A question for Tom

Top tutor Tom Clendon explains a concept that all students need to know by heart

Question
Why are there two methods of measuring NCI (one at fair value and the other as a proportion of net assets) and what are the consequences?

Tom's answer
Ultimately, the reason why there is a choice in the measurement of NCI at acquisition and therefore the measurement of goodwill is because the standard says so!

The conceptual framework
From a framework perspective, this choice is I think unsatisfactory because it reduces comparability for users. It's also hard for them to understand. For these reasons the choice reduces the usefulness of information for stakeholders.

The historical background is that the standard was produced at a time when there were attempts to converge and harmonise international accounting standards with US GAAP. Traditionally, international accounting standards had used the proportional method, whereas US GAAP had used the fair value method. By the standard allowing both it results in a compromise that all parties were happy with.

The most important thing, though, is to appreciate the consequences of this choice.

Consequences
When NCI is at fair value goodwill is in full, and therefore any impairment loss relating to the goodwill is split between the group retained earnings and the NCI in the proportion that profits and losses are shared between the parent and the NCI.

On the other hand, when NCI is a proportion of net assets the goodwill is wholly attributable to the parent company only and therefore all impairment losses are charged to the group retained earnings. The same principle is true when it comes to exchange differences on goodwill as well.

Conceptually, the use of the measurement of NCI at fair value is considered superior. This is because it is consistent in that all the other ingredients in the calculation of goodwill also at fair value. In addition, it means that we are consolidating all of the goodwill of the subsidiary (not just a proportion) and reporting an NCI interest in that goodwill. This is again consistent with the way that we consolidate the other assets of the subsidiary. We consolidate all of the subsidiaries' land and buildings, for example, and report an NCI in that asset as a result.

The consequences of measuring NCI at fair value do mean that there is a larger goodwill figure and this in turn will mean, in due course, there will be more impairment losses to be charged. Therefore in future group profits will be potentially diminished.

There is another additional benefit of measuring NCI at fair value and therefore having full goodwill which is that, when you come to calculate the impairment loss arising, there is no need to do the confusing and convoluted artificial grossing up of the goodwill in the impairment review process that is only necessary when you are calculating NCI as a proportion of net assets. PQ

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