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Certain Issues That Affect Accounting for Minority Interest in Consolidated Financial Statements

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INTRODUCTION

1. Minority interest has been defined as the part of a subsidiary's operating results and of the subsidiary's equity attributable to shares of its stock owned by other than the parent or another subsidiary. (IASC Statement 3, "Consolidated Financial Statements," paragraph 4.)

2. Consolidated financial statements are prepared for and are of interest to several classes of users. But, such financial statements are generally not prepared for and are not of interest to minority shareholders, because minority shareholders do not have a financial interest in the consolidated group--they have an interest in only one or more of the companies in the group other than the parent.

3. The accounting standards division has identified several areas in consolidation in which diversity in practice has developed because the accounting literature concerning minority interest is inadequate or unclear. Those areas affect accounting for minority interest in consolidated financial statements

- following business combinations accounted for by the purchase method,
- when accounting principles of a subsidiary differ from those of the consolidated group,
- in applying FASB Statement No. 12, "Accounting for Certain Marketable Securities,"

- in applying FASB Statement No. 34, "Capitalization of Interest Cost," and
- in eliminating intercompany profit or loss.

4. This paper explores issues that affect how minority interest should be accounted for in consolidated financial statements in each of those areas.

ACCOUNTING FOR MINORITY INTEREST FOLLOWING BUSINESS COMBINATIONS

Background

5. There is minority interest following a business combination involving more than 50% but less than 100% of an entity's common stock. Accounting for minority interest in consolidated financial statements depends on how the subsidiary's assets and liabilities are valued under APB Opinion 16, "Business Combinations." There is no valuation issue when a business combination is accounted for by the pooling of interests method because under that method (paragraph 12 of APB Opinion 16), the assets and liabilities of the constituents are carried forward to the combined corporation at their historical amounts. This issue therefore relates only to business combinations accounted for by the purchase method.

6. Concerning the purchase method, paragraph 87 of APB Opinion 16 states that at the date of acquisition, an acquiring entity shall record at fair value the assets acquired and the liabilities assumed of an acquired entity. But neither APB Opinion 16 nor any other authoritative pronouncement states whether the fair values of the assets acquired and liabilities assumed should be based (a) on the fair value of the acquired

entity taken as a whole imputed from the transaction or (b) only on the acquiring entity's proportional interest in the acquired entity.

7. To illustrate, if an entity acquires a 60% interest in another entity for $12 million, under view (a), the fair values of the assets acquired and liabilities assumed of the acquired entity should be $20 million; under view (b), the fair values of the assets acquired and liabilities assumed of the acquired entity should be adjusted by the difference between the price paid ($12 million) and the book value of a 60% interest in the acquired entity. The approach used determines the accounting for the minority shareholders' 40% interest in the consolidated financial statements.

Issue

8. In a business combination accounted for by the purchase method, should the fair values of the assets acquired and liabilities assumed of an acquired entity be based (a) on the fair value of the acquired entity taken as a whole imputed from the transaction or (b) only on the acquiring entity's proportional interest in the acquired entity?

Arguments

9. Those who believe the fair values of the assets acquired and liabilities assumed should be based on the fair value of the acquired entity taken as a whole imputed from the transaction have these reasons:

- The acquired entity is in substance a new entity and the fair value of the acquired entity taken as a whole best indicates the fair values of the assets acquired and liabilities assumed at the time of the business combination.

- When there is a substantial change in ownership, the price paid is the most relevant basis for measuring the assets acquired and liabilities assumed of the acquired entity.
- There is no apparent reason to account for minority interest sometimes by reference to historical amounts and sometimes by reference to fair values.
- Minority interest in consolidated financial statements is not intended to be meaningful to minority shareholders. It is simply a balancing amount.

10. Those who believe the fair values of the assets acquired and liabilities assumed should be based only on the acquiring entity's proportional interest in the acquired entity have these reasons:

- The price paid for an entity's assets and liabilities in a less than 100% acquisition cannot always be relied on to indicate the fair values of all the entity's assets and liabilities.
- Under view (a) in paragraph 6, there are overwhelming measurement problems if the acquisition is made in steps. For

example, if 60% is purchased initially and 35% is later purchased, there is no way to determine which purchase better indicates the value or whether the investment should be revalued at each acquisition.

- Minority shareholders are not shareholders of the consolidated group; their interest in the assets and liabilities of the acquired entity should be based on historical carrying amounts --not on fair values.
- The accounting literature generally supports historical cost accounting. Pro rata consolidation is consistent with historical cost concepts -- imputation of value is not.

ACCOUNTING FOR MINORITY INTEREST WHEN ACCOUNTING PRINCIPLES OF A SUBSIDIARY DIFFER FROM THOSE OF THE CONSOLIDATED GROUP

Background

11. Accounting principles of a subsidiary are sometimes adjusted in consolidation to conform to those of the consolidated group. For example, the consolidated group may present inventories on the first in, first out (FIFO) basis in the consolidated financial statements, but a subsidiary may account for its inventories on the last in, first out (LIFO) basis. Similarly, the consolidated group may use the declining balance method in depreciating property and equipment in the consolidated financial statements, but a subsidiary may use straight line. If an

adjustment is made in consolidation to conform the accounting principles of a subsidiary to those of the consolidated group, the adjustment affects the accounting for minority interest in consolidated financial statements.

12. If such an adjustment is made in consolidation, the Task Force on Consolidation Problems believes three approaches in making that adjustment are possible:

(a) the entire adjustment could be allocated between majority and minority interests,

(b) the entire adjustment could be allocated to majority interest, or

(c) the adjustment could relate only to to the majority shareholders' percentage of ownership.

Of the three approaches, the experiences of the task force members indicate that approach (a) is the most commonly used and approach (c) is the least commonly used.

13. To illustrate, an adjustment of $1,000 is to be made in consolidation to conform the subsidiary's straight line depreciation to declining balance, the method the consolidated group uses. The following illustrates, using a 40% minority interest, the effects of the possible alternatives discussed in paragraph 12.

	(a)	(b)	(c)
Decrease in consolidated net assets	$1,000	$1,000	$600
Decrease in majority interest share of income and equity	600	1,000	600
Decrease in minority interest share of income and equity.	$ 400	$- 0 -	$- 0 -

Issue

14. If an adjustment is made in consolidation to conform the accounting principles of a subsidiary to those of the consolidated group, (a) should the entire adjustment be allocated between majority and minority interests, (b) should the entire adjustment be allocated to majority interest, or (c) should the adjustment relate only to the majority shareholders' percentage of ownership?

Arguments

15. Those who believe the entire adjustment should be allocated between majority and minority interests have these reasons:

- Minority interest should be measured by reference to consolidated totals including adjustments, if any, made in consolidation.
- The view is consistent with the underlying assumption that consolidated financial statements represent the financial position and operating results of a single business unit.

16. Those who believe the entire adjustment should be allocated to majority interest have these reasons:

- The view is consistent with the underlying assumption that consolidated financial statements represent the financial position and operating results of a single business unit.

- Minority shareholders are not shareholders of the consolidated group, so adjustments made in consolidation should not affect their interest.

17. Those who believe the adjustment should relate only to the majority shareholders' percentage of ownership have this reason:

- Adjustments made in consolidation to conform a subsidiary's accounting principles to those of the consolidated group should affect only the interest of the majority shareholders and should relate only to their percentage of ownership.

ACCOUNTING FOR MINORITY INTEREST IN ACCOUNTING FOR MARKETABLE SECURITIES

Background

18. Under paragraph 8 of FASB Statement No. 12, "Accounting for Certain Marketable Securities," the carrying amount of a marketable equity securities portfolio is the lower of its aggregate cost and market value. Paragraph 9 of that Statement states that the current (and similarly the noncurrent) portfolios of entities consolidated in financial statements are treated as a single portfolio for comparing aggregate cost and market value.

19. Because the comparison is made at the consolidated level, the consolidated writedown to market value may differ from the

total writedowns in the separate financial statements of the components. That affects the accounting for minority interest in consolidated financial statements.

20. To illustrate:

	Parent	Subsidiary	Consolidated
Cost of securites	$1000	$1100	$2100
Market value of securities	1100	1000	2100
Unrealized gain (loss)	100	(100)	-0-
Adjustment in financial statements	$ -0-	$(100)	$ -0-

No writedown is made in the consolidated financial statements because the market value of the consolidated portfolio is not lower than its aggregate cost. (The unrealized gain in the parent's portfolio offsets the unrealized loss in the subsidiary's portfolio.) But, some argue minority interest should be credited with a proportional share of the unrealized gain in the parent's portfolio.

Issue

21. Under FASB Statement No. 12, the lower of cost and market value of marketable equity securities portfolios is determined and writedowns, if any, are made at the consolidated level. Should minority interest be credited with a proportional share of the unrealized gain in a parent's portfolio?

Arguments

22. Those who believe minority interest should not be credited with a proportional share of the unrealized gain in the parent's portfolio have these reasons:

- Minority shareholders are not shareholders of the consolidated group, so adjustments made at the consolidated level should not affect their interest.
- Such adjustments should relate only to the entity that owns the securities generating the unrealized gain or loss.
- If the securities generating the unrealized gain are sold, no portion of the proceeds or realized gain is allocated to minority interest.

23. Those who believe minority interest should be credited with a proportional share of the unrealized gain in the parent's portfolio have this reason:

- Minority interest should be measured by reference to consolidated totals including adjustments, if any, made in consolidation.

Corollary Issue

24. Arguments may differ if the situation discussed in paragraph 20 is reversed. To illustrate, this time the parent's portfolio has an unrealized loss and the subsidiary's portfolio has an unrealized gain.

	Parent	Subsidiary	Consolidated
Cost of securities	$1100	$1000	$2100
Market value of securities	1000	1100	2100
Unrealized gain (loss)	(100)	100	-0-
Adjustment in financial statement	$(100)	$ -0-	$ -0-

Some argue minority interest should be credited for a proportional share of the unrealized gain in the subsidiary's portfolio, which offsets the unrealized loss in the parent's portfolio. Others argue that since unrealized gains are not presented in financial statements, the accounting for minority interest should be the same as that in the subsidiary's separate financial statements.[1]

ACCOUNTING FOR MINORITY INTEREST IN CAPITALIZING INTEREST COST

Background

25. Under paragraph 15 of FASB Statement No. 34, "Capitalization of Interest Cost," (a) the total amount of interest capitalized in an accounting period should not exceed the total amount of interest cost incurred by the enterprise in that period and (b) in consolidated financial statements, that limitation should be applied to the total amount of interest incurred by the parent and consolidated subsidiaries on a consolidated basis.

26. Because the limitation is applied on the consolidated level, the consolidated amount of capitalized interest may differ from the total amounts capitalized in the separate financial statements of the components. That affects the accounting for minority interest in consolidated financial statements.

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[1] This could create recordkeeping problems depending on when the securities were acquired.

To illustrate:

	Parent	Subsidiary	Consolidated
Total amount of interest incurred during a period	$50,000	$100,000	$150,000
Amount of interest based on amount of qualified expenditures multiplied by interest rate	25,000	200,000	225,000
Amount that can be capitalized because of limitation	$25,000	$100,000	$150,000

27. $150,000 is capitalized in the consolidated financial statements, though a total of only $125,000 ($25,000 by parent and $100,000 by subsidiary) is capitalized in the separate financial statements of the components.

Issue

28. Should minority interest be adjusted for a proportional share of the difference between the amount of interest capitalized in consolidation and the total amounts capitalized in the separate financial statements of the components?

Arguments

29. The arguments are essentially the same as those developed in the earlier section, "Accounting for Minority Interest in Accounting for Marketable Securities."

ACCOUNTING FOR MINORITY INTEREST IN ELIMINATING INTERCOMPANY PROFIT OR LOSS

Background

30. Intercompany profit or loss arises when one component of a consolidated group sells inventory, equipment, or other assets to another component at amounts different from those at which the selling component carried the assets.

31. Until the issuance of ARB 51, "Consolidated Financial Statements," three approaches in accounting for intercompany profit or loss elimination were to:[2]

(a) allocate the entire intercompany profit or loss elimination between majority and minority interests,

(b) allocate the entire intercompany profit or loss elimination only to majority interest, or

(c) relate the intercompany profit or loss elimination only to the majority shareholders' percentage of ownership.

32. Paragraph 6 of ARB 51 states, however, that <u>any</u> profit or loss on assets remaining within the consolidated group should be eliminated. Paragraph 14 of ARB 51 states (a) the amount of intercompany profit or loss is not affected by the existence of minority interest and (b) the elimination of the intercompany profit or loss <u>may be</u> allocated between majority and minority interests.

33. Though ARB 51 appears to proscribe relating the elimination only to the majority shareholders' percentage of ownership it is still found in practice. A 1979 survey found that seven Fortune 500 companies eliminated in consolidation only the parent's proportional share of the intercompany profit.[3]

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[2] Each of these approaches could create recordkeeping problems depending on when the inventories were acquired.

[3] "Corporate Consolidation Policies" by James A. Dwane, Professor of Accounting, Fairleigh Dickinson University. (An unpublished research paper.)

34. Therefore the division believes all three approaches need to be reconsidered because the application of those approaches affects the accounting for minority interest in consolidated financial statements.

35. The experiences of the members of the Task Force on Consolidation Problems indicate that ARB 51 is generally interpreted to require the elimination of profit or loss from a sale by the parent to a subsidiary to be entirely allocated to majority interest. This issue therefore relates only to the sale by a subsidiary to the parent or to another subsidiary.

36. To illustrate, $1000 of intercompany profit remains in the parent's year end inventory of goods purchased from a 60% owned subsidiary (40% minority interest). The following illustrate the effects of the alternatives discussed in paragraph 31:

	(a)	(b)	(c)
Decrease in consolidated net assets	$1,000	$1,000	$600
Decrease in majority interest share of income and equity	600	1,000	600
Decrease in minority interest share of income and equity	$ 400	$ - 0 -	$ - 0 -

Issue

37. Should intercompany profit or loss elimination

(a) be entirely allocated between majority and minority interests,

(b) be entirely allocated to majority interest, or

(c) relate only to the majority shareholders' percentage of ownership?

Arguments

38. The arguments are essentially the same as those developed in the earlier section, "Accounting for Minority Interest When Accounting Principles of a Subsidiary Differ from Those of the Consolidated Group."

EXCEPTIONS TO APB OPINION 18

39. Under paragraph 19 of APB Opinion 18, "Equity Method for Investments in Common Stock," an investor's net income for a period and its equity are the same whether an investment in a subsidiary is accounted for on the equity basis or the subsidiary is consolidated.

40. Footnote 5 to FASB Statement No. 12 recognizes an exception to paragraph 19 of APB Opinion 18 because the lower of cost and market value comparison of certain marketable equity securities does not include the portfolios of unconsolidated subsidiaries, so the writedown may differ from the writedown that is made if the subsidiary is consolidated.

41. The division notes that the resolution of some of the issues raised in this paper might create other exceptions to paragraph 19 of APB Opinion 18, which the Board should recognize or reconcile.

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ADVISORY CONCLUSIONS

42. These are the advisory conclusions of the Accounting Standards Executive Committee and its Task Force on Consolidation Problems on the issues raised in this paper:

a) In a business combination accounted for by the purchase method, the fair values of the assets acquired and liabilities assumed of an acquired entity should be based on the acquiring entity's proportional interest in the acquired entity.

AcSEC: (9 yes, 3 no);

Task Force: (5 yes, 2 no)

This conclusion is based on the following:

(1) the underlying theory in consolidation is to emphasize proper accounting for assets and liabilities and to account for minority interest only after assets and liabilities are properly stated.

(2) there are overwhelming measurement problems in accounting for step transactions if the fair values of the assets acquired and liabilities assumed of an acquired entity are based on the fair value of the entity taken as a whole imputed from the transaction.

b) If an adjustment is made in consolidation to conform the accounting principles of a subsidiary to those of the consolidated group, the adjustment should be allocated between majority and minority interests.
AcSEC: (11 yes, 0 no, 1 absention);
Task Force: (7 yes, 0 no)

c) In accounting for marketable equity securities in consolidation,

   (1) minority interest should be credited with a proportional share of the unrealized gain in the parent's portfolio.
   AcSEC: (11 yes, 0 no, 2 abstentions);
   Task Force: (5 yes, 2 no)

   (2) minority interest should be credited with a proportional share of the unrealized gain in a subsidiary's portfolio.
   AcSEC: (11 yes, 0 no, 2 abstentions);
   Task Force: (5 yes, 2 no)

d) Minority interest should be adjusted for a proportional share of the difference between the amount of interest capitalized in consolidation and the total amounts capitalized in the separate financial statements of the components.
AcSEC: (11 yes, 0 no, 2 abstentions);
Task Force: (4 yes, 3 no)

e) In consolidation, intercompany profit or loss elimination should be entirely allocated between majority and minority interests.
AcSEC: (12 yes, 0 no, 1 abstention);
Task Force: (5 yes, 2 no)

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