



Controlling the effects of a non-controlling interest

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When negotiating the acquisition of a business, the accounting consequences may be far from the mind of the negotiator. However, how a deal is negotiated significantly affects the acquirer's future results from operations and financial position. This article is the fourth in a series of publications looking at issues to consider when negotiating an acquisition of a business.

In a recent survey, 71% of those surveyed said that they want to complete an acquisition during the next six months.¹

There are numerous reasons why management might decide not to acquire 100% of a target company, and leave a non-controlling interest remaining. Leaving non-controlling interests (NCI) in an acquiree (subsidiary) can significantly affect operations and finances of the acquirer after the deal closes. In this article, we examine effects of NCI on financial statements and the impact of management's choice of how to measure NCI at the date of gaining control (the acquisition date). Because the guidance on how to measure NCI at the acquisition date changes for annual periods beginning on or after 1 July 2009, management should carefully consider the implications, since they might be different from prior acquisitions and reporting periods.

In rare cases, the accounting effect and the consequential impact on the business might be significant enough for management to consider restructuring the deal. In other cases, awareness of the effect and consequences of the business combination during the negotiations is sufficient to plan for the effects on other aspects of the business, including changes in how management communicates with its stakeholders. Different options suit different needs, but one thing is clear: an understanding of the accounting and the potential consequences is critical before a deal is signed.

Box 1: Reasons to leave a non-controlling interest

- ▶ To manage scarce capital and decrease the cash needed as consideration
- ▶ To incentivise former shareholders/executives for the entity to continue performing well
- ▶ To comply with regulatory requirements, such as anti-trust laws, which may prevent management from acquiring 100% of a competitor, customer, or vendor
- ▶ To partner with local shareholders to limit risk and exposure when expanding into emerging markets

¹ Ernst & Young survey, "Why capital matters: Building competitive advantage in uncertain times," which surveyed 490 executives in September and October 2009.



Choices for NCI

In their simplest form, NCI are any shares in an entity owned by a party other than that which owns the controlling interest. For example, if a parent entity owns 60% of a subsidiary, shareholders that own the remaining 40% represent the NCI. There are other instruments to consider when identifying NCI, which are discussed in more detail below.

IFRS 3 *Business Combinations* amended in 2008, giving entities a choice of how to measure NCI arising in a business combination:

- ▶ Option 1 - At fair value
- ▶ Option 2 - At its proportionate share of net assets acquired

Previously, only option 2 was available. Both measurements are determined as at the acquisition date. It is important to note that the choice is available separately for each business combination (rather than applying one option consistently to all combinations).

Impact upon acquisition

Table 1 below illustrates the implications of this choice upon acquisition, using the following fact pattern:

On 1 January 2010, Entity A purchased 60% of Entity B for €600. The fair value of the 40% NCI is €400. The fair value of Entity B's identifiable net assets at the acquisition date is €700.

Table 1: Impact of measurement of NCI at acquisition date

	Fair value	Proportionate share of net assets
NCI in statement of financial position	Higher – results in balance sheet 'gross-up'. €400 in fact pattern	Lower – no balance sheet 'gross-up'. €280 in fact pattern (€700 * 40%)
Goodwill	Higher – represents goodwill related to entire acquiree. €300 in fact pattern (€600 + €400 – €700)	Lower – represents goodwill related to acquired portion. €180 in fact pattern [€600 + €280 – €700)



Post-acquisition impact – allocation of losses

Even though the choice of how to measure NCI only applies at each acquisition date, the measurement choice does affect the ongoing financial position in periods after the acquisition. This is because the statement of financial position continues to reflect the carrying amount of NCI.

How management chooses to measure NCI at each acquisition date does not affect the allocation of profits or losses of the subsidiary to NCI, and therefore does not affect profit or loss attributable to the parent, as illustrated in Table 2. Consider this extension of the fact pattern:

During the year ended 31 December 2010, Entity B recognised a loss of €100.

As discussed below, a negative carrying amount of NCI is not a problem per se, except that it may be a difficult concept to explain to shareholders and analysts. This is one area where IAS 27 *Consolidated and Separate Financial Statements*, which was also amended in 2008, changed previous practice. The previous version of IAS 27 prohibited a negative NCI balance, unless there was a binding obligation and ability for non-controlling shareholders to make an additional investment to cover the losses.

Table 2: Impact of measurement of NCI at initial acquisition upon ongoing results

	Fair value	Proportionate share of net assets
Allocating profit/loss	<p>Lower risk of negative NCI – because beginning balance is higher.</p> <p>NCI's share of Entity B's loss is €40 (€100 * 40%)</p> <p>Reduces NCI to €360 (€400 – €40)</p>	<p>Higher risk of negative NCI – because beginning balance is lower.</p> <p>NCI's share of Entity B's loss is €40 (€100 * 40%)</p> <p>Reduces NCI to €240 (€280 – €40)</p>



Post-acquisition impact – impairment of goodwill

Even if there is an impairment of goodwill related to NCI, the measurement choice for NCI selected by management at the acquisition date affects the results of operations and the statement of financial position in that reporting period, as illustrated in Table 3. Consider this extension of the fact pattern:

Entity B (the acquiree) is a single cash-generating unit (CGU). The goodwill that arose upon the acquisition of Entity B is wholly attributable to that CGU. On 31 December 2010, management determines that the recoverable amount of that CGU is €840. The carrying amount of that CGU is €600, excluding goodwill.

This example shows one way to ‘gross up’ goodwill for the impairment test, but there might be alternative methods. In addition, the gross-up becomes more complex when the parent paid a control premium for the controlling interest in the acquiree, when there is a change in ownership interests, and when there are other instruments that are NCI, but do not have a present ownership interest (which are discussed in more detail below).

When management chooses at the acquisition date to measure NCI at fair value for some business combinations, and at proportionate share of net assets for other business combinations, and the acquired businesses are in the same CGU, the goodwill impairment test becomes even more complex.

Table 3: Impact of measurement of NCI in goodwill impairment

	Fair value	Proportionate share of net assets
Test for impairment of goodwill	Less complex – there is no ‘gross-up’ of goodwill. The carrying amount of the CGU for the impairment test is €900 (€600 + €300)	More complex – there is a ‘gross-up’ for goodwill. The carrying amount of the CGU for the impairment test is €900 (€600 + €180/60%)
Goodwill impairment amount	Recognise goodwill impairment related to entire acquiree. €60 is recognised in total (€840 – €900)	Recognise goodwill impairment related to parent’s interest. €36 is recognised in total (€840 – €900) * 60%
Allocation of goodwill impairment loss	Impairment loss is allocated to parent and NCI based on ownership interests. Parent’s share of impairment loss is €36 (€60 * 60%) NCI’s share of impairment loss is €24 (€60 * 40%) Reduces NCI to €336 (€360 – €24)	Impairment loss is only allocated to parent, because the NCI’s goodwill is not recognised. Parent recognises €36 NCI remains at €240



Box 2: Reasons to acquire a non-controlling interest

- ▶ Completes established plan set in original business combination
- ▶ Previously unavailable cash becoming accessible through capital markets
- ▶ Price of the NCI decreases to an attractive level
- ▶ Higher efficiencies can be obtained after acquiring the NCI
- ▶ Court orders the buy-out of the NCI following a dispute
- ▶ Fulfils needs of non-controlling shareholders becomes unsustainable

Subsequent acquisitions of NCI

If management decides to acquire NCI, it adjusts NCI for the change in ownership interests. Any difference between consideration paid to acquire NCI and the carrying amount of NCI is recognised directly as an increase or decrease to equity attributable to the parent shareholders, regardless of the option chosen to measure NCI at the acquisition date (that is, at fair value, or at proportionate share of the net assets). However, the option chosen affects the amount recognised as an increase or decrease to equity attributable to the parent shareholders, which may be important for some companies. Consider this extension of the fact pattern, illustrated in Table 4:

For the year ended 31 December 2011, Entity B has nil profits (therefore, there is no allocation of profit or loss to Entity A). There was no impairment of goodwill in 2011. On 31 December 2011, Entity A acquires an additional 30% of the subsidiary for €330.

When the consideration paid to acquire the NCI is less than the carrying amount of NCI, the difference is not recognised in profit or loss. Rather, an entity recognises such difference directly in the equity attributable to the parent shareholders. However, a transaction such as this might indicate impairment of the goodwill recognised in the acquisition of the entity (subsidiary) to which the NCI related.

Table 4: Impact of measurement of NCI at initial acquisition upon the subsequent acquisition of NCI

	Fair value	Proportionate share of net assets
Subsequent acquisition of NCI	<p>Lower impact on equity attributable to the parent shareholders – because NCI has a higher carrying amount before the acquisition of NCI.</p> <p>Reduces equity attributable to the parent by €78</p> <p>Calculated as €330 of cash less €252 [carrying amount of NCI of €336 * (30%/40% of NCI acquired)]</p>	<p>Higher impact on equity attributable to the parent shareholders – because NCI has a lower carrying amount before the acquisition of NCI.</p> <p>Reduces equity attributable to the parent by €150</p> <p>Calculated as €330 of cash less €180 [carrying amount of NCI of €240 * (30%/40% of NCI acquired)]</p>



In the next article in this series, we will explore various disposal strategies for businesses. Some disposal strategies may result in the loss of control of a subsidiary. Generally, selecting fair value to measure NCI at the acquisition date results in less of a reduction to the equity attributable to the parent shareholders, compared to the proportionate share of net assets approach, because the carrying amounts of goodwill and NCI are higher (using fair value) and lower (using proportionate share of net assets), respectively.

Other instruments that are NCI

When the IASB amended IAS 27 in 2008, it also effectively changed the definition of NCI. This change in terminology and definition means that now, all equity instruments issued by the acquiree (subsidiary) that are not owned by the acquirer (parent) are classified as NCI. In addition to ordinary shares issued by the subsidiary, NCI can include the following instruments not held by the parent:

- ▶ Equity component of convertible debt and other compound financial instruments
- ▶ Preference shares (including both those with, and without, an entitlement to a pro rata share of net assets upon liquidation)
- ▶ Share warrants
- ▶ Options over own shares
- ▶ Options under share-based payment plans

These instruments are NCI, regardless of whether or not they are vested and regardless of the exercise price (e.g., whether they are 'in-the-money'), where applicable. The principle underlying the accounting for NCI is that all residual economic interest holders of any part of the consolidated entity have an equity interest in that consolidated entity. This principle applies regardless of the decision-making ability and where in the group that interest is held.

As shown in Table 5, the combination of the revised definition of NCI and the choice of how to measure NCI at the acquisition date may give a significantly different accounting result than under the previous standards.

The IASB is currently amending IFRS 3 *Business Combinations* so that those items within NCI that are not present ownership instruments (e.g., options or warrants) are measured at fair value at the acquisition date, unless another measurement basis is required by other IFRS. That is, the choice on how to measure NCI at the acquisition date (at fair value or at proportionate share of net assets) will only be available for components of NCI that represent present ownership interests (e.g., ordinary shares). If finalised as proposed, this amendment will result in the changes shown in Table 4. Management should consider the future amendments, which we expect the IASB to finalise in the second quarter of 2010.² However, until the 2010 amendment is finalised, the considerations noted above (with respect to the implications of choosing fair value or proportionate share of net assets) apply to all types of NCI.

² IASB Workplan - projected timetable as at 1 March 2010.



Table 5: Measuring NCI at the acquisition date

Instruments issued by the acquiree (subsidiary)	Before the 2008 amendment	After the 2008 amendment	After the 2010 amendment (if adopted as proposed)
Ordinary shares	Proportionate share of net assets	Proportionate share of net assets OR fair value	Proportionate share of net assets OR fair value
Preference shares entitled to a pro rata share of net assets upon liquidation			
Preference shares not entitled to a pro rata share of net assets upon liquidation*	Proportionate share of net assets*	Proportionate share of net assets* OR fair value	Fair value
Equity component of convertible debt and other compound financial instruments	Practice varied: some entities measured at fair value and some did not recognise	Proportionate share of net assets [◇] OR fair value	Fair value
Share warrants			
Options over own shares			
Options under share-based payment transactions	Not recognised [†] OR proportionate share of net assets [◇] OR fair value	Proportionate share of net assets [◇] OR fair value	IFRS 2 'market-based measure'

* As these instruments are not entitled to a share of net assets as of the acquisition date, their proportionate share of net assets is nil. If the 2010 amendment is finalised as proposed, these instruments may only be measured at fair value (determined at the acquisition date).

◇ In practice, because these instruments are generally not entitled to a share of net assets as of the acquisition date, their proportionate share of net assets is nil. As a result, these instruments would only be recognised when exercised.

† Prior to the revision to IAS 27, some held the view that options under share-based payment plans were not a component of minority interest (the predecessor term to NCI).



Determining fair value

Measuring the fair value of NCI at the acquisition date might be difficult. When acquiring a business, consideration paid often includes a control premium (that is, value associated with controlling the acquired business). Thus, if management chooses to measure NCI at fair value at the acquisition date, it cannot just extrapolate the fair value of NCI from the consideration paid for the controlling ownership interest.

For an acquiree that was previously or continues to be a public/ listed company that is actively traded, fair value of NCI can be determined based on the shares' trading price.

Measuring the fair value of NCI at the acquisition date is more challenging for privately held entities. Valuing an investment in a privately held entity often requires using a model, such as an income approach or market approach. Some methodologies produce enterprise values (i.e., debt plus equity), while others produce equity values. If the valuation methodology produces an enterprise value, management (or its appraiser/expert) should consider the fair value of any debt and related provisions that affect the fair value of NCI at the acquisition date. Furthermore, different methodologies under each approach may produce the fair value of controlling interests or the fair value of NCI, therefore requiring further adjustment.

Other challenges that management (or its appraiser/expert) might encounter when determining the fair value of NCI at the acquisition date include the following:

- ▶ Determining marketability discounts
- ▶ Preparing or assessing the reliability of historical and future cash flows
- ▶ Estimating risk parameters for privately held entities

Given the complexities of valuing NCI in a privately held entity, employing an expert is strongly encouraged. Therefore, when management chooses to measure NCI at fair value at the acquisition date, additional time and expertise may be needed. Other factors to consider include how to explain the transaction (and valuation) to shareholders (of both the parent and the subsidiary), which should be considered with other factors raised herein.

When determining the fair value of NCI at the acquisition date, management should also consider any future guidance issued by the IASB. In particular, management should consider the Exposure Draft *Fair Value Measurements*, which is expected to be released as a standard in the third quarter of 2010.³

Business impact

The choice of how to measure NCI at the acquisition date (that is, fair value or proportionate share of net assets) is not just an accounting decision that affects the financial statements. There are several business implications to consider when choosing how to measure NCI at each acquisition date.

Covenant compliance

As shown in the tables above, each choice affects the financial statements differently: in equity, net assets and potentially future impairment losses. Management should consider whether NCI are included in 'equity' as defined in loan agreements for covenants such as debt-to-equity ratios (i.e., gearing or leverage ratios). In a recent survey, one-third of the companies interviewed expected their capital structure to receive increased attention next year – debt-to-equity ratio being a key consideration.⁴ Therefore, determining whether NCI are included – and, if so, where – might be an area of concern.

In addition, if there is a risk of impairment, management should determine whether such loss is included in any covenants related to profit or loss. Management should seek clarity and renegotiate covenants early, if needed.

Analysing returns

With capital being scarce in the downturn, there is greater pressure from analysts and investors to improve the return on investment, return on invested capital, and return on equity. Therefore, management should consider whether any such measures include or exclude NCI and the potential effects of erosion of equity attributable to the parent shareholders when NCI are later acquired (as shown in Table 4). Management should communicate clearly with analysts and shareholders, particularly when simplifying or resetting such metrics.

³ IASB Workplan – projected timetable as at 1 March 2010.

⁴ Ernst & Young survey "Why capital matters: Building competitive advantage in uncertain times" which surveyed 490 executives in September and October 2009.



A recent survey showed that goodwill represented 47% of enterprise value in recent transactions.⁵

Management compensation

The recession focused attention on remuneration of management and the relationship to the entity's performance. Where management is evaluated on performance measures that reflect impairment (e.g., net income), or ratios such as gearing ratios or return on investment, management should consider the implications of the choice at the acquisition date for measuring NCI, and adjust compensation structures accordingly.

External communications

Owning less than 100% of a subsidiary may complicate communications with both controlling and non-controlling shareholders.

Shareholders of the parent company may not understand the nature of NCI and what it represents in the financial statements, particularly for the allocation of profit or loss, or if NCI becomes a negative balance. Non-controlling shareholders may have different profit motivations (e.g., they might be looking for a short-term return on investment, whereas controlling shareholders take a longer view on profits of the subsidiary). Therefore, non-controlling shareholders might need different information than controlling shareholders and balancing these needs might be difficult. Management should consider how it would explain the measurement of NCI at the acquisition date, and the consequential affects of that decision.

Consolidation and financial reporting

The accounting for NCI is complex. Regardless of which method (fair value

or proportionate share of net assets) management selects to measure NCI at the acquisition date, the process of consolidating with NCI is more time-consuming than consolidating a wholly-owned subsidiary. To assist management in making decisions in the current economic environment, it is often necessary to prepare consolidated financial information in a short period or as needed. Management should consider the impact of NCI on its current systems and processes when selecting how it will measure NCI at the acquisition date, and adapt those systems and processes as needed.

Furthermore, management should develop scenario planning and strategic modelling to evaluate changes in market conditions (e.g., the price at which remaining NCI might be acquired), or company-specific conditions (e.g., impairment, availability of additional cash to acquire remaining NCI) on other aspects of the company's financial reporting, strategy and business.

Industry expectations and comparability

Management should consider whether choosing the fair value or the proportionate share of net assets is more common in the industry in which the company operates – and how that trend affects management's choice in measuring NCI at each acquisition date. Although the measurement of NCI at each acquisition date is not an accounting policy choice (that is, management has a free choice for each acquisition), management might decide to make a consistent choice for all NCI, because of the prevalence in the industry, if this is an important consideration.

⁵ Ernst & Young Survey "Acquisition accounting - what's next for you?" February 2009.



US GAAP convergence and comparability

US GAAP only permits entities to measure NCI using fair value at the acquisition date. Therefore, when comparability with US competitors or convergence with US GAAP for local regulatory reporting requirements is important, management should consider this factor in selecting its choice.

Taxes

Management should consult with a tax advisor to determine whether the choice of how to measure NCI at the acquisition date affects taxes payable in their jurisdiction(s). For example, in Australia, measures relating to capitalisation (which is affected by the amount of NCI) affect the deductibility of interest.

However, in other jurisdictions, the option selected - fair value or proportionate share of net assets - does not affect tax cash flows. This is because in such jurisdictions, taxes payable are based upon the separate financial statements of the subsidiary. Since the measurement choice for NCI at the acquisition date only affects accounting entries in consolidation, the financial statements of the subsidiary (to which the NCI relates) and taxes payable by that subsidiary are not affected.

The choice for measuring NCI at the acquisition date may affect the effective tax rate disclosed in the financial statements. As shown in tables 2 and 3, measuring NCI at fair value at the acquisition date generally results in higher goodwill (which may not be tax-deductible). This leads to a larger write-off upon an impairment event, which then affects the effective tax rate if goodwill is non-deductible. This may require additional explanation in the financial statements.

Transaction costs

When the entity subsequently acquires NCI, any directly attributable transaction costs are deducted from equity (net of any related income tax benefit). There is no difference in accounting for transaction costs incurred to acquire NCI, regardless of whether management chooses to measure NCI at fair value or proportionate share of net assets at the acquisition date. However, if the potential erosion of equity attributable to the parent shareholders is a concern, management should consider transaction costs when choosing between fair value and proportionate share of net assets. Management might choose

to measure NCI at fair value at the acquisition date, because the chance of erosion to the equity attributable to the parent shareholders (if any) will be less upon subsequent acquisition of NCI, because equity attributable to the parent shareholders is generally higher, as shown in Table 4.

Management should consider that the greater the number of steps taken to acquire 100% of a subsidiary, the higher the cumulative transaction costs will be (and therefore cash outflows). Some costs must be incurred (e.g., legal fees) at each acquisition step, regardless of how much of an ownership interest is acquired.

Conclusion

The revised IFRS 3 and IAS 27 introduce significant changes to accounting for NCI and subsequent transactions to acquire or dispose of additional ownership interests. The accounting for NCI can significantly affect profit or loss attributable to shareholders of the parent entity, as well as equity attributable to such shareholders. Managing these changes requires considerable planning and potentially involves a variety of experts, including legal counsel, tax experts, valuation professionals and accountants.

Management should carefully consider the above factors when deciding how to measure NCI at the acquisition date - whether at fair value or at a proportionate share of net assets. In rare cases, the accounting or operational consequences (and the consequential effects on covenant compliance and remuneration, etc.) might be so adverse as to cause management to consider pursuing a different acquisition strategy (e.g., acquiring the entire subsidiary). In other cases, awareness of the consequences during negotiations is sufficient to plan timely and efficient actions (e.g., renegotiate covenants for impact of NCI when seeking funding for a business combination, development of systems and processes).

Regardless of management's choice of how to measure NCI at the acquisition date, in good times or bad, the best approach is to evaluate each transaction against the company's strategy, whether that be for growth, to meet a customer's needs, or to gain access to a new technology. An alternative deal structure, such as leaving the NCI with former owners of an acquiree, might be an effective way to manage scarce capital and increased risks present today.

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