the clarification, specifically to NCI puts that are exercisable at fair value. Some constituents find the current accounting for those NCI puts particularly counter-intuitive. That is because there likely will be significant volatility in the measurement of the liability over its life even though the instrument's fair value will always be close to zero. However we note that the issue that was submitted to the Committee was not limited to NCI puts that are exercisable at fair value. Moreover, similar to the observation in paragraph 35 of this paper, limiting the scope to NCI puts that are exercisable at fair value could create confusion and generate many questions from constituents—eg what to do with NCI puts that are exercisable at a proxy for fair value.

Alternative (b)

41. 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 transactions with owners in their capacity as owners (IAS 27 and IFRS 10). While constituents asked for guidance only on NCI puts, that potential conflict applies equally to NCI forward contracts.

42. Consistently with that observation, at the September 2011 IASB meeting, 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.

43. If Board members only want to address the potential conflict described in paragraph 3 but to do so comprehensively, alternative (b) might be preferable to alternative (a).

Alternative (c)

44. In addition to raising concerns about the potential conflict described in paragraph 3, some constituents have stated that the requirement in paragraph 23 of IAS 32 to measure particular contracts written on an entity's own equity instruments on a gross basis does not result in useful information. Some constituents have used that criticism

to support their view that subsequent changes in the grossed-up liability should be recognized in equity.

45. However, that criticism is applicable to all put options and forward contracts written on an entity's own equity—not only puts and forwards written on NCI balances. Therefore, if the Board want to address criticisms about the usefulness of the information provided by grossing up particular derivative contracts on an entity's own equity instruments, alternative (c) might be preferable to the other alternatives. Also, most of the knock-on questions discussed earlier in this paper (please refer to paragraph 31) apply to all of the instruments in alternative (c), not only to NCI puts.

46. However, alternative (c) suggests a significantly wider scope than alternatives (a) and (b) — and represents a major shift away from the narrow scope of the issue that was submitted to the Committee.

47. Moreover, alternative (c) could raise difficult questions about how this issue relates to the accounting for puttable and mandatorily redeemable shares. As noted in the basis for conclusions in IAS 32 (paragraph BC11 and BC12), the Board's objective when it developed the requirement to gross up some put options and forward contracts written on an entity's own equity was to account for those contracts **the same as** puttable and mandatorily redeemable shares. IAS 32 requires that puttable and mandatorily redeemable shares are classified as liabilities and remeasured through P&L.[3] Alternative (c) could add further complexity and inconsistency to this area of accounting because it could result in different accounting treatment for grossed-up derivatives on own equity and puttable/mandatorily redeemable shares , which conflicts with the Board's original conclusions in IAS 32 .

48. Given its wide scope, we think alternative (c) will take a considerable amount of time to discuss. Moreover, the accounting for the instruments in alternative (c) has been a fundamental issue in the FICE project. Arguably it would be inappropriate to make decisions on such a fundamental issue while the future of that project is still uncertain.

[3] As an exception, the Board decided in 2008 that some puttable and mandatorily redeemable shares must be classified as equity and not remeasured.

A final observation on scope

49. The scopes described in alternatives (a) and (b) are based on a potential conflict between the requirements for measuring financial liabilities (IAS 32, IAS 39 and IFRS 9) and the requirements for transactions with owners in their capacity as owners (IAS 27 and IFRS 10). Therefore this potential conflict assumes that the put option or forward contract is held by the non-controlling interest shareholder (ie a current owner of the controlling shareholder's subsidiary).

50. However, it is possible that the contract is **not** held by the non-controlling interest shareholder—but rather is held by another counterparty, which may be the case particularly when the subsidiary has liquid shares. In other words, the party that holds the non-controlling interest and the party that holds the NCI put are not the same. In that case, there would not be a conflict (ie because there is no reason to consider the guidance in IAS 27 or IFRS 10). Alternatively, the contract could be originally issued to the non-controlling interest holder who then sells it to another counterparty or vice versa (ie the contract could be originally issued to another counterparty who then sells it to the non-controlling interest holder).

51. Therefore if the Board wants to pursue alternatives (a) or (b), it might consider whether the accounting for subsequent changes in the liability should depend on whether the counterparty is the non-controlling interest shareholder (and, if so, what happens if the put or forward can be transferred or sold to another party).

Question 1 – A potential clarification
Does the Board want the Committee to consider whether IFRSs should be clarified to address whether subsequent changes in the liability recognized for NCI puts should be recognized in: (a) P&L; (b) equity; or (c) OCI? If not, what does the Board want to do and why?

Question 2 – The scope of the clarification
Does the Board want the Committee to consider whether any clarification should be applied to a wider population than only NCI puts, such as those populations described in paragraphs 36(b) and 36(c)? If not, what does the Board want to do and why?

APPENDIX

A1 While some Board members supported the Committee's proposal to exclude NCI puts from IAS 32 as a practical, targeted solution that was consistent with what the Board has requested, the Board decided not to proceed with the proposed amendment to the scope of IAS 32.

A2 Board members expressed the following concerns with excluding NCI puts from the scope of IAS 32:

(a) IAS 32 should not be amended until the Board decides how it will proceed in its project on Financial Instruments with Characteristics of Equity (FICE). Ideally, this issue should be addressed comprehensively within the context of that project. However, the Board acknowledged that the timing of the FICE project is uncertain and is subject to the current agenda consultation. While the Committee's recommendation is consistent with the tentative decisions to date in the FICE project, some (or perhaps many) of those decisions are likely to change before that project is finalized.

(b) Constituents have raised other issues related to the guidance in IAS 32 (eg the accounting for convertible debt that is denominated in a foreign currency). It is not clear why the Board would address the NCI put issue more urgently than others.

(c) There will be significant confusion about the 'scope of the scope exclusion'—ie why NCI puts are treated differently than other contracts on an entity's own equity. The criticisms about the usefulness of the information provided by the current 'gross' measurement basis are equally applicable to all put options and forward purchase contracts written on an entity's own equity (not only NCI puts).

(d) Consistent with the rationale set out in paragraphs BC11 and BC12, the 'gross' measurement basis required by IAS 32 is appropriate. Therefore, the accounting result of the scope exclusion (ie measuring NCI puts on a 'net' basis) is inappropriate.

(e) The scope exclusion would change the measurement basis of NCI puts but would not address the original issue submitted to the Committee—ie the potential inconsistency between the requirements for measuring financial liabilities and the requirements for transactions with owners in their capacity as owners. In other words, changing the liability from a 'gross' measurement basis to a 'net' measurement basis does not answer the original question about whether subsequent changes in the liability should be recognized in P&L or equity. [We think the Committee's intention was that subsequent changes in the NCI put would be recognized in P&L if it were measured on a 'net' basis.]