International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

28 September 2012

Dear Sir or Madam,

Re: Draft Interpretation DI/2012/2 Put Options Written on Non-controlling Interests

We are writing in response to your invitation to comment on the draft interpretation DI/2012/2 *Put Options Written on Non-Controlling Interests.*

In summary, BUSINESSEUROPE disagrees that subsequent measurement of an NCI put liability should be through profit or loss. We believe that the arguments for this treatment included in the basis of conclusions do not consider the economics of the transaction and are conceptually flawed.

We believe a more appropriate solution would be to record such changes through equity, or to reconsider whether a financial liability exists in the first place, i.e. to treat the NCI put as a derivative.

We acknowledge this is a complex area and therefore propose that the Board address this issue more comprehensively in the financial instruments with characteristics of equity (FICE) project. In the meantime companies should continue to disclose their current treatment (i.e. profit or loss vs equity) in their accounting policies.

Whilst one may argue that this will not solve the perceived issue of divergence in practice it should not exacerbate the problem and is better than trying to “fix” this issue with a short-term solution which, at a later stage, may be considered to be inappropriate.

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The current drafting of the interpretation does in our view not explain sufficiently the thought process of the Interpretation Committee ("IFRIC") and we therefore cannot really comment on why the IFRIC reached the conclusion it did with respect to several of the questions discussed (see e.g. our answer to question 2).

We therefore strongly suggest that the basis of conclusion is significantly enhanced so that constituents can comment on these arguments before any further steps are taken.

We explain further below by answering the questions in the draft interpretation.

If you would like to discuss any of the matters raised in this letter, please do not hesitate to contact us.

Yours sincerely,

Jérôme P. Chauvin
Director
Legal Affairs and Internal Market

BUSINESSEUROPE

QUESTIONS

Question 1 – Scope

We agree that NCI puts written as part of contingent consideration under IFRS 3 should be excluded from the scope. However, we believe that the limitation to "the parent's consolidated financial statements" in relation to "put options that oblige the parent to purchase shares of its subsidiary" is an unhelpful restriction. This DI is an interpretation of IAS 32.23 which deals explicitly with puts over an entity's own equity. As explained below, it is far from clear that variations in the value of such puts should be dealt with in profit or loss. It is therefore necessary to proceed by logical steps: first to confirm the treatment of variations in the value of own-equity puts, and only then proceed to the potential second step of considering the appropriateness of applying that same treatment by analogy to NCI puts in a consolidation. For the sake of clarity, we confirm that we do not think that IAS 32 requires variations in the value of either type of put to be <u>recognized</u> in profit or loss, and it would be counter-intuitive and conceptually unsound to do so.

Question 2 – Consensus

<u>Point 1 - Paragraph 7 – Subsequent changes through profit or loss according to IAS 39 or IFRS 9</u>

We disagree with the above statement in paragraph 7. We believe that IFRIC is applying an overly simplified process in addressing the issue. Only applying what is written in one part of the IFRS literature, seemingly ignoring other parts, is not interpreting (i.e. questioning what is the background and has been the purpose of the guidance as currently reflected in standards) and is clearly not the best approach for finding a solution that will reflect the true nature and economics of the transaction. Indeed, in this particular case it does not.

At the outset of the debate, one must recognize that this is not a "normal" financial liability, which is evidenced by three facts:

(a) the classification as a financial liability is based on the fiction, which assumes that the option has been exercised, i.e. representing an "as if" liability, which is a fundamentally different starting point and inconsistent with "normal" financial liabilities as a typical loan at amortised cost or a derivative liability at fair value that will definitely be settled at maturity. This view was expressed in the dissenting opinion of J. Leisenring on the issuing of IAS 32 in 2003 which made it clear that recording a liability in this way is inconsistent with the Framework as there is no present obligation for the strike price (IAS 32.DO1).

(b) Further, paragraph 23 of IAS 32 requires initial measurement to be the present value of the redemption amount (rather than fair value), which again indicates that this is a liability that is different from "normal" financial liabilities.

(c) Finally, IAS 32.23 continues by stating that the liability should be subsequently measured (NB not accounted for) in accordance with IAS 39, which requires amortised cost to be used for financial liabilities other than those classified as at fair value through profit or loss (FVTPL) (IAS 39.47). To be classified as a liability at FVTPL it must either be held for trading or designated as such by the entity at inception, neither of which is likely in the case of NCI puts. The treatment of gains or losses in respect of financial liabilities carried at amortised cost is defined in IAS 39.56: "recognized in profit or loss when…derecognized or impaired, and through the amortization process". However, IAS 32.23 provides an exception to this accounting as it requires reclassification of the carrying amount of the "as if" liability to equity, not profit or loss, when it expires without delivery.

If one accepts that the transaction we are dealing with does not represent a normal financial liability and IAS 32 already provides a specific exemption to how normal financial liabilities are accounted for, it seems only logical to assume that the accounting in between should not simply follow the logic of a normal liability. We therefore believe that under any circumstances such an "as if" liability warrants its own complete accounting model and therefore strongly disagree with the claim that this would introduce another exception to IAS 32 and IAS 39, as in fact it would just resolve an issue and ensure consistent accounting throughout the life of this "as if" liability.

In interpreting the currently existing guidance, we would have expected the IFRIC to reflect that if recognition and derecognition of the NCI put liability are specified by IAS 32 as exceptions to normal accounting under IAS 39, in that the opposite side of the entry is made to equity, and, given that IAS 32 does not specify the accounting model for the intervening period one may justifiably wonder whether the Board intended that all intervening changes should also go to equity and interpret the existing IFRS literature to its full extent to reflect this.

Point 2) - Paragraph 8 - There is no change in ownership interest and therefore this is not an equity transaction

We disagree with the above statement in paragraph 8. In our view, there are two possible ways to analyse the situation:

1) there is no change in ownership interest when the option is written; and

2) there is a change in ownership transaction at the time the option is written.

Ad 1) "No change in ownership"

The IFRIC argues in paragraph 8 of the DI that the "changes in measurement of that financial liability do not change the relative interests in the subsidiary that are held by the parent and the non-controlling-interest shareholder and therefore are not equity transactions (ie they are not transactions with owners in their capacity as owners) as described in paragraph 30 in IAS 27 (...)".

First of all, we believe that the IFRIC is mixing two things in that sentence. The questions (i) if there is a change in ownership and (ii) if the transaction is with "owners in their capacity as owner" cannot be considered to be the same, as obviously several different types of transactions can take place where owners act in their capacity as owner and no change in ownership takes place. Consequently, just because no change in ownership is assumed, it does not mean that it is not an equity transaction.

The change in value of the option written actually reflects exactly the fact that the owners of the entity are acting in their capacity as owners and reflect this in the fact that the price that will eventually be settled will depend on what happened between writing the option and the exercise date (see also below "Other Comments"). The exercise of the option by one owner is obviously done in its capacity as an owner and IAS 1.106(d) and IAS 1.109 clearly state how changes resulting from such transactions are to be accounted for. In its July 2009 Agenda Decision on Transactions Costs for NCI, the IFRIC correctly followed that logic and did not discuss if IAS 32, IAS 27 or IFRS 3 would be the relevant guidance, but rather correctly reflected on the overarching guidance included in IAS 1.

Ad 2) "Change in ownership"

The DI assumes that the triggering event for the transaction is a change in ownership interest which occurs upon exercise of the option. However it can be argued that because at inception of the NCI put, both the parent and the NCI shareholder agree on the terms of the instrument and sign a contract, that this is a more appropriate time to recognize that there has been a transaction between owners. Indeed, IAS 32 implies that this event is equivalent to a transaction between owners since it requires the booking of a financial liability for the present value of the redemption amount with a corresponding debit to equity.

Moreover, the justification for the liability is the assumption that the option will be exercised.

- If this assumption is wrong then there should be no liability booked at inception and the instrument is treated as a derivative.
- If this assumption is valid then it might be appropriate to require a liability to be recorded, as per the exception in IAS 32.23, for the present value of the redemption amount. However, to assume that the option will be exercised to justify the requirement of IAS 32:23 and the recognition of the liability but then to assume it will not be exercised when considering if this is a transaction between owners is inconsistent and counter-intuitive.

In addition, there is clearly the assumption inherent in IAS 32 that a change of ownership interest takes place at some stage between the initial agreement and the exercise of the put option in order to justify the recognition of the liability. Paragraph 31 of IAS 27 requires that "Any difference between the amount by which the non-controlling interests are adjusted and the fair value consideration paid or received shall be recognized directly in equity and attributed to the owners of the parent." The standard does not make any distinct reference to the relative timing of the change in ownership interest and the settlement.

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Question 3 – Transition

Since we do not agree with the proposed interpretation we cannot comment on the transition.

Other comments

<u>Accounting should reflect the economic reality</u>

The IASB indicated that it did not want to change IAS 32, because puts on NCI are not different from other puts on own equity instruments (BC11). We do not agree with this as we believe NCI puts and puts on own shares are likely to be different transactions with different motivations, both from an economic and operational standpoint.

The motivation for many written puts over NCI is that the parent wants to buy out the NCI and the NCI shareholder wants to sell, i.e. this is a different transaction from the own shares put. Generally there is no premium paid as the strike is usually based on the market price of the shares (since both parties want the transaction to be at fair value). If the subsidiary is not listed then this can mean some type of fair value formula, e.g. EBITDA multiple. This feature could introduce significant volatility in profit or loss when compared to puts over own shares as illustrated in the simple example below.

	Liability At inception	**Liability Year 1**	**Liability Year 2**	**Liability Year 3 (settled)**
(i) NCI put (strike @av. EBITDA for last 3yrs x 8)	$500m (estimate)	$350m (estimate)	$600m (estimate	$500m (actual)
Impact in Profit or Loss	-	$150m gain	$250m loss	$100m gain
(ii) Put over own shares (strike $100/share x 50m shares)	$500m	$500m	$500m	$500m
Impact in Profit or Loss	-	-	-	-

(Time value ignored).

If the NCI put is not exercised then the $500m liability is credited back to equity. However, a user would have seen significant volatility in years 1 to 3. If the NCI put was written at the time of an acquisition then a gain would arise when the acquired business performs below expectations (NCI liability is reduced) whereas a loss is likely to arise when the acquired business performs above expectations (NCI liability is increased). How can this counter-intuitive result be explained to management and shareholders in terms of the qualitative characteristics of the framework, namely understandability and reliability?

<u>Inconsistency between IAS 27 and IAS 39</u>

The inconsistency arising from the application of IAS 27 (no impact in P&L for a transaction between equity owners) and those prescribed under IAS 39 / IFRS 9 (subsequent measurement via profit and loss) is not unique . The same inconsistency exists when accounting for intangible assets acquired via a business combination, for which contingent consideration relating to milestones associated with the same intangible asset(s) is required to be measured via profit or loss rather than being recognized as part of the original intangible asset . We note that the IFRIC put on hold the question on accounting for contingent consideration related to IAS 16 and IAS 38 transactions.

Complications of the “as if” approach of IAS 32 - Group perspective

The premise of IAS 32 that the writing of an option over the entity’s own shares requires the recognition of a liability as though a change of ownership has occurred leads to more complications when extended by analogy to NCI shares in a consolidated group. The questions raised include:

- Is the initial debit to the parent’s equity or the NCI’s equity? If the put is for the whole of the NCI interest, is there no NCI to be presented within equity?
- If gains and losses are recognized in profit or loss, are they entirely attributable to the parent or proportionately to the NCI in the subsidiary?
- Are distributions paid to the NCI deducted from the parent’s equity (to reflect the notional change of ownership interest) or from NCI’s equity?

These points further illustrate why it would be sensible to cover this debate in a wider context. Finally, while the short term solution proposed would reduce diversity in practice this should not be at the expense of inappropriate accounting which does not follow the economics of the transaction.

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