Accounting for deals with puts, calls or forward contracts can be complex

What you need to know

- Today’s buyers and sellers of businesses are coming up with innovative deal structures that include call or put options or forward contracts indexed to the portion of the business not acquired.

- The accounting for these options and forward contracts over noncontrolling interests can be complex and often will affect future earnings, earnings per share and other operating metrics.

- Companies should carefully consider the potential consequences before entering into deals that include the use of call or put options and forward contracts.

Overview

While the volume of merger and acquisition (M&A) activity has declined slightly in recent years, we are seeing an increase in the complexity of deal structures, particularly those using contingent consideration or call or put options or forward contracts (referred to in this publication as equity contracts) that allow the buyer and seller to share the economic risks of an acquired business for a period of time.

The accounting for acquisitions using these features can be complex and often will affect future earnings. Before consummating these transactions, companies should fully understand the accounting implications and effects on future earnings, earnings per share (EPS) and other financial metrics.

This publication – the second in a series – addresses the accounting for equity contracts entered into between a buyer (i.e., the new parent that acquires a controlling interest in a business) and noncontrolling interest (NCI) holders in a business combination. In December 2012, we issued a companion publication, Complex deal structures can affect future earnings and other metrics, which focused on accounting and valuation considerations for contingent consideration issued in a business combination.
Use of call options, put options or forward contracts

A buyer that acquires a controlling financial interest (but less than 100%) in an acquiree may want the right to obtain the NCI at a later date. The buyer could execute a call option (a right) or a forward contract (an unconditional obligation) on the NCI with the seller, which in effect would give the buyer flexibility in the timing and financing to acquire the NCI. When the seller wants to retain an equity interest to participate in the future performance of the business but have the right to sell its NCI after a period of time, it may execute a put option over the NCI with the buyer.

Buyers and sellers may enter into such arrangements for the following reasons:

- **Tax planning** – A seller may want to defer capital gains that would result from selling 100% of an entity. The seller may be willing to sell a controlling interest with a put option giving it the right to sell the remaining interest or a call option giving the buyer the right to acquire the remaining interest (or both).

- **Flexibility for the buyer** – Call options and forward contracts provide flexibility for the buyer in financing an acquisition.

- **Liquidity to the seller** – Put options and forward contracts give the seller an exit strategy for its retained interest.

- **Seller retention** – Call options, put options or forward contracts with a fair value exercise price create an incentive for the seller to remain involved with the business and help make it successful.

Agreements between buyers (i.e., new parents) and NCI holders may:

- Grant the NCI holders an option to sell their remaining interests in the business to the buyer (i.e., a written put option from the buyer’s perspective)

- Grant the buyer an option to acquire the remaining interests held by the NCI holders (i.e., a purchased call option from the buyer’s perspective)

- Obligate the buyer to acquire and the NCI holders to sell their remaining interests (i.e., a forward contract to purchase shares from the buyer’s perspective)

- Grant the buyer a purchased call option and grant the NCI holders a written put option (i.e., an arrangement similar to but not exactly the same as a forward contract)

Accounting for these types of arrangements can be difficult, due to the complexity and volume of authoritative guidance that needs to be considered. The accounting often is affected by whether (1) the feature (e.g., call option, put option, forward contract) is considered embedded or freestanding and (2) the strike price is fixed, variable (according to a formula) or at fair value. Buyers also should carefully evaluate how these arrangements affect future earnings and EPS.
This publication addresses the accounting for a buyer’s equity contracts and embedded features over the NCI retained by the seller in a business combination. The accounting is based on guidance for contracts on an issuer’s shares, including those of a consolidated subsidiary if the subsidiary is substantive. In some situations, a buyer may initially purchase an NCI and use call or put options or forward contracts to acquire additional shares and obtain a controlling financial interest in the future (i.e., a business combination achieved in stages). However, until the investee is consolidated, the derivative literature in ASC 815-10\(^1\) would apply to those financial instruments rather than the guidance in ASC 815-40\(^2\) and ASC 480,\(^3\) as described in this publication.

**Initial recognition of NCI in a business combination**

NCI is the portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to the parent. In a business combination, it is recognized at its acquisition-date fair value in accordance with ASC 805.\(^4\)

If the target is a public company, determining the fair value of the NCI generally is straightforward. The amount typically is based on the percentage ownership interest and the share price. However, if the target is a private company, determining the fair value of NCI requires further consideration. In many instances, it is determined by calculating the fair value of the acquired business as a whole (considering the value of the company under the new ownership, which often includes a control premium) and subtracting the consideration the buyer pays for its controlling interest. It is important to note that the fair value of NCI may not reflect the per-share price paid by the buyer for its controlling interest because the shares acquired by the buyer may have additional features that are not shared by the NCI, and the buyer may have paid a premium for these features.

For example, if a buyer paid $100 for an 80% controlling interest in a target company, it may not be appropriate to assume that the fair value of the 20% NCI is $25 (i.e., 20% of an enterprise value calculated as $100 divided by the 80% interest acquired). The analysis should consider the value of the target company that is consistent with the transaction price, given the rights and preferences of the securities the buyer received in the transaction, and the value of the NCI should be estimated considering those rights and preferences. In addition, certain equity contracts that are embedded in the NCI (as discussed below) may need to be considered in determining the fair value of the NCI.

**Roadmap for initial classification of equity contracts over NCI**

The following flowcharts provide a roadmap for determining the appropriate classification of equity contracts over NCI arising in a business combination. We discuss each decision in more detail after the charts.
Illustration 1 – Determining the buyer’s initial classification of equity contracts over NCI in a business combination

1. Is the feature embedded in NCI?
   - No: The feature is freestanding and is accounted for separately from NCI (see flowchart in Illustration 2)
   - Yes: The NCI (including the embedded feature) is classified as a liability

2. Is the NCI (including the embedded feature) within the scope of ASC 480?
   - No: Does the embedded feature meet the definition of a derivative pursuant to ASC 815?
     - No: Does the feature require bifurcation from the NCI?¹
       - Yes: The feature is classified separately from NCI as an asset or liability
       - No: The NCI (including the embedded feature) is classified as equity
     - Yes: Does the feature cause the NCI to be redeemable pursuant to ASC 480-10-S99-3A?²
       - Yes: The NCI is classified as temporary equity (i.e., in the mezzanine)
       - No: The NCI is classified as permanent equity

¹ - This includes determining whether the economic characteristics and risks of the embedded feature are clearly and closely related to the host contract and, if not, whether the embedded feature is eligible for a scope exception from ASC 815 (e.g., ASC 815-10-15-74(a)).

² - Features considered embedded in the NCI, regardless of whether they are bifurcated and accounted for separately from the NCI, should be considered in determining whether the NCI is subject to ASC 480-10-S99-3A. That is, the NCI host may still require mezzanine classification even if the embedded derivative is bifurcated.
The first step is to determine whether the equity contract is embedded or freestanding.

### Evaluation whether an equity contract is embedded or freestanding

The first step in the accounting for equity contracts on NCI is to determine whether the contract is an embedded feature in the NCI or a freestanding financial instrument. This determination requires a careful analysis of the facts and circumstances, including an evaluation of the substance of the transaction. For example, an instrument that is documented in a separate contract is not necessarily freestanding. Similarly, an instrument that is documented in the same contract isn't necessarily embedded.

Under ASC 480, an equity contract that is issued at the same time and to the same counterparty as another instrument such as NCI is freestanding if it is both:

- **Legally detachable** – Generally, the two instruments can be legally separated and transferred, and the two components may be held by different parties.

- **Separately exercisable** – Generally, one instrument can be exercised without resulting in the termination of the other (e.g., through redemption, simultaneous exercise, expiration).

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### Illustration 2 – Buyer’s initial classification of freestanding equity contracts over NCI in a business combination

<table>
<thead>
<tr>
<th>Question</th>
<th>Step 1</th>
<th>Step 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>At inception, does the equity contract embody an obligation to (1) buy back the NCI by transferring assets or (2) issue a variable number of shares for which the monetary value is predominantly (i) fixed, (ii) varying with something other than the fair value of the issuer’s equity shares or (iii) varying inversely in relation to the issuer’s equity shares?</td>
<td>Yes</td>
<td>Record the equity contract as a liability (or an asset in some circumstances) pursuant to ASC 480</td>
</tr>
<tr>
<td>Is the equity contract indexed to the issuer’s own stock?</td>
<td>No</td>
<td>Does the equity contract meet the definition of a derivative?</td>
</tr>
<tr>
<td>Does the equity contract meet all the conditions for equity classification?</td>
<td>No</td>
<td>Account for the equity contract as a derivative</td>
</tr>
<tr>
<td>Classify the instrument in equity</td>
<td>Yes</td>
<td>Classify the equity contract as an asset or liability</td>
</tr>
<tr>
<td>Classify the equity contract as an asset or liability</td>
<td>No</td>
<td>Determine whether the equity contract meets the definition of a derivative; if it does, it is subject to the derivative disclosures requirements</td>
</tr>
</tbody>
</table>

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Continued from Illustration 1 (i.e., conclusion that the feature is a freestanding instrument)
If exercising one instrument results in the termination of the other, the instruments generally would not be considered freestanding under ASC 480. However, if one instrument can be exercised while the other remains outstanding, the instruments would be considered freestanding, as long as the contract is legally detachable from the NCI.

For example, if a buyer acquires a controlling financial interest in a private company and at the same time enters into a contract with the NCI holders that permits the NCI holders to sell their shares to the buyer at a fixed price, that written put option generally would be considered to be embedded in the shares held by the NCI holders (i.e., embedded in the NCI). In these circumstances, the NCI holder would need to hold the private company shares in order to exercise the put (i.e., the NCI holder could not go into the open market to obtain shares to deliver upon exercise). Thus, in substance, the put option would not be separately exercisable from the NCI shares because the NCI shares will cease to exist when the put is exercised.

Conversely, if a buyer acquires a controlling financial interest in a public company and at the same time enters into a contract with certain NCI holders that permits them to sell any common shares of the subsidiary to the buyer at a fixed price (i.e., the NCI holder could exercise the put using shares of the subsidiary it already owns or shares acquired in the public market), the put option would be considered freestanding if it is also legally detachable from the shares.

**Embedded call or put options**

If a call or put option is considered embedded in the NCI shares, the shares should be analyzed to determine whether they are mandatorily redeemable financial instruments under ASC 480 and therefore liabilities. If the shares are not mandatorily redeemable, the feature or features should be evaluated for bifurcation as an embedded derivative. Since embedded call or put options usually do not result in the shares being considered mandatorily redeemable (because the contracts convey options rather than obligations), those features are most frequently evaluated to determine whether bifurcation is required.

To determine whether bifurcation is required, the hybrid instrument (the NCI shares and embedded feature) is evaluated under ASC 815-15. Bifurcation is required only if the embedded feature meets the definition of a derivative under ASC 815-10. Unless the subsidiary is publicly traded, the feature generally does not meet the definition of a derivative in ASC 815-10-15 because these features usually require gross physical settlement (i.e., the transfer of the full amount of consideration payable in exchange for the full number of underlying subsidiary shares). Because the underlying shares of a nonpublic entity usually are not readily convertible to cash, gross physical settlement frequently does not meet any of the forms of net settlement under ASC 815-10-15-99. Exchanging cash and an asset that is not as liquid as cash is not the same as a net settlement.

If the embedded feature meets the definition of a derivative, it may still qualify for an exception to bifurcation under ASC 815-10-15-74(a) for features that are indexed to the issuer’s own stock and would be classified in equity. The guidance in ASC 815-40 should be considered in making this determination. When subsidiary shares are involved, ASC 815-40-15-5C discusses additional considerations for determining whether a feature is indexed to the issuer’s own stock (i.e., whether the subsidiary is substantive).
Embedded call or put options that do not require bifurcation under ASC 815 would be considered in the accounting for the NCI. Depending on the terms of the embedded feature or features, the accounting could be as follows:

<table>
<thead>
<tr>
<th>Embedded feature</th>
<th>NCI recognized separately?</th>
<th>Redeemable under SEC guidance?</th>
<th>Subsequent accounting</th>
<th>Further discussion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchased call option</td>
<td>Yes</td>
<td>No</td>
<td>ASC 810</td>
<td>See below</td>
</tr>
<tr>
<td>Written put option</td>
<td>Yes</td>
<td>Yes</td>
<td>ASC 810, then ASC 480-10-599-3A</td>
<td>See below and p. 9</td>
</tr>
<tr>
<td>Combination of purchased call and written put with different exercise price or date</td>
<td>Yes</td>
<td>Yes</td>
<td>ASC 810, then ASC 480-10-599-3A</td>
<td>See p. 8-9</td>
</tr>
<tr>
<td>Combination of purchased call and written put with same or similar fixed exercise price and same exercise date</td>
<td>No</td>
<td>Not relevant</td>
<td>ASC 480</td>
<td>See p. 8</td>
</tr>
<tr>
<td>Forward contract</td>
<td>No</td>
<td>Not relevant</td>
<td>ASC 480</td>
<td></td>
</tr>
</tbody>
</table>

For a single embedded purchased call or written put, or an embedded combination of options that do not have the same or similar exercise prices and exercise dates, any changes in fair value would not be recognized. Also, earnings of the subsidiary would be attributed to the controlling and noncontrolling interests according to the guidance in ASC 810⁵ without consideration of the embedded call or put option. If the embedded call or put option is exercised, the NCI is reduced and additional paid-in-capital is adjusted for any difference between the NCI’s carrying amount and the consideration paid. However, as noted above, buyers that prepare financial statements in accordance with the SEC’s Regulation S-X should consider the incremental SEC guidance on redeemable NCI if the equity contract is an embedded written put option (or combination of an embedded written put option and a purchased call option).

Call or put options that require bifurcation under ASC 815 are recognized as a single derivative (or a single compound derivative if multiple features are bifurcated) and is accounted for separately from NCI as a derivative asset or liability. The NCI is first recognized at its acquisition-date fair value in accordance with ASC 805. The embedded derivative asset or liability is then bifurcated from the NCI and its fair value is recorded separately. For example, if the acquisition-date fair value of the NCI was $100 and the fair value of the embedded derivative liability was $10, after bifurcation the NCI balance and derivative liability balance would be $90 and $10, respectively. In this example, the fair value of the NCI of $100 would be included in the calculation to determine the amount of goodwill.

Illustrations 3 and 4 show the accounting for an embedded put option and an embedded call option in a business combination, respectively.
**Embedded forward contracts and certain combinations of embedded options**

In some business combinations, the buyer embeds an agreement with the seller in the NCI that requires the buyer to pay and the seller to accept a specified price (either fixed, variable or at fair value) for the NCI at a specified date (forward contract).

In other situations, the buyer may embed in the agreement a combination of a written put option and a purchased call option with the seller, in which the options have the same fixed exercise price and same exercise date. The combination of these two options is economically similar to a forward contract at a specified price.

In substance, both of these transactions provide flexibility to the buyer in financing the transaction, and result in no NCI being recognized. Instead, the buyer recognizes a liability for the future purchase of the NCI. The buyer has obtained the risks and rewards of owning the NCI during the period of the contract, even though the NCI holders retain legal ownership of the NCI.

**Embedded forward contract**

Because an embedded forward contract represents an obligation of the buyer to mandatorily redeem the NCI for cash, the NCI (including the embedded forward contract) is recognized as a liability within the scope of ASC 480. The liability is initially measured at fair value. Subsequently, it should be measured at either (1) the present value of the amount to be paid at settlement under an accretion model if both the amount to be paid and the settlement date are fixed, or (2) the amount of cash that would be paid under the conditions specified in the contract as if settlement occurred at the reporting date if the amount to be paid or the settlement date varies. Under both approaches, any change in the fair value of the liability is recognized as interest expense.

Illustration 5 shows the accounting for an embedded forward contract in a business combination.

**Combination of embedded call and put options that are similar to forward contracts**

The combination of an embedded purchased call option and a written put option that have the same fixed exercise price and same exercise date does not represent a forward contract because there is the possibility that the fair value at the exercise date will equal the shared strike price and neither party would be economically motivated to exercise. However, the effect of the embedded options on the measurement and valuation of the NCI is essentially the same as that of a forward contract under US GAAP.

According to ASC 480-10-55-59 through 55-62, an embedded purchased call option and a written put option that have the same (or similar, meaning not necessarily equal but not significantly different) fixed exercise prices and are exercisable at a stated future date result in the NCI being a liability. Because the fixed prices give the buyer the risks and rewards of owning the NCI during the period that the options are outstanding, accounting for the NCI and embedded options together as a liability reflects their economic substance even though the legal ownership of the NCI is still retained by the NCI holders. Therefore, the buyer does not recognize any NCI. Instead, the buyer recognizes a liability for the financing.
Because the NCI is not considered mandatorily redeemable (given the possibility neither party exercises its option), ASC 480-10-55-60 indicates that the liability should be measured initially at the present value of the fixed price settlement amount. Subsequently, the liability is accreted to the fixed price over the term of the contract, with the resulting expense recognized as interest expense.

If the exercise price for the embedded options is not fixed (i.e., it is variable or at fair value), the arrangement would not be viewed as a financing. As described above, the NCI would continue to exist, and the options would be recognized as part of the NCI in equity. Earnings would be attributed to the controlling and noncontrolling interests according to the guidance in ASC 810, with no recognition of changes in the fair value of the options. However, for financial statements that are prepared in accordance with the SEC’s Regulation S-X, there are additional considerations because the NCI is considered redeemable.

Illustrations 6 and 7 demonstrate the accounting for the combination of an embedded call and put option in a business combination. Illustration 6 shows the accounting when the put and call option have the same fixed exercise price and exercise date. Illustration 7 shows the accounting when the call and put option are to be settled at fair value.

**Redeemable NCI**

Generally, an embedded feature (whether or not bifurcated) that permits or requires an NCI holder to deliver subsidiary shares in exchange for cash or other assets from the buyer results in the NCI being considered redeemable equity if the NCI is not presented as a liability. In these cases, financial statements prepared in accordance with the SEC’s Regulation S-X need to consider the SEC staff’s guidance on redeemable equity securities (included in Codification at ASC 480-10-S99-3A) when classifying and measuring redeemable NCI. The SEC guidance may result in the NCI being presented as “mezzanine” or temporary equity (between liabilities and permanent equity) on the balance sheet. While private companies usually don’t have to follow this guidance, we generally believe that its application is preferable.

For all entities, NCI is initially accounted for and subsequently measured in accordance with ASC 810. For financial statements prepared in accordance with the SEC’s Regulation S-X, if the NCI is considered redeemable under ASC 480-10-S99-3A, it is presented as mezzanine equity and subsequently measured in accordance with the SEC guidance.

The SEC measurement guidance is not applied in lieu of the accounting for NCI under ASC 810. Instead, it is an incremental accounting requirement. After the carrying amount is measured under ASC 810 (determined by attributing the subsidiary’s net income or loss and related dividends to the NCI), that amount is adjusted for any increases necessary to reflect the measurement under the SEC’s redeemable equity guidance. Decreases in the SEC’s measurement basis can be reflected only to the extent they offset previous increases, but the NCI balance presented in the financial statements is never adjusted below the ASC 810 balance. That is, the amount presented should be the greater of the NCI balance determined under ASC 810 and the amount determined under ASC 480-10-S99-3A. Adjustments to the carrying amount of redeemable NCI from the application of the SEC staff’s guidance are charged to retained earnings (or to additional paid-in capital if there are no retained earnings) and do not affect net income or comprehensive income in the consolidated financial statements. That adjusted NCI balance is presented in temporary equity.
Under ASC 480-10-S99-3A, a security (including NCI) that is currently redeemable is measured at the current redemption amount. If a security is not currently redeemable but it is probable that it will become redeemable in the future, the SEC guidance permits the following methods of adjusting the security’s carrying amount:

- **Method 1** – Accrete changes in redemption value over time, to the earliest redemption date, using an appropriate method (e.g., the interest method)

- **Method 2** – Adjust the carrying amount of the redeemable security to what would be the redemption amount assuming the security was redeemable at the balance sheet date

The SEC guidance does not specify which method is to be used when measurement is required. We generally believe that financial statements prepared under this guidance should evaluate the facts and circumstances of a redemption feature and the level of subjectivity and assumptions necessary and apply the method that best presents the economics of the redeemable NCI. Once the method is selected, it should be applied consistently.

If the NCI is not currently redeemable and it is not probable that it will become redeemable, the NCI should still be classified in temporary equity. However, an adjustment to the carrying amount for the SEC guidance is not necessary until it is probable that the NCI will become redeemable and not whether it is probable that the NCI will be redeemed.

**Freestanding equity contracts**

Freestanding equity contracts on NCI are evaluated the same way as freestanding equity contracts on a parent’s own shares.

**Accounting for freestanding put or call options**

If a call option or put option is considered a freestanding financial instrument, it should be accounted for separately from the NCI. The combination of a freestanding written put option and a purchased call option on the NCI needs to be carefully evaluated to determine whether (1) there are two freestanding instruments or (2) there is a single freestanding instrument comprising both options.

The call or put options initially are evaluated under ASC 480 to determine whether liability classification is required. That evaluation depends on how many freestanding instruments there are. Instruments that require the issuer to transfer cash or other assets in exchange for its own shares are classified as liabilities under ASC 480. Therefore, a written put option would be classified as a liability under ASC 480 because it requires the buyer to transfer cash or other assets in exchange for the NCI, but a purchased call option would not be in the scope of ASC 480 because it does not represent an obligation. However, if a single contract contains both the put and call options, it will be a liability (or asset in some cases) due to the inclusion of the written put option.

If an equity contract such as a purchased call option is not a liability under ASC 480, it should be evaluated to determine whether it is indexed to the issuer’s own stock and meets all of the conditions for equity classification, and possibly whether it meets the definition of a derivative. This analysis determines the classification and subsequent measurement of the freestanding instrument.\(^7\)
The following table summarizes that evaluation for a purchased call option at inception:

<table>
<thead>
<tr>
<th>Indexed to the issuer’s own stock?</th>
<th>Meets conditions for equity classification?</th>
<th>Meets the definition of a derivative?</th>
<th>Resulting classification and subsequent measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>Yes</td>
<td>Not relevant</td>
<td>Contract initially measured at fair value and classified as equity with no subsequent measurement</td>
</tr>
<tr>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Derivative classified as an asset and initially and subsequently measured at fair value</td>
</tr>
<tr>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>Contract classified as an asset and initially and subsequently measured at fair value</td>
</tr>
<tr>
<td>No</td>
<td>Not relevant</td>
<td>Yes</td>
<td>Derivative classified as an asset and initially and subsequently measured at fair value</td>
</tr>
<tr>
<td>No</td>
<td>Not relevant</td>
<td>No</td>
<td>Contract initially measured at fair value and classified as an asset. Subsequent measurement requires judgment</td>
</tr>
</tbody>
</table>

If the equity contract is accounted for as a derivative, additional disclosures may be required. Equity contracts frequently do not meet the definition of a derivative because they cannot be net settled, as discussed above. That is, a gross physical settlement of cash for shares is made, and the shares generally are not considered readily convertible to cash if the subsidiary is not a public company.

Because the equity contract is freestanding, the NCI would continue to exist, would be classified in equity and would be subsequently accounted for in accordance with ASC 810. That is, earnings would be attributable to the controlling and noncontrolling interests without consideration of the equity contract. Also, there would be no need to evaluate the NCI for mezzanine classification under ASC 480-10-S99-3A. Finally, if an asset or liability is recorded for the equity contract as of the acquisition date, that asset or liability would form part of the consideration transferred and therefore would affect the amount of goodwill recorded.

Illustration 8 shows the accounting for a freestanding put option in a business combination.

**Accounting for a freestanding forward purchase contract**

If a forward contract is considered a freestanding financial instrument, it is classified as a liability. The buyer does not recognize any NCI. Instead, the buyer recognizes the liability for the financing. The initial and subsequent measurement of the liability depends on whether the payment amount and settlement date are fixed. If the payment amount and settlement date are fixed, the liability initially is measured at the present value of the contract amount. Subsequently, the liability is accreted to the settlement amount over the term of the forward contract with the resulting expense recognized as interest expense. If the payment amount or settlement date varies, the liability is initially measured at the fair value of the shares. Subsequently, the liability is measured at the amount that would be paid on the reporting date, with any changes in value recognized as interest expense.
Effect of equity contracts on NCI on EPS

As discussed above, an embedded feature (whether or not bifurcated) that permits or requires an NCI holder to deliver subsidiary shares in exchange for cash or other assets from the buyer will result in the NCI being considered redeemable NCI. Adjustments to the carrying amount of redeemable NCI from the application of the SEC staff’s guidance are charged to retained earnings (or to additional paid-in capital if there are no retained earnings) and do not affect net income or comprehensive income in the consolidated financial statements. However, when the NCI is in the form of common stock, the adjustments may affect EPS, depending on the redemption amount of the NCI.

If the redemption of NCI in the form of common stock is at fair value, adjustments to the carrying amount of redeemable NCI do not affect EPS because redemption at fair value does not result in the NCI holder receiving a distribution different from what other common shareholders would receive. However, if the redemption amount is anything other than fair value (e.g., fixed or variable) the NCI holder will receive a distribution that is different from what other common shareholders could receive if selling their shares. In those cases, the increases and decreases in the carrying amount of redeemable NCI are treated in the same manner as dividends on nonredeemable common stock.

There are two acceptable approaches for computing EPS for the effect of NCI that is redeemable at other than fair value:

- Treat the entire periodic adjustment resulting from the SEC’s guidance to the instrument’s carrying amount like a dividend
- Treat only the portion of that periodic adjustment to the instrument’s carrying amount that reflects redemption in excess of fair value like a dividend

These alternative approaches are accounting policy elections that should be applied consistently and disclosed in the notes to the financial statements.

In addition, the parent has two presentation alternatives: (1) adjust net income attributable to the parent (as reported on the face of the income statement) for changes in the carrying amount of the redeemable NCI, or (2) do not adjust net income attributable to the parent and consider only the effect of the redemption feature in the calculation of income available to common shareholders of the parent (which may be disclosed on the face of the income statement under SEC guidance). These approaches affect presentation and disclosure only. They do not affect the amount of reported EPS. The approach selected should be applied consistently.

Illustration 3 demonstrates the application of both presentations for NCI when the buyer has elected to treat the entire periodic adjustment to the instrument’s carrying amount like a dividend.

Companies should carefully consider the effect redeemable NCI will have on EPS.
Examples of common transactions

Illustrations 3 through 7 demonstrate the application of the concepts discussed above to some of the more common business combination scenarios involving the use of equity contracts over NCI. The analysis section in each illustration follows the flowchart depicted in Illustrations 1 and 2.

Illustration 3 – Accounting for embedded written put options in a business combination

On 1 January 20X7, Company P (an SEC registrant) acquires 80% of the outstanding common shares of Target, a private company, from Company Y for cash consideration. Company Y retains a 20% noncontrolling interest in Target. In connection with the acquisition, Company P and Company Y enter into an agreement that permits Company Y to sell its remaining 20% interest in Target to Company P on or after 1 January 20X9 for $475 in cash. The put option is non-transferrable and terminates if Company Y sells its shares.

At the acquisition date, the fair value of the NCI is $500. Target recognized net losses of $250 for 20X7. Company P has adopted an accounting policy of treating the entire periodic adjustment to the redeemable NCI’s redemption amount like a dividend.

Analysis

Is the put option embedded in the NCI?

Yes. The put option is not legally detachable from the NCI because it is non-transferrable. Further, it is not separately exercisable because the NCI terminates upon exercise of the option. As a result, the put option would be considered embedded in the underlying NCI.

Is the NCI (including the embedded feature) within the scope of ASC 480?

No. The put option does not cause the NCI to be mandatorily redeemable by Company P (because the embedded equity contract conveys an option rather than an obligation).

Does the put option meet the definition of a derivative and require bifurcation under ASC 815?

No. The put option does not meet the definition of a derivative because it requires gross physical settlement and the shares of Target are not publicly traded and therefore not readily convertible to cash.

Does the put option cause the NCI to be redeemable under ASC 480-10-S99-3A?

Yes. Because the put option permits Company Y to sell its equity interest to Company P (which is an SEC registrant) for cash, the NCI is considered to be redeemable equity under ASC 480-10-S99-3A. Therefore, the NCI should be classified as “mezzanine” (between liabilities and equity) on Company P’s balance sheet.
Illustration 3 – Accounting for embedded written put options in a business combination (continued)

At the acquisition date, the cash consideration transferred plus the fair value of the NCI ($500) would be used to determine the amount of goodwill. The NCI balance of $500 would be classified as “mezzanine.” After the acquisition date, the amount presented as “mezzanine” would be determined first by applying the guidance in ASC 810 and attributing the losses of Target to the controlling and noncontrolling interests. Therefore, at 31 December 20X7, before applying the guidance in ASC 480-10-S99-3A, the carrying amount of the NCI would be $450 ($500 - (20% x $250)).

Because the NCI is not currently redeemable but will become redeemable with only the passage of time, as discussed above, ASC 480-10-S99-3A permits two methods of adjusting the carrying amount of the redeemable security. For purposes of this illustration, assume that Company P elects to accrete the carrying amount for changes in the redemption value over time using the effective interest method, and that the accreted redemption value as of 31 December 20X7 is $470.

Accordingly, Company P adjusts the carrying amount of its redeemable NCI to its redemption value of $470 with a $20 credit to the NCI and a corresponding debit to retained earnings (or if there were no retained earnings, to additional paid-in capital).

That $20 debit to retained earnings would reduce the numerator in the earnings per share calculation. This reduction could be presented either as an adjustment on the income statement in determining net income attributable to the parent (refer to Alternative 1 below) or through the calculation of income available to common shareholders when deriving earnings per share (refer to Alternative 2 below). The manner in which the reduction is treated is an accounting policy election that should be applied consistently and disclosed in the notes to the financial statements.

The following is an excerpt from Company P’s income statement for the year ended 31 December 20X7.

<table>
<thead>
<tr>
<th></th>
<th>Alternative 1</th>
<th>Alternative 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>1,750</td>
<td>1,750</td>
</tr>
<tr>
<td>Plus: Net loss attributable to redeemable noncontrolling interest</td>
<td>30</td>
<td>50</td>
</tr>
<tr>
<td>Net income attributable to Company P</td>
<td>1,780</td>
<td>1,800</td>
</tr>
<tr>
<td>Earnings per share – basic:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income attributable to Company P common stockholders</td>
<td>$1.78</td>
<td>$1.78</td>
</tr>
<tr>
<td>Earnings per share – diluted:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income attributable to Company P common stockholders</td>
<td>$1.41</td>
<td>$1.41</td>
</tr>
<tr>
<td>Weighted average shares outstanding:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Basic</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Diluted</td>
<td>1,264</td>
<td>1,264</td>
</tr>
</tbody>
</table>
Illustration 3 – Accounting for embedded written put options in a business combination (continued)

The following table is an excerpt from the notes to the financial statements where basic and diluted net income attributable to Company P common stockholders per share has been computed:

<table>
<thead>
<tr>
<th></th>
<th>31 December 20X7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alternative 1</td>
<td></td>
</tr>
<tr>
<td>Net income attributable to Company P common shareholders</td>
<td>1,780</td>
</tr>
<tr>
<td>Or</td>
<td></td>
</tr>
<tr>
<td>Alternative 2</td>
<td></td>
</tr>
<tr>
<td>Net income attributable to Company P</td>
<td>1,800</td>
</tr>
<tr>
<td>Accretion of redeemable noncontrolling interest, net of tax</td>
<td>(20)</td>
</tr>
<tr>
<td>Net income attributable to Company P common shareholders after accretion of redeemable noncontrolling interest</td>
<td>1,780</td>
</tr>
</tbody>
</table>

**Basic:**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Weighted average shares outstanding and used in the computation of basic net income per share</td>
<td>1,000</td>
</tr>
<tr>
<td>Net income attributable to Company P common shareholders per share – basic</td>
<td>$1.78</td>
</tr>
</tbody>
</table>

**Diluted:**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares used in the computation of basic net income per share</td>
<td>1,000</td>
</tr>
<tr>
<td>Dilutive effect of stock options</td>
<td>264</td>
</tr>
<tr>
<td>Shares used in the computation of diluted net income per share</td>
<td>1,264</td>
</tr>
<tr>
<td>Net income attributable to Company P common stockholders per share – diluted</td>
<td>$1.41</td>
</tr>
</tbody>
</table>

A Comprised of loss attributable to noncontrolling interest in Target (calculated as $250 x 20%) less accretion of redeemable noncontrolling interest (calculated as $470 – $450)

B $250 x 20%

C $470 – $450

Illustration 4 – Accounting for embedded purchased call option in a business combination

On 1 January 20X7, Company P (an SEC registrant) acquires 80% of the outstanding common shares of Target, a private company, from Company Y for cash consideration. Company Y retains a 20% noncontrolling interest in Target. In connection with the acquisition, Company P and Company Y enter into an agreement that permits Company P to purchase the remaining 20% interest in Target from Company Y on or after 1 January 20X9 for $525 in cash. The call option is non-transferrable and terminates if Company P purchases the shares.

At the acquisition date, the fair value of the NCI is $500. Target’s earnings for 20X7 are $200.
Illustration 4 – Accounting for embedded purchased call option in a business combination (continued)

<table>
<thead>
<tr>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Is the call option embedded in the NCI?</td>
</tr>
<tr>
<td>Yes. The call option is not legally detachable from the NCI because it is non-transferrable. Further, it is not separately exercisable because the NCI terminates upon exercise of the option. As a result, the call option would be considered embedded in the underlying NCI.</td>
</tr>
<tr>
<td>Is the NCI (including the embedded feature) within the scope of ASC 480?</td>
</tr>
<tr>
<td>No. The NCI is not mandatorily redeemable because it is redeemable only at the option of Company P.</td>
</tr>
<tr>
<td>Does the call option meet the definition of a derivative and require bifurcation under ASC 815?</td>
</tr>
<tr>
<td>No. The call option does not meet the definition of a derivative because it requires gross physical settlement and the shares of Target are not publicly traded and therefore not readily convertible to cash.</td>
</tr>
<tr>
<td>Does the call option cause the NCI to be redeemable under ASC 480-10-S99-3A?</td>
</tr>
<tr>
<td>No. Because the exercise of the embedded call option is within the control of Company P (i.e., Company P is not obligated to transfer cash to Company Y unless Company P exercises the call option), the embedded call option does not cause the NCI to be redeemable under ASC 480-10-S99-3A. Therefore, the call option is recognized as part of the NCI in equity. Changes in the fair value of the call option are not recognized. At the acquisition date, the cash consideration transferred plus the fair value of the NCI ($500) would be used to determine the amount of goodwill. After the acquisition date, earnings would be attributed to the controlling and noncontrolling interests without consideration of the call option. Accordingly, the carrying amount of the NCI at 31 December 20X7 would be $540 ((20% x $200) + $500).</td>
</tr>
</tbody>
</table>

Illustration 5 – Accounting for embedded forward contract in a business combination

| On 1 January 20X7, Company P (an SEC registrant) acquired 80% of the outstanding common shares of Target, a private company, from Company Y for cash consideration. Company Y retains a 20% noncontrolling interest in Target. In connection with the acquisition, Company P and Company Y executed a forward contract that requires Company P to purchase Company Y’s remaining 20% interest in Target on 1 January 20X9 for a fixed price of $300. The forward contract is non-transferrable and will terminate when Company P acquires the shares. |
Illustration 5 – Accounting for embedded forward contract in a business combination (continued)

Analysis

Is the forward contract embedded in the NCI?

Yes. The forward contract is not legally detachable from the NCI because it is non-transferrable. Further, it is not separately exercisable because the NCI terminates through its settlement. As a result, the forward contract would be considered embedded in the underlying NCI.

Is the NCI (including the embedded feature) within the scope of ASC 480?

Yes. Because the forward contract embodies an obligation of Company P to mandatorily redeem the NCI for cash, the NCI (including the embedded forward contract) is a mandatorily redeemable financial instrument that should be accounted for as a liability under ASC 480.

As a result, Company P will account for this transaction as a financing, which means that Company P will not recognize any NCI. Instead, it will recognize a liability for the future purchase of the NCI. Because the NCI is mandatorily redeemable, the liability should be initially measured at fair value. Company P would subsequently measure the liability at the present value of the amount to be paid at settlement, accruing interest using the rate implicit at inception. At the acquisition date, the cash consideration transferred plus the fair value of the liability would be used to determine the amount of goodwill.

Because NCI is not recognized, no earnings would be allocated to the NCI after the acquisition date. The accretion of the NCI liability would be presented as interest expense in the income statement.

Companies that prepare financial statements in accordance with the SEC’s Regulation S-X must evaluate whether an equity contract causes NCI to be redeemable.

Illustration 6 – Accounting for embedded call and put option with the same fixed price and exercise date in a business combination

On 1 January 20X7, Company P (an SEC registrant) acquired 80% of the outstanding common shares of Target, a private company, from Company Y for cash consideration. Company Y retains a 20% noncontrolling interest in Target.

In connection with the acquisition, Company P and Company Y enter into an agreement that permits Company P to purchase the remaining 20% interest from Company Y for a fixed price of $300 on 1 January 20X9 and permits Company Y to sell its remaining 20% interest to Company P under those same terms. The call and put options are non-transferrable and will terminate if Company P purchases the shares or Company Y sells the shares.

Analysis

Are the call and put options embedded in the NCI?

Yes. For purposes of this step, Company P’s call option and Company Y’s put option should be evaluated separately to determine whether the features are embedded or freestanding. The call and put options are not legally detachable from the NCI because they are non-transferrable. Further, they are not separately exercisable because the NCI terminates upon exercise of the options. As a result, the call and put options would be considered embedded in the underlying NCI.
Illustration 6 – Accounting for embedded call and put option with the same fixed price and exercise date in a business combination (continued)

*Is the NCI (including the embedded feature) within the scope of ASC 480?*

Yes. Under ASC 480-10-55-59 through 55-62, since the call and put options are embedded in the NCI, they should be viewed on a combined basis with the NCI.\(^A\) Because the risks and rewards of owning the NCI have been retained by Company P during the period that the options are outstanding (notwithstanding the legal ownership of the NCI by Company Y), combining the two transactions reflects the economic substance of the transaction. That is, Company Y’s investors are providing financing to Company P for the acquisition of Company Y. Under this approach, Company P will not recognize any NCI (i.e., it will consolidate 100% of Target). Instead, it will recognize a liability for the future purchase of the NCI.

According to the guidance in ASC 480, the liability should be measured initially at the present value of the settlement amount. Subsequently, the liability is accreted to the strike price with the accretion recognized as interest expense. At the acquisition date, the cash consideration transferred plus the present value of the settlement amount of the liability would be used to determine the amount of goodwill.

Because NCI is not recognized, no earnings are allocated to the NCI after the acquisition date. The accretion of the NCI liability would be presented as interest expense in the income statement.

\(^A\) This instrument is not considered mandatorily redeemable because it is possible, though highly unlikely, that on the exercise date the NCI will have a fair value equal to the strike price in the options and neither party will be economically motivated to exercise its options. An embedded forward contract, by contrast, requires settlement and renders the shares mandatorily redeemable.

Illustration 7 – Accounting for embedded call and put option to be settled at fair value in a business combination

On 1 January 20X7, Company P (an SEC registrant) acquires 80% of the outstanding common shares of Target, a private company, from Company Y for cash consideration. Company Y retains a 20% noncontrolling interest in Target. In connection with the acquisition, Company P and Company Y enter into an agreement that permits Company P to purchase the remaining 20% interest from Company Y at fair value on 1 January 20X9 and permits Company Y to sell its remaining 20% interest to Company P under those same terms. The call and put options are non-transferrable and will terminate if Company P purchases the shares or Company Y sells the shares.

At the acquisition date, the fair value of the NCI is $500. Target’s earnings for 20X7 are $200.
Illustration 7 – Accounting for embedded call and put option to be settled at fair value in a business combination (continued)

Analysis

Are the call and put options embedded in the NCI?

Yes. For purposes of this step, Company P’s call option and Company Y’s put option should be evaluated separately to determine whether the features are embedded or freestanding. The call and put options are not legally detachable from the NCI because they are non-transferrable. Further, they are not separately exercisable because the NCI terminates upon exercise of the options. As a result, the call and put options would be considered embedded in the underlying NCI.

Is the NCI (including the embedded feature) within the scope of ASC 480?

No. Unlike in Illustration 6, the NCI (including the embedded feature) is not subject to ASC 480-10-55-59 through 55-62, which applies only to situations in which the embedded put and call options have the same (or similar) fixed exercise price and the same exercise date. The put option does not cause the NCI to be mandatorily redeemable by Company P (because the embedded equity contract conveys an option rather than an obligation).

Do the call and put options meet the definition of a derivative and require bifurcation under ASC 815?

No. The call and put options do not meet the definition of a derivative because they require gross physical settlement and the shares of Target are not publicly traded and therefore not readily convertible to cash.

Do the call and put options cause the NCI to be redeemable under ASC 480-10-S99-3A?

Yes. Because the put option permits Company Y to sell its equity interest to Company P for cash, the NCI is considered to be redeemable equity under ASC 480-10-S99-3A. Therefore, the NCI (including the embedded options) should be classified as “mezzanine” (between liabilities and equity) in Company P’s balance sheet.

At the acquisition date, the cash consideration transferred plus the fair value of the NCI ($500) would be used to determine the amount of goodwill. The NCI balance of $500 would be classified as “mezzanine.” After the acquisition date, the amount presented as “mezzanine” would be determined first by applying the guidance in ASC 810 and attributing the earnings of Target to the controlling and noncontrolling interests. Therefore, at 31 December 20X7, before applying the guidance in ASC 480-10-S99-3A, the carrying amount of the NCI would be $540 ($200 x 20% + $500).
Illustration 7 – Accounting for embedded call and put option to be settled at fair value in a business combination (continued)

Because the NCI is not currently redeemable but will become redeemable with only the passage of time, as discussed above, ASC 480-10-S99-3a permits two methods of adjusting the carrying amount of the redeemable security. For purposes of this illustration, assume that Company P elects to adjust the carrying amount of the NCI to what the redemption amount would be if the NCI was redeemable at 31 December 20X7. Assume that the redemption amount (fair value) is $590 at 31 December 20X7.

Accordingly, Company P adjusts the carrying amount of its redeemable NCI to its redemption value of $590 with a $50 credit to the NCI and a corresponding debit to retained earnings (or if there were no retained earnings, to additional paid-in capital). Unlike in Illustration 3, because the redemption amount is at fair value, the adjustment to the carrying amount of the redeemable NCI does not affect EPS.

Illustration 8 – Accounting for freestanding written put option in a business combination

On 1 January 20X7, Company P acquires 80% of the outstanding common shares of Target, an SEC registrant, from Company Y for cash consideration. Company Y retains a 5% noncontrolling interest in Target, with the public shareholders holding the remaining 15% interest. In connection with the acquisition, Company P and Company Y enter into an agreement that permits Company Y to sell an additional 5% interest in Target to Company P on or after 1 January 20X9 for $100 in cash. The put option is transferable without restriction, and Company Y can use any shares of Target (e.g., shares it currently owns or shares it subsequently acquires in the public market) to satisfy the put option.

At the acquisition date, the fair value of the NCI is $500. Target’s earnings for 20X7 are $75.

Analysis

Is the put option embedded in the NCI?

No. The put option is legally detachable from the NCI because it is transferrable. Further, because the NCI will not necessarily terminate upon the settlement of the put option (because Company Y could purchase shares in the open market to satisfy the put option), it is separately exercisable. As a result, the put option would not be considered embedded in the underlying NCI, but would be considered a freestanding financial instrument and accounted for separately from the NCI.

At inception, does the equity contract embody an obligation to (1) buy back the NCI by transferring assets or (2) issue a variable number of shares for which the monetary value is predominantly (i) fixed, (ii) varying with something other than the fair value of the issuer's equity shares or (iii) varying inversely in relation to the issuer’s equity shares?

Yes. Because the put option requires Company P to acquire the NCI for cash, it is accounted for as a liability under ASC 480. At the acquisition date, the cash consideration transferred plus the fair value of the NCI ($500) plus the fair value of the liability would be used to determine the amount of goodwill.
Illustration 8 – Accounting for freestanding written put option in a business combination (continued)

Because the put option is freestanding, the NCI would continue to exist, would be classified in equity and would be subsequently accounted for in accordance with ASC 810. Therefore, at 31 December 20X7, the carrying amount of the NCI would be $515 ((20% x $75) + $500). The freestanding put option would be classified as a liability and marked to fair value through earnings at each subsequent reporting date.

Endnotes:

1. ASC B15-10, Derivatives and Hedging – Overall.
2. ASC B15-40, Derivatives and Hedging – Contracts in Entity’s Own Equity.
3. ASC 480, Distinguishing Liabilities from Equity.
4. ASC B05, Business Combinations.
5. ASC B10, Consolidation.
6. Paragraph 16e of ASC 480-10-S99-3A states that the amount in temporary equity should not be less than the redeemable instrument’s initial amount reported in temporary equity. It also states that reductions in the carrying amount of a temporary equity contract are appropriate only to the extent of increases in the redeemable instrument’s carrying amount from the application of the SEC guidance. We generally believe only the incremental measurement under the SEC staff’s guidance is subject to this requirement. A company applying this guidance could potentially adjust a redeemable NCI’s balance below its initial carrying amount when applying ASC B10.
7. The order of this analysis is not important in this situation. The freestanding instrument could be evaluated first to see whether it meets the definition of a derivative, and then whether it gets an exception from derivative accounting if it is “indexed to” the issuer’s stock and would be “classified in” equity. However, if it is not a derivative by definition, the same “indexed to” and “classified in” literature is considered in determining balance sheet classification. Thus, it is sometimes more expeditious to evaluate the indexation and classification provisions first. In addition, this analysis would be performed at each reporting date to determine whether the previous classification remained appropriate.
8. A contract receiving an exception from derivative accounting, or not meeting the definition of a derivative, generally should be reassessed at each reporting date to ensure that treatment remains appropriate.
9. The asset has no measurement guidance in the codified accounting literature. The fair value option under ASC 825 could be elected. In addition, the guidance in the AICPA’s 1986 Issues Paper, Accounting for Options, could be considered.
10. When addressing the initial measurement of a forward contract on shares of a subsidiary, there are three conflicting measurement models. A freestanding forward contract under ASC 480-10-30-3 is initially measured at the fair value of the shares to be repurchased, adjusted for any consideration or unstated rights or privileges. A freestanding forward contract under ASC 480-10-55-54 is initially measured at the present value of the contract amount, which we believe should be discounted using a market-based rate reflecting the issuer’s own credit risk. A mandatorily redeemable NCI is measured at fair value under ASC 480-10-30-1. We generally believe that these methods should result in approximately the same initial measurement. Any significant differences would require additional analysis to determine whether additional rights or privileges were granted in the transaction.
11. Additional considerations apply when the NCI is in the form of preferred stock.

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