

Standard Setting Department
Hong Kong Institute of Certified Public Accountants
37th Floor, Wu Chung House
213 Queen's Road East
Wanchai, Hong Kong

Dear Sir/Madam,


**Response to invitation to comment on IFRS Interpretations Committee ('IFRIC') Exposure
Draft of Put Options Written on Non-controlling Interests**

We are pleased to respond to a draft IFRIC Interpretation titled *Put Options Written on Non-controlling Interests* issued by the International Accounting Standards Board (the IASB).

We welcome the IFRIC Interpretations Committee ('IFRIC') addressing how put options on non-controlling interests ('NCI') should be accounted for in the parent's consolidated financial statements. However, we have *significant* concerns over the proposed scope and accounting treatment set out in the draft Interpretation. In particular, we strongly believe that the Interpretation should cover only derivative contracts on non-controlling interests that meet the definition of 'equity instruments' set out in IAS 32 *Financial Instruments: Presentation*. For derivative contracts on non-controlling interests that do not meet the definition of 'equity instruments', they should be outside the scope of the Interpretation and should be accounted for as derivatives in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* (i.e. measured on a net basis). Please see our responses to Questions 1 and 2, which are set out in the appendix to this comment letter.

If you have any questions concerning our comments, please contact Ms. Monita Tang at (852)2829-9845 or the undersigned at (852)2829-9816.

Yours sincerely,



Lai Ni Hium, Frank
Chief Financial Officer
For and on behalf of the Board
China Resources Enterprise, Limited



Appendix - Our response to the three questions raised in the draft Interpretation

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 assets (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?

Our response to Question 1

We *disagree* with the proposed scope set out in the draft Interpretation.

The proposed scope set out in the draft Interpretation is *too broad*. For instance, it covers the following two different types of put options:

- **Put option 1:** Put options that oblige the parent to purchase a fixed number of shares for a fixed amount of cash; and
- **Put option 2:** Put options that oblige the parent to purchase a fixed number of shares for a variable amount of cash (e.g. the exercise price of the put option is based on the fair value of the interest that the parent has the obligation to acquire at the date when the put option is exercised).

The draft Interpretation proposes the same accounting treatment for both put option 1 and put option 2. This is *inconsistent* with the current literature set out in IAS 32 *Financial Instruments: Presentation* and IAS 39: *Financial Instruments: Recognition and Measurement* that the classification and measurement of derivative contracts that will or may be settled in an entity's own equity instruments depend on whether or not the derivative contracts will or may be settled by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments (i.e. whether the contracts meet the 'fixed-for-fixed requirement' and hence meet the definition of 'equity instruments').

In addition, we do not believe that it is appropriate to account for put option 2 in accordance with the proposed accounting treatment set out in the draft Interpretation. We believe that the scope of the Interpretation should be restricted to put options on non-controlling interests that meet the fixed-for-fixed requirement (please see our response to Question 2 in more details).



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 alternative do you propose?

Our response to Question 2

We *do not agree* that the proposed accounting set out in the draft interpretation should be applied to put options on non-controlling interests that do not meet the fixed-for-fixed requirement.

We noted that paragraph 4 of the draft Interpretation states: 'The[draft] Interpretation applies, 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 other financial assets (NCI puts).'

The draft Interpretation goes on proposing that put options on non-controlling interests that are within the proposed scope of the draft Interpretation would result in a financial liability being recognised and measured on a gross basis based on the present value of the redemption amount in the parent's consolidated financial statements, with the subsequent changes in the carrying amount of the liability being recognised in profit or loss (see paragraphs 7 and 8 of the draft Interpretation).

As mentioned in our response to Question 1 above, the draft Interpretation proposes the same accounting treatment for put option 1 and put option 2. We do not believe that it is appropriate for the draft Interpretation to be applied to put option 2 as we do not believe that the proposed accounting treatment is appropriate for put option 2. Our rationale is explained in more details below, in particular, from the following two perspectives:

- What do the current IFRS requirements say?
- Why does it not make commercial sense to account for put option 2 in accordance with the draft interpretation?



What do the current IFRS requirements say?

IAS 32 *Financial Instruments: Presentation* contains specific requirements as to how a derivative contract that will or may be settled in the entity's own equity instruments should be classified (i.e. equity or derivative liability).

Under IAS 32, the classification of such a derivative contract depends on whether or not the fixed for fixed requirement is met (see paragraph 11 of IAS 32). Specifically, under IAS 32,

- if the fixed for fixed requirement is not met, the derivative contract is required to be accounted for as a derivative in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*; and
- if the fixed for fixed requirement is met, the derivative contract is an equity instrument which is required to be accounted for in accordance with IAS 32.

Such a fixed-for-fixed requirement is a fundamental principle in classifying derivative contracts that will or may be settled in an entity's own equity instruments and the IASB/IFRIC have acknowledged, on many occasions, the existence of such a fixed-for-fixed requirement in IAS 32. On this basis, it is unclear to us why the IFRIC did not differentiate between the two types of put options (i.e. put option 1 and put option 2) when they developed the draft Interpretation. The Basis for Conclusions on the draft Interpretation did not address this point either.

In addition, we noted that, when the IFRIC deliberated the issue, it *merely* made reference to paragraph 23 of IAS 32. Paragraph 23 of IAS 32 says that a contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability for the present value of the redemption amount. However, we do not believe paragraph 23 of IAS 32 is clear as to whether it covers (a) all put options on non-controlling interests or (b) merely put options that meet the fixed-for-fixed requirements. Indeed, we noted that Example 6 set out in Illustrative Examples accompanying IAS 32 regarding how to account for written put option on shares covers 'fixed-for-fixed' scenario only (please see IE 30 accompanying IAS 32).

Similarly, the application guidance in IAS 32.AG27, which explains the application of IAS 32.23, covers 'fixed-for-fixed' scenario only. It states that 'a contract that will be settled by the entity receiving or delivering a ***fixed number of its own shares*** for no future consideration, or exchanging a fixed number of its own shares for a ***fixed amount of cash or another financial asset***, is an equity instrument. Accordingly, any consideration received or paid for such a contract is added directly to or deducted directly from equity. One example is an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed amount of cash. However, if the contract requires the entity to purchase (redeem) its own shares for cash or another financial asset at a fixed or determinable date or on demand, the entity also recognises a financial liability for the present value of the redemption amount. One example is an entity's



obligation under a forward contract to repurchase a fixed number of its own shares for a fixed amount of cash.' **[Emphasis added]**.

Moreover, we believe that another paragraph in IAS 32 should be considered in determining how put option 2 should be accounted for, that is paragraph 24 of IAS 32. Paragraph 24 of IAS 32 states 'A contract that **will be settled by the entity delivering or receiving a fixed number of its own equity instruments in exchange for a variable amount of cash or another financial asset is a financial asset or financial liability.** **[Emphasis added]**. IAS 39 is the applicable standard that deals with the recognition and measurement of financial assets and financial liabilities. In addition, under IAS 39, derivative liabilities are required to be measured at their fair values, i.e. on a net basis (rather than on a gross basis). In our view, paragraph 24 of IAS 32 is relevant to how put option 2 should be classified. It is unclear why the IFRIC did not take it into account. The Basis for Conclusions on the draft Interpretation did not address this point either.

Based on the above current IFRS requirements (in particular the general principle set out in IAS 32 as well as paragraph 24 of IAS 32), we believe that it is reasonable to have the following accounting treatments:

- For put options on non-controlling interests that **do not meet the fixed-for-fixed requirement (i.e. put option 2)**, they are reclassified as derivatives and measured at their fair values, i.e. on a **net** basis, in accordance with IAS 39. Under IAS 39, all derivatives are required to be measured at their fair values, i.e. on a net basis. We believe all derivatives that are within the scope of IAS 39 should be accounted for in the same way. We do not see any rationale why put option 2 should be accounted for in a different way from other derivatives within the scope of IAS 39. Further, we noted that the scope requirements of IAS 39 do not contain any scope exemption for put option 2.
- For put options on non-controlling interests that **meet the fixed-for-fixed requirement (i.e. put option 1)**, they are within the scope of IAS 32. We agree that such put options should be accounted for in accordance with paragraph 24 of IAS 32.

The above accounting treatments would ensure consistency with the current accounting standards. This is because paragraph 2(d) of IAS 39 exempts only 'financial instruments issued by the entity that meet the definition of an equity instrument in IAS 32 (including options and warrants).....' from its scope.

For the above reasons, we **do not agree** that put option 2 must be accounted in accordance with paragraph 23 of IAS 32. The IASB/IFRIC should take into account all relevant IFRSs in arriving at an appropriate interpretation of the current IFRSs, not just based on an 'isolated paragraph' in IAS 32 alone.



Why does it not make commercial sense to account for put option 2 in accordance with the draft interpretation?

As mentioned above, the draft interpretation proposes that put option 2 should be measured on a gross basis based on the present value of the redemption amount. In subsequent reporting periods, changes in the measurement of the liability are recognised in profit or loss.

Let's consider the following scenario:

<p>Parent P writes an option to Shareholder X that gives Shareholder X the right to require Parent P to purchase the 20% interest in Entity A.</p>	<p>Facts:</p> <ul style="list-style-type: none"> On 1 January 20X1, Entity A issued new ordinary shares to Shareholder X for a cash consideration of CU380 million. After the transaction, Parent P's equity interest in Entity A has been diluted by 20% from 100% to 80%. Shareholder X is a non-controlling shareholder of Entity A. The relevant shareholders agreement contains a clause that says that Parent P, on 1 January 20X1, writes an option to Shareholder X that gives Shareholder X the right to require Parent P to acquire the 20% interest in Entity A at a specified future date, 1 January 20X2. The exercise price of the put option is the fair value of the 20% interest owned by Shareholder X at the date when Shareholder X exercises the option. The risks and rewards regarding the 20% interest in Entity A have been transferred by Parent P to Shareholder X.
<p>Proposed accounting set out in the draft interpretation:</p> <p>On initial recognition of the put option, a financial liability is recognised and measured at the present value of the redemption amount. Parent P needs to estimate the fair value of the 20% interest and recognises the liability based on the present value of the fair value of the 20% interest. The corresponding entry is recognised in equity.</p> <p>At subsequent reporting dates, Parent P needs to re-estimate the fair value of the 20% interest.</p> <p>Assume that the fair value of the 20% interest in Entity A as at subsequent reporting dates increases (as Entity A's business improved and is expected to continue to be so in the future).</p> <p>Parent P will increase the carrying amount of the liability to reflect the present value of the increase in fair value of the 20% interest in Entity A, with the difference recognised in profit or loss.</p>	



The following illustrates the accounting effect in more details:

Key assumptions

On initial recognition

- The draft Interpretation proposes that a financial liability should be recognised and measured at the present value of the redemption value. For illustration purpose, it is assumed that the fair value of the 20% interest in Entity A at the time when Shareholder X exercises the option is equal to CU380 million, which is determined based on an assumed price earnings ratio (P/E ratio) of 25 multiple and assumed profit for the year ending 31 December 20X1 attributable to the 20% interest of CU15 million.
- Present value effect is ignored for illustration purpose.

At subsequent measurement dates

- Assume that Entity A's profit attributable to the 20% interest for the year ended 31 December 20X1 amounted to CU22 million. The actual performance of Entity A is better than what was expected).
- The draft Interpretation proposes that a financial liability should be measured at the present value of the redemption value at each subsequent reporting date. Therefore, the carrying amount of the liability is re-estimated and increased to CU550 million as at 31 December 20X1 (assuming that the appropriate P/E ratio remained at 25 (i.e. 25*profit attributable to the 20% interest for the year ended 31 December 20X1 of CU22 million)).



Below are the related accounting entries that illustrate why the proposed accounting set out in the draft Interpretation does not make any commercial sense.

Currency: CUmillion

In the consolidation financial statements of Parent P

	Dr / (Cr)				
	Profit after Tax	Parent's Equity	NCI	Liability	Cash
<u>On 1 January 20X1 (i.e. initial recognition)</u>					
Issuance of new shares to Shareholder X (dilution of 20% interest) – The adjustment to NCI of CU 50 million is determined based on the share of the carrying amount of net assets of Entity A as at 1 January 20X1.		(330)	(50)		380
Initial recognition of NCI put		380		(380)	
Net effect of initial recognition		50	(50)	(380)	380
<u>At subsequent reporting dates</u>					
Subsequent measurement of NCI put for the year ended 31 December 20X1	170	170		(170)	
Profit of Entity A attributable to Parent P and Shareholder X for the year ended 31 December 20X1	(110)	(88)	(22)		
	60	132	(72)	(550)	380
<u>On 1 January 20X2</u>					
Exercise of put option with fair value of the 20% interest to be certified by an independent valuer				550	(550)
Derecognition of NCI		(72)	72		
	60	60	-	-	(170)

The above illustration shows that the better the business performance of Entity A is, the larger the loss to be recognised by Parent P in its consolidated financial statements.

We are of the view that applying the proposed accounting treatment set out in the draft Interpretation to the put option in the above example will give rise to an accounting anomaly. Indeed, as illustrated above, the increase in profit attributable to the owners of Parent P for the year ended 31 December 20X1 arising from the increase in the profits of Entity A (i.e. CU28million = (CU22million/20% – CU15 million/20%)*80%) will be 'more than offset' by the CU170 million charge in profit and loss account due to the increase in the carrying amount of the liability.

The above illustration raises a question as to whether the accounting treatment proposed in the draft Interpretation makes any commercial sense. However, where such a put option is accounted for as a derivative and measured at its fair value, i.e. on a net basis, in accordance with IAS 39, such an accounting anomaly will not arise. This is because, where the exercise price of the put option is equal to the fair value of the 20% at the time when the option is exercised, the fair value of the option at each reporting date is not expected to be significant.



For the above reasons, we propose the following changes to the draft interpretation:

- Restricting the scope of the Interpretation to only derivative contracts on non-controlling interests that meet the fixed for fixed requirement; and
- Clarifying in the Interpretation and/or IAS 32 that derivative contracts on non-controlling interests that fail the fixed for fixed requirement should be accounted for as derivatives and measured in accordance with IAS 39 (i.e. measured on a net basis).

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?

Our response to Question 3

The proposed draft Interpretation does not give any transitional provision. In other words, the draft Interpretation proposes full retrospective application and hence comparative figures have to be restated when derivative contracts were entered into in prior accounting periods.

As mentioned above in our response to Question 2, we strongly believe that the scope of the Interpretation should be restricted to derivative contracts on non-controlling interests that meet the fixed-for-fixed requirement. If the IASB/IFRIC make the changes to the Interpretation as suggested by us, we are happy with the proposed transition guidance.

However, if the IASB/IFRIC decline to make the suggested changes (see our response to Question 2 above), we believe that:

- the IASB/IFRIC should explain clearly in the Interpretation and the Basis for Conclusions as to how our concerns as expressed in our responses to Questions 1 and 2 are addressed; and
- specific 'grandfather' transitional provision should be given (please see below).

Suggested transitional provision:

'That is, this Interpretation shall be applied prospectively to all derivative contracts on non-controlling interests that do not meet the definition of an equity instrument that were entered into in accounting periods beginning on or after [date].'

Such transitional provision will help ease preparers' burden on restating comparative figures in respect of the prior accounting periods.