

## STAFF PAPER

November 2012

## IFRS Interpretations Committee Meeting

Project	New items for initial consideration
Paper topic	Mandatory purchase of non-controlling interests in business combinations
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

## Introduction

1. The IFRS Interpretations Committee (the Interpretations Committee) received a request to address the accounting for mandatory purchase of Non-Controlling Interests (NCI) in business combinations. The submitter notes 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.
2. This agenda paper is organised as follows:
  - (a) Issue and staff analysis
  - (b) Outreach request
  - (c) Annual improvements criteria assessment
  - (d) Agenda criteria assessment
  - (e) Staff recommendation
  - (f) Appendix A—Proposed amendments
  - (g) Appendix B—Submission.

## Issue and staff analysis

3. The issue is the accounting by an acquirer of the acquisition of an additional interest in an acquired subsidiary from the NCI arising from a Mandatory Tender Offer (MTO) required by the local laws and regulations. The circumstances arise because the local laws and regulations require a party who acquires a controlling interest in a listed company to initiate an MTO to the NCI to buy remaining interests at the same price or higher. This obligation under the law is triggered when the acquirer obtains a controlling stake in a listed company.
4. The submitter thinks that it is not clear whether the MTO should be accounted for as part of the business combination under IFRS 3 or as a separate transaction. This issue is not specifically addressed in IFRS 3.
5. An example from the submitter could be helpful in illustrating the issues.

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 100 per share and obtains control of 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 for the 60%. The remaining shareholders have the option to either accept or not accept the offer. It may take another 2 months to know the final results of the offer. Let's assume Entity A ends up owning 75% of B at the end of the mandatory offer period. However, the MTO period ends after the year end reporting date.
6. The two issues that arise are:
  1. Should the initial acquisition of 60 per cent and subsequent 15 per cent purchase following the MTO be treated as separate transactions or as one single acquisition (linked transactions)?

The answer to this question has implications on the amount of goodwill recognised if the entity chooses the option permitted by IFRS 3 to measure the NCI at the present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets, as opposed to the fair value of the NCI.

2. Should a liability be recognised for the MTO at the date Entity A obtains control of Company B?

***Issue 1: should the initial acquisition of 60 per cent and subsequent MTO be treated as separate transactions or as one single acquisition?***

*View 1: one single acquisition*

7. View 1 is to account for the two transactions as one single acquisition. The offer to the NCI is a mandatory securities law requirement triggered by the acquisition of the controlling interest. The acquirer cannot avoid making the offer. From the acquirer's perspective, it can be viewed as one deal for which the acquirer needs to plan for the subsequent increase in interest including the financing of it. In addition, the two transactions are linked because the spirit and intent of the MTO securities law is to protect the minority shareholders' interest when the controlling interest is sold.
8. Under this view, the acquisition of the initial controlling stake and the following MTO will be accounted for as a single transaction that is completed over a period of time. Consequently, for the example in paragraph 5, goodwill is recognised based on the 75 per cent stake if the proportionate share method is adopted.

*View 2: separate transactions*

9. View 2 is to account for the two transactions as separate transactions. Although the regulations create a linkage between the initial 60 per cent acquisition and subsequent MTO, each transaction on its own is economically justified. The objective of the 60 per cent acquisition is to obtain control over Company B, and the 60 per cent acquisition is also the result of a separate negotiation between

Entity A and the previous controlling party. Also, the subsequent purchase from NCI has economic substance on its own.

10. Under this view, the first transaction is accounted for as a business combination and any subsequent transactions are accounted for as the acquisition of NCI. Consequently, for the example in paragraph 5, goodwill is recognised based on the 60 per cent stake if the proportionate share method is adopted. The acquisition of the 15 per cent is accounted for when it occurs as an equity transaction in accordance with paragraph 23 of IFRS 10 (or paragraph 30 of IAS 27).

*Staff analysis*

11. Paragraph B97 of IFRS 10 (or paragraph 33 of IAS 27) provides explicit guidance of when to account for two or more arrangements as a single transaction when a parent loses control of a subsidiary. Paragraph B97 states:

A parent might lose control of a subsidiary in two or more arrangements (transactions). However, sometimes circumstances indicate that the multiple arrangements should be accounted for as a single transaction. In determining whether to account for the arrangements as a single transaction, a parent shall consider all the terms and conditions of the arrangements and their economic effects. One or more of the following indicate that the parent should account for the multiple arrangements as a single transaction:

- (a) They are entered into at the same time or in contemplation of each other.
- (b) They form a single transaction designed to achieve an overall commercial effect.
- (c) The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.
- (d) One arrangement considered on its own is not economically justified, but it is economically justified when considered together with other arrangements. An

example is when a disposal of shares is priced below market and is compensated for by a subsequent disposal priced above market.

12. These factors could be very helpful when assessing whether the acquisition, including the NCI acquired under the MTO should be accounted for as separate transactions or as one single acquisition. It is logical to apply the same factors regardless of whether an acquirer obtains control, or a parent loses control, of a subsidiary.
13. If the acquirer considers the above factors for the MTO of an NCI in business combinations in the example in paragraph 5, the acquirer might evaluate whether:
  - (a) the transactions occur within a short period;
  - (b) the transactions are not negotiated separately by each counterparty (e.g. the pricing of the MTO is not negotiated separately, but specified by the laws and regulations);
  - (c) the acquirer does not have a choice of whether to enter into each transaction separately; and
  - (d) the securities law requirement is enforceable, and the acquirer needs to plan for the MTO from the onset.
14. Although the MTO in the example is likely to be accounted for as a single transaction, there should be a level of judgement required because related laws and regulations may vary depending on the jurisdiction. Consequently, guidance would be helpful in making the necessary judgement.

***Issue 2: should a liability be recognised for the MTO at the date Entity A obtains control of Company B?***

*View 1: no liability*

15. View 1 is not to recognise any liability for the MTO at the date Entity A obtains control of Company B. The statutory obligation to perform an MTO does not represent a contract between Entity A and the remaining shareholders because a contract requires agreement between two or more parties (as per the definition of

financial instrument under paragraph 11 and 13 of IAS 32 *Financial Instruments: Presentation*), but an MTO is only an offer until an NCI accepts. When the NCI accepts, a contract is established. The liability for the MTO is hence outside the scope of IAS 32 until the NCI accepts the offer, at which point a contract between the NCI and the acquirer is established. Paragraph AG12 of IAS 32 clarifies that “Liabilities or assets that are not contractual (such as income taxes that are created as a result of statutory requirements imposed by governments) are not financial liabilities or financial assets”.

16. Under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, no liability should be recognised, because IAS 37 excludes from its scope contracts that are executory in nature, and there is no onerous contract. When the offer is made, neither party has performed any of its obligations, ie the entity has not paid for the shares and the NCI has not delivered the shares.

*View 2: liability recognised*

17. Economically, the existence of the statutory obligation is not different from a put option granted to NCI, which would be recognised as a financial liability based on the present value of expected payments.
18. When the entity makes the offer to the NCI, it places itself in a position in which it can be obliged to pay cash in return for receipt of the shares held by the NCI. It can therefore be required to pay cash and does not have any means to avoid that. As a result those supporting View 2 assert that the entity has a liability.

*Staff analysis*

19. We think that the statutory obligation to perform an MTO does not represent a contractual liability under paragraph AG12 of IAS 32.
20. The statutory obligation to perform an MTO is a type of non-contractual obligation. We think that an entity should apply IAS 37 because no other Standard deals with that statutory obligation.

21.      Consequently, for the statutory obligation to perform an MTO, we think that the entity should recognise a provision if the recognition conditions are met in accordance with paragraph 14 of IAS 37, which includes a legal obligation.
  
22.      We do not agree with View 1 because this view asserts that IAS 37 excludes from its scope contracts that are executory in nature. The offer to the NCI is not a contract but a legal obligation. We agree with View 2 that a liability should be recognised. We think that the MTO to purchase own equity that is irrevocable and enforceable for a period of time, should be accounted for in accordance with IAS 37 until the offer expires or is accepted.
  
23.      Some might argue that this statutory obligation will evolve into a contractual obligation before being settled and is in the scope of IAS 32. They think that this obligation seems to be somewhere in between a contractual obligation and a non-contractual obligation, and that a statutory obligation to stand ready to enter into a contractual obligation should be treated like a contractual obligation. They also argue that this obligation should be treated as contractual because the obligation arises from the contract to acquire the controlling interest and the obligation will become contractual before it is settled. In that respect, they maintain it is different from the tax obligations and constructive obligations that paragraph AG12 of IAS 32 describes as being outside the scope of IAS 32.
  
24.      However, we think that this obligation may or may not evolve into a contractual obligation depending on whether or not the NCI accepts the offer. Accordingly we do not agree with the view that classifies this statutory obligation as a contractual obligation. Even though the obligation arises from the contract to acquire the controlling interest, this obligation will (or may not) evolve into another contract with another party. Also, paragraph AG12 of IAS 32 explicitly states that “Liabilities or assets that are not contractual (such as income taxes that are created as a result of statutory requirements imposed by governments) are not financial liabilities or financial assets”.

## Outreach request

25. We sent a request for information to the International Forum Accounting Standard Setters (IFASS) and securities regulators International Organization of Securities Commissions (IOSCO) and European Securities and Markets Authority (ESMA) in order to help assess the Interpretations Committee’s agenda criteria as summarised below:

Q1. In your jurisdiction, how common is this type of transaction? If it occurs, could you provide us with information that the Interpretations Committee could use to assess how widespread the issue is?

Q2. In your view, is there diversity in practice in accounting for the initial acquisition of controlling stake and subsequent MTO? Please describe the predominant approach that you observe in your jurisdiction.

26. The views expressed below are informal feedback from members of the IFASS and regulators. They do not reflect the formal views of the boards of those organisations. The geographical breakdown for the responses is as follows:

<b>Geographical area</b>	<b>Number of respondents</b>
Asia/Oceania	6
Africa	1
Europe	5
North America	3
<b>Total respondents</b>	<b>15</b>

27. Ten respondents answered that they do have similar laws and regulations for the MTO to the NCI in their jurisdictions, and six of them have observed diversity in practice.

28. We noted that five respondents generally favour or observe an approach to treat the initial acquisition of controlling stake and subsequent MTO as linked transactions and recognise it as a liability, but specific reasons were not provided.

29. We also did research for U.S. GAAP because IFRS 3 is a converged Standard. As far as the requirement of MTO is concerned, we understand that U.S. securities



laws do not require an MTO made to the NCI holders. However, U.S. companies may face such laws and regulations in other jurisdictions, in which case they would need to account for the MTO to the NCI holders.

30. Under U.S. GAAP we understand that the NCI would be accounted for at acquisition date fair value, because ASC 805: *Business Combinations* does not provide an option to recognise the NCI as a portion of the recognisable net assets acquired in a business combination.
31. When it comes to the issue on whether the MTO should be accounted for as a financial liability, we understand that there are different views in practice. Some treat the MTO as a non-contractual obligation and recognise a loss based on the probability of occurrence in accordance with ASC 450 *Contingencies*.
32. Others treat the MTO as a contractual obligation and consider it a financial instrument. The question is whether this financial instrument is a freestanding financial instrument or an embedded feature in a financial instrument that is not a derivative in its entirety. If the MTO would qualify as a freestanding financial instrument, it would generally be accounted for as a liability at fair value as if it is a written put option. However, for an embedded feature, it would first need to be assessed whether it is a derivative or not. If it is not a derivative (or qualifies for the exception for derivative accounting) it would be classified as temporary equity and measured at the maximum redemption amount. In the case that the embedded feature is separated from the host contract and accounted for as a derivative, it would be accounted for as a liability at fair value.

### **Annual improvements criteria assessment**

33. In planning whether an issue should be addressed by amending IFRSs within the Annual Improvements project, the IASB assesses the issue against certain criteria. All the criteria (a)–(d) must be met to qualify for inclusion in annual improvements. We have assessed the potential amendment against the annual improvements criteria, which are reproduced in full below:

<b>Annual improvements criteria</b>	<b>Staff assessment of the proposed amendment</b>
<p>(a) The proposed amendment has one or both of the following characteristics:</p> <p>(i) clarifying—the proposed amendment would improve IFRSs by:</p> <ul style="list-style-type: none"> <li>• clarifying unclear wording in existing IFRSs, or</li> <li>• providing guidance where an absence of guidance is causing concern.</li> </ul> <p>A clarifying amendment maintains consistency with the existing principles within the applicable IFRSs. It does not propose a new principle, or a change to an existing principle.</p> <p>(ii) correcting—the proposed amendment would improve IFRSs by:</p> <ul style="list-style-type: none"> <li>• resolving a conflict between existing requirements of IFRSs and providing a straightforward rationale for which existing requirements should be applied, or</li> <li>• addressing an oversight or relatively minor unintended consequence of the existing requirements of IFRSs.</li> </ul> <p>A correcting amendment does not propose a new principle or a change to an existing principle, but may create an exception from an existing principle.</p>	<p>(a) Yes.</p> <p>The proposed amendment provides guidance to apply the same factors to both an acquirer obtaining, and a parent losing, control of a subsidiary. It also provides guidance on the recognition of a liability. This is the provision of guidance where there is an absence, and this guidance is an extension of guidance that is already there.</p>
<p>(b) The proposed amendment is well-defined and sufficiently narrow in scope such that the consequences of the proposed change have been considered.</p>	<p>(b) Yes. The issue is sufficiently narrow in scope to ensure that the proposed amendment has been considered sufficiently and identified.</p>
<p>(c) It is probable that the IASB will reach conclusion on the issue on a timely basis. Inability to reach conclusion on a timely basis may indicate that the cause of the issue is more fundamental than can be resolved within annual improvements.</p>	<p>(c) Yes. We think that the IASB will reach a conclusion on this issue on a timely basis.</p>
<p>(d) If the proposed amendment would amend IFRSs that are the subject of a current or planned IASB project, there must be a need to make the amendment sooner than the project would.</p>	<p>(d) Yes. There are no current projects on IFRS 3 although the post-implementation review of IFRS 3 is planned to commence in the first quarter of 2013.</p>

## Agenda criteria assessment

34. The staff's preliminary assessment of the agenda criteria is as follows:

(a) *The issue is widespread and has practical relevance.*

Yes, the issue arises in practice and the staff agree that it is an issue that needs to be resolved.

(b) *The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). An item will not be added to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.*

On the basis of the outreach result, the issue indicates that there are divergent interpretations of the accounting for mandatory purchase of NCI in business combinations.

(c) *Financial reporting would be improved through elimination of the diverse reporting methods.*

Yes.

(d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Conceptual Framework, and the demands of the interpretation process. The issue should be sufficiently narrow in scope to be capable of interpretation, but not so narrow that it is not cost-effective for the Interpretations Committee and its constituents to undertake the due process associated with an interpretation?*

Yes.

(e) *It is probable that the Interpretations Committee will be able to reach a consensus on the issue on a timely basis.*

Yes, we think that the conclusion can be determined.

(f) *If the issue relates to a current or planned IASB project, there is a pressing to provide guidance sooner than would be expected from the IASB activities. The Interpretations Committee will not add an item to*

*its agenda if an IASB project is expected to resolve the issue in a shorter period than the Interpretations Committee requires to complete its due process.*

There are no current projects on IFRS 3 although the post-implementation review of IFRS 3 is planned to commence in the first quarter of 2013.

### **Staff recommendation**

35. We support View 1 for Issue 1, which is to account for initial acquisition and subsequent MTO as one single acquisition. 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.
36. We propose additional guidance to apply the same factors to both an acquirer obtaining, and a parent losing ,control of a subsidiary as provided in paragraph B62C of Appendix A to this paper. Because related laws and regulations may vary depending on the jurisdiction, there should be a level of judgement required. Accordingly, guidance would be helpful in making the judgement, based on the facts and circumstances, in determining the appropriate accounting for an MTO.
37. We support View 2 for Issue 2, which is to recognise a liability for the MTO at the date the acquirer obtains control of the acquiree. The statutory obligation to perform an MTO is a type of provision, and no other Standard, except for IAS 37 provides any specific guidance on this. Consequently, IAS 37 should be applied for the MTO to NCI because no other Stanard deals with those transactions.
38. We propose additional guidance to recognise a liability under IAS 37 to clarify the accounting treatment for an MTO as provided in paragraph B62D of Appendix A to this paper.

**Question to the Interpretations Committee**

Q1. Does the Interpretations Committee agree with the staff recommendation that additional paragraphs to the Application guidance should be added to provide explicit guidance on the accounting for a mandatory tender offer associated with a business combination?

Q2. Does the Interpretations Committee agree that a recommendation should be put to the IASB to include the proposed amendment within Annual Improvements?

## Appendix A—Proposed amendments

- A1. A new heading and paragraphs B62C, B62D 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 remaining interests at the same price or higher. 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 a mandatory tender offer) as a single transaction, the acquirer should consider the factors set out in paragraph B97 of IFRS 10.
- B62D The obligation under a mandatory tender offer to purchase own equity that is irrevocable and enforceable for a period of time, should be recognised as a liability and should be accounted for in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* until the offer expires or is accepted.

### **Effective date**

- 64H *Annual Improvements Cycle 2012–2014* issued in [date] added paragraphs B62C and B62D. An entity shall apply those amendments 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.

**Draft Basis for Conclusions on proposed amendments to IFRS 3  
Business combinations**

This Basis for Conclusions accompanies, but is not part of, the proposed amendments.

**Mandatory purchase of non-controlling interests in  
business combinations**

- BC1 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 determining the appropriate accounting for a mandatory tender offer.
- BC2 In addition, the IASB noted that the statutory obligation to perform a mandatory tender offer to purchase own equity that is irrevocable and enforceable for a period of time is a type creates an obligation that gives rise to a provision. The IASB therefore proposes to make clear that IAS 37 should be applied in accounting for the mandatory tender offer to non-controlling interests.

## Appendix B—Submission

### IFRS IC POTENTIAL AGENDA ITEM

#### **Issue:**

The issue is the accounting for an acquirer of an additional interest in an acquired subsidiary from the Non Controlling Interest shareholders (NCI) arising from a Mandatory Tender Offer (MTO) required by the local laws and regulations. A party who acquires a controlling interest in a listed company must initiate a MTO to the NCI to buy remaining interests at same price or more. This law is triggered when the acquirer obtains a controlling stake in a listed company which is accounted for under IFRS 3 'Business Combinations'<sup>1</sup>. It is not clear whether the MTO should be accounted for as part of the business combination under IFRS 3, IAS 27(2008), and IFRS 10 or as a separate transaction. This issue is not specifically addressed in IFRS 3. Most large accounting firm guidance says to apply the factors in IAS 27(2008).<sup>33</sup> by analogy. These same factors are included in IFRS 10.B97. The guidance published by the large accounting firms indicates diversity in practice on whether a MTO is a linked or separate transaction from the business combination.

This could be further supplemented through the help of an example:

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 100 per share and obtains control of 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 for the 60%. The remaining shareholders have the option to either accept or not accept the offer. It may take another 2 months to know the final results of the offer. Let's assume Entity A ends up owning 75% of B at the end of the mandatory offer period. However, the MTO period ends after the year end reporting date.

The two issues which arise are:

1. Should the initial acquisition of 60% and subsequent MTO be treated as separate transactions or as one single acquisition (linked transactions)?
2. Should a liability be recognised for the MTO at the date Entity A obtains control of company B?

#### **Current practice:**

There are two views currently with respect to both the issues which are as follows:

#### **Issue 1 – Should the acquisition of the subsequent 15% be accounted for as a separate transaction?**

#### **View 1 – No (the two transactions should be accounted for as linked transactions)**

The following points support view 1:

- The offer to the NCI is a mandatory securities law requirement triggered by the acquisition of the controlling interest. The acquirer cannot avoid making the offer. The acquirer has no discretion on the price that must be offered to the minority shareholders.
- A judgment that the transactions are separate implies that the securities law is not enforceable or substantive.
- The transaction occurs within short period of time.

<sup>1</sup> Note that local laws and regulations may also mandate a MTO upon acquisition of a non-controlling stake above a certain threshold, say 40%. This paper only deals with the situation of an MTO triggered by the acquisition of a controlling stake.



- Although the acquirer has separately negotiated with the former owner the acquisition of the controlling stake, the acquirer knows from the onset that it will have to launch a MTO. From the acquirer's perspective, it can be viewed as one deal for which the acquirer needs to plan for the subsequent increase in interest (including the financing of it)
- The indicator in IAS 27(2008).33 regarding 'They form a single transaction designed to achieve an overall commercial effect.' supports linked transactions because the spirit and intent of the MTO securities law is to protect the minority shareholders interest when the controlling interest is sold.
- Both transactions should be accounted for one single acquisition because the pricing of the MTO is related to the amount paid for the controlling stake.

The treatment will be as follows, assuming it is concluded on issue 2 that the legal requirement to initiate a MTO does not give rise to a liability:

- The acquisition of the initial controlling stake and the following MTO will be accounted for as a single transaction that is completed over a period of time.
- There will be no NCI recorded at the year-end reporting date because the MTO is finalised after year end reporting date.
- The acquisition of 60% will be based on provisional accounting and additional goodwill for additional 15% stake and NCI of 25% will be recognised after closure of MTO period. Because the additional goodwill for additional 15% stake results from facts and circumstances arising on completion of the MTO (i.e. after the acquisition date), the additional goodwill is not accounted for retrospectively from the acquisition date.
- A company would make the terms of the MTO and the accounting at year-end transparent through disclosures.

Refer to the example in appendix BC, issue 1, view 1 for further detail. Refer to the example in appendix BC , view 3 for the treatment of the MTO as linked transaction when the conclusion on issue 2 is that a liability should be recorded.

### **View 2 – Yes (the two transactions should be accounted for separately)**

The following points support view 2:

- Although the regulations create a linkage between the initial 60% acquisition and subsequent MTO, each transaction on its own is economically justified (i.e., they do not form a single transaction designed to achieve an overall commercial effect).The objective and economic justification of the 60% acquisition is to obtain control over B. It is also the result of a separate negotiation between A and the previous controlling party.
- The objective of the 60% acquisition is to obtain control over B and is separately negotiated between A and the previous controlling party. The MTO and its terms (same price as for the 60%) is more the result of a legal protection of the remaining shareholders rather than a willing decision from A to buy their stake.
- There is no compulsion on the remaining shareholders to accept the offer and it will be subject to a separate decision from their end.
- Local laws and regulations often include a price adjustment mechanism for the MTO, where the NCI will receive a higher price than the price paid for the controlling stake if the market value of the acquiree company has increased above the price paid for the controlling stake. This supports the view that the subsequent purchase from NCI has economic substance on its own.

Goodwill is recognised based on the 60% stake if proportionate share method is adopted. The acquisition of the 15% is treated as acquisition of NCI within equity. Refer to the example in appendix BC, issue 1, view 2 for further detail.

**Issue 2 – Does the legal requirement to initiate the MTO meet the definition of a liability at the date control is obtained?**

**View 1 – No**

The following points support view 1:

- The statutory obligation to do a MTO does not represent a contract between A and the remaining shareholders, hence is out of the scope of IAS 32.
- No IAS 37 liability should be recognised because IAS 37 scopes out contracts that are executory in nature, and there is no onerous contract.

Refer to the example in appendix BC, issue 1, view 1 and view 2 for further detail.

**View 2 – Yes**

The following points support view 2:

- Economically, the existence of the statutory obligation is no different from a put option granted to NCI, which would be recognised as a financial liability based on the present value of expected payments.

Issues 1 and 2 are related. The transactions are more likely to be linked if a liability exists for the MTO at the acquisition date. Refer to the example in appendix BC, issue 2, view 2 for further detail.

**Reasons for the IFRS IC / IASB to address the issue:**

IFRS 3 does not specifically address the accounting for a sequence of transactions that begins with acquirer gaining control over a business followed by an additional interest being acquired shortly thereafter as a result of a tender offer. The issue occurs frequently and is widespread and practical in nature because many jurisdictions have company law or securities law that requires mandatory tender offers. We believe it is currently resulting in divergent interpretations and treatment in practice. There are mixed views between large firms resulting in an inconsistent approach currently. Refer to appendix D<sup>2</sup> for the guidance developed by some of the large firms.

A particular accounting treatment may impact the amount of goodwill recognised. Further, the amount of NCI to be recognised may differ in different reporting periods. We feel there is scope for an improvement in financial reporting through elimination of this diversity. The issue is currently not directly related to any IASB project. This issue might be considered as part of the post-implementation review of IFRS 3 or as a separate annual improvement project to amend IFRS 10.

A proposed clarification on this issue could avoid further divergence in the accounting for MTOs. See appendix BB for potential narrow amendments that could be done through an annual improvement project.

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<sup>2</sup> Not included in this paper

## Appendix BA – Relevant IFRS guidance

*IAS27(2008).30 – Changes in a parent’s ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions (i.e. transactions with owners in their capacity as owners).*

*IAS27(2008).33 - A parent might lose control of a subsidiary in two or more arrangements (transactions). However, sometimes circumstances indicate that the multiple arrangements should be accounted for as a single transaction. In determining whether to account for the arrangements as a single transaction, a parent shall consider all of the terms and conditions of the arrangements and their economic effects. One or more of the following may indicate that the parent should account for the multiple arrangements as a single transaction:*

- (a) They are entered into at the same time or in contemplation of each other.*
- (b) They form a single transaction designed to achieve an overall commercial effect.*
- (c) The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.*
- (d) One arrangement considered on its own is not economically justified, but it is economically justified when considered together with other arrangements. An example is when one disposal of shares is priced below market and is compensated for by a subsequent disposal priced above market.*

*IFRS 10.B97 A parent might lose control of a subsidiary in two or more arrangements (transactions). However, sometimes circumstances indicate that the multiple arrangements should be accounted for as a single transaction. In determining whether to account for the arrangements as a single transaction, a parent shall consider all the terms and conditions of the arrangements and their economic effects. One or more of the following indicate that the parent should account for the multiple arrangements as a single transaction:*

- a) They are entered into at the same time or in contemplation of each other.*
- b) They form a single transaction designed to achieve an overall commercial effect.*
- c) The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.*
- d) One arrangement considered on its own is not economically justified, but it is economically justified when considered together with other arrangements. An example is when a disposal of shares is priced below market and is compensated for by a subsequent disposal priced above market.*

*IAS32.11 - A financial liability is any liability that is:*

*(a) a contractual obligation:*

*(i) to deliver cash or another financial asset to another entity; or*

*(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or*

*IAS32.AG12. Liabilities or assets that are not contractual (such as income taxes that are created as a result of statutory requirements imposed by governments) are not financial liabilities or financial assets. Accounting for income taxes is dealt with in IAS 12. Similarly, constructive obligations, as defined in IAS 37 Provisions, Contingent Liabilities and Contingent Assets, do not arise from contracts and are not financial liabilities.*

## Appendix BB – Proposed improvement amendments

### View 1 & 3: Linked transactions

IFRS 3.B50 The acquirer should consider the following factors, which are neither mutually exclusive nor individually conclusive, to determine whether a transaction is part of the exchange for the acquiree or whether the transaction is separate from the business combination:

(a) the reasons for the transaction—Understanding the reasons why the parties to the combination (the acquirer and the acquiree and their owners, directors and managers—and their agents) entered into a particular transaction or arrangement may provide insight into whether it is part of the consideration transferred and the assets acquired or liabilities assumed. For example, if a transaction is arranged primarily for the benefit of the acquirer or the combined entity rather than primarily for the benefit of the acquiree or its former owners before the combination, that portion of the transaction price paid (and any related assets or liabilities) is less likely to be part of the exchange for the acquiree. Accordingly, the acquirer would account for that portion separately from the business combination.

(b) **how was the transaction initiated** ~~who initiated the transaction~~— Understanding **how the transaction was initiated** ~~who initiated the transaction~~ may also provide insight into whether it is part of the exchange for the acquiree. For example, a transaction or other event that is initiated by the acquirer may be entered into for the purpose of providing future economic benefits to the acquirer or combined entity with little or no benefit received by the acquiree or its former owners before the combination. On the other hand, a transaction or arrangement initiated by the acquiree, its former owners, or **triggered by regulatory law as a result of the business combination** is less likely to be for the benefit of the acquirer or the combined entity and more likely to be part of the business combination transaction.

(c) the timing of the transaction—The timing of the transaction may also provide insight into whether it is part of the exchange for the acquiree. For example, a transaction between the acquirer and the acquiree that takes place during the negotiations of the terms of a business combination may have been entered into in contemplation of the business combination to provide future economic benefits to the acquirer or the combined entity. If so, the acquiree or its former owners before the business combination are likely to receive little or no benefit from the transaction except for benefits they receive as part of the combined entity.

### View 2: Separate transactions

IFRS 10.23 Changes in a parent's ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary are equity transactions (ie transactions with owners in their capacity as owners) **irrespective of whether the transaction was initiated as a result of another transaction in which control was obtained or lost (ie a mandatory tender offer)**.

## Appendix BC – Example

**Facts:** Entity A acquires 60% of listed company B from the previous controlling shareholder at a price of CU300 and obtains control of B. Local listing rules require Entity A to make a mandatory tender offer (MTO) to the remaining interests within 2 months from the acquisition date at the higher of the price per share paid for the 60% or the average highest price traded on the exchange during 90 days prior to the announcement of the MTO. The remaining shareholders have the option to accept or not the offer. It may take another 2 months to know the final results of the offer. Let's assume Entity A ends up owning 85% of B at the end of the mandatory offer period. The price for the additional 25% in the mandatory tender offer is the same as the acquisition date price (e.g., CU125). Assume the net identifiable assets of company B have a fair value of 400. Assume the proportionate share method is used to measure NCI.

<u>Date</u>	<u>Event</u>
November 30, 20X1	Acquisition date for 60%
January 30, 20X2	MTO published, share price is the same as acquisition date
March 30, 20X2	MTO closes and shares are tendered for cash for 25%

### Issue 1, View 1: No Liability, Linked transactions

November 30, 20X1: Entity A records the following on the acquisition date:

DR	Net Assets	CU400	
	CR    Cash		CU300
	CR    Equity (parent)		CU100 <sup>3</sup>

*To record the acquisition of company B assuming the MTO will result in 100% ownership.*

March 30, 20X2: Entity A has records the mandatory tender offer 4 months after the acquisition date.

DR	Equity (parent)	CU100	
DR	Goodwill	CU85	
	CR    Cash		CU125
	CR    NCI		CU60

*To record the final outcome of the mandatory tender offer of 85% ownership. This entry is accounted for prospectively and the period ending December 31, 20X1 is not adjusted.*

Fair value of consideration	425
Proportionate share of NCI	<u>60</u>
Subtotal	485
less: recognised value of 100% of net assets	<u>400</u>
Goodwill recognised	85

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<sup>3</sup> If the cash paid for the 60% is more than the fair value of the net identifiable assets, then there would be a debit to goodwill instead of a credit to equity.

**Issue 1, View 2:** No Liability, Separate transactions

November 30, 20X1: Entity A records the following on the acquisition date:

DR	Net Assets	CU400
DR	Goodwill	CU60
	CR    Cash	CU300
	CR    NCI	CU160

*To record the acquisition of 60% of company B.*

Fair value of consideration	300
Proportionate share of NCI	<u>160</u>
Subtotal	460
less: recognised value of 100% of net assets	<u>400</u>
Goodwill recognised	60

March 30, 20X2: Entity A has records the mandatory tender offer 4 months after the acquisition date.

DR	NCI	CU100
DR	Equity (parent)	CU25
	CR    Cash	CU125

*To record the final outcome of the mandatory tender offer of 85% ownership.*

**Issue 2, view 2:** Liability, Linked transactions

November 30, 20X1: Entity A records the following on the acquisition date:

DR	Net Assets	CU400
DR	Goodwill	CU100
	CR    Cash	CU300
	CR    Liability	CU200

*To record the acquisition of company B assuming the MTO will result in 100% ownership.*

January 30, 20X2: Entity A re-measures the liability for the increase in share price.

DR	Finance expense	CU0
	CR    Liability	CU0

*To re-measure the fair value of the liability. There is no impact in this example because the price did not increase.*

March 30, 20X2: Entity A has records the mandatory tender offer 4 months after the acquisition date.

DR	Liability	CU200
	CR    Cash	CU125
	CR    NCI	CU60
	CR    Goodwill	CU15

*To record the final outcome of the mandatory tender offer of 85% ownership.*