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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting:	**22 February 2007, London**
Project:	**Business Combinations II**
Subject:	**Proposed Amendments to IAS 27/Proposed Replacement of ARB 51: Attribution of Profits or Losses to Controlling and Non-controlling Interests (Agenda Paper 2C(i))**

INTRODUCTION

1. This Agenda Paper is presented in two sections:

   a. The first section addresses the question how profits or losses and changes in equity/other comprehensive income (OCI) should be attributed to controlling and non-controlling interests.

   b. The second section analyses situations where losses attributable to non-controlling interest exceed the non-controlling interests equity.

ATTRIBUTION OF PROFIT OR LOSS AND CHANGES IN EQUITY/OCI

2. The FASB ED (the proposed replacement of ARB 51) contains detailed guidance on the attribution of profits or losses and changes in equity/OCI to the controlling and non-controlling interests. The FASB decided to add this guidance during its initial deliberations. In contrast, the IASB ED proposes no such guidance. This section analyses whether the FASB should affirm its proposal and whether the IASB should provide similar guidance in an amended IAS 27.

3. Paragraph 21 of the FASB ED states:

> Net income or loss and each component of other comprehensive income shall be attributed to the controlling and non-controlling interests. That attribution shall be based on relative ownership interests unless the controlling and non-controlling interests have entered into a contractual arrangement that requires net income or loss or the components of other comprehensive income to be attributed differently between them. In that case, net income or loss and the components of other comprehensive income shall be attributed to the controlling and non-controlling interests based on the contractual requirements of that arrangement.[6]
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> [6] The Board is researching in a separate effort whether or how variable interest entities should apply the guidance in this paragraph. In addition, paragraph 38 of FASB Statement No. 142, Goodwill and Other Intangible Assets, as amended by proposed Statements 141(R), provides guidance for assigning goodwill impairment losses to controlling and non-controlling interests of a partially owned subsidiary.

4. During initial deliberations, the staff recommended that the IASB not address this issue because paragraph 23 of IAS 27 contains already guidance on the attribution of profits or losses to controlling and non-controlling interest. Paragraph 23 states:

> When potential voting rights exist, the proportions of profit or loss and changes in equity allocated to the parent and minority interests are determined on the basis of present ownership interests and do not reflect the possible exercise or conversion of potential voting rights.

5. FASB constituents' views on the proposal in the FASB's NCI ED were mixed. Most constituents who agreed with the proposal did not provide a rationale for their opinion. Constituents who disagreed with the FASB proposal had the following comments:

   a. *The proposed attribution requirement adds unnecessary complexity to the financial statements, creates confusion and represents an irrelevant disclosure item.* The staff disagrees that the proposed attribution adds complexity to the financial statements. Entities are already required to attribute income and losses and OCI to the controlling and non-controlling interests (even thought the non-controlling interest's share is recognised as an expense under US GAAP.) As such, the proposal does not add complexity, it just clarifies what is already being done. In addition, providing guidance on how to do that attribution should decrease confusion rather than increase it. The staff does not see how the income attributable to the non-controlling interest could be an irrelevant disclosure item.

b. *Any attribution to controlling and non-controlling interest is subjective in nature (even if it appears objective as a quantitative calculation) and is not a faithful representation of economic activity and ownership characteristics of the equity of the entity.* The staff disagrees that the attribution is subjective. It is based on ownership interests or the terms of a contract. The guidance just clarifies the attribution and makes the attribution less subjective.

c. *An allocation based on contractual arrangements could be subject to abuse.* It is not clear how or why this would be the case. Although the controlling interest might be motivated to enter into a profit sharing arrangement that provides it earnings in excess of its ownership interest, it is not clear why the non-controlling interest would agree to it. If they did, then the terms of the contract should dictate how the earnings are attributed.

d. *The statement of comprehensive income is already too confusing and the requirements of the FASB ED would add to that confusion.* Statement 130 already requires that OCI be attributed between the controlling and non-controlling interests, although some would argue that that requirement is not clear since it can only be inferred from a discussion in the basis for conclusions. The proposed guidance only clarifies what is already required.

6. In addition, a number of FASB constituents expressed concerns about the lack of guidance for attributing net income or loss and the components of other comprehensive income to variable interest entities. Constituents understood that the FASB is researching separately whether to provide additional guidance for variable interest entities, but they requested that this guidance be provided as soon

as possible because it is currently an issue, or at least before the business combinations standard is issued.

7. IASB constituents did not express similar concerns. The staff suspects that IASB respondents did not express concern because the IASB did not propose any new guidance. Typically, respondents only comment on proposed changes, not existing guidance.

8. The staff thinks, however, that the absence of concern from IASB respondents suggests that IAS 27 *Consolidated and Separate Financial Statements* is not causing significant problems in relation to allocation of profits and losses. Respondents have commented on current requirements when they view them as problematic, so the silence can be informative. The staff believes that the concerns expressed by FASB respondents are genuine but that the IASB experience suggests that they are unlikely to cause a significant practice issue as those respondents fear. If anything, the staff thinks that the FASB's proposals provide clearer guidance than IAS 27 because of improved wording.

9. The staff notes that paragraph 23 of IAS 27 addresses only the attribution of profits or losses to controlling and non-controlling interest when potential voting rights exist. We believe that the IASB intended the same attribution principle as stated in paragraph 23 of IAS 27 to guide the profit or loss attribution between controlling and non-controlling interests in absence of potential voting rights. However, this principle is not stated explicitly in IAS 27. The staff notes also that IAS 27 is silent on how to attribute profits or losses when contractual arrangements (ie profit sharing agreements) stipulate a sharing of profits or losses between the controlling and non-controlling interests which is disproportional to their ownership interests. The staff therefore recommends that the IASB add additional guidance to IAS 27, similar to that in paragraph 21 of the FASB ED, on how profits or losses and changes in equity should be attributed between controlling and non-controlling interests.

10. The staff acknowledges that some FASB constituents question the informational relevance of attributing profits or losses to controlling and non-controlling interests and are concerned about the complexity and abuse-potential of such an

attribution. However, the staff believes information on how profits or losses should be attributed by the controlling or non-controlling interest to be critical for the analysis of financial statements (ie for the valuation of the group's controlling interest). Discussions that IASB staff have had with analysts indicate that this is one area where there is relatively widespread agreement—understanding the relative interests in the financial performance of a business is essential to being able to value the interests of the primary shareholders.

11. IAS 27 already requires an attribution of profits or losses to controlling and non-controlling interest. The staff recommendation is that the FASB affirms the guidance proposed in paragraph 21 of the FASB ED and that the IASB amend the existing guidance. By agreeing to reaffirm the proposal in its exposure draft the FASB will be providing guidance consistent with IFRSs. And by agreeing to adopt the FASB ED's wording the IASB will ensure that the allocation guidance is converged with US GAAP.

Does the FASB agree to affirm its proposed guidance (in paragraph 21 of the NCI ED)?

Does the IASB agree to add guidance, similar to that in paragraph 21 of the FASB ED, on how profits or losses and changes in equity should be allocated between controlling and non-controlling interests in IAS 27?

Attribution of losses in excess of NCI's equity

12. Paragraph 35 of IASB ED / Paragraph 22 of the FASB ED states:

> Losses applicable to the non-controlling interest in a consolidated subsidiary may exceed the non-controlling interest in the subsidiary's equity. The excess, and any further losses attributable to the non-controlling interest shall be allocated to non-controlling interest.

13. Paragraphs BC14 and BC15 of ED IAS 27 summarise the IASB's basis for conclusions as follows:

> The current version of IAS 27 states that when losses attributed to the minority (ie non-controlling interest) exceed the minority's interest in the subsidiary's equity, 'the excess, and any further losses applicable to the minority are allocated against the majority interest except to the extent that the minority has a binding obligation and is able to make an additional investment to cover losses'.
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> The Board decided that this treatment was inconsistent with its conclusion that non-controlling interests are part of the equity of the group. Although it is true that non-controlling interests have no further obligation to contribute assets to the subsidiary, the parent has no further obligation either. Non-controlling interests participate proportionally in the risks and rewards of an investment in the subsidiary. If a non-controlling interest enters into an arrangement that obligates it to the subsidiary, the Board believes that that arrangement should be accounted for separately and the arrangement should not affect the way losses are attributed to the controlling and non-controlling interests. Thus the Board concluded that losses applicable to non-controlling interests should be attributed to them, even if doing so would result in a non-controlling interest being reported as a deficit.

Paragraphs B17 and 18 of FASB ED summarise the FASB's basis for conclusions as follows:

> B17. In this Statement, the Board reconsidered whether losses of a partially owned subsidiary in excess of the noncontrolling interests' equity capital should be attributed to noncontrolling interests. ARB 51 required that:
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> > In the unusual case in which losses applicable to the minority interest in a subsidiary exceed the minority interest in the equity capital of the subsidiary, such excess and any further losses applicable to the minority interest should be charged against the majority interest, as there is no obligation of the minority interest to make good such losses. [paragraph 15]
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> B18. The Board concluded that that requirement was based on the view that the noncontrolling interest lacks characteristics of equity. While it is true that noncontrolling interests have no further obligation to contribute assets to the subsidiary, the parent has no further obligation either. Noncontrolling interests participate proportionately in the risks and rewards of an investment in the subsidiary. If a noncontrolling interest holder enters into an arrangement that obligates itself to the subsidiary, the Board believes that that arrangement should be accounted for separately and that arrangement should not affect the way losses are attributed to the controlling and noncontrolling interests.

> Thus, the Board concluded that losses applicable to noncontrolling interests should be attributed to them, even if doing so would result in a deficit noncontrolling interest.

14. Some constituents agreed with the proposal, noting that non-controlling interests share proportionately in the risks and rewards of the investment in the subsidiary and that the proposal is consistent with the classification of non-controlling interests as equity. Those constituents offered the following suggestions to improve the guidance:

    a. The Board should provide guidance on the accounting for guarantees and similar arrangements between controlling and non-controlling interests, in particular (1) an arrangement that involves a floor on the non-controlling interest holders' losses in the subsidiary, and (2) an arrangement that requires the parent to provide additional funding to the subsidiary in the event of subsidiary losses.

    b. The Basis of Conclusions should be expanded to emphasise that, if the losses are in excess of the subsidiary's equity, the controlling interest would have to consider whether it should recognise a liability to fund the losses.

    c. The Board should require disclosures on inter-company guarantees and the extent of deficits, if any, of non-controlling interests.

15. Other constituents disagree with the proposal, often because they prefer the parent entity perspective and do not think that controlling and non-controlling interests should be treated alike. Those constituents argued that there is no need to change the current guidance in ARB 51 and IAS 27 (ie that excess losses should be allocated to the controlling interest unless the non-controlling interest has a binding obligation and is able to make an additional investment to cover the losses).

16. In addition, constituents who disagreed with the proposal offered the following reasons:

    a. The proposal does not reflect the economics of the situation. The non-controlling interest is not compelled to cover the deficit (unless otherwise specifically agreed) and it is reasonable to assume that, should the subsidiary call for additional capital in order to continue operations, the non-controlling interest would prefer to abandon its investment. On the other hand, the controlling interest has an implicit obligation to maintain the subsidiary as a going concern.

b. Under the proposals, guarantees or other support arrangements, without any effect on the way losses are attributed to the controlling and non-controlling interests, would be recognised separately. Constituents did not believe that this would reflect the underlying economics, which are that one party would absorb the losses of the subsidiary. In their view, it is misleading for financial statements to imply that the non-controlling interest has an obligation to make additional investments.

c. Constituents also believed that recognising guarantees separately is contrary to the principle of the non-recognition of transactions between equity holders.

d. Loss allocation should take into account legal, regulatory or contractual constraints some of which may prevent entities from recognising negative non-controlling interests, especially for regulated businesses (banks and insurers).

17. For example PwC wrote:

> This requirement may result in the non-controlling interest absorbing losses that it will never suffer economically since these losses are generally absorbed by the parent shareholders. Since we believe that the non-controlling interest should be presented separately from parent company equity, it would be consistent for these losses to be charged against the controlling interest. We acknowledge that the parent entity may not have any legal obligation to contribute assets to the subsidiary, but also note that the non-controlling interest does not have such a legal obligation either. However, because of its relationship with its subsidiary, we have observed in practice that the parent is more likely to fund such losses to protect its investment in the subsidiaries. We therefore suggest that current practice under both US GAAP and IFRS should not be altered.

18. The Accounting Standards Committee of Germany wrote:

> Misleading information may result from the aggregation of several positive and negative controlling interests. Therefore we prefer the current treatment under IAS 27.35 or recommend requiring additional disclosure of the negative amount of non-controlling interests insofar as there are no binding obligations to make an additional capital contribution to cover losses.

19. The staff assessment of the comment letters is that there are two main themes. Firstly, a deficit in equity is different to positive equity and there might be different levels of responsibility for making good a deficit between the controlling and non-controlling interests. Second, the proposals do not appear to take into consideration arrangements such as cross-guarantees.

20. Many of the concerns expressed in the comment letters about a deficit for NCI generally relate to the fact that the non-controlling interest is not legally required to contribute additional capital to the group in order to make good losses in excess of its equity . The staff thinks that there is merit in the concerns raised. However, the staff also thinks that this is an issue that is wider than negative NCI. The liabilities of a subsidiary are not liabilities of the entire group, and there are often factors that restrict the ability of a parent entity to move assets around a group—which means that the assets of the group are not necessarily freely available to that entity.

21. On the face of it, in most jurisdictions, shareholders are not legally required to make up for a corporation's losses in excess of its equity. Some jurisdictions will claw back losses from shareholders in some circumstances but in other cases the shareholders can walk away from accumulated losses. In practice it is sometimes in the best interest of some or all shareholders to contribute additional capital to the corporation and to assume the losses in excess of equity. Whether the simple aggregation of accumulated losses with the retained earnings of other parts of a group is a fair presentation will depend on the circumstances of the entity reporting. Those circumstances might include how those losses arose, the legal or constructive obligation to make good losses and the intentions of management.

22. The current proposals are predicated on the assumption that components of equity such as negative and positive equity of subsidiaries (whether they are attributable to the controlling or non-controlling interests) are economically similar. This means they can be added together without any loss of information. Many respondents appear to challenge this assumption.

23. The staff continues to believe that it is appropriate to continue to allocate losses to NCI even if the NCI is in deficit. If the affected subsidiary trades its way to a

surplus, all of the subsdiary shareholders including the NCI will share in that recovery. However, the staff also thinks that users would welcome information about how any deficit affects the controlling and non-controlling interests such as cross-guarantees. This analysis reflects the staff assessment that a cross-guarantee is more likely to affect the relative rights and responsibilities associated with a deficit rather than the allocation of profits and losses.

24. Consistent with this, the staff believes that the decision-usefulness of financial statements is reduced if losses in excess of the subsidiary's equity are attributed to the controlling and non-controlling interest if those losses will not be recovered (from one or both of the parties). In those circumstances, the staff believes that it is preferable to present losses in excess of a subsidiary's equity (for which no legal, contractual or constructive obligation to bear those losses has been incurred by the controlling or non-controlling interest) separately from retained earnings. Some staff think they should be a separate item of equity whereas other staff think that it is sufficient to separate negative and positive components of equity within the controlling and non-controlling interest disclosures.

25. Some staff think that the proposal to allocate losses to NCI in excess of the NCI's equity in a subsidiary should be reaffirmed, but that the final standards should include a requirement for a group to disclose material accumulated losses in subsidiaries in which there is a non-controlling interest and to describe any contractual or other factors that will help users assess the recoverability of those losses.

26. Other staff agree that the allocation of losses to NCI should be reaffirmed but are less supportive of additional disclosures. First of all, those staff do not see why the Board would provide such a limited disclosure. If the Boards found merit in the disclosure, they suggest that the disclosure be expanded to require a group to disclose material accumulated losses in all subsidiaries, not just those in which there is a non-controlling interest. Second of all, those staff are concerned that the recorded "losses" do not necessarily equate to the amount of a guarantee. That is, to some extent, the recorded losses do not reflect the true economic circumstances or the amount of working capital a subsidiary needs. That is because US GAAP

and IFRS do not require recognition of all assets and liabilities and many recognised assets and liabilities are not measured at fair value.

27. On one hand, it seems clear that information that helps users assess which of the owners in the group are likely to be responsible for deficits in members of the group (if at all) would be useful. An obvious candidate for this is information about cross-guarantees, for example. On the other hand, adding a requirement to provide information about the relative interests of the controlling and non-controlling interests in deficits seems piecemeal. The discussions the IASB staff have had with analyst groups suggests that it might be more appropriate to address disclosures about NCI as part of a more comprehensive review.

28. The preliminary assessment of the staff is that (a) requiring the separation of negative equity from positive equity and (b) a requirement to disclose information about cross-guarantees, for example, that affect the relative responsibility of equity holders to make good those deficits is likely to provide the sort of information users would find helpful. However, the staff remains concerned that adding piecemeal disclosures does not address the more fundamental question of what the disclosures in consolidated financial reports ought to be. That is beyond the scope of this project and, in the staff view, should be addressed in the consolidations project. The staff seeks direction from the Boards on this matter.

Do the Boards agree that the requirement to continue to allocate losses in excess of the NCI's equity of a subsidiary should be affirmed?

Do the Boards want the staff to assess a requirement for a group to disclose material accumulated losses in subsidiaries in which there is a non-controlling interest and to explain any contractual or other factors that will help users assess the recoverability of those losses?