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**International Accounting Standards Board**



**INFORMATION FOR OBSERVERS**

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| **Board Meeting:** | **March 2006, London** |
| **Project:** | **Business Combinations II** |
| **Subject:** | **The Nature and Classification of Noncontrolling Interests in the Consolidated Balance Sheet (Agenda Paper 2D)** |

## PURPOSE OF THE MEETING

1. At the IASB's March 29, 2006 Board meeting and the FASB's March 28, 2006 Board meeting, the staff will discuss the nature and classification of noncontrolling interests in the consolidated balance sheet. Currently, IAS 27 requires a parent to present noncontrolling [minority] interests in subsidiaries in the consolidated balance sheet within equity, separately from the parent shareholders' equity (paragraph 33). However, the FASB has not finalized that conclusion.

2. As noted in the January 2006 meeting materials, respondents did not raise any compelling arguments to classify noncontrolling interests in subsidiaries as something other than equity. This memorandum summarizes the Boards' previous decisions about the nature and classification of noncontrolling interests in subsidiaries and provides an analysis of comments received.

## BACKGROUND

### Initial Deliberation Materials for the Nature and Classification of Noncontrolling Interests

3. The Boards concluded that noncontrolling interests in subsidiaries represent an equity interest in the consolidated entity and that noncontrolling interests in subsidiaries should be classified as a separate component of equity in the consolidated balance sheet. Those issues were discussed at the following meetings:

   (a) October 30, 2002 FASB Board Meeting

   (b) November 2002 IASB Board Meeting.

[Remainder of paragraph 3 not reproduced in observer notes.]

4. The Boards reached the conclusion that noncontrolling interests in subsidiaries represent an equity interest in the consolidated entity and, therefore, should be classified as equity, albeit separately from the parent's shareholders equity for the following reasons:

   (a) Noncontrolling interests in subsidiaries do not meet the definition of liabilities in the IASB's Framework or the FASB's Concepts Statements. Not one of the entities involved—the parent, the subsidiary, or the consolidated entity—is obligated to transfer assets or provide services to the shareholders that hold equity shares in the subsidiary.

   (b) Noncontrolling interests in the net assets of consolidated subsidiaries do not represent present obligations of the entity to pay cash or distribute other assets to noncontrolling shareholders. Rather, those shareholders have an ownership or residual interest in components of a consolidated entity.

   (c) No compelling reasons exist to create a new "mezzanine" element of financial statements to report the interests of shareholders that do not control the parent or its subsidiaries. Appropriate labeling and disclosure of items and distinctions between items within the existing elements of financial statements should report financial information in consolidated financial statements that is representationally faithful, understandable, and relevant to owners of the parent as well as to creditors and other resource providers of the parent.

   (d) The argument that noncontrolling interests in subsidiaries are not equity interests in the consolidated financial statements of the parent because noncontrolling interests have no interest in the equity of the parent is based on too narrow a view of consolidated financial statements. Holders of noncontrolling interests are owners of a residual interest in a component of the consolidated entity.

## Comment Letter Responses

5. Although the IASB and FASB issued separate NCI EDs, respondents to the NCI EDs generally raised the same concerns in their comment letters, which are discussed below. The staff notes that the issues raised by respondents were considered by the Boards before issuing the NCI EDs.

6. KPMG's comments were representative of many of the concerns expressed by respondents to both NCI EDs. KPMG stated:

> We do not object to the proposal that noncontrolling interests be included in consolidated equity if presented separately from the parent company's equity. With respect to this proposal, we believe that classification of noncontrolling interests in equity should only relate to presentation as we believe that the economic entity approach is not an appropriate basis for preparing consolidated financial statements of the parent company.
>
> We also agree that noncontrolling interests should be presented separately from the equity attributable to shareholders of the parent. We observe that shareholders representing noncontrolling interests have rights very distinct from the shareholders of the parent. Noncontrolling interests represent equity claims that are restricted to particular subsidiaries, whereas the shareholders of the parent have equity claims on the entire consolidated group.
>
> However, classification of noncontrolling interests in equity should only relate to presentation and should not affect the accounting for transactions with the noncontrolling interests. [FASB CL #33; IASB CL #38]

**Respondents to the IASB's NCI ED**

7. As noted in paragraph 1 above, IAS 27 already requires that noncontrolling [minority] interests in subsidiaries be presented in the consolidated balance sheet within equity, separately from the parent shareholders' equity. Therefore, most respondents to the IASB's NCI ED agreed that noncontrolling interests are equity and agreed with classifying noncontrolling interests as equity *for presentation purposes*. However, those respondents did not necessarily agree with the proposed accounting treatment that results from classifying noncontrolling interests as equity. For example, many respondents agreed with the alternative views of the Board members "that noncontrolling interests represent equity claims that are restricted to particular subsidiaries, whereas the controlling interests are affected by the performance of the entire group" (IASB NCI ED, paragraph AV2). Therefore, those respondents generally believe that noncontrolling interests are a different type of equity that should receive different accounting treatment than the equity of the parent's shareholders.

**Respondents to the FASB's NCI ED**

8. Most respondents to the FASB's NCI ED disagreed that noncontrolling interests are equity and disagreed with classifying noncontrolling interests as equity for the following reasons:

(a) Although noncontrolling interests do not meet the definition of a liability, noncontrolling interests do not meet the definition of equity either. Noncontrolling interests do not have an ownership interest in the equity of the parent and, therefore, should not be classified as equity in the consolidated balance sheet.

(b) The parent company approach to financial reporting is favored in practice over the economic unit approach. Therefore, the proposals, which are based on the economic unit approach, will not improve the relevance and transparency of financial information.

(c) The current practice of presenting noncontrolling interests on the balance sheet in the mezzanine is common, well understood, reflects the economics underlying the entities and, therefore, should be retained.

(d) The classification of noncontrolling interests should be addressed in the Conceptual Framework Project. Many respondents stated that the Board should delay considering this issue until it is addressed in the Conceptual Framework project. They also suggested that a new financial statement element for noncontrolling interests should be created as part of the Conceptual Framework project.

9. A minority of respondents to the FASB's NCI ED agreed that noncontrolling interests are equity and gave the following reasons for their support:

(a) They support the economic unit concept.

(b) There is no support in the conceptual framework for classifying noncontrolling interests as liabilities or mezzanine items.

(c) Holders of noncontrolling interests in subsidiaries are owners of a residual interest in a component of the consolidated entity.

## STAFF ANALYSIS

10. The staff believes it is hard to argue that noncontrolling interests in subsidiaries are not part of the equity of the consolidated entity. Both Boards consistently concluded in

previous due process documents[1] that noncontrolling interests in the net assets of consolidated subsidiaries should be classified in the consolidated balance sheet within equity, separately from the parent shareholders' equity.

11. The staff also believes that presenting noncontrolling interests within equity, separate from the parent shareholders' equity provides transparent and useful information for both noncontrolling and controlling shareholders. No information is lost as a result of the proposals to present noncontrolling interests in consolidated subsidiaries as a separate component of equity.

12. Presenting noncontrolling interests in subsidiaries as a separate component of equity is consistent with presenting other types of equity that only relate to a specific part of the consolidated entity. For example, some companies issue "tracking stocks" that track the financial performance of particular segments or subsidiaries of a parent. Shareholders of those tracking stocks have an interest only in that particular segment or subsidiary of the parent that they are tracking just as noncontrolling interests only have an interest in a particular subsidiary of the parent. The parent presents the tracking stock as a separate component of equity because the shareholders of tracking stocks (similar to holders of noncontrolling interests) bear risks and benefits of the consolidated group to a different degree than the owners of a parent entity.

**STAFF RECOMMENDATION**

13. The staff recommends the Boards affirm that noncontrolling interests in subsidiaries are equity and should be presented in the consolidated balance sheet within equity, separately from the parent shareholders' equity.

14. *Do the Boards agree with the staff's recommendation?*

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[1]Due process documents that discussed noncontrolling interests include the following:

(a) The FASB's October 2000 Exposure Draft, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both*

(b) The FASB's October 1995 Exposure Draft, *Consolidated Financial Statements: Policy and Procedures*

(c) The FASB's September 1991 Discussion Memorandum, *Consolidation Policy and Procedures*

(d) The IASB's May 15, 2002 Exposure Draft of Proposed *Improvements to International Accounting Standards.*