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Re: EFRAG DCL on the Draft Interpretation D1/2012/2 Put options written on Non-controlling interests

We are writing to comment on the EFRAG DCL on the Draft Interpretation (D1/2012/2) *Put options written on Non-controlling interest* issued by IFRS Interpretation Committee ('the Interpretations Committee') on 31 May 2012 (the 'Draft Interpretation').

As better explained in the appendix to this letter we have some concerns on the positions taken by EFRAG in its draft comment letter:

- Scope:

  the EFRAG's proposal to widen the scope of the IFRS IC interpretation – in order to address all types of off-balance sheet transactions on the reporting entity's equity – is conceptually sound because it would permit to have a consistent accounting approach applicable in all circumstances (contingent consideration, shares-based payments, etc.). Nevertheless this general consistency can be achieved only through a contemporaneous organic intervention on several standards (IAS 32, IFRS 3, IFRS 10/IAS 27, IFRIC 17) and this intervention can be done only by the IASB. This is even more true, considering that equity is one of the most sensible topic in the accounting framework and therefore deserves a particular attention and adequate due process. For this reason, we agree on the need to urge the IASB to accelerate the project on equity-liability classification. At the same time we think it is useful that IFRS IC gives its interpretation on the specific questions raised. The importance of targeted answers to narrow questions – which per se help in reducing diversity in practice – should not be underestimated by the consideration that a wider amendment could achieve much more far-reaching effects.

- Consensus:

  on the consensus about the subsequent measurement, we think that within the narrow scope of the IFRS IC tentative decision, the proposed solution seems reasonable. However, looking at the same issue from a more general perspective, we believe that to identify a unique remeasurement principle that is valid for all the circumstances could not be the right way forward. Perhaps, a new approach should be based on the different characteristics that put options may have (e.g. strike price). A starting point could be to determine "when", in substance, the equity transaction has taken place (i.e. when NCI have ceased to bear the shareholders' risks).

- <u>Consistency between IAS 32 and IFRS 10:</u>

  we do not agree with the EFRAG conclusion that the diversity in practice on initial recognition of NCI puts arises from a perceived inconsistency in IFRS guidance between IAS 32 and IFRS 10. Both the standards require entities to recognize transactions on NCI as equity transactions; under certain conditions the IAS 32 requires to account for forward purchases of own shares (e.g. deriving from written put options) as they were spot purchases (i.e. immediate recognition of the liability, using as a contra-item the equity, for the present value of its redemption amount). This has been confirmed in the outreaches we conducted where we have not identified any diversity in practice because preparers usually apply IAS 32 for the recognition of the liability. The other supposed inconsistency between IAS 32 and paragraph B90 ([1]) of the IFRS 10 seems deriving from an error of perspective: paragraph B90 relates to potential voting rights – i.e. a situation where the reporting entity has the possibility, but not the obligation, to buy a certain amount of shares which could determine the control of the issuing entity and for this reason it is relevant to check whether or not the "substance" of the transaction gives the entity the current access to the returns of the other entity. Vice versa, IAS 32 considers a situation where the reporting entity is obliged to buy by a third party a certain amount of NCI, with the consequent possible reduction of its consolidated equity. In this case, the main concern of the standard is to ensure that the amount of equity presented in the financial statement is not overestimated and for this reason the IAS 32 makes it mandatory to recognize immediately the liability. It is our opinion that this is an overarching principle of current rules which should not be questioned.

- <u>Separate financial statement:</u>

  notwithstanding the need to start a more comprehensive project on the role of separate financial statements (SFS), as already in general communicated to the IASB in the meetings we had, we believe that every time a principle or an interpretation may have an impact on the accounting treatment in the separate financial statements it should also be addressed. In relation to the interpretation on NCI put option we welcome a clarification on the accounting treatment in SFS, where the put option should be recognised consistently with other put option over any equity instrument.

Should you need any further information, please do not hesitate to contact us.

Yours sincerely,

Angelo Casò
(Chairman)

[1] Paragraph B90: "*In some circumstances an entity has, in substance, 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 proportion allocated to the parent and non-controlling interests in preparing consolidated financial statements is determined by taking into account the eventual exercise of those potential voting rights and other derivatives that currently give the entity access to the returns*."

APPENDIX 1: Specific comments

EFRAG Q1 to constituents

In its draft comment letter EFRAG questions whether the recognition of the liability should be debited to the NCI or directly to the equity of the entity. However in the comment letter it cannot be found any example of situations in which equity should be debited, whilst are described different principles (IFRS 10 and IAS 32) that lead to a derecognition of the NCI due to the written put option. We believe that, if different views exist, arguments in favor of each view should be described with reference to existing standards and not by generally saying that “some believe” and “others believe”. In the outreach we have performed no significant difference in practice has been recognised by participants on the initial recognition. Therefore, we have difficulties of figuring out situations in which equity is debited at initial recognition instead of NCI.

Moreover we note that EFRAG refers to potential inconsistencies between IAS 32 and paragraph B90 of the IFRS 10, claiming that in IFRS 10, differently from IAS 32, links the derecognition of NCI to the fact that the transaction gives the entity the current access to the returns associated to the ownership interest. EFRAG, while recognizing that IFRS 10 does not provide any guidance on how to assess that access, indicates that there could be several factors for determining whether the parent has acquired “*a current economic ownership in the underlying NCI shares*” (exercise price, potential restriction on dividends, existence of mirroring calls).

As already said in the cover note, we note that IFRS 10 considers the right side of the contracts (call option), whilst IAS 32 deals with the obligation side of the contracts (written put option). In our view this fundamental difference justifies the different accounting guidance of the two standards (IFRS 10, IAS 32). Therefore we do not see an inconsistency in relation to the written put option. If the issue is referred to other instruments that are not options (such as forward contracts), currently out of scope of the draft interpretation, we believe that it is clear that IAS 32 applies first to the recognition of the liability and therefore the guidance of IFRS 10 does not apply (as NCI was already derecognised). Finally, it has to be recognized that today there is an implicit hierarchy of standards: IAS 32, in laying down the definition of equity, establishes a clear general principle: no obligation (in term of principal or return) can affect equity instruments. This overrides potentially different rules provided in other standards (e.g. IFRS 10). Spot or forward transaction on own shares (separate financial statement) or NCI (consolidated financial statement) which contains clauses which contradict the abovementioned principle, trigger – no matter of other aspects – the reclassification of the NCI.

EFRAG Q2 to constituents

We agree with the IFRS IC that the scope should be limited to the subsequent measurement as no difference in practice has been recognised on the initial recognition of the liability in accordance with IAS 32. However, we believe that some additional issues should be better investigated. We especially refer to the use of other instruments, such as forward contracts, and the consistency with other standards, such as IFRS 3. We do not see the reasons why not to address the issue in more general terms that could be valid in all the circumstances. If there is a specific reason the IFRS IC should clarify it in the basis for conclusions. For example we do not see a particular conceptual difference between the remeasurement of a liability arisen from a put option written to the NCI and a liability that arise from a forward contract on the NCI or a liability arisen from a put option written on the NCI in the context of a business combination.

As there might be consequential issues in the separate financial statements, it should be clarified in the interpretation that in the separate financial statements the written put option is initially recognised as a derivate (net basis) because underlying NCI shares relate to a different legal entity. The exercise of the put option gives rise to the increase of the investment in subsidiaries.

Finally, we note that EFRAG raise a number of issues that need to be addressed such as put options used as contingent considerations in a business combination, or as employee remuneration, or when puts interact with call option. The issues related to some of these cases are not illustrated in the letter; therefore it is difficult to comment on that.

EFRAG Q3 to constituents

We are not convinced that a unique model for the remeasurement of the liabilities is necessarily the right solution to be pursued. We acknowledge that instruments such as written put options may have different features which imply different representation of the effects of remeasurement. It is agreed that the initial recognition of a put option follows the IAS 32, and we also agree that it gives rise to an equity transaction in accordance with IFRS 10. The issue is to establish “when”, in substance, the equity transaction has taken place (i.e. when NCI have ceased to bear the shareholders’ risks). This approach is strictly related on whether or not the entity is exposed to variation of value of the shares being exchanged.

For example, if the strike price of the put option is fixed, than the entity is no more exposed to the risk of variations of the value of the NCI shares ; therefore the equity transaction should be considered performed at the trade date. In that case we would expect that the financial liability would be measured at amortized cost, according to IAS 39, and hence any subsequent change of its carrying amount should be due the time value of the money. On the contrary, if the strike price is indexed to the fair value of the shares being exchanged, the entity is still exposed to the variation of value of the shares and therefore the equity transaction should be considered to take place at the settlement date. Therefore the remeasurement of the liability prior to settlement should be considered a part of the equity transaction and therefore accounted in accordance with IFRS 10 with effects of remeasurement recognised in equity.