

Consolidation of Financial Statements and Reporting – New Challenges



When a joint stock company acquires a majority of voting shares in another joint stock company, the investor-investee relationship becomes closely connected and these two separate legal entities are viewed as a single entity with the investor company gaining 'control' over the investee company. Control is the power to govern the strategic operating, investing and financing policies of an entity so as to derive economic benefits from the activities of the investees. The conclusive proof is to combine the balance sheets of these two entities according to the rules of accounting. In simpler terms, consolidation refers to the process of bringing together all the assets, liabilities, revenues and expenses of the group and presenting the combined numbers after making proper eliminations and adjustments in respect of intra-group transactions, as that of a single economic entity. Larger companies acquiring controlling interest in smaller companies have become common and, in fact, necessary under the present globalised economic scenario. The challenge, however, comes from the complex individual business policies and practices of the entities that are grouped together, multiple currencies as well as accounting standards and regulations. This article discusses about the various challenges faced by the corporate accounting at the company that controls other entities in the matter of preparation and presentation of consolidated financial statements.

The Need for Consolidation of Financial Statements

The Companies Act makes consolidation of financial statements of subsidiaries with those of holding companies mandatory. Presentation of consolidated financial statements by the parent company is in addition to the mandatory presentation of its individual financial statements as the holding company. Companies, to which the provisions of the Act apply, are now increasingly controlling entities such as partnership firms, special purpose vehicles, variable interest entities, jointly controlled entities, associations, etc., which



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are non-corporate bodies and the responsibility for proper maintenance of records in such cases rests with that of the parent company. The combined economic influence and power wielded by the apex corporate entity at the pinnacle is by no means small and the true financial and marketing leverage that this combination has within the industry segment would not become visible if the parent company's financial statements are viewed in isolation.

The increasing globalisation has unveiled unlimited opportunities for even small and medium enterprises to expand overseas and establish production and sales facilities abroad. These small and medium enterprises too are linked with each other based on different business strategies and look at consolidated financial reporting as a means and tool for managerial decision making, the same way as large groups do. In recent times, some investors, financial rating agencies as well as lending institutions have also shown interest in obtaining the consolidated financial position of the entities even for periods less than a year and analyse the business risk of the entire group and not just the entity being rated. Legal consolidation is performed according to different accounting standards, *i.e.*, Indian ASs, IFRS/IAS, US GAAP, etc. For groups that report according to Indian AS, US GAAP or IAS, business segment reporting is also required. Most local accounting principles also demand business segment reporting from companies listed on stock exchanges. These requirements may differ with each level in the hierarchy within a group of complex corporate structure.

The legal requirement apart, consolidation of the financial statements of all the entities in a group is becoming significant in more ways than one for effective management of these entities. Management consolidation, for example, focuses on the consolidation of profit centers, divisions, strategic business units and lines of business in the product-based hierarchy. Of late, enterprises have realised the importance of consolidating even their planning, budgeting and forecasting data as these are used on a day to day basis in the management decision making processes. The current business scenario gives little room for an enterprise that has ambitious growth plans to ignore the need for consolidating the planning, budgeting and forecasting data for the group to perform

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analysis for managerial decision making and this is as important as the legal requirements for consolidation of the financial statements. It is imperative to quickly adjust plans and forecasts, shorten budget cycle time, close the books more quickly, help ensure compliance with regulatory and financial standards and get the information needed to make more confident decisions. This situation has thrown a lot of challenges to any parent company in the exercise of consolidating the financial statements of the group entities. Besides, the ability of the parent company to close books on time ensuring accuracy, data quality and in full compliance with global regulatory standards is a critical management challenge that could impact its image.

Key Considerations in Financial Consolidation

Despite the fact that the parent company's CFO and his team would have to reckon with and manage a number of issues, such as the evaluation and assessment of the purpose and design of the investee to determine the level of control over an investee for the purpose of consolidation, nevertheless, equally painstaking efforts are required in the actual consolidation of financial statements of the investor and the investee companies. The following are the primary areas of 'concern' for the corporate accounting at the investor company:

- Balancing speed and accuracy in financial reporting
- Overcoming data normalisation challenges
- Intercompany reconciliation and elimination
- Data accuracy and audit trail for activity and data
- Compliance and enhanced reporting

- Faster, close, greater agility and higher-quality reporting

All the above imperatives put the corporate accounting of the investor company in a tight spot and there is a felt need for a solution that resolves all the above issues in a cost effective manner.

Consolidation Procedures and Accounting Requirements

The guiding principle of consolidated financial statements is that of the 'single entity' concept and the aim of consolidated financial statements is to show the performance of the group as if it were a single entity by regrouping financial data for a company's subsidiaries into a unified set of accounting records. The elimination entry that is passed for avoiding the double-counting forms the core of consolidation adjustments. This process of regrouping and reclassifying the accounting records of two different entities must be carried out systematically, in line with the generally accepted accounting principles (GAAP) and in compliance with the regulatory requirements – IFRS/IAS. To achieve this purpose, the accounting principles to be applied in respect of consolidation of financial statements of a parent and its subsidiaries are:

A. Intergroup transactions are eliminated in full:

- Combine like items of assets, liabilities, equity, income, expenses and cash flows of the parent with those of its subsidiaries.
- Eliminate by offsetting the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary. Any goodwill or gains from a bargain purchase (capital reserve) that arises will have to be presented as a separate item in the statement of financial position (balance sheet).

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B. Uniform accounting policies

The consolidated financial statements are to be prepared applying uniform accounting policies for like transactions and other events in similar circumstances.

C. Reporting date

Consolidation of an investee shall begin from the date the investor obtains control of the investee and cease when the investor loses control of the investee.

D. Non-controlling interests (Minority Interests)

The amount of the equity capital as well as reserves pertaining to the non-controlling interests (minority shareholders) is to be presented in the consolidated financial statements separately from the equity of the owners of the parent.

The Challenges of the 'First Financial Close' after an M&A

The need to consolidate the financial statements becomes necessary when an entity merges with or acquires another entity. A merger or acquisition normally creates sensation but the challenges it throws up post-merger, on the finance executives is not generally perceived outside of the acquirer's CFO and his team. The first financial closure, or more technically, 'the first consolidation,' soon after an acquisition or merger, is always a test for the wisdom of the CFO and is often, the CFO's 'nightmare.' More often than not, the first financial closure after an acquisition or merger is completed under tremendous pressure due to the challenges that the entry of the new entity has posed to the parent company. The key challenge is the timely completion of the whole consolidation process without errors and with necessary process controls so that the information quality, accuracy and data integrity are not compromised. There is also a need to maintain compliance costs and risks lower.

For example, the following, among other things, are some of the finance related challenges when a company merges with or acquires another:

- Synergising different accounting policies and processes.
- Harmonising different procedures and workflows, such as, different closing cycles.
- Integrating different processes and eliminating overlaps.

The challenges of the first consolidation apart, the quarterly and annual close and preparation of the consolidated financial statements ('subsequent consolidation') of the existing entities in a group also has its own formidable situations especially in the light of the compliance requirements of IFRSs/IASs besides local GAAP. In recent times, the purpose of consolidating the financial statements of entities in a group has undergone a drastic change.

- Taming different ERP/non-ERP systems and stand-alone packages.
- Compiling and collating data residing and scattered across many legacy systems and spreadsheets.
- Reconciling different data definitions before mapping the Chart of Accounts and financial data structures and deciding on the manner of roll-up.
- Devising a transition plan for all key areas, such as accounts payable, accounts receivable, general ledger, fixed assets and intercompany transfers and executing the same.
- Migrating the existing data to populate the new consolidation system.

The whole process could become complicated if the parent company is an Indian Company and the acquired company is outside India following different GAAP. Unless the Indian company fully understands all the policies and processes on the basis of which the data have been collected, compiled and used for the financial statements of the acquired company, the consolidation process is not going to be easy.

Under the new Companies act, those parent companies with their subsidiaries though existing for a long time, but were not consolidating until now, will have to consolidate and when they do, each one of them is going to carry out a 'first consolidation' task. Besides, there are Ind ASs, IFRSs and IASs to comply with in preparing the consolidated financial statements and reporting.

Periodic Consolidation, Regulatory Compliance and Challenges Facing the Investor Company

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- The regulators review all the decisions that the group makes to ensure that these decisions comply with the legislations and industry practices.
- The financial markets are exposed to corporates more than ever before.
- The imperatives of protecting the investors.
- The investors and creditors gauge a firm's market share, competitive standing and business performance.
- The company's top leadership evaluates the economic health of the company and identifies non-performing areas, countries or segments.

The above factors have weighed heavily and contributed to the issue/revision of IFRS and IAS guidelines pertaining to consolidation, by the International Accounting Standards Board (IASB), in particular as a consequence of the global financial crisis of 2007/2008. The crisis had highlighted a lack of transparency about the extent to which investors were exposed to risks associated with an investee's involvement with 'off balance sheet vehicles'. These are entities that are not consolidated, but which have the potential to give rise to exposures in the event of losses and are now brought into consolidation requirements even if an investee company is not technically a subsidiary company of the investor company. The need to consolidate only if the investee company is truly a subsidiary by virtue of the capital contribution made by the investor company beyond a certain percentage is not the valid criterion any more. Thus, the single criterion, *viz.*, 'control' is all that needs to be tested to reckon the investor-investee relationship and in terms of the various standards, the financial statements of the entities are to be consolidated and presented in the manner specified.

Implications of an M&A vis-à-vis Accounting Standards

A 'Merger and Acquisition' results in a business combination and it is very necessary to consider the various implications of business combinations because these implications, in addition to the various challenges specified above, include a number of standards that have been issued in respect of accounting and preparation of financial statements after a merger and acquisition. All these challenges and the standards have made it necessary to initiate a formidable program of corporate accounting governance on the part of the entity gaining control over other entities. The most important challenge besides the actual task of consolidating the financial numbers of the acquired entity into the consolidated financial statement is that the CFO of the acquiring entity has to consider the requirements of IFRS 3 *Business Combinations* and IAS 27 *Consolidated and Separate Financial Statements* (as well as the local GAAP) that recognise the acquisition or merger as a 'business combination', that gives rise to the need for a consolidation of the financial statements.

IFRS 3 (2008) and IAS 27 (2008)

What constitutes a business and if there results a business combination in the event a business is acquired by another are now subject to the recognition and measurement requirements of the revised IFRS 3 *Business Combinations* and the related revised IAS 27 *Consolidated and Separate Financial Statements* issued by the International Accounting Standards Board (IASB) on 10th January 2008. IFRS 3 also reckons with the acquisition of a group of assets by an entity as part of its ongoing business strategy of investment. IFRS 3 gives a definition of business as consisting of *inputs* and *processes* applied to those inputs that have the ability to create *outputs*. These are the elements of the framework that determine if an acquisition is a business or a group of assets.

The revised IFRS 3 requires the following guidance to be followed in the application of acquisition method (purchase method) while accounting for the business combination:

- *Identifying a business combination:* Identify if an acquirer obtains control of assets and assumption of liabilities of one or more businesses. 'True mergers' or 'mergers of

equals' are also business combinations. If the group of assets acquired by the acquirer does not constitute a business, then the event or transaction is accounted for as asset acquisition.

- *Recognition and measurement:* Each business combination should be accounted for by using the acquisition method which involves:
 - o Identifying the acquirer
 - o Determining the acquisition date
 - o Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling (minority) interest in the acquiree
 - o Recognising and measuring goodwill or a gain from a bargain purchase (capital reserve)

The guidance in the revised IAS 27(2008) is used to identify the acquirer – the entity that obtains control of the acquiree [However, this guidance is now part of IFRS 10 *Consolidated Financial Statements* and IAS 27 is now *Separate Financial Statements* after its amendment in 2011. The power-to-govern approach to consolidation under IAS 27 (2003) and IAS 27 (2008) has been taken away].

The Entity Concept

The revised IFRS 3 is based on the principle of 'entity concept' and accordingly, the economic unity of the group is recognised which is seen as a single economic entity. The purpose is to make the consolidated financial statement (Balance Sheet) present the total resources managed by the group and as such, as part of revision of IAS 27 in 2008, the equity holding of the controlling entity as well as the equity of the non-controlling interest (minority interest) are both included in the


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group's equity but separately disclosed. Similarly, the share of non-controlling interest of net income is to be presented as an allocation rather than as a deduction within the statement of comprehensive income (Statement of profit and loss). Presentation in this manner is to view the non-controlling interest as part of equity and not as liability of the group. According to the entity concept, if the consideration paid exceeds the fair value of the net assets acquired, the difference between the fair value of the acquiree as a whole and its net equity as a whole is to be shown as goodwill in the consolidated financial statement of the acquiring entity. Thus, the 'full goodwill' of the acquired business is shown and not just the acquirer's share of goodwill.

With the need to comply with the requirements of IFRS 3 and the consequential compliance with other IFRSs in respect of each merger or acquisition, the CFO and his team have plenty of tasks to perform in responding to the challenges of first consolidation. If there are uncertainties as to whether the transaction is acquisition of business or assets, the complexity expands and adds to the challenges. In that case, the CFO needs to find a solution to identify the three elements, *viz.*, input, processes and output in the acquired group and assess the capability of the group and market participant to produce outputs. Another test to determine whether the acquired group of assets is business is that if the consideration paid is significantly in excess of the fair value of assets acquired, it is indicative of goodwill and so the acquisition is business. The determination requires judgment to assess the capabilities of the group to produce outputs and the relevant facts and circumstances are to be considered.

New Perspectives on Financial Consolidation and Reporting

Having determined the acquisition was either a business or a group of assets, there are other matters to be considered while consolidating the financial statements. In furtherance of an M&A, assets acquired, liabilities assumed or incurred and equity instruments issued in a business combination are to be subsequently measured and accounted for in accordance with other applicable IFRSs according to their nature. The acquiring entity or the parent needs to adhere to the following as a package in the process of preparing

and presenting the consolidated financial statements:

- IFRS 10 Consolidated Financial Statements
- IFRS 11 Joint Arrangements
- IFRS 12 Disclosure of Interests in Other Entities
- IAS 27(2011) Separate Financial Statements
- IAS 28(2011) Investments in Associates and Joint Ventures.

The IFRSs above are newly issued by the International Accounting Standards Board in May 2011 along with the two revised IASs, effective for periods beginning on or after 1st January 2013 and are required to be adopted as a package. The early application is permitted but all the five standards are to be applied together as a package.

Further, on 31st October 2012, IASB also published Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27) as consolidation exception specific to investment entities as an industry-specific solution. These amendments will be effective for annual periods beginning on or after 1st January 2014.

The Next Step Forward

With the issue of IFRS 3(2008), the M&A scenario is witnessing different perspectives in identifying a business combination and the recognition and measurement of various assets, liabilities, goodwill, etc., and the subsequent issue of IFRS 10, IFRS 11, IFRS 12, IAS 27 (2011), and IAS 28(2011) extend the regulatory compliance requirements well forward. The reporting standards brought in by the new regulatory guidance have compounded the complexities involved in an M&A forcing the CFO and his team to plan ahead for an incident-free financial close, consolidation and reporting. The new requirements and their implications are discussed in "Consolidation of Financial Statements and Complying with Accounting and Reporting Standards – New Framework". ■

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