EFRAG
European Financial Reporting Advisory Group

[Draft Comment Letter]

Comments should be submitted by 19 September 2012 to commentletters@efrag.org

XX October 2012

Mr Wayne Upton
IFRS Interpretations Committee
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir,

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

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Draft Interpretation (D1/2012/2) *Put Options Written on Non-controlling Interests* issued by the IFRS Interpretations Committee ('the Interpretations Committee') on 31 May 2012 (the 'Draft Interpretation').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS in the European Union and European Economic Area.

The Draft Interpretation addresses the subsequent measurement of put options written on shares held by non-controlling shareholders ('NCI puts') in the consolidated financial statements of the parent entity. The scope of the Draft Interpretation includes only NCI puts that oblige a parent entity to pay cash or another financial asset for the NCI shares which give rise to a financial liability as defined in IAS 32.

EFRAG agrees that diversity in practice exists in accounting for the subsequent measurement of the financial liability that is recognised in a parent entity's consolidated financial statements for an NCI put. The diversity arises from a perceived inconsistency in existing IFRS guidance for measuring financial liabilities under IAS 32 and the accounting for transactions with owners in their capacity as owners under IFRS 10/IAS 27. Therefore, EFRAG supports the Interpretations Committee's efforts to address the issue.

However, we have a number of significant concerns (that are described in detail in the Appendix) regarding the proposals and the use of an Interpretation to resolve the issue.

In our view, the scope of the Draft Interpretation is too narrow, as it does not address all relevant aspects of accounting for derivatives written over non-controlling interests, including whether or not NCI should be derecognised when the financial liability for the NCI put is initially recognised, and accounting for similar transactions involving NCI. EFRAG believes that diversity in practice will continue, and further diversity might emerge, unless these related issues are also addressed in a manner consistent with existing IFRS.

Overall, we believe that the Draft Interpretation should address the complexity and broad range of issues arising from transactions with NCI, including NCI puts, in a manner that is consistent with the principles underlying IFRS 3, IFRS 10/IAS 27, IAS 32 and IFRIC 17 as this would result in a more robust and principles-based solution. These broader issues have been noted on multiple occasions by the Interpretations Committee and the IASB. If the Interpretations Committee is unable to develop such an interpretation, they should report back to the IASB who should consider prioritising their project on financial instruments with characteristics of equity, including a comprehensive review of the accounting for NCI puts and similar instruments, including aspects of initial and subsequent recognition in that project.

If you would like to discuss our comments further, please do not hesitate to contact Benjamin Reilly or me.

Yours sincerely,

Françoise Flores

EFRAG Chairman

APPENDIX

General comments

Notes to EFRAG's constituents

1 *The Draft Interpretation addresses the subsequent measurement in consolidated financial statements of an NCI put written by a parent.*

2 *NCI puts arise most frequently as part of business combinations, where they are used (1) to facilitate an acquisition in stages for tax reasons, (2) as a form of contingent consideration, (3) as a form of employee remuneration to maintain the involvement of the former owner of a newly acquired subsidiary or (4) as a mechanism for providing an orderly exit in case of disagreements. In addition NCI puts also exist in the context of share-based payments, as part of the equity structure in venture capital investments and to provide liquidity to minority shareholders in unlisted subsidiaries. The exercise price of NCI puts depends on the purpose of the instrument and may be (1) fixed, (2) at the market value of the underlying stake or (3) based on a formula (e.g. five times EBITDA or net asset value).*

3 *Paragraph 23 of IAS 32 requires an obligation by an entity to purchase an equity instrument (in this case shares in a subsidiary currently held by external shareholders) for cash or another financial asset to be recognised in the consolidated financial statements as a financial liability at the present value of the redemption amount. Therefore a liability in relation to an NCI put is not accounted for as a derivative and recognised at the fair value of the option, but is measured gross at the present value of the expected cash outflows. The debit side of the journal entry is to equity but IFRS does not specify where.*

4 *Diversity in accounting for NCI puts arises in practice on both initial recognition and measurement of changes in the liability. On initial recognition, some preparers take the initial debit to the NCI (and in some cases completely derecognise NCI). Others recognise the debit elsewhere in equity. The Interpretations Committee, as noted in paragraph BC13 of the Draft Interpretation, chose not to address this element of diversity in practice.*

5 *In relation to changes in the measurement of the financial liability recognised for the NCI put:*

(a) *Some preparers recognise the remeasurement of the liability in profit or loss as paragraph 23 of IAS 32* Financial Instruments: Presentation *requires that the financial liability is subsequently 'measured in accordance with IFRS 9'.*

(b) *Other preparers recognise remeasurements of the liability directly in equity as paragraph 30 of IAS 27* Consolidated and Separate Financial Statements *requires that '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 (i.e. transactions with owners in their capacity as owners).' This paragraph was retained in IFRS 10* Consolidated Financial Statements*.*

6 *The Draft Interpretation addresses the diversity in recognition of changes in the measurement of the NCI put liability by requiring recognition in profit or loss.*

Consistency with other IFRS literature

7 We are concerned that the Interpretations Committee has chosen, as noted in paragraph BC13 of the Draft Interpretation, not to address the wider issues involved with accounting for NCI puts and similar contracts. The Interpretations Committee has instead concluded that the only solution is to recognise subsequent measurement of the NCI put liability in profit or loss, without having carefully considered the guidance in existing IFRS literature that addresses NCI accounting and transactions with owners, and whether the proposals are consistent with existing IFRS literature. For example:

(a) IFRS 10/IAS 27 regards NCI as 'equity' in the consolidated financial statements, and after control of an entity is obtained, requires changes in a parent's ownership interest that do not result in a change in control to be accounted for as equity transactions in the consolidated financial statements. IFRS 10 says such transactions are transactions with owners in their capacity as owners, and prohibits the recognition of gains or losses arising on such transactions in profit or loss. In relation to NCI puts, a key question is whether the transaction is with an owner in its capacity as owner, particularly if the NCI has not been derecognised in the consolidated financial statements.

(b) NCI puts may be issued as part of a share-based payment transaction. This could have the economic impact of converting an equity-settled share-based payment to a cash-settled share based-payment. Simply requiring remeasurement of the NCI put liability in profit or loss could conflict with the requirements of IFRS 2 *Shared-based payment*.

(c) Similarly, some NCI puts are a form of contingent consideration in a business combination, which in our view should be accounted for in the same way as other contingent consideration under IFRS 3 (2008) *Business Combinations*.

8 In summary, we believe it is inappropriate to make changes to existing IFRS literature before all aspects of NCI puts and similar contracts have been further investigated. We believe that the Draft Interpretation should address the complexity and broad range of issues arising from transactions with NCI, including NCI puts, in a manner that is consistent with the principles underlying IFRS 3, IFRS 10/IAS 27, IAS 32 and IFRIC 17 *Distributions of Non-cash Assets to Owners* as this would result in a more robust and principles-based solution. In particular, EFRAG believes that the Interpretations Committee should consider the accounting for mirroring put/call options, forward contracts and contingent consideration arrangements related to NCI, as well as the question whether NCI should be derecognised in the aforementioned situations. Some EFRAG members believe that to be consistent with IFRS 10 and IFRIC 17, a key question is whether the writing of an NCI put by an entity to an NCI shareholder should be considered a transaction with an owner in its capacity as owner, particularly if the NCI is not derecognised in the consolidated financial statements.

9 If the Interpretations Committee is unable to develop such an interpretation, they should report back to the IASB who should consider prioritising their project on financial instruments with characteristics of equity, including a comprehensive review of the accounting for NCI puts and similar instruments, including aspects of initial and subsequent recognition.

Is subsequent measurement of an NCI put liability the right starting point?

10 While we recognise that the potential inconsistency in the remeasurement of the financial liability is the primary question posed to the Interpretations Committee,

we believe that there are related questions on the accounting for the initial recognition of NCI puts for which diversity might also exist in practice (e.g. which component of equity should be debited when a financial liability is recognised and should NCI be derecognised).

11 Some believe that, in accordance with IAS 32, the NCI that has been recognised when the underlying subsidiary was initially consolidated should be debited (derecognised). In their view, the diversity in practice arises with the subsequent measurement of the NCI put liability and the issue is whether IAS 32 should be applied also to subsequent measurement.

12 However, others believe that IFRSs are not clear about whether it is the NCI or another component of equity that should be debited when the NCI put liability is recognised. In their view, this is a fundamental question that needs to be addressed before developing guidance on subsequent measurement.

13 Paragraph B90 of IFRS 10 states that there may be circumstances in which a parent has 'an existing ownership interest as a result of a transaction that currently gives the entity access to the returns associated with an ownership interest'. In such circumstances the NCI should be derecognised to the extent it would be when the transactions (e.g. forward contracts) are exercised. No further guidance is given in existing IFRS on identifying an existing ownership interest and which facts and circumstances should be considered in making that assessment. EFRAG's discussions with European National Standard Setters have confirmed that there is current diversity regarding the circumstance in which NCI is derecognised upon recognition of an NCI put. EFRAG believes that the Draft Interpretation should not just address subsequent measurement of the NCI put, but also address whether NCI should be derecognised. Some EFRAG members believe that the latter drives other aspects of NCI accounting, such as accounting for payment of dividends to NCI and allocation of profit or loss.

14 EFRAG believes that to address diversity in practice effectively, the Draft Interpretation should also address accounting for forward contracts and mirroring put/call options.

15 Finally, EFRAG notes that there could be a range of factors to consider when determining whether the parent has acquired a current economic ownership in the underlying NCI shares. In the context of an NCI put option these include:

(a) Whether the exercise price is dependent upon future results of the entity (e.g. by referencing to fair value or a business value proxy);

(b) Whether dividend rights are restricted; and

(c) Whether the put was written in conjunction with a mirroring call.

Question to EFRAG's constituents

16 Do you agree that the Interpretations Committee should develop a broader interpretation that is consistent with IFRS 3, IFRS 10/IAS 27, IAS 32 and IFRIC 17 (as recommend in paragraph 8 above)? Please explain why.

17 To what extent do you believe diversity in practice arises on initial recognition of NCI puts? If you are not aware of wider practice, please explain how your organisation accounts for the debit entry of an NCI put liability.

EFRAG's responses to the questions asked in the Draft Interpretation

18 Although EFRAG's recommendation to the IFRS Interpretation Committee is not to pursue any interpretation based on the current draft, EFRAG has answered the questions in the Draft Interpretation and include a technical analysis of the issues presented below.

Question 1 – Scope

The Draft Interpretation would apply, in the parent's consolidated financial statements, to put options that oblige the parent to purchase shares of its subsidiary that are held by a non-controlling-interest shareholder for cash or another financial asset (NCI puts). However the Draft Interpretation would not apply to NCI puts that were accounted for as contingent consideration in accordance with IFRS 3 *Business Combinations* (2004) because IFRS 3 (2008) provides the relevant measurement requirements for those contracts.

Do you agree with the proposed scope? If not, what do you propose and why?

Notes for EFRAG's constituents:

19 *The Draft Interpretation is limited to the accounting in the parent's consolidated financial statements for NCI puts written by that parent when it has an obligation to pay cash or another financial asset for the NCI shares. Therefore it does not address NCI puts that are settled by delivery of non-financial assets or own equity.*

20 *The Draft Interpretation excludes from its scope NCI puts accounted for as contingent consideration under IFRS 3 (2004). Under IFRS 3 (2004) a change in the amount payable for an acquisition resulted in a change in the measurement of goodwill. IFRS 3 (2008) requires such changes to be recognised in profit or loss, but the standard only applied to acquisitions made after the standard was applied by an entity. As such, changes in contingent consideration for acquisitions accounted for under IFRS 3 (2004) continue to be reflected in goodwill.*

21 *IFRS 3 (2008) requires initial recognition of contingent consideration at fair value, with subsequent measurement under IFRS 9* Financial Instruments/*IAS 39* Financial Instruments: Recognition and Measurement*.*

22 *The Draft Interpretation does not explicitly state whether it applies to NCI puts that are in effect contingent consideration payable in a business combination on acquisitions made after adoption of IFRS 3 (2008).*

EFRAG's response

EFRAG thinks that the scope is too narrow in limiting applicability to NCI puts written only by the parent itself.

EFRAG agrees that NCI puts written as part of contingent consideration under IFRS 3 (2004) should be excluded from the scope.

23 As expressed in the general comments above EFRAG disagrees with the scope of the Draft Interpretation, and believes that the Interpretations Committee should address accounting for NCI puts in a wider context and in a manner consistent with existing IFRS. The comments provided below apply in the context of the Draft Interpretation.

24 The Draft Interpretation addresses only NCI puts that are accounted for as gross liabilities in accordance with IAS 32. By considering the accounting for NCI puts in isolation, the proposed scope fails to consider how NCI puts interact with similar transactions involving NCI.

25 In our view, the scope of the Draft Interpretation is too narrow, as it does not address all relevant aspects of accounting for contracts written over non-controlling interests in a manner that is consistent with the principles underlying IFRS 3, IFRS 10/IAS 27, IAS 32 and IFRIC 17. These include common situations where NCI puts interact with mirroring call options, the use of NCI puts in contingent consideration and employee remuneration, and determining whether or not the NCI should be derecognised in the consolidated financial statements. EFRAG believes that diversity in practice will continue to exist, and further diversity might emerge, unless these related issues are also addressed in a manner consistent with existing IFRS. Therefore, the scope of the Draft Interpretation should be widened.

NCI puts as contingent consideration

26 EFRAG agrees that NCI puts accounted for as contingent consideration under IFRS 3 (2004) should continue to be accounted for by changing the cost of investment, as required by IFRS 3 (2008), as this is consistent with the decisions taken when IFRS 3 (2008) was adopted.

27 EFRAG believes that it would aid understanding of the Draft Interpretation if the final sentence in paragraph 5 of the Draft Interpretation explicitly referred to paragraphs 65A to 65E of IFRS 3 (2008).

28 The Draft Interpretation does not state whether it applies to NCI puts that are in effect contingent consideration in a business combination made after an entity adopted IFRS 3 (2008). EFRAG notes that the 2010-2012 Annual Improvements cycle contains a proposed amendment requiring contingent consideration to be measured at fair value through profit or loss. However, paragraph 7 of the Draft Interpretation allows changes in the financial liability for NCI puts to be measured at either amortised cost or fair value. EFRAG believes the Interpretations Committee should clarify whether NCI puts that are in effect contingent consideration should be accounted for under IFRS 3 (2008) or the Draft Interpretation.

Application only to the parent entity's consolidated financial statements

29 The Draft Interpretation limits its scope to 'the parent's consolidated financial statements' in relation to 'put options that oblige the parent to purchase shares of its subsidiary'. This means that NCI puts written by group entities other than the reporting parent would be outside the scope of the Draft Interpretation. EFRAG believes that this is an unnecessary restriction in the scope of the Draft Interpretation. We therefore suggest that the word 'parent' be replaced by 'entity' as this is consistent with the wording in paragraph 23 of IAS 32 and would therefore cover all NCI puts written by entities within a group.

Question 2 – Consensus

The consensus in the Draft Interpretation (paragraphs 7 and 8) provides guidance on the accounting for the subsequent measurement of the financial liability that is recognised for an NCI put. Changes in the measurement of that financial liability would be required to be recognised in profit or loss in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments*.

Do you agree with the consensus proposed in the Draft Interpretation? If not, why and what alternatives do you propose?

Notes to EFRAG's Constituents

30 *EFRAG has not reached a consensus on whether it believes remeasurement in profit or loss is appropriate. This Draft Comment Letter therefore sets out the views of EFRAG members and asks constituents for their comments.*

EFRAG's response

31 The views of EFRAG members can be summarised as follows:

(a) View 1: Remeasurement in profit or loss is appropriate in all circumstances (the approach taken in the Draft Interpretation);

(b) View 2: Remeasurement in profit or loss is not appropriate; and

(c) View 3: Remeasurement in profit or loss is only appropriate in some cases.

View 1 – Remeasurement in profit or loss is appropriate in all circumstances

32 Some EFRAG members believe that the accounting for NCI puts should be consistent with that for other contracts written on an entity's own equity. In their view, the accounting in IFRS 10 for transactions with NCI (in their capacity as owners) does not apply to the measurement and remeasurement of a financial liability.

33 These EFRAG members consider that as an NCI put gives rise to a financial liability, it follows that the remeasurement of the financial liability should be recognised in profit or loss, in accordance with IAS 32 and IFRS 9/IAS 39. Specifically, they believe that the Draft Interpretation is consistent with paragraph 23 of IAS 32, which addresses classification of put options and forward contracts that oblige an entity to purchase its own equity instruments. Paragraph 23 of IAS 32 requires subsequent measurement in profit or loss, in accordance with IFRS 9/IAS 39.

34 To the extent that one might believe that the underlying shares and the NCI put should be considered as a single instrument, these EFRAG members note that an NCI share with a separate put option is economically equivalent to a puttable share. On this basis, the accounting requirements for NCI puts should be consistent with the requirements for puttable financial instruments (paragraphs 16A to 16F of IAS 32). That is, if a subsidiary issues puttable shares, those shares are classified as liabilities in the consolidated financial statements and subsequent changes in the financial liability will be accounted for in profit or loss.

35 Conversely, if NCI puts are to be considered separately, these EFRAG members note that 'owners' are defined by paragraph 7 of IAS 1 as 'holders of instruments

classified as equity'. In other words, a party in its capacity as a holder of an NCI put is not an 'owner' by virtue of the fact that a written put option is a liability.

36 These EFRAG members also note that paragraphs 4.47 and 4.49 of the Conceptual Framework for Financial Reporting states that income (expense) is recognised when a liability decreases (increases). Therefore any changes in the liability recognised for an NCI put should result in recognition of income or expense to be consistent with the Conceptual Framework.

View 2: Remeasurement in profit or loss is never appropriate

37 Some EFRAG members believe that accounting for changes in the liability in equity would be appropriate in all cases. In their view, recognition of changes in profit or loss of a liability intrinsically linked to equity is not consistent with the Interpretations Committee's decisions when developing IFRIC 17. Recognition in equity is consistent with IAS 1 *Presentation of Financial Statements* which specifies that transactions with owners in their capacity as owners should not be reflected in the income statement.

38 They further note that IFRS 10/IAS 27 regards NCI as equity in the consolidated financial statements, and after control of an entity is obtained, requires changes in a parent's ownership interest that do not result in a change in control to be accounted for as equity transactions in the consolidated financial statements. IFRS 10 refers to such transactions as transactions with owners in their capacity as owners, and prohibits the recognition of gains or losses arising on such transactions in profit or loss. In relation to NCI puts, a key question is whether the transaction is one with an owner in its capacity as owner, particularly if the NCI is not derecognised in the consolidated financial statements.

39 As discussed in paragraph 13 above, existing IFRS provide limited guidance on when NCI should be derecognised. Paragraph 23 of IFRS 10 states that 'changes in a parent's ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary are equity transactions (i.e. transactions with owners in their capacity as owners)'. Paragraph BC8 of the Draft Interpretation argues that paragraph 23 of IFRS 10 gives guidance on the accounting in circumstances in which the respective ownership interests of the parent and the non-controlling interest shareholders change. Therefore, the Interpretations Committee concluded that paragraph 23 is not relevant to the remeasurement of the NCI put liability.

40 These EFRAG members disagree with that argument and the conclusion set out in paragraph BC8 because, in their view, an NCI put contract involves a change in the ownership of a subsidiary that does not result in the parent losing control of the subsidiary, but the 'change' occurs at a later stage – if and when the NCI put option is exercised. In their view, it could be argued that the NCI put is therefore part of the transaction with owners of the entity that triggers the anticipated change in a parent's ownership interest in a subsidiary.

41 Furthermore, these EFRAG members question whether recognition in profit or loss would reflect the economic reality underlying NCI puts and whether the resulting information is decision-useful. In their view, recognition of remeasurement changes in profit or loss results in counterintuitive accounting for NCI puts exercisable at fair value (or an amount determined by a formula, such as a multiple of earnings). An increase in the value of the underlying shares, for example because of improved performance by the subsidiary, results in recognition of a loss and therefore creates an accounting mismatch as the underlying net assets of that subsidiary are not necessarily remeasured.

42 In addition, remeasurement in profit or loss of the NCI put liability would mean the requirements in IFRS 10/IAS 27 on allocation of profit could result in misleading information. In particular:

(a) For fixed price options, although losses may be attributed to NCI the existence of the put may mean no transfer of wealth actually takes place; and

(b) For options where the exercise price is market value or determined by a formula, changes in the liability would be attributed to shareholders of the parent only. Therefore, the profit attributable to the parent entity shareholders is affected twice; first reduced (increased) by remeasurement of the NCI put liability and second it is reduced by attribution of profits to NCI.

43 However, these EFRAG members acknowledge that recognition of remeasurement changes in equity for NCI puts is inconsistent with the accounting under IAS 32 for all other contracts over own equity, including contracts settled net in cash and accounted for as derivatives under IFRS 9/IAS 39. Furthermore, accounting for the remeasurement in equity would be different to that of an economically similar puttable share.

View 3: Remeasurement in profit or loss is appropriate in some cases

44 Some other EFRAG members only agree in some cases that remeasurement in profit or loss is appropriate, while in other cases remeasurement in equity produces relevant information for the reasons explained above in View 2.

45 These EFRAG members believe that recognition of remeasurement changes in profit or loss is appropriate as discussed below.

<u>Where the NCI has been derecognised</u>

46 If a parent entity has determined that it has, in substance, acquired an ownership interest as a result of a transaction that gives it access to the returns associated with an ownership interest then NCI will have been derecognised (paragraph B90 of IFRS 10). As the NCI has been derecognised it is not an owner and therefore paragraph 23 of IFRS 10 does not apply.

47 Paragraph B90 of IFRS 10 states that NCI should be derecognised when an entity has 'an existing ownership interest [in the NCI shares] as a result of a transaction that currently gives the entity access to the returns associated with an ownership interest'. In the context of an NCI put option the facts and circumstances that could be considered in determining whether an entity has a existing ownership interest include whether:

(a) The exercise price is fixed, fair value or formula-based;

(b) The NCI shareholders have given up rights to dividends as part of the put; and

(c) The NCI put option was written in conjunction with a mirroring parent company call option.

48 Those EFRAG members believe that the exercise price of an NCI put should be considered in assessing whether NCI should be derecognised.

NCI put as contingent consideration

49 IFRS 3 (2008) requires that post-acquisition changes in financial liabilities recognised as contingent consideration be recognised at fair value through profit or loss. An NCI put written as part of a business combination is economically similar to contingent consideration and should also therefore not be remeasured through equity.

Other circumstances

50 In other circumstances, those EFRAG members believe that the change in the measurement of the liability should be reported in equity, for the reasons set out in View 2 above.

Questions to EFRAG constituents

51 How do you believe NCI puts should be accounted for? Please explain why.

52 Do you believe that whether or not NCI has been derecognised should determine the accounting for NCI puts? Please explain why.

53 Do you believe that the exercise price of NCI puts (e.g. fixed, fair value or formula-based) should determine the accounting for NCI puts? Please explain why.

Question 3 – Transition

Entities would be required to apply the Draft Interpretation retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*

Do you agree with the proposed transition requirements? If not, what do you propose and why?

Notes to EFRAG's constituents

54 *The Draft Interpretation requires full retrospective application, with no transitional provisions.*

EFRAG's response

EFRAG agrees with retrospective application.

55 EFRAG agrees with the Interpretations Committee's view that entities will not face significant challenges in obtaining the information required for retrospective application. It therefore supports this transition requirement.