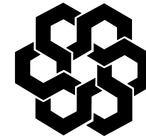

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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **14 December 2006, London**

Project: **Business Combinations II**

Subject: **Non-controlling Interests and Goodwill: Questions and Answers (Agenda Paper 2A)**

Introduction

Background

1. In October the staff presented a paper that suggested that the Boards should decide on the measurement attribute for non-controlling interests (NCI) in a business combination. The Business Combinations Exposure Draft (BC ED) provides guidance on how to measure NCI, based on the NCI's interest in the identifiable net assets and an allocation of goodwill, but does not state what that measurement attribute purports to be.

2. The main purpose of the October paper was to have the Boards think about what NCI is and how it should be measured. Until then the discussions tended to focus on what goodwill is and how it should be measured, with NCI being measured as a consequence of its proportional share in the identifiable assets and liabilities plus its share of goodwill. The Boards provided some initial reactions to this new approach and asked the staff to develop its thinking further.

3. The staff notes that one of the key reasons we are bringing the issues related to the measurement of NCI and goodwill back to the Boards is because, while the

FASB was strongly in favour of the full goodwill method (6-1), the IASB decided only by a bare majority to support full goodwill (8-6). Due to the closeness in voting, there is a concern that the final business combinations standards will not converge.

4. The staff is using this paper to try to converge the thinking between the two Boards. Thinking about the recognition and measurement of goodwill related to NCI in a new way (ie shifting the discussion to the measurement of NCI, rather than focusing on the measurement of goodwill) has helped the staff to clarify its thinking about the related costs and benefits. The staff believes that the resulting cost-benefit analysis in this paper might provide a way forward for the Boards to achieve a converged answer.

Staff recommendations and decisions for the Boards

5. The staff will ask the Boards to decide how to measure NCI in a business combination. The staff will ask that question in two steps:

   (a) In the first step the staff will ask the Boards to decide on the principle.

   (b) In the second step the staff will ask the Boards to decide if an exception should be made to that principle.

6. If Board members disagree with the staff's proposal to measure NCI at fair value, we would like to understand whether they disagree with the principle itself or if they are concerned with the practicalities of its application.

7. The staff notes that Board members do not have to compromise their view of goodwill in order to agree with the principle of measuring NCI at fair value. That is to say, Board members can still hold the view that goodwill is 'just a residual' (because it includes measurement errors, overpayments, etc.) **and** agree that fair value is the appropriate measurement attribute for NCI.

Should the fair value measurement principle in business combinations apply to NCI?

8. In March 2006, the Boards affirmed the following measurement principle for applying the acquisition method:

   > In a business combination, the acquirer measures each recognised asset acquired and each liability assumed at its acquisition date fair value.

9. The staff believes that this principle should be extended to NCI and therefore recommends that NCI be measured in a business combination at its acquisition date fair value *(footnote reference omitted from observer notes).* The staff

believes that NCI is a component of a business combination and therefore should be treated consistently with the other components of a business combination (assets acquired, liabilities assumed and consideration transferred).

Do practical difficulties justify a departure from the measurement principle for NCI?

10. The staff will then ask the Boards whether an exception should be made to the business combinations measurement principle for NCI. An exception to the measurement principle might be justified because of the practical difficulties associated with measuring the fair value of NCI. The staff has concluded that it is appropriate to ask the Boards to consider making an exception because of comment letter feedback and the alternative views expressed by some Board members in relation to measuring goodwill. Although the staff is shifting the emphasis to NCI it is likely that many of the concerns raised in the comment letters and by Board members in relation to goodwill are also relevant to measuring NCI.

11. The Boards decided in March that if they do not agree with an accounting requirement they will either make an exception to the principle or suggest an alternative principle. If the Boards decide to make an exception to the principle, this should be identified clearly as an exception within the standard.

12. An objective of this paper is, therefore, to provide the Boards with the information necessary to decide whether an exception should be made. That decision should be based on the relative cost-benefit, complexity (including reliability and subjectivity of measurement), and decision-usefulness of measuring NCI at fair value or in some other way.

13. To assist the Boards the paper includes descriptions of some of the requirements under IFRS 3 *Business Combinations*, FASB Statement No. 141, *Business Combinations*, the BC ED and other alternatives described here. This should help clarify what is currently required under IFRSs and US GAAP, what the BC ED proposed and the impact, if any, of measuring NCI at fair value.

14. The staff recommends that no exception be made, and that NCI be measured at fair value.

Structure of the paper

15. The staff has discussed the matters raised in the October paper with some Board members, other staff and outside parties.

16. The staff remains concerned that some of those people view a shift of focus onto NCI as a backdoor way of getting to full goodwill. For that reason, this paper includes a discussion of the nature of goodwill. The purpose of this discussion is to help reconcile the thinking about measuring NCI and measuring goodwill.

17. The discussions also highlighted several common themes and questions. Because so many of the questions were common a large portion of this paper is written in the form of a question and answer session, as follows:

Question 1:	Isn't recognising NCI at fair value just a 'backdoor' way of getting to full goodwill?
Question 2:	The staff assumes that fair value is the most relevant measurement attribute for NCI. That is to say, it is informative to users of the financial statements. Is this assumption reasonable?
Question 3:	It seems like NCI in the group financial statements should be equal to the equity of the related subsidiary multiplied by the NCI's ownership interest. Doesn't measuring NCI at fair value disrupt that relationship?
Question 4:	Isn't measuring NCI at fair value inconsistent with how other components of equity are measured?
Question 5:	Why bother recognising NCI at fair value on acquisition when it is only 'right' for one day?
Question 6:	How should goodwill be allocated to CGUs/RUs, and what is the relationship between the acquisition premium and the allocation of goodwill for impairment purposes?
Question 7:	How should an impairment loss be allocated between the controlling and non-controlling interests?
Question 8:	Is the accounting for goodwill impairment more or less complicated under the staff's proposal, in the BC ED or as required by current IFRSs and US GAAP?
Question 9:	Could the staff's proposal result in both goodwill and a gain on a bargain purchase being recognised simultaneously at the acquisition date?
Question 10:	What are the alternatives to measuring NCI at fair value and what are their implications?

Part 1 – The principle

18. The first part of this paper considers what measurement attribute should be used when NCI is accounted for in a business combination. The paper begins by analysing what NCI represents. It then suggests that NCI should be included in the components of a business combination that are measured at fair value. That is to say, the presumption is that NCI is like most other components of a business combination. This part of the paper then concludes by assessing the relevance and understandability of NCI measured at fair value.

The meaning of NCI

19. The FASB's proposed replacement of ARB No. 51, *Consolidated Financial Statements, Including Accounting and Reporting of Non-controlling Interests in Subsidiaries* (ARB 51 ED), defines a non-controlling interest as 'the portion of the equity (residual interest) of the consolidated group attributable to the owners of the subsidiary other than the parent and the parent's affiliates'. IAS 27 *Consolidated and Separate Financial Statements* defines a minority interest as 'that portion of the profit or loss and net assets of a subsidiary attributable to equity interests that are not owned, directly or indirectly through subsidiaries, by the parent'.

20. In IAS 27 and the ARB 51 ED, the Boards concluded that NCI should be presented in the consolidated balance sheet within equity separately from the parent shareholders' equity. The Boards concluded that NCI does not meet the definition of a liability in either of the Boards' conceptual frameworks.[1] Not one of the entities involved—the parent, the subsidiary, or the consolidated entity—is obligated to transfer assets or provide services to the shareholders that hold equity interests in the subsidiary. Rather, the holders of NCI have an ownership or residual interest in a component of the consolidated entity. In other words, NCI represents the portion of the residual interest in the net assets of the subsidiary to which the parent does not have a claim, but to which the NCI does. For example, if the NCI holders own 20 per cent of the outstanding shares of the subsidiary, they are generally allocated 20 per cent of the profits and losses and 20 per cent of the net assets of the subsidiary.

[1] Some constituents would prefer to treat NCI as a liability. The staff notes that if NCI was treated as a liability, it would be measured at fair value consistently with the measurement of other liabilities assumed in a business combination. This would result in the same measurement attribute for NCI at initial recognition as that proposed by the staff in this paper.

21. Because the NCI represents a claim on the residual net assets of the subsidiary, it must, by default, represent a claim on the corresponding portion of the total goodwill of the subsidiary. The staff believes that the acquiree, and therefore the NCI holders, will benefit from the synergies that result from the acquiree's assembled collection of net assets and will benefit from some portion of the synergies that will result from combining the acquirer's and acquiree's net assets.

22. Many respondents agreed with the alternative view in the IAS 27 ED that non-controlling interests represent equity claims that are restricted to particular subsidiaries, whereas the shareholders of the parent have equity claims on the entire consolidated group. Furthermore, they believe that NCI holders do not control the subsidiary and, as a consequence, NCI's influence over the subsidiary's financial and operating policies is often limited to the rights attributed to NCI holders by local legislation and the subsidiary's bylaws. For example, NCI holders generally cannot influence the amount and timing of the subsidiary's dividend distributions. Similarly, NCI holders normally cannot influence which parts of the group benefit from the synergies that are expected to be generated as a consequence of the transaction. Therefore, respondents believe that NCI should be treated differently from the equity of the parent.

23. The staff agrees that NCI has economic and legal characteristics which distinguish it from other forms of consolidated equity. However, the staff notes that creditors of a subsidiary also have direct claims against only the subsidiary, but the related liabilities are treated in the same manner as other liabilities of the group in the consolidated balance sheet.[2] Although the NCI holders are equity holders with interests in only a portion of the consolidated entity, they are still capital providers of the consolidated entity and should be recognised in the balance sheet in the same manner as other providers of risk capital.

24. As a form of equity capital for the parent company, the fair value of NCI represents the non-controlling shareholders' expectations of the future cash flows (or dividends) of the subsidiary, just as any other investment. These future cash flows and dividends are based on expectations about the financial and operating policies adopted by the controlling interest. That is to say, the fair value measurement of NCI will capture only those synergies from which NCI

[2] There might be cross-guarantees or other arrangements, but those guarantees will simply be additional obligations of each subsidiary.

holders expect to benefit, not the synergies that will benefit only the parent entity.

25. Furthermore, the expected future income of the subsidiary includes the income generated from the synergies that the NCI holders expect the subsidiary to realise as a result of the acquisition. However, if NCI is recognised at anything other than fair value (ie if it does not reflect the goodwill attributable to the NCI), it is inconsistent for NCI to receive the income that results from the synergies but to not recognise the asset that represents the synergies.

Question 1: Isn't recognising NCI at fair value just a 'backdoor' way of getting to full goodwill?

26. The BC ED proposes that *all* goodwill be recognised in the consolidated financial statements. Similarly, the proposal to measure NCI at fair value means that the consolidated financial statements would reflect NCI's interest in the goodwill.[3] That is to say, all of the goodwill would be recognised.

27. Having said that, the staff disagrees that recognising NCI at fair value is just a 'backdoor' way of getting to the full goodwill method. The staff acknowledges that in many cases the outcome of the proposal in the BC ED and the staff's proposal to measure NCI at fair value will be the same. However, the fact that the answer might be the same does not mean that focusing on NCI is the same as focusing on goodwill.

28. The BC ED states that NCI should be measured and recognised based on its proportional share in the identifiable assets and liabilities plus its share of goodwill (paragraph 58). It also describes how to calculate the goodwill attributable to the controlling interest, but states that 'the remainder of the goodwill shall be allocated to the non-controlling interests' (paragraph A62). It does not provide any guidance to assist in the analysis of what portion of goodwill would be attributable to the NCI holders versus the controlling interest holder. As a result, the measurement of NCI is an allocation process and less thought is given to what NCI actually means.

[3]This is referred to as the 'full goodwill' method. In the **full goodwill** method, all of the goodwill arising in a business combination, not just the acquirer's share, is recognised on the acquisition date. Goodwill is measured as the difference between the acquisition-date fair value of the acquiree as a whole and the fair value of the acquiree's identifiable assets and liabilities. In the **partial goodwill** method the goodwill recognised is adjusted to exclude the NCI's share of goodwill. Goodwill is measured as the difference between the acquisition-date fair value of the acquirer's interest in the acquiree and the acquirer's interest in the fair value of the acquiree's identifiable assets and liabilities.

29. The measurement of NCI in the BC ED is, in the opinion of the staff, a proxy for fair value. However, there are some circumstances, such as overpayments and underpayments, when NCI might not be measured at fair value. The staff thinks that the proposed standard should state the measurement attribute for NCI rather than stating how to calculate it.

30. Some staff members believe that characterising the alternative methods of measuring NCI and goodwill as the 'full goodwill' and 'partial goodwill' methods might be unhelpful. These characterisations imply that the 'methods' are competing concepts or theories that focus on the best way to account for goodwill. The argument, invariably, turns to assessing the informational relevance of goodwill.

31. The staff also has difficulty with the requirement in the BC ED to 'allocate' goodwill between the controlling and non-controlling interests. The BC ED explains that goodwill is an asset and, like other assets, should be recognised when control is achieved. Yet no other asset is 'allocated' between the controlling and non-controlling interests. The staff notes that the BC ED proposed to allocate goodwill under the 'full goodwill' method only for purposes of performing the goodwill impairment test. But that reason might not be easily understood and might have added confusion around the 'full goodwill' method.

32. The fact that goodwill is neither defined nor measured independently makes it difficult to assess its informational relevance. The BC ED proposes measuring goodwill as a residual. The BC ED (and IFRS 3) describes goodwill as:

> 'the future economic benefits arising from assets that are not individually identified and separately recognised.'

    In other words, goodwill is 'the assets that are not identified'.

33. The way that the BC ED proposes that goodwill be measured means that it absorbs any overpayment or underpayment and any (unobservable) differences between the fair value of the assets acquired and liabilities assumed and the recorded acquisition-date amount of those assets and liabilities for which exceptions to fair value measurement have been made. This amount is then allocated between the controlling interests and NCI. Therefore, any 'noise' in goodwill will impact NCI.

34. The relative merits of the 'full goodwill' and 'partial goodwill' methods then centre on whether all or some of that residual should be recognised. The five IASB Board members who subscribed to the alternative view in the IASB's BC ED questioned the relevance of the goodwill recognised under the proposals. They also questioned the relevance of the goodwill allocated to NCI.

35. The staff understands the difficulty of defending the information usefulness of goodwill. Having accepted that it is a residual, and that it absorbs underpayments and overpayments and any measurement errors in other assets and liabilities, debating whether to recognise all or some of the goodwill seems problematic.

36. Some staff believe that insufficient attention has been given to the impact on NCI of the proposals and that the focus of the discussion instead should be on measuring NCI. These staff emphasise that this change in focus is not an attempt to deflect the discussion from goodwill. Whatever the decision the Boards make about how to measure NCI, goodwill will, by necessity, absorb the same errors and measurement residuals identified above. The change in focus is designed to have the Boards identify the most relevant and decision-useful basis for measuring NCI in a business combination. That is to say, the informational content of NCI might be improved if NCI is measured directly.

37. Whatever decision is made about NCI measurement will affect goodwill. Indeed, if the fair value of NCI is recognised, full goodwill is the result since the fair value of the NCI includes its interest in the goodwill of the entity. However, given that the Boards have already decided that goodwill is to be measured as a residual, any method of measuring NCI that involves allocating goodwill to it means that NCI is, essentially, a residual of a residual. Decoupling the thinking allows the Boards to consider whether there is a measurement attribute that is more informative for NCI than one that relies on goodwill.

38. The staff also thinks that focusing on NCI forces preparers to analyse the components of goodwill and to attribute it to CGUs/RUs that reflect the interests that the controlling and non-controlling interests have in those CGUs/RUs (see paragraphs 84-93 for further discussion on how goodwill should be allocated to CGUs/RUs for the purposes of applying the impairment test). In Appendix A the staff outlines the components of goodwill and how controlling and non-controlling interests are likely to benefit from it. The purpose of this discussion is to demonstrate that when NCI is measured at fair value it will reflect the

residual interest the NCI has in that goodwill. The NCI has an economic interest in the goodwill whether or not it is recognised for accounting purposes.

Measurement attribute

39. The Boards have decided to measure at fair value all components of a business combination (with a few exceptions). For example, the Boards have decided that all assets acquired and liabilities assumed (with a few exceptions) in a business combination should be recognised at fair value at the acquisition date. In addition, equity instruments issued as consideration should be measured at fair value at the acquisition date.

40. In this paper, the staff is asking the Boards to include NCI within the items that are measured at fair value in a business combination. To help the Boards make that decision the staff thinks that the Boards should consider:

- the relevance of fair value of NCI, and
- the understandability of NCI.

Relevance

41. The IASB's *Framework* states that, in order to be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.[4] FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information,* also emphasises the importance of relevance. CON 2 states that accounting information is relevant if it is timely and has predictive value and/or feedback value. Relevance is defined in terms of the capability of information to make a difference to someone who does not already have it.[5]

Question 2:	**The staff assumes that fair value is the most relevant measurement attribute for NCI. That is to say, it is informative to users of the financial statements. Is this assumption reasonable?**

42. The staff believes that it is reasonable to assume that fair value is the most relevant measurement attribute for NCI.

43. Many of the respondents who disagreed with the full goodwill method did so on the basis that they believe that the consolidated financial statements should

[4] *Framework* 26.
[5] CON 2.47

reflect only the value of the controlling interests of the group (ie from the perspective of the parent company shareholders). However, we understand from the IASB's Analysts' Representative Group (ARG) meeting in November 2006 that information regarding the fair value of NCI would be useful for doing just that—estimating the value of the controlling interest.

44. The ARG members stated that currently it is difficult to determine the portion of the value of the group that is attributable to the parent company shareholders only. Ideally, the analysts would like the cash flow statement to provide information about which parts of the group (ie parts in which the NCI does or does not have an interest) are generating the cash flows of the group. However, specifying that entities should report this type of information is outside the scope of the business combinations project.

45. The ARG members stated that, because they do not have access to information about the cash flows attributable only to the parent, they use the information that is available to them—the results of the consolidated group—to estimate the value of the parent company shareholders' stake in the group. To do this, it is necessary for them to estimate the fair value of the NCI so that they can 'back it out' of the value of the business as a whole to arrive at a value of the controlling interest in the group. Because of this, they said that it would be useful for them to have the fair value of NCI at the acquisition date. Currently, their estimate of the fair value of the NCI is based on either the book value of the NCI or calculated earnings multiples because they have no better information on which to estimate the fair value of the NCI.

Understandability

46. The *Framework* states that an essential quality of the information provided in the financial statements is that it is readily understandable by users.[6] CON 2 also emphasises the importance of understandability. CON 2 states that understandability can be classified as relating to whether the decision maker 'speaks that language' or the information is 'intelligible to the audience for which it is intended'.[7]

47. In assessing NCI and goodwill, the staff has considered the accounting for goodwill and NCI in IFRS 3, Statement 141, the BC ED and the proposals in this paper in relation to this qualitative characteristic. In making this assessment

[6] *Framework* 25.
[7] CON 2.41.

the staff has asked whether the information that is generated by the current and proposed accounting treatment is easy to explain, intuitive and consistent with the way users appear to think about NCI.

Question 3: **It seems like NCI in the group financial statements should be equal to the equity of the related subsidiary multiplied by the NCI's ownership interest. Doesn't measuring NCI at fair value disrupt that relationship?**

48. The staff believes that the proposal to measure NCI in a business combination at fair value does not introduce any 'new' break in the relationship between the group financial statements and the stand-alone financial statements of its subsidiaries.

49. Some commentators believe that a natural relationship exists currently between the measurement of NCI in the group financial statements and the individual financial statements of the subsidiary and suggest that measuring NCI at fair value will break that relationship.[8] Those commentators believe that the NCI in the consolidated financial statements should be equal to the equity of the related subsidiary multiplied by the NCI's ownership interest. In a similar manner, the profit or loss attributable to the NCI should be equal to the profit or loss of the related subsidiary multiplied by the NCI's ownership interest. Commentators have expressed concern that by measuring NCI at fair value this link is lost because the initial measurement of NCI disrupts the relationship.

50. The staff notes that in most jurisdictions (except those permitting or requiring push-down accounting), the accounting treatment required by IFRS 3 and Statement 141 already means that neither the carrying amount of NCI, nor NCI's share of profits or losses, in the financial statements of the group are likely to be equal to the NCI's interest in the equivalent amounts in the stand-alone financial statements of the related subsidiary.[9],[10] That is to say, the

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[8] Any subsidiary in which there is an NCI will, presumably, prepare and present those financial statements to its shareholders. In many jurisdictions a wholly owned subsidiary is also required to prepare, and sometimes file, financial statements.

[9] When push-down accounting is applied all acquisition-date measurements of individual assets and liabilities are pushed down to the individual subsidiary's accounting records—including goodwill and other intangible assets that would not have otherwise been recognised in the subsidiary. The result is that the acquisition-date financial statements of the subsidiary are adjusted to mirror the amounts that will be recognised in the group when the business combination is recognised. In the US, push-down accounting is required when a subsidiary is substantially wholly owned (95% ownership and above). Push-down accounting is permitted when the NCI is a relatively small percentage of the total ownership interests, but is not permitted when the proportion of NCI reaches a particular level (above around 20 per cent).

proposal to measure NCI in a business combination at fair value does introduce any 'new' break in the relationship between the group financial statements and the stand-alone financial statements of its subsidiaries.

51. This is because generally the carrying values of the assets and liabilities *in the subsidiary's financial statements* are not affected when the subsidiary is acquired. In contrast, IFRS 3 and Statement 141 require, and the BC ED proposed, that those assets and liabilities be recognised at their acquisition-date fair values (IFRS 3 and the BC ED) or as a series of layers comprising portions of fair value and a portion of carry-over amount (Statement 141) *in the group financial statements* following the business combination. There are also many assets that might be recognised in a business combination that are not reported in the financial statements of the subsidiary (such as goodwill and identified intangible assets).

52. The equity of the subsidiary in its own financial statements will therefore be different from the equity as reflected in the group financial statements. The difference will be the aggregate of all of the differences between the amounts recognised in the business combination and the carrying amounts in the subsidiary.

53. These differences have an impact on the profit or loss attributable to the NCI. That is to say, the profit attributable to the NCI will be equal to the NCI's proportionate interest in the profit or loss of the subsidiary plus the impact of any differences between the accounting in the subsidiary and the accounting in the group. For example, the depreciation at the group level will be based on the new deemed costs of the assets brought into the group whereas the subsidiary in its stand-alone financial statements will recognise depreciation based on its original cost.

54. The staff also notes that, if push-down accounting is required (or permitted) and NCI is not stated at fair value, the effect is that the stand-alone financial statements of the subsidiary will recognise the goodwill attributable to the acquirer but not the goodwill attributable to the shareholders in the subsidiary who are the NCI holders at the group level. In other words, it is the investors in

[10] The staff is not suggesting that there should be a link between the measurement of NCI in the financial statements of the subsidiary and the group financial statements (ie that carryover amounts should be used in the group financial statements or that push-down accounting should be required). The staff is simply noting that the proposal to measure NCI at fair value would not introduce a 'new' break in that relationship.

the subsidiary—the NCI holders—who will be missing the complete information related to their investment post-acquisition. This does not seem to the staff to be an intuitive result.

Question 4: Isn't measuring NCI at fair value inconsistent with how other components of equity are measured?

55. The staff does not believe that measuring NCI at fair value is inconsistent with the measurement of other components of equity.

56. NCI is a component of equity that is being recognised for the first time in the consolidated balance sheet. It should be measured the same as every other component of equity that is being recognised for the first time—at fair value.

57. The Boards have decided that any shares issued as consideration in a business combination should be measured at their acquisition-date fair value. This ensures that any equity issued as part of the business combination (ie new equity) is at fair value.

58. At the simplest level, shares issued by an entity are recognised at fair value at the time they are issued.

Question 5: Why bother recognising NCI at fair value on acquisition when it is only 'right' for one day?

59. Some Board members and respondents have also questioned why NCI should be measured at fair value at the acquisition date given that after that date it will, presumably, not be measured at fair value at each subsequent reporting data. Instead, in periods after the business combination, the NCI will be attributed its share of net income or loss and each component of other comprehensive income based on its entitlement (through its ownership interests or contractual arrangement).

60. The staff thinks that this outcome is appropriate. Other components of equity generally are not remeasured to fair value in subsequent periods. That is to say, all components of equity are accounted for in a consistent manner.

61. In addition, the staff believes that measuring NCI at fair value at the acquisition date provides a useful starting point for analysts in estimating the fair value of NCI in subsequent periods.

Staff recommendations and decisions for the Boards

62. The BC ED does not include NCI in the components of a business combination that are measured at fair value. The staff believes that fair value is the most relevant measurement attribute for NCI. It is consistent with the way other components of equity are accounted for in a business combination and it is how users appear to think about NCI.

63. Several comment letters also stated that the measurement attribute for NCI should be fair value.[11] The staff notes that, although many comment letters stressed the importance of the parent perspective, the feedback from analysts indicates that the reason they are interested in the fair value of NCI is to help them measure the value of the parent's interest in the group. Because they currently do not have access to information about the parent's cash flows from which they can derive the fair value of the parent's interest in the group, they estimate this value by valuing the group as a whole and 'backing out' their estimate of the fair value of NCI.

64. The staff recommends that the final business combinations standard state that, in principle, non-controlling interests should be measured at fair value at the acquisition date. The next part of this paper considers whether an exception should be made to the principle because of the practical difficulties associated with its application.

65. ***Do the Boards agree? If not, please explain why.***

[11] The CFA Institute [CL #273] and PwC [#66], for example.

Part 2 – Application of the principle

66. Application of the principle requires that NCI be measured at fair value. As described in the previous section, the staff believes that measuring NCI at fair value is the correct principle. However, the staff acknowledges that some Board members and constituents have concerns about the complexity and reliability of measuring NCI at fair value. In this section of the paper we ask the Boards to consider whether the concerns expressed warrant an exception to the principle of measuring NCI at fair value.

67. To assist the Boards in making that assessment, this section evaluates the proposed approach against the current requirements in IFRS 3 and Statement 141 by considering the following issues:

    (a) the reliability of each of the NCI measures,

    (b) the implications of measuring NCI at fair value for the allocation of goodwill for impairment testing purposes, and

    (c) the cost of measuring NCI at fair value.

Reliability

68. The *Framework* states that an essential quality of the information provided in the financial statements is that it is reliable. Information is reliable when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.[12] CON 2 also emphasises the importance of reliability, stating that the reliability of a measure rests on the faithfulness with which it represents what it purports to represent, coupled with an assurance for the user that it has that representational quality.[13]

69. Five IASB Board members dissented on the BC ED because they disagreed that goodwill could be measured reliably under the proposal. Paragraphs AV4 and AV5 of the IASB ED state:

> The process of measuring goodwill is […] extremely difficult. The residual nature of its measurement means that it captures measurement errors in other assets and sometimes non-recognition of those assets. Moreover, the total value of the acquired business is an extremely subjective measure, based

[12] *Framework* 31.
[13] CON 2.59.

> upon the acquirer's judgement of the potential returns that it will generate. These returns will depend upon the synergies that the acquirer expects to achieve with its own business. Thus they are entity-specific to the particular acquirer and there will not be an observable fair value in the marketplace, especially when the acquisition is combined with restructuring.
>
> Not only is the total value of the acquired business difficult to measure but so is the allocation of the goodwill between the parent and the subsidiary. Some synergies will benefit the parent entity rather than, or in addition to, the subsidiary. Thus, the allocation of the goodwill between the parent and the subsidiary is also problematic, and this adds to the difficulty of measuring the goodwill attributable to the non-controlling interest in the subsidiary.

70. The staff acknowledges that, in many cases, the acquirer will need to measure the fair value of the acquiree as a whole in order to derive the fair value of NCI. We therefore believe that the Board members' concerns about the reliability of measuring goodwill are equally applicable to the staff's proposal to measure the fair value of NCI.

71. The staff acknowledges that measuring the fair value of NCI contains necessarily subjective elements and relies heavily on management's assumptions. Many valuation professionals refer therefore to the measurement of the acquiree as a whole (and indeed the underlying assets and liabilities) as being part art (based on judgement) and part science (based on finance theory). The degree of subjectivity in the measurement of NCI might cause challenges for auditors and users of financial statements because the inputs and the valuation methodologies might be difficult to audit or analyse. However, some staff members believe that this is no different with regard to the measurement of many of the entity's assets and liabilities.

72. The staff believes that fair value is the most relevant measurement attribute for NCI and is preferable over other measurement attributes which could be measured with higher reliability but would lack relevance. We note that in many cases accounting involves the use of estimates. Making an estimate involves judgement based on the latest available and most reliable information. The use of judgement in selecting and applying a valuation technique is therefore not objectionable but is a necessary step in the estimation process. Furthermore, we believe that management's assumptions generally represent reliable information because they are closest to the entity. Paragraph 30 of

Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* states:

> Level 3 inputs are unobservable inputs for the asset or liability, that is, inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability (including assumptions about risk) developed based on the best information available in the circumstances.

73. The staff believes that concerns about the reliability of fair value measurement can be mitigated by the following factors:

    (a) *The use of several valuation techniques*: A variety of valuation techniques are available and are widely used in practice. We believe that the use of several valuation techniques in the fair value measurement of NCI provides a way to verify the reliability of the resulting fair value measure.

    (b) *Disclosure requirements*: Paragraphs 32 – 35 of Statement 157 require footnote disclosures on the applied valuation technique and the key model inputs. We believe that if the Boards decide that fair value is the right measurement attribute for NCI comparable disclosure requirements should apply to all business combinations. The staff intends to bring the disclosures required in a business combination back to the Boards in a comprehensive package at later Board meetings.

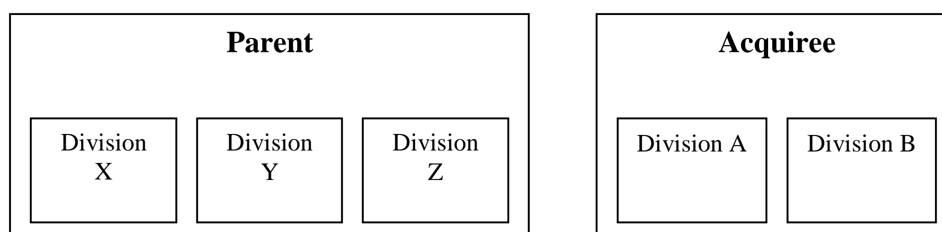
74. Moreover, the staff notes that the need to measure the fair value of the acquiree as a whole and to allocate synergies between controlling interests and NCI is not unique to the proposals but arises currently under Statement 141 and IFRS 3. In current practice, in a business combination effected through the exchange of privately held securities, acquirers routinely measure the fair value of the acquiree and recognise the goodwill related to the business combination in the absence of a purchase transaction. In the acquisition of a privately held company, the acquirer must derive the purchase price based on non-public information. In addition, acquirers currently measure the fair value of their RUs/CGUs (which are not usually publicly traded entities) when conducting their goodwill impairment tests. The impairment test requires an allocation of synergies to RUs/CGUs.

75. The staff notes that the Boards have already decided as part of this project that the fair value of pre-existing NCI can be estimated reliably.[14] The staff does not believe that a requirement to determine the fair value of the 'new' NCI will be substantially different and more burdensome. Therefore the staff believes that a reliable estimate of the fair value of 'new' NCI will be able to be obtained. However, we recognise that the costs of doing so must be considered. The costs and benefits of measuring 'new' NCI at fair value are summarised in paragraphs 120-129.

76. Appendix B describes the measurement of non-controlling interests from a valuation perspective, whether they are pre-existing or 'new'.

Goodwill impairment

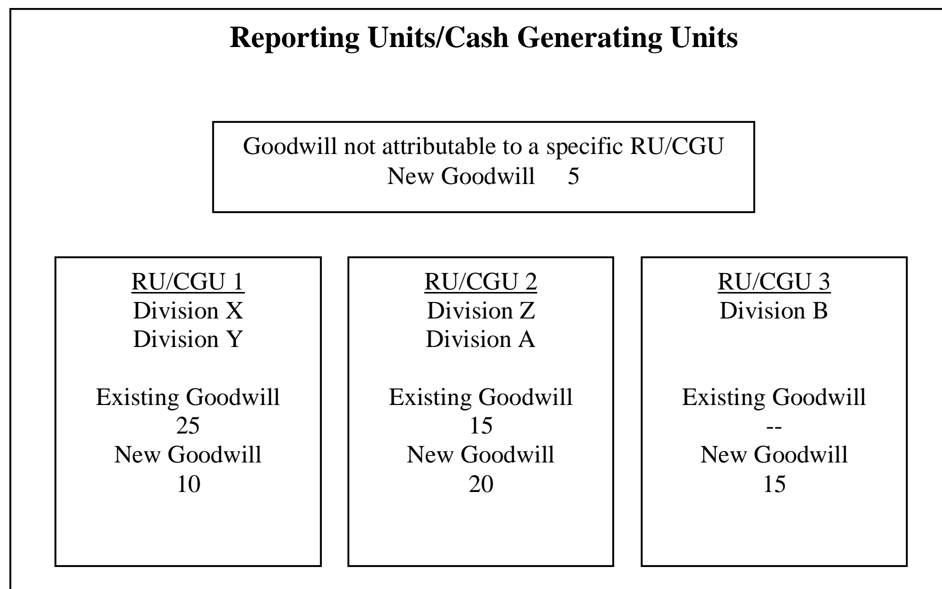
77. To help facilitate the discussion, consider the following example in which a Parent and Acquiree are structured as follows:



78. IAS 36 *Impairment of Assets* and FASB Statement No. 142, *Goodwill and Intangible Assets,* require that goodwill arising from a business combination be allocated to each CGU/RU that is expected to benefit from the goodwill. That allocation is required so that the acquirer can measure impairment losses attributable to NCI.

79. Based on the requirements in IAS 36 and Statement 142, the Acquirer determines that the goodwill arising from the acquisition is CU 50 and should be allocated to CGUs/RUs as follows:

[14] The Boards concluded that gaining control of a business is a significant economic event that should trigger remeasurement. This is because a change from holding a non-controlling investment to obtaining control of that entity is a significant change in the nature of the economic circumstances surrounding the investment. That change warrants a change in the classification and measurement of the investment and is different from the current requirements in IFRS 3 and Statement 141.



80. A portion of the goodwill (CU 5, depicted in the top box) cannot be allocated on a non-arbitrary basis to individual CGUs/RUs, but only to a group of CGUs/RUs which benefit from the goodwill.

- RU/CGU 1 is an RU/CGU in which the NCI does not have an interest. A portion of the synergies arising from the acquisition (CU 10) will benefit only Division X and Division Y of the parent and not the subsidiary (ie the NCI will not share in those synergies).
- A portion of the synergies arising from the acquisition (CU 20) will benefit RU/CGU 2, which is an RU/CGU in which the NCI has an interest in only a portion of the RU/CGU (Division A).
- A portion of the synergies arising from the acquisition (CU 15) will benefit RU/CGU 3, which is an RU/CGU in which the NCI has an interest in the entire RU/CGU.

81. The example highlights two points:

(a) Firstly, the requirement to allocate goodwill to CGUs/RUs is a current requirement. Notwithstanding whether NCI is measured at fair value, in accordance with the BC ED or in accordance with IFRS 3 or Statement 141, that allocation must be made.

(b) Secondly, the acquired subsidiary and the CGU/RU might not align. A CGU/RU could be bigger than the subsidiary or parts of the subsidiary could form several CGUs/RUs.

82. Furthermore, IAS 36 and Statement 142 require that the acquirer identify all of the goodwill and allocate it to the CGUs/RUs to which it relates. In contrast, IFRS 3 and Statement 141 only allow the recognition of the parent's portion of that goodwill. In the current example, only some of the goodwill allocated to RU/CGU 2 and RU/CGU 3 would be recognised in a business combination. Thus, although IFRS 3 and Statement 141 recognise some of the goodwill, it is necessary to identify and track all of the goodwill for impairment testing purposes.

83. The complexities described here could be eliminated by amending the impairment standards to require that an entity with NCIs always be its own CGU/RU. Some staff are concerned that such a change would conflict with the way businesses manage their activities in an acquisition. That is to say, in many cases the acquirer is likely to combine some of the activities of the acquiree with its own activities. On the other hand, an entity with an NCI might not be as fully integrated with the acquirers other activities as a wholly owned entity might. The staff believes that this would need to be considered in conjunction with any review of the impairment standards.

Question 6: **How should goodwill be allocated to CGUs/RUs, and what is the relationship between the acquisition premium and the allocation of goodwill for impairment purposes?**

84. Both the IAS 27 ED and the BC ED acknowledge the existence of a control premium and state that the control premium component of goodwill should be allocated only to the **controlling** interest. The IAS 27 ED states that:

> … the portion of a subsidiary's goodwill may not be equal to the total amount recognised as goodwill multiplied by the non-controlling ownership interest in the subsidiary. This would be the case, for example, if an 80 per cent controlling interest in a subsidiary were acquired at an amount that exceeds 80 per cent of the subsidiary's fair value because the acquirer paid a premium to obtain control of the acquiree. [Paragraph 30B(b)]

85. The basis for conclusions in the BC ED states that the allocation of goodwill should reflect 'the assumption that any premium paid by the acquirer for control

rights that is included in the full amount of goodwill should be allocated to the acquirer's interests, and not to the non-controlling interest.' (paragraph BC150)

86. Paragraph 80 of IAS 36 states:

> For the purpose of impairment testing, goodwill acquired in a business combination shall, from the acquisition date, be allocated to each of the acquirer's cash-generating units, or groups of cash-generating units, that is expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units or groups of units.

87. Paragraph 81 of IAS 36 states, in part:

> … Goodwill sometimes cannot be allocated on a non-arbitrary basis to individual cash-generating units, but only to groups of cash-generating units. As a result, the lowest level within the entity at which the goodwill is monitored for internal management purposes sometimes comprises a number of cash-generating units to which the goodwill relates, but to which it cannot be allocated.

88. The question then becomes, if the acquisition premium referred to in Appendix A contains several elements, in addition to the premium paid for control, how is the 'control premium' supposed to be allocated—in a non-arbitrary manner—to the cash-generating units of the acquirer?

89. The allocation of goodwill between controlling and non-controlling interests requires an assessment of whether and from where the benefits are expected to come.

90. Many components of an acquisition premium (see Appendix A) will benefit the buyer but not the NCI in the acquiree (for example, the premiums paid for control, overpayments and negotiating power, and any buyer-specific synergies that will not benefit the acquiree). In contrast, other components of goodwill will benefit both the buyer and the NCI (such as synergies that arise from the acquiree's assembled net assets and the synergies resulting from the combination of the two businesses). On the face of it, the goodwill attributable to the NCI will align with the goodwill allocated to CGUs/RUs in which the NCI has an interest.

91. The staff understands from discussions with valuation professionals that acquirers often do a detailed analysis of the synergies they expect to realise as a result of the business combination. Typically, these are done to a level of detail that allows the acquirer to allocate the goodwill between the CGUs/RUs that are expected to benefit from the acquisition. This level of detail shows:

(a) the cost savings and revenue enhancements expected to arise from the combination (both in amount and how/where they will be achieved), and

(b) the amounts that are buyer-specific versus market participant.

92. This type of analysis will implicitly result in the amounts to allocate between the controlling and non-controlling interests.

93. The components of goodwill and acquisition premiums are further discussed in Appendix A.

Question 7: How should an impairment loss be allocated between the controlling and non-controlling interests?

94. Returning to the previous example, if CGU/RU 2 had an impairment loss of 6, the question is how much is allocated to the controlling and non-controlling interests?

95. In IFRS 3, because only some of the goodwill of 10 has been recognised, the amount recognised needs to be grossed up to reflect the unrecognised portion attributable to the NCI. Statement 141 requires that the fair value of the RU be based only on the controlling interest value and should not reflect the non-controlling interest (in other words, it is 'grossed down'). In the BC ED (and the staff's proposal), the goodwill is recognised at the appropriate amount as of the acquisition date.

96. The allocation of the impairment loss in IFRS 3 is based on the relative ownership interests of the controlling and non-controlling interests. Similarly, the BC ED (and the staff's proposal) between the controlling and non-controlling interests is based on the relative ownership interests of each. Because Statement 141 measures the impairment loss based on the controlling interest only, no further adjustment needs to be made.

97. Appendix C describes in more detail the allocation of an impairment loss under the BC ED and the staff's proposal.

Question 8: Is the accounting for goodwill impairment more or less complicated under the staff's proposal, in the BC ED or as required by current IFRSs and US GAAP?

98. The staff believes that our proposal will simplify the accounting for goodwill impairment when compared to the BC ED or current IFRSs and US GAAP.

99. The BC ED and the current proposal impose no additional requirements for allocating goodwill for the purposes of the impairment test. IAS 36 and Statement 142 already require that goodwill that will benefit only the controlling interests (such as buyer-specific synergies from which the NCI will not benefit) be allocated to a CGU/RU in which the NCI does not have an interest. The current proposals would require that all of this goodwill be recognised in the financial statements. In contrast, IFRS 3 and Statement 141 only recognise some of the goodwill.

100. The requirements in IAS 36 and Statement 142 mean that entities have to maintain the same information whether they recognise all of the goodwill (the proposals) or only some of it (IFRS 3 and Statement 141).

Bargain purchases

101. At the October 2006 Board meetings, a question was raised about the implications of the staff's proposal to measure NCI at fair value on the accounting for a bargain purchase.

Question 9: **Could the staff's proposal result in both goodwill and a gain on a bargain purchase being recognised simultaneously at the acquisition date?**

102. The staff's proposal to measure NCI at fair value would result in goodwill being treated as the final residual. Therefore if the difference between:

   (a) the fair values of the liabilities assumed, NCI and consideration transferred and

   (b) the fair value of the assets acquired

   is positive, goodwill will be recognised. If the difference is negative, a gain on the bargain purchase will be recognised.

103. The staff acknowledges that the Boards discussed this issue in their initial deliberations and that the staff's proposal might be inconsistent with the accounting for bargain purchases proposed in the BC ED. This is because the proposal would result in NCI reflecting the full value of its share of goodwill, whereas the BC ED would result in deducting NCI's portion of goodwill from the balance of NCI in a bargain purchase situation.

104. For example, assume that AC acquires an 80 per cent interest in TC for CU152. In accordance with the staff's proposal, AC determines the following:

Fair value of identifiable assets acquired	CU250
Fair value of liabilities assumed	50
Fair value of 20 per cent NCI	45

105. Under the staff's proposal, goodwill would be calculated as the final residual. The difference between:

(a) the fair values of the liabilities assumed, NCI and consideration transferred and

(b) the fair value of the assets acquired

is negative (ie a bargain purchase exists) and a gain of CU3 is recognised.

<u>Alternative 1</u>

Dr. Identifiable assets	250	
Cr. Liabilities		50
Cr. NCI		*45*
Cr. Consideration		152
Cr. Gain on bargain purchase		*3*

106. Under the BC ED, the value of NCI's portion of goodwill would be deducted from the balance of NCI as follows:

<u>Alternative 2</u>

Dr. Identifiable assets	250	
Cr. Liabilities		50
Cr. NCI		*40*
Cr. Consideration		152
Cr. Gain on bargain purchase		*8*

107. A third alternative might be to reconsider the Boards' proposal to permit the simultaneous recognition of goodwill and a bargain purchase.

<u>Alternative 3</u>

Dr. Identifiable assets	250	
Dr. Goodwill	*5*	
Cr. Liabilities		50
Cr. NCI		*45*
Cr. Consideration		152
Cr. Gain on bargain purchase		*8*

108. If the Boards decide that NCI should be measured at fair value, the staff seeks the Boards' input on whether (1) its proposal to measure NCI at fair value at the

acquisition date should be modified in the case of a bargain purchase or (2) the Boards' would prefer to modify the bargain purchase accounting to maintain consistency in the initial measurement of NCI at fair value.

109. No staff members support Alternative 3. The staff believes that alternative is inconsistent with the Boards' decisions on the accounting for bargain purchases. The Boards decided that if a bargain purchase exists, goodwill should be reduced to zero before a gain is recognised.

110. Some staff members support Alternative 1. Those staff members believe that fair value is the most relevant attribute for NCI and that principle should not be compromised in a bargain purchase situation. A consequence of Alternative 1 is that all of the write-down of the goodwill is attributable to the controlling interest. Some staff members believe that this is not a faithful representation of the gain attributable to the controlling interest. Other staff members note that the gain of 8 that would be recognised in Alternatives 2 and 3 does not represent the economic gain (of 28) and would prefer to preserve NCI at fair value.

111. Other staff members support Alternative 2. Those staff members believe that Alternative 1 effectively is recognising goodwill related to the NCI and therefore is also inconsistent with the Boards' previous decisions on bargain purchase accounting. The staff who support Alternative 2 note that a gain of CU8 appropriately reflects the bargain purchase achieved by the acquirer. That is, the bargain purchase also can be calculated at the difference between the consideration paid of CU152 and the acquirer's interest in the net identifiable assets [(CU250 – CU50) x 80 per cent].

Potential alternatives to fair value

112. If the Boards decide to make an exception to the principle of measuring NCI at fair value, they need to consider other alternatives for the measurement of NCI at the acquisition date.

Question 10: What are the alternatives to measuring NCI at fair value and what are their implications?

Alternatives

113. The staff has considered the following alternatives to the principle of measuring NCI at fair value:

(a) Alternative 1: Measure NCI as the sum of the proportion of the acquiree's identified net assets plus the portion of the goodwill attributable to the NCI (ie retain the proposal in the BC ED).

(b) Alternative 2: Measure NCI as a proportionate interest of the fair value of the acquiree as a whole. All of the goodwill would be recognised, although this methodology would result in the allocation of a portion of the acquisition premium to NCI.

(c) Alternative 3: Measure NCI as a proportion of the fair value of the acquiree's identified net assets. This would have a similar result as applying the 'partial goodwill' method.[15]

Implications of the alternatives

114. The staff believes that in many cases calculating NCI using the guidance in the BC ED (Alternative 1) will result in the same outcome as measuring NCI at fair value. However, the difference is that the staff's proposal results in NCI being measured at a relevant measurement attribute rather than as an accumulation of measurements.

115. An advantage of Alternative 2 (proportion of the whole) is that it would be operationally easier to apply than measuring 'new' NCI at fair value or Alternative 1 (BC ED) because it relieves the acquirer from having to identify the acquisition premium.[16] However, Alternative 2 does not relieve the acquirer from having to measure the fair value of the acquiree as a whole. Because Alternative 2 attributes some of the acquisition premium to the NCI, Alternative 2 does not represent the fair value of NCI and therefore does not provide a basis for measuring the fair value of any previously-held NCI. In addition, Alternative 2 has less informational value than the staff's proposal (measuring NCI at fair value) or Alternative 1 (BC ED) because it does not provide analysts with a starting point for determining the value of the group that is attributable to the controlling interest. Alternative 2 also implies that getting the correct value for NCI is less important than getting the correct value for goodwill.

[15] However, the accounting treatment might be different from the current treatment in IFRS 3 and Statement 141 because of other proposals in the BC ED, namely the remeasurement of previously-held NCI to fair value at the acquisition date and the requirement to measure at fair value the identifiable net assets acquired.

[16] The acquisition premium is the additional price paid by the acquirer to obtain an interest in the target company. It includes, amongst other items, the control premium. See Appendix A for further discussion regarding the acquisition premium.

116. An advantage of Alternative 3 is that initial measurement is much less complex than under the staff's proposal (measuring NCI at fair value), Alternative 1 or Alternative 2. However, Alternative 3 understates both NCI and goodwill in the acquirer's balance sheet and would cause operational difficulties during subsequent impairment testing. In addition, Alternative 3 might result in a larger reduction in equity when subsequent acquisitions are made because the value of NCI will not reflect its portion of the goodwill.

117. If the Boards select Alternative 3, they will need to provide guidance on accounting for subsequent acquisitions after control is obtained and how to perform goodwill impairment testing. The staff has considered the following alternatives:

    (a) Alternative A—Layers approach. This is the current requirement under Statement 141 and is one of five accepted practices under IFRS 3.[17] For each incremental layer of ownership interest acquired, an incremental portion of goodwill is recorded to the extent of the ownership interested acquired. That layer would be measured as the difference between the fair value of the noncontrolling interest acquired and the fair value of the proportional ownership interest acquired in the subsidiary's identifiable net assets on the date of the transaction.

    (b) Alternative B—'Freeze' goodwill at the acquisition date. Goodwill would be measured once (at the acquisition date) and would not be remeasured when additional interests are acquired by the parent after control is obtained. Subsequent changes in controlling ownership interests would be treated as exchanges between equity holders.

118. Both methods would require a 'gross up' of goodwill for subsequent impairment testing. However, if the Boards decide to use the latter approach (ie freezing goodwill at the date control is obtained), the 'gross up' is more artificial than it would be under a layers approach because the acquirer would have to continue to 'gross up' goodwill even if it subsequently obtained control of 100 per cent of the acquiree.

119. If the Boards decide to remeasure goodwill when additional interests are acquired (Alternative A) the proposal would need to state that each asset and liability acquired would need to be measured at fair value for each subsequent

[17] Based on the staff's understanding through discussions with accounting firms. For example, see KPMG's comment letter (#88).

acquisition so that goodwill could be calculated. One of the benefits of the staff's proposed model (measuring NCI at fair value) is that the accounting for subsequent acquisitions is easier because goodwill is only measured once (at the acquisition date). The staff believes that it is important to retain that benefit, even if the Boards decide against measuring NCI at fair value. Therefore the staff recommends Alternative B (freezing goodwill at the acquisition date) in the event that the Boards support Alternative 3 above (measuring NCI as a proportion of the acquiree's identified net assets).

Cost-benefit considerations

120. Both Boards assess the relative costs and benefits of alternative accounting requirements as a part of their deliberations, although they acknowledge that a formal quantitative assessment of the costs and benefits might not be practicable. The IASB considers the following points in assessing the costs and benefits:

    (a) The costs incurred by preparers of financial statements;

    (b) The costs incurred by users of financial statements when information is not available;

    (c) The comparative advantage that preparers have in developing information, when compared with the costs that users would incur to develop surrogate information; and

    (d) The benefit of better economic decision-making as a result of improved financial reporting.

121. The table that follows summarises the staff's assessment of the relative costs and benefits of the current requirements under IFRS 3 and Statement 141, the BC ED and the staff's proposals.

	Staff proposal (FV NCI)	BC ED	IFRS 3 SFAS 141	Most important attributes
Benefits (1 = highest benefit)				
Relevance of NCI to investors	1=	1=	3	✓
Understandability of NCI to investors	1	2	3	✓
Understandability of goodwill to investors	1	2	3	
Understandability of goodwill allocation	1	2	3	
Understandability of the impairment test	1	2	3	
Costs (1 = lowest costs)				
Costs associated with measuring NCI and goodwill in a business combination	2	2	1	✓
Application of the impairment test	1=	1=	1=	

122. The table highlights the importance of assessing which of the attributes are most important in the analysis. The staff thinks that relevance, understandability and preparation costs are likely to be the most significant factor in assessing the relative costs and benefits.

123. More often than not, an assessment of the relative costs and benefits of measurement alternatives will involve deciding whether one or more measurement proxies are more or less relevant than each other and what the costs of obtaining each measurement are. In the present case, the staff thinks that fair value is the only relevant measurement attribute for NCI in a business combination.

124. The question is whether the marginal benefits for users from providing that information exceed the marginal costs of having the acquirer provide it.

125. Respondents to the BC ED who were preparers believed that the costs associated with the fair value measurement of the acquiree as whole were high. The staff disagrees with those respondents. The comment letters indicate that acquirers already value the acquiree in a business combination. As part of the acquisition process acquirer's routinely estimate the amount of consideration which can be paid for the acquiree without causing the transaction to be unfavourable.

126. In addition, legal requirements (or litigation risks) sometimes cause an acquirer to engage external experts for the valuation of the acquiree for independence purposes or due to specific measurement attributes or techniques that are specified by local law or legal practice. The staff believes that business valuation expertise is already widely used in applying Statement 141 and IFRS 3.

127. The staff believes that the incremental costs of estimating the fair value of NCI over estimating the purchase price for a controlling interest in the company are minimal because the acquirer will have access to financial and strategic information—including access to the target company's management—as part of the due diligence and negotiation processes. In addition, as part of a business combination, the acquirer in most cases will do a business valuation of the target. Although the staff's proposal does not require a business valuation *per se*, it is likely that doing such a valuation would be useful in estimating the fair value of the NCI.

128. Users believe that it is important for the analysis of consolidated financial statements to generate an estimate of the fair value of the NCI. The group financial statements do presently not provide this information. Users might be able to estimate the fair value of the NCI at the acquisition date, but it is not likely to be as reliable as an estimate provided by the acquirer. Currently, their estimate of the fair value of the NCI is based on either the book value of the NCI or calculated earnings multiples because they have no better information on which to estimate the fair value of the NCI. The staff believes that these estimation techniques provide only very imprecise approximations of the fair value of the NCI. Hence, users' estimate of the fair value of the NCI faces a significant risk of measurement error and potentially leads to the misallocation of economic reserves. The staff is not able to assess the costs associated with this potential misallocation of economic resources.

129. We believe that information on the fair value of the NCI in the group financial statements would significantly improve users' economic decision making. As a consequence of having information gathered as part of a business acquisition the acquirer has a significant informational advantage over users and can therefore estimate more reliably the fair value of the NCI than external users. The staff thinks that it is also likely that the collective costs of requiring all users to

estimate the fair value of NCI will be higher than the marginal costs that would be borne by the acquirer to obtain a fair value measure of NCI.

Staff recommendations and decisions for the Boards

130. The staff assessment of the relative costs of measuring NCI at fair value indicates that there are incremental costs associated with ensuring that the measurement is reliable. The staff believes, however, that those additional costs are relatively low because the fair value of NCI will be measured as part of the business combination. That is to say, the cash flow estimates and all of the information necessary to be able to allocate goodwill to the CGUs/RUs (which requires an assessment of whether the NCI will benefit from that goodwill) will be generated as part of the business combination process. The marginal cost of converting this to a valuation is therefore likely to be considerably lower than a fair value measurement made outside of a business combination.

131. A business combination is also an event in which the acquirer has a significant informational advantage over outside parties in being able to measure the fair value of the NCI.

132. Measuring NCI at fair value also aligns the measurement of the acquisition premium with the way goodwill is allocated for impairment purposes. And further, NCI at fair value is understandable and aligns the measurement of NCI with other components of equity.

133. Taken together, it seems clear to the staff that the marginal costs are unlikely to exceed the marginal benefits of measuring NCI at fair value. The staff therefore does not believe that an exception to fair value measurement for NCI can be justified.

134. ***Do the Boards agree?***

135. ***If so, how should the acquirer account for a bargain purchase?***

    - ***Alternative 1: maintain consistency in the initial measurement of NCI at fair value, do not recognise goodwill (including NCI's portion) and modify the accounting for the bargain purchase gain accordingly;***
    - ***Alternative 2: retain the BC ED proposal for bargain purchase accounting and deduct the value of NCI's portion of goodwill from the initial fair value measurement of NCI in a bargain purchase (ie***

make an exception to the principle of measuring NCI at fair value); or

- *Alternative 3: maintain consistency in the initial measurement of NCI at fair value and recognise NCI's portion of goodwill even in a bargain purchase.*

136. *If not, which alternative do the Boards support?*

- *Alternative 1: Measure NCI as the sum of the proportion of the acquiree's identified net assets plus the portion of the goodwill attributable to the NCI;*
- *Alternative 2: Measure NCI as a proportionate interest of the fair value of the acquiree as a whole; or*
- *Alternative 3: Measure NCI as a proportion of the fair value of the acquiree's identified net assets.*

137. *If the Boards support Alternative 3, how should subsequent acquisitions be accounted for?*

- *Alternative A—Layers approach. For each incremental layer of ownership interest acquired, an incremental portion of goodwill is recorded to the extent of the ownership interested acquired. That layer would be measured as the difference between the fair value of the noncontrolling interest acquired and the fair value of the proportional ownership interest acquired in the subsidiary's identifiable net assets on the date of the transaction.*
- *Alternative B—'Freeze' goodwill at the acquisition date. Goodwill would be measured once (at the acquisition date) and would not be remeasured when additional interests are acquired by the parent after control is obtained. Subsequent changes in controlling ownership interests would be treated as exchanges between equity holders.*

Appendix A—Components of Goodwill

A1. The 'core goodwill' of an entity is comprised of two separate components (paraphrased from paragraph B102 of Statement 141):[18]

- Component 1—the value that arises from the ability of the established business to earn a higher rate of return on an assembled collection of net assets than would be expected if those net assets had to be acquired separately. That value stems from the synergies of the net assets of the business, as well as from other benefits (such as factors related to market imperfections, including the ability to earn monopoly profits and barriers to market entry—either legal or because of transaction costs—by potential competitors). This is also known as 'going concern value'; and
- Component 2—the value of the expected synergies and other benefits that arise from combining the acquiring entity's and acquired entity's net assets and businesses. Those synergies and other benefits are unique to each combination, and different combinations would produce different synergies and, hence, different values.

A2. The first component arises through the day-to-day operations of an entity. It represents the pre-existing goodwill that was either internally generated by the acquired entity or acquired by it in prior business combinations. The second component relates to the acquired entity and acquiring entity jointly and reflects the excess assembled value that is created by the combination—the synergies that are expected from combining those businesses.

A3. These two components benefit both the controlling and non-controlling interests of an entity. However, the second component will impact NCI only to the extent that the acquiree (rather than only the acquirer) benefits from the acquisition. This could be the case when there are buyer-specific synergies that are expected to benefit other parts of the acquirer's business but not the acquiree. Paragraphs A7-A13 address the issue of the allocation of goodwill between the controlling and non-controlling interests with respect to buyer-specific synergies and other components of goodwill.

A4. The staff believes that core goodwill benefits both the controlling and non-controlling interests of an entity. The acquiree, and therefore the NCI holders,

[18] The amount of goodwill recognised as a result of an acquisition includes other components because it is measured as a residual.

will benefit from the higher rate of return that results because of the synergies in the acquiree's assembled collection of net assets (component 1) and will likely benefit from the synergies that will result from combining the acquirer's and acquiree's net assets (component 2).[19]

A5. In a business combination, the acquirer will be willing to pay only for the portion of core goodwill from which it will benefit. However, core goodwill also generates benefits for the NCI holders. Because the acquirer has control of its own assets and liabilities as well as the assets and liabilities of the acquiree, it follows that it has the ability to control the goodwill arising from the combination of the two businesses. Therefore, recognising only part of the goodwill understates the value of the goodwill controlled by the acquirer.

A6. In addition, the amount that in practice has been recognised as goodwill also includes the following components:

- Component 3—the premium paid for control (similar to an option premium, this is the amount paid to have the opportunity to realise the synergies in Components 1 and 2);[20]
- Component 4—any over- and under-payments;
- Component 5—the fair values of net assets acquired as part of the business combination that are not recognised separately (eg, intangible assets that did not meet the identifiability criterion); and
- Component 6—any measurement errors or measurement exceptions (eg, employees benefits and deferred taxes).

Goodwill attributable to controlling and non-controlling interests

A7. Because all of the first component and, generally, a large portion of the second component benefit the acquiree, and therefore the NCI holders, it follows that this level of the goodwill should be recognised—including that related to NCI.

[19] The second component of goodwill will impact NCI only to the extent that the acquiree (rather than only the acquirer) benefits from the acquisition. This could be the case when there are buyer-specific synergies that are expected to benefit other parts of the acquirer's business but not the acquiree. Part 2 of the paper addresses the issue of the allocation of goodwill to CGUs/RUs in which the controlling and non-controlling interests have an interest, with respect to buyer-specific synergies and other components of goodwill.

[20] This is closely related to, but separate from, Components 1 and 2. Component 3 is the price that must be paid to be able to realise the synergies in Components 1 and 2. The 'true' control premium is rarely observable or known. See paragraphs A14-A17 for further discussion of the acquisition premium.

A8. The staff believes that this makes intuitive sense; otherwise it is necessary to justify why a portion of the goodwill is not reflected in the financial statements of the group. Some Board members and constituents have argued that, because there has been no transaction to acquire all of the goodwill, it should not be recognised in its entirety because it does not meet the recognition criteria. Instead, they assert, only the acquired goodwill should be recognised because they believe that only the acquired goodwill is under the control of the acquirer.

A9. But which portion should be left out? It cannot be the synergies from the second component because the acquirer clearly has paid some amount *to be able to* use 100 per cent of the assets and liabilities of the acquiree. That is to say, since the acquirer has control over all of the assets and liabilities of the acquiree, it benefits from the synergies that arise from the combination of the two companies. Would the acquirer have to pay more to receive additional synergies? Probably not. The acquirer gets the full benefit of the synergies because it has a controlling interest. It would not need to acquire additional interests to get more synergies.

A10. Furthermore, consider a situation in which an intangible asset is deemed to be non-identifiable and therefore is subsumed into goodwill (such as a non-contractual customer relationship). Some portion of this asset would be recognised by the acquirer but none would be recognised by the NCI.

A11. What if, instead, the same intangible asset was considered identifiable (perhaps simply this is due to different interpretations of the meaning of 'identifiable')? An asset that is recognised separately from goodwill is partly attributable to the controlling interest and partly attributable to NCI. Does it make sense to have different treatment depending on which 'bucket' the asset falls into?

A12. Some Board members and constituents believe that because there has not been a transaction for 100 per cent of the acquiree, and therefore 100 per cent of the goodwill, the subjectivity involved in estimating the fair value of the acquiree as a whole means that goodwill does not meet the recognition criteria because it is not reliably measurable. The staff recognises that the valuation of businesses is subjective, but thinks that this does not make goodwill any less reliable. The concept of reliability includes the notion of being 'representationally faithful'. Is it more reliable to not recognise any of the non-acquired goodwill because of concerns about measurement? Or might it be appropriate to recognise an

amount that might be more subjective than other measurements, but which is representationally faithful?

A13. The staff believes that the 'no transaction' argument potentially could be misused to justify the non-recognition of some identifiable assets and liabilities. Does this make their fair values any less reliable, given that there was (a) not a transaction involving the individual assets and liabilities of the acquiree and (b) the acquirer did not buy rights to them in their entirety?

The acquisition premium

A14. An acquisition premium, is the additional price that any market participant might pay to acquire an interest in another entity and exists whenever any size controlling stake is acquired, whether or not it is for 100 per cent of the acquiree. In fact, it is not unusual to hear of a company paying a premium to acquire a minority stake in another company, or to acquire additional interests when the company already has control. Consider, for example, Royal Dutch Shell's recent announcement that it would acquire the 22 per cent it does not own of Shell Canada Limited at effectively a 22.5 per cent premium over the share price of Shell Canada.[21] In the case of an acquisition of a minority stake, this is often called a 'strategic premium'. A strategic premium is the additional price paid to ensure co-operation between the entities in the future.

A15. It is because of this type of situation and the many interpretation issues that have arisen from the use of the term 'control premium' that the staff would like to move away from that term. The phrase 'control premium' implies that the observed premium relates only to obtaining control. In fact, the observed premium paid to acquire a controlling stake in an entity does not only reflect the premium for control. Rather, it is comprised of several components, including:[22]

(a) the amount paid to obtain 'control' in the traditional sense—the price paid to get power over the entity's strategic operating and financing policies;[23]

(b) the amount paid to obtain 'control' such that any restrictions imposed by the minority shareholders are removed;

[21] Press release dated 23 October 2006.

[22] The premium generally is calculated as the difference between the purchase price for the shares of the acquiree and the trading price of those shares prior to the acquisition. Control premium data are not available for transactions involving privately-held acquirees. Instead, the control premia observed for transactions involving publicly-traded acquirees are used in the valuation of privately-held entities.

[23] In other words, the 'control premium' is not a quantification of the expected synergies, but it is the price that must be paid to be given the opportunity to realise the synergies. In concept, the 'control premium' is similar to an option premium.

(c) the amount of any overpayments;

(d) the amount by which the acquirer believes that the target's shares are undervalued;

(e) the amount paid for market-participant synergies;

(f) the amount paid for any buyer-specific synergies;

(g) the relative negotiating power of the parties to the transaction; and

(h) the amount paid simply to win the bid—in other words, the price to outbid the other parties, which depends on the level of competition in the bidding process.

A16. That is to say, the payment of the acquisition premium, in a majority acquisition, gives the acquirer control over the strategic operating and financing policies of the acquired entity and allows them to (try to) realise the synergy potential to be gained from the combination of the two companies. The size of the acquisition premium is based on several factors, including:[24]

(a) The nature and magnitude of non-operating assets,

(b) The nature and magnitude of discretionary expenses,

(c) The perceived quality of existing management,

(d) The nature and magnitude of business opportunities that are not currently being exploited, and

(e) The ability to integrate the acquiree into the acquirer's business or distribution channels.

A17. The amount of the acquisition premium attributable to the controlling and non-controlling interests will need to be assessed by the acquirer. The portion of goodwill related to the acquisition premium (generally, Components 2, 3 and 4) should be allocated to the RUs/CGUs that are expected to benefit from the business combination, as appropriate.

[24] Pratt, Shannon, et al. Valuing a Business: The Analysis and Appraisal of Closely Held Companies, Fourth edition, p. 349.

Appendix B—Measuring NCI at fair value

B1. This appendix summarises the main issues regarding the measurement of non-controlling interests from a valuation perspective. Specifically, it addresses some of the complexities of measuring pre-existing NCI and the NCI that exists after the acquisition.

B2. In a partial acquisition, an acquirer purchases less than 100 per cent of the shares of the acquiree. This can be accomplished in one transaction or in a series of transactions (ie in a step acquisition). If the acquisition occurs through a series of transactions, the Boards have concluded that the transaction in which the acquirer obtains control is a significant economic event which requires that the acquirer remeasure the previously-held non-controlling interest at fair value. This is because a change from holding a non-controlling investment to obtaining control of that entity is a significant change in the nature of the economic circumstances surrounding the investment.

B3. Some Board members and constituents have raised concerns regarding the complexity of measurement, under the staff's proposal, of the portion of the shares not acquired in a partial acquisition (the 'new' NCI). The staff's proposal would require the 'new' NCI to be measured directly at fair value as of the acquisition date. Therefore, under the staff's proposal there would be potentially two types of NCI to be measured:

(a) the fair value of any previously-held non-controlling interest (ie the investment held by the acquirer prior to obtaining control), and

(b) the fair value of the 'new' non-controlling interest (ie the portion that was not acquired).

B4. Investment assets, including pre-existing non-controlling interest investments, currently are measured at fair value under IAS 39 *Financial Instruments: Recognition and Measurement* for both initial recognition and subsequent measurement.[25, 26] This is done on a continuous basis so that all relevant

[25] Note that paragraph 46(c) of IAS 39 states that 'investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured… shall be measured at cost.' The fair value is presumed to be reliably measurable if (a) the variability in the range of reasonable fair value estimates is not significant for that instrument or (b) the probabilities of the various estimates within the range can be reasonable assessed and used in estimating fair value. (IAS 39.AG80)

[26] In addition, paragraph 37 of IAS 27 *Consolidated and Separate Financial Statements* states that, when separate financial statements are prepared, investments in subsidiaries and associates (accounted for in IAS 28 *Investments in Associates*) can be recognised either at cost or in accordance with IAS 39.

information is reflected in the fair value of the investment on each reporting date. Accordingly, the remeasurement of pre-existing NCI (a) is being done continuously so the fair value is known on any given date, and (b) will not result in an additional gain or loss as long as the remeasurement occurs on the acquisition date. If an investment asset is not measured at fair value, the recognition of a gain or loss at the acquisition date is merely a consequence of the delayed recognition of the economic gain or loss that is present in that financial instrument.

B5. A requirement to measure the 'new' NCI at fair value upon initial recognition in a business combination would be new under IFRSs. The following sections describe some of the issues that will affect the measurement of the fair value of the pre-existing and 'new' NCI on the acquisition date.

[Remainder of Appendix B has been omitted from observer note.]

Appendix C—Goodwill Impairment Loss Allocation

C1. This appendix discusses goodwill impairment loss allocation between controlling and non-controlling interests as proposed in the BC ED.

Proposal in the BC ED

C2. The BC ED proposes that at initial recognition goodwill be allocated between controlling and non-controlling interests as follows:

a. Controlling interest—the difference between the fair value of the acquirer's equity interest in the acquiree and the acquirer's share of the fair value of the identifiable net assets acquired.

b. Non-controlling interest—the goodwill remaining after the allocation to the controlling interest.

C3. The proposal in the BC ED amends IAS 36, with regard to goodwill impairment loss allocation, as follows:

> C8. In a cash-generating unit that includes a partially-owned subsidiary or is a stand-alone partially-owned subsidiary, goodwill impairment losses are allocated between the controlling and non-controlling interests pro rata using the relative carrying values of goodwill.
>
> C9. If the partially-owned subsidiary is itself a cash-generating unit, the impairment loss is allocated to the controlling and non-controlling interests on the basis of the relative carrying values of goodwill allocated to them.
>
> C10. If the partially-owned subsidiary is part of a larger cash-generating unit, goodwill impairment losses are allocated first to the components of the cash-generating unit and then to the controlling and non-controlling interests of the partially-owned subsidiary. The portion of the impairment loss allocated to the subsidiary is determined by multiplying the goodwill impairment loss for the unit by the carrying value of the goodwill assigned to that subsidiary, divided by the carrying value of the goodwill assigned to the cash-generating unit as a whole. The amount of impairment loss allocated to the partially owned subsidiary is then allocated to the controlling and non-controlling interests on the basis of the relative carrying values of goodwill allocated to those interests.

C4. The BC ED amends Statement 142 as follows:

> 38. Goodwill impairment losses shall be assigned first to the components of the reporting unit if the partially owned subsidiary is part of a larger reporting unit, and then to the controlling and non-controlling interests of the partially owned subsidiary. For example, if a partially owned subsidiary is part of a reporting unit, the portion of the impairment loss assigned to that subsidiary would be determined by multiplying the goodwill impairment loss by the proportion of the carrying value of the goodwill assigned related to that partially owned subsidiary over the carrying value of the goodwill assigned to the reporting unit as a whole. The amount of the impairment loss allocated to the partially owned subsidiary would then be allocated to the controlling and non-controlling interests pro rata based on the relative carrying values of goodwill allocated to those interests. If the partially owned subsidiary incurs a goodwill impairment loss and is itself a reporting unit, then the impairment loss is only allocated to the controlling and non-controlling interests based on the relative carrying values of goodwill allocated to them.

C5. To summarise, if the acquiree becomes a standalone CGU/RU, goodwill impairment losses are allocated between the controlling interest and NCI on a pro rata basis on the relative carrying values of the goodwill allocated to them. In other words, the NCI portion would be calculated as:

Goodwill impairment for the CGU/RU x (Goodwill ascribed to NCI ÷ Total goodwill acquired)

This might result in the proportion of goodwill allocated between controlling and non-controlling interests being different from their relative ownership interests.

C6. If the acquiree becomes part of a larger CGU/RU, goodwill impairment losses are allocated using a two step process:

(a) First, they are allocated to the acquiree/subsidiary as follows:

Goodwill impairment for the CGU/RU x (Carrying value of goodwill assigned to acquiree ÷ Total carrying value of goodwill of the CGU/RU)

(b) Second, they are allocated between the controlling interest and NCI as described above. That is, the NCI portion would be calculated as:

Goodwill impairment for the acquiree/subsidiary x (Goodwill ascribed to NCI ÷ Total goodwill acquired)

Again, this could result in the proportion of goodwill allocated between controlling and non-controlling interests being different from their relative ownership interests.

Staff concerns with that proposal

C7. Neither of the amended Standards will provide sufficient guidance to address how to apply a goodwill impairment loss to the NCI of a subsidiary when the goodwill of that subsidiary has been allocated to other CGUs/RUs of the acquirer.

C8. The staff questions the appropriateness of the proposed methodology for attributing goodwill between the controlling and non-controlling interests as described above, particularly in circumstances in which a portion of the acquiree's goodwill is allocated to other CGUs/RUs. The staff has considered whether the impairment loss attributable to NCI instead should be based on the percentage ownership of NCI (ie related to the proportion of goodwill that remains in the acquiree after the allocation of goodwill, if any, to other CGUs/RUs within the acquirer).

C9. This is one of the methodologies considered (and rejected) by the Boards during the initial deliberations for the BC ED. Paragraph BC149(c) of the IASB's BC ED (see also paragraph B154(c) of the FASB's BC ED) states that an alternative for allocating goodwill between controlling and non-controlling interests is to 'allocate a portion of goodwill to a reporting unit of the controlling interest that is expected to benefit from synergies of the combination, and then allocate the remainder to the controlling and non-controlling interests on the basis of their relative ownership interests in the fair value of the acquiree'. Paragraph BC150 of the IASB's BC ED (see also paragraph B155 of the FASB's BC ED) then states that this alternative would be difficult and costly to apply.

C10. However, IAS 36 states that 'goodwill acquired in a business combination shall, from the acquisition date, be allocated to each of the acquirer's cash-generating units, or groups of cash-generating units, that is expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units or groups of units' (paragraph 80). Statement 142 has similar language.

Staff suggestions for modification of the proposal

C11. The staff believes that goodwill impairment losses should be based on the proportion of goodwill that remains in the acquiree after the allocation of

goodwill to other CGUs/RUs within the acquirer. That is to say, it should be allocated between controlling and non-controlling interests based on the amount of goodwill recorded in the acquiree/subsidiary within a CGU/RU after the goodwill of the acquiree has been allocated to other CGUs/RUs of the acquirer. This would result in the 'cleanest' allocation of goodwill between the controlling interest and NCI because the consideration paid for the controlling interest (and therefore the goodwill related to the controlling interest) will absorb the control premium, buyer specific synergies, and over- or under-payments, etc.

C12. *[Paragraph omitted from observer notes]*

C13. Based on the methodology in paragraph C11, the staff's proposed modifications to IAS 36 and Statement 142 are shown in the following paragraphs. The inserted text is underlined and deleted text is ~~struck through~~.

C14. The staff suggests that IAS 36 be clarified as follows:

> C8. In a cash-generating unit that includes a partially-owned subsidiary or is a stand-alone partially-owned subsidiary, goodwill impairment losses are allocated between the controlling and non-controlling interests pro rata using ~~the relative carrying values of goodwill~~ their relative ownership interests.
>
> C9. If the partially-owned subsidiary is itself a cash-generating unit, the impairment loss is allocated to the controlling and non-controlling interests on the basis of ~~the relative carrying values of goodwill~~ their relative ownership interests.
>
> C10. If the partially-owned subsidiary is part of a larger cash-generating unit, goodwill impairment losses are allocated first to the components of the cash-generating unit and then to the controlling and non-controlling interests of the partially-owned subsidiary. The portion of the impairment loss allocated to the subsidiary is determined by multiplying the goodwill impairment loss for the unit by the carrying value of the goodwill assigned to that subsidiary, divided by the carrying value of the goodwill assigned to the cash-generating unit as a whole. The amount of impairment loss allocated to the partially-owned subsidiary is then allocated to the controlling and non-controlling interests on the basis of ~~the relative carrying values of goodwill allocated to those interests~~ their relative ownership interests in the subsidiary within the cash-generating unit.

C15. Similarly, the staff suggests that Statement 142 be clarified as follows:

> 38. Goodwill impairment losses shall be assigned first to the components of the reporting unit if the partially owned subsidiary is part of a larger reporting unit, and then to the

controlling and non-controlling interests of the partially owned subsidiary. For example, if a partially owned subsidiary is part of a reporting unit, the portion of the impairment loss assigned to that subsidiary would be determined by multiplying the goodwill impairment loss by the proportion of the carrying value of the goodwill assigned related to that partially owned subsidiary over the carrying value of the goodwill assigned to the reporting unit as a whole. The amount of the impairment loss allocated to the partially owned subsidiary would then be allocated to the controlling and non-controlling interests pro rata based on ~~the carrying values of goodwill allocated to those~~ their relative ownership interests. If the partially owned subsidiary incurs a goodwill impairment loss and is itself a reporting unit, then the impairment loss is ~~only~~ allocated to the controlling and non-controlling interests based on ~~the relative carrying values of goodwill allocated to them~~ their relative ownership interests.

C16. To summarise, if the acquiree becomes a standalone CGU/RU, goodwill impairment losses are allocated between the controlling interest and NCI on a pro rata basis on their relative ownership interests. This is because the goodwill related solely to the controlling interest will have been allocated to another CGU/RU. For example, the NCI portion would be calculated as (the changes identified by showing inserted text as underlined and deleted text as ~~struck through~~):

Goodwill impairment for the CGU/RU x NCI's proportionate ownership interest ~~(Goodwill ascribed to NCI ÷ Total goodwill acquired)~~

C17. If the acquiree becomes part of a larger CGU/RU, goodwill impairment losses are allocated using a two step process:

(a) First, they are allocated to the acquiree/subsidiary as follows:

Goodwill impairment for the CGU/RU x (Carrying value of goodwill assigned to acquiree ÷ Total carrying value of goodwill of the CGU/RU)

(b) Second, they are allocated between the controlling interest and NCI as described above. The NCI portion would be calculated as:

Goodwill impairment for the acquiree/subsidiary x NCI's proportionate ownership interest ~~(Goodwill ascribed to NCI ÷ Total goodwill acquired)~~

C18. Note that this does not resolve the following issues:

(a) Goodwill impairment testing becomes more complicated once the acquiree becomes fully integrated into the acquiring entity (for those which are not a separate CGU/RU). This is particularly an issue when, perhaps years after the acquisition, an acquiring entity undergoes a

restructuring process. The acquiring entity must separately track the goodwill that was originally ascribed to the subsidiary even if it is combined with other subsidiaries that form a larger CGU/RU.

(b) It is possible that the goodwill related to a business unit (ie not the acquiree) within a CGU/RU could become impaired on its own.[27] The current methodology of allocating goodwill impairment losses proportionately within a CGU/RU might result in a portion of the impairment loss being allocated to the NCI of the acquiree when it should not be.

C19. However, these are problems that currently exist in practice, and it happens whether the controlling interest is 100 per cent or less than 100 per cent. They also happen regardless of the methodology used to ascribe goodwill to NCI. The staff therefore suggests addressing subsequent measurement in these situations as part of the impairments project.

[27] This is more likely to occur under US GAAP than IFRS since a reporting unit is generally larger than a cash-generating unit.