Consolidation of Financial Statements and Complying with Accounting and Reporting Standards – New Framework

Of all the accounting standards issued by the International Accounting Standards Board (IASB) from time to time, the standards concerning the consolidation of financial statements and reporting have assumed great importance in the past few years, especially those IFRSs that were issued after the 2007/2008 global financial crisis. Typical norms obtaining for the consolidation of financial statements of the investee companies with those of the investor companies have been given entirely new definitions. Existing International Accounting Standards have been replaced and/or redefined by the introduction of new standards. Thus, IFRS 10, IFRS 11, IFRS 12 have been introduced and IAS 27 and IAS 28 have been revised in 2011, containing new principles of financial consolidation and reporting. These guidelines bring with them a number of challenges for the reporting entities. Nevertheless, along with the other IFRSs, these are increasingly being recognised as global financial reporting standards and more and more countries around the globe have either adopted or plan to adopt these, including India, as a step towards achieving global convergence in financial reporting. In this article, the author briefly touches upon the standards that have been issued by the IASB in respect of consolidation and the related accounting requirements. Read on…

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Consolidation of financial statements is becoming necessary in view of the operations of corporations getting geographically extended with local and overseas acquisitions as a strategy for inorganic growth as well as fresh investments in new projects. Operations of the new entity are tracked and consolidated for legal as well as managerial reporting

purposes. There are well-defined regulatory guidance issued by local and international bodies for legal reporting with a view to bring in uniformity and strict compliance to various standards. Standards issued by the IASB (International Accounting Standards Board) for the consolidation of financial statements are increasingly being adopted by accounting bodies worldwide to ensure compliance with globally accepted standards of financial reporting. There are a handful of standards issued by the IASB that have introduced new principles and concepts in respect of consolidated financial statements.

IFRS guidance relating to financial consolidation

In May 2011, the IASB published a *package of five* new and amended guidance that set out new requirements for consolidation, accounting for joint arrangements and disclosure of interests in other entities:

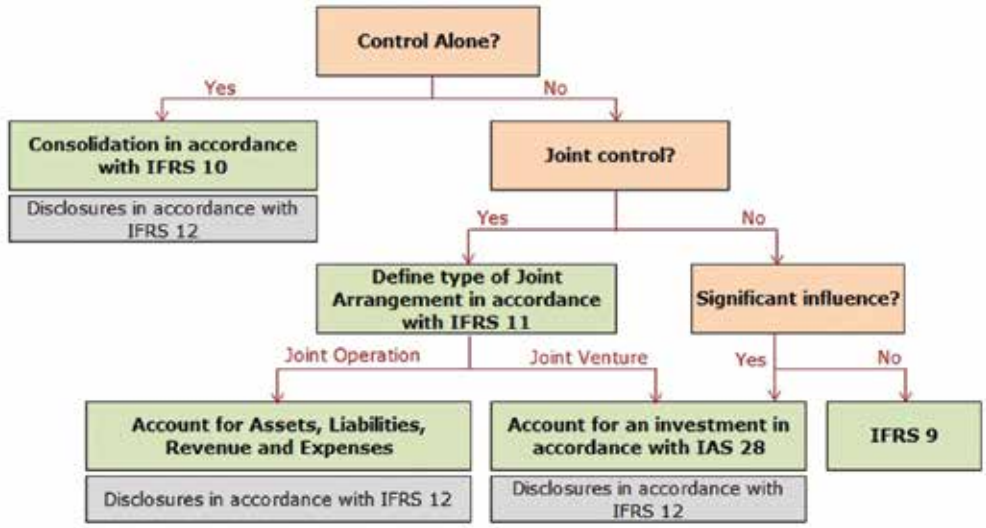
- IFRS 10 *Consolidated Financial Statements* (replacing IAS 27 *Consolidated and Separate Financial Statements* and SIC *12 Consolidation – Special Purpose Entities)*
- IFRS 11 *Joint Arrangements*
- IFRS 12 *Disclosure of Interests in Other Entities.*
- IAS 27(2011) *Separate Financial Statements* (Revised and renamed following the issuance of IFRS 10, retaining the existing guidance on Separate Financial Statements)
- IAS 28(2011) *Investments in Associates and Joint Ventures* (Revised following the issuance of IFRS 10 and IFRS 11)

The consolidation requirements previously included in IAS 27(2008) *Consolidated and Separate Financial Statements and SIC-12 Consolidation – Special Purpose Entities* have been replaced and are set out in a single standard, IFRS 10. The revised IAS 27(2011) now only includes guidance for separate financial statements.

These are effective for annual periods beginning on or after 1st January, 2013, and are required to be adopted as a *package of five*, with earlier application permitted if all the standards in the package are so applied (except for IFRS 12 that can be applied earlier on its own). If it is applied for a period beginning before 1st January, 2013, disclosure is required of that early adoption and the extensive consequential amendments to other IFRSs also need to be applied.

Further, on 31st October, 2012, the 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. Accordingly, the *qualifying investment entities* as defined in the Amendment to IFRS 10, upon meeting some tests, need to recognise and account for their investments in controlled entities as well as investments in associates and joint ventures in a single line item in the statement of financial position (balance sheet) measured at *fair value through profit or loss (FVTPL).*

These five standards should be considered from a holistic point of view as they strongly interact. The IASB has published the following scheme to explain how IFRS 10, 11, 12 and IAS 28 interact:



Source: IFRS Foundation website

IFRS 10 clarifies that the power exists if the investor company has the ability to direct these relevant activities of the investee company even if these relevant activities are performed only when particular circumstances arise or specific events occur.

The revised standards use the principle of *economic entity*, which treats all providers of equity capital as shareholders even if they are not actually shareholders in the parent company.

Key changes introduced in IFRS 10 and their challenging posers

The new IFRS 10 *Consolidated Financial Statements* has introduced two significant aspects that determine when/whether an investee should be consolidated. Accordingly, the new principles are:

1. ***Single control model*** for all entities: An investor controls an investee when 'the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.' This summarises that the investor should possess *all the* following three elements to conclude that it controls an investee:
   - *Power over the investee* (whether or not that power is used in reality).
   - *Exposure*, or rights, to *variable returns* from its involvement with the investee.
   - The *ability* to use its power to affect the amount of the investor's returns.

An investor must possess all the three elements to conclude that it controls an investee. On the basis of the existing facts and circumstances, if there are changes to at least one of the three elements, the level of control should be reassessed to determine if the investee should be consolidated or not.

2. The concept of ***relevant activities:*** These are defined as *'activities of the investee that significantly affect the investee's returns.'* IFRS 10 has introduced a new requirement to analyse the activities of an investee company in order to determine which of these activities most significantly affect its bottom line and ascertain to what extent the investor company has control over these activities. This necessitates the investor company to:
   - Consider the purpose and design of the investee's business activities.
   - Identify and assess the relevant activities that significantly affect the investee's returns.
   - Determine the rights that give the decision making power in respect of the relevant activities, how decisions about these activities are made and who has these rights.
   - Ascertain if the investor company influences these decisions with its power to direct these activities.

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Three criteria for assessment of control

The evidence of power over the investee: IFRS 10 contains an explicit requirement for investor/investee relationships to be assessed on a continuous basis to determine if the investee company needs to be consolidated. These requirements have necessitated careful analysis on the part of the investor company and it is required to analyse all the facts and circumstances and apply their judgment in making the control assessment to take into account the evidence of power. Although in some cases, it will be straightforward to identify and attribute, in others the approach will be more complex because the scope of certain assessment and analysis may be highly judgmental, especially where an investor company potentially controls an investee company that is not wholly owned or with less than the majority holding of voting shares.

The issue of de facto control: IFRS 10 explicitly includes the concept of *de facto* control, where an investor with less than a majority of voting rights has power over an investee which could result in different consolidation conclusions for groups that have substantial, but not majority, shareholdings in other entities. The investors' size of the holding of voting rights relative to the size and dispersion of holdings of other vote holders is one determining factor for the evidence of power in favour of the investor company, especially where it holds 49% of the voting shares and the remaining voting shares are all held by highly dispersed individuals, with no

IFRS 11 distinguishes two types of Joint Arrangements by the rights and obligations of the parties to the arrangement, which have joint control. In the case of Joint Operation, the joint operators have rights to the assets and obligations for the liabilities of the arrangement and the individual share of assets, liabilities, revenue and expenses must be recognized by each of the joint operator in accordance with the applicable IFRSs.

one holding more than 1% of the voting rights and may conclude that it has power over the investee. Even if an investor holds much less than 49% of the voting shares, it may still reasonably conclude that it has power over the investee if the other shareholders are generally passive in nature at previous shareholder's meetings. The investor company should also consider the existence of rights other than voting rights that control the investee where the investor company holds less than the absolute majority of voting shares.

Exposure or existence of rights to variable returns: The second criterion in the assessment is the variable returns that an investor company gets from its involvement with an investee company and would generally include the dividends, interest, the direct returns on its investment, changes in the value of its investment, management or service fee arrangement, the operational benefits derived from the investee company in the form of reduction in cost, market reach, as well as strategic and logistical advantages. The investor company needs to identify such exposure and rights and acknowledge them as emanating directly from its involvement with the investee company.

The linkage of 'Power' with 'Variable Returns': The third criterion deals with the 'ability' of the investor company to use the 'power' over the investee company that affects the amount or quantum of 'returns' for the investor company. This linkage is the conclusive proof of the power that the investor company has over the investee company that affects the returns for the investor's own benefit.

Changing control level and determination of entity hierarchy

Thus, the consolidation scenario is now dynamic and could be constantly changing due to the fact that the *relevant activities* may be changing and on the basis of continuous assessment, an investee, during a single year, may or may not be required to be consolidated (but instead, reckoned under *Equity Method* of accounting). This is especially so when more than one investor have the rights to direct different relevant activities. There may be questions as to why an investor does not control the investee even though it holds more than half of the voting rights of the investee or why an investor controls an investee even though it holds less than half of the voting rights of the investee. This may be in addition to the changing equity holding by the investor company during any year.

When it comes to the actual consolidation exercise, the *entity hierarchy* position (entity hierarchy is one where the entities will change according to evolving business needs as opposed to the fixed hierarchy that does not change and is used in management reporting) relevant at the point of time as exists at the end of the reporting period, may be different from what it was at the beginning of the period as a result of the determination of whether an investee company is still under the control of the investor company. The investor company's CFO and his team need to work with the entire management team in the analysis of the relevant transactions, business and operations of the investee company and therefore, require substantial management involvement and co-ordination in this exercise.

IFRS 11 *Joint Arrangements*

IFRS 11 *Joint Arrangements* deals with jointly controlled entities that were previously included in IAS 31 *Interests in Joint Ventures*. The new standard as per IFRS 11 is that there are only two forms of joint arrangements – 'Joint Operations' and 'Joint Ventures'. As a consequential amendment, the IASB also amended IAS 28, which has been renamed as IAS 28 *Investments in Associates* and Joint Ventures, to describe the application of the equity method to investments in joint ventures in addition to associates.

IFRS 11 distinguishes two types of Joint Arrangements by the rights and obligations of the parties to the arrangement, which have *joint control*. In the case of Joint Operation, the *joint operators* have rights to the assets and obligations for the liabilities of the arrangement and the individual share of the assets, liabilities, revenue and expenses must be recognised by each of the joint operator in accordance with the applicable IFRSs.

In case of a Joint Venture, the *joint venturers* have rights to the net assets of the arrangement and each of the joint venturers must account for its interest by using the equity method of accounting under IAS 28(2011).

As far as accounting is concerned, the following is the new standard:

- Joint operations are accounted for in accordance with IFRS 11.
- Joint ventures are accounted for in accordance with IAS 28 using the equity method of accounting.
- Proportionate consolidation is no longer permitted when accounting for investments in joint ventures.
- Equity accounting is now used when accounting for investments in both associates and joint ventures.

Since the new standard, as required by IFRS 11 does away with the proportionate method of accounting and instead requires the equity method to be used, there are challenges in the year of transformation, that is, the periods beginning on or after 1st January, 2013. While transitioning from the proportionate method to equity method, the investor company has to break up the proportionately consolidated net asset value into a single investment for the restated financial statements.

IFRS *12Disclosure of Interests in Other Entities*

All the disclosure requirements that were included in the individual standards - IAS 27(2008), IAS 28(2008) and IAS 31 under previous guidance - are now set out in IFRS 12*Disclosure of Interests in Other Entities*. These requirements mandate disclosure in such a way that the information would help the readers of the consolidated financial statements to evaluate the nature, risks and financial effects associated with the investor company's interests in subsidiaries, associates and joint arrangements as well as unconsolidated structured entities.

The IASB has also issued *Investment Entities (Amendments to IFRS 12)* on 31st October, 2012, specific to investment entities to be effective from the annual periods beginning on or after 1st January, 2014.

To sum up:

- Accounting for investments in the consolidated financial statements is different depending on the control or influence the investor has over the investee.
- Subsidiaries (entities that are controlled by the parent according to criteria defined in IFRS 10) are consolidated using the full consolidation (purchase) method.
- Joint ventures (IFRS 11 *Joint Arrangements*) and associates are accounted for using the equity method as defined in IAS 28.
- Proportionate Consolidation is no longer permitted.
- Investment Entity – *Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27)* published by IASB on 31st October, 2012 requires qualifying investment entities to recognise their investments in controlled entities in a single line item in the statement of financial position (Balance Sheet), measured at Fair Value Through Profit or Loss (FVTPL). However, a non-investment entity parent is required to consolidate, line by line, the investment entity it controls, thereby including those other entities controlled through the investment subsidiary, that is, full consolidation.

These IFRS-converged accounting standards could be early-adopted by the specified class of companies. However, since these converged standards are yet to be notified and adopted, the financial statements prepared under these standards may not be acceptable as sufficient compliance with Section 211(3C) of the Companies Act, 1956.

Mandatory Accounting Standards issued by ICAI and IFRS convergence in India

Here, it is necessary to consider the Indian position in regards to the various accounting standards pertaining to the preparation and presentation of consolidated financial statements.

The Core Group, constituted by the Ministry of Corporate Affairs for convergence of Indian Accounting Standards with International Financial Reporting Standards (IFRS) from 1st April, 2011, that held its meeting on 11th January, 2010 agreed that in view of the roadmap for achieving convergence, there will be two separate sets of Accounting Standards under Section 211(3C) of the Companies Act, 1956:

- The first set would comprise of the Indian

Accounting Standards which are converged with the IFRSs which shall be applicable to the specified class of companies - the date on which these will come into force is yet to be notified. Until such time, the existing Indian Accounting Standards as notified under the Companies (Accounting Standards) Rules, 2006 will continue to apply to these companies.

These *IFRS-converged accounting standards* could be adopted early by the specified class of companies. However, since these converged standards are yet to be notified and adopted, the financial statements prepared under these standards may not be acceptable as sufficient compliance with Section 211(3C) of the Companies Act, 1956.

- The second set would comprise of the existing Indian Accounting Standards and would be applicable to other companies, including Small and Medium Companies (SMCs) as currently notified under Companies (Accounting Standards) Rules, 2006.

Besides, for banking and insurance companies, there will be a separate roadmap. As decided by the Council of The Institute of Chartered Accountants of India at its 269th meeting, the process of convergence to IFRS was to begin for the accounting period commencing on or after 1st April, 2011. The Council of the ICAI has finalised 11 new/revised Ind ASs during the first quarter of 2011 which are under consideration of the National Advisory Committee on Accounting Standards (NACAS) and are yet to be notified. These converged standards include:

- Ind AS 110-Consolidated Financial Statements corresponding to IFRS 10
- Ind AS 111-Joint Arrangements corresponding to IFRS 11
- Ind AS 112-Disclosures of Interest in Other Entities corresponding to IFRS 12
- Ind AS 27-Separate Financial Statements corresponding to IAS 27
- Ind AS 28-Investments in Associates and Joint Ventures corresponding to IAS 28

Since the Guidance Note on Audit of Consolidated Financial Statements states that the auditor's objectives in an audit of con¬solidated financial statements are to satisfy himself that the consolidated financial statements have been prepared in accordance with the requirements of Accounting Standard (AS) 21*Consolidated Financial Statements*, Accounting Standard (AS) 23*Accounting for Investments in Associates in Consolidated Financial Statements* and Accounting Standard (AS) 27*Financial Reporting of Interests in joint Ventures*, these are the standards that should be followed until a formal notification is made to make the converged standards mandatory.

AS 23 speaks about the preparation and presentation of consolidation of financial statements by using the equity method of accounting where an investor has significant influence over an enterprise which is neither a subsidiary nor a joint venture.

The existing Accounting Standards that are mandatory now, relating to consolidation of financial statements (AS 21, AS 23 and AS 27) issued by The Institute of Chartered Accountants of India differ in some areas with the corresponding IFRSs and the revised/amended IASs that have been issued in 2011 by the International Accounting Standards Board (IASB).The key differences between the existing mandatory ASs and the IFRSs are noted here.

Accounting Standard AS 21 *Consolidated Financial Statements*

AS 21 is mandatory *if* an enterprise presents the consolidated financial statements. In other words, the accounting standard does not mandate an enterprise to present the consolidated financial statements, but if the enterprise presents the consolidated financial statements for complying with the requirements of any statute or otherwise, it should prepare and present consolidated financial statements in accordance with AS 21. According to AS 21, the primary test of control of the investor company comes from the ownership, directly or indirectly through subsidiary(es) of more than half of the voting power of an enterprise or control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from its activities.

AS 21 is rule based whereas IFRS 10 is principle-based. Control is the single basis for consolidation. This difference is quite emphatic when the stress is on the power that arises from the existing *substantive rights* that give the investor company

the *ability* to use the power to affect the investee's *variable returns* from the *relevant transactions*. This principle needs to be applied even if the controlling entity holds less than a majority of voting rights in the controlled entities.

Accounting Standard AS 23 Accounting for Investments in Associates in Consolidated Financial Statements

AS 23 speaks about the preparation and presentation of the consolidation of financial statements by using the equity method of accounting where an investor has significant influence over an enterprise which is neither a subsidiary nor a joint venture. The corresponding international standard, IFRS 11 J*oint Arrangements* regulates Joint Operations/Joint Ventures. IFRS 11 focuses more on the nature and substance of the rights and obligations arising from the arrangement that determine whether the joint arrangement is a joint operation or a joint venture.

Accounting Standard AS 27 Financial Reporting of Interests in Joint Ventures

AS 27 recognises three different forms and structures for a Joint Venture - jointly controlled operations, jointly controlled assets, and jointly controlled entities. According to AS 27, this Standard is mandatory in nature only if the enterprise prepares and presents the consolidated financial statements. It is pertinent to note that following a major redefinition and realignment of these three different forms and structures by the IASB with the introduction of IFRS 11 *Joint Arrangements* along with the amendment of IAS 28 and renaming it as 'IAS 28*Investments in Associates and Joint Ventures*', the financial reporting requirements for jointly controlled operations, jointly controlled assets and jointly controlled entities have undergone a sea change. The new guidance has not retained the proportionate method of accounting for consolidation and requires all joint ventures to be accounted for using equity method. However, AS 27 requires the consolidated financial statements of a venturer to show the interest in a jointly controlled entity using proportionate consolidation method. This is a major difference between AS 27 and IAS 28(2011).

IFRS 11 and IAS 28(2011) give guidance as to how a joint arrangement is to be differentiated between a joint operation and a joint venture with reference to the legal form, the terms and contractual arrangement and the other facts and circumstances relating to the parties' rights to the assets and obligations for the liabilities in the arrangements. IFRS 11*Joint Arrangements* seeks to group together jointly controlled operations and jointly controlled assets as Joint Operations that were defined under IAS 31. The defining and differentiating factor is that the parties that have joint control have *rights* to the assets and obligations for the liabilities relating to the arrangement.

A joint arrangement is classified either as a Joint Operation or a Joint Venture depending not just upon the structure or legal form of the joint arrangement but more upon the nature and substance of the rights and obligations of each of the parties to the arrangement. If the legal form, the terms and contractual arrangement and the other facts and circumstances give the parties their rights to the assets and obligations for the liabilities relating to the arrangement, it is a joint operation. If the joint arrangement is initiated through a structured organisational set up, such as a partnership, corporation or other financial structure, but there are no rights to the assets and obligations for the liabilities relating to the arrangement arising from the legal form, the terms and contractual arrangements and the other facts and circumstances, the joint arrangement is a joint venture. Simply put, in a joint venture, the parties to the arrangement have rights to the net assets of the arrangement.

IFRS 11 requires that all parties to joint arrangements evaluate whether the arrangement meets the definition of a joint operation or a joint venture. Once this is determined, IFRS 11 requires that the parties to a joint operation would recognise their share of the assets, liabilities, revenues and expenses in accordance with the applicable IFRSs, whereas the parties to a joint venture would account for their interest using the equity method of accounting under IAS 28(2011). Further, the

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accounting for an interest in a joint venture will depend on whether the party has joint control or not. The party would account for its interest in a joint venture using the equity method of accounting if it has a joint control or significant influence over the joint venture. The other party that does not have the control or significant influence would apply IFRS 9 *Financial Instruments* (or IAS 39 *Financial Instruments: Recognition and Measurement*, as applicable). The corresponding Indian Accounting Standard to this effect is AS 13 *Accounting for Investments*.

Consolidation – scope and methods

Now, it becomes clear that there are only three recognised methods of financial consolidation that could be used for statutory reporting purposes and the new standards issued by the International Accounting Standards Board restrict the adoption of only the following methods of consolidation:

- ***Fair-value method*** – in cases where the investor company is an investment company coming under the definition as prescribed in the *Investment Entities (Amendments to IFRS 10, IFRS 12, and IAS 27)*. An investment entity is required to measure its subsidiaries at fair value through profit or loss (FVTPL) in accordance with IFRS 9 *Financial Instruments* (or IAS 39 *Financial Instruments: Recognition and Measurement*, if IFRS 9 has not yet been adopted) and not to consolidate its subsidiary or apply IFRS 3 *Business Combinations* when it obtains control of another entity.
- ***Equity method*** – in cases, where the investor company holds enough voting stock of the investee company that indicates the ability to exercise significant influence over the investee company but *control* is not achieved. The equity holding would normally be between 20% and 50%.
- ***Consolidation of Financial Statements*** – in cases where the investor company holds more than 50% of the voting stock of the investee company to have a natural *control* that enables the investor company to direct the entire decision-making process. Even in cases where the investor company holds less than 50% of the voting equity of the investee company, if the investor company is able to 'control' the activities of the investee company as stipulated by IFRS 10, then the investee company must be consolidated. This method is also known as *Purchase Method*.

The determination of an investee company as a *controlled* entity is based on the assessment made by the investor company with reference to the various tests for the *control*, supplemented by the extent of *relevant activities*. This primarily decides the consolidation method to be applied.

The next step forward

Whatever be the method of consolidation hitherto followed by the investor companies, the issuance of the IFRS package of five standards (including the amendment specific to investment companies) has no doubt, increased the complexities in the consolidation realm especially while preparing the financial statements for the period commencing on or after 1st January, 2013 or 1st January, 2014 (for Investment entities).These regulatory requirements have placed tremendous obligations in the matter of assessing the status of the investee company while preparing the consolidated financial statements of an investor company. Given these complexities, it makes perfect sense to reduce the efforts, cycle time, cost and risks as much as possible in preparing the consolidated financial statements. The various modes and tools of consolidation of financial statements available for an investor company are discussed in "*Streamlining Consolidation with Automation and Enhancing Regulatory Compliance and Performance Management*" along with an overview of one of the popular tools available for easing and streamlining the process of financial consolidation. ■