

Beyond the GAAP

Mazars' newsletter on accounting standards

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Editorial

As the IASB is asked to re-examine some aspects of IFRS 17, we enter a period of uncertainty as regards both EFRAG's work on the endorsement advice and the likely effective date of the standard. This also has implications for the deferral of IFRS 9, an alternative which many European bancassurers and insurance companies opted for. Meanwhile, the IFRS IC has published four agenda discussions; in this issue, we discuss the two relating to capitalisation of borrowing costs.

Following on from last issue's feature, which provided a general overview of the IASB's proposals for classifying financial instruments as liabilities or equity, this month our experts examine the impact of the proposals on the much-discussed topic of puts on non-controlling interests.

Happy reading!

Edouard Fossat

Isabelle Grauer-Gaynor

IFRS highlights

IFRS 17, *Insurance Contracts*: where are we now?

This summer and early autumn we have seen multiple developments regarding IFRS 17, *Insurance Contracts*, which is currently scheduled to come into effect on 1 January 2021.

In July, the European Insurance CFO Forum (a discussion group for major insurance companies) sent a letter to the EFRAG President and IASB Chair recommending the re-opening of IFRS 17. The CFO Forum notes that this could delay the effective date of IFRS 17 by up to two years.

The CFO Forum has made this recommendation after identifying issues with IFRS 17, including difficulties with operational implementation. It has already reported these issues to EFRAG, supported by case studies carried out by various members of the CFO Forum. EFRAG is expected to address these findings as part of its ongoing work towards EU adoption of IFRS 17. In the letter, the CFO Forum also requests that more attention should be paid to interactions with IFRS 9 - *Financial Instruments*. The letter is available here:

<http://www.cfoforum.eu/letters/CFO-Forum-letter-to-EFRAG-and-IASB-16-July-2018.pdf>.

At the beginning of September, EFRAG sent a letter to the IASB in its turn, with a view to opening discussions with the international standard-setter on the following six points (previously identified by the CFO Forum):

- acquisition costs (incurred in expectation of contract renewals);
- contractual service margin (CSM) amortisation, particularly for contracts that include investment services;
- reinsurance (onerous underlying contracts that are profitable after reinsurance, contract boundary where underlying contracts are not yet issued);
- transition (extent of relief offered by the modified retrospective approach and challenges in applying the fair value approach);
- annual cohorts (cost-benefit trade-off, including for the variable fee approach (VFA) contracts);
- balance sheet presentation (cost-benefit trade-off of separate disclosure of groups in an asset position and groups in a liability position and non-separation of receivables and/or payables representing premiums already billed).

EFRAG's letter is available here:

<https://www.efrag.org/News/Project-329/Letter-to-IASB-on-IFRS-17>.

The fourth meeting of the IASB's Transition Resource Group for IFRS 17, which addresses issues with transition to IFRS 17, took place at the end of September. The group discussed ten topics; a summary of the discussion is available on the IASB's website via the following link:

<https://www.ifrs.org/-/media/feature/meetings/2018/september/trg-insurance/trg-for-ic-meeting-summary-september-2018.pdf>.

Lastly, at the beginning of October the European Parliament adopted a resolution on IFRS 17, which can be found here:

<http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P8-TA-2018-0372+0+DOC+XML+V0//EN&language=EN>.

Among other things, the resolution draws attention to the fact that IFRS 17, if adopted, must meet the 'European public good' criterion and support long-term investment.

The final months of 2018 are likely to see further breaking news on IFRS 17, what with the IASB's monthly discussions of the points raised in the letters mentioned above, and the fifth meeting of the TRG for IFRS 17, scheduled for the start of December. Meanwhile, EFRAG, which had initially expected to publish its IFRS 17 endorsement advice in the fourth quarter of 2018, has now removed any mention of an expected publication date from its website.

IAS 23: IFRS IC publishes two agenda decisions

At the end of its September meeting, the IFRS IC decided to publish two agenda decisions relating to IAS 23, *Borrowing Costs*.

The first decision relates to the amount of borrowing costs eligible for capitalisation when an entity that initially has no borrowings is constructing a qualified asset, and borrows funds generally part-way through construction. The question was whether the entity should include expenditures for the asset before it obtained the general borrowings when determining the amount of borrowing costs eligible for capitalisation.

In accordance with paragraph 17 of IAS 23, which stipulates when an entity should begin capitalising borrowing costs, the Committee concluded that the entity would not begin capitalising borrowing costs until it has obtained the general borrowings, but once it has obtained it, the entity does not disregard expenditures on the qualifying asset incurred before it obtains the general borrowings when determining the expenditures eligible for capitalisation.

The second decision relates to the point at which an entity ceases capitalising borrowing costs on land, when the land has been acquired in order to construct a building on it. The question was whether the entity should cease capitalising

borrowing costs incurred in respect of land expenditures once it starts construction of the building, or whether it should continue to capitalise them during construction.

The Committee concluded that if the land is not capable of being used for its intended purpose during the construction phase, the land and building should be considered together when determining when to cease capitalising borrowing costs on land expenditures.

European highlights

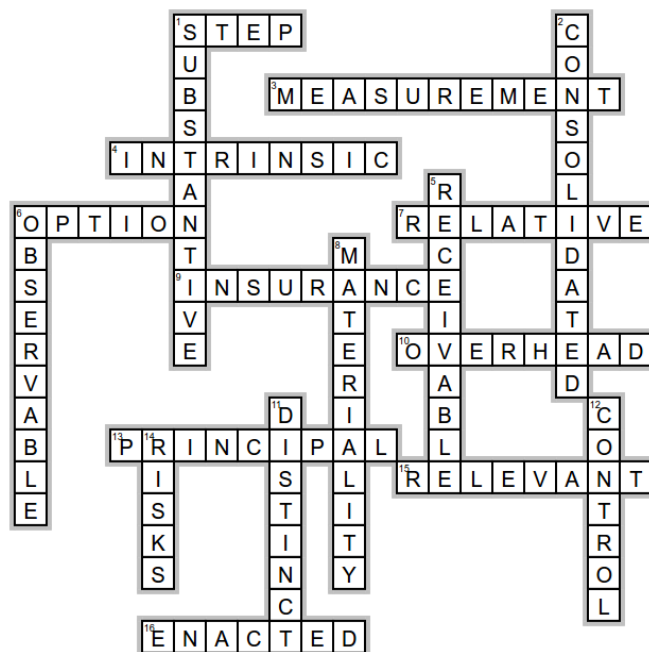
European Commission to discuss the future of corporate reporting

Following its 'Fitness check' consultation last March (see Beyond the GAAP no. 120, March 2018), the European Commission has announced that it will be hosting a conference on the future of corporate reporting in a digital and sustainable economy. The conference will take place on Friday 30 November 2018 in Brussels and will provide an opportunity to consider participants' responses to the consultation and to have face-to-face discussions between different types of stakeholders (regulators, preparers and users of financial statements, civil society, etc.).

Details of the conference can be found here:

https://ec.europa.eu/info/events/finance-181130-companies-public-reporting_en

Crossword: last month's solution



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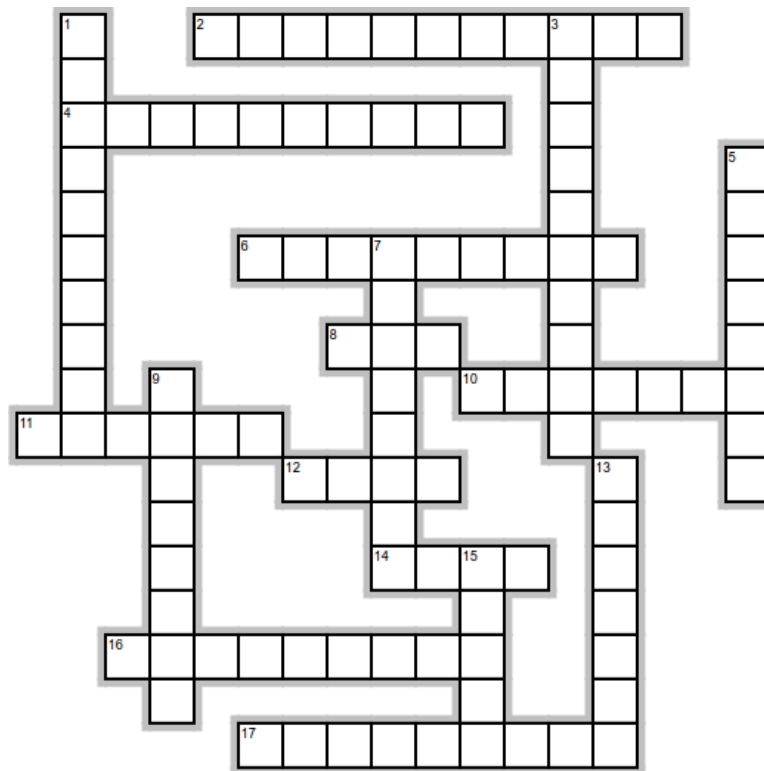
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Crossword: The subtleties of investment property accounting



Across

2. Commencement of development of an investment property with a view to sale requires transfer of the property to this class of asset
4. These assets do not fall within the scope of IAS 40
6. Measurement of investment property at fair value following initial recognition is not this
8. This type of right was introduced by IFRS 16 and is subsequently accounted for in accordance with IAS 16 unless it is classified as investment property
10. A property that is leased under this type of lease is not an investment property
11. Investment property may generate such income
12. An investment property is initially recognised at this amount
14. This is considered to be investment property as defined in IAS 40 if it is held for a currently undetermined future use
16. In situations where an entity provides services to the occupants of a building it owns, it must make use of it to determine whether the building is investment property as defined in IAS 40
17. Depending on estimated future cash inflows and outflows, an entity may need to recognise one if the investment property is measured at fair value

Down

1. The presumption that an entity can reliably measure the fair value of an investment property is this
3. An investment property that is not measured at fair value shall be subject to such a test if certain indications are present
5. The fair value of an investment property shall be measured in accordance with this IFRS and the clarifications provided by IAS 40
7. This transaction generally requires derecognition of the investment property
9. These costs are usually recognised as expenses
13. Owner-occupied property is accounted for under this IAS, rather than IAS 40
15. When an investment property is measured using the cost model, its fair value shall be disclosed here

A Closer Look

Puts on non-controlling interests: what changes are proposed in the FICE Discussion Paper?

Following on from our 'A Closer Look' feature on the *Financial Instruments with Characteristics of Equity* (FICE) Discussion Paper in the July-August issue of *Beyond the GAAP*, this month's feature will look specifically at put options granted to minority shareholders ('Puts on non-controlling interests').

1. How did the current accounting treatment come about?

When IFRS standards were first implemented in 2005, they did not yet include provisions on changes in percentage holdings in a subsidiary, and the requirement to immediately recognise a liability for their obligation to buy back equity instruments in the future came as a surprise to French companies.

IAS 32 required (and still requires) that put options granted to minority shareholders should be recognised as liabilities at the present value of the strike price of the put option but did not give any further guidance on the contra journal entry. This has resulted in diversity in practice, both at the date of initial recognition and subsequently.

At initial recognition, entities have generally chosen one of two approaches, both of which anticipate the eventual buyback of the shares by the entity:

- an approach that involves recognising an additional goodwill for the difference between the liability and the value of the shares likely to be repurchased; or
- an approach that involves recognising the difference in group equity, on the assumption that this is permissible in the absence of any clarifications to the contrary.

Similarly, a variety of different accounting methods have been used for subsequent changes in the value of the liability:

- recognition in profit or loss, based on the general assumption that changes in the value of a financial liability have an impact on profit or loss;
- recognition in equity, based on the argument that an obligation relating to own shares should not have an impact on profit or loss (particularly if the strike price depends on the fair value of the underlying shares, which is quite often the case); or
- recognition in goodwill using the 'partial goodwill' method, which is consistent with the approach mentioned above that anticipates the buyback of the shares (all other things being equal).

The French Securities Regulator, the AMF, noted this diversity in practice, stating in its 2005 year-end recommendations that entities should give details of the

accounting treatment used at initial recognition of the liability and for subsequent changes in its value.

The IFRIC (now the IFRS IC) also tackled the issue, trying to reach a consensus but failing. Consequently, it decided in 2006 not to add the topic to its agenda.

In 2008, phase II of the *Business Combinations* project brought us a step further towards the current accounting treatment for puts on non-controlling interests, by reducing the number of permitted approaches. After this, IAS 27 was amended to stipulate that the impact of changes in percentage holdings in subsidiaries should be recognised in equity.

Logically, following these amendments, the AMF's year-end recommendations for 2009 clarified that the use of the 'partial goodwill' method at initial recognition could still be retained for existing puts, but would no longer be permissible for new put issues. The AMF also stated that its preferred approach for subsequent changes in the value of the liability was recognition in equity, rather than in profit or loss; however, both approaches were still permissible.

In March 2011, the IFRIC tried to resolve the practical issues submitted to it by proposing to exclude put options written on non-controlling interests of subsidiaries, to be settled by the physical delivery of shares, from the scope of IAS 32. This would have meant that these puts would be accounted for under IAS 39 (now IFRS 9) in line with all other derivative instruments, i.e. at fair value through profit or loss.

A few months later, in September 2011, this proposal was rejected by the IASB.

The IFRIC continued its discussions on the subject and in March 2012 it published a draft interpretation that would require subsequent changes in the value of the liability to be recognised in profit or loss.

In January 2013, after receiving comments on the draft interpretation, the IFRIC stated that the draft was a correct interpretation of the existing standard (and specifically of paragraph 23 of IAS 32) but that it remained convinced that its proposal from March 2011 – that these put options should be accounted for like any other derivative – would provide better quality financial information. With this in

mind, the IFRIC asked the IASB to reconsider its position on paragraph 23 of IAS 32.

In March 2013, the Board responded by cancelling the IFRIC's draft interpretation, putting a halt to its efforts to clarify the issue.

Since then, the IFRS IC has still not reached a conclusion, despite receiving further requests for clarification, particularly as regards the accounting treatment of written put options to be settled by a variable number of the parent company's shares (in 2016). The IFRS IC noted at the time

that the issue was too broad for it to address, and that the Board's ongoing work on the FICE project could provide some answers.

Against this background, this summer's FICE Discussion Paper (DP) proposes a new approach for determining what shall be classified as a liability, applicable to both derivatives and non-derivative instruments. Here, we analyse the potential repercussions of the DP.

2. What does the FICE DP say about puts on non-controlling interests?

Let's begin with a reminder of the Board's preferred approach: an instrument would be classified as a liability if a) the entity has an obligation to transfer economic resources before liquidation (timing feature) or b) the entity has an obligation to transfer an amount independent of the entity's economic resources (amount feature).

In addition, the Board is proposing a specific accounting treatment for derivatives that are physically settled in the entity's own shares (meaning they are extinguished in accounting terms). Under the proposed accounting treatment, written put options would be classified together with the underlying own shares as a single transaction.

Thus, in the case of puts on non-controlling interests (NCI puts), the Board notes that the entity faces two potential outcomes:

- either the minority shareholders exercise their put options and the entity is obliged to repurchase its own shares at the price agreed in the contract, resulting in the extinguishment of its own shares;
- or the minority shareholders do not exercise their put options and the shares are not extinguished.

In this case, as the exercise of the puts is at the option of the minority shareholders, it is possible that the entity will have an obligation to transfer economic resources before liquidation. Under the Board's preferred approach, this would mean that the instrument meets the criterion for the timing feature, and thus should be recognised as a liability. The contra journal entry for the liability would be the extinguishment of the shares held by the non-controlling interests, at the date when the entity issues the put options.

The Board proposes that the existence of NCI puts should be viewed in the same way as a bond convertible to own shares, as both have the same outcomes: either an obligation to transfer economic resources, or own shares still outstanding. The Board believes that this justifies using the same accounting treatment. It should however be noted that this approach ignores one difference: the shares already exist in the case of shares + NCI puts, but are yet to be issued in the case of convertible bonds.

Having looked at the accounting treatment at initial recognition, how should an entity account for subsequent changes in the value of the liability it has recognised? It is interesting, in the light of the past discussions reviewed above, that the Board is proposing that they should by default be booked to profit or loss.

However, the Board has also introduced a new presentation requirement. Liabilities that do not meet the criterion for the amount feature (i.e. the amount transferred is dependent on the entity's economic resources) are to be presented separately in the balance sheet. Subsequent changes in the value of these instruments would then be recognised in other comprehensive income (OCI) without recycling to profit or loss.

The Board suggests that the separate presentation principle should be applied consistently to derivatives that do not have an underlying variable that is independent of the entity's economic resources (with the exception of interest rates, which by definition affect all derivatives, and foreign currency exposures under certain circumstances).

Thus, if an entity issues put options on its non-controlling interests with a strike price equal to the fair value of the shares, the separate presentation requirement would *de facto* apply.

The accounting treatment would thus be as follows:

- at the date when the puts are issued, the entity recognises a liability for the fair value of the shares (the strike price of the puts) with a contra journal entry for an equivalent reduction in equity. The liability is presented separately in the balance sheet;
- subsequent changes in the share price will require the entity to remeasure the liability, with a contra journal entry as a separate line item in OCI (not recyclable).

To cover all the bases, we also need to look at the accounting treatment for fixed-price puts on non-controlling interests. Once again, we start by analysing the rights and obligations of the instruments in conjunction with the underlying shares. Effectively, these are treated as fixed-price puttable shares; the holders (i.e. the minority shareholders) have the option

of putting them back to the entity. As the entity cannot avoid the obligation to transfer a fixed amount of economic resources, the IASB's position in the DP is that the entity should recognise a liability for the present value of the strike price. The Board also believes that underlying own equity should be reduced by an amount equal to the fair value of the shares at the issue date of the put. In the previous case, the amount of the liability was equal to the amount of equity extinguished. But in this case, there is a discrepancy.

The Board acknowledges that it is also possible that the minority shareholders will not exercise the put option. Economically speaking, there is no incentive for a minority shareholder to put its shares back to the entity at a price that is lower than their actual value. Therefore the shares could remain outstanding. Attempting to represent this in financial terms would effectively give us a written call option. The Board considers that the residual amount is a component of the call option, which is a component of equity.

We can represent this as follows:

Written put option (original instrument) = forward contract (represented by a liability for the amount of the strike price) + written call option (representing the possibility that the put may not be exercised)

It is also interesting to note that recognising a liability and a written call option in this way corresponds exactly to the accounting treatment of a convertible bond; thus, the Board's analogies are consistent.

In summary, a fixed-price, physically-settled put on non-controlling interests would be accounted for, under the Board's proposed approach, as follows:

- i. the extinguishment of the shares held by the non-controlling interests at an amount equal to the fair value of the shares at the issue date of the put
- ii. recognition of a liability for an amount equal to the present value of the strike price of the put
- iii. a call option written on own shares, with an initial value of the difference between i) and ii).

In conclusion, this Discussion Paper represents a shift in the Board's position on the complex issue of NCI puts with a strike price equal to the fair value of the underlying shares. In this case, the Board is moving towards the position put forward by the AMF in 2009. In contrast, the Board's proposal for fixed-price NCI puts is more innovative. We have no doubt that many comments on this topic will be submitted to the Board before the closing date of its consultation on 7 January 2019!

Key points to remember

- A lot of ink has been spilt on the topic of puts on non-controlling interests since IFRS came into effect in 2005, and in the absence of clear guidance on the subject, a diverse range of accounting methods have been used.
- The IASB has proposed a new accounting treatment as part of its FICE project, differentiating between NCI puts with a strike price equal to the fair value of the underlying shares, and fixed-price NCI puts.
- For NCI puts with a strike price equal to the fair value of the underlying shares, an entity would recognise a liability (presented separately) for the fair value of the shares, with a contra journal entry for a reduction in equity, at the date when the put is issued. Subsequent changes in the value of the liability would be recognised in OCI without recycling to profit or loss.
- For fixed-price, physically-settled NCI puts, an entity would recognise a liability for an amount equal to the present value of the strike price of the put, with a contra journal entry for the extinguishment of the shares held by the non-controlling interests at an amount equal to the fair value of the shares at the issue date of the put, and a call option written on own shares for an amount equal to the difference between the first two components.

Events and FAQ

Frequently asked questions

IFRS

- Free share allocation plans
- IFRS 3 and the concept of a “business”
- Business combinations under common control
- Securitisation of R&D tax credit receivables
- IFRS 5 and the cash flow statement
- Accounting treatment of sale and leaseback transactions

IFRS		EFRAG	
IASB	Committee	Board	TEG
22-26 October	27-28 November	22 November	29 November
12-16 November	16 January	18 December	20 December
10-15 December	5-6 March	29 January	16-17 January

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