STAFF PAPER

Week of 20 May 2013

IASB Meeting

Project	**IFRS 3 *Business Combinations***		
Paper topic	Mandatory purchases of non-controlling interests		
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Background

1. The IFRS Interpretations Committee (the Interpretations Committee) received a request to address the accounting for mandatory purchases of non-controlling interests (NCI) in business combinations. The submission noted that IFRS 3 *Business Combinations* does not specifically address the accounting for a sequence of transactions that begins with an acquirer gaining control of an entity and is followed shortly thereafter by the acquisition of additional ownership interests as a result of a regulatory requirement that obliges the acquirer to offer to purchase the ownership interests of NCI shareholders.

2. The following example illustrates the sequence of transactions:

> Company B is a listed company with a 60% single controlling shareholder and a 40% public ownership. Entity A acquires the 60% ownership block from the controlling shareholder at a price of CU100 per share and obtains control of Company B. Local listing rules require Entity A to make a mandatory tender offer to the remaining 40% public shareholders within 2 months from the acquisition date at the same price per share as it paid for the 60% (ie CU100 per share). The remaining shareholders have the option to either accept or not accept Entity A's offer. It may take another 2 months to know the final results of the offer. Entity A ends up owning 75% of Company B at the end of

the mandatory offer period. The mandatory offer period ends after Entity A's year-end reporting date.

3. There are two questions that arise from this sequence of transactions:

   (a) Should the initial acquisition of the controlling stake and the subsequent mandatory tender offer (MTO) be treated as separate transactions or as a single acquisition (ie as linked transactions)?

   (b) Should a liability be recognised for the MTO at the date that the acquirer obtains control of the acquiree?

Discussions to date

November 2012

4. In November 2012 the Interpretations Committee discussed both of the questions set out in the preceding paragraph. The relevant section of the IFRIC Update is reproduced in Appendix B.

5. On the first issue, the Interpretations Committee tentatively agreed that the initial acquisition of the controlling stake and the subsequent MTO should be treated as a single acquisition. It tentatively decided to propose that the guidance in IFRS 10 *Consolidated Financial Statements* on how to determine whether the disposal of a subsidiary achieved in stages should be accounted for as one or more transactions should also be applied to circumstances when the acquisition of a business is followed by successive purchases of additional interests in the acquiree. The Interpretations Committee tentatively decided to propose to the IASB that the Board amend IFRS 3 through Annual Improvements.

6. At that meeting the Interpretations Committee also discussed the second issue. It noted that IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* excludes from its scope contracts that are executory in nature and therefore concluded that no liability needs to be recognised for the MTO. Therefore the

Interpretations Committee tentatively decided to recommend to the IASB not to amend IFRS 3 for this second issue.

Feedback received after the November 2012 meeting

7. Subsequent to the Interpretations Committee's meeting in November 2012, we received feedback on the Committee's tentative conclusion on the second issue, ie that no liability needs to be recognised for an MTO. Some expressed the view that the Interpretation Committee's rationale (summarised in paragraph 6 of this paper) was unclear. Others disagreed with the Interpretations Committee's tentative conclusion.

8. Specifically, the following concerns were expressed:

   (a) The wording in the IFRIC Update is unclear. If MTOs are excluded from the scope of IAS 37 because they are executory **contracts**, that would seem to contradict the assertion that they are excluded from the scope of IAS 32 *Financial Instruments: Presentation* because they are **not contracts**. (In other words, how can an MTO be an executory contract if it is not a contract?)

   (b) As currently worded, the Interpretations Committee's tentative conclusion permits the non-recognition of a liability for an MTO but, at the same time, it does not prohibit the recognition of a liability (emphasis added below):

      …and concluded that no liability **needed to be** recognised for the MTO.

      This wording may not result in greater consistency in the accounting for MTOs.

   (c) The Interpretation Committee's tentative conclusion that a liability does not need to be recognised for an MTO is inconsistent with its tentative decision that the initial acquisition of the controlling stake and the subsequent MTO should be treated as a single acquisition. If the transactions are linked, that means that the occurrence of the second transaction is dependent on the occurrence of the first transaction. Therefore, an obligation to purchase the NCI shareholders' shares is generated by the acquisition of the controlling stake—and should be reflected in the financial statements as a liability.

(d) The recognition of a liability will be dependent on the facts and circumstances of the transaction and will be influenced by the legal requirements of a particular jurisdiction. Any proposed Annual Improvement to IFRS 3 should therefore be silent on the issue of whether a liability needs to be recognised for an MTO, including not providing any comment as to whether such contracts are executory in nature.

(e) If a liability is not recognised, the entity's financial statements will not reflect the acquirer's unconditional obligation to pay cash (or deliver another financial asset) in exchange for the NCI shareholders' shares. It generally takes several months to know the final results of an MTO and the MTO period could end after the acquirer's period-end reporting date.

(f) It seems troubling that the source of the obligation (contractual versus statutory) could result in different accounting outcomes when the underlying economics are similar (or the same). That is, the Interpretation Committee's tentative conclusion on MTOs is inconsistent with the accounting for put options written on non-controlling interests (NCI puts). If the Interpretations Committee believes this is appropriate, the IFRIC Update should explain why.

(g) The requirement to make an offer to NCI shareholders that arises from an MTO effectively creates an NCI put. As a result of an MTO, an NCI shareholder's right to put its shares is an unconditional right that is enforceable by law and becomes part of the contractual terms and conditions embedded in the share held by the NCI shareholder. It might be suggested that since the put option arising from an MTO is not the result of a contractual obligation but rather is the result of a legal/statutory obligation, it does not meet the definition of a liability in

IAS 32. However, the legal obligation has an impact on the contractual relationship between the shareholder and the reporting entity and is therefore no different from any other put option on NCI. This is consistent with paragraph 5 of IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* (emphasis added below):

> …the entity must consider all of the terms and conditions of the financial instrument in determining its classification as a financial liability or equity. **Those terms and conditions include relevant local laws, regulations and the entity's governing charter in effect at the date of classification**, but not expected future amendments to those laws, regulations or charter.

(h) An MTO meets the definition of a liability in paragraph 4.4(b) of the *Conceptual Framework* and therefore should be reflected in the entity's financial statements:

> A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

The staff's subsequent analysis and recommendation

9. In the light of the feedback received on the Interpretations Committee's tentative conclusion, we performed additional analysis on whether a liability should be recognised for the MTO. As a result of that analysis we concluded that a liability should be recognised for an MTO in a manner consistent with IAS 32 at the date that an acquirer obtains control of an acquiree.

10. In reaching that conclusion, we noted:

(a) An MTO meets the definition of a liability in the *Conceptual Framework*. Indeed, we think an MTO —like an NCI put—is a present obligation that arises from a past event (ie obtaining control of the acquiree), the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits (ie cash or another financial asset). We think it would be misleading to users of financial statements to omit this liability from the financial statements because it would ignore the acquirer's present unconditional obligation to pay cash—and, as some have pointed out, the MTO period could span several months and cross reporting periods.

(b) An MTO should be accounted for in accordance with the requirements for financial instruments (IAS 32 and IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments*). Economically, the MTO described in the submission to the Interpretations Committee is the same as an NCI put; the entity has a present unconditional obligation to purchase the shares held by the NCI shareholders. We acknowledge that the 'form' of an MTO is different from the 'form' of an NCI put because in the latter the parties have entered into a bilateral contract whereas in the former they have not. However, we think the substance of the arrangements is the same—and therefore should have the same accounting treatment.[1]

(c) We think the rights and obligations that arise from an MTO are inextricably linked to the share contracts that are held by the controlling and NCI shareholders. Specifically, the acquirer (*by virtue of becoming the controlling shareholder*) has an unconditional obligation to offer to purchase the shares held by the NCI shareholders. Correspondingly, the other shareholders (*by virtue of being NCI shareholders*) have an unconditional right to sell their shares to the acquirer. Therefore while the MTO is a statutory requirement, the controlling and NCI

[1] We acknowledge that the Interpretations Committee and the IASB have discussed the accounting for NCI puts over the course of many meetings. In March 2013 the IASB tentatively decided to re-consider the requirements in paragraph 23 of IAS 32, including whether all or particular put options and forward contracts written on an entity's own equity should be measured on a net basis at fair value. We are not prejudging the outcome of the IASB's future discussions. Rather we believe that the accounting for MTOs should be the same as the accounting for NCI puts—and if the IASB decides to change the measurement basis for NCI puts (ie from a 'gross' measurement basis to a 'net' measurement basis), we think that decision should also apply to MTOs.

shareholders are bound by that arrangement as a result of holding their respective ownership contracts.

(d) If the Board thinks that MTOs are not explicitly within the scope of the financial instruments guidance, we think paragraphs 10 and 11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provide relevant requirements. Paragraph 10 notes that, in the absence of an IFRS that specifically applies to a transaction, management must use its judgement in developing and applying an accounting policy that is (a) relevant to the economic decision-making needs of users of financial statements and (b) reliable, in that the financial statements represent faithfully the financial position, financial performance and cash flows of the entity; reflect the economic substance of the transaction and not merely its legal form; are neutral (ie free from bias); are prudent; and are complete in all material respects. Paragraph 11 further notes that in making that judgement, management must refer to (and consider the applicability of) the requirements in IFRSs dealing with similar and related issues. MTOs and NCI puts are economically the same. Therefore, we think that the requirements in IAS 8 support accounting for MTOs in accordance with IAS 32 and IAS 39 or IFRS 9 so that they are accounted for in the same way as NCI puts.

March 2013

11. We presented our analysis and recommendation to the Interpretations Committee in March 2013. The relevant section of the IFRIC Update is reproduced in Appendix A.

12. A small majority of Interpretations Committee members expressed the view that a liability should be recognised for the MTO in a manner that is consistent with IAS 32 at the date that the acquirer obtains control of the acquiree. Other Interpretations Committee members expressed the view that an MTO is not within the scope of IAS 32 or IAS 37 and that a liability should therefore not be recognised.

13. During the meeting, the Interpretations Committee acknowledged that in some jurisdictions an entity is obliged to offer to purchase the remaining ownership interests when it obtains less than a controlling stake (eg an entity obtains a 30 per cent stake and is obliged to offer to purchase the remaining 70 per cent). The Interpretations Committee noted that there may be similar questions in practice about whether a liability should be recognised in those circumstances.

14. The Interpretations Committee directed the staff to report its views on whether a liability should be recognised for the MTO to the IASB and noted that the IASB could address this issue as part of its post-implementation review of IFRS 3. The Interpretations Committee noted that the IASB plans to initiate that review later in 2013.

Staff recommendation

15. On the first issue, the Interpretations Committee recommended that the Board propose an amendment to IFRS 3 through Annual Improvements to clarify that the initial acquisition of the controlling stake and the subsequent MTO should be treated as a single acquisition. Specifically, the guidance in IFRS 10 on how to determine whether the disposal of a subsidiary achieved in stages should be accounted for as one or more transactions should also be applied to circumstances when the acquisition of a business is followed by successive purchases of additional interests in the acquiree. The proposed amendments are set out in Appendix C to this paper.

16. On the second issue, consistent with the analysis set out in paragraph 10 of this paper, we believe that a liability should be recognised for an MTO in a manner consistent with IAS 32 at the date the acquirer obtains control of an acquiree.[2] Therefore we recommend that the IASB consider this issue. Consistent with the Interpretation Committee’s discussion in March 2013, we think it could be addressed as part of the Board’s post-implementation review of IFRS 3.

[2] As noted in FN1, we are not intending to prejudge the Board’s future discussion of the measurement requirements in IAS 32. The issue in this paper is focused on the recognition of a MTO liability.

Questions for the Board
(1) On the first issue, does the Board agree with the recommendation set out in paragraph 15? If not, what does the Board want to do instead and why? (2) On the second issue, does the Board agree with the recommendation set out in paragraph 16? If not what does the Board want to do instead and why?

Appendix A: March 2013 IFRIC Update

IFRS 3 *Business Combinations*—Mandatory purchases of non-controlling interests in business combinations

The Interpretations Committee received a request to address the accounting for mandatory purchases of non-controlling interests that arise as a result of business combinations. The submission noted that IFRS 3 does not specifically address the accounting for a sequence of transactions that begins with an acquirer gaining control of an entity and is followed shortly thereafter by the acquisition of additional ownership interests as a result of a regulatory requirement that obliges the acquirer to offer to purchase the ownership interests of non-controlling-interest shareholders.

At its November 2012 meeting, the Interpretations Committee tentatively agreed that the initial acquisition of the controlling stake and the subsequent mandatory tender offer (MTO) should be treated as a single acquisition. The Interpretations Committee tentatively decided to propose that the guidance in IFRS 10 *Consolidated Financial Statements* on how to determine whether the disposal of a subsidiary achieved in stages should be accounted for as one transaction, or as multiple transactions, should also be applied to circumstances in which the acquisition of a business is followed by successive purchases of additional interests in the acquiree. The Interpretations Committee tentatively decided to propose to the IASB that it should amend IFRS 3 through Annual Improvements.

Also at its November 2012 meeting, the Interpretations Committee discussed whether a liability should be recognised for the MTO at the date the acquirer obtains control of the acquiree. The Interpretations Committee noted that IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* excludes from its scope contracts that are executory in nature and concluded that no liability needed to be recognised for the MTO. The Interpretations Committee tentatively decided to recommend to the IASB that it should not amend IFRS 3.

At this meeting, the Interpretations Committee continued to discuss whether a liability should be recognised for the MTO. A small majority of Interpretations Committee members expressed the view that a liability should be recognised for the MTO in a manner that is consistent with IAS 32 *Financial Instruments: Presentation* at the date that the acquirer obtains control of the acquiree. Other Interpretations Committee members expressed the view that an MTO is not within the scope of IAS 32 or IAS 37 and that a liability should therefore not be recognised.

The Interpretations Committee acknowledged that in some jurisdictions an entity is obliged to offer to purchase the remaining ownership interests when it obtains less than a controlling stake (eg an entity obtains a 30 per cent stake and is obliged to offer to purchase the remaining 70 per cent). The Interpretations Committee noted that there may be similar questions in practice about whether a liability should be recognised in those circumstances.

The Interpretations Committee directed the staff to report its views on whether a liability should be recognised for the MTO to the IASB and noted that the IASB could address this issue as part of its post-implementation review of IFRS 3. The IASB plans to initiate that review later in 2013.

Appendix B: November 2012 IFRIC Update

IFRS 3 *Business Combinations*—Mandatory purchase of non-controlling interests in business combinations

The Interpretations Committee received a request to address the accounting for mandatory purchase of non-controlling interests that arise as a result of business combinations. The submitter noted that IFRS 3 *Business Combinations* does not specifically address the accounting for a sequence of transactions that begins with acquirer gaining control over another entity, followed by acquiring an additional ownership interest shortly thereafter as a result of a regulatory requirement to offer to purchase the additional interest. The issues considered by the Interpretations Committee were:

- Should the initial acquisition of the controlling stake and the subsequent Mandatory Tender Offer (MTO) be treated as separate transactions or as one single acquisition (linked transactions)?
- Should a liability be recognised for the MTO at the date the acquirer obtains control of the acquiree?

The Interpretations Committee tentatively agreed that the initial acquisition of the controlling stake and the subsequent MTO should be treated as one single acquisition. The Interpretations Committee tentatively decided to propose that the guidance in IFRS 3 on how to determine whether the disposal of a subsidiary achieved in stages should be accounted for as one or more transactions should also be applied to circumstances when the acquisition of a business is followed by successive purchases of additional interests in the acquiree. The Interpretations Committee tentatively decided to propose to the IASB to amend IFRS 3 through Annual Improvements.

The Interpretations Committee also discussed whether a liability should be recognised for the MTO at the date the acquirer obtains control of the acquiree. The Interpretations Committee noted that IAS 37 excludes from its scope contracts that are executory in nature and concluded that no liability needed to be recognised for the MTO. The Interpretations Committee tentatively decided to recommend to the IASB not to amend IFRS 3.

Appendix C: Proposed amendments to IFRS 3 related to the first issue (described in paragraph 5 of this paper)

A1. A new heading and paragraphs B62C and 64H are proposed to be added to IFRS 3:

Mandatory purchase of non-controlling interests in business combinations

B62C A jurisdiction might require an entity that acquires a controlling interest in a listed company to initiate a mandatory tender offer to the non-controlling interests to buy the remaining interests. This obligation under the law is triggered when the acquirer obtains a controlling stake in the listed entity. In determining whether to account for the initial acquisition and subsequent transaction triggered by regulatory law (ie the mandatory tender offer) as a single transaction, the acquirer should consider the factors set out in paragraph B97 of IFRS 10.

Effective date

64H *Annual Improvements Cycle 2012-2014* issued in [date] added paragraph B62C. An entity shall apply that amendment to all business combinations for which the acquisition date is on or after 1 January 2015. Earlier application is permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact.

A2. The proposed draft basis for conclusions is below.

Mandatory purchase of non-controlling interests in business combinations

BC 1 The IASB proposes to provide additional guidance on the accounting for a mandatory tender offer for the purchase of shares held by non-controlling interest shareholders. The IASB proposes that an entity shall apply the same factors to an acquirer obtaining control of a subsidiary as is currently applied by a parent losing control of a subsidiary in relation to determining whether two arrangements should be accounted for as one transaction. The IASB understands that while paragraph B97 of IFRS 10 provides explicit guidance on when to account for two or more arrangements as a single transaction when a parent loses control of a subsidiary, it is not clear whether and how to analogise to this guidance when assessing whether to account for multiple arrangements as a single transaction when gaining control. The IASB thinks that guidance would be helpful in making the judgement, based on the facts and circumstances, to determine the appropriate accounting for a mandatory tender offer.