IFRIC Meeting | Agenda reference **8**

Staff Paper | Date **January, 2010**

Project **Annual improvement — 2008 – 2010 Cycle**

Topic **IFRS 3 *business combinations* - Measurement of NCI**

Introduction

1. In the 2009 Annual Improvements Exposure Draft(ED), the Board addressed the measurement of non-controlling interests (NCI). The Board proposed amending IFRS 3 *business combinations* to clarify that the option to measure NCI at the proportionate share of the acquiree's identifiable net assets should be applied to those NCI-components only that are present ownership instruments and entitle their holders to a pro rata share of the entity's net assets in the event of liquidation.

2. The objective of this paper is:

   (a) to provide background information on the issue;

   (b) to analyse the comment letters we received; and

   (c) to recommend that the IASB amend the wording from the ED as proposed in the appendix.

Background

3. In July 2009, the IFRIC discussed requests to clarify whether an entity should apply the measurement choice in paragraph 19 of IFRS 3 (as revised in 2008) to

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IFRIC.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IFRIC or the IASB. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

Decisions made by the IFRIC are reported in IFRIC *Update*.

Interpretations are published only after the IFRIC and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in IASB *Update*.

all components of NCI.[1] Paragraph 19 states that, for each business combination, the acquirer shall measure any NCI in the acquiree either at fair value or at the non-controlling interest's proportionate share of the acquiree's identifiable net assets.

4. In addition to minority interests as defined in IFRS 3 (issued in 2004), the definition of NCI includes, for example, options or warrants over an entity's own shares that are classified as equity and the equity component of a convertible instrument. Some believe that if an entity chooses to measure NCI as a proportionate share of the acquiree's identifiable net assets, it should apply this measurement to all components of the acquiree's equity. The consequence would be that instruments other than those equivalent to minority interest would be measured at nil on acquisition, because those equity components which are not present ownership instruments do not share any of its identifiable net assets on the business combination.

5. The IFRIC concluded that the measurement choice should apply only to instruments currently entitled to a proportionate share of the acquiree's net assets. However, because IFRSs do not provide sufficient guidance to resolve this issue an amendment to the revised IFRS 3 is required. Therefore, the IFRIC decided not to add the issue to its agenda but to recommend that the Board amend IFRS 3 to address the issues identified as a part of the annual improvements project.

6. At its July 2009 meeting, the Board decided to add the issue to the annual improvements project.[2]

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[1] See Agenda Paper 3C of the July IFRIC meeting: http://www.iasb.org/Meetings/IFRIC+Meeting+-+9+July+2009.htm

[2] See Agenda Paper 3E of the July IASB meeting: http://www.iasb.org/Meetings/IASB+Board+Meeting+21+July+2009.htm

Respondents' comments

7. The Board received 70 comment letters on its 2009 annual improvements ED of which 24 dealt with the measurement of NCI. The other comment letters did not address this issue specifically.

Need for an amendment

8. Most respondents who commented on the measurement of NCI supported the proposal. Those respondents were concerned that without the proposed amendment some constituents might measure NCI at a proportionate share of net assets of nil because they do not grant present ownership rights or residual claims. They were worried that, as a consequence, third party economic interests in the acquiree would not be reflected in the acquisition accounting. In their view, this would be inconsistent with the principles underpinning IFRS 3 .

9. In contrast, a few respondents questioned the need for an annual improvement. In their view, the change from 'minority interest' to 'non-controlling interest' in the second phase of the Board's project on business combinations was widely understood as a change in terminology only. Those respondents were concerned that the proposed amendment would widen the application of the definition of NCI to other components of equity without providing any rationale why such an amendment would improve financial reporting.

Need for a separate project

10. Some respondents argued that because of the significance of the amendment the proposal would not be within the scope of the annual improvements process. Rather, the measurement of NCI should be dealt with in a separate project that should address the fundamental questions of what NCI is, what the criteria for the measurement of NCI are and how it should be measured. A few respondents recommended an even broader scope of such a separate project and suggested that the Board should address the measurement of NCI along with the establishment of general measurement principles for equity.

11. A few respondents noted also that such a project would be closely related to other major projects such as the reporting entity phase of the conceptual framework project and the project on consolidations. Those respondents argued that the Board should not proceed with any amendment to the measurement of NCI until those projects are finalised.

12. Other respondents expressed concerns about the fact that the IASB amended unilaterally the accounting for business combinations. In their view, the proposed amendment creates a difference between IFRSs and US GAAP that should be addressed as a convergence item.

Scope of the proposed amendment

13. The proposed amendment refers to "components of NCI that are present ownership instruments and entitle their holders to a pro rata share of the entity's net assets in the event of liquidation". Some respondents asked the Board to clarify whether it intended the measurement choice to apply only to common shares or whether it intended the measurement choice also to apply to preference shares. Similarly, respondents asked the Board whether puttable financial instruments that are classified as liabilities in a subsidiary should be classified as NCI at the group level because the instruments entitle the holder to a pro rata share of the entity's net assets on liquidation.

14. Other respondents asked the Board to remove the requirement that the ownership instrument must entitle their holders to a pro rata share of the entity's net assets in the event of liquidation. In their view, the additional requirement is "confusing and inconsistent with paragraph 19 of IAS 27". IAS 27.19 states that profit or loss and changes in equity are allocated to the parent and non-controlling interest on the basis of present ownership interests. However, it does not refer to the NCI's entitlement to a share of the net assets in the event of liquidation.

15. If a reporting entity chooses not to measure NCI at its pro rata share of the entity's net assets, the ED proposes that the reporting entity must measure NCI at fair value or other measurement basis as requirement by IFRSs. A few respondents believed that in this case the fair value measurement should apply to

all components and a fall-back to other IFRSs should not be allowed. This means, for example, that, if the reporting entity chooses not to measure NCI at its pro rata share of the entity's net assets, unreplaced share-based payment awards should be measured at fair value and not at the market-based measure as required in IFRS 2.

Need for additional application guidance

16. Some respondents asked the Board to provide further application guidance regarding the following issues:

    - *Measurement of NCI in accordance with other IFRSs*: Respondents asked the Board to clarify how particular components of NCI should be measured when other IFRSs do not address the measurement of those components. For example, they asked how a constituent should measure a vested but unexercised share-based payment award, as this scenario is not addressed in IFRS 2 *Share-based payment*.
    - *Measurement date*: Respondents asked the Board to clarify at which date a component of NCI must be measured in accordance with other standards. For example, IAS 32.31 requires the equity component of convertible debt to be measured upon inception as the residual of the fair value of the overall instrument and the fair value of the liability component. Respondents asked the Board to clarify whether and how the equity component should be remeasured as of the acquisition date.
    - *Subsequent measurement of NCI*: The ED addresses only the initial measurement of NCI. Respondents argued that the Board should also provide application guidance on the subsequent measurement.
    - *Calculation of impairment losses*: Respondents asked the Board to clarify how the requirements in IAS 36 to determine goodwill impairment should be applied to NCI that are not present ownership instruments.
    - *Reverse acquisitions*: Respondents asked the Board how the guidance in paragraphs B23 and B24 of IFRS 3 on the treatment of NCI in a reverse

acquisition should be applied to components of NCI other than ordinary shares.

Transition

17. The ED proposes that the amendments to the measurement of NCI be applied retrospectively. Some respondents asked the Board to require retrospective application only when the fair value was determined at that date. Those respondents would object to a retrospective fair value measurement if this would imply the use of hindsight. Other respondents argued that the changes should be applied prospectively, so not to require the restatement of NCI for previous periods to which the revised version of IFRS 3 already applied.

Drafting

18. Many respondents asked the Board to clarify the drafting of the proposed amendments. In particular, they asked the Board:

    (a) to clarify whether there is a ranking in the measurement alternatives or whether the measurement of NCI is an accounting policy choice. Furthermore, if the requirement is an accounting policy choice, they asked the Board to clarify whether the reporting entity can decide about the measurement on an instrument-by-instrument basis or for each business combination.

    (b) to explicitly name those instruments that should be measured in accordance with other IFRSs.

    (c) to provide illustrative examples.

Staff analysis

Should the measurement of NCI be addressed in the annual improvements project?

19. We believe that both the deliberations of phase II of the business combinations project as well as the initial deliberations of the annual improvement highlight the need to clarify the measurement of NCI in a business combination.

20. When the Board deliberated the second phase of its business combinations project it has replaced the definition of minority interest by a new definition of non-controlling interest. During the deliberations, some constituents made the Board aware that the new definition of non-controlling interest would include equity instruments other than ordinary shares that were not attributable to the shareholders of the parent entity (for example share-based payments). In their view, those equity instruments were not included in the definition of minority interests. However, they acknowledged that it was unclear under the old version of IFRS 3 how those equity instruments should be accounted for in a business combination. In their view, most preparers measured those equity instruments either at fair value or another measurement basis.

21. Paragraph 19 of the revised IFRS 3 states that for each business combination, the acquirer shall measure any non-controlling interest in the acquiree either at fair value or at the non-controlling interest's proportionate share of the acquiree's identifiable net assets. Several constituents believed that the wording was not clear on whether the measurement choice in paragraph 19 applies to all NCI components or should be limited to those equity instruments that would have previously met the definition of minority interest. Therefore, they asked to Board to clarify the requirement as part of the annual improvements project.

22. During its deliberations of the annual improvements project the Board clarified that it intended the measurement choice to apply only to those equity components that would have previously met the definition of minority interest. The Board did not intend to change the accounting practice for other equity instruments that are now included in the definition of NCI. Some Board members believed that this interpretation was already clear from the current wording in paragraph 19. However, in light of constituents' requests, the Board decided to propose in the ED an amendment to the wording in paragraph 19 that would clarify the Board's intent. Most respondents to the ED supported an amendment of the wording in paragraph 19.

23. We believe that the issue can be addressed in the Board's annual improvements project and that there is no need for a separate project on the measurement of NCI. This is because the proposal is only intended to clarify the current

requirements in paragraph 19 of IFRS 3. We do not expect the proposal to change current accounting practice. For the same reason, we do not see a need to await the further deliberations in other projects, such as the conceptual framework or the consolidation project.

24. Finally, we note that the proposed amendment would not affect the alignment between IFRS 3 and the US GAAP requirements in SFAS No. 141(R) Business Combinations. The comparison of IFRS 3 and SFAS 141(R) in the appendix of IFRS 3 highlights that the measurement of NCI is one of the remaining differences between the two standards.

Question1 – Which process should address on this issue
Does the IFRIC agree that the measurement of NCI should be addressed in the final annual improvements standard? If not, why?

How should the measurement requirements for NCI be amended?

25. We agree with those respondents who argue that the Board should remove the requirement that for the measurement choice to apply the ownership instrument must entitle their holders to a pro rata share of the entity's net assets in the event of liquidation. The definition of minority interest did not contain a comparable requirement and we are concerned that the proposed criterion might change current practice without providing a clear rationale for such a change. We are also concerned that the proposed amendment might create inconsistencies within the accounting treatment of non-controlling interest. For example, the allocation of profit or loss to the shareholders of the parent entity and non-controlling interest is generally based on present ownership interests, but does not consider whether the ownership instruments entitle their holders to a pro rata share of the entity's net assets in the event of liquidation.

26. We believe that the proposed change to the requirements in the ED will clarify that the measurement choice applies to preference shares that are classified as equity. In contrast, the measurement choice would not apply to puttable financial instruments that are classified as liabilities.

27. Some respondents suggested that if a reporting entity chooses to measure NCI that are present ownership instruments at fair value then all other components of NCI should also be measured at fair value. We acknowledge that such a principle would improve the comparability of the measurement of different NCI components.

28. However, we note that in IFRS 3 the Board has made exceptions from the fair value measurement principle when assets acquired or liabilities assumed in a business combination could not be readily measured at fair value. For example, paragraph 24 of IFRS 3 states that deferred taxes must be measured in accordance with IAS 12 *Income Taxes*, rather than at fair value. We believe that the same principle should apply to the measurement of NCI. Hence, outstanding unvested share-based payment awards should be measured at the market-based measure specified in IFRS 2, rather than at fair value.

Should additional application guidance be provided?

29. We do not believe that the Board should provide further application guidance on the measurement of NCI in the annual improvements project.

30. Some respondents asked the Board to clarify how NCI should be measured that are not present ownership instruments, but for which other IFRSs do not contain specific measurement guidance. For example, IFRS 2 does not address the measurement of a vested but unexercised share-based payment award. We believe that the proposed amendment is clear that it would require such an instrument to be measured at fair value. The proposed wording in the ED allows a reporting entity only to measure those NCI components at a measure other than fair value for which a different measurement basis is required by other IFRSs. Therefore, we do not believe that further application guidance is required on this issue.

31. NCI is measured at fair value or at a different measurement basis required by other IFRSs as of the acquisition date of the business combination. We believe that this follows directly from the general principles in the revised IFRS 3 which establish the acquisition date as the measurement date for all assets acquired, liabilities assumed, the fair value of the consideration transferred as well as the non-controlling interest. We intend to clarify this conclusion when drafting the final amendment.

32. We have sympathy for those respondents who asked the Board to provide also application guidance for the subsequent measurement of NCI. However, we note that in July 2009 the Board has decided that this issue should be postponed to the two-year post-implementation review of the revised IFRS 3. We believe that, similarly, the implications of the proposals for the calculation of impairment losses according to IAS 36 and the treatment of NCI in reverse acquisitions should be addressed in the post-implementation review. We are concerned that addressing those issues (a) might go beyond the scope of the annual improvements project and (b) delay the issue of the final measurement guidance for NCI as proposed in the ED.

Drafting

33. We have incorporated respondents' comments on the drafting of the proposal in the amended wording in Appendix A.

Questions to the IFRIC

34. We recommend that paragraph 19 of IFRS 3, which deals with the measurement of NCI, be amended in the final annual improvements standard. In light of respondents' comments on the ED, we have made several changes to the drafting of the paragraph. We have attached the final wording in Appendix A.

35. We also recommend providing illustrative examples in IFRS 3 that illustrate the measurement requirements for NCI. If the IFRIC agrees with the staff recommendation, we will present those illustrative examples to the IFRIC at its next meeting.

Question 2 – Drafting and examples
1) Does the IFRIC agree with the amended wording in Appendix A of this paper? If not, how would you amend the wording? 2) Does the IFRIC agree that IFRS 3 should provide illustrative examples of the measurement of NCI?

Other issues for this project

36. Provided the IFRIC concludes that this project should proceed, the staff requests the IFRIC provide the staff with guidance on the remaining other issues for this project to assist in its finalisation.

Re-exposure

37. The Due Process Handbook for the IASB states that after resolving issues arising from the exposure draft, the IFRIC considers whether it should expose its revised proposals for public comment, for example by publishing a second exposure draft. Paragraph 47 of the Due Process Handbook states:

> In considering the need for re-exposure, the Board
>
> - identifies substantial issues that emerged during the comment period on the exposure draft that it had not previously considered
> - assesses the evidence that it has considered
> - evaluates whether it has sufficiently understood the issues and actively sought the views of constituents
> - considers whether the various viewpoints were aired in the exposure draft and adequately discussed and reviewed in the basis for conclusions on the exposure draft.

38. The staff believes that re-exposure would not result in the identification of new issues or accounting alternatives. The staff also believes that any benefits from re-exposing the amendments would be too minor to justify the delay in issuing it.

Therefore, the staff recommends that the IFRIC should not re-expose the revised amendments.

Question 3 – Re-exposure
Does the IFRIC agree that the revised amendments should not be re-exposed?

Effective date

39. If the IFRIC agrees that a re-exposure is not necessary, it is likely that the final amendment will be included in the omnibus Improvements to IFRSs issued in April 2010 in accordance with the recurring estimated project timetable set out by the Board. As proposed in the exposure draft, the staff recommends that the final amendment be effective for annual periods beginning on or after 1 July 2010. The staff also recommends that earlier application is permitted; however, if an entity applies the proposed amendment before 1 July 2010, it shall disclose that fact.

Question 4 – Effective date
Does the IFRIC agree with an effective date requiring that an entity shall apply this amendment for annual periods beginning on or after 1 July 2010?

Transition and first-time adoption

Transition for current IFRS preparers

40. We believe that the proposed amendment should be applied retrospectively. We do not anticipate that many preparers will be required to restate NCI as a consequence of the proposed amendment because:

(a) the proposed amendment does not aim to change current accounting practice, but intends to clarify that the wording in the revised IFRS 3 is in line with that practice.

(b) the revised IFRS 3 must be applied for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 July 2009. We have learnt that only very few entities have decided to early-adopt IFRS 3. Furthermore, the Board has deliberated the measurement of NCI in July 2009 and issued the annual improvements ED in August 2009. Therefore, the proposed amendment was in the public domain for virtually all business combinations that are accounted for under the revised standard.

First-time adoption

41. The staff believes that no specific relief is required for first-time adopters of IFRS and accordingly no amendment to IFRS 1 is proposed.

Question 5 – Transition
Does the IFRIC agree with that retrospective transition should be applied and that no amendment is required to IFRS 1?

Other issues

Question 6 – Authorisation to proceed with drafting and to ballot
Does the IFRIC approve the staff to proceed with this proposed amendment including finalisation of drafting and presentation to the Board for finalisation of this proposed amendment with inclusion in the *Improvements to IFRSs* to be issued in April 2010?

Appendix A - Amendment to IFRS 3

Paragraph 19 is amended and (added text is underlined and deleted text is struck-through) and paragraph 19A is added:

19 For each business combination, the acquirer shall measure any non-controlling interests in the acquiree ~~either~~ at fair value ~~or at the non-controlling interest's proportionate share of the acquiree's identifiable net assets~~, unless another measurement basis is required by IFRSs.

19A Paragraph 19 does not apply to components of non-controlling interests that are present ownership instruments. For such non-controlling interests, the entity must choose, for each business combination, to measure such non-controlling interests at either:

a) fair value; or

b) the present ownership instruments' proportionate share in the recognised amounts of the identifiable net assets.

Basis for Conclusions

A new heading is added after paragraph BC221 and paragraph BC221A is added:

Subsequent improvements to IFRS 3

BC221A In *Improvements to IFRSs*, issued in xx 2010, the Board decided to limit the measurement choice to non-controlling interests that are present ownership instruments and entitle their holders to a pro rata share of the entity's net assets in the event of liquidation. The acquirer should measure other components of non-controlling interest at fair value or other measurement bases as required by IFRSs. For example, a share-based payment transaction that is classified as equity shall be measured in accordance with IFRS 2 *Share-based Payment* and the equity component of a convertible instrument shall be measured in accordance with IAS 32 *Financial Instruments: Presentation*. The Board observed that without this amendment, if the acquirer chooses to measure NCI at its proportionate share of the acquiree's identifiable net assets, the acquirer might measure some equity instruments at nil. In the Board's view, this would result in not recognising economic interests that other parties have in the acquiree. Therefore, the Board proposes to amend IFRS 3 to limit the choice of measuring non-controlling interest at its proportionate share of the acquiree's identifiable net assets to those components of non-controlling interests that are present ownership instruments that entitle their holders to a pro rata share of the entity's net assets in the event of liquidation.

Appendix B - Changes from the proposal in the ED

Added text is double underlined and deleted text is struck-through with a double line:

19 For each business combination, the acquirer shall measure any non-controlling interest in the acquiree ~~either~~ at fair value ~~or other measurement basis as required by IFRSs, except for the components of non-controlling interest that are present ownership instruments and entitle their holders to a pro rata share of the entity's net assets in the event of liquidation. The acquirer shall measure those components of non-controlling interest either at fair value or at the present ownership instruments' non-controlling interest's proportionate share of the acquiree's identifiable net assets,~~ unless another measurement basis is required by IFRSs.

19A Paragraph 19 does not apply to components of non-controlling interests that are present ownership instruments. For such non-controlling interests, the entity must choose, for each business combination, to measure such non-controlling interests at either:

a) fair value; or

b) the present ownership instruments' proportionate share in the recognised amounts of the identifiable net assets.

Basis for Conclusions

Subsequent improvements to IFRS 3

~~BC1~~BC221A In *Improvements to IFRSs*, issued in xx 2010, t~~T~~he Board ~~proposes~~ decided to limit the measurement choice to non-controlling interests that are present ownership instruments and entitle their holders to a pro rata share of the entity's net assets in the event of liquidation. The acquirer should measure other components of non-controlling interest at fair value or other measurement bases as required by IFRSs. For example, a share-based payment transaction that is classified as equity shall be measured in accordance with IFRS 2 *Share-based Payment* and the equity component of a convertible instrument shall be measured in accordance with IAS 32 *Financial Instruments: Presentation*. The Board observed that without this amendment, if the acquirer chooses to measure NCI at its proportionate share of the acquiree's identifiable net assets, the acquirer might measure some equity instruments at nil. In the Board's view, this would result in not recognising economic interests that other parties have in the acquiree. Therefore, the Board proposes to amend IFRS 3 to limit the choice of measuring non-controlling interest at its proportionate share of the acquiree's identifiable net assets to those components of non-controlling interests that are present ownership instruments that entitle their holders to a pro rata share of the entity's net assets in the event of liquidation.