

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

Attention: Ms. Winnie Chan

26 July 2012

Dear Sirs,

**IFRIC Interpretation Exposure Draft – Put Options Written on Non-Controlling Interests (the “Exposure Draft” / “ED”/ “Interpretation”)**

I welcome the opportunity to review the above Exposure Draft and my comments and observations are set out in the paragraphs below. I have included some comments that may need to be considered and these may be addressed by IFRIC and the IASB either jointly or separately.

Scope of the Interpretation to be simplified, clarified and widened

The scope of the interpretation should be amended to indicate more clearly and in simple terms when the Interpretation guidance is expected to be applied. Paragraphs 4 and 5 of the ED could be simplified as they may be misinterpreted. Paragraph 4 makes reference to options granted to Non-Controlling Interests (“NCI”) but paragraph 5 subsequently states that the guidance is not applicable to options that were accounted for as “contingent consideration”.

As contingent consideration relate to an acquisition of a subsidiary and options accounted for as contingent consideration will be exempted or scoped out, it appears that the guidance is intended for options granted “after” obtaining a controlling interest in a subsidiary. It is unclear whether this “after the acquisition premise” is the intention of IFRIC and if it is it could be more simply expressed by stating that fact.

The ED assumes that options granted at the time of an acquisition would be accounted for as contingent consideration. The Interpretation should also clearly indicate whether options granted “at the time of the acquisition of a subsidiary” (with the criteria to be clearly set out) is the only exception or whether there are others. Other option

possibilities could include options granted "before" a change in control but are linked to a planned transfer of control, which upon exercise of the options (whether partially or in full) result in a change of effective control. This scenario could possibly be regarded as integral to a change in control but these options may not involve the type of future "contingent consideration" as referred to under IFRS 3.

Another suggestion to possibly improve the wording of the Interpretation would be to amend paragraph 4 by not making a reference to NCI but instead making reference to a wider generic group of shareholders of the investee. Paragraph 5 could then qualify paragraph 4 by specifying those transactions that would be excluded. However this will mean that a wider scope of options would be covered by the interpretation, that is, not only those made by a parent to NCI. It is unclear whether this is the intention or wish of IFRIC and the IASB but if it is not, it is possible that other interpretations may need to be issued to address them as there may be also inconsistencies in their accounting treatment.

Currently the ED deals with options to "acquire" additional interests in a non wholly-owned subsidiary. However, a more common occurrence would be a controlling shareholder seeking to "sell down" to reduce his interest whilst retaining control and this may be the case where venture capital partners are involved who wish to exit from their investments.

In addition, it is possible an option may be granted to other shareholders or a group of shareholders to facilitate the "possibility" of acquiring a new controlling interest rather than increasing controlling interest. For these, at the time of granting the option, such investments may have been treated as an associated company or an equity interest in a joint venture.

The above arrangements could be more common than those covered under the ED and therefore the scope of the ED is considered too narrow. The ED with its limited scope may result in the need for the issue of additional interpretations to address other circumstances.

Lastly, it is also necessary for the ED to distinguish the "option" from the "obligation to purchase shares" in the non wholly-owned subsidiary. The latter obligation is merely contingent and will only arise if the option is exercised. If the option is not exercised it will lapse and it too will have no value. The ED currently appears to discuss the two together and this makes the ED confusing. The difficulty may be due to the wording used in paragraph 23 of IAS 32 which is not easy to understand.

It is important to note that paragraph 23 of IAS 32 begins with “*With the exception of the circumstances described in paragraphs 16A and 16B or paragraphs 16C and 16D,...*”. This could be interpreted to mean that those matters covered under paragraphs 16A to 16D (and paragraph 16A deals with puttable instruments) are excluded from the treatment advocated in paragraph 23 which is the creation of a financial liability at the present value of the redemption amount. If this alternative interpretation is valid, the proposals included in the ED would be inappropriate and IFRIC should re-examine its analysis and develop other proposals.

### Clear principles

It is suggested that a clear principle should be set out. The Basis for Conclusions appears to indicate that the main reason for the proposed scope out is that another IFRS expressly requires a different treatment. The justification for the different treatment is not fully explained in the ED and this would have been helpful. It is recommended that clear principles be included and explained so that the Interpretation is complete, can stand on its own and can be easily understood. BC 7 attempts to provide some rationale and BC 11 appears to indicate inconsistencies between IAS32 and IAS 39. BC 11 and B13 also appear to imply that the Interpretation will be possibly superseded in the future due to other projects.

If not already in place, the IFRIC and the IASB may wish to consider developing a policy or principles for dealing with situations where different accounting treatments are advocated by different standards for seemingly similar transactions. This should be useful and helpful and would include criteria for deciding which accounting treatment should take priority. For example, in the current ED, IFRS 3 in effect takes priority as it is allowed as an exception but the decision could have been otherwise. Explaining reasons or the rationale for moving away from a primary accounting treatment would be helpful as it would focus attention on whether there are sound, conceptual and logical reasons to justify an exception or a different treatment.

Explaining an underlying principle and reasons would also provide preparers of financial statements and their auditors a better understanding of how to approach and appropriately account for similar transactions entered into under different circumstances.

## Analysis of paragraph 23 of IAS 32

Paragraph 2 of the ED explains that *“In the consolidated financial statements that put option is a contract to purchase the group’s own equity instruments and thus gives rise to a financial liability for the present value of the redemption amount in accordance with paragraph 23 in IAS 32”*. I am not sure whether this is an appropriate interpretation of IAS 32 for the reason explained above on the introductory part of paragraph 23 of IAS 32.

Moreover, IAS 32 appears to be worded and intended for the purpose of preparing financial statements at the entity level rather than at the consolidated level. It does not address what should be the accounting treatment at the consolidated level.

Paragraph BC 3 of the ED attempts to make a linkage but I believe this should be re-examined. In my analysis, at the entity level an option would not be regarded as an obligation to acquire its own equity instruments (namely, its own shares). Rather the option is for the purchase of shares in another company (namely, those of its non-wholly owned subsidiary). Moreover, the option is merely a commitment to possibly acquire but “not” an obligation to acquire. An obligation to acquire the shares will only arise if and when the option is exercised. The obligation to purchase shares is just contingent.

If this analysis is valid at the company level the same conclusion should apply at the consolidated level. The ED seems to imply under paragraph BC 8 that the option does not relate to a transaction with owners in their capacity as owners and this seems to be at odds with the conclusion in paragraph BC 3. The IFRIC may wish to reconsider its reasoning and especially that set out in paragraph BC 3 of the ED .

Paragraph BC 11 of the ED could be improved by explaining in simple terms the gross and net basis arguments mentioned. The paragraph is very long and should be broken up for the different points raised to improve clarity.

## References to other IFRS and IAS

There are a number of references in the ED to other standards but based on the July 2011 paperback book version of the standards at my disposal some of the references made appear to be out of date. Some examples are listed below. It is suggested that the references in the ED be updated.

- (a) Paragraph 7 of the ED makes reference to paragraphs 55 and 56 of IAS 39 which have been deleted from the latest edition of IAS 39.

- (b) The reference in paragraph 7 of the ED to paragraph 5.7.2 of IFRS 9 also appears to be inappropriate as it relates to financial assets or liabilities measured at amortised cost which is a different subject matter.
- (c) Paragraph 8 of the ED refers to paragraph 30 of IAS 27 which has been deleted.

### Contingent consideration

The reason for the exception in paragraph 5 of the ED appears to be due to guidance included in IFRS 3 which is related to "contingent consideration". I believe that "contingent consideration" should normally only relate to additional consideration payable for a "fixed" and pre-determined percentage interest acquired that results in the acquisition of a subsidiary which is a one-time event .

However, the type of options covered under the ED are those that would result in an "increase" in the percentage interest in an investee beyond the existing controlling interest. Accordingly, the underlying principle is unclear. IFRS 3 deals with obtaining control whereas as explained above the apparent intention of the ED is to deal with options granted "after" control has already been obtained.

### "Consolidated" or "separate" financial statements

The ED only makes reference to "consolidated" financial statements. The ED would be more useful if it was worded more widely to cover the separate financial statements of the reporting entity so it is clear that the Interpretation will also cover them. In many jurisdictions only the company itself has legal standing and importance, and specifically concerning distributions, such as paying dividends to shareholders. The separate financial statements of the legal entity itself are normally required to be presented "together with" the consolidated financial statements. Covering the separate financial statements would make the ED more complete and will ensure that there is consistency and clarity on interpretation of IFRS where separate financial statements are required or presented.

### Applying the Interpretation retrospectively

Paragraph A2 of the Interpretation makes reference to IFRS 8 but further goes on to say that it shall be applied retrospectively which means that adjustments to prior period figures should be made. As prior period adjustments are only applicable for changes in

significant accounting policies or fundamental and material errors it should be left to the preparers and auditors to decide the appropriate treatment as set out in IFRS 8. A simple reference to the need to comply with the requirements of IFRS 8 should be sufficient. It is suggested that the word “retrospectively” should be deleted.

#### Other comments and observations

I believe the Interpretation raises a more fundamental issue as to whether re-statements to value fair value in the primary financial statements provide relevant and useful information as the rights and obligations themselves under the options are usually not transferable to other parties.

The option represents an agreement of a pre-determined price for acquiring an agreed block of shares from NCI in the future but only if the option holder elects to exercise. The commitments therefore will only turn into liabilities or "present obligations" for the amount of shares to be transferred if the option is exercised.

Recognising fair values and changes thereto in the primary financial statements does not provide useful and crucial information as they are hypothetical. Rather, the more relevant and important information which should be highlighted and included in the notes to the financial statements if the amounts are material would be the key terms of the option such as the time period during which the option is exercisable and the price and also whether the pre-determined price deviates from the current price at the period end date.

Resolving the conceptual issue on subsequent measurement fair value accounting may lead to fundamental changes in the way transactions should be treated. As any prescribed accounting has a potential significant impact on the reported results and financial positions of entities, I believe that it is imperative that work be expedited on the Conceptual Framework project as without it more diversity in practice is likely to develop leading to a need to issue more and more interpretations.

#### Removal of par value shares and what is profit

Although I may be digressing a little from the immediate issue of the ED I believe that it is necessary to make the following comment. Hong Kong and other jurisdictions have or are moving towards removing par value or nominal value shares from their company law and the result will be the removal of the “share premium reserve account” included under equity. These changes will have implications on what should be regarded as the company’s “capital” and as a consequence what should be regarded “profits” and its

“distributable profits”. It therefore raises the fundamental conceptual question of what and when a “profit” or a “loss” arises and when and how they should be recognised. Although company law changes take time they will have an impact on future financial statements especially for those newly incorporated after the legislation has changed. It is nevertheless a live issue for those companies that currently do not have par value/ nominal value shares.

### Conclusion

In summary, without clear principles, the proposed ED may have unintended consequences. In particular, the fundamental accounting issue of what, when and how transactions with shareholders should be treated and differentiated from transactions with non-shareholders has yet to be fully explored and decisions on these questions will impact on the amounts recognized and whether they are made directly to equity or recognised in the income statement.

I hope that the above comments are useful and if you wish further elaboration please let me know.

Yours faithfully,



Mr. Colin Chau

Contact address: [rbcolini@gmail.com](mailto:rbcolini@gmail.com)