30 Cannon Street, London EC4M 6XH, United Kingdom
Phone: +44 (0)20 7246 6410, Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: http://www.iasb.org

International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**March 2006, London**
Project:	**Business Combinations II**
Subject:	**Accounting for Partial and Step Acquisitions, Changes in Controlling Ownership Interests, and Loss of Control with a Retained Ownership Interest (Agenda Paper 2B)**

PURPOSE OF THE MEMO

1. The purpose of this memo is to ask the Boards to consider the accounting for *partial acquisitions,*[1] *step acquisitions,*[2] changes in controlling ownership interests, and loss of control with a retained ownership interest.

2. This memo specifically addresses:

(a) *SECTION 1:* Accounting for partial and step acquisitions, including:

(i) *Issue 1:* Measuring the *identifiable net assets* in a partial or step acquisition

(ii) *Issue 2:* Measuring *goodwill* in a partial or step acquisition

(iii) *Issue 3:* Issues that would need to be resolved if the Boards pursue the *purchased goodwill* method

(iv) *Issue 4:* Issues that would need to be resolved if the Boards pursue the *full goodwill* method

(v) *Issue 5:* Accounting for the acquirer's previously held equity interests in the acquiree in a step acquisition

[1] The BC ED referred to partial acquisitions as *business combinations in which the acquirer holds less than 100 percent of the acquiree's equity interests at the acquisition date*.
[2] The BC ED referred to step acquisitions as *business combinations achieved in stages*.

(b) *SECTION 2:* Accounting for subsequent acquisitions or dispositions of noncontrolling interests (changes in controlling ownership interests)

(c) *SECTION 3:* Accounting for loss of control of subsidiaries.

SECTION 1: PARTIAL AND STEP ACQUISITIONS

3. This section analyzes the proposed accounting for partial and step acquisitions in three steps:

(a) *Issue 1:* Measurement of the identifiable net assets

(b) *Issue 2:* Measurement of goodwill

(c) *Issue 3:* The recognition and measurement of any adjustment to the carrying value of the previously held noncontrolling equity interests in a step acquisition.

4. The following table outlines the accounting for partial and step acquisitions proposed in the BC ED and required by IFRS 3 and US GAAP. (Statement 141 does not provide guidance for accounting for step acquisitions. Statement 141 does not change the accounting for a step acquisition described in AICPA Accounting Interpretation 2, "Goodwill in a Step Acquisition," of APB Opinion No. 17, *Intangible Assets*.)

	Proposed in the BC ED	**IFRS 3**	**US GAAP**
The acquiree's identifiable net assets	Fair value (with limited exceptions)	Fair value[3]	The sum of: (a) the proportional interest in the fair values of each individual asset or liability on the date that each individual interest was acquired plus (b) the carrying value of any remaining portion owned by the noncontrolling interest.
Goodwill	The difference between the fair value of the acquiree and the fair value of the acquiree's identifiable net assets (with limited exceptions)	The sum of: (a) the cost of each transaction less (b) the acquirer's interest in the fair value of the acquiree's identifiable net assets and contingent liabilities on the date of each	The sum of: (a) the cost of each transaction less (b) the acquirer's interest in the fair value of the acquiree's identifiable net assets on the date of each transaction.

[3] IFRS 3 has additional recognition criteria that requires that (a) the acquiree's identifiable net assets be *reliably measurable* and (b) it is *probable* that the future economic benefits will flow to the acquirer or that an outflow of economic benefits will be required to settle the obligation. (Intangible assets and contingent liabilities need not meet criterion (b)) (paragraphs 36 and 37, paraphrased).

		transaction.	
Previously held noncontrolling equity interests in the acquiree	Remeasure to fair value and recognize remeasurement adjustment in *net income / profit or loss.*	Remeasure to adjust only the acquiree's *identifiable* net assets and contingent liabilities to fair value on the acquisition date and recognize revaluation adjustment *directly in equity* by applying IAS 16 *Property, Plant and Equipment.*	No remeasurement.

Issue 1: Measurement of the *Identifiable* Net Assets in a Partial or Step Acquisition

5. This memo considers two alternatives for measuring the acquiree's *identifiable* net assets in a partial or step acquisition.

(a) ***Alternative One: Fair value approach***—Under the fair value approach, the acquirer would measure the acquiree's assets and liabilities (with a few exceptions) at fair value on the date the acquirer obtains control of the acquiree. This is the approach proposed in the BC ED and already required in IFRS 3.

(b) ***Alternative Two: Cost accumulation approach***—Under the cost accumulation approach, the acquirer would measure the acquiree's assets and liabilities (with a few exceptions) using a layered approach. That is, on the acquisition date the acquirer would measure the acquiree's assets and liabilities as the sum of the proportional interest in the fair values of each individual asset or liability on the date that each individual interest was acquired plus the carrying value of any remaining portion owned by the noncontrolling interest. This is the approach required by US GAAP.

6. (The Boards allowed for a few exceptions to the proposed requirement to measure the acquiree's individual assets and liabilities at fair value on the acquisition date. The approaches outlined above are not intended to undermine those exceptions. The staff will bring those exceptions back to the Boards for consideration at a future meeting.)

7. *Alternative One: Fair Value Approach* is currently required by IFRS 3. The staff understands that it is unlikely the IASB would reconsider using a cost accumulation approach. However, the FASB has yet to reach a conclusion on this issue.

Initial Deliberation Materials and the Boards' Basis for Conclusions

8. The Boards reached the decision to measure the acquiree's identifiable net assets at 100 percent of their fair values in a partial or step acquisition on the acquisition date on the basis that that approach provides more relevant and transparent financial information than a cost accumulation approach. It is also consistent with the following principles:

> **In a business combination, the acquirer *recognizes* all of the assets acquired and all of the liabilities assumed.**
>
> **In a business combination, the acquirer *measures* each recognized asset acquired and each liability assumed at its acquisition-date *fair value*.**

9. This issue was discussed by:

(a) The IASB at the October 2001 Board meeting in its deliberations leading to the issuance of IFRS 3

(b) The FASB at the October 31, 2001 Board meeting.

[Remainder of paragraph 9 not reproduced in observer notes.]

Comment Letter Responses

10. The majority of respondents agreed with the proposal in the BC ED that in a partial acquisition, the acquiree's identifiable net assets should be measured at full fair value (*Alternative One: IFRS 3 Approach*). Those respondents, who were represented by analysts, preparers, and accounting firms, agreed that Alternative One provided the most **relevant** and **transparent** financial information. A small minority of respondents, generally preparers in the United States, supported Alternative Two. Those respondents generally supported a cost accumulation model for accounting for business combinations. They believe that an alternative that involves accumulating costs provides relevant information over time in assessing an entity's returns from an acquisition relative to the costs incurred in acquiring another entity.

Measurement Issues

When measuring the identifiable net assets, Alternative One does not create or result in any new measurement difficulties. Both alternatives require that the acquirer measure the fair value of the acquiree's identifiable net assets on the acquisition date. However, a cost accumulation approach (Alternative Two) would result in some added complexity. Using a cost accumulation approach requires that the acquirer separately track the "cost" of each individual layer and the fair value of the underlying assets and liabilities on the date each interest is acquired.

Staff Recommendation

11. The staff recommends that the Boards affirm the proposal in the BC ED that in a partial or step acquisition the acquirer would measure the acquiree's *identifiable* assets and liabilities at 100 percent of their fair values on the acquisition date (Alternative One) for the following reasons:

(a) Alternative One is consistent with the following principles:

In a business combination, the acquirer *recognizes* all of the assets acquired and all of the liabilities assumed.

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

(b) The staff finds it difficult to argue that a cost accumulation approach provides more relevant or useful information. For example, how could recording a building at part fair value and part carryover value provide users with more useful information?

(c) The staff does not support having fundamentally different presentations for the same economic interest based solely on the manner on which it is acquired. For example, why should an acquirer's 70 percent interest in a business be presented in the financial statements differently depending on whether it was acquired in one transaction or in multiple transactions?

(d) The majority of respondents to the BC ED, including financial statement analysts, supported this approach.

(e) This approach converges with the current requirements of IFRS 3.

12. If the Boards do not agree with Alternative One, the staff asks the Boards to provide the alternative principle or principles they believe should be the basis for accounting for business combinations.

Issue 2: Measurement of *Goodwill* in a Partial or Step Acquisition

13. The next issue for the Boards to consider is how to measure *goodwill* in a partial or step acquisition. In this memo, the staff provides a detailed analysis of this issue because:

(a) Measuring goodwill in a partial or step acquisition was one of the most controversial issues raised in the comment letters to the BC ED.

(b) Some current Board members were not yet members of the Boards during initial deliberations in the first half of 2003.

(c) The IASB had five alternative views on this issue in the BC ED.

14. Therefore, the remainder of this section analyzes the issues related to measuring *goodwill* in a partial or step acquisition. That analysis incorporates the issues that were raised by constituents in their comment letters and at the roundtable discussions.

Initial Deliberation Materials and the Boards' Basis for Conclusions

15. The Boards reached the decision to recognize the full amount of the acquiree's goodwill in a partial or step acquisition on the acquisition date because the full goodwill method provides more relevant and transparent financial information than either a cost accumulation approach or purchased goodwill approach.

16. The Boards concluded that users of an entity's financial statements are provided with useful information about the entity's financial position when that information reflects the assets under the control of the entity, regardless of the extent of ownership interests held. If the objective of the consolidated financial statements is to provide information about the assets under the control of an entity, and goodwill meets the definition of an asset, which is the conclusion reached by the Boards in Statement 141 and IFRS 3, then the financial statements should reflect all the acquiree's goodwill, not just the parent's proportionate share.[4] Thus, the Boards believed that the full goodwill method was conceptually more appealing than any other alternative. They also believed that the full goodwill method provided the most relevant and useful financial information.

---

[4] In the basis for conclusions of Statement 141, the FASB Board concluded that goodwill meets the definition of an asset in FASB Concepts Statements No. 6, *Elements of Financial Statements*. According to paragraph 25 of Concepts Statement 6, "assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events" (footnote reference omitted and underscore added). IFRS 3 defines goodwill as "future economic benefits arising from assets that are not capable of being individually identified or separately recognized." An asset is described in the IASB's Framework as a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

17. This issue was discussed by the Boards at the following meetings:

(a) The IASB's November 2002 meeting; the FASB's October 30, 2002 meeting

(b) The IASB's March 2003 Board meeting; the FASB's March 17, 2003 Board meeting

(c) The IASB's June 2003 Board meeting; the FASB's June 4, 2003 Board meeting.

[Remainder of paragraph 17 not reproduced in observer notes.]

Alternatives for Recognizing Goodwill in a Partial or Step Acquisition

18. During initial deliberations, the staff explored two alternatives for measuring goodwill in a partial acquisition at the acquisition date—the "full goodwill method" and the partial or "purchased goodwill method." Respondents and roundtable participants did not raise any other alternatives that the staff believes need to be discussed at a Board meeting.[5] Therefore, this section analyzes the alternatives that were explored previously.

(a) ***Alternative One: Full goodwill method***—all of the acquiree's goodwill, not just the acquirer's share, is recognized 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.

(b) ***Alternative Two: Partial or "purchased" goodwill method***—only the acquirer's share of goodwill is recognized on the acquisition date. Any goodwill related to the noncontrolling interest is not recognized. Goodwill is measured as the difference between the acquisition-date fair value of the acquirer's interest in the acquiree and the acquiree's interest in the fair value of the acquiree's identifiable assets and liabilities.

Comments Received about the Full Goodwill Method

19. The full goodwill method was one of the most controversial issues in the BC ED. Respondents' comments were similar in nature and are summarized and analyzed below. Respondents' comments can be put into three broad categories:

(a) Reliability of measurement

(b) Relevance of information

(c) Cost-benefit.

[5] A few respondents suggested a non-recognition approach. That is, they suggested that goodwill be expensed on the acquisition date. However, the Boards rejected that approach in their deliberations leading to IFRS 3 and Statement 141. Furthermore, that approach is inconsistent with the conclusion reached in IFRS 3 and Statement 141 that goodwill is an asset. Therefore, the staff did not explore that alternative in this memo.

Reliability of Measurement

20. The most common comment was that it is not possible to reliably measure the fair value of the acquiree as a whole in a business combination when less than 100 percent is acquired on the acquisition date. Inherent in the full goodwill issue is a trade-off between *reliability* and *relevance*. Some respondents believe that issues related to reliability of measurement outweigh the relevance of the information provided. Some went so far as to argue that the full goodwill method provides irrelevant information because goodwill is not a "real" asset.

21. Five IASB Board members provided an alternative view in the BC ED based on the issue of reliability of measurement. They stated:

> The full goodwill method is based upon the assumption that in a business combination all assets of the acquiree, including goodwill, should be accounted for on a similar basis. The five Board members note that goodwill is different from other assets, because it is a component of the value of the business as a whole, rather than having a separate existence. Thus, under the full goodwill method, it has to be measured as the difference between the value of the acquired business as a whole and the sum of the separately measurable assets. The total goodwill of the acquiree then has to be apportioned between the controlling and non-controlling interests…. (AV3)
>
> The process of measuring goodwill is therefore extremely difficult. The residual nature of its measurement means that it captures measurement errors in other assets, and sometimes non-recognition of those assets…. (AV4)

22. The staff understands the concerns about reliability of measurement and notes that the Boards considered most of those concerns before issuing the BC ED. In considering reliability of measurement, the Boards came to the following conclusions:

Constituents already encounter those measurement difficulties in current practice

23. The need to measure the fair value of a business or part of a business in the absence of a purchase transaction for the whole business arises in current practice. For example:

(a) 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 recognize the goodwill related to the business combination in the absence of a purchase transaction.

(b) Acquirers routinely measure the fair value of their reporting units/cash generating units in the absence of a purchase transaction when conducting their goodwill impairment tests.

24. Therefore, these measurement issues arise in current practice and have not been insurmountable.

Before determining what an acquirer is willing to pay for part of a business, it has to determine what the whole business is worth

25. Appraisers have consistently told the Boards and staff that to determine what an acquirer would be willing to pay for a partial interest in a business, the acquirer first measures the fair value of the whole business. Therefore, the consideration transferred to acquire an interest in a business is based on what the acquirer believes the whole business is worth.

Concerns about reliability of measurement can be alleviated through clear and adequate disclosure

26. Some users also suggested that the minimum disclosure requirements should be enhanced so that acquirers would disclose the identifiable net assets and goodwill attributable to the noncontrolling interests (Fitch Ratings [CL #16] and UK Society of Investment Professionals [CL# 244]). That disclosure might help alleviate any concerns about reliability of measurement since users would be able to clearly determine the total goodwill, the amount of goodwill attributable to the controlling interest, and the amount of goodwill attributable to the noncontrolling interest. Then users would be able to judge for themselves whether the amount recorded for the fair value of the business is reasonable. Additionally, if a user believes that the amount of goodwill attributable to the noncontrolling interest is not relevant, then the user could back out that amount.

How to measure the fair value of any previously held noncontrolling interest in a step acquisition

27. Another issue raised by some respondents is how to measure the fair value of any previously held noncontrolling interest when control was obtained through the purchase of a relatively small interest. For example, PwC, in its letter stated that "it would be helpful to understand the Boards' thinking in connection with the allocation of value to a control premium and the valuation issues that arise when an entity that owns 45% of another entity acquires a further 10%, giving rise to a business combination. What should the valuation professional and the preparer consider when using the price paid for the 10% interest as a basis to value the acquiree as a whole?" (CL #66).

28. The BC ED does not provide any guidance on how to measure the previously held noncontrolling interest in a step acquisition. If the Boards decide to go forward with the full goodwill method, the staff will explore whether should be provided and, if so, how much.

Relevance of Information

29. Many respondents stated that users of financial statements were not supportive of the full goodwill method. They also stated that goodwill is a different type of asset and that the goodwill that was paid for should not be "grossed-up" because doing so does not provide users with any relevant information. A few respondents also stated that a method of accounting for partial and step acquisitions based on accumulating the cost of each transaction provides more useful and relevant information than the proposals in the BC ED.

Many analysts believe the full goodwill method provides more relevant information

30. The staff notes that the respondents who claimed that analysts do not support the full goodwill method were not analysts themselves. They were mostly preparers. The staff and Boards solicited feedback from analysts about the full goodwill method and the majority of analysts who provided feedback were supportive of the full goodwill method. For example, the CFA Institute stated:

> We agree that it is appropriate, where the acquirer holds less than 100 per cent of the equity interests of the acquiree at the acquisition date, that the acquirer recognize 100 per cent of the fair values of the identifiable assets acquired, liabilities assumed, and goodwill, including goodwill attributable to the non-controlling interest. We believe that full and complete transparency require that 100 per cent of the assets acquired be recorded at fair value at the date of acquisition (transfer of control), including any interests of the non-controlling equity holders. Similarly, all of the interests, claims, and obligations must be fully recognized and measured at fair value as of the acquisition date on the right-hand-side of the balance sheet. **These amounts would include the fair value of the non-controlling interest assumed by the company, which should be measured at fair value, including goodwill.** In short, we believe that the transfer of control of the acquiree to the acquirer is a major economic event and should result in the revaluation of all interests to fair value, including any prior equity interests of the acquirer as well as those of the non-controlling interests.
>
> A particular advantage of this approach to the recognition and measurement is that all such acquisitions will be recognized and measured in a similar manner with 100% recognition of all acquired assets at fair value, and with full recognition of the various claims and interests in those assets. That is, financial reporting will not depend upon the particular structure, method or terms of an acquisition. We believe that this approach will result in greater clarity, comparability and usefulness of the information to investors and other users. [CL #273]

31. Fitch Ratings stated:

> We believe that goodwill in a business combination should reflect the total goodwill and not just the amount that is attributable to the portion acquired. Viewing the transaction and the entity acquired as a whole and not just from the acquirer's perspective produces —more meaningful and useful information for both the majority and noncontroling interest holders' perspective. Therefore, we agree with the proposed approach of recognizing 100 percent of the acquisition-date fair value of the acquiree. The current practice for acquisitions less than 100% generally results in recognizing the identifiable assets and liabilities of the acquiree at a hybrid of some current market prices and some carry-forward of the book values versus using fair value of all assets and liabilities. This approach lacks consistency and is difficult to understand for the users of the financial statements.... [CL #16]

32. The UK Society of Investment Professionals stated:

> The Exposure Drafts propose that in a business combination in which the acquirer gains control with less than 100%, the non-controlling interests should represent the sum of their proportional interest in the net identifiable assets and the goodwill attributable to the non-controlling interest.
>
> Essentially UKSIP regards this approach as fair valuing the non-controlling interest on the basis of the fair value established by the transaction. Conceptually the Society agrees that this is the most appropriate basis to adopt but remains uneasy that no transaction has occurred involving the non-controlling interests themselves. Moreover UKSIP is unclear as to whether the proposals mandate an estimation of the theoretical control premium or not. Nevertheless if this approach were to be adopted it is crucial that the accounts clearly disclose the goodwill attributable to the non-controlling interests separate from their attributable share of identifiable net assets. [CL# 244]

33. The staff also notes that the FASB staff held meetings with users on two occasions: The User Advisory Council Meeting on September 29, 2005, and the User Resource Group Meeting on August 12, 2003. On both occasions, the users indicated that many of them supported the full goodwill method. The minutes from those meetings are available on the FASB’s Intranet.

Goodwill may be measured differently than other assets, but it is still an asset

34. Many respondents stated that goodwill is a different type of asset that warrants different accounting in a partial or step acquisition. They believe that goodwill is only a residual that cannot be measured independently. In addition to synergies and other benefits that will be achieved by the combination, they believe that goodwill also includes measurement errors and other items that do not represent assets. As a result, it is not appropriate to “gross-up” that residual and recognize more goodwill.

35. The staff agrees that goodwill can only be measured as a residual and that other things besides synergies and other benefits, like measurement errors and non-recognition of some assets or liabilities, are subsumed into goodwill. However, if the Boards find this argument persuasive, then they should be persuaded to require that all goodwill be expensed on the acquisition date because the purchased amount of goodwill is also measured as a residual and contains measurement errors.

36. One respondent who agreed with the proposal on conceptual grounds noted the inconsistency in allowing only the purchased amount of goodwill to be recognized. The New Zealand Treasury stated:

> We agree taking this approach to goodwill is more conceptually sound than the current approach. If goodwill in considered to be an asset associated with the business, then minority interest must also own some, and therefore it makes sense to consolidate the full amount of goodwill similar to any other asset being consolidated. The opposing argument would be that goodwill holds little meaning as an asset and is really just a soft way of expensing the excess portion of consideration that can't be linked to an identifiable asset. If this view was valid, there would be an equally strong argument for not recognizing goodwill in the first place and expensing any excess immediately. [CL #29]

A cost accumulation method does not provide more useful and relevant information

37. A small minority of respondents argued that a method that involves accumulating the cost of each transaction provides more useful and relevant information over time in assessing an entity's returns from an acquisition relative to the costs incurred in acquiring another entity. The staff notes that the respondents who put forth this argument were preparers. No analysts put forth this argument.

38. For the same reasons the staff finds this argument hard to accept when it comes to recognizing the identifiable net assets, the staff find this argument hard to accept when it comes to measuring goodwill. We do not understand how an accumulation of layers of goodwill provides relevant information to users of financial statements. In addition, no users indicated that they support a cost accumulation method.

The full goodwill method provides more complete information

39. Some respondents argued that because the noncontrolling interests do not participate in the business combination, they should not be attributed any share of goodwill. Based on

that argument, it is not clear why the noncontrolling interest should be attributed any part of any asset or liability.

40. In addition, the Boards considered and rejected that argument before issuing the BC ED. The Boards concluded that users of an entity's financial statements are provided with useful information about the entity's financial position when that information **reflects the assets under the control of the entity, regardless of the extent of ownership interests held**. If the objective of the consolidated financial statements is to provide information about the assets under the control of an entity, and goodwill meets the definition of an asset, which is the conclusion reached by the Boards in Statement 141 and IFRS 3, then the assets under control of an entity should include all the acquiree's goodwill, not just the parent's proportionate share. Thus, the Boards concluded that the full goodwill method is consistent with the concept that **control over another entity makes the controlling entity accountable for all of that other entity's assets and liabilities**. That notion is consistent with the IASB's Framework, which states:

> The financial position of an enterprise is affected by the economic resources it controls, its financial structure, its liquidity and solvency, and its capacity to adapt to changes in the environment in which it operates. **Information about the economic resources controlled by the enterprise and its capacity in the past to modify these resources is useful in predicting the ability of the enterprise to generate cash and cash equivalents in the future**. [Paragraph 16; **emphasis** added.]

41. That notion also is consistent with the conclusions reached in the October 1995 FASB Exposure Draft, *Consolidated Financial Statements: Policy and Procedures*, which states:

> The [FASB] Board concluded that the transaction that gives the parent control over the subsidiary also makes the parent accountable for **the subsidiary's assets and liabilities—not just the tangible ones and not just a proportionate share of those assets and liabilities**. [Paragraph 115; **emphasis** added.]

42. Therefore, the Boards concluded that the full goodwill method is more consistent with the control and completeness concepts underlying the preparation of consolidated financial statements.

Cost-Benefit Considerations

43. Some constituents argued that the costs of the full goodwill method outweigh the benefits of the information provided. They believe that the full goodwill method is more

costly because the acquirer is required to measure the fair value of the acquiree as a whole rather than just the fair value of the interest acquired. They also argue that the full goodwill method is more costly because it is more complex than the purchased goodwill method.

The full goodwill method may result in additional costs to the acquirer, but the benefits outweigh the costs

44. As noted above, appraisers told the Boards and staff that acquirers measure the fair value of the acquiree to determine what it is willing to pay for a less than 100 percent interest. Therefore, acquirers already are measuring the fair value of the acquiree. However, if the Boards require *recognition* of the full amount of goodwill, acquirers may measure the fair value of the acquiree with greater precision than they may have otherwise. This may add some costs to an acquisition, but if the end result is a better measurement of the fair value of the acquiree, it is hard to argue that that is a negative consequence.

The full goodwill method will result in less complexity in the final business combinations standard

45. Under the purchased goodwill method, the Boards would need to provide additional guidance for measuring and recognizing goodwill, in particular situations such as:

(a) How to measure goodwill in a partial acquisition in which no consideration is paid
(b) How to measure goodwill in a step acquisition
(c) Whether to recognize, and if so how to measure goodwill for subsequent acquisitions of noncontrolling interests.

46. This will add complexity to the final business combinations standard. The staff explores how to measure and recognize goodwill in these circumstances in paragraphs 58–94.

The full goodwill method will result in less complexity in future periods when performing the annual goodwill impairment test

47. The full goodwill method will result in less complexity in future periods when performing the annual goodwill impairment test.

Goodwill impairment testing in accordance with Statement 142

48. Currently, goodwill recognized in a business combination is measured using the purchased goodwill method rather than the full goodwill method. Therefore, goodwill attributable to a noncontrolling interest is not recognized in the parent's consolidated financial statements. Paragraph 38 of Statement 142 describes how to perform the goodwill impairment test when the reporting unit is less than wholly owned:

> Goodwill arising from a business combination with a continuing noncontrolling interest shall be tested for impairment using an approach consistent with the approach used to measure the noncontrolling interest at the acquisition date. (A noncontrolling interest is sometimes referred to as a minority interest.) For example, if goodwill is initially recognized based only on the controlling interest of the parent, **the fair value of the reporting unit used in the impairment test should be based on that controlling interest and should not reflect the portion of fair value attributable to the noncontrolling interest.** Similarly, the implied fair value of goodwill that is determined in the second step of the impairment test and used to measure the impairment loss should reflect only the parent company's interest in that goodwill. [**Emphasis** added.]

49. Statement 142 requires that the goodwill assigned to each *reporting unit* be tested for impairment at least annually and between annual periods in certain circumstances (paragraph 26). A reporting unit is an operating segment or one level below an operating segment (paragraph 30). Depending on the circumstances, an acquired business might be its own reporting unit, might be broken apart into multiple reporting units, or might become part of a larger reporting unit.

50. Consider a simple example in which Acquirer, who has one wholly owned reporting unit, acquires an 80 percent interest in Target. Target is incorporated into Acquirer's existing reporting unit.

51. In accordance with Statement 142, the first step of the goodwill impairment test is to compare the fair value of the reporting unit to its carrying amount. If a reporting unit includes operations that are not wholly owned, determining the fair value of the reporting unit is more complicated under the purchased goodwill method. That is because in order to get an "apples-to-apples" comparison, Acquirer would need to determine (a) the fair value of its operations that are wholly owned plus (b) 80 percent of the fair value its operations that are 80 percent owned. In contrast, if Acquirer recognizes the full amount of goodwill on the acquisition date, Acquirer would not need to separately measure the operations that are less than wholly owned because Acquirer would be comparing the fair value of 100 percent of the reporting unit to 100 percent of its carrying amount.

Goodwill impairment testing in accordance with IAS 36

52. IAS 36 requires that the goodwill assigned to each *cash-generating unit* be tested for impairment annually (paragraph 96). A cash-generating unit is the smallest group of assets that includes the asset and generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets (paragraph 68).

53. Currently, "[i]n accordance with IFRS 3, goodwill recognised in a business combination represents the goodwill acquired by a parent based on the parent's ownership interest [purchased goodwill], rather than the amount of goodwill controlled by the parent as a result of the business combination [full goodwill]. Therefore, goodwill attributable to a minority interest is not recognised in the parent's consolidated financial statements" (IAS 36, paragraph 91). Therefore, paragraphs 91–95 of IAS 36 provide guidance for testing the goodwill of a non-wholly-owned cash-generating unit:[6]

> **Minority Interest**
>
> ….if there is a minority interest in a cash-generating unit to which goodwill has been allocated, the carrying amount of that unit comprises:
>
> (a) both the parent's interest and the minority interest in the identifiable net assets of the unit; and
>
> (b) the parent's interest in goodwill.
>
> However, part of the recoverable amount of the cash-generating unit determined in accordance with [IAS 36] is attributable to the minority interest in goodwill.
>
> Consequently, for the purpose of impairment testing a non-wholly-owned cash-generating unit with goodwill, **the carrying amount of that unit is notionally adjusted, before being compared with its recoverable amount. This is accomplished by grossing up the carrying amount of goodwill allocated to the unit to include the goodwill attributable to the minority interest.** This notionally adjusted carrying amount is then compared with the recoverable amount of the unit to determine whether the cash-generating unit is impaired. If it is, the entity allocates the impairment loss in accordance with paragraph 104 first to reduce the carrying amount of goodwill allocated to the unit. [**Emphasis** added.]

54. What the guidance in IAS 36 effectively requires is that the acquirer measure the full amount of goodwill *every time* the acquirer performs the annual impairment test. In contrast, if the acquirer applied the full goodwill method on the acquisition date, it would only measure the full amount of goodwill once and would not need to repeat that step every time it performs the impairment test.

Staff Recommendation

55. The staff believes that the only compelling argument in support of the purchased goodwill method is *reliability of measurement*. However, we do not believe that the concerns

---

[6] IAS 36's Illustrative Example 7 illustrates the impairment testing of a non-wholly-owned cash-generating unit with goodwill.

expressed about reliability of measurement outweigh the benefits of improved relevance and transparency of financial statements and reduced complexity. In some circumstances, the same measurement issues are present when the purchased goodwill method is used. For the following reasons, the staff recommends the full goodwill method:

(a) Consolidated financial statements should include the fair value of all of the assets and liabilities of an acquired entity that are under the control of the acquirer.

(b) Constituents already encounter similar measurement difficulties in current practice (paragraph 23).

(c) The full goodwill method is supported by analysts of financial statements (paragraphs 30–33).

(d) The full goodwill method is consistent with measuring and recognizing the identifiable net assets at 100 percent of their fair values.

(e) The arguments put forth by respondents were not compelling enough to justify treating goodwill differently from other assets.

(f) Concerns about reliability of measurement can be alleviated through disclosure. Specifically, the staff recommends adding the disclosure described in paragraph 26: that acquirers disclose the identifiable net assets and goodwill attributable to the noncontrolling interests.

(g) The purchased goodwill method will result in added complexity, such as:

    (1) Added complexity in the final business combinations standard because the Boards will need to provide guidance for measuring and recognizing goodwill in a variety of different type of business combinations. Those situations are described in the following section of this memo (paragraphs 58–94).

    (2) Added complexity in the goodwill impairment test (paragraphs 47–54).

(h) The costs of the full goodwill method do not outweigh the benefits.

56. Additionally, the full goodwill method is consistent with the principle that **in a business combination, the acquirer recognizes all of the assets acquired and all of the liabilities assumed**. If the Boards reject the full goodwill method and accept the purchased goodwill method, the staff asks the Boards to either:

(a) State that goodwill is an exception to the principle of **recognizing all of the assets acquired and all of the liabilities assumed** and provide the basis for their allowing that exception; or

(b) If they believe that that principle is not the appropriate principle, provide the alternative principle(s) they believe should be the basis for accounting for business combinations.

57. The staff notes that under the full goodwill method, goodwill is measured as a residual. Thus, goodwill is an exception to the fair value measurement principle regardless of whether the full goodwill method or the purchased goodwill method is used.

Issue 3: Issues That Would Need to Be Resolved If the Boards Pursue the Purchased Goodwill Method

58. While the staff believes that the Boards adequately considered and rejected the arguments put forth by respondents against the full goodwill method, the Boards may still decide to pursue the purchased goodwill method. If that is the case, the Boards will need to provide additional guidance for issues that might arise under the purchased goodwill method, such as:

(a) How to measure goodwill in a partial acquisition in which no consideration is paid.

(b) How to measure goodwill in a step acquisition.

(c) Whether to recognize, and if so how to measure goodwill for subsequent acquisitions of noncontrolling interests.

59. The arguments for or against the alternatives under each of these situations are based on practical considerations rather than conceptual arguments. The staff finds it difficult to argue the conceptual merits of any of the alternatives presented below since we find the purchased goodwill method a practical compromise rather than a conceptually superior approach. That being said, some alternatives are more conceptually consistent with the proposals in the BC ED. The staff will indicate when that is the case.

(a) How to Measure Goodwill in a Partial Acquisition in which No Consideration Is Paid

60. If the Boards pursue the purchased goodwill method, they need to resolve how goodwill should be measured if an acquirer obtains control of a business without a purchase transaction, such as a business combination achieved:

(a) When an acquirer obtains control of a business because the acquiree bought back some of its shares and an existing investor, the acquirer, became the controlling shareholder.

(b) By contract alone, like in a stapling transaction.

61. If the Boards pursue the purchased goodwill method, there are two alternatives:

(a) **Alternative One:** Measure goodwill as the difference between the acquisition-date fair value of the acquirer's interest in the acquiree and its interest in the acquiree's identifiable net assets.[7]

(b) **Alternative Two:** Do not recognize goodwill in a business combination that occurs without a purchase transaction involving the acquirer.

Alternative One

62. Under Alternative One, the acquirer would measure goodwill as the difference between the acquisition-date fair value of the acquirer's interest in the acquiree and its interest in the acquiree's identifiable net assets. For example, an entity had a 55 percent equity interest in a business but did not control that business because the noncontrolling shareholders had certain veto rights. Those veto rights lapse and the entity obtains control of the acquiree. The acquirer would measure goodwill as the difference between the acquisition-date fair value of the acquirer's 55 percent interest in the acquiree and the 55 percent of the acquisition-date fair value of the acquiree's identifiable net assets.

[7] The staff acknowledges that the term "purchased goodwill method" is not an appropriate description if the Boards choose Alternative One since goodwill would be recognized in the absence of a purchase transaction. However, the staff views this as a drafting issue. We will continue to describe this method as the *purchased goodwill method* throughout this memo.

Arguments Supporting Alternative One

63. Alternative One is consistent with how the purchased goodwill method would be applied in a business combination effected through a purchase transaction.

Arguments Against Alternative One

64. The staff believes that Alternative One would not accommodate those constituents who assert that the full goodwill method is not justifiable because the fair value of the acquiree cannot be reliably measured in the absence of a purchase transaction involving the acquirer. The measurement issues that arise under this alternative are the same that exist under the full goodwill method. The acquirer would need to measure the fair value of its ownership interest in the acquiree on the acquisition date in the absence of a purchase transaction. For example, in a business combination in which the acquirer obtains control of an acquiree through the lapse of minority veto rights, the acquirer would need to measure the fair value of its interest in the acquiree on the acquisition date. This would be done by first measuring the fair value of the acquiree and then determining the fair value of the acquirer's partial controlling interest. This measurement issue is the same measurement issue that arises under the full goodwill method.

65. This approach would result in no goodwill being recognized if the acquirer obtains control of the acquiree without acquiring any equity interests. For example, in a stapling transaction the entities involved often do not acquire an equity or ownership interest in the other entities that are involved in the transaction. Therefore, the acquirer would recognize no goodwill on the acquisition date under Alternative One and would recognize only the acquiree's identifiable net assets at fair value.

Alternative Two

66. Under Alternative Two, the acquirer would recognize no goodwill in a business combination effected without a purchase transaction involving the acquirer. For example, in a stapling transaction an entity obtains control of another entity without a purchase transaction. Therefore, the acquirer would recognize no goodwill on the acquisition date under Alternative Two. Therefore, the acquirer would recognize only the acquiree's identifiable net assets at fair value.

Arguments Supporting Alternative Two

67. Alternative Two would accommodate those constituents who argue that goodwill can only be measured when there is a purchase transaction involving the acquirer. Thus, this alternative would not result in any measurement issues.

Arguments Against Alternative Two

68. Alternative Two implies that an acquirer can only recognize the goodwill that it pays for. Another way to look at it is that goodwill can only be measured as a residual, and to measure the residual the acquirer needs a purchase transaction from which to start. That view is inconsistent with the fact that business combinations in which there is no exchange of *readily measurable* consideration occur quite frequently and goodwill is recognized on those combinations in present practice. For example, in business combinations in which two entities exchange privately held shares, the acquirer routinely measures and recognizes the fair value of the acquiree (and the full amount of goodwill).

69. Alternative Two is also inconsistent with the concept that all economically similar transactions (that is, business combinations) should be accounted for similarly.

70. Alternative Two is consistent with the approach the FASB decided to take for not-for-profit combinations. The FASB reached that conclusion on the basis that not-for-profit organizations are different from business entities and the costs of requiring not-for-profit organizations to perform valuations to determine the fair value of the acquiree does not exceed the benefits of the information provided. While Alternative Two is consistent with the FASB's not-for-profit combinations project, the IASB does not have a similar project. Thus, using that analogy to support Alternative Two could result in divergence between the FASB and IASB.

Staff Recommendation

71. The staff believes that neither alternative is perfect. However, the staff prefers Alternative One because it is consistent with how the purchased goodwill method would be applied in a business combination in which the acquirer pays consideration. However, the staff notes that to apply Alternative One when the acquirer obtains control of the acquiree without a purchase transaction involving the acquirer, the acquirer would need to measure the fair value of its interest in the acquiree on the acquisition date. That measurement would be accomplished by first measuring the fair value of the acquiree as a whole to determine the fair value of the acquirer's interest. Thus, the same measurement issue that exists with the full goodwill method—having to measure the fair value of the acquiree—would still exist when there is no exchange of consideration if the Boards select Alternative One. However, the number of instances in which this measurement issue would arise would be less—that is, under the full goodwill method, the measurement issues would arise in every partial acquisition; under the purchased goodwill method, the measurement issues would arise only in a business combination effected without a purchase transaction involving the acquirer.

(b) How to Measure Goodwill in a Step Acquisition

72. If the Boards pursue the purchased goodwill method, they would need to resolve how goodwill should be measured in a step acquisition. For example, step acquisitions that occur:

(a) When the acquirer purchases additional shares in the acquiree and becomes the controlling shareholder.

(b) Without a purchase transaction involving the acquirer, like through the lapse of minority veto rights or if the acquiree buys back some of its own shares and, as a result, an existing investor becomes the controlling shareholder.

73. There are several alternatives:

(a) **Alternative One:** Measure goodwill as the difference between the acquisition-date fair value of the interest acquired on the acquisition date and the interest in the fair value of the acquiree's identifiable net assets acquired on the acquisition date.

(b) **Alternative Two:** Measure goodwill as the difference between the acquisition-date fair value of the acquirer's *cumulative* interest in the acquiree and its *cumulative* interest in the fair value of the acquiree's identifiable net assets (that is, recognize the total goodwill attributable to the parent).

(c) **Alternative Three:** Measure goodwill on a step by step basis for each interest acquired (present practice).

Alternative One

74. Under Alternative One, the acquirer would measure goodwill as the difference between the acquisition-date fair value of the interest acquired on the acquisition date and the interest in the fair value of the acquiree's identifiable net assets acquired on the acquisition date. For example, an acquirer obtains control of the acquiree in two steps—first through the purchase of 30 percent of its equity interests, and then through the purchase of 50 percent of its equity interests. The acquirer would measure goodwill as the difference between acquisition-date fair value of the 50 percent interest in the acquiree on the acquisition date and the acquisition-date fair value of 50 percent of the acquiree's identifiable net assets.

75. This alternative implies that the acquirer should only recognize the goodwill that it paid for on the acquisition date.

Arguments Supporting Alternative One

76. The argument in support of Alternative One is *reliability of measurement*. Alternative One would accommodate those constituents who assert that goodwill cannot be measured in

the absence of a purchase transaction involving the acquirer. That is, goodwill would be measured by comparing the consideration paid for the interest acquired on the acquisition date to the interest in the net assets acquired on the acquisition date. Thus, issues related to reliability of measurement would be eliminated in most circumstances, except when the consideration paid is not readily measurable or no consideration is paid on the acquisition date.

Arguments Against Alternative One

77. Issues related to reliability of measurement would continue to exist if the consideration paid to acquire the controlling interest was not readily measurable. For example, if the acquirer issued its own privately held shares as consideration and those shares are not readily measurable. In that case, the acquirer likely would measure the fair value of the acquiree on the acquisition date to determine the fair value of the controlling interest acquired. This is the same measurement issue that exists under the full goodwill method.

78. This approach might result in no goodwill in a step acquisition in which control is obtained without the acquirer acquiring any equity interests on the acquisition date. For example, no goodwill would be recognized if the acquirer obtains control of the acquiree through the lapse of minority veto rights without acquiring any additional equity interests on the acquisition date.

79. This approach might also result in the recognition of only a very small amount of goodwill in particular step acquisitions. For example, an acquirer owns a 46 percent *noncontrolling* interest in an entity and then obtains control of that entity by purchasing an additional five percent interest. Under this alternative, goodwill would be measured as the difference between the acquisition-date fair value of the five percent interest in the acquiree and the acquisition-date fair value of five percent of the acquiree's identifiable net assets. Recognizing such a small amount of goodwill likely would not present useful, transparent, or relevant financial information.

Alternative Two

80. Under Alternative Two, the acquirer would measure goodwill as the difference between the acquisition-date fair value of the acquirer's **cumulative** interest in the acquiree and its **cumulative** interest in the acquiree's identifiable net assets. For example, an acquirer obtains control of the acquiree in two steps—first through the purchase of 30 percent of its

equity interests, and then through the purchase of 50 percent of its equity interests. The acquirer would measure goodwill as the difference between acquisition-date fair value of its cumulative 80 percent interest in the acquiree and its cumulative 80 percent interest in the acquiree's identifiable net assets.

Arguments Supporting Alternative Two

81. This alternative eliminates the issue in Alternative One that no goodwill would be recognized in a step acquisition in which control is obtained without the acquirer acquiring any equity interests on the acquisition date.

82. This alternative also eliminates a possible issue under Alternative One that in some step acquisitions only a very small amount of goodwill would be recognized, such as when an acquirer obtains control of an acquiree through the purchase of a relatively small equity interest (say, five percent).

Arguments Against Alternative Two

83. The argument against this alternative is *reliability of measurement.* Alternative Two would not accommodate those constituents who assert that the full goodwill method is not justifiable because the fair value of the acquiree cannot be reliably measured when a less than 100 percent interest is acquired. Under Alternative Two, the acquirer would have to measure the fair value of its cumulative interest—most often by adding together the amount paid for the interest that gave the acquirer control and the fair value of the previously held equity interest, which would have to be independently measured. The acquirer would have to first measure the fair value of the acquiree to determine the fair value of its previously held interest. Thus, the same perceived measurement issue that exists under the full goodwill method would exist under Alternative Two.

Alternative Three

84. Under Alternative Three, the acquirer would measure goodwill on a step-by-step basis for each interest acquired. This Alternative is consistent with present practice under Statement 141 and IFRS 3. For example, an acquirer obtains control of the acquiree in two steps—first through the purchase of 30 percent of its equity interests, and then through the purchase of 50 percent of its equity interests. The acquirer would measure goodwill as the sum of:

(a) The difference between the fair value of the 30 percent interest in the acquiree on the date it was obtained and the fair value of 30 percent of the acquiree's identifiable net assets on the date the 30 percent interest was obtained.

(b) The difference between acquisition-date fair value of the 50 percent interest in the acquiree on the acquisition date and the acquisition-date fair value of 50 percent of the acquiree's identifiable net assets.

Arguments Supporting Alternative Three

85. Alternative Three should not result in any reliability of measurement issues when the amount paid for each equity interest is readily measurable.

Arguments Against Alternative Three

86. Alternative Three likely would result in the least transparent, relevant, and useful financial information. An accumulation of cost layers for goodwill does not provide the most useful or relevant financial information. Consider a step acquisition that was effected through two purchases of 30 percent interests. The first purchase occurred 25 years ago. The goodwill that would be measured under Alternative Three would be an accumulation of the goodwill related to the first 30 percent purchase and the goodwill related to the second 30 percent interest. It is not clear how the goodwill related to a purchase that occurred 25 years ago could provide any relevant or useful information about a current transaction.

87. Alternative Three might, in some step acquisitions, result in a significant amount of complexity. For example, consider a step acquisition that was effected by purchasing 10 separate ownership interests in five percent increments. The acquirer would have to accumulate the amount of goodwill that should be measured for each of those purchases. While this might be an unlikely example, it is possible.

Illustrative Example

88. Below is an example that illustrates each of the three alternatives for measuring goodwill in a step acquisition.

Parent owns a 10 percent interest in Subsidiary and acquires an additional 60 percent interest, which gives Parent control of Subsidiary. Assume no change in the investment in Subsidiary between 1/1/X8 and 1/1/X9 and no control premium.

Date	*Interest purchased*	*Amount paid*	*Shares purchased*	*Subsidiary's identifiable net assets*		*FV of Subsidiary*
				FV	*CV*	
1/1/X8	10%	$1,800	100	$15,000	$12,000	$20,000
1/1/X9	60%	$15,000	600	$19,000	$16,000	$25,000
	70%		700			

Below is a summary of the journal entries that would be recorded in the consolidated financial statements under each Alternative:

	Alternative One	**Alternative Two**	**Alternative Three**
1/1/X8			
Dr. Investment in Sub.	1,800	1,800	1,800
Cr. Cash	(1,800)	(1,800)	(1,800)
1/1/X9			
Dr. Identifiable net assets	19,000	19,000	19,000

Dr. Goodwill	***3,600***	***4,200***	***3,900***
Cr. Noncontrolling interest	(5,700)	(5,700)	(5,700)
Cr. Gain	***(100)***	***(700)***	***(400)***
Cr. Cash	(15,000)	(15,000)	(15,000)
Cr. Investment in Sub.	(1,800)	(1,800)	(1,800)

The following table summarizes how the 1/1/X9 journal entries were calculated.

	Alternative One	**Alternative Two**	**Alternative Three**
Identifiable net assets	All examples assume that the identifiable net assets are recognized at 100% of their fair values.		
Goodwill	The difference between the FV of the 60% interest acquired and 60% of the FV of acquiree's identifiable net assets ($15,000 – ($19,000 × 60%)).	The difference between the FV of the cumulative 70% interest acquired and 70% of the FV of the acquiree's identifiable net assets (($25,000 × 70%) – ($19,000 × 70%)).	The sum of: - The difference between the FV of the 10% interest acquired on the date it was acquired and 10% of the FV of acquiree's identifiable net assets on the date the 10% interest was acquired. ($1,800 – ($15,000 × 10%) – The difference between the FV of the 60% interest acquired and 60% of the FV of acquiree's identifiable net assets ($15,000 – ($19,000 × 60%)).
Noncon-trolling interest	Under the purchased goodwill method, the noncontrolling interest is recognized as 30 percent of the fair value of the identifiable net assets ($19,000 × 30%).		
Gain	The difference between the FV of 10% of the acquiree's identifiable net assets on the acquisition date and the CV of the investment (($19,000 × 10%) – $1,800).	The difference between the fair value of the 10% interest on the acquisition date and the CV of the investment (($25,000 × 10%) – $1,800).	The difference between 10% of the FV of the identifiable net assets on the acquisition date and 10% of the FV of the identifiable net assets on the date the 10% interest was acquired (10% × ($19,000 – $15,000))

Staff Recommendation

89. The staff recommends Alternative Two. We acknowledge that the acquirer would encounter some reliability of measurement issues because it would have to measure the fair value of the acquiree to determine the fair value of its cumulative interest in the acquiree. However, Alternative Two eliminates the relevance issues associated with Alternatives One and Three.

(c) Whether to Recognize, and, If so, How to Measure Goodwill for Subsequent Acquisitions of Noncontrolling Interests

90. Another issue that would need to be resolved under the purchased goodwill method is whether, and, if so, how to measure goodwill for each subsequent acquisition of noncontrolling interests in a partially owned subsidiary. That is, if an acquirer only recognizes the purchased amount of goodwill in a partial acquisition, should the acquirer then recognize more goodwill if the acquirer purchases some or all of the outstanding noncontrolling interests in the partially owned subsidiary sometime after the business combination? If so, how should that amount of goodwill be measured? The staff considered two alternatives:

(a) **Alternative One:** Recognize a layer of goodwill each time the acquirer acquires any outstanding noncontrolling interests. That layer would be measured as the difference between the fair value of the noncontrolling interest and the proportional ownership interest acquired in the subsidiary's identifiable net assets on the date of the transaction.

(b) **Alternative Two:** Do not recognize goodwill for subsequent acquisitions of noncontrolling interests.

Alternative One

91. Alternative One is consistent with current practice under IFRS 3 and US GAAP. Under IFRS 3 and US GAAP, for each incremental layer of ownership interest acquired, an incremental portion of goodwill is recorded[8] to the extent of the ownership interest acquired. In the United States, that practice continues for incremental purchases after control of a subsidiary is obtained. IFRS does not provide specific guidance on how to account for additional purchases of noncontrolling interests after control is obtained. Although differing practices may exist, this generally results in a step-by-step accumulation of the cost of the individual purchases (investments). Thus, under current United States and some international practices, each time a layer of "purchased" goodwill is recognized it is related to the percentage of ownership interest in the incremental purchase transaction for which the consideration was paid and the unrecognized goodwill generally relates to that portion attributable to the noncontrolling interests in the subsidiary at any particular point in time. Thus, under present practice the recognized goodwill is a "cumulative" amount of goodwill based on measures at various dates.

[8] Before obtaining control, the incremental portions of goodwill generally are embedded within the cost of the investment in the investee company (associate), rather than reported as a separate asset.

Alternative Two

92. Alternative Two is consistent with the notion that goodwill should only be recognized on the date of the business combination (when control of a business is obtained).

93. Alternative Two is also a simpler method to apply since under Alternative One the parent (acquirer) would need to measure the fair value of the subsidiary’s identifiable net assets each time it acquires some of the outstanding noncontrolling interests.

Staff Recommendation

94. The staff does not find either alternative appealing but would support Alternative Two on the basis that it is simpler to apply and that an equity transaction should not result in the entity recognizing additional assets.

Issue 4: Issues That Would Need to Be Resolved with the Full Goodwill Method

Control Premium

95. As described in paragraph 27 of this memo, the staff believes that if the Boards pursue the full goodwill method, they might need to provide some guidance relating to how to measure any previously held noncontrolling interests (that is, should any control premium paid also be attributed to the previously held interest). If the Boards affirm the full goodwill method, the staff will bring this issue back to the Boards at a future meeting.

Allocating Goodwill between the Controlling and Noncontrolling Interests in a Partial Acquisition

96. The BC ED proposes that in a partial acquisition the acquirer:

(a) First, calculate goodwill as the difference between the fair value of the acquiree and the fair value (with limited exceptions) of the acquiree's identifiable net assets.

(b) Second, allocate goodwill to the acquirer and noncontrolling interest. The amount of goodwill allocated to the acquirer would be measured as the difference between the acquisition-date fair value of the acquirer's equity interest in the acquiree (often, the consideration paid) and the acquirer's share in the acquisition-date fair value of the separately recognized assets acquired and liabilities assumed. The remainder would be allocated to the noncontrolling interest. (Paragraph A62, paraphrased).

Comments Received from Respondents

97. Very few respondents addressed the issue of allocating goodwill between the acquirer and noncontrolling interests. The respondents who did not support the full goodwill method generally did not address the issue in their letters. Even of those that supported the full goodwill method, very few addressed the issue. However, several respondents questioned the proposed goodwill allocation approach in the BC ED. Those respondents preferred that goodwill be treated like other acquired assets and liabilities in a partial acquisition and be attributed to the acquirer and noncontrolling interests based on proportional ownership interests. For example, three respondents stated:

> From a practical viewpoint, with the proposed goodwill allocation method, the percentage of ownership would no longer be able to be used as a reasonableness check on the reported amount of non-controlling interests. Because of this, the proposals would complicate the accounting for non-controlling interests, and result in less understandable financial statements for users. [Syngenta; CL #161]

> ….we are concerned that the proposals would substantially increase the complexity of tracking and calculating minority interests. With the proposed goodwill allocation method, the percentage of ownership would no longer be an indication which can be used directly. [Industrie-Holding; CL #183]

> AcSEC also observes that the allocation of goodwill as described in paragraphs B154 and B155 will likely raise a number of implementation and valuation issues. As a result of the lack of precision that may be inherent in determining the fair value of business when less than 100% is acquired, [respondent] questions whether the prescribed method to allocate to the controlling and noncontrolling interests on other than a proportionate basis is operational. [AcSEC; CL #208]

98. Some staff members agree with the respondents who believe that goodwill should be treated like other assets and liabilities and attributed proportionally to the controlling and noncontrolling interests. Those staff members believe that the costs of the disproportional allocation do not outweigh the benefits. For example, allocating goodwill proportionally would result in:

(a) Consistent accounting for goodwill and other assets

(b) Less complexity in recognizing goodwill impairment losses

(c) Proportional allocation of goodwill impairment losses like other gains and losses

(d) The noncontrolling interest recognized on the acquisition date would represent its ownership interest in the fair value of the acquiree

(e) The possibility of allocating all of the goodwill related to the transaction to the acquirer if the acquirer pays a significant enough premium to acquire control of the acquiree.

99. If the Boards affirm the full goodwill method, the staff will bring these issues back to the Boards at a future meeting. The staff also notes that it may not be helpful to describe goodwill as being allocated to the controlling and noncontrolling interests. It may be more appropriate to describe the requirements for measuring the noncontrolling interest rather than allocating goodwill to the noncontrolling interest. However, the staff views this as a drafting issue.

Issue 5: Accounting for the Acquirer's Previously Held Equity Interests in the Acquiree in a Step Acquisition

Background

100. The BC ED proposes that in a step acquisition the acquirer would remeasure its noncontrolling equity investment in the acquiree at fair value as of the acquisition date and recognize any gain or loss in *net income/profit or loss* (paragraph 56, paraphrased).

101. IFRS 3 requires that in a step acquisition, the acquirer recognizes a *revaluation adjustment directly in equity* (*other comprehensive income*) to adjust only the acquiree's *identifiable* net assets and contingent liabilities (not goodwill) to fair value on the acquisition date (paragraph 59, paraphrased). Under IFRS 3, goodwill is recognized on a step-by-step basis. Therefore, no portion of the revaluation adjustment relates to goodwill.

102. Under Statement 141, any previously held noncontrolling equity investments are not remeasured on the acquisition date. Therefore, no remeasurement or revaluation adjustment is recognized in a step acquisition.

103. **This issue is NOT exclusively a full goodwill issue.** If the Boards decide that in a step acquisition the acquiree's *identifiable net assets* should be measured at fair value on the acquisition date, they will need to decide whether to recognize the remeasurement adjustment in net income/profit or loss or other comprehensive income/directly in equity. *Therefore, this issue arises independent of whether the Boards decide to pursue a full goodwill approach or a purchased goodwill approach*. The full goodwill method only impacts the amount of the remeasurement adjustment, not whether one is recognized. If the Boards pursue the full goodwill method, the remeasurement adjustment likely would be larger than it would be under the purchase goodwill method. However, this issue would not be eliminated.

104. Therefore, this issue is a consequence of the Boards reaching either of the following decisions:

(a) In a step acquisition, the acquirer should measure the acquiree's net identifiable assets at fair value (Issue 1 in this memo)

(b) In a step acquisition, the acquirer should measure goodwill using the full goodwill method (Issue 2 in this memo).

The only way this would not be an issue is if the Boards choose a cost-accumulation model for measuring the *identifiable assets and liabilities* and *goodwill* in a partial or step acquisition.

105. The following section of the memo does not differentiate between the remeasurement adjustment that would be recognized if the Boards decide that in a step acquisition, the identifiable net assets should be recognized at fair value and the remeasurement adjustment that would be recognized if the Boards decide that in a step acquisition, the full amount of goodwill should be recognized.

Initial Deliberation Materials and the Boards' Bases for Conclusions

106. The Boards reached the decision that the acquirer should remeasure its noncontrolling equity investment in the acquiree at fair value as of the acquisition date and recognize any gain or loss in *net income/profit or loss* at the followings:

(a) The IASB's December 2002 Board meeting

(b) The FASB's December 4, 2002 Board meeting.

[Remainder of paragraph 106 not reproduced in observer notes.]

107. Paragraphs B156–B160 of the basis for conclusions of the FASB's BC ED and paragraphs BC151–BC153 of the basis for conclusions of the IASB's BC ED discuss the reasons why the Boards decided that the remeasurement adjustment should be recognized in net income/profit or loss. Those reasons are summarized below:

(a) **Gaining control or losing control of a business changes the nature of any previously held or retained investments, and thus is a remeasurement event**—A change from holding a noncontrolling investment in an entity to obtaining control of that entity is a significant change in the nature of and economic circumstances surrounding that investment.

(b) **The acquirer no longer is the owner of a noncontrolling investment asset in an entity when control of the underlying entity is obtained**—When control of a former investee is obtained, the acquirer ceases its investment accounting as an owner of an investment asset and begins reporting the underlying assets, liabilities, and results of operations of the entity as part of its consolidated results. In effect, the acquirer exchanges its status as an owner of an investment asset in an entity for control of all of the underlying assets and liabilities of that entity (acquiree) and the right to direct how the acquiree and its management use those assets in conducting its operations.

(c) **Financial statement users indicated they did not have significant concerns about remeasuring any noncontrolling equity investment and recognizing the remeasurement in income/profit or loss as long as the amount of the gain or loss is clearly disclosed**—In August 2003, the FASB held a roundtable meeting with users of financial statements to discuss, among other things, the decision to require that an acquirer remeasure any noncontrolling equity investment in an acquiree at its acquisition-date fair value and recognize any gain or loss in net income/profit or loss of the period. The users of financial statements indicated they did not have significant concerns with that requirement as long as the amount of the gain or loss is clearly disclosed. Paragraph 72(j) of the BC ED proposes that an acquirer in a business combination achieved in stages disclose "the amount of any gain or loss recognized . . . and the line item in the income statement in which that gain or loss is recognized…."

(d) **Recognition of the remeasurement adjustment is not recognizing a gain on the purchase of more equity interests**—Some constituents were concerned about allowing gain recognition on a "purchase transaction." (The required remeasurement also could result in loss recognition.) The Boards rejected the characterization that the resulting recognition of a gain or loss is from a *purchase*. Rather, under the mixed attribute accounting model that exists today, economic gains and losses are recognized as they occur for particular, but not all, financial instruments. If a noncontrolling equity interest in an entity is not required to be measured at its fair value, the Boards noted that the recognition of a gain or loss at the acquisition date is merely a consequence of the mixed practice that permits the delayed recognition of the economic gain or loss that is present in that financial instrument. However, if an investment asset is being measured at fair value in accordance with GAAP, the gain or loss would be recognized as it occurs in accordance with that accounting, and remeasurement would result in no further gain or loss to be recognized in comprehensive income/directly in equity of the period.

Comment Letter Responses

108. Question 10 in the Notice/Invitation addresses the accounting for step acquisitions. Respondents to the BC ED had mixed views on the proposed accounting for step acquisitions. Those views can be broken down into three categories. Those three categories are the same three alternatives the Boards considered during initial deliberations:

(a) Disagree with remeasuring previously held noncontrolling equity investments (prefer a cost-accumulation model).

(b) Agree with remeasuring previously held noncontrolling equity investments and recognizing any gain or loss in *net income/profit or loss* (at least for the identifiable net assets and possibly for goodwill).

(c) Agree with remeasuring previously held noncontrolling equity investments but would recognize any gain or loss in *other comprehensive income/directly in equity* (at least for the identifiable net assets and possibly for goodwill).

Disagree with remeasuring previously held noncontrolling equity interests (prefer a cost-accumulation model)

109. A small minority of respondents disagreed with remeasuring the previously held noncontrolling equity interests when the acquirer obtains control of the business. Those respondents generally believed that the acquirer should account for step acquisitions using a cost accumulation approach.

Agree with remeasuring previously held noncontrolling equity investments and recognizing any gain or loss in net income/profit or loss (at least for the identifiable net assets and possibly for goodwill).

110. Some respondents agreed that any remeasurement adjustment should be recognized in net income/profit or loss. Those respondents agreed with the Boards' view that obtaining control of a business is an economic event that changes the nature of any previously held investments. For example, CPA Australia stated that they "consider…it…appropriate for the acquirer to recognize in profit or loss any gain or loss on previously acquired non-controlling equity investments on the date it obtains control of the acquiree" (CL #118).

Agree with recognizing the acquiree at fair value and with remeasuring previously held noncontrolling equity interest but would recognize any gain or loss in other comprehensive income/directly in equity

111. The majority of respondents believed that any remeasurement adjustment should be recognized in other comprehensive income / directly in equity. They do not agree with the view that obtaining control of an entity is a remeasurement event that should result in the recognition of net income/profit or loss. They analogize the accounting for previously held noncontrolling equity investments to the accounting for available-for-sale securities. Changes in the value of available-for-sale securities are recognized in other comprehensive income/directly in equity. In their view, in a step acquisition the acquirer only obtains more shares in the acquiree. The shares that the acquirer previously held have not been exchanged or sold; thus, recognition of net income/profit or loss is not appropriate. For example, Grant Thornton stated:

> We do not agree that the acquisition-date remeasurement gains or losses on the previously acquired noncontrolling equity interests should be recognized in profit or loss (IASB)/income (FASB). Those remeasurement gains and losses would not have been realized through an acquisition-date exchange with an outside party. Therefore, we do not believe that they should be recognized in a measure of performance. We think that those acquisition-date remeasurement gains and losses are analogous to unrealized gains and losses on available-for-sale securities. Accordingly, we recommend that the effect of remeasuring previously acquired noncontrolling equity interests in

> the acquiree as part of a business combination be recognized in equity (other comprehensive income (FASB)) and recycled to profit or loss (IASB)(reclassified to income (FASB)) upon impairment or disposal of the related interests. We acknowledge that preparers will need to account for those gains and losses subsequent to the acquisition-date. [CL #20]

Staff Recommendation

112. The staff supports the Boards' view that obtaining control or losing control of an entity is a remeasurement event. We, therefore, support recognizing remeasurement adjustments in net income/profit or loss. In addition to the reasons cited above, the staff prefers not to recognize such remeasurement adjustments in other comprehensive income/directly in equity because those adjustments would be "trapped" indefinitely until the acquirer sells the business or even permanently if the acquirer never sells the business.[9] We understand that respondents expressed concern about inappropriate gain or loss recognition. However, we believe that those concerns would be alleviated through disclosures. The BC ED proposes that in a step acquisition, the acquirer disclose the amount of any gain or loss recognized and the line item in the income statement in which that gain or loss is recognized (paragraph 72(j), paraphrased). The staff believes that that disclosure will bring transparency around the gain or loss recognized and should mitigate the concerns expressed by respondents. Therefore, the staff believes that disclosure should be retained if the Boards affirm the decision that the remeasurement adjustment should be recognized in net income/profit or loss. For example, Fitch Ratings stated:

> We do not believe that the effect of subsequently obtaining control can be analogized to an exchange. Rather, it gives the acquirer ability to direct the underlying net assets of the acquiree, and is therefore inappropriate to reclassify previous gains and losses on that investment in earnings. Reclassification would open the door to gaming of the accounting rules to manufacture income by making acquisitions in multiple steps. While we disagree with the proposed approach as it relates to holding gains and losses that would be recorded for previously owned shares when acquisitions of partial interests result in gaining control over a subsidiary, **we believe clear and adequate disclosure as currently required under the Exposure Draft will assist the analysts and investors in their evaluation process and therefore, could mitigate the issues we identified under the proposed approach.** [CL#16; **emphasis** added.]

[9] The staff does note, however, that the Performance Reporting Project might affect how or where such remeasurement adjustments are disclosed.

SECTION 2: ACCOUNTING FOR SUBSEQUENT ACQUISITIONS OR DISPOSITIONS OF NONCONTROLLING INTERESTS (CHANGES IN CONTROLLING OWNERSHIP INTERESTS)

113. This section analyzes the proposed accounting for subsequent acquisitions or dispositions of noncontrolling interests without a change in control (referred to as "**changes in controlling ownership interests**" in this memo). For example, a parent can increase its controlling ownership interest in a subsidiary by (a) purchasing (or causing an affiliate to purchase) additional outstanding shares of the subsidiary owned by noncontrolling shareholders, (b) causing the subsidiary to reacquire some of its outstanding shares, or (c) causing the subsidiary to issue shares of the subsidiary to the parent. A parent can decrease its controlling ownership interest in a subsidiary (a) by selling (or causing an affiliate to sell) some of its holding of the subsidiary's shares or (b) by causing the subsidiary to issue shares to noncontrolling interests.

Initial Deliberation Materials and the Boards' Bases for Conclusions

114. The Boards reached the decision that changes in controlling ownership interests should be accounted for as equity transactions. Thus, no gain or loss in net income/profit or loss would be recognized. The Boards discussed this issue at the following meetings:

(a) The IASB's December 2002 Board meeting

(b) The FASB's December 4, 2002 Board meeting.

[Remainder of paragraph 114 not reproduced in observer notes.]

115. The Boards considered two approaches for accounting for changes in controlling ownership interests.

(a) Account for changes in controlling ownership interests as transactions with members outside the consolidated group with gains or losses recognized in net income/profit or loss.

(b) Account for changes in controlling ownership interests as *equity transactions* (similar to acquisitions of treasury stock) with no gain or loss recognized in net income/profit.

116. Under the first approach, a parent accounts for changes in controlling ownership interests as transactions with members **outside** the consolidated group. Thus, any difference between the proceeds and the carrying amount of the noncontrolling shares are recognized as gains or losses in net income/profit or loss. That approach is based on the concept that

noncontrolling shareholders are like third parties and are not members of the consolidated group. It is consistent with classifying noncontrolling interests in subsidiaries as liabilities.

117. Under the second approach, a parent accounts for changes in controlling ownership interests as transactions with members **of** the consolidated group (equity transactions). Thus, any difference between the proceeds and the carrying amount of the noncontrolling shares are recognized as gains or losses in equity (additional paid in capital). That approach is based on the concept that noncontrolling shareholders are part of the consolidated group. It is consistent with classifying noncontrolling interests in subsidiaries as equity.

118. The Boards proposed the second approach in the NCI EDs. The Boards believe that transactions in the shares of a subsidiary by any of the affiliates are transactions in the equity of the consolidated group, which comprises the parent and its subsidiaries. The shares of the subsidiary are neither an asset nor a liability of the group. Rather, those shares are part of the residual interest remaining after subtracting consolidated liabilities from consolidated assets. Therefore, no gains or losses should be recognized on those transactions. While the Boards acknowledge that an equity interest of a noncontrolling shareholder in a subsidiary is not an equity interest in the parent, the Boards did not agree that that makes transactions with noncontrolling shareholders like transactions with nonowners. That conclusion also is consistent with the accounting for treasury and other capital stock transactions.

Comment Letter Responses

119. The majority of respondents disagreed that changes in controlling ownership interests should be accounted for as equity transactions and requested that the Boards retain current practice for accounting for those transactions. Those respondents generally disagreed that noncontrolling interests are part of the equity of the consolidated entity and with the economic unit perspective of presenting financial statements. They view transactions with noncontrolling shareholders like transactions with other third parties that should result in recognizing gains or losses in net income/profit or loss. For example, Citibank (CL #14) stated that "[w]e disagree with the proposed accounting for changes in ownership interest in a subsidiary. We view these as transactions with third parties and therefore disagree with their being account[ed] for as equity transactions."

120. BDO Seidman (CL #25) stated that this "particular part of the proposal is the most troublesome to us, because it fails to hold management accountable for the costs incurred in acquiring a business and requires part of the cost, as well as part of the gain or loss on disposal, to permanently bypass the income statement."

121. Respondents also expressed the following concerns with the proposal:

(a) When an additional interest in a successful subsidiary is acquired some time after control was first obtained, the accounting for this transaction can result in a significant reduction in reported equity. This accounting treatment does not reflect economic reality.

(b) The proposals will result in "gaming" to achieve desired accounting results, even with the additional guidance on treating multiple transactions as a single transaction.

122. Respondents that agreed with the proposal generally supported the concept that noncontrolling interests are part of the equity of the consolidated entity. Most of those respondents did not provide any additional reasons for their support.

123. Several respondents to the IASB's NCI ED stated that they welcomed guidance in this area as divergent practice has resulted from the current lack of guidance. Currently, IFRS does not provide any guidance for accounting for these transactions and respondents noted that the IASB's constituents are using as many as five different methods of accounting for increases in controlling ownership interests. (US GAAP provides guidance for accounting for these transactions.)

Alternatives for Consideration

124. This memo considers the following three alternatives for accounting for changes in controlling ownership interests:

(a) ***Alternative One:*** Account for changes in controlling ownership interests as *equity transactions* (like acquisitions of treasury stock) with no gain or loss recognized in net income/profit or loss or comprehensive income/directly in equity.

(b) ***Alternative Two:*** Account for changes in controlling ownership interests as transactions with members outside the consolidated group with gains or losses recognized in *net income/profit or loss*.

(c) ***Alternative Three:*** Account for (1) increases in controlling ownership interests as transactions that result in the recognition of an additional purchase layer of net identifiable assets and goodwill and (2) decreases in controlling ownership interests as transactions with members outside the consolidated group with gains or losses recognized in net income/profit or loss. (*Current US GAAP requirement.*)

125. These alternatives are the result of fundamentally different interpretations of the nature of a noncontrolling interest in a subsidiary and of consolidated financial statements. (Refer to IASB Agenda Paper 2D/FASB Memo #12—"Nature and Classification of Noncontrolling Interests" for the staff's analysis of the nature of noncontrolling interests.)

Alternative One

126. Alternative One is consistent with the concept that noncontrolling interests in subsidiaries are part of the ownership interests in the consolidated group and with reporting noncontrolling interests as a separate component of equity.

127. Alternative One is consistent with existing guidance for accounting for acquisitions of treasury shares under U.S. GAAP and IFRS. Paragraph 28 of APB Opinion No. 9, *Reporting the Results of Operations*, states:

> The Board reaffirms the conclusion of the former committee on accounting procedure that **the following should be excluded from the determination of net income or the results of operations under all circumstances: (a) adjustments or charges or credits resulting from transactions in the company's own capital stock,**[5] (b) transfers to and from accounts properly designated as appropriated retained earnings (such as general purpose contingency reserves or provisions for replacement costs of fixed assets) and (c) adjustments made pursuant to a quasi-reorganization. [**Emphasis** added.]
>
> [5] See paragraph 12 of APB Opinion No. 6, *Status of Accounting Research Bulletins*. [Paragraph 12 of APB Opinion No. 6, *Status of Accounting Research Bulletins*, provides guidance for accounting for acquisitions of a corporation's own shares.]

Paragraph 33 of IAS 32 *Financial Instruments: Disclosure and Presentation* states that "[i]f an entity reacquires its own equity instruments, those instruments ('treasury shares') shall be deducted from equity. No gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments…."

Alternative Two

128. Alternative Two is consistent with the view that noncontrolling interests do not represent part of the ownership interest of the reporting entity—only owners of the parent are viewed as owners of the consolidated entity. That is, a parent's ownership interest in a subsidiary continues to be viewed as an investment of the parent that is displayed differently in consolidated financial statements. The reporting entity is viewed as the parent (with investments in subsidiaries) rather than the parent and its subsidiaries. Therefore, in consolidated financial statements, under Alternative Two, changes in a parent's controlling interest are transactions with outsiders (purchases or sales of investments) that result in the recognition of gains or losses in the income statement.

129. Some supporters of Alternative Two cite the fact that Alternative One will lead to a reduction of equity when an entity (a) acquires noncontrolling shares that have appreciated in value over time or (b) sells noncontrolling shares that have depreciated in value over time. However, Alternative Two will still result in a reduction to equity in those circumstances, albeit through retained earnings rather than additional paid-in capital.

Alternative Three

130. Alternative Three is consistent with existing US GAAP. The staff believes this approach is viable only if the Boards decide against recognizing the identifiable assets acquired and liabilities assumed at 100 percent of their fair values in a partial acquisition. That is, if the Boards decide that in a partial acquisition the acquirer should recognize the acquiree's identifiable net assets at fair value on the acquisition date, then there would be no justification for recognizing an additional purchase layer each time noncontrolling shares are acquired. (However, paragraphs 90–94 address whether it would be appropriate to recognize a layer of goodwill when noncontrolling shares are acquired if the purchased goodwill method was used on the date of the initial business combination.)

Current Accounting for Increases in Controlling Ownership Interests (Acquisitions of Noncontrolling Interests)

131. Paragraph 14 of Statement 141 states that "[t]he acquisition of some or all of the noncontrolling interests in a subsidiary—whether acquired by the parent, the subsidiary itself, or another affiliate—should be accounted for by the purchase method…." Therefore, on each date that the parent purchases additional shares from the noncontrolling shareholders, the parent remeasures the percentage of the assets and liabilities representing the ownership percentage acquired.

132. The accounting for increases in controlling ownership interests is not specifically addressed in IFRS guidance. As noted previously, several respondents to the IASB's NCI ED stated that they welcomed guidance in this area as divergent practice has resulted from the current lack of guidance.

Current Accounting for Decreases in Controlling Ownership Interests

133. US GAAP addresses a subsidiary's issuance of its own shares in SEC SAB 51, *Accounting for Sales of Stock by a Subsidiary* (issued March 1983), and SEC SAB 84, *Views Regarding Accounting in Consolidation for Issuances of a Subsidiary's Stock That Cause*

Changes in the Parent's Ownership Percentage in the Subsidiary (issued July 1989). SAB 51 and SAB 84, which are applicable only to SEC registrants, *permit* recognition of gains on issuances by a subsidiary of its own shares under certain circumstances. SAB 51 states:

> Although the staff has previously insisted that such transactions be accounted for as capital transactions in the consolidated financial statements, it has recently reconsidered its views on this matter where the sale of such shares by a subsidiary is not a part of a broader corporate reorganization contemplated or planned by the registrant. In situations where no other such capital transactions are contemplated, the staff has determined that it will accept accounting treatment for such transactions that is in accordance with the Advisory Conclusions in paragraph 30 of the June 30, 1980 [AICPA] Issues Paper. . . . The staff believes that this issues paper should provide appropriate interim guidance on this matter until the FASB addresses this issue as a part of its project on Accounting for the Reporting Entity, including Consolidations, the Equity Method, and Related Matters.

134. [Paragraph 134 not reproduced in observer notes.]

135. Decreases in the controlling interest by members of the consolidated group in which the parent maintains control is not specifically addressed in IFRS guidance.

Illustrative Example

136. This example illustrates each of the three alternatives for accounting for increases in controlling ownership interests:

Parent owns a 70 percent controlling ownership interest in Subsidiary and acquires an additional 15 percent interest:

Date	*Interest purchased*	*Amount paid*	*Shares purchased*	*Subsidiary's identifiable net assets*		*FV of Subsidiary*
				FV	*CV*	
1/1/X8	70%	$17,000	700	$19,000	$15,000	$25,000
1/1/X9	15%	$4,500	150	$27,000	$25,000	$30,000
	85%		850			

137. On 1/1/X9, the carrying value of the noncontrolling interest is $7,500.

How should Parent account for the acquisition of the additional 15 percent interest?

Alternative One

138. Under Alternative One, the difference between the consideration paid and the noncontrolling interest transferred to the controlling interest is considered to be a premium paid for treasury shares and is debited to equity (additional paid-in capital).

Alternative Two

139. Under Alternative Two, the transaction is viewed as an additional purchase of shares from outsiders of the consolidated group. Consistent with how transactions with outsiders are generally accounted for, the premium paid to the noncontrolling shareholders would be recorded in net income/profit or loss.

Alternative Three

140. Under Alternative Three, Parent would recognize an additional purchase layer each time it acquires some of the outstanding noncontrolling shares. Therefore, Parent recognizes an increase in Subsidiary's net identifiable assets of $300 [($27,000 – $25,000) × 15 percent] and an increase of goodwill of $450 [$4,500 – ($27,000 × 15 percent)].

All Alternatives

141. Under all alternatives, 50 percent of the noncontrolling interest, or $3,750, is transferred to the controlling interest (15 percent acquired on 1/1/X3 / 30 percent noncontrolling interest previously).

142. Below is a summary of the journal entries that would be recorded in the consolidated financial statements under each alternative:

	Alternative One	Alternative Two	Alternative Three
Dr. Equity (APIC)	***750***	-	-
Dr. Loss (net income/p or l)	-	***750***	-
Dr. Identifiable net assets	-		***300***
Dr. Goodwill	-		***450***
Dr. Noncontrolling interest	3,750	3,750	3,750
Cr. Cash	(4,500)	(4,500)	(4,500)

Staff Recommendation

Accounting for Changes in Controlling Ownership Interests

143. The staff recommends the Boards affirm that changes in a parent's controlling interest should be accounted for using Alternative One—as equity transactions. The staff believes this recommendation is consistent with the Boards' decision that noncontrolling interests are part of the equity of the consolidated group. (Issues related to *presentation* of changes in controlling ownership interest are addressed in IASB Agenda Paper 2E/FASB Memo #13.)

Transition Issues Related to Changes in Controlling Ownership Interests

144. Some respondents to the NCI ED noted that the proposed prospective transition proposals for changes in ownership interests might be problematic for entities with partially owned subsidiaries at the time of transition. They noted that the controlling interest's equity would be reduced if the acquirer acquires additional noncontrolling interest shares after adoption of the final NCI standard and the value of those shares has appreciated. Some of those respondents are quoted below. For example, PwC stated that "[s]ubsequent to the effective date of the standards, if the parent entity decides to purchase the non-controlling interest and the non-controlling interest has appreciated over time, the parent entity may record a significant reduction in its equity which would not reflect any underlying economic event" (CL #12). Another respondent, Affiliated Managers Group, stated:

> ...[i]f the Proposed Standard is adopted as currently drafted, the transition approach offered will not result in financial statements being presented on a comparable basis for business combinations consummated before the adoption of the Proposed Standard. For companies that acquire controlling interests in businesses, there will be a permanent difference in the method of accounting for acquisitions completed before and after January 1, 2007. This difference will make comparability of financial statements difficult for financial statement users. [CL #38]

Transition Alternatives for Changes in Ownership Interests

145. The staff understands the concerns expressed by respondents. This issue was considered by the Boards before the NCI EDs were issued. The Boards initially considered this issue at the May 28, 2003 FASB Board meeting and the May 2003 IASB Board meeting.

146. In addition, this issue was raised by Affiliated Managers Group in their field visit with the FASB. The FASB Board and staff held discussions after that field visit and attempted to develop a transition alternative that would mitigate this issue. At that time, the FASB and the staff were unable to develop a more suitable transition alternative.

147. The following table analyzes the transition alternatives (a) previously considered and rejected by the Boards and/or (b) suggested by respondents to the NCI EDs. The table also explains why the Boards ultimately decided against those transition alternatives.

Method	Apply to all partially owned subsidiaries	Variation: Apply on a case-by-case basis	Why the Boards rejected the transition alternative
Retrospective application of business combination requirements	**Upon adoption of the final BC standard**, **retrospectively apply** the requirements of the BC standard to **all partially owned subsidiaries** that were acquired in business combinations before adoption of the standard.	**Each time some of the noncontrolling interests in a subsidiary are acquired**, **retrospectively apply** the requirements of the final BC standard to **that partially owned subsidiary** that was acquired in a business combination before adoption of the standard.	The Boards rejected these alternatives for the same reasons they rejected broad retrospective application of the BC requirements: In many circumstances, it will not be possible to retrospectively apply the requirements of the BC standard to combinations completed before the standard is adopted. Especially for combinations completed some time ago, the acquiree's current and possibly noncurrent assets and liabilities would have unwound over time. The information needed to restate prior financial statements would likely no longer exist. The Boards also considered allowing entities to apply the BC requirements retrospectively if the entity is able (if practicable). However, the Boards rejected that approach because such an option would likely act as an incentive to restate financial statements only if that restatement serves to benefit the entity in some way. The quality of financial reporting would not be improved if restatement occurs only when it serves to benefit an entity.
Apply the final BC requirements on the date of adoption	**Upon adoption of the final BC standard**, apply the requirements of the final BC standard to **all partially owned subsidiaries** that were acquired in business combinations before adoption of the standard.	**Each time some of the noncontrolling interests in a subsidiary are acquired**, apply the requirements of the final BC standard to **that partially owned subsidiary** that was acquired in a business combination before adoption of the standard.	The Boards rejected these alternatives. If an acquisition occurred some time in the past, the acquiree's assets and liabilities would have unwound over time and likely would not be the same assets and liabilities recorded on the date of adoption. Thus, these alternatives would essentially allow an entity to remeasure certain assets and liabilities upon adoption of the final BC standard when no remeasurement event had occurred.
Partial purchase method	n/a	**Each time some of the noncontrolling interests in a subsidiary are acquired**, apply the	The FASB considered allowing entities to record purchase layers for acquisitions of noncontrolling interests if the partial acquisition was completed before the

		"partial purchase method" (current Statement 141 requirement) if the partial acquisition was completed before adoption of the final BC standard.	effective date of the final business combinations standard. The FASB rejected this alternative. The IASB does not use the partial purchase method. Therefore, this method would result in divergence between the IASB and the FASB.

148. Therefore, the Boards and staff considered, but could not develop a transition alternative that would mitigate the concerns raised by some respondents.

This Is Not Just a Transition Issue

149. While the staff understands the concerns expressed by respondents, we note that this issue is not a *transition issue*, although it may be more significant for partially owned entities acquired before adoption of the final BC standard.

150. If changes in controlling ownership interests are accounted for as equity transactions, *any time* an entity acquires some of the noncontrolling shares in one of its partially owned subsidiaries and those shares have appreciated in value over time, the entity will recognize a reduction (debit) to equity. However, the reduction to equity might be larger if the partially owned subsidiary was acquired before adoption of the final BC and NCI standards, which is why some respondents view this as a transition issue. The following example illustrates a possible scenario that assumes the initial acquisition of a controlling, but less than 100 percent, interest was accounted for using three scenarios—using the proposals in the BC ED (full goodwill), using IFRS 3 (purchased goodwill), and using Statement 141 (layered approach). The example illustrates that the equity reduction is the smallest if the requirements of the BC ED (full goodwill) are used.

Illustrative example

151. Parent owns a 70 percent controlling ownership interest in Subsidiary and acquires the outstanding 30 percent interest. *Assume no change in the noncontrolling interest balance from 1/1/X8 to 1/1/X9.*

Date	*Interest purchased*	*Amount paid*	*Shares purchased*	*Subsidiary's identifiable net assets* *FV*	*CV*	*FV of Subsidiary*
1/1/X8	70%	$17,500	700	$19,000	$15,000	$25,000
1/1/X9	30%	$9,000	300	$27,000	$25,000	$30,000
	100%		1,000			

	Journal entries assuming the 1/1/X8 transaction was accounted for using the proposals in the BC ED	**Journal entries assuming the 1/1/X8 transaction was accounted for using IFRS 3**	**Journal entries assuming the 1/1/X8 transaction was accounted for using Statement 141**
1/1/X8			
Dr. Identifiable net assets	19,000	19,000	17,800
Dr. Goodwill	6,000	4,200	4,200
Cr. NCI	***(7,500)***	***(5,700)***	***(4,500)***
Cr. Cash	(17,500)	(17,500)	(17,500)
1/1/X9			
Dr. Equity (APIC)	***1,500***	***3,300***	***4,500***
Dr. Noncontrolling interest	***7,500***	***5,700***	***4,500***
Cr. Cash	(9,000)	(9,000)	(9,000)

152. As this example illustrates, the staff believes this issue would be partially mitigated by two things:

(a) Recognizing the acquiree's identifiable net assets at 100 percent of their fair value on the date of the partial acquisition (as shown in the middle column since this is what is already required by IFRS 3).
(b) Using the full goodwill method (as shown by comparing the first column and the middle column).

153. That is, if the acquirer recognizes the acquiree's identifiable net assets at 100 percent of their fair values and uses the full goodwill method on the acquisition date in a partial acquisition, the carrying value of the noncontrolling interest likely would be the largest. Therefore, if the acquirer then purchases additional noncontrolling shares after the acquisition date and the value of those shares has increased, then the reduction (debit) to equity would be smaller. While this would not mitigate the issue for acquisitions completed before adoption of the final business combinations standard, it will help mitigate the issue going-forward.

This Is Not Just an Issue for Changes in Controlling Ownership Interests

154. The staff notes that this issue exists in current practice when an entity reacquires some of its own shares (treasury share transactions). When an entity buys back some of its own shares and the value of the shares has appreciated, it results in a reduction (debit) to equity. Some argue that this is an unreasonable result—that recognizing a reduction of equity because the value of the shares is increasing is unreasonable. The staff notes, however, that even if the entity accounted for the acquisition of shares as an income statement transaction, it would ultimately result in a reduction of equity, albeit through retained earnings rather than additional paid-in capital.

Staff Recommendation

155. The staff continues to support the transition alternative proposed in the NCI EDs. While we understand respondents' concerns, we do not believe that any other transition alternative is more appropriate.

SECTION 3: THE ACCOUNTING FOR LOSS OF CONTROL OF SUBSIDIARIES

156. This section analyzes the proposed accounting for the loss of control of a subsidiary in the FASB's and the IASB's NCI EDs. Those EDs propose that if control of a subsidiary is lost, any gain or loss should be recognized in net income/profit or loss. The gain or loss is measured as the difference between the following:

(a) The aggregate of (1) the fair value of the proceeds, if any, from the transaction that resulted in the loss of control and (2) **the fair value of any retained investment in the former subsidiary at the date control is lost**

(b) The parent's interest in the former subsidiary's net assets at the date control is lost, which includes its share of the other comprehensive income of the former subsidiary.

If the subsidiary was partially owned, the noncontrolling interest's share of the carrying amount of the net assets of the former subsidiary would be derecognized against the carrying amount of the noncontrolling interest. Thus, no gain or loss related to the noncontrolling interest would be recognized.

Initial Deliberation Materials and the Boards' Basis for Conclusions

157. This issue was discussed at:

(a) The IASB's December 2004 Board meeting

(b) The FASB's December 4, 2002 Board meeting.

[Remainder of paragraph 157 not reproduced in observer notes.]

158. Similar to the Boards' conclusion in the BC ED that obtaining control of a business is a remeasurement event that should result in gain or loss recognition, the Boards decided that losing control of a subsidiary is also a remeasurement event that should result in gain or loss recognition. That notion is consistent with how a disposition of a subsidiary is accounted for currently under US GAAP or IFRS—the gain or loss is equal to the difference at the date of sale between the selling price and the carrying amount of the shares or net assets sold. However, what is different is how the Boards proposed to account for the loss of control if the former parent retains a noncontrolling equity investment in the former subsidiary.

159. The Boards considered two approaches for measuring the gain or loss on the loss of control of a subsidiary if the former parent retains a noncontrolling equity investment in the former subsidiary. The first approach would be to measure the gain or loss using the carrying

amount of the investment retained in the consolidated financial statements. However, the Boards decided that that approach is inconsistent with the view that losing control of a subsidiary is a significant economic event that changes the nature of the investment held in the subsidiary. It also is inconsistent with the decision reached for step acquisitions—that is, that upon obtaining control of a business, any previously held noncontrolling equity investment should be remeasured to fair value.

160. Under the second approach, if control of a subsidiary is lost and an investment in the former subsidiary is retained, that retained investment would be remeasured to its fair value on the date control is lost and any gain or loss would be recognized in consolidated net income. The Boards decided to adopt the second approach. That decision reflects the Boards' view that a decrease in a parent's ownership interest in a subsidiary to the point that the parent no longer controls that subsidiary is a significant economic event. The parent-subsidiary relationship ceases to exist and an investor-investee relationship begins that differs significantly from the former parent-subsidiary relationship. The Boards also believe that recognizing the retained investment at fair value is more representationally faithful and provides users of financial statements with better information about the value of the retained investment.

Comment Letter Responses

161. Respondents to the BC ED had mixed views on the proposed accounting for loss of control. Those views can be broken down into three categories. Those three categories are the same three alternatives the Boards considered during initial deliberations:

(a) Disagree with remeasuring any retained noncontrolling equity investments.

(b) Agree with remeasuring any retained noncontrolling equity investments and recognizing any gain or loss in *net income/profit or loss*.

(c) Agree with remeasuring any retained noncontrolling equity investments but would recognize any gain or loss in *other comprehensive income/directly in equity* any retained.

Disagree with Remeasuring Any Retained Noncontrolling Equity Interests

162. Most respondents disagreed that any retained investment in a former subsidiary should be remeasured to fair value. They disagreed because they believe the principles for revenue and gain recognition in the conceptual framework would not be satisfied on the portion of the investment retained. The following comments were representative of the respondents that disagreed.

163. PwC (CL #12) stated:

> No. We do not believe that a retained investment in a former subsidiary should be re-measured as there is no exchange transaction with an unrelated third party involving the interest that has been retained. Re-measuring the retained investment loses the record of the invested capital in that investment along with the basis for evaluating the performance of that investment.

164. KPMG (CL #33) stated:

> We disagree with the Boards' proposal that loss of control should give rise to a remeasurement of the remaining investment at fair value with the adjustment recognized in profit or loss. We believe that upon the loss of control, gains and losses should be recognized for the portion of the investment that is sold. Any remaining investment would retain its carrying amount at that date and would be accounted for subsequently in accordance with appropriate existing GAAP (e.g., equity method investment, available-for-sale security, trading security).
>
> We agree that loss of control of a subsidiary is a significant economic event. However, we do not believe that such an event, in and of itself, justifies the recognition of revaluation gains and losses.

Agree with Remeasuring Any Retained Noncontrolling Equity Investments and Recognizing Any Gain Or Loss in Net Income/Profit or Loss.

165. A few respondents agreed with the proposed accounting for a loss of control of subsidiaries, but generally did not provide the rationale for their support. Those that did provide their rationale agreed with the Boards that loss of control is a remeasurement event that should result in gain or loss recognition. For example, Credit Suisse Group (CL #11) stated that "[w]e believe that the change in character from a controlled entity to either an equity method investment or a cost method investment is sufficient to support recognition of a gain or loss."

Agree with Recognizing Any Retained Noncontrolling Equity Interest but Would Recognize Any Gain or Loss in Other Comprehensive Income/Directly in Equity

166. A few respondents agreed with remeasuring the retained investment to fair value, but they believed the remeasurement adjustment should be recognized in other comprehensive income/directly in equity until the investment is sold. For example, Grant Thornton (CL #8), stated:

> We agree with remeasurement to fair value for the purpose of balance sheet recognition of the retained investment. However, we do not believe it is appropriate to recognize the difference between the fair value and the carrying amount of the retained interest in income because the amount has not been realized through an exchange with an outside party. We think these transactions are analogous to unrealized gains and losses on available-for-sale securities and therefore it would be more appropriate for them to be recorded in other comprehensive income until disposal of the retained interest.

Alternatives for Consideration

167. This memo considers the following three alternatives for measuring and recognizing the any retained noncontrolling equity investment on the date control is lost:

(a) ***Alternative One:*** *Remeasure* any retained noncontrolling equity investment to *fair value* on the date control is lost and recognize the remeasurement gain or loss in *net income/profit or loss*.

(b) ***Alternative Two:*** *Remeasure* any retained noncontrolling equity investment to *fair value* on the date control is lost and recognize the remeasurement gain or loss in *other comprehensive income/directly in equity*.

(c) ***Alternative Three:*** Do not remeasure any retained noncontrolling equity investment on the date control is lost.

Staff Recommendation

168. The staff continues to support the notion that obtaining control or losing control of an entity changes the nature of any previously held or retained investments, and thus is a remeasurement event. We, therefore, recommend that the Boards affirm the proposal in the NCI ED that any retained noncontrolling equity investment should be remeasured to fair value and that the adjustment should be recognized net income/profit or loss (Alternative One).

169. The staff would prefer not to recognize such remeasurement adjustments in other comprehensive income/directly in equity (Alternative Two), where they would be “trapped” indefinitely until the former parent sells the retained investment or even permanently if the former parent never sells the investment. We understand that respondents have expressed concern about inappropriate gain or loss recognition. However, we believe that those concerns should be alleviated through disclosures. The NCI EDs propose that if control of a subsidiary is lost, the former parent should disclose the amount of the gain or loss and the line item in the income statement where that gain or loss is recognized. Additionally, the NCI EDs propose that if the former parent retains a noncontrolling equity investment in the former subsidiary, the amount of the gain or loss related to the remeasurement of the retained investment to fair value should be separately disclosed. The staff believes the Boards should retain those disclosure requirements.

170. However, the staff believes this issue is the same as whether or how to recognize a remeasurement adjustment in a step acquisition (Issue 3, beginning in paragraph 100). The staff’s primary recommendation is that the Boards be consistent with what they decide for

recognizing the remeasurement adjustment in a step acquisition. If the Boards decide to recognize the remeasurement adjustment in a step acquisition on other comprehensive income/directly in equity, then the staff recommends that they also decide to recognize the remeasurement adjustment for the retained investment in a former subsidiary in other comprehensive income/directly in equity.

171. The staff notes that Alternative One also is consistent with the proposals in the FASB's Exposure Draft, *The Fair Value Option for Financial Assets and Financial Liabilities.* Paragraph 6 of that Exposure Draft states:

> On the date that a financial asset or financial liability is initially recognized or upon an event that gives rise to new-basis accounting at fair value under generally accepted accounting principles (GAAP), an entity may elect to use fair value as the initial and subsequent measurement attribute in accounting for that financial asset or financial liability….The election of the fair value option (a) is made on a contract-by-contract basis, (b) is irrevocable, and (c) requires that changes in fair value be recognized in earnings (or other performance indicators for entities that do not report earnings) as those changes occur. The election of the fair value option shall be supported by concurrent documentation or a preexisting documented policy for automatic election.

172. It is not clear to the staff how Alternatives Two or Three would be applied if an entity elected the fair value option.

173.