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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **21 March 2007, London**

Project: **Business Combinations II**

Subject: **Accounting for Bargain Purchases (Agenda Paper 2C)**

The issue discussed in this paper is relevant only if NCI is measured at fair value because if NCI is measured as its proportion of identifiable net assets, goodwill attributable to the NCI will not be recognised in any circumstance, including bargain purchases. Therefore, if the IASB decides not to permit the measurement of NCI at fair value in any circumstance (see IASB Agenda Paper 2A), the IASB will not discuss this paper at the March meeting.

Background

1. In March 2006, the Boards tentatively affirmed the accounting for bargain purchases proposed in the Business Combinations Exposure Draft (BC ED):

> If the fair value of the acquirer's interest in the acquiree exceeds the fair value of the consideration transferred for that interest, the acquirer shall account for that excess by reducing the amount of goodwill that otherwise would be recognised. If the goodwill related to that business combination is reduced to zero, any remaining excess shall be recognised as a gain attributable to the acquirer on the acquisition date.

2. The proposed guidance is based on the BC ED's approach of measuring the fair value of the acquiree as a whole to calculate goodwill and then attributing goodwill to the controlling interest and non-controlling interests (NCI). However, in October 2006, the Boards tentatively decided that it is more

helpful to focus on the measurement of NCI and to calculate goodwill as the excess of:

a. the consideration transferred plus the recognised amount of the NCI in the acquiree over

b. the recognised amounts of the identifiable net assets acquired.

3. In light of the Boards' decision to focus on the measurement of NCI, a question arises about how to measure NCI and goodwill if the acquisition is a bargain purchase.

Alternatives

4. In the BC ED, a bargain purchase is defined as a situation in which the acquisition-date fair value of the acquirer's interest in the **acquiree** exceeds the fair value of the consideration transferred for that interest. However, an acquirer would recognise a gain only if the fair value of the acquirer's interest in the **identifiable net assets** of the acquiree exceeded the fair value of the consideration transferred.

5. Under the new method of focusing on the measurement of NCI, an acquirer would not be required to determine the fair value of the acquiree. Therefore, a question arises about how to identify a bargain purchase. The staff proposes that a bargain purchase be defined based on the way that the bargain purchase gain was calculated in the BC ED. That is, a bargain purchase is a situation in which the fair value of the acquirer's interest in the identifiable net assets of the acquiree exceeds the fair value of the consideration transferred.

6. The staff believes that there are three alternatives for measuring NCI and goodwill in a bargain purchase:

a. **Alternative 1:** Measure NCI at fair value and calculate goodwill or a bargain purchase gain as the final residual. An acquirer would compare:

i. the consideration transferred plus the fair value of the NCI and

ii. the recognised amounts of the identifiable net assets acquired.

If (i) is larger than (ii), the excess is recognised as goodwill. If (ii) is larger than (i), the excess is recognised as a bargain purchase gain attributable to the acquirer.

b. **Alternative 2:** Measure NCI as its proportional interest in the identifiable net assets. No goodwill would be recognised. A gain attributable to the acquirer would be recognised at the acquisition date for the excess of:

   i. the **acquirer's interest** in the recognised amounts of the identifiable net assets acquired over

   ii. the consideration transferred.

c. **Alternative 3:** Measure NCI at fair value and recognise goodwill attributable to NCI (calculated as the difference between the fair value of NCI and NCI's proportional interest in the identifiable net assets). A gain attributable to the acquirer would be recognised at the acquisition date for the excess of:

   i. the **acquirer's interest** in the recognised amounts of the identifiable net assets acquired over

   ii. the consideration transferred.

7. The differences between the alternatives are:

   a. Alternatives 1 and 3 result in recognising the NCI at fair value, whereas Alternative 2 results in recognising the NCI at its proportional interest in the identifiable net assets.

   b. Alternatives 2 and 3 result in the same gain attributable to the controlling interest, whereas Alternative 1 results in a smaller gain attributable to the controlling interest.

   c. Alternative 3 results in the recognition of the full amount of goodwill attributable to NCI, which results in the simultaneous recognition of goodwill and a bargain purchase gain. Under Alternatives 1 and 2, simultaneous recognition of goodwill and a bargain purchase gain does not occur because goodwill attributable to NCI is reduced.

8. The following example illustrates the differences between the alternatives.

Example

Assume that AC acquires an 80 per cent interest in TC. AC determines the following:

Fair value of **identifiable** net assets acquired	CU200
Fair value of 20 per cent NCI	45

A bargain purchase exists in situations in which the fair value of the acquirer's interest in the identifiable net assets of the acquiree (CU200 x 80 per cent = CU160) exceeds the fair value of the consideration transferred for that interest. Therefore, a bargain purchase exists in Cases A and B.

	Case A **AC pays CU152 for its 80% interest.**	**Case B** **AC pays CU159 for its 80% interest.**	**For all cases in which consideration is CU160 or higher (ie there is not a bargain purchase), Alternatives 1–3 will result in the same entry.** **Case C** **AC pays CU160 for its 80% interest.**
Alternative 1 NCI at fair value; calculate goodwill or gain as final residual	Dr. Identifiable net assets 200 Cr. NCI *45* Cr. Consideration 152 Cr. Gain on bargain purchase *3*	Dr. Identifiable net assets 200 Dr. Goodwill *4* Cr. NCI *45* Cr. Consideration 159	Dr. Identifiable net assets 200 Dr. Goodwill *5* Cr. NCI *45* Cr. Consideration 160
Alternative 2 NCI at proportional interest in identifiable net assets	Dr. Identifiable net assets 200 Cr. NCI *40* Cr. Consideration 152 Cr. Gain on bargain purchase *8*	Dr. Identifiable net assets 200 Cr. NCI *40* Cr. Consideration 159 Cr. Gain on bargain purchase *1*	
Alternative 3 NCI at fair value; recognise goodwill attributable to NCI	Dr. Identifiable net assets 200 Dr. Goodwill *5* Cr. NCI *45* Cr. Consideration 152 Cr. Gain on bargain purchase *8*	Dr. Identifiable net assets 200 Dr. Goodwill *5* Cr. NCI *45* Cr. Consideration 159 Cr. Gain on bargain purchase *1*	All goodwill attributable to NCI. NCI GW = 45 – (200 x 20%) = 5

Staff Analysis

9. The staff is divided on this issue, with individual staff members placing different weights on different arguments. Each alternative is analysed below.

Alternative 1

10. Alternative 1 is consistent with the principle of measuring NCI at fair value. The Boards have decided that fair value is the most relevant measurement attribute for NCI and might not want to compromise that principle in a bargain purchase.

11. Another advantage of Alternative 1 is that the accounting for a bargain purchase would be simple to implement and is consistent with the goal of recognising as many of the components of a business combination as possible at fair value and treating the difference as the final residual. In all business combinations, an acquirer would compare (a) the consideration transferred plus the fair value of NCI and (b) the recognised amounts of the identifiable net assets acquired. If (a) is larger than (b), the excess is recognised as goodwill (see Cases B and C of the example). If (b) is larger than (a), the excess is recognised as a bargain purchase gain (see Case A of the example).

12. Alternative 1 results in the measurement of NCI at fair value (which includes goodwill attributable to the NCI), but does not result in the recognition of the goodwill embodied in the NCI in the balance sheet. Therefore, some staff members believe that Alternative 1 is inconsistent with the Boards' previous decision to prohibit recognition of goodwill in a bargain purchase because goodwill is embedded in the amount recognised for the NCI.

13. In addition, some staff members believe that Alternative 1 understates the amount of the gain attributable to the controlling interest because it effectively recognises a portion of the gain in NCI. Those staff members believe that the gain of CU8 in Case A of the example appropriately reflects the bargain purchase achieved by the acquirer. That is, the bargain purchase also can be calculated as the difference between the consideration paid of CU152 and the acquirer's interest in the identifiable net assets [CU200 x 80 per cent = CU160]. Other staff members note that the gain of CU8 does

not represent the true economic gain because it excludes the goodwill related to the controlling interest.

Alternative 2

14. Some staff members believe Alternative 2 is an appropriate extension of the exception that the Boards made for bargain purchases (that is, no goodwill could be recognised). Therefore, consistent application of that exception would result in the recognition of no goodwill for the NCI. Thus, the NCI should be recognised as its proportional interest in the identifiable net assets.

15. As noted above, some staff members also believe that Alternative 2 more faithfully represents the gain attributable to the controlling interest.

16. However, a disadvantage of Alternative 2 is that it results in an exception to the fair value measurement of NCI. Alternative 2 also results in a 'jump' in goodwill at the point at which an acquisition becomes a bargain purchase. This is illustrated in Cases B and C of the example. In moving from Case C to Case B, a decrease in consideration of CU1 results in a reduction of CU5 in goodwill because none of the NCI's goodwill is recognised at the point at which the acquisition becomes a bargain purchase.

17. Alternative 2 results in measuring NCI as its proportion of the identifiable net assets. Therefore, the gain recognised under Alternative 2 would be consistent with the gain that would be recognised under the IASB's exception to the fair value measurement of NCI.

Alternative 3

18. Alternative 3 is consistent with the principle of measuring NCI at fair value. It also resolves the concern under Alternative 1 related to recognising a portion of the gain attributable to the controlling interest in NCI.

19. Alternative 3 results in the recognition of goodwill attributable to the NCI in a bargain purchase even though no goodwill is recognised for the controlling interest. In addition, Alternative 3 could result in the simultaneous recognition of goodwill attributable to the NCI and a bargain purchase gain attributable to the controlling interest.

20. Some staff members believe that Alternative 3 is inconsistent with the bargain purchase accounting proposed in the BC ED (that is, that no goodwill could be recognised). Other staff members believe that Alternative 3 is not inconsistent with the Boards' underlying basis for the exception proposed in the BC ED. Those staff members believe that the Boards' real objection was to recognising goodwill when the offset is a gain through income. Under Alternative 3, the offset to the goodwill that is recognised is NCI, not income.

21. The gain recognised under Alternative 3 would be consistent with the gain that would be recognised under the IASB's exception to the fair value measurement of NCI (ie measuring NCI as its proportion of the identifiable net assets).

Question for the Boards

Which alternative do the Boards support?