EFRAG
European Financial Reporting Advisory Group

DRAFT COMMENT LETTER
Comments should be submitted by 5 October 2010 to
Commentletters@efrag.org

XX October 2010

Robert Garnett, Chairman
IFRS Interpretations Committee
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Mr. Garnett,

Re: Put options written over non-controlling interests

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the IFRS Interpretations Committee ('the Committee') tentative decision not to proceed with the agenda item a request for guidance on how to account for changes in the carrying amount of put options written over non-controlling interests in the consolidated financial reports of the parent ('NCI put issue').

The letter is submitted in EFRAG's capacity of contributing to the IFRS Interpretations Committee ('the Committee') due process. EFRAG addresses wordings for rejection by exception, i.e. when European constituents express concern that they are expected to have a significant and undesirable effect in practice and EFRAG TEG would share that concern after proper technical assessment. Such circumstances have just arisen, with the IFRS Interpretation Committee issuing its tentative wording for rejection on *Put options written over non-controlling interests.*

EFRAG agrees with the Committee that the NCI put issue is a matter that warrants action from the IASB because there is conflict between accounting standards that has lead to significant divergence in practice.

We agree with the Committee's decision not to take this item onto its agenda, however the wording of the rejection notice should be changed to explain that there is an inconsistency between IAS 39 and IAS 27 and that for that reason the issue should be taken onto the IASB's agenda.

In this instance, we believe that the decision has not been reached in accordance with the Committee's due process rules. In particular, in accordance with the *IFRIC Due Process Handbook* that any consensus reached should not conflict with other IFRSs. As explained in more detail in Appendix 1, in our view that precludes a conclusion that deems IAS 39 *Financial Instruments: Recognition and Measurement* more appropriate than IAS 27 *Consolidated and Separate Financial Statements*, without providing a rationale for such a conclusion.

If you would like to discuss our comments further, please do not hesitate to contact Alessandro Turris, Stuart Studsrud or me.

Yours sincerely

Françoise Flores

EFRAG, Chairman

APPENDIX 1

EFRAG response to the tentative agenda decision in relation to how to account for changes in the carrying amount of a financial liability for a put option

Notes to EFRAG constituents

1 *A parent that owns 70% of a subsidiary's shares may have written a put option over the remaining 30% that are held by the non-controlling interests. There is a variety of business reasons for such options to exist:*

(a) *they provide liquidity to the non-controlling interest shares;*

(b) *they allow for a degree risk sharing;*

(c) *they may act as an 'earn out' mechanism in a business combination; and*

(d) *they are part of a tax efficient transfer of ownership.*

2 *The exercise price of the put options will be set in a way that reflects the objectives of the transaction and may be:*

(a) *a fixed price;*

(b) *a market price;*

(c) *fair value;*

(d) *a formula that is intended to approximate fair value (e.g. multiple of EBITDA);*

(e) *a formula that provides for an 'earn out'.*

3 *The IFRS Interpretations Committee received a request for 'additional guidance on how an entity should account for changes in the carrying amount of a financial liability for a put option, written to a non-controlling interest shareholder (NCI put), in the consolidated financial statements of a parent'.*[1]

4 *The issue arises because of a potential conflict between the guidance in:*

(a) *IAS 27 Consolidated and Separate Financial Statements which requires transactions with non-controlling interests to be recognised in equity. Put options written over non-controlling interests are a transaction with non-controlling interests that should therefore subsequent measurement of the liability should be recognised in equity; and*

(b) *IAS 32 Financial Instruments: Presentation and IAS 39 Financial Instruments: Recognition and Measurement which requires put options written over non-controlling interests to be recognised initially as a financial liability with subsequent changes in the carrying amount should be recognised in profit and loss.*

[1] IFRIC, May 2010, Agenda Paper 11, IAS 27 Consolidated and Separate Financial Statements – Puts on Non–Controlling Interest, paragraph 1.

5 *The IFRIC discussed accounting for put options written over non-controlling interests on several occasions in 2006, but decided not to proceed with an interpretation because the Board was working on its Business Combinations project at the time.*

6 *The IASB discussed the issue in 2009 as part of its Annual Improvements project, but decided to defer the issue to the post-implementation review of IFRS 3 and IAS 27.*

7 *In May 2010 the Committee decided that this was an acute issue that could lead to divergence in practice. The Committee also noted that 'this issue is unrelated to any Board project that is expected to be completed in the near future, and the issue is sufficiently self-contained that it could be dealt with by the IFRIC on a timely basis'.*

8 *The Committee discussed this issue subsequently in July 2010 and in September 2010. At the latter meeting, the Committee decided (with two votes against) that it would not be able to issue an Interpretation in a timely fashion and should drop the issue from its agenda. The Committee decided with nine votes in favour and four votes against that the change in the put held by NCIs should go through profit or loss. The Committee determined that the additional accounting concerns that this conclusion gives rise to should be addressed as part of the Board's* Financial Instruments with Characteristics of Equity *(FICE) project. The full text of the rejection notice is attached as Appendix 2.*

EFRAG's view

We think that the IFRS IC rejection notice on a potential conflict in guidance between two standards should not deem one of those standards to be the most appropriate, rather it should explain the conflict between those standards and the reasons why the issue should be taken on IASB's agenda

9 EFRAG understands that the Committee rejected taking accounting for put options written over non-controlling interests onto its agenda because the issue could not be solved on a timely basis.

10 In general, EFRAG agrees with the Committee that the NCI put issue is a matter that warrants action from the IASB because there is conflict between accounting standards that has lead to significant accounting divergence in practice. We also think that there are many concerns that goes beyond the subsequent measurement of financial liabilities for NCI put options that should be addressed by the IASB.

11 It would seem to us that the consensus rea*ched by the Committee in the rejection notice, which* considers one particular methodology as being the most appropriate, may not comply with the following paragraphs of the *IFRIC Due Process Handbook*:

"7. The IFRIC does not reach a consensus that change or conflicts with IFRSs or the framewor*k ...*

8. The IFRIC informs the IASB of any existing or emerging issues that it perceives as indicative of inadequacies in IFRSs ..."

The consensus reached is not supported by an explanation as to why IAS 39 should take precedence over IAS 27 and the consensus reached conflicts with the requirements of IAS 27. We therefore believe that providing accounting guidance on this topic would be outside the remit of the Committee.

12 EFRAG also agrees with the Committee's decision not to take this item onto its agenda. However, we think that the rejection notice should not consider one particular method as the most appropriate, but rather it should explain that there is an inconsistency between IAS 39 and IAS 27 and refer the issue to the IASB for consideration (in relation to this please refer to our comments in paragraph 14).

13 The rejection notice specifies that IAS 39 should be the reference point so that the changes in the liability are recognised in the profit and loss. Without commenting specifically on whether or what method we consider most appropriate, we believe there should be a balanced view. In fact, in its meeting in September 2010 four Committee members voted against clarifying that a change in the value of put options written over non-controlling interests should be accounted for through profit or loss. In the spirit of the Committee's due process rules on issuing draft Interpretations (in particular, paragraph 34 of the *IFRIC Due Process Handbook*), we believe that the Committee should refrain from issuing a rejection notice that contains an interpretation of existing standards when more than three members vote against including such an interpretation.

14 On a separate note, we also wonder whether the FICE project is the appropriate project to address the concerns raised, as we understand that there is uncertainty as to the general direction and timetable of the FICE project.

APPENDIX 2

Wording of the rejection notice

This Appendix details the Committee's rejection notice that has been exposed for a 30-day comment period:

IAS 32 Financial Instruments: Presentation — Put options written over non-controlling interests

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 an 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.

The Committee noted that these additional accounting concerns would be best addressed as part of the Board's *Financial Instruments with Characteristics of Equity* (FICE) project. Consequently, the Committee [decided] not to add this issue to its agenda but to recommend that the Board should address these additional accounting concerns as part of the FICE project. The Committee also 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.