Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Our Ref.: C/FRSC

Sent electronically through the IASB website (www.ifrs.org)

16 October 2012

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

Dear Sirs,

IFRS Interpretations Committee Exposure Draft of *Put Options Written on Non-Controlling Interests*

The Hong Kong Institute of Certified Public Accountants is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on this Exposure Draft.

We note that the draft Interpretation covers the accounting for the financial liability arising in respect of a put option written by a parent to a non-controlling shareholder over its interest in a subsidiary (NCI) which falls within the scope of paragraph 23 of IAS 32 and which is initially measured at the net present value of the amount which the parent would be required to pay for the NCI. The draft Interpretation proposes that this financial liability is subsequently measured in accordance with IAS 39 or IFRS 9 with changes in the measurement of the financial liability being recognised in profit or loss.

Such a written put option is hereinafter referred to a "NCI put" in this comment letter.

We agree 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. However, we are concerned with the narrow focus of this project which does not address the broad range of issues arising from the accounting for derivatives written over non-controlling interests.

Specifically, we understand that diversity in practice may also exist for:

- Initial measurement of written NCI puts and other derivatives - whether all types of NCI puts are within the scope of IAS 32 paragraph 23 and hence whether all types of NCI puts must be measured initially at the present value of the redemption amount (e.g. whether IAS 32 paragraph 23 is only applicable to situations where the NCI puts meet the fixed-for-fixed requirements).

- Accounting for written put options that oblige the parent to purchase NCI for a variable number of its own equity instruments or equity instruments in another subsidiary (that is, whether a variable number of equity instruments of the parent or another subsidiary is considered "cash or another financial asset" under paragraph 23 of IAS 32)

In addition, while we agree to the underlying principle that the financial liability recognised for NCI put should be accounted for consistently with all other such financial liabilities that are within the scope of IAS 39/IFRS 9, we are concerned that the proposal may not reflect the commercial substance of some NCI put transactions and that the proposed accounting may result in counter-intuitive outcomes (e.g. losses being recognised in respect of profitable subsidiaries and gains being recognised in respect of loss-making subsidiaries).

We have significant concerns regarding the IASB's proposed approach in dealing with NCI puts and in the proposed scope of the draft Interpretation, as set out in our response to question 1. We would encourage the IASB to reconsider its previous decision not to proceed with the limited amendment to the scope of IAS 32, proposed by the IFRS Interpretations Committee in September 2011, as we believe that accounting for such contracts as derivatives in accordance with IAS 39 or IFRS 9 would provide the most meaningful information to users of the financial statements; or, as an alternative as we discuss in our response to question 2, for the IFRIC to consider whether the basis for the conclusion reached in IFRIC 17 concerning the re-measurement of a dividend is equally valid by analogy for the re-measurement of an NCI put.

We acknowledge that classification of financial instruments is a complex and broad-ranging topic. We express our concern that the scope of the draft Interpretation is effectively limited in attempting to address subsequent measurement issues for NCI puts more by way of patching up a difficult and incomplete area of IFRS rather than addressing the whole issue in a comprehensive and coherent manner. Rather than proceeding with an Interpretation, we believe the IASB should address the accounting for NCI puts on a more comprehensive basis. We urge the IASB to consider the broader issues in the Financial Instruments with the Characteristics of Equity project, which the IASB has expressed support to be added to its research programme with the aim of developing more principle-based guidance.

If you have any questions regarding the matters raised in our submission please contact Winnie Chan, our Manager of Standard Setting, at winniechan@hkicpa.org.hk.

Yours faithfully,

Simon Riley
Director, Standard Setting

SR/WC

Encl.

Hong Kong Institute of CPAs

Comments on the IFRS Interpretations Committee Exposure Draft of *Put Options Written on Non-Controlling Interests*

<u>Question 1 – Scope</u>

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?

We express our concern that the scope of the draft Interpretation is effectively limited in attempting to address subsequent measurement issues for NCI puts more by way of patching up a difficult and incomplete area of IFRS rather than addressing the whole issue in a comprehensive and coherent manner. Rather than proceeding with an Interpretation, we believe the IASB should address the accounting for NCI puts on a more comprehensive basis: We urge the IASB to consider the broader issues in the Financial Instruments with the Characteristics of Equity project, which the IASB has expressed support to be added to its research programme with the aim of developing more principle-based guidance.

If, however, the IFRIC proceeds with the proposed Interpretation, we would recommend the IFRIC to address the following:

- 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. It is not clear whether the draft interpretation is also applied to NCI puts that are settled by delivery of the parent's own equity instruments e.g. exchange of a variable number of shares. We suggest that specific guidance should be provided to ensure consistent accounting outcomes.

- The draft Interpretation is written to address a scenario where the parent writes NCI puts that oblige the parent to purchase equity held by an NCI. Also, we noted that the draft Interpretation focuses on the consolidated financial statements of the parent. We believe that the draft Interpretation should be applied to other scenarios where the NCI puts are written by other group entities that oblige the group to purchase NCI.

- The draft Interpretation should also apply to NCI forwards that oblige the group to purchase NCI.

<u>Question 2 – Consensus</u>

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?

We express our concern that the scope of the draft Interpretation is effectively limited in attempting to address subsequent measurement issues for NCI puts more by way of patching up a difficult and incomplete area of IFRS rather than addressing the whole issue in a comprehensive and coherent manner. Apart from the reasons that we have discussed in our cover letter and Q1 above, it is noted that some constituents in our jurisdiction have expressed concerns that the proposal that requires changes in the measurement of the NCI put liability are recognised in profit or loss would give rise to an accounting anomaly. For example, a parent writes a fair value NCI put to the non-controlling shareholder of its subsidiary such that the non-controlling shareholder has the right to require the parent to purchase the NCI shares at the fair value of the NCI at the time when the put is exercised. The proposed accounting may result in the parent in its consolidated financial statements recording a loss despite the fact that the related subsidiary earns profits and the value of the NCI shares increase. Similarly, a parent would record a gain where the subsidiary performs poorly and the fair value of its shares decreases. In their view, the proposed accounting does not make commercial sense and is counter-intuitive. This counterintuitive result is not dissimilar to the own credit risk issue for financial liabilities where the IASB decided that changes in fair value of financial liabilities that are attributable to changes in the liabilities' credit risks should not be recognised in profit or loss (per IFRS 9 *Financial Instruments*).

However, if the IASB decides to proceed with the proposed Interpretation, we believe that the IFRIC should provide clear guidance on whether an entity could elect to measure a financial liability that arises from an NCI put at fair value through profit and loss under the criteria set out in paragraph 4.2.2 of IFRS 9. If the fair value option is applicable, paragraph 7 of the draft interpretation should be amended to include the requirements of paragraph 5.7.7 in IFRS 9 such that changes in the fair value of the financial liability that are attributable to changes in the credit risk of that liability are presented in other comprehensive income.

We would encourage the IASB to consider whether there should be different accounting for those put options that meet the "fixed-for-fixed" requirement (i.e. put options that oblige the parent to purchase a fixed number of shares for a fixed amount of cash or another financial asset) from those that do not. For put options that oblige the parent to purchase a fixed number of shares for a variable amount of cash or another financial asset (e.g. NCI puts exercisable at fair value or an amount determined by a formula), the requirement to measure all changes in gross value through profit and loss could result in the counter-intuitive outcome referred to above which would not be the case if they were accounted for as derivatives in accordance with IAS 39 or IFRS 9 and hence were recognised on a net basis (rather than at the present value of the redemption amount).

We also note that the issue considered in the Interpretation is not dissimilar in principle to the re-measurement issue discussed in paragraphs BC35 to BC37 of IFRIC 17, when IFRIC explained why re-measurements of a dividend payable are recorded as adjustments to equity, rather than in profit or loss, even though the dividend liability itself meets the definition of a financial liability. We note that, as stated in BC36-BC37 of IFRIC 17, in the case of dividends payable IFRIC concluded that changes to the estimate of the distribution should be accounted for in equity until settlement of the dividend payable as these are re-estimations of distributions to owners. We would like to suggest that the IFRIC consider whether this principle or approach could be applied be analogy to the re-estimation of the gross liability deemed to arise under an NCI put, given that paragraph 30 of the currently-applicable IAS 27 (paragraph 23 of IFRS 10) requires that changes in NCI which do not result in loss of control are accounted for as transactions with owners in their capacity as owners. If such an approach was applied to the NCI put issue, then the re-estimates of the NCI put gross liability would be made through equity until the put was exercised, and the accounting, if the put was exercised, would overall be the same as if the change in NCI had occurred in a single transaction in accordance with paragraph 30 of IAS 27. Given the anomaly described above which arises on re-measurement through profit and loss when a NCI put has a fair value strike price, we believe that the approach by analogy set out in IFRIC 17 concerning the re-measurement of dividends would be a more appropriate conclusion than the one currently proposed.

Furthermore, we believe that paragraph 7 of the draft Interpretation should be amended as follows (new text is underlined and deleted text is struck through) to make it clear that the draft Interpretation should only be restricted to the subsequent measurement of NCI puts:

7 ~~In accordance with paragraph 23 in IAS 32,~~ An NCI put that gives rise to a financial liability in accordance with paragraph 23 of IAS 32 ~~that~~ is initially measured at the present value of the redemption amount in the parent's consolidated financial statements. Subsequently, the financial liability is measured in accordance with IAS 39 or IFRS 9. Paragraphs 55 and 56 in IAS 39 and paragraphs 5.7.1 and 5.7.2 in IFRS 9 require that changes in the measurement of that financial liability are recognised in profit or loss.

We would also note that the first sentence of paragraph 7 does not provide any interpretive guidance whatsoever and, consistent with the Basis of Conclusions lack of coverage on the matter, the proposed Interpretation effectively confines itself to subsequent measurement issues. If the IFRIC proceeds with this Interpretation, we believe this should be reflected and acknowledged in the Scope (paragraph 4) and that the first sentence of paragraph 7 be shifted to the Background section.

<u>Question 3 – Transition</u>

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?

We do not disagree with this proposal. However, as we mentioned above, there are many fundamental issues that the IASB needs to address (both initial and subsequent measurement issues). And there has been diversity in views regarding these initial and subsequent measurement issues (as highlighted above). For these reasons, we believe the IASB should consider whether transitional provisions should be provided if the IASB decides to proceed with the proposed Interpretation.

~ End ~