International Accounting Standards Board®

Accounting for changes in the relative proportion of the controlling and non-controlling interests

Introduction

1 In January 2008 the International Accounting Standards Board completed the second phase of its business combinations project by issuing a revised IFRS 3 *Business Combinations* and an amended IAS 27 *Consolidated and Separate Financial Statements*.

2 The amendments to IAS 27 include new requirements for the accounting for changes in the relative proportion of the controlling and non-controlling (minority) interests in a subsidiary. The purpose of this note is to explain why the accounting required by the amended IAS 27 is more appropriate than the methods that emerged in practice in the absence of guidance.

Background

3 After a parent has control of a business (subsidiary) the parent might increase its holding by buying additional shares from the non-controlling interests, or reduce its holding by selling some shares. A parent's relative interest in a subsidiary will also change if the subsidiary issues shares to a party other than the parent.

4 Until IAS 27 was amended, IFRSs did not address the accounting for any of these transactions. An analysis of the methodologies documented by major accounting firms indicates that they would accept at least six methods.

5 The new requirement is that transactions between these equity holders must be accounted for on the same basis as any other transaction between equity holders—within equity.[1] Not only is this one of the simplest of the six methods but, more importantly, it is the only method that leads to the appropriate reporting of income and equity. All of the other methods cause difficulties with how one or more of the components in the statement of financial position or statement of comprehensive income are measured.

[1] The IASB's *Framework* includes definitions of liabilities and equity. On the basis of those definitions, the Board concluded in its 2003 revision of IAS 27 that non-controlling interests are a separate component of equity. The amendments to IAS 27 reflect the consequences of that classification.

Acquisitions of non-controlling interests

Overview of the methods

6 This section summarises the six methods of accounting being applied in practice for the acquisition of non-controlling interests. For illustration purposes, suppose that at the date of the acquisition the carrying amount of the non-controlling interests reported in the group financial statements is lower than the consideration paid.

Method 1 – a transaction between equity holders

Any difference between the consideration paid and the carrying amount of the non-controlling interests being derecognised is attributed to the parent, within equity.	Dr Non-controlling interests Dr Parent equity Cr Consideration paid

Method 2 – assume all of the difference is goodwill

Any difference between the consideration paid and the carrying amount of the non-controlling interests is recognised as additional goodwill.	Dr Non-controlling interests Dr Goodwill Cr Consideration paid

Method 3 – adjust goodwill based on the original business combination

Adjust goodwill for the additional non-controlling interest acquired using the difference between the recorded goodwill and the 'grossed-up' goodwill used for the impairment test in IAS 36 *Impairment of Assets*. Any remaining difference between the consideration paid and the non-controlling interests being derecognised is attributed to the parent, within equity.	Dr Non-controlling interests Dr Goodwill Dr Parent equity Cr Consideration paid

Method 4 – adjust identifiable net assets to fair value, with the residual to goodwill

Adjust each identifiable asset and liability to its fair value. Any difference between the consideration paid and the carrying amount of the non-controlling interests plus the fair value adjustments attributable to them is recognised as additional goodwill.	Dr Non-controlling interests Dr Net assets Dr Goodwill Cr Consideration paid Cr Revaluation reserve

Method 5 – adjust a proportion of identifiable net assets to fair value, with the residual to goodwill

A variation of method 4 is to adjust each identifiable asset and liability only for the portion of the difference between its fair value and its carrying amount attributable to the additional ownership interest acquired.	Dr Non-controlling interests Dr Net assets Dr Goodwill Cr Consideration paid

Method 6 – allocate the proportionate increase in the net identifiable assets to the parent

A variation of method 5 is to recognise a reduction in parent equity, rather than an increase in the carrying amount of the net assets.	Dr Non-controlling interests Dr Parent equity Dr Goodwill Cr Consideration paid

Assessment of the methods

7 This section provides an assessment of the six methods. That assessment is supported by a numerical example.

Illustrative example

A company has a subsidiary. The parent owns 70 per cent of the shares and outside parties (the non-controlling interests) own 30 per cent.

The parent buys the non-controlling interests for cash of CU450. The carrying amount of the non-controlling interests is CU390.

The difference between the consideration transferred and the carrying amount of the non-controlling interests is because an asset with a carrying amount of CU300 has a fair value of CU500.[2]

Of the total unrecognised value, CU60 (30 per cent of the CU200) is attributable to the non-controlling interests.

Benchmark case

8 To establish a benchmark case, suppose that the subsidiary sells the asset with the unrecognised fair value increment, for cash, immediately **before** the parent acquires the non-controlling interests. This scenario establishes what the accounting would be if the consideration paid for the non-controlling interests was equal to the carrying amount.

9 In such a case, the entity would recognise a gain on disposal of the asset of CU200, which would be allocated CU140 to the parent and CU60 to the non-controlling interests. As a result, the carrying amount of the non-controlling interests would be CU450 (390 + 60).

10 If the parent then buys the non-controlling interests for CU450, the assets of the group will be reduced by CU450 and the equity of the group by the same amount. There does not seem to be any controversy about this outcome.

Analysis of methods

11 To evaluate the alternative methods, suppose instead that the subsidiary sells the asset with the unrecognised value immediately **after** the acquisition of the non-controlling interests. It seems intuitive that the overall effect on income and equity should be the same as in the benchmark case.

Method 1 – a transaction between equity holders

12 This method was proposed in the exposure draft and adopted in the amended IAS 27.

13 Applying this method, the parent recognises a reduction in the non-controlling interests of CU390 (their carrying amount) and a reduction in the equity of the parent of CU60.

[2] The analysis in this section is valid whether the value difference is because of unrecognised value in tangible assets, intangible assets or goodwill. Paragraphs 48–52 examine those other cases.

14 When the subsidiary sells the asset all of the realised gain of CU200 is allocated to the parent in the group accounts. After that sale, the parent's interest in the subsidiary is CU140 higher than it was in the beginning of the case (200 - 60). This outcome is intuitive because the CU140 is equal to the 70 per cent of the value that accrued while the parent had a 70 per cent interest in the subsidiary. The gain of CU200 associated with the asset is recognised in the period in which the asset is sold and not the period the non-controlling interests are acquired.

15 Some argue that reporting the parent's share of the profit as CU200 overstates the parent's share. This is because the parent had only a 70 per cent interest when the value changes occurred. However, the purpose of attributing income to the controlling and non-controlling interests is to identify their share of income in the period in which it is recognised. The CU200 is the parent's share of the gain in the period that gain is recognised and is the overall profit from selling the asset. The group reports the correct amount of the gain related to that asset.

16 The adjustment to the parent's interest is the amount the parent pays for the non-controlling interests' portion of the unrecognised value changes. Without this adjustment, the parent's reported interest in the subsidiary would be higher than in the benchmark case. The parent would be overstating its interest in the recognised gains.

17 In the examples presented here the initial measurement of the non-controlling interests (when the subsidiary was acquired) is assumed to be at fair value. IAS 27 requires that entities account for an acquisition of a non-controlling interest using method 1, regardless of whether non-controlling interests were measured initially at fair value or at their proportionate interest in the net identifiable assets of the subsidiary.

18 If an entity elects to measure non-controlling interests initially as their proportionate interest in the net identifiable assets of the subsidiary, the carrying amount of non-controlling interests is likely to be lower than the fair value of those interests. In such cases, any adjustment to the parent's equity that is made when non-controlling interests are acquired will be higher than it would have been if those interests had been measured initially at fair value, by the amount of that difference.

19 By measuring the non-controlling interests at their proportionate interest in the net identifiable assets of the entity the acquirer will have elected not to recognise some of the value of the business acquired. The additional adjustment to the parent's interest in the subsidiary ensures that, as with any other unrecognised asset, when the value is recognised by the group the parent will be allocated its share of that gain.

Method 2 – assume all of the difference is goodwill

20 Many respondents to the exposure draft stated that any difference between the consideration paid and the carrying amount of the non-controlling interests being derecognised should be recognised as goodwill (regardless of whether the unrecognised value relates to tangible or other assets). Applying this method, the parent recognises additional goodwill of CU60.

21 Method 2 results in an overstatement of the parent's equity. The parent's equity will be CU200 higher than it was at the beginning of the case, rather than the CU140 increase in the benchmark case. In addition, the net assets of the subsidiary will be CU60 higher than they are in the benchmark case because the unrecognised value is measured as part of goodwill.

22 The premise underlying IFRS 3 is that the parent controls the subsidiary and that achieving control is the basis for the initial measurement of each asset and liability of the subsidiary in the group financial statements. Acquiring an additional interest in a subsidiary is not an appropriate basis for remeasuring any of the subsidiary's assets. The parent is not investing in additional assets (or acquiring more goodwill); it is securing the rights to the returns it has been sharing with the non-controlling interests. The parent already controls the assets but, until it buys the remaining equity, it does not have rights to all of the returns on those assets.

Method 3 – adjust goodwill based on the original business combination

23 This method would be valid only for those entities that elect to measure the non-controlling interests at their proportionate interest in the net identifiable assets of the acquiree when the business combination is recognised.

24 The idea behind this method is that the portion of goodwill attributable to the non-controlling interests acquired is recognised at the time of the subsequent acquisition in the same manner as it would have been had the entity elected to measure non-controlling interests at fair value at the date of the business combination. However, the entities have chosen not to measure non-controlling interests at fair value at the time of the original business combination and therefore are unlikely to have that information. Therefore, this method uses the grossed-up goodwill amount used for the impairment test in IAS 36 as the basis for the adjustment.

25 The amount recognised for goodwill using this approach will not necessarily be the same as it would have been if the entity had measured the non-controlling interests at fair value at the date of the business combination. The fair value of non-controlling interests will reflect factors such as the liquidity of the market in which the non-controlling interests would be exchanged.

26 This approach has the same problems as method 2 and conflicts with the underlying premise of IFRS 3. Method 3 is also complex. A parent might have an 80 per cent interest in an entity that it decreases through sale to 70 per cent. Any subsequent increase in the holding would generate an adjustment to goodwill only for that portion above the original 80 per cent interest.

Method 4 – adjust identifiable net assets to fair value, with the residual to goodwill

27 Some respondents suggested that the identifiable net assets of the subsidiary should be adjusted to fair value with each subsequent acquisition. Any difference between the consideration paid and the carrying amount of the non-controlling interests plus the fair value adjustments attributable to them would be recognised as additional goodwill.

28 Adjusting the net assets would require a full valuation exercise to adjust (possibly) every asset and liability of the subsidiary. In this example, the valuation would establish that all of the unrecognised value relates to one asset, which the parent would adjust by CU200. The parent would not recognise any additional goodwill because the carrying amount of the non-controlling interests (CU390) plus the fair value adjustment attributable to them (30 per cent of the CU200) equals the consideration paid.

29 As with methods 2 and 3, this approach conflicts with the underlying premise in IFRS 3 that the parent controls the subsidiary and that achieving control is the basis for the initial measurement of each asset and liability of the subsidiary in the group financial statements. There is no basis for remeasuring an asset upon the subsequent acquisition of some of the non-controlling interests, given that the IFRS 3 model recognises their full value at the date of its initial recognition in the group.

30 In addition, this method has high preparation costs. As well as requiring a full valuation exercise, the parent would also, having established a new cost for each asset, need to review and possibly change the annual depreciation expense etc for those assets.

31 The profit of the group is also misstated in this method. When the asset is sold the subsidiary would report a gain of CU140, which would be allocated to the parent. The other portion of the value change (the CU60) bypasses income.

Method 5 – adjust a proportion of identifiable net assets to fair value, with the residual to goodwill

32 This method is the same as method 4, except that the identifiable net assets are adjusted only for the portion of the difference between their fair value and carrying amount attributable to the additional ownership interest acquired.

33 Accordingly, this method has the same problems as method 4. In addition, the adjusted asset carrying amounts are meaningless. The new carrying amount of the asset in question of CU360 (300 + 60) is a series of layers of fair value measured at different times.

Method 6 – allocate the proportionate increase in the net identifiable assets to the parent

34 This example does not have unrecognised goodwill so, in this case, the answer is the same as for method 1. However, this method has the same problems as method 4, to the extent that the unrecognised value does not relate to identifiable assets. A valuation exercise is also required for the purpose of identifying to what the unrecognised value relates.

Disposals of, or issuing additional, shares

Overview of the methods

35 This section summarises the three methods of accounting applied in practice when there is a reduction in a parent's ownership interest in a subsidiary without the loss of control. For illustration purposes, suppose a parent sells shares of its

wholly-owned subsidiary to non-controlling interests. At the date of the transaction, the consideration received is higher than the related proportion of the carrying amount of the net assets of the subsidiary in the group financial statements.

Method 1 – a transaction between equity holders

Any difference between the consideration received (proceeds of the sale of shares) and the carrying amount of the non-controlling interests recognised is attributed to the parent, within equity.	Dr Consideration received Cr Parent equity Cr Non-controlling interests

Method 2 – recognise the difference as income

Any difference between the consideration received (proceeds of the sale of shares) and the carrying amount of the non-controlling interests recognised is income.	Dr Consideration received Cr Income Cr Non-controlling interests

Method 3 – measure non-controlling interests at fair value

The non-controlling interests are recognised at fair value on the basis of the consideration received.	Dr Consideration received Cr Non-controlling interests

Assessment of the methods

36 This section provides an assessment of the three methods. That assessment is supported by a numerical example.

Illustrative example

A company has a subsidiary. The parent owns all of the shares. The parent sells 30 per cent of the shares in the subsidiary for cash of CU600.

At the date when the parent sells the shares the carrying amount of the net assets of the subsidiary (including any goodwill in cash-generating units that are part of the subsidiary) is CU1,800.

Assume that the difference between the consideration transferred and the carrying amount of the non-controlling interests results from an asset with a carrying amount of CU300 having a fair value of CU500.[3]

Benchmark case

37 To establish the benchmark case, suppose that the subsidiary sells the asset with the unrecognised increase in fair value, for cash, immediately **before** the parent sells 30 per cent of the shares. This scenario establishes what the accounting would be if the consideration received for the shares was the same as their carrying amount.

38 In such a case, the entity would recognise a gain on disposal of the asset of CU200, all of which would be allocated to the parent. If the parent sells its shares at this

3 The analysis in this section is valid whether the value difference is because of unrecognised value in tangible assets, intangible assets or goodwill. Paragraphs 48–52 examine those other cases.

point the group would recognise an increase in cash of CU600 and an increase in the non-controlling interests of CU600. This accounting seems uncontroversial.

Analysis of methods

39 To evaluate the alternative methods, suppose instead that the subsidiary sells the asset with the unrecognised value immediately **after** the parent sells 30 per cent of the shares. It seems intuitive that the overall effect on income and equity should be the same as in the benchmark case.

Method 1 – a transaction between equity holders

40 This is the method required by the amended IAS 27.

41 The group will recognise the cash received of CU600 for the sale of shares. It will also recognise an increase in equity of CU600. CU60 of that increase is credited to the parent, with the remaining CU540 being credited to the non-controlling interests. The CU60 adjustment to the parent is equal to 30 per cent of the unrecognised value increase in the asset (200 × 30 per cent).

42 From an economic perspective the parent is selling its rights to 30 per cent of the returns of the subsidiary. The parent is retaining control of the subsidiary and will continue to account for the individual assets and liabilities of the subsidiary in the group financial statements. The parent is not giving up control of any of these assets—it is selling the rights to a portion of the returns on the net assets.

43 When the subsidiary sells the asset with the unrecognised value increment after the non-controlling interests have acquired their shares, it will recognise a gain of CU200. Of that gain, CU140 (70 per cent) would be allocated to the parent and CU60 (30 per cent) to the non-controlling interests. The parent's interest in the subsidiary will be CU200 higher than it was at the beginning of the case (60 + 140) and the non-controlling interests will be CU600 (540 + 60).

44 That outcome is intuitive because the CU200 is equal to the 100 per cent of the value increase to which the parent was entitled and the non-controlling interests reflect the fact that the value it acquired has been recognised. The gain reported in profit or loss is CU200, which represents the realised gain on disposal of the asset. Again, this is intuitive and the result is identical to that achieved in the benchmark case.

Method 2 – recognise the difference as a gain

45 Some respondents argued that instead of allocating the CU60 to the parent (within equity), it should be recognised as a gain in profit or loss. That profit would be allocated to the parent, giving the same result in the statement of financial position as the benchmark case (and the accounting that will be required by IAS 27). However, the difference is that the group profit or loss will be CU260, which is CU60 higher than the benchmark case. Put simply, this approach double-counts the profit of the group by recognising the profit related to the asset twice—when the non-controlling interests are created and again when the gain related to the asset is realised.

46 Many respondents who advocated this approach also advocated recognising additional goodwill when non-controlling interests are acquired (method 2, as described in paragraphs 20–22). Recognising additional goodwill on a step up but not derecognising goodwill on a step down is inconsistent. It also means that an entity that acquires non-controlling interests and then immediately sells them to another party for the same price would, generally, recognise a gain.

Method 3 – measure non-controlling interests at fair value

47 Some respondents suggested recognising the additional non-controlling interests at an amount equal to the consideration received. The problem with this approach is that when the previously unrecognised profits are realised and recognised, 30 per cent of those profits will be allocated to the non-controlling interests when they actually relate to the parent. This has the effect of overstating the non-controlling interests and understating the parent's interest.

Extension to unrecognised value in intangible assets and goodwill

48 The examples shown above use a simple case for which the difference between the amount paid (or received) for the non-controlling interests and their carrying amount is attributable to one asset. That difference 'reverses' when the asset is sold.

49 The analysis applies equally when the difference is attributable to unrecognised goodwill or an unrecognised identifiable asset. It does not matter whether the realisation and recognition of the value difference is through sale or through use. The outcome will be the same, although the timing might be different.

50 To illustrate this point, assume the subsidiary has developed a pharmaceutical drug. Suppose that the drug gets regulatory approval, giving the subsidiary exclusive rights to the drug for the next seven years. The carrying amount of the drug is likely to be lower than its fair value because internal research and development activity is usually accounted for on a more conservative basis.

51 The subsidiary could realise the value of the drug either by selling the rights to it or by manufacturing and selling the drug. If the subsidiary sells the rights to the drug it will recognise a gain on disposal equal to the difference between the carrying amount and the selling price. In contrast, if the subsidiary retains the rights and manufactures and sells the drug, it will recognise the profits from that activity. It simply takes longer for the value of the drug to flow through the statement of comprehensive income and be allocated to the parent if the subsidiary retains the rights and manufactures the drug itself.

52 Some argue that, by selling some shares in the subsidiary, the parent is realising some of the value of the drug through a partial sale of the rights to the drug (through the sale of shares) and some of the value through manufacture and sale of the drug. Although this argument might be appealing, it is not consistent with the accounting for subsidiaries. The parent is not losing control of the subsidiary and therefore retains control of the rights to the drug. The parent still has the power to decide whether to sell those rights or to manufacture the drug, set selling prices and

so on. What the parent is doing is sharing the consequences of its actions with the minority (non-controlling) partner.

Conclusion

53 The revised IFRS 3 places particular emphasis on the acquirer achieving control of the acquiree. Achieving, or losing, control is a fundamental change in the nature of one entity’s interest in another. Achieving control is a business combination and causes the initial recognition of the assets acquired and liabilities and equity instruments assumed.

54 IFRS 3 (both the original and the revised version) requires each asset and liability to be measured at fair value. The revised IFRS 3 allows an acquirer to choose to measure non-controlling interests either at their proportionate interest in the net identifiable assets of the acquiree or at fair value. Goodwill is the difference between the acquisition-date measurements of the consideration paid, the net identifiable assets and the non-controlling interests.

55 As a result, every component of the business acquired is measured on the basis of its value at the date control is achieved, or in the case of goodwill as a residual of those components. In the original IFRS 3, goodwill was the one item that was measured using a pseudo cost accumulation approach—as the accumulated difference between the consideration paid and the proportionate interest in the fair value of the net identifiable assets at the time each step was made.

56 The revised IFRS 3 and the amended IAS 27 are now consistent, because the acquisition of an additional interest in a subsidiary does not affect the measurement of individual assets or liabilities of the subsidiary—they are already controlled by the parent and are being accounted for on that basis by the group. This principle applies equally to goodwill and non-controlling interests, regardless of how they are measured initially.

57 Allowing asset carrying amounts to be adjusted as a result of a change in the relative level of non-controlling interests (whether an increase or a decrease in non-controlling interests) reduces comparability. This is because the accounting for assets and liabilities becomes dependent on the capital structure of the reporting entity rather than the characteristics of its assets and liabilities.