# Accounting for noncontrolling interests: presenting the new standards in the classroom

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**Abstract**

This paper presents a teaching note that may be used by faculty teaching accounting for consolidations. It discusses new and revised accounting standards which will result in greater convergence of international standards. The paper discusses the conceptual issues involved with three alternative approaches (economic unit, proportional, and parent company) to preparation of consolidated financial statements for an acquired company where a noncontrolling interest is present. The conceptual differences between the existing (FASB 141) and the new accounting standard (FASB 141R) are discussed as well as differences in the components of the consolidation process. A problem illustration is used to show the financial statement impact of the two standards. The paper also presents the new disclosure requirements under FASB 160.

Keywords: Consolidations, economic unit concept, noncontrolling interests, FASB 141, FASB 141R, FASB 160

## Introduction

As accounting educators we frequently face situations where we have to teach newly adopted accounting standards that have not yet been incorporated into existing texts. When this occurs we must develop our own materials that conceptually explain the change and develop illustrations that guide the student through the application of the new standard. Unfortunately, many times we are reinventing the wheel because our colleagues at other schools are also developing similar materials.

Such a situation currently exists with new standards on business acquisitions that were adopted in December of 2007 and became effective in 2009. The new standards make significant changes in how we account for an acquired business entity where the parent acquires less than 100% (Bahnson et al., 2008). In order to aid fellow instructors, we have prepared a teaching note explaining the new standard and illustrating its application.

## Accounting for Business Acquisitions under FASB 141R

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have been working together to promote international convergence of accounting standards (Wall Street Journal, 2002). In 2001, the FASB's Standard 141 changed the method of accounting for business acquisitions by adopting the purchase method and eliminating the pooling of interests as an alternative (Quick and Goldschmid, 2002). The pooling method was not used in other countries. However, the specific accounting for business acquisitions remained an area where the two standard setting bodies were trying to achieve convergence. As a result of this effort, the FASB issued a revision of Standard 141, called FASB 141R. The new standard significantly impacts the manner in which consolidated financial statements are prepared (Miller et al., 2008). The FASB also issued Standard 160 which requires additional disclosures relating to noncontrolling interests (Bahnson et al., 2008). This teaching note discusses the major issues involved in FASB 141 and 141R and provides a conceptual comparison of the two, as well as an illustrative example.

## Elimination of Pooling of Interests

In June of 2001, the FASB issued Statement 141 on Business Combinations eliminating the pooling of interest method as an alternative and adopted the purchase method, now named the acquisition method. In addition, the standard requires separate recognition of intangibles apart from goodwill when they meet specific contractual-legal or separability criteria. The FASB indicated that the new standard results in financial statements that:

1) better reflect the investment made in an acquired entity
2) improve the comparability of reported financial information
3) provide more complete financial information.

(Journal of Accountancy, 2001)

**Reporting Partial Ownership under the Acquisition Method**

When a company acquires all of the equity of another company it records all of the assets and liabilities at their full fair value. An issue arises when less than 100% ownership is acquired. There are basically three views that have existed regarding how the acquired company could be recognized:

1. Economic unit view – under this approach the business entity acquired is viewed as a total, indivisible, entity and 100% of assets, liabilities and income are reported. Assets and liabilities are reported at their fair value on the date of acquisition. The non-controlling interest's share of these is also separately reported in the financial statements.
2. Proportional view – this approach views the acquired entity as divisible and only the percentage of equity acquired is used to recognize the portion of assets, liabilities and income to be reported. Thus, if 90% of the equity was acquired, only 90% of assets, liabilities and income would be reported. Under this approach there is no need to report the noncontrolling interest's share of the entity since none of their share of assets, liabilities, etc. is recognized.
3. Parent company – under this approach all of the acquired company's assets, liabilities and income are reported. However, adjustments to fair value are made only for the portion acquired by the parent. Non-controlling interest is reported at book value with no adjustments to market (Jeter and Chaney, 2007).

Table 1 summarizes the reporting under the three methods. From a conceptual standpoint the economic unit and proportional views are more logically consistent than the parent company view. These two methods are each consistent throughout the reporting process. The economic view reports all assets and liabilities at their full fair value, reports the non-controlling interest at fair value and records additional depreciation/amortization based on full fair value. The proportional method reports the percent ownership of assets and liabilities at fair value, including adjustments for depreciation /amortization. Under this method, non-controlling interest is not reported.

[Place Table 1 about here]

The parent company view is not consistent in its view. The approach reports all of the asset and liability book value but makes market adjustments only for the portion acquired by the parent; none are made for the non-controlling interest's share. This partial adjustment is also reflected in the recognition of additional depreciation/amortization. The non-controlling interest's share is reported at book value not fair value.

**Existing GAAP**

Current GAAP uses the parent company method which has been in use for many years and was continued under FASB # 141. The revision (FASB 141R) eliminates the parent company approach and adopts the economic unit method (Miller et al., 2008). When consolidated financial statements are to be prepared, a consolidation work sheet is used to adjust the amounts reported on the individual parent and subsidiary books to reflect amounts appropriate for the consolidated statements. These worksheet entries eliminate the parent's investment account against the subsidiary's equity accounts (to eliminate double counting), recognize unrecorded assets and revalue the subsidiaries assets and liabilities to fair value. Comparable consolidation worksheet entries, for a parent that records its investment account under the equity method, under FASB 141 and 141R are presented in Table 2.

[Place Table 2 about here]

The first entry eliminates the subsidiary's beginning retained earnings and other equity account balances against the parent's investment account (for its share) and establishes a non-controlling interest account for the remainder. The purpose of this entry is to eliminate double counting of the subsidiary. The consolidated statements will reflect the subsidiary's assets and liabilities which are also reflected in the parent's investment account. Eliminating the investment account eliminates the double counting. This entry is the same in the revised standard.

The second entry recognizes the subsidiary's unrecorded assets and liabilities, revalues items to fair value and recognizes any goodwill. Under #141, asset and liability values are adjusted to fair value only for the percentage of ownership by the parent. These values are also used to recognize goodwill. Under the revised standard, adjustments to fair value are for the full amount, including the portion belonging to non-controlling interest. Full subsidiary goodwill is also recognized, not just the parent's share.

The third entry adjusts the subsidiary's depreciation and amortization to reflect the new asset and liability values. Under #141 this is for the parent's share of revaluation only while #141R recognizes additional expense based on full revaluation to fair value.

Next the revised subsidiary net income (after the additional depreciation from the third entry) is offset against the parent's investment account and the non-controlling interest account for their respective shares. This entry eliminates double counting of the subsidiary's income since the consolidated statements will contain the subsidiary's revenues and expenses. The amounts eliminated under the old and revised standard differ since the revised standard recognizes full fair value revaluations and related depreciation, not just the parent's share of them.

Finally the subsidiary's dividends are eliminated against both the parent's investment and the non-controlling interest accounts for their respective ownership amounts. The consolidated statements should reflect only the parent's dividends. The entry will be the same under both approaches.

**Illustration:**

The differences discussed above are illustrated through the use of a simple example. Assume the following information regarding the subsidiary as of the date of acquisition, January 1:

| | Book value | Fair value | Difference |
|---|---|---|---|
| Non-depreciable assets | $300,000 | $370,000 | $70,000 |
| Depreciable assets | 600,000 | 800,000 | $200,000 |
| Liabilities | 100,000 | 100,000 | |
| Common stock, no par | 700,000 | | |
| Retained earnings | 100,000 | | |

Additional assumptions:

1) The difference in valuation of non-depreciable assets was because the fair value of land exceeded its book value.
2) Depreciable assets have an average remaining life of ten years.
3) The subsidiary's net income for the year was $80,000 and it paid dividends of $10,000.
4) The parent purchased 80% of the subsidiary for $950,000 and there were no unrecorded assets or liabilities.
5) The fair value of the subsidiary on the date of acquisition was $1,187,500.

**Goodwill to be recognized:**

Goodwill is the excess of the purchase price over the fair value of identifiable **net** assets (assets less liabilities). Under FASB141 the fair value is considered to be only the parent's share while under 141R the full fair value is recognized. Given the above information, the calculation of goodwill under 141 and 141R is as follows:

<u>141:</u>

| | | |
|---|---|---|
| Parent's purchase price | | $950,000 |
| Book value of equity acquired: | | |
| ($700,000 + $100,000).8 | | <u>640,000</u> |
| Excess | | 310,000 |
| Adjust assets to fair value for parent's share: | | |
| Non-depreciable $70,000 X 80% = | $56,000 | |
| Depreciable $200,000 X 80% = | <u>160,000</u> | <u>216,000</u> |
| Goodwill | | $94,000 |

<u>141R:</u>

| | |
|---|---|
| Total fair value of the subsidiary: | $1,187,500 |
| Total fair value of subsidiary's net assets: | |
| $370,000 + $800,000 - $100,000 | <u>1,070,000</u> |
| Goodwill | <u>$117,500</u> |

In this example, under 141R, asset and liability valuations are greater because they reflect full fair value which also results in recognition of the full amount of goodwill.

**Illustrative Elimination Entries:**

Table 3 illustrates the consolidation worksheet elimination entries under the existing and the revised FASB standards. The first entry eliminates the subsidiary's beginning equity against the parent's investment account and establishes the Non-controlling interest account. The entry is the same under both the existing and revised standards.

The second entry under #141 revalues the assets for the parent's share of the difference between book value and fair value and also recognizes the goodwill calculated above. The #141R entry revalues assets for the full difference between book value and fair value and also recognizes the full entity goodwill.

The third entry records additional subsidiary depreciation based on depreciable asset revaluations: #141 ($160,000) and #141R ($200,000). These additional amounts are depreciated over the ten year average remaining life of the assets.

Entry four eliminates the subsidiary's adjusted net income against the parent's investment account and the non-controlling interest account in their respective share. Under #141, since only the parent's share of the difference between book value and fair value is recognized, the parent's share of income is adjusted for additional depreciation but the non-controlling interest's share is not adjusted. The parent's share is 80% of the $80,000 reported subsidiary income less the $16,000 additional depreciation. The non-controlling interest's share is their percentage of the Sub's reported income without adjustments for additional depreciation. Under #141R, the full asset adjustment is made resulting in additional depreciation of $20,000 and the adjusted net income of $60,000 ($80,000 – 20,000) is offset against the parent's investment and the non-controlling interest for their respective ownership percentages. The last entry eliminates the subsidiary's declared dividends of $10,000 against the parent's investment account and the non-controlling interest account for their respective share.

**Non-controlling Interest:**

After the adjustments and eliminations, the non-controlling interest under the two standards is:

| | 141 | 141R |
|---|---|---|
| Beginning equity | $160,000 | $160,000 |
| Asset revaluations and goodwill | N/A | 77,500 |
| Share of Sub's net income | 16,000 | 12,000 |
| Share of Sub's dividends | (2,000) | (2,000) |
| Ending balance | $174,000 | $247,500 |

Note that the amount is larger under 141R because it includes full fair value adjustments. Under the new standards, the noncontrolling interest must now be reported as part of equity rather than in the mezzanine between liabilities and equity. It is shown as the last item in the equity section.

**Disclosure Requirements:**

FASB 160 includes the following additional required disclosures:

1. In the financial statements, the portion of consolidated net income and comprehensive income attributable to both the parent and the noncontrolling interest.
2. Amounts attributable to the noncontrolling interest for each of the following, if relevant:
    a. income from continuing operations
    b. discontinued operations
    c. extraordinary items
    d. components of other comprehensive income
3. A reconciliation of the annual change in reported amounts of noncontrolling interest including separate disclosure of :
    a. consolidated net income attributable to noncontrolling interest.
    b. investments by and distributions to noncontrolling interest.
    c. each component of comprehensive income.

4. A footnote schedule showing the effects of transactions with the noncontrolling interest on the equity attributable to the noncontrolling interest (Bahnson et al., 2008).

**Summary:**

FASB 141R will result in adoption of a conceptually more consistent method of consolidation and provide better financial reporting by reflecting the economic unit concept. The method reflects the FASB's recent emphasis on the balance sheet. The method recognizes all assets and liabilities of the acquired company and values them at full fair value. Generally this will result in higher consolidated assets and non-controlling interests. The new approach will better reflect the investment made by the parent, enhance financial statement comparability between companies and provide more complete and relevant financial information. The new disclosures will also provide greater transparency.

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Table 1
Comparison of the Concepts

| | Economic unit | Proportional | Parent company |
|---|---|---|---|
| Asset/liability book value | 100% | % ownership | 100% |
| Adjustments to fair value | 100% | % ownership | % ownership |
| Additional depreciation or amortization | 100% | % ownership at FV | % ownership at FV |
| Non-controlling interest shown | % at fair value | none | % at book value |
| Subsidiary revenue and expenses shown | 100% | % ownership | 100% |
| Non-controlling interest in income | % ownership | none | % ownership |

Table 2
Comparative Consolidation Worksheet Entries

| FASB # 141 | FASB # 141R |
|---|---|
| 1. Eliminate beginning retained earnings and subsidiary equity accounts against the parent's investment account and recognize non-controlling interest. | 1. Same |
| 2. Recognize and adjust all asset and liability values to fair value for percent owned; goodwill is recognized based on parent's percentage ownership only. | 2. Recognize and adjust all asset and liability values to fair value, including non-controlling interest's share and recognize total goodwill. |
| 3. Additional subsidiary depreciation and amortization is recognized based on revised asset and liability valuations. | 3. Additional subsidiary depreciation and amortization is recognized based on revised asset and liability valuations, including non-controlling interest's share of revaluation. |
| 4. Eliminate revised subsidiary's net income against parent's investment account and non-controlling interest's account. | 4. Same –except amounts differ because of differences in depreciation and amortization based on full fair values rather than just the parent's share of these. |
| 5. Subsidiary's dividends are eliminated against the parent's investment account and the non-controlling interest account. | 5. Same |

Table 3
Illustrative Worksheet Entries

| | Statement #141 | | Statement #141R | |
|---|---|---|---|---|
| Account | Debit | Credit | Debit | Credit |
| 1. Retained Earn. - sub | $100,000 | | $100,000 | |
| Common Stk. - sub | 700,000 | | 700,000 | |
| Investment in Sub | | $640,000 | | $640,000 |
| Non-controlling Int. | | 160,000 | | 160,000 |
| | | | | |
| 2. Non-depr. assets | 56,000 | | 70,000 | |
| Depr. assets | 160,000 | | 200,000 | |
| Goodwill | 94,000 | | 117,500 | |
| Investment in Sub | | 310,000 | | 310,000 |
| Non-controlling Int. | | N/A | | 77,500 |
| | | | | |
| 3. Depreciation Exp-Sub | 16,000[1] | | 20,000[2] | |
| Accum. Depr. | | 16,000 | | 20,000 |
| | | | | |
| 4. Net Income - Sub | 64,000[3] | | 60,000[4] | |
| Investment in Sub | | 48,000[5] | | 48,000 |
| Non-controlling Int | | 16,000[6] | | 12,000[7] |
| | | | | |
| 5. Investment in Sub | $8,000 | | $8,000 | |
| Non-controlling Int. | 2,000 | | 2,000 | |
| Dividends - Sub | | $10,000 | | $10,000 |

[1] $160,000/10 yrs.
[2] $200,000/10 yrs.
[3] $80,000 - $16,000
[4] $80,000 - $20,000
[5] $80,000 X 80% = $64,000 - $16,000 Depr.
[6] $80,000 X 20%
[7] $$60,000 X 20%