Grant Thornton

Insights into MFRS 3

Recognising and measuring non-controlling interests

Acquisitions of businesses can take many forms and can have a fundamental impact on the acquirer's operations, resources and strategies. These acquisitions are known as mergers or business combinations, and the accounting and disclosure requirements are set out in MFRS 3 'Business Combinations'.

Our 'Insights into MFRS 3' series summarises the key areas of the Standard, highlighting aspects that are more difficult to interpret and revisiting the most relevant features that could impact your business.

This article sets out the requirements for recognising and measuring any non-controlling interest (NCI).

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Definition of NCI

NCI is the term used in MFRS 3 and MFRS 10 'Consolidated Financial Statements' to describe equity instruments of a subsidiary not held directly or indirectly by a parent. In a business combination, a NCI arises when an entity acquires less than 100% of the equity of the acquiree.

MFRS 3 defines NCI as 'the equity in a subsidiary not attributable, directly or indirectly, to a parent'

The simplest and most common form of NCI is shares in the acquiree held by non-selling shareholders. However, all instruments issued by the acquiree that meet the definition of equity set out in MFRS 132 'Financial Instruments: Presentation' – such as some share options, preferred shares, equity component of convertible bonds, etc – are also NCI if they are not owned or acquired by the acquirer. It is therefore important to identify and distinguish the acquiree's equity instruments from its financial liabilities based on the definitions in MFRS 132. This is because NCI is presented as a separate component of equity in the acquirer's post-combination consolidated financial statements and is subsequently accounted for in accordance with MFRS 10.

Category of NCI and measurement option

Depending on the nature and the rights those equity instruments entitle their holders, NCI can be grouped into two broad categories, which in turn determine the available measurement options at initial recognition. Determining whether a NCI measurement option is available is key when accounting for a business combination, since the measurement of NCI can affect the amount of goodwill and subsequent accounting.

Category	Description	Measurement option
Present ownership instruments	Acquiree's shares held by non-selling shareholders that are present ownership interest and entitle them to a proportionate share of the acquiree's net assets in the event of liquidation (eg common or ordinary shares).	Measured either at fair value (fair value model) or proportionate share of recognised amount of assets and liabilities of the acquiree (proportionate interest model). The choice between the two measurement options is to be made for each business combination on a transaction-by-transaction basis, rather than being a policy choice applicable to all business combinations.
All other equity instruments not held directly or indirectly by the acquirer	Financial instruments issued by the acquiree other than those covered by the first category above that meet MFRS 132's definition of equity (eg warrants or stock options on 'fixed-for-fixed' terms and non-mandatorily redeemable preferred shares that do not entitle its holder to a proportionate share of the acquiree's net assets in the event of liquidation).	Measured at fair value, unless another measurement basis is required by MFRS eg share-based payment awards classified as equity and held by parties other than the acquirer are measured in accordance with MFRS 2 'Share-Based Payment'.

These measurement options are only available on initial recognition of a NCI, as part of a business combination transaction, in order to determine the amount of goodwill. Once initially recognised in accordance with MFRS 3, MFRS 10 guidance on subsequent accounting should be applied.

Present ownership instruments – NCI measurement options impact

The basis on which NCI of which are present ownership instruments is initially measured, affects goodwill at the acquisition date but could also have a financial impact on subsequent impairment and transactions with those NCI. When the fair value model is used, 100% of the goodwill in the acquiree is recognised (both the acquirer's and the NCI's share). This is sometimes described as the full goodwill model. Under the proportionate interest model only the acquirer's interest in the goodwill is recognised (a lesser amount).

The following example shows the basic effect of the two models:

Example – Measuring NCI

Entity A pays CU800 for an 80% interest in Entity B. Entity A does not have any previously held equity interest in Entity B. The fair value of Entity B's identifiable net assets is estimated to be CU750. Using a valuation technique, the fair value of the remaining 20% in Entity B (the NCI) on the acquisition date is determined to be CU180. The NCI gives right to a present ownership interest in the acquiree's equity.

Analysis

The amount of NCI and goodwill recognised under the alternative methods is as follows:

	Fair Value Model CU	**Proportionate interest model CU**
Cash consideration	800	800
NCI at fair value	180	–
NCI at 20% of identifiable net assets*	–	150
Total	980	950
Fair value of 100% of identifiable net assets	750	750
Goodwill	**230**	**200**
Recognised amount of NCI	**180**	**150**

* The proportionate share of NCI in the identifiable net assets is determined as follows: CU750 * 20 % = CU150.

Apart from the effect on goodwill, other factors that may influence the measurement model choice are:

- a lower goodwill amount under the proportionate interest model can lead to lower impairment charges later. This is explained by the fact that if a cash-generating unit (CGU) is subsequently impaired, any resulting impairment of goodwill recognised through profit or loss is likely to be lower than it would have been if the NCI had been measured at fair value. Under MFRS 136 'Impairment of Assets', goodwill is grossed up to include the NCI's portion when NCI is measured as its proportionate share of the acquiree's identifiable net assets. The gross amount is compared to the recoverable amount to determine any impairment but only the impairment loss relating to the parent's goodwill is recognised, ie the impairment loss attributable to NCI is not recognised in the parent's consolidated financial statements.
- estimating the fair value of NCI may increase costs and complexity when the shares of the acquiree are not quoted, and
- the measurement model chosen can have a different financial impact when accounting for a subsequent transaction with NCI in accordance with MFRS 10. MFRS 10 requires transactions with NCI that do not result in a loss of control of a subsidiary to be recognised as equity transactions. In a transaction where a parent subsequently purchases all the share held by the NCI in its subsidiary, applying the guidance of MFRS 10 means that any difference between the consideration paid for acquiring a NCI and the carrying amount of the NCI derecognised is recognised in equity. In this latter situation, if a parent subsequently purchases some (or all) of the shares held by the NCI, presumably at fair value, and the amount of the consideration paid is higher than the carrying amount of the NCI derecognised, the equity of the consolidated group would be reduced for the difference between those two amounts. If the NCI is measured initially at its proportionate share of the acquiree's identifiable net assets, rather than at fair value, that reduction in the reported equity attributable to the parent is likely to be larger. This is explained by the fact that the carrying amount of the NCI initially recognised using the proportionate interest model is generally lower at the time. It is subsequently purchased than if it had been initially recognised at fair value.

Determining the fair value of NCI

Fair value of NCI should be measured in accordance with MFRS 13 'Fair Value Measurement'. Refer to our article **Insights into MFRS 3 – How are the identifiable assets and liabilities measured?** (will be released later) which provides some guidance on how to determine fair value in accordance with MFRS 13.

MFRS 3 provides however some guidance on how the fair value of NCI is determined when applicable:

Fair value of NCI

The fair value of NCI is based on the quoted price in an active market for the equity shares not held by the acquirer, if available. Otherwise, the acquirer would measure the fair value of NCI using other valuation techniques.	The fair value of the acquirer's interest and NCI in the acquiree on a per-share basis might differ and as such it might not be relevant to retain the acquirer fair value per share to determine the fair value of NCI as the fair value per share of the acquirer's interest in the acquiree is likely to include a control premium or conversely, the fair value of the NCI might include a discount for lack of control (also referred to as a NCI discount).

Call and put options on NCI

The acquirer may arrange with non-selling shareholders during the period of negotiation for the acquisition to acquire NCI shares after the acquisition date – eg by entering into put or call options or a forward contract over the remaining shares held by the non-selling shareholders of the acquiree. An analysis is then required to determine whether, in substance, the underlying shares still legally owned by the NCI are economically attributable to non-selling shareholders or to the acquirer. This analysis and its consequences on the acquisition accounting is discussed further in our article **Insights into MFRS 3 – Determining what is part of a business combination transaction**.

How we can help

We hope you find the information in this article helpful in giving you some insight into MFRS 3. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact.