STAFF PAPER

March 2013

IFRS Interpretations Committee Meeting

Project	New items for initial consideration		
Paper topic	Mandatory purchase of non-controlling interests in a business combination		
CONTACT(S)	Liz Figgie	efiggie@ifrs.org	+44 (0)20 7246 6410

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*.

Background

1. In November 2012 the IFRS Interpretations Committee (the Interpretations Committee) discussed 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. Agenda Paper 18 from the November 2012 Interpretations Committee meeting has been attached as Appendix A to this paper.

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%. 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. At the meeting in November 2012 the Interpretations Committee discussed two issues:

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

   (b) whether a liability should be recognised for the MTO at the date that the acquirer obtains control of the acquiree.

4. 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.

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

6. This paper discusses only the second issue.

Feedback received after the November 2012 meeting

7. We received some feedback on the Interpretations Committee's tentative conclusion that no liability needs to be recognised for an MTO. The three letters that we received are attached to this paper as Appendix B. Additional feedback was received on a more informal basis (eg emails and discussions).

8. Some expressed the view that the Interpretation Committee's rationale (as set out in the November 2012 IFRIC Update and summarised above in paragraph 5) was unclear. Others disagreed with the tentative conclusion. 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. The 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 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 for Financial Reporting* 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.

Purpose of this paper

9. In the light of the feedback received on the Interpretations Committee's tentative conclusion, we have performed additional analysis on whether a liability should be recognised for the MTO. We will ask the Interpretations Committee whether it wishes to reconsider the recommendation that it made at its November 2012 meeting.

Analysis and recommendation

10. We think a liability should be recognised for an MTO at the date that an acquirer obtains control of an acquiree.

11. We agree with those parties who pointed out that such an arrangement 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 investors 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.

12. Furthermore, we agree with those who expressed the view that 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]

13. Moreover, 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 shareholders are bound by that arrangement as a result of holding their respective ownership instruments.

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[1] We acknowledge that the Interpretations Committee has discussed the accounting for NCI puts over the course of many meetings. In January 2013, the Interpretations Committee decided to ask the IASB to reconsider the requirements in paragraph 23 of IAS 32 for put options and forward contracts written on an entity's own equity. We intend to bring that issue to the Board at a future meeting. This paper is not intended to prejudge the outcome of the IASB's discussion. 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 accounting for NCI puts (ie from a 'gross' measurement basis to a 'net' measurement basis), we think that decision should also apply to MTOs.

A final observation

14. Finally, if the Interpretations Committee 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 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.

15. MTOs and NCI puts are economically similar. Therefore, we think that the requirements in IAS 8 support accounting for MTOs in accordance with IAS 32 and IAS 39 or IFRS 9 such that they are accounted for in the same way as NCI puts.

Question to the Interpretations Committee
Does the Interpretations Committee agree 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? If not, why?

Appendix A

Appendix B