IFRIC
30 Cannon Street
London EC4M 6XH
UK

Paris, September 28, 2012

Re: **DI/2012/2 – Put options written on non-controlling interests (the DI)**

Dear Mr Upton

As already stated in our previous letter (dated May 5, 2012), we are strongly opposed to the proposed draft interpretation regarding put options written on non-controlling interests (NCI Puts). Indeed, over the last two years or so we have regularly communicated our grave concerns about this issue to the IASB and have tried to explain to the Board our disagreement with the form and content of this project.

In addition to the technical considerations outlined below, we would ask the IFRIC/IASB to consider carefully the economic cost that the DI may have on entities because of the "headline" figures that will result from it. We believe that the negative impact could be significant. In contrast, we have not seen any convincing arguments that the quality of financial reporting would be substantially improved by it. In particular, we do not think that there is real benefit to be obtained from merely imposing uniformity in an accounting solution which is far from satisfactory. As mentioned below, the more sophisticated users we have spoken to anticipate that they will remove the effect of the variation in the value of the debt from profit and loss as they see no predictive or other value to it. If smaller investors react negatively to the resultant accounting and sophisticated users essentially ignore it, we wonder what the value of such an approach might be.

In conclusion, we respectfully urge the Committee and the IASB to suspend their work upon the DI as it stands. We request the IASB to consider the whole of the broad range of issues raised by this topic in order to avoid piecemeal and inconsistent accounting solutions. In this context, we think that the subject merits not only a review of IAS 32/IFRS 9 but also IFRS 3, perhaps coupled with the post-implementation review of the latter.

Please find below a further recital of our primary comments concerning this issue.

We would be happy to discuss any of the above with you, Yours sincerely,

1. Concerns about the process and scope of this project

- First of all, we believe that the subject is far too broad to be dealt only with a "mere interpretation" dealing with only one aspect of the whole of the accounting model for NCI puts.

  As we have stressed in earlier correspondence, it is far from satisfactory to treat only the issue of the subsequent measurement of the financial debt in isolation. Indeed, the real, fundamental issue is the initial recognition of a gross liability – a treatment which is in itself an exception to the general principle of IAS 39/IFRS 9 in respect of derivatives. The issue of the presentation of the subsequent remeasurement of this deemed liability is only one of the consequential problems to be resolved.

  Indeed, we believe that only a comprehensive review of the model for the initial recognition and subsequent measurement of such an instrument, and its inter-action with the accounting for non-controlling interests, could help to provide appropriate and relevant solutions. We believe that without such a fundamental analysis, diversity in practice will remain for all the other aspects of accounting for NCI puts.

- Nonetheless, if the Board really wants to proceed quickly with this aspect in isolation, we would support one of the first solution proposed by IFRIC (i.e. accounting for NCI put as a derivative), which at least has the merit of treating the topic a little more broadly than currently proposed in this draft interpretation. We therefore agree with what is stated in paragraph BC 11 of the DI.

  Furthermore, we do not understand the reason why the Board rejected this first recommendation: indeed, NCI puts are very different from other derivatives written on an entity's own equity instruments and are not used for the same purposes, or in the same circumstances. We would also remind the members of the IFRIC that the original paragraph IAS 32.23 was the subject of a strong dissenting opinion in the final standard.
  Moreover, our reading of paragraph IAS 32.23, is that this was drafted primarily to deal with put options written on the reporting (or parent) entity's own equity instruments, and the application of this to those belonging to the NCI of a subsidiary in a consolidation, which is a treatment arrived at by analogy, may not have been contemplated at the time. We suspect therefore that the potential consequences on NCI puts had not been analysed deeply and appropriately at the time.
  Before going any further with the DI, it is therefore necessary, in our view, for the Committee first to consider whether the Board originally intended that variations in the value of the puts over the entity's own equity be treated in profit or loss. Although the Illustrative Examples provided in IAS 32 indicate use of profit or loss, these are not part of the mandatory standard and we are not convinced that they reflect the Board's express intention, as discussed below.
  Having resolved that issue, the Committee should then go on to consider whether

application of such an interpretation to NCI puts is in fact itself a proper interpretation of the standard before going any further with developing this aspect of the DI. This is a further indication that the topic of the DI is far from simple, and that all aspects must be dealt with if this is to be resolved successfully.

- Finally, in our view, the Board has at no time provided a convincing argument that the quality of financial information will be improved by the solution proposed. We are aware that some members of both the IASB and the IFRS Interpretations Committee feel quite uncomfortable with the proposed outcome.
  However, we understand that these members have chosen to follow the possibly flawed logic of current standards, in order to not convey a misleading signal about the value of the technical conclusion of the Interpretations Committee.

  We are very concerned by this approach, as, in our view, it may lead to a devaluation of the standards themselves: if current standards do not provide relevant information but are left uncorrected, one might legitimately conclude that the standards as a whole are not appropriate and need to be amended in order to meet the criteria for a set of high-quality accounting principles.
  One might also question the validity of an interpretation in which the basis for conclusion (BC11) mentions serious doubts expressed by those who have drafted it.

  Finally, the Board has been known to change standards when their outcomes were judged to be irrelevant. Application of this DI provides an illustration of one such case: the example of a fair value put option based upon the performance of the subsidiary. It would require a profit to be recognized when the subsidiary's financial situation deteriorates and a loss to be recognized in the case of an improvement in its performance. We believe that this is as irrelevant and counter-intuitive as to recognize a gain when the entity's own credit risk deteriorates, and this was recognized by the Board in arriving at the solution of the optional use of OCI in IFRS 9. We see no reason therefore why subsequent changes in the put liability should be recognized in net income.

2. Technical concerns

- It seems to us that a preliminary analysis of a sample of the different uses of NCI puts and their economic effect is a unavoidable prerequisite before any conclusion can be reached about the appropriateness of the accounting solution.
  Indeed, all NCI Puts are not identical, and therefore it is likely that they should not all have the same accounting treatment. We think that what we perceive to be the current trend of the IASB and IFRIC Board, that is, to impose uniform accounting treatment, is neither helpful nor desirable. We expressed this concern in our recent letter to the Trustees about the draft Due Process Handbook, as follows: *Comparability, which can be artificial and misleading*

where there is a valid reason for differences, should not be considered as the main and sole objective; predominance should be given to relevance and economic substance.

We therefore support the approach that EFRAG has proposed, which is to consider that it is essential to understand the substance of transactions before determining what should be the appropriate accounting treatment, and which acknowledges that different accounting models may cohabit if necessary to reflect differences in substance.

- We provide the following different situations involving NCI Puts as illustrative examples. We have also noted the questions that we think are raised by these different examples. :

    - *Example 1: NCI put for use in case of deadlock*

      Entity A had included an NCI call and an NCI put as part of the establishment of an industrial partnership (construction of a factory for the purposes of the two partners - not in the context of an acquisition / business combination).

      Entity A holds 70% of the equity instruments, but all decisions are taken unanimously, and the board is constituted 50/50 of representatives of both partners. Governance is is therefore shared 50/50. However, in case of serious disagreement with the partner, entity A can trigger the deadlock process stipulated in the contract which ultimately gives it the right to redeem securities held by the partner. The partner will be forced to sell its shares to entity A., Thus one may conclude that the entity holds exclusive control because the entity may exercise a call option at any time in case of deadlock. This call is in essence a substantive right giving control to entity A;

      The mirror of this call is the put option held by the partner who also can, in case of serious disagreement, require entity A to repurchase its shares. This put is essentially a protective measure provided to the minority shareholder who can exit the partnership in which it has given up control by awarding the call option to entity A.

      Upon exercise, the call or put option will be at fair value.

⇨ Even if the call option is considered to amount to exclusive control for entity A (because this potential right is substantive as described in IFRS 10), it does not mean that the call or the put option is likely to be exercised. Indeed, it would be better for both of the partners to avoid triggering the deadlock situation: one would lose its industrial capacity and the other would lose cash and the capacity to absorb fixed costs provided by the other partner. Such a low probability of exercise should at least be taken into account in deciding whether to recognize a liability.

⇨ Furthermore, this example illustrates the lack of symmetry of accounting method between the NCI put, accounted for as if it were a gross liability, and the NCI call, accounted for as a derivative.

- *__Example 2: NCI put which is not substantive__*

  Put options are often issued at the request of minority shareholders who wish to ensure a potential exit route, with pre-negotiated conditions that will make their interest "liquid"

  Entity A has provided a put option to the minority shareholders who hold 34% of the subsidiary. This put option has no fixed term and its exercise price includes a 20% discount compared to the market value of the equity instrument.

⇨ When the partner has no interest in exercising the put (because of the 20% discount), what is the relevant information provided to the user by accounting for a financial liability?
This example also raises the question of those Put options whose particular features make them non-substantive. If we refer to IFRS 10 and the features it defines for potential rights to be considered as substantive, it seems that since such a put option is very unlikely to be exercised, it should therefore not be considered as to be a debt.

- *__Put option required by minority shareholders to balance the call option they consent to the acquirer__*

During a Business combination, the acquirer may want a guarantee on the future sale of NCI, to ensure both its ability to acquire and the price to be paid for a potential future purchase of the NCI. For that, the acquirer requires a call option. Faced with this demand, the seller also usually wants to have a symmetrical guarantee to sell if he wants to and at an acceptable price. He therefore asks for a put option;

⇨ One may question the absence of symmetry between the accounting for the put option on the one hand and the call option in the other. We believe that to recognize a liability for the former and only a derivative for the latter (which will be equal to nil because of the fair value price) does not improve financial information provided to users.

⇨ This case illustrates that NCI puts are not usually akin to a liability with deferred payment; they are not at the acquirer's initiative and represent only a guarantee for the seller that should be accounted for symmetrically with the guarantee held by the acquirer with its call option.

- *__NCI Put proposed by the acquirer to guaranty minority shareholders' interest in the forthcoming business__*

The purpose of this is to involve the seller in the acquired business until its complete disengagement through the exercise of the NCI put and to allow it to enjoy an earn-out. These cases may possibly be assimilated to deferred payment of a commitment *from the business combination. This is one set of circumstances for which we may agree that changes in the valuation of the liability should be recognized through net income.*

- **Other technical concerns :**

The main argument of the DI appears to be that the change in debt measurement is not in itself a transaction between shareholders (paragraph BC8) and therefore cannot be recognized thought equity.

We do not accept this justification as we believe it is far too expeditious and superficial. In fact, we too do not believe that changes in the debt measurement are transactions between shareholders; nonetheless, we believe that this does not preclude recognition thought equity for the following principal reasons:

- The application of paragraph IAS 32.23 leads to an outcome similar to that which would be obtained if the NCI's holding had been effectively acquired. If one considers that when the put is agreed there has been a transaction which is more than the granting of a derivative –that is, the purchase of the NCI's holding - then one must pursue this assumption to its logical conclusion and account for all its consequences consistently : It is thus necessary to cancel the non-controlling interest in the equity of the consolidated entity, adjusting for the difference between the cost of the shares "acquired" and the corresponding share in the equity. Going forward, there should be no allocation of the net profit or loss to the NCI, and any dividends paid to the NCI should be deducted in arriving at the net profit or loss.
  In this case, the transaction is treated as an acquisition with deferred payment of consideration in line with the relevant accounting under IFRS3 depending upon when the transaction is deemed to occur (taken into account when assessing goodwill if it occurs on the date of control being obtained or as an adjustment to equity if the transaction occurs after control has been obtained). If the option is not exercised then the liability is cancelled with the effect taken through equity as required by IAS 32.23. However, the whole current accounting treatment is inconsistent, as the NCI put is considered sometimes like an equity transaction (at initiation and termination) and at other times like a mere financial liability (with remeasurements recognised though net income and net income still allocated between Group and NCI).

  In fact, in finalising IAS 32.23 the IASB made two exceptions from the principles of IAS 39 for the accounting for put derivatives relating to the entity's own shares: in accounting for the initial transaction as a gross liability with a transfer from equity (instead of being treated as a derivative) and in requiring the extinguishing of this debt on the lapsing of the option without exercise to be transferred in its entirety to equity (instead of being taken to profit and loss in accordance with [IFRS 9.3.3.3/IAS

39...]. In view of these exceptions relating to the initiation and termination of the deemed liability, we think that it is reasonable to treat the variations in the deemed liability in the same way, that is, also through equity.

- *As an aside to this above comment, we would also indicate that we do not agree that all variations in contingent consideration should systematically be recognised in profit or loss, as this treatment will not always provide the most relevant information. We are therefore following closely both the IFRS Interpretation Committee's debates on the treatment of contingent consideration in respect of tangible and intangible fixed assets and the IASB's discussions on the leases project, in which variable lease payments might in certain circumstances be reflected as changes in the value of an asset.*

- Moreover, one may also argue that even if the variations in the measurement of the liability are not in themselves transactions with other owners, they could follow by analogy the principle established in IFRIC 17. This Interpretation requires variations in the fair value of a dividend to be taken to equity since they represent a change in the value of the initial liability.