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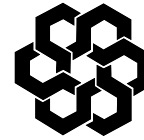
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These notes are based on the staff papers prepared for the IASB and FASB. Paragraph numbers correspond to paragraph numbers used in the joint IASB-FASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IASB/FASB Meeting:	**24 October 2006, London**
Project:	**Business Combinations II**
Subject:	**Non-controlling interests and goodwill (Agenda Paper 5B) (Also issued as observer note for IASB meeting Agenda Paper 2F)**

Introduction

1. The Business Combinations Exposure Draft (BC ED) proposes that the full goodwill method be used for the recognition of goodwill in a business combination.[1] That proposal, recognising all of the goodwill upon consolidation, was one of the most controversial aspects of the BC ED. The majority of respondents do not agree with the full goodwill method. They believe that only the portion of goodwill that is related to the controlling interest (ie, the acquired

[1] In the **full goodwill** method, all of the acquiree's goodwill, not just the acquirer's share, is recognised on the acquisition date. Goodwill is measured as the difference between the acquisition-date fair value of the acquiree as a whole and the fair value of the acquiree's identifiable assets and liabilities. In the **partial or purchased goodwill** method, only the acquirer's share of goodwill is recognised on the acquisition date. Any goodwill related to the NCI is not recognised. 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.

goodwill) should be recognised and that no goodwill should be attributed to the non-controlling interests (NCI).

2. During the redeliberations, in the March 2006 Board meetings (IASB Agenda Paper 2B/FASB Memorandum #9), the staff asked the Boards to reconsider how to measure goodwill in a partial or step acquisition. The FASB was strongly in favour of the full goodwill method (6-1), while the IASB decided only by a bare majority (8-6).

3. Due to the closeness in the voting of the IASB members, there is a concern that the final business combinations standards will not converge. The staff therefore is bringing the issue of the recognition and measurement of goodwill back to the Boards to try to close this gap and bring convergence in the thinking between the two Boards.

4. The proposal in the BC ED is that the acquirer measure and recognise the fair value of each asset acquired and liability assumed as part of the business combination. Goodwill is measured as any excess of the purchase price over the net assets acquired.

5. Under the 'full goodwill' method, the acquirer recognises all of the goodwill resulting from the business combination. As a result, a portion of the goodwill is attributable to the NCI. One of the main concerns regarding the 'full goodwill' method is that the allocation of any goodwill to NCI is perceived to be meaningless because goodwill is viewed by many as having far less information value than other assets. Allocating goodwill to the NCI, as proposed in the BC ED, reduces the information value because it results in two meaningless figures.

6. The staff believes that one of the drawbacks of the BC ED is that the measurement basis of NCI is not identified; the BC ED only addresses how to calculate NCI. A better methodology, in the staff's view, would be to require that NCI be measured directly at fair value. Accordingly, goodwill would be calculated as the difference between (1) the fair value of the consideration transferred and the fair value of NCI, and (2) the fair value of the identifiable net assets acquired. The staff is not suggesting that there be a change in the underlying principles of the BC ED with regard to the recognition and measurement of NCI, but that there be a change in focus such that the NCI that results from a partial acquisition is recognised and measured directly at fair value. That is to say, to increase the information usefulness of the financial statements.

7. The fair value of NCI, when measured directly, has more information value because it represents the amount that would need to be paid to buy out the NCI holders. The direct measurement of NCI also means that the goodwill attributable to NCI is captured in its fair value. Thus, 'full goodwill' will be the result.

8. The staff's proposal, therefore, is as follows:

   (a) Measure the identifiable assets acquired and liabilities assumed at fair value,

   (b) Measure the fair value of the consideration transferred[2] and the fair value of NCI, and

   (c) Calculate the goodwill of the controlling interest as the difference between these components.

Characterisation of Goodwill

9. Characterising the alternative methods of measuring NCI and goodwill as the 'full goodwill' and 'purchased (or partial) goodwill' methods may be unhelpful. These characterisations imply that the 'methods' are competing concepts or theories that focus on the best way to account for goodwill. The argument, invariably, turns to assessing the informational relevance of goodwill.

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

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

[2] The October 2006 IASB Agenda Paper 2E/FASB Memorandum #30/Joint Agenda Paper 5A discusses whether the consideration transferred is representative of the fair value of the acquired interest.

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

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

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

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

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

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

17. Whatever decision is made about NCI measurement will affect goodwill. Indeed, if the fair value of NCI is recognised, full goodwill is the result since the fair value of the NCI includes its interest in the goodwill of the entity. However, given that the Boards have already decided that goodwill is to be measured as a residual, any method of measuring NCI that involves allocating goodwill to it means that NCI is, essentially, a residual of a residual. Decoupling the thinking

allows the Boards to consider whether there is a measurement attribute that is more informative for NCI than one that relies on goodwill.

Measuring Non-controlling Interests

18. The staff thinks that a more productive and consistent approach to describing and accounting for NCI and goodwill is to:

    (a) Recognise NCI and measure it using an appropriate measurement attribute, and

    (b) Measure goodwill as a residual, being the difference between the consideration transferred and the assets acquired, the liabilities assumed and the interests of the non-controlling equity holders.

19. An appropriate measurement attribute could be one of the following:

    (a) Option 1: Measure NCI at fair value. This would be consistent with the measurement attribute of the other components of a business combination. A consequence would be that all of the goodwill would be recognised because the goodwill attributable to NCI would be reflected in the fair value of the NCI.

    (b) Option 2: Measure NCI as a proportionate interest in the business as a whole. This would result in the allocation of a portion of the control premium to NCI.

    (c) Option 3: Measure NCI as a proportion of the identified net assets. This would have the same result as applying the 'partial goodwill' method.

20. An alternative way to express Option 1 is that NCI could be measured as a proportionate interest in the fair value of the identified net assets and the goodwill, excluding the control premium. This is the method proposed in the BC ED. In many cases the resulting NCI under Option 1 will be the same as that measured in the BC ED. However, the difference is that this characterisation results in NCI being measured at a relevant measurement attribute rather than as an accumulation of measurements. There might also be differences between the fair value of NCI measured this way and the NCI measured in Option 1 if there are risk or liquidity adjustments used in measuring the NCI that are not reflected in the fair value of the acquiree as a whole.

21. The staff's preference is first for Option 1 because it is consistent with the measurement of the other components of a business combination and it reflects

the price that could be paid to buy out the NCI holders. This option therefore has the highest informational content.

22. The staff's second preference is Option 2 because it would be operationally easy to apply. It is a mechanical attribution of the NCI's proportionate interest in the fair value of the business as a whole. This option does not relieve the acquirer from having to measure the fair value of the acquiree as a whole. It does, however, relieve the acquirer from having to identify the control premium Because Option 2 attributes some of the control premium to the NCI, the recognised value of NCI does not reflect the price that would be paid to buy out the NCI holders. Option 2 therefore has less informational value than does Option 1.

23. The staff does not recommend using Option 3 for the reasons discussed in the March 2006 Board meetings (IASB Agenda Paper 2B/FASB Memorandum #9). This would understate both NCI and goodwill on the face of the acquirer's balance sheet and would cause operational difficulties during subsequent impairment testing.

24. The staff acknowledges that some Board members might be concerned that measuring NCI directly could imply that goodwill is measured as a consequence of measuring a component of equity. Generally, equity is a consequence of asset and liability recognition rather than the other way around. There are precedents for this approach. IFRS 2 *Share-based Payment* and FASB Statement No. 123, *Share-based Payment*, require that goods or services received be measured 'by reference to the fair value of the equity granted' if this is the more reliable basis (IFRS 2.10).

25. Furthermore, when a put option is attached to the NCI, the NCI is recorded as a liability. If liabilities are to be measured at fair value, it seems inconsistent to have a different measurement objective for the same item (the NCI) only because of the existence of the put option. Put options attached to NCI are discussed in paragraphs 58-62.

Measuring the fair value of the acquiree as a whole

26. Two of the basic principles underlying the BC ED are:

(a) The total amount to be recognised for the acquiree should be the fair value of the acquiree as a whole,[3] and

(b) The assets acquired and liabilities assumed should be recognised and measured at fair value.

27. In laying out the foundation for redeliberations, the staff explained why the first of these principles was not the helpful cornerstone that it was purported to be.[4]

28. Notwithstanding the concerns the staff and Board have about this principle, the staff believes that the goal should be to recognise all assets acquired and liabilities assumed **as if they had been acquired or assumed individually**. In a perfect world, recognising and measuring the individual assets and liabilities at a market exchange value and recognising the fair value of a business acquired as a whole at fair value are indistinguishable. Unfortunately, this is not observed in practice. The main reason for this is the existence of goodwill, which is not directly measurable given the various, and often inter-related and immeasurable, factors that affect its value.[5]

29. Also in a perfect world, it is possible to observe that the fair value of the business as a whole is equal to the sum of the controlling interests and non-controlling interests. A controlling interest has a greater value than a non-controlling interest because of the acquirer's ability to effect changes in the overall business structure and to influence business policies. The existence of a control premium means that the value of the business as a whole actually can be thought of as four components: (1) the controlling interest excluding the control premium, (2) the non-controlling interest, (3) the expected synergies from the combination of the entities, and (4) the control premium.[6] The sum of (1) and (2), in a publicly-traded entity, would be equal to the market capitalisation of the acquiree. Components (3) and (4) would be evident only as a result of a business combination.

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[3] The most common comment from respondents on this issue related to the reliability of measurement of the fair value of the acquiree as a whole. This was addressed in the March 2006 Board meetings (IASB Agenda Paper 2B/FASB Memorandum #9). An excerpt from this paper of the discussion on this topic is shown in Appendix A.

[4] See the April 2006 Joint Agenda Paper 2A.

[5] Even if you were able to identify all assets and liabilities and to allocate synergies, overpayments, and underpayments to them, you would still be left with an 'unidentified' amount. This is due to the interrelationships between assets, which could be described as 'business-specific' synergies. That is to say, they are those synergies that result from the business operating as a going concern, which has nothing to do with the impact of a business combination.

[6] The controlling interest and control premium are shown separately to illustrate that the controlling interest, on its own, plus the non-controlling interest will not add to 100 per cent of the acquiree. There is another factor to consider, which is the control premium.

Estimation of the control premium

30. Based on respondents' comments, it is clear that there is confusion as to how to apply the principles in the IAS 27 ED and the BC ED with regard to the acquisition of a partial controlling interest in another entity, particularly in relation to the control premium.

31. Both the IAS 27 *Consolidated and Separate Financial Statements* Exposure Draft (IAS 27 ED) and the BC ED acknowledge the existence of a control premium and state that the control premium component of goodwill should be allocated only to the **controlling** interest. The IAS 27 ED states that:

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

32. The basis for conclusions in the BC ED states that the allocation of goodwill should reflect 'the assumption that any premium paid by the acquirer for control rights that is included in the full amount of goodwill should be allocated to the acquirer's interests, and not to the non-controlling interest.' (paragraph BC150) This is consistent with valuation theory and empirical studies that show that the control premium relates only to the controlling interest of an entity.

33. Whether an acquirer intends to buy all or less than all of the shares of an acquiree, in many cases the offer is structured such that any NCI holder has the option to tender his or her shares. It might be the case that some opt not to do so.

34. Consider, for example, a tender offer in which the acquirer offered to buy 100 per cent of the shares, but less than 100 per cent of the acquiree's shares are tendered. In such a case the NCI shareholders have, simply by not tendering their shares, opted to not take the control premium offered. Instead, they are hoping that the gains to be realised from the combination of the two firms will be higher than the control premium paid. Because the NCI holders have not given up their shares in exchange for the control premium, the value of their interest should not reflect it.

35. In other cases the offer might be open only to specific NCI holders. This would mean that some have the opportunity to receive the control premium and some have the opportunity to participate in the potential gains to be realised through

the business combination. Regardless of the amount acquired, only the NCI holders that have given up their shares would receive the control premium itself.

36. A control premium is the additional price that any market participant would have to pay to acquire a controlling interest in another entity and exists whenever any size controlling stake is acquired, whether or not it is for 100 per cent of the acquiree.

37. The payment of the control premium gives the acquirer control over the strategic operating and financing policies of the acquired entity and allows them to (try to) realise the synergy potential to be gained from the combination of the two companies. In other words, the control premium is not a quantification of the expected synergies, but it is the price that must be paid **to be given the opportunity** to realise the synergies.

38. The size of the control premium is based on several factors, including, amongst others, the existence of non-operating assets or operational inefficiencies, the quality of management, and any potential business opportunities that are not currently being exploited. However, the **observed** premium paid to acquire a controlling stake in an entity[7] does not only reflect the premium for control, but it also includes other factors. It is therefore difficult, if not impossible, to assess the 'true' premium paid for control, hence respondents' request for guidance in how to determine the amount that should be applied in the estimation of the fair value of the acquiree as a whole when the acquiree is a privately-held entity.

39. Furthermore, observed control premia are stated as percentages or per share amounts. Conceptually, however, the control premium is an absolute number. That is to say, the absolute amount paid for control does not change whether 51 per cent or 100 per cent is acquired—control is control.

40. This poses an operational issue in that the stated premia imply that the amount paid for control increases as larger and larger stakes are acquired. The application of a control premium to a privately-held entity relies on the observed control premia for the 'market' (generally based on transactions in the industry of the acquiree, and adjusted for the specific characteristics of the acquiree). Since the premia are quoted as a percentage of the pre-acquisition traded equity

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

price, the implication is that the larger the stake, the higher the control premium that will be applied.

41. Respondents also commented that the examples in the BC ED are unhelpful, inconsistent and oversimplify the issues so that the guidance cannot be applied in practice. For example, Example 1 (paragraphs A12-A13) conflicts with paragraph 30B(b) in the IAS 27 ED. The IAS 27 ED states that it is not appropriate to 'gross up' the controlling interest to estimate the fair value of the acquiree as a whole. In effect, such a methodology would ascribe a portion of the control premium to the NCI. However, Example 1 has caused confusion with respondents in that it 'grosses up' a 90 per cent interest to estimate the fair value of a 100 per cent interest.

42. In Example 4 (paragraph A63), an 80 per cent interest is acquired and a control premium is reflected in the fair value of the controlling interest. However, it is not clear whether or not the fair value of the acquiree as a whole reflects the control premium and how the control premium was estimated.

43. The staff suggests that some of the examples either be removed from or revised in the final business combinations standard. As an illustration, the staff's proposed revision to Example 4 is provided in Appendix B.

Direct measurement of non-controlling interests

44. As stated previously, the staff thinks that NCI should be recognised and be measured using an appropriate measurement attribute and that only goodwill should be a residual.

45. Of the options in paragraph 19, the staff recommends Option 1. Directly measuring NCI at fair value will accomplish the following:

    (a) NCI will be measured consistently with the assets and liabilities of the entity;

    (b) The goodwill attributable to NCI will, by the nature of the valuation, be included in the fair value of the NCI and will exclude the control premium; and

(c) Goodwill will be the residual, and will capture any over- or underpayments (including buyer-specific synergies), estimation errors, or other differences.[8, 9]

46. The other two options (ie, proportionate to the business as a whole or proportionate to the identified assets and liabilities) would not accomplish these objectives. Another alternative would be to directly measure goodwill. The staff cautions that this would be nearly (if not completely) impossible to do given the unobservable nature of goodwill and the inter-relationship between the variables that drive its value.[10]

Impact of synergies on the value of non-controlling interests

47. Some IASB Board members expressed an alternative view in the BC ED that the NCI should not include synergies attributable to the parent entity. The staff believes that in many cases this will not be an issue because:

(a) it could be argued that the synergies attributable to the entire entity (even those that have not been 'pushed down' to a CGU/RU) benefit all interest holders, not just the controlling interests. It is likely that many of the cost savings/revenue enhancements associated with the acquisition would flow to the NCI as well as to the controlling interest. The staff therefore believes that, in most cases, it would not be necessary to 'strip out' many of the synergies because they will benefit all interest holders of the entity.

(b) any buyer-specific synergies (including overpayments) would not be incorporated into the fair value of the NCI if it was measured directly. This is because the goodwill associated with the NCI would reflect only the portion of goodwill attributable to the NCI.

48. Having said that, the staff would like to point out that in practice acquirers often do an analysis of the synergies they expect to realise as a result of the business combination because the perceived value of (some portion of) the synergies is incorporated into the transaction price (as evidenced by the many transaction announcements in which expected synergies are quantified). Often these

[8] This is not to imply that the valuation of NCI will never result in measurement errors, but only to state that the cumulative effect of any errors (including those from the measurement of the assets acquired and liabilities assumed) would be captured in goodwill rather than equity at initial recognition.

[9] The fact that the goodwill attributable to the NCI is implied by the total goodwill of the entity means that there is potential for the measurement errors and other issues related to goodwill to be reflected in the carrying value of NCI upon subsequent measurement. The staff believes that this will be the case regardless of the option chosen and that Option 1 is the 'cleanest' methodology.

[10] Other practical issues include the selection of an appropriate discount rate, estimating future growth rates based on currently unidentified future product launches, etc.

analyses are detailed enough to allow the preparer to see which are entity specific vs. market participant and the CGU/RU to which they relate (if any).

49. In fact, the staff is aware that it is not unlikely that some portion of the acquired goodwill will be allocated to other CGUs/RUs of the acquirer. This generally would be based on the acquiring entity's view of where within the combined company the synergies will be realised. See paragraphs 66-79 and Appendix C for a discussion and example of how this has the potential to affect goodwill impairment testing.

Measurement based on the transaction price (implicit measurement)

50. Directly measuring NCI does not mean that the valuation of the controlling interests and non-controlling interests should be done independently. As stated in paragraph 29 the fair value of a business as a whole is the sum of the controlling interest (including the control premium) and the non-controlling interest. Presumably the fair value of the acquiree as a whole is known or could reasonably be determined (see Appendix A). The acquirer knows how much it paid for its controlling stake in the acquiree. The purchase price includes any control premium paid. As proposed in the BC ED, the difference **must be** the value of the non-controlling interest (excluding the control premium). That is not to say that NCI is a residual because it can be calculated implicitly in this way. Although it is simply a mathematical exercise, the fact is that the value of the whole must equal the sum of the parts.

Measurement based on traded share prices (explicit measurement)

51. Alternatively, with a publicly-traded entity, the NCI can be estimate based on the trading price prior to the acquisition announcement. Since traded share prices are based on minority holdings, the fair value of the NCI is simply the product of the share price and the number of shares held by the NCI holders. Again, the value of the whole must equal the sum of the parts. The consideration paid for the controlling interest plus the fair value of the NCI must equal (or very nearly approximate) the fair value of the acquiree as a whole. If the sum of NCI measured in this way and the consideration paid does not equal the estimate of the fair value of the acquiree as a whole, then arguably this would be evidence that the fair value of the controlling interest is not equal to the

consideration transferred[11] (or that there is an error in the calculations and/or the assumptions).

Measurement of a previously held non-controlling interest

52. The BC ED proposes that any NCI held in the acquiree prior to obtaining a controlling interest be measured at fair value with any gain or loss taken in income (paragraph 56 of the BC ED). This requires that the acquirer measure the fair value of the previously held NCI at the acquisition date.

53. The staff believes that it is inconsistent to require the previously held NCI to be measured at fair value at the acquisition date, yet not to require any NCI remaining after the business combination to be also measured at fair value. In fact, the fair value of the previously held NCI and the post-acquisition NCI, at the acquisition date, can be measured simultaneously.

54. For example, Company A holds a 40 per cent interest in Company B. Company B is a publicly-traded entity trading at CU3.00-CU3.05 per share. Company A announces that it intends to acquire 15 per cent to achieve a controlling interest of 55 per cent. The price to be paid by Company A is CU3.15 per share. The fair value of the NCI (both Company A's prior holding and the 'new' NCI of 45 per cent) can be measured using the trading price prior to the announcement. Theoretically there should be no difference in the fair value of the NCI held by the acquirer prior to obtaining a controlling interest and the NCI held by the NCI holders after the acquisition **if the measurement date is the same**.[12]

55. There could be a difference between the fair value of the NCI held by the acquirer prior to the acquisition and the NCI held by the NCI holders after the acquisition **if the measurement date is different**. For example, the market participant synergies expected to be realised as a result of the acquisition will not be reflected in the share price prior to the announcement of the acquisition, but will be reflected after the announcement.

56. This becomes more complicated when the minority stake is held in a privately-held company. Still the concept is the same—if the measurement date is the

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[11] See the October 2006 IASB Agenda Paper 2E/FASB Memorandum #30/Joint Agenda Paper 5A for a discussion about whether the consideration transferred for a partial acquisition is representative of the fair value of the acquired interest.

[12] For simplicity the staff has stated that the fair value before and after will be the same. This does mean that the fair value itself will be the same, but that the basis for measuring fair value will be the same. For example, if the fair value of the 'old' NCI was CU3.00 per share, the fair value of the 'new' NCI would be CU3.00 per share, and vice versa.

same, the fair value of the NCI held by the acquirer prior to the acquisition and the NCI held by the NCI holders after the acquisition will be the same.[13]

Fair value measurement guidance in the BC ED

57. In that regard, some respondents stated that Appendix E of the BC ED does not provide sufficient guidance regarding the application of valuation techniques to privately-held entities (whether for the valuation of controlling or non-controlling interests). They state that Appendix E does not articulate sufficiently the underlying principles. The staff does not agree. Appendix E is meant only to provide general guidance regarding valuation methodologies and principles as they apply to measuring at fair value the assets acquired and liabilities assumed in a business combination. It is not meant to provide detailed guidance regarding specific assumptions to be made in determining those fair values.

Put options on non-controlling interests

58. As part of the purchase of a controlling interest in the subsidiary a parent entity sometimes enters into a commitment, through a written put option or a forward contract, to acquire the shares of a subsidiary held by a third party. The payment might be fixed, or based on the fair value of the shares at the settlement date or based on a formula (eg, a multiple of EBITDA or net income).

59. The IASB IFRIC has been asked whether any variability in the amount potentially payable under a forward commitment or a put to a [non-controlling] minority interest entered into as part of a business combination is contingent or deferred consideration under IFRS 3.

60. The staff believes that puts or forwards are relevant to the current discussion because the measurement objective for an instrument with a put or forward attached to it is similar to the measurement objective for NCI.

61. Suppose that an entity acquired a controlling interest in another entity and issued a put to the remaining shares. That is to say, the equity instruments of the acquiree are not purchased as part of the acquisition but the owner of those shares can elect to put them to the acquirer at some point in the future. As far as the subsidiary is concerned, those shares are equity instruments. From the perspective of a business combination, however, the instruments are likely to be recognised as liabilities. That is to say, the instruments would not be recognised

[13] Differences might arise due to factors that could affect the fair value of the 'new' NCI that did not apply to the 'old' NCI. These could include a put option on the NCI or other negotiated rights (such as special voting rights) for the NCI holders. Most likely, this would apply in the case of a privately held acquiree, but it is possible that it could affect the fair value of a publicly-traded acquiree.

as NCI in a business combination. That being so, those instruments would, presumably, be recognised as liabilities and measured at their acquisition-date fair value (even though they will continue to be equity instruments in the acquiree's separate, or individual, financial statements).

62. The fair value of these instruments is likely to be different from the fair value of the instruments if they did not have the put attached. However, the staff thinks that the measurement attribute for a financial instrument that represents interests the investors who share in the risks and rewards for the subsidiary in which an acquirer has obtained a controlling interest should be the same whether that instrument has a put or forward attached to it or not. That attribute should be fair value.

Transactions between the controlling and non-controlling interests

63. The Boards have agreed that the interests of the shareholders in the parent entity are particularly important, and have agreed that the final standard should include a requirement to disclose supplementary schedules about those interests.

64. The proposals will require transactions between the controlling and non-controlling interests in a subsidiary be accounted for as transactions between equity holders. By measuring NCI at fair value at the acquisition date, any subsequent exchange between the controlling and non-controlling interests would reflect the change in fair value between initial recognition and the date of exchange. If NCI is recognised, initially, using another approach the change in the carrying amount of the controlling interests will reflect both the change in fair value and a 'correction' for the portion of the difference between fair value of NCI on the date of exchange and the amount recognised at acquisition date. For example, if the purchased goodwill method (Option 3) is used the change in the controlling interests will be the change in fair value, plus the NCI's previously unrecognised goodwill, plus any changes to that portion of goodwill. If Option 2 is used to measure NCI the change in the controlling interests would be the change in fair value of the NCI plus or minus the portion of the control premium and any over or under payments previously allocated (incorrectly) to the NCI.

65. The staff believes that recognising the change in fair value (ie, Option 1) provides more useful information than the change measured under Options 2 or 3.

Goodwill impairment testing

66. The issue of goodwill allocation between controlling and non-controlling interests and between reporting units (RU) or cash-generating units (CGU) was addressed in the March 2006 Board meetings (IASB Agenda Paper 2B/FASB Memorandum #9) and in the July 2003 Board meetings (IASB Agenda Paper 2A/FASB Memorandum #2). An excerpt from the March 2006 agenda papers is provided in Appendix A.

Initial recognition and subsequent measurement

67. The methodology proposed in the BC ED appropriately reflects the value of the control rights that accompany the purchase of a controlling ownership interest because the measurement of the controlling interest reflects the control premium whereas the goodwill attributed to the NCI does not. Both interests reflect the (market participant) synergies expected to be realised from the business combination (see discussion in paragraphs 47-49 above).

68. In the BC ED proposal, the acquirer recognises all of the goodwill at the acquisition date. Subsequently, the acquirer would not need to separately measure the operations that are less than wholly-owned because the acquirer would be comparing the fair value of 100 per cent of the RU/CGU to 100 per cent of its carrying amount.

69. However, there is a trade-off between the reliability of measurement for initial recognition and subsequent measurement for annual impairment testing. If an acquiree is absorbed into an existing RU or CGU, the subsequent measurement becomes more complicated.

Goodwill impairment losses

70. Paragraphs C8-C10 of the amended IAS 36 *Impairment of Assets* (after the revised IFRS 3 becomes effective) states:

> C8. In a cash-generating unit that includes a partially-owned subsidiary or is a stand-alone partially-owned subsidiary, goodwill impairment losses are allocated between the controlling and non-controlling interests pro rata using the relative carrying values of goodwill.
>
> C9. If the partially-owned subsidiary is itself a cash-generating unit, the impairment loss is allocated to the controlling and non-controlling interests on the basis of the relative carrying values of goodwill allocated to them.
>
> C10. If the partially-owned subsidiary is part of a larger cash-generating unit, goodwill impairment losses are allocated first to

> the components of the cash-generating unit and then to the controlling and non-controlling interests of the partially-owned subsidiary. The portion of the impairment loss allocated to the subsidiary is determined by multiplying the goodwill impairment loss for the unit by the carrying value of the goodwill assigned to that subsidiary, divided by the carrying value of the goodwill assigned to the cash-generating unit as a whole. The amount of impairment loss allocated to the partially owned subsidiary is then allocated to the controlling and non-controlling interests on the basis of the relative carrying values of goodwill allocated to those interests.

71. Paragraph 38 of the amended FASB Statement No. 142, *Goodwill and Other Intangible Assets* (after Statement 141R becomes effective) states:

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

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

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

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

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

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

(b) Second, they are allocated between the controlling interest and NCI as described in paragraph 72. The NCI portion would be calculated as:

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

74. Neither of the amended Standards will provide sufficient guidance to address how to treat pre-existing goodwill (ie, that which exists as a result of previous acquisitions) within a CGU/RU, how to apply a goodwill impairment loss to a CGU/RU that contains more than one subsidiary,[14] or how to apply a goodwill impairment loss to the NCI of a subsidiary when the goodwill of that subsidiary has been allocated to other CGUs/RUs of the acquirer.

75. For example, Example 7A in the amended IAS 36 illustrates the proposed accounting treatment of a goodwill impairment loss using a simple example involving one acquiree that becomes its own CGU. The total impairment loss is simply split between the controlling and non-controlling interests. The example does not address, however, the more likely situations in which (a) the acquiree is absorbed into an existing CGU, (b) the acquiree is split into more than one CGU, or (c) the CGU has pre-existing goodwill from a previous acquisition. Similarly, the amended Statement 142 only provides an example related to disclosure requirements.

76. The staff questions the appropriateness of the proposed methodology for attributing goodwill between the controlling and non-controlling interests as described in paragraph 73(b). In circumstances in which a portion of the acquiree's goodwill is allocated to other CGUs/RUs, the staff wonders if the impairment loss attributable to NCI instead should be based on the percentage ownership of NCI, be related to the proportion of goodwill that remains in the acquiree, or if perhaps some other methodology would be better. The staff therefore suggests that further work be done with regard to this issue.

77. An example of how the BC ED's proposed methodology could be extended to Example 4 of the BC ED is shown in Appendix C. The example is based on a situation in which the acquiree is absorbed into an existing CGU/RU and the goodwill of the acquiree has been allocated to other CGUs/RUs of the acquirer based on the acquirer's expectations regarding the realisation of synergies.

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[14] The latter is more an issue for the FASB since a CGU under IFRSs will generally be at a lower level than an RU under US GAAP.

78. Goodwill impairment testing becomes more complicated once the acquiree becomes fully integrated into the acquiring entity (for those which are not a separate CGU/RU). This is particularly an issue when, perhaps years after the acquisition, an acquiring entity undergoes a restructuring process. The acquiring entity must separately track the goodwill that was originally ascribed to the subsidiary even if it is combined with other subsidiaries that form a larger CGU/RU.

79. However, this is a problem that currently exists in practice, and it happens whether the controlling interest is 100 per cent or less than 100 per cent. It also happens regardless of the methodology used to ascribe goodwill to NCI. The staff therefore suggests addressing subsequent measurement in this situation as part of the impairments project.[15]

Staff Recommendations

80. The staff believes that the terms 'full goodwill' and 'partial (or purchased) goodwill' are unhelpful and that it would be more useful to remove this terminology.

81. The staff thinks that NCI should be measured directly using an appropriate measurement attribute, with goodwill being the residual. The staff suggests using Option 1 (see paragraph 19) and measuring NCI at fair value.

82. The staff does not recommend providing additional application guidance in Appendix A or Appendix E with regard to the valuation of privately-held entities or with regard to the treatment of a control premium. The staff agrees that the standard should provide guidance on general valuation issues; however, the staff thinks sufficient guidance is provided in the BC ED.

83. The staff recommends that further work be done with regard to the attribution of acquired goodwill between the controlling and non-controlling interests, particularly in situations in which a portion of the acquired goodwill has been allocated to other CGUs/RUs of the acquiring entity.

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[15] This is one area of divergence between IFRS and US GAAP. Other significant 'day 2' issues include (1) the level at which the impairment testing is done because there is a practical difference between what constitutes a CGU and what constitutes an RU; and (2) US GAAP includes several steps of impairment testing and IFRS includes one step.

Questions for the Boards

84. Do the Boards agree that the change of focus from goodwill to NCI is helpful?

85. Do the Boards agree that NCI should be measured directly rather than being a residual?

- **(a) If the Boards agree that it should be directly measured, should NCI be measured at fair value or at something other than fair value (such as a proportion of the business as a whole or a proportion of the identified assets)?**

86. Do the Boards want to provide additional application guidance (in Appendix A and/or Appendix E) regarding (i) the measurement and application of a control premium or (ii) the valuation of privately-held entities?

87. Do the Boards agree that further work should be done with regard to the attribution of acquired goodwill between controlling and non-controlling interests in situations in which a portion of the acquired goodwill has been allocated to other CGUs/RUs of the acquiring entity?

Appendix A: Excerpts from the March 2006 IASB Agenda Paper 2B/FASB Memorandum #9

[Appendix A has been omitted from observer note].

Appendix B: Illustration of a proposed example

Example 4—Initial Calculation of Goodwill and Non-controlling Interests in the Acquiree

B1. On 1 January 20X5, AC acquires 80 per cent of the equity interests in TC, a privately-held entity, for CU160. There is no evidence to suggest that this transaction is not an exchange of equal values. Therefore, the consideration transferred of CU160 is presumed to be the fair value of the 80 per cent interest acquired by AC.

B2. Through valuation techniques, the fair value of TC as a whole is determined to be CU195, which includes the market participant synergies expected from the transaction and a control premium.[*Note: These last two characteristics must be specified in order to avoid confusion. It is possible to interpret the fair value of CU195 to mean either that it reflects the fact that the acquisition has taken place (and potentially including buyer-specific synergies) or that it does not. It also can be interpreted to mean that it includes the control premium or that it does not. Different interpretations would lead to different figures being recorded.*] The fair value of the 20 per cent non-controlling interest, therefore, is CU35. [*Note: This is the amount that will be recorded as NCI on the consolidated balance sheet.*]

B3. As of the acquisition date, the fair value of the separately recognisable identifiable assets acquired is CU210 and the fair value of the liabilities assumed is CU60. On the basis of those facts, the amount of goodwill is measured as follows:

Fair value of TC	195
Less: net amount of the fair values of the separately recognised identifiable assets acquired and liabilities assumed [CU210– CU60]	(150)
Total goodwill	45

B4. [*Note: The total goodwill of CU45 will be recorded on the consolidated balance sheet. Note that, when NCI is measured directly, the amount of goodwill attributable to the controlling and non-controlling interests is relevant only for impairment testing purposes for calculating the relative proportions of any goodwill impairment loss. However, the staff questions whether the approach in the remainder of the example is appropriate, particularly in circumstances in which a portion of the acquiree's goodwill is allocated to other CGUs/RUs.*]

B5. For purposes of goodwill impairment testing, the proportion of goodwill attributable to AC and to the non-controlling interests of TC is calculated as follows:

Fair value of AC's 80 per cent interest in TC	160	
Less: AC's share of the fair value of the identifiable net assets acquired (80 per cent × [CU210 – CU60])	(120)	
Goodwill attributable to AC	40	89.9%
Goodwill attributable to the non-controlling interests in TC [CU45 – CU40]	5	11.1%

B6. Therefore, the portion of the goodwill of TC attributable to AC is 89.9 per cent [CU40 ÷ CU45] and the goodwill attributable to the non-controlling interests is 11.1 per cent [CU5 ÷ CU45].

B7. [*Note: This example clearly illustrates, as stated in the IAS 27 ED, that the fair value of the NCI will not equal 20 per cent of the fair value of the acquiree as a whole when a control premium is reflected in the controlling interest stake. Similarly, the controlling interest will be higher than 80 per cent because of the control premium. In this example, the fair value of the acquiree as a whole is comprised of:*

Controlling interest (excluding the control premium)	*71.8%*
Control premium	*10.3%*
Total controlling interest	*82.1%*
Non-controlling interest	*17.9%*

[Remainder of paragraph omitted from observer note].

Appendix C: Illustration of goodwill impairment loss allocation

[Appendix C has been omitted from observer note].