20 Consolidation: controlled entities

ACCOUNTING STANDARDS IN FOCUS

IFRS 10 ***Consolidated Financial Statements***
IFRS 12 ***Disclosure of Interests on Other Entities***

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. explain the meaning of consolidated financial statements
2. discuss the meaning and application of the criterion of control
3. discuss which entities should prepare consolidated financial statements
4. understand the relationship between a parent and an acquirer in a business combination
5. explain the differences in disclosure requirements between single entities and consolidated entities.

INTRODUCTION

The purpose of this chapter is to discuss the preparation of a single set of financial statements, referred to as the consolidated financial statements. The preparation of consolidated financial statements views the group as the economic entity that is of interest to users of financial statements. It involves combining the financial statements of the individual entities so that they show the financial position and financial performance of the group of entities, presented as if they were a single economic entity.

The first issue covered in this chapter is the determination of which entities are required to prepare consolidated financial statements. This involves a discussion of the criterion for consolidation and its application to economic situations. The second issue in this chapter is the accounting procedures for preparing the consolidated financial statements. The application in this chapter is to a very simple group structure involving two entities, one of which owns all the issued shares in the other. Further issues associated with the preparation of consolidated financial statements are discussed in the chapters that follow (*see chapters 21–23*).

The accounting standards governing the preparation of consolidated financial statements are IFRS 3 *Business Combinations* issued in 2008 and IFRS 10 *Consolidated Financial Statements* issued in 2011.

The objective of IFRS 3, as stated in paragraph 1:

> is to establish principles and requirements for how the acquirer:
>
> (a) recognises and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree;
> (b) recognises and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and
> (c) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.

The objective of IFRS 10 is stated in paragraph 1:

> to establish principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities.

To achieve this, IFRS 10 then:

- requires a parent to present consolidated financial statements
- establishes control as the criterion for consolidation
- defines the criterion of control
- provides guidance on identifying when one entity controls another
- sets out the accounting requirements for the preparation of consolidated financial statements.

20.1 CONSOLIDATED FINANCIAL STATEMENTS

Consolidated financial statements are defined in Appendix A of IFRS 10 as follows:

> The financial statements of a **group** in which the assets, liabilities, equity, income, expenses and cash flows of the **parent** and its **subsidiaries** are presented as those of a single economic entity.

Consider figure 20.1. P Ltd has investments in a number of other companies. A shareholder's wealth in P Ltd is dependent not only on how well P Ltd performs, but also on the performance of the other entities in which P Ltd has an investment. Rather than require a shareholder in P Ltd to analyse each of the companies in the economic group, if P Ltd prepared a set of financial statements by adding together the financial statements of all entities in the group, this would assist investors in P Ltd to analyse their investment. Assuming that one share equals one voting right, P Ltd owns 70% of S1 Ltd and effectively owns 42% (70% × 60%) of S2 Ltd. However, P Ltd controls both S1 Ltd and S2 Ltd (through S1 Ltd's control of S2 Ltd). P Ltd also owns and controls 100% of S3 Ltd.

Consolidated financial statements perform this function as they are a consolidation, or an adding together, of the financial statements of all entities within an economic entity. As stated in paragraph B86 of IFRS 10, consolidated financial statements 'combine like items of assets, liabilities, equity, income, expenses and cash flows' of the entities in the group.

This process of adding the financial statements together can be seen in its simplest form in figure 20.2. In this example there are two entities in the group, P Ltd and S Ltd. The consolidated financial statements are prepared by adding together the assets and liabilities of both entities. In chapter 21 a consolidation worksheet is used to perform this addition process.

This aggregation process is subject to a number of adjustments, and these are covered in detail in later chapters. However, in this chapter, the process of consolidation should be seen simply as a process of aggregation of the financial statements of all entities within the group. Note that the consolidation process does *not* involve making adjustments to the individual financial statements or the accounts of the entities in the group. This is because the individual companies within the group remain separate legal entities. The consolidated financial statements are an additional set of financial statements and are prepared using a worksheet to facilitate the addition and adjustment process.

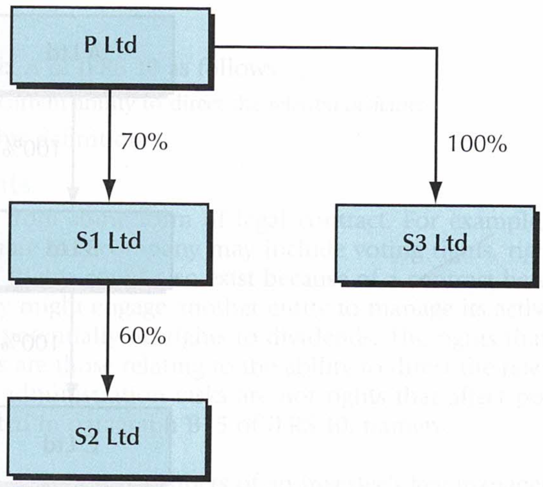

FIGURE 20.1 A group of entities

	P Ltd		S Ltd		Consolidation of P Ltd and S Ltd
Non-current assets*	150 000	+	120 000	=	270 000
Current assets	50 000	+	20 000	=	70 000
Total assets	200 000		140 000		340 000
Total liabilities	(80 000)	+	(30 000)	=	(110 000)
Net assets	$120 000		$110 000		$ 230 000

* Excluding P Ltd's investment in S Ltd *(explained in chapter 21)*

FIGURE 20.2 The consolidation process

The consolidated financial statements consist of a consolidated statement of financial position, consolidated statement of profit or loss and other comprehensive income, a consolidated statement of changes in equity, and a consolidated statement of cash flows.

The following definitions are contained in Appendix A of IFRS 10:

Group A parent and its **subsidiaries**.
Parent An entity that **controls** one or more entities.
Subsidiary An entity that is controlled by another entity.

The consolidated financial statements combine the financial statements of all the entities within a group. The entities in the group consist of two types; namely, parent and subsidiary. There is only one parent in a group, which is the controlling entity; that is, the entity that controls all other entities in the group. *Section 20.2* discusses the meaning of control. All other entities in the group — the controlled entities — are called subsidiaries. Hence, in figure 20.1, assuming that P Ltd controls all other companies in the figure, P Ltd is the parent entity, and all other entities in the group are subsidiaries.

Note that for a number of entities that are interconnected there may be a number of groups. Consider figure 20.3. If B Ltd controls C Ltd, then B Ltd is a parent and C Ltd is its subsidiary, and together they form a group. If A Ltd controls both B Ltd and C Ltd, then A Ltd is a parent and both B Ltd and C Ltd are its subsidiaries, and all together they form a group.

20.1.1 Reasons for consolidation

There are several reasons why consolidated financial statements are prepared:

1. *Supply of relevant information.* The information obtained from the consolidated financial statements is relevant to investors in the parent entity. These investors have an interest in the group as a whole, not just in the parent entity. To require these investors to source their information from the financial statements of each of the entities comprising the group would place a large cost burden on the investors.
2. *Comparable information.* Some entities are organised into a group structure such that different activities are undertaken by separate members of the group. Other entities are organised differently, with some having all activities conducted within the one entity. For an investor to make useful comparisons between entities, access to consolidated financial statements makes the comparative analysis an easier task.

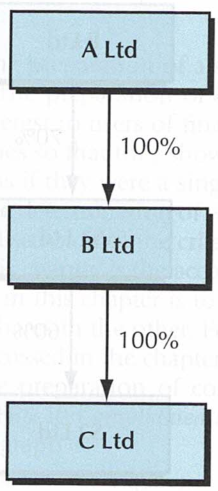

FIGURE 20.3 Multiple groups

3. *Accountability*. A key purpose for all financial reporting is the discharge of accountability by management. Entities that are responsible or accountable for managing a pool of resources, being the recipients of economic benefits and responsible for payment of obligations, are generally required to report on their activities, and are held accountable for the management of those activities. The management of the parent entity is not just responsible for the management of the assets and liabilities of the parent itself. As the parent controls the assets of all subsidiaries, the assets under the control of the parent entity's management are the assets of the group. The consolidated financial statements report the assets under the control of the group management as well as the claims on those assets.
4. *Reporting of risks and benefits*. There are risks associated with managing an entity, and an entity rarely obtains control of another without obtaining significant opportunities to benefit from that control. The consolidated financial statements allow an assessment of these risks and benefits at a group level.

Notwithstanding these advantages, it should be noted that the aggregation process of the consolidation results in little information being available for the individual subsidiaries. Hence, users of consolidated financial statements would not normally be able to identify individual subsidiaries that exhibit better or worse financial position and performance.

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20.2 CONTROL AS THE CRITERION FOR CONSOLIDATION

In Appendix A of IFRS 10, a parent is defined as an entity that *controls* one or more entities while a subsidiary is a controlled entity. The entity that is responsible for preparing the consolidated financial statements is the parent. An entity must then determine when it is a parent and which entities it controls. The determination of whether one entity controls another is crucial to the determination of which entities need to prepare consolidated financial statements. Paragraph 5 of IFRS 10 notes that 'an investor' must determine whether it is a parent by assessing whether it controls an 'investee'.

Under IFRS 10, the criterion for consolidation is control. It should first be noted that determination of whether control exists is a matter of judgement. In many situations it will not be clear cut that one entity controls another, and determination will have to be made by considering all available facts and circumstances (paragraph 8 of IFRS 10). As noted later in this section, IFRS 10 provides numerous factors to be considered in making the decision concerning the existence of control. Hence, it is important to understand the meaning of the term 'control' and what evidence may be accumulated to determine its existence or non-existence in specific circumstances. Further, if those circumstances change, there may be a need to assess whether control still exists.

Second, note that control is an exclusionary power. In a group there can be only one parent. If two or more investors join together to direct the activities of the investees, neither investor controls the investee — decision-making ability cannot be shared.

Control of an investee is defined in Appendix A of IFRS 10 as follows:

> 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.

Paragraph 7 of IFRS 10 identifies three elements, all of which must be held by an investor in order for it to have control, namely:
1. power over the investee
2. exposure, or rights, to variable returns from its involvement with the investee
3. the ability to use its power over the investee to affect the amount of the investor's returns.

These three elements are discussed in detail in the following sections.

20.2.1 Power

Power is defined in Appendix A of IFRS 10 as follows:

> Existing rights that give the current ability to direct the *relevant activities*.

Note the key features of this definition.

Power arises from rights

These rights generally arise from some form of legal contract. For example, the rights that are held by the owner of an ordinary share in a company may include voting rights, rights to dividends or rights on liquidation of the company. Rights could also exist because of a contract between one entity and another entity. For example, an entity might engage another entity to manage its activities — the latter entity then has management rights but potentially no rights to dividends. The rights that are of importance in determining whether power exists are those relating to the ability to direct the relevant activities of an investee. Rights in relation to purely administration tasks are not rights that affect power. Examples of rights that affect who has power are listed in paragraph B15 of IFRS 10, namely:

- voting rights
- rights to appoint, reassign or remove members of an investee's key management personnel
- rights to appoint or remove another entity that participates in management decisions
- rights to direct the investee to enter into, or veto any changes to, transactions that affect the investee's returns.

Some questions that could be asked to assist in determining whether certain rights give rise to power are as follows (based on paragraph B18 of IFRS 10):

- Can the investor appoint or approve the investee's key management personnel who direct the relevant activities?
- Can the investor direct the investee to enter into or veto any changes to significant transactions that affect the investor's returns?
- Can the investor dominate either the nominations process of electing members of the investee's governing body or the obtaining of proxies from other holders of voting rights?

The rights must also be *substantive* rights. According to paragraph B22 of IFRS 10, for rights to be substantive the holders must have the practical ability to exercise the rights; that is, there are no barriers to the holders exercising the rights. The rights need to give the holder the current ability to direct the relevant activities when decisions about those activities need to be made.

As judgement is required in assessing whether rights are substantive, paragraph B23 of IFRS 10 provides some factors to consider in making that determination:

- whether the party or parties that hold the rights would benefit from the exercise of those rights, for example, potential voting rights.
- whether there are any barriers — economic or otherwise — that prevent a holder from the exercising of rights. Examples of such barriers are financial penalties, terms and conditions that make it unlikely that rights will be exercised, and the absence of specialised services necessary for exercising the rights. Paragraph B23(a) of IFRS 10 provides a detailed list of possible barriers.
- where more than one party is involved, whether there is a mechanism in place to enable those parties to practically exercise the rights.

If the rights are purely protective rights, the holder does not have power (paragraph 14). Protective rights are defined in Appendix A of IFRS 10 as follows:

> Rights designed to protect the interest of the party holding those rights without giving that party power over the entity to which those rights relate.

Paragraph B28 of IFRS 10 provides examples of protective rights, which include:

> (a) a lender's right to restrict a borrower from undertaking activities that could significantly change the credit risk of the borrower to the detriment of the lender.
> (b) the right of a party holding a non-controlling interest in an investee to approve capital expenditure greater than that required in the ordinary course of business, or to approve the issue of equity or debt instruments.
> (c) the right of a lender to seize the assets of a borrower if the borrower fails to meet specified loan repayment conditions.

A non-controlling interest is equity in a subsidiary not attributable to a parent. For example, if a parent owns 80% of the shares of a subsidiary, then the non-controlling interest in the subsidiary is 20%.

Power is the ability to direct

There is a distinction between ability to direct and actually directing. An entity that has the ability to direct may decide not to exercise that ability and so allow another entity to actually direct. For example, Entity C may have two owners — Entity A that owns 55% of the shares in Entity C and Entity B that holds the remaining 45% of issued shares. Entity A may have the ability to direct the activities of Entity C but, as it is an investment company and holds shares purely for cash flow via dividends, may have no interest in management of other entities. Entity B may then actually undertake the management of Entity C. In such a circumstance, Entity B is the parent as it has the ability to direct the activities of Entity C.

The ability to direct must be current

The investor must be able to exercise its rights to direct at the time decisions are made concerning the activities of an investee. However, there are circumstances where power is still held by an investor even though there may be a time period to pass, or an activity that needs to be undertaken, before the right to direct can be currently exercisable. Paragraph B24 of IFRS 10 provides examples of these circumstances. One example is:

> An investor holds an option to acquire the majority of shares in an investee that is exercisable in 25 days and that would generate a profit for the investor upon exercising the option; that is, the value of the share exceeds the exercise price. A special meeting to change existing policies requires 30 days' notice. The existing shareholders cannot change existing policies before the exercise of the option. The investor has a substantive right that gives them the current ability to direct the relevant activities even before the option is exercised.

In contrast, assume the investor held a forward contract to acquire the majority of shares at a settlement date in 6 months' time. The existing shareholders would have the current ability to direct the activities of the investee as they can change the existing policies before the forward contract is settled.

It is relevant activities that are directed

Relevant activities are defined in Appendix A of IFRS 10 as:

> activities of the investee that significantly affect the investee's returns.

The determination of relevant activities may change over time and differ between entities; hence it may be necessary to analyse the purpose and design of an investee. For many investees, the relevant decisions are those that govern the financial and operating policies of the investee. Paragraph B11 of IFRS 10 provides examples of some possible relevant activities, including:

- selling and purchasing goods and services
- managing financial assets
- selecting, acquiring and disposing of assets
- researching and developing new products
- determining a funding structure or obtaining funding.

To have power, an investor need not be able to make any decision it likes in relation to an investee, as the investor is constrained by corporate and contract laws under which the interests of non-controlling investors, creditors and others are protected.

Level of share ownership

Ownership of ordinary shares in a company normally provides voting rights that enable the holder of the majority of shares to dominate the appointment of directors or an entity's governing board. As paragraph B35 of IFRS 10 states, where an investor holds more than half of the voting rights of an investee, the investor has power providing:

> (a) the relevant activities are directed by a vote of the holder of the majority of voting rights, or
> (b) a majority of the members of the governing body that directs the relevant activities are appointed by a vote of the holder of the majority of the voting rights.

Hence, in the absence of other evidence, where an investor holds a majority of voting shares that investor would be considered to have power over the investee.

Where an investor holds less than 50% of the shares of an investee, the determination of whether the investor has power over the investee is more difficult. In determining the existence of power, it is necessary to examine the potential actions of the holders of the other shares in the investee. Some factors to assist in this process are:

- *Size of the voting interest.* The more voting shares an investor has, the more likely it is that it will have power. A further consideration is the number of shareholders who hold the remaining voting shares and the extent of their holdings. Where the remaining voting shares are held by a large number of shareholders, each holding a small number of shares, the probability of these other shareholders getting together to outvote the shareholder who holds a substantial proportion, but not a majority, of the shares must be considered. Note that, where the remaining shares are held by a small number of shareholders, the probability that they could get together and outvote the holder of the large parcel of shares is higher. Paragraphs B44–B45 of IFRS 10 provide examples of these circumstances.

  In the first example, investor A holds 45% of the voting rights of an investee. Two other investors each hold 26% of the voting rights of the investee. The remaining voting rights are held by investors who hold less than 1% each. There are no other arrangements that affect decision making. In this case, consideration of the size of investor A's voting interest and its relative size to the other shareholdings is sufficient to conclude that investor A does not have power. The two investors who hold 26% each would need to cooperate to be able to prevent investor A from controlling the investee.

  In the second example, an investor holds 40% of the voting rights of an investee, with the next two largest holdings of voting rights being 10% and 4%. The remaining voting rights are held by thousands of shareholders, none holding more than 1% of the voting rights. None of the shareholders has any arrangements to consult each other or make collective decisions. In this case, on the basis of the absolute size of its holding and the relative size of the other shareholdings, the investor has a sufficiently dominant voting interest to meet the power criterion without the need to consider any other evidence of power.

- *Attendance at annual general meetings*. Although all shareholders may attend general meetings and vote in matters relating to governance of the entity, it is rare for this to occur. If, therefore, only 60% of the eligible votes are cast at a general meeting and an entity has more than a 30% interest in that entity, it can cast the majority of votes at that meeting. It then has power over that entity.
- *The existence of contracts*. As noted in paragraph B39 of IFRS 10, the contractual arrangement between an investor and other holders of shares may give the investor sufficient voting rights to give the investor power. An example of such a contract is provided in application example 5 of paragraph B43 of IFRS 10:

  Investor A holds 40% of voting rights of an investee and twelve other investors each hold 5% of voting rights of the investee. A shareholder agreement grants investor A the right to appoint, remove and set the remuneration of management responsible for directing the relevant activities.

  In this case, consideration of the absolute size of the investor's holding and the relative size of the other shareholdings alone is not conclusive to determine the investor has rights sufficient to give it power. However, the fact that investor A has the contractual right to appoint, remove and set the compensation of key management is sufficient to conclude that investor A has power over the investee. The fact that investor A might not have exercised this right yet or the likelihood of investor A exercising their right to select, appoint or remove key management should not be considered when assessing whether investor A has power.
- *Level of disorganisation or apathy of the remaining shareholders*. This factor is affected by the dispersion of the shareholders, and reflected in their attendance at general meetings. Holders of small parcels of shares are often not organised into forming voting blocks. Shareholders with environmental or ethical concerns may be less apathetic about the actions of an entity and its management policies, and may form voting blocks.

The assessment of the existence of power where the investor holds less than a majority of voting shares is difficult and requires judgement. In many cases that assessment relies on an analysis of the non-action of other shareholders. Do the non-voting shareholders at an annual general meeting not vote because they are happy with the management ability of the investor, as opposed to being apathetic? Would they be willing to combine to outvote the investor if the latter's decisions were considered untenable? The success of the investee under the control of the investor is a further measure of the potential for generally passive shareholders to be sufficiently concerned to cast a vote at the next annual general meeting. When an investee is performing poorly, the interest of shareholders as well as their willingness to become involved generally increases. Poor performance with resultant lowering of share prices may also result in a current or new shareholder acquiring a large block of shares and changing the voting mix at general meetings.

Numerous problems arise in applying the concept of power under IFRS 10. First, there is the question of temporary control. Where the investor holds more than 50% of the voting shares of the investee, there is no danger of a change in the identity of the parent. However, if the identification of the parent is based on factors that may change over time, the process becomes more difficult. For example, the percentage of votes cast at general meetings may historically be 70%, but in a particular year it may be 50%. A shareholder with 30% of the voting shares has control in the latter circumstance but not in the former. Similarly, consider the situation where there are two substantial block holdings of voting shares, meaning that neither has power over the investee. One of the holders of a substantial block of shares may then sell its shares to a large number of buyers. The other holder of a substantial block may suddenly find that it has the power to control, regardless of whether this investor wants to exercise control or not.

Second, the ability of an entity to control another may be affected by relationships with other entities. For example, a holder of 40% of the voting shares may be 'friendly' with the holder of another 11% of shares. The 11% shareholder might be a financial institution that has invested in the holder of the 40% of votes and plans to vote with that entity to increase its potential for repayment of loans. However, business relationships and loyalties are not always permanent.

These two examples illustrate some of the practical issues in applying the concept of power in IFRS 10.

Potential voting rights

Paragraphs B47–B50 of IFRS 10 discuss the issue of whether potential voting rights should be considered in assessing the existence of power. Potential voting rights are rights to obtain voting rights of an investee, such as those within an option or convertible instrument (paragraph B47).

As noted earlier in this section:

- the rights must be substantive
- the investor must have a current ability to exercise those rights.

Where this occurs, potential voting rights must be taken into consideration when assessing the existence of power. Illustrative examples 20.1 and 20.2 provide some examples of potential voting rights adapted from paragraph B50 of IFRS 10.

ILLUSTRATIVE EXAMPLE 20.1 Potential voting rights — exercisable options

Arctic holds 70% of the voting rights of an investee. Baltic holds the other 30% but also holds an option to acquire half of Arctic's voting rights, with the option being exercisable at a fixed price over the next 2 years.

If the option is deeply 'out of the money' (that is, the fixed price is too high relative to the current share price of the investee) then Arctic would be considered to hold power as the current economic conditions are such that the rights associated with the option are not substantive, in that it is not practicable for Baltic to exercise the option.

If the option was 'in the money' (that is, where the underlying share price is well above the exercise price) then Baltic would be considered to have power as it could exercise the option and direct the activities of the investee.

Source: Adapted from IASB 2011, IFRS 10 *Consolidated Financial Statements*, Example 9, p. 33.

ILLUSTRATIVE EXAMPLE 20.2 Potential voting rights — convertible debt instruments

An investee has three shareholders — Ant and two other investors. Each investor holds one-third of the voting rights. Ant also holds debt instruments that are convertible into voting shares of the investee at a fixed price that is 'out of the money', but not by a large amount. If the debt was converted, Ant would hold 60% of the shares of the investee. Because of the advantages of controlling the investee, it may be considered that Ant has power over the investee given Ant's ability to convert the debt instrument into shares. Additional information would need to be considered, including the current influence that Ant has on directing the activities of the investee.

Source: Adapted from IASB 2011, IFRS 10 *Consolidated Financial Statements*, Example 10, p. 33.

20.2.2 Exposure or rights to variable returns

Besides having power to direct the activities of an investee, an investor must also have the rights to variable returns from that investee. IFRS 10 does refer to this explicitly, but it appears that the standard equates control with exposure to risk.

Where an investor holds ordinary shares in an investee, it expects returns in relation to dividends, changes in the value of the investment, and residual interests on liquidation. These returns can be positive or negative; hence, the use of the term 'returns' rather than 'benefits'. The returns are not exclusive to the parent, but may also be received by other non-controlling shareholders. Other returns include (see paragraph B57 of IFRS 10 for examples of returns):

- returns from structuring activities with the investee; for example, obtaining a secure supply or raw material, access to a port facility, or a distribution network
- returns from denying or regulating access to a subsidiary's assets; for example, obtaining control of a patent for a competing product and stopping production
- returns from economies of scale
- remuneration from provision of services such as servicing of assets, and management.

The returns must have the potential to vary based on the performance of the investee. Examples of such variability are:

- dividends from ordinary shares that will change based on the profit performance of the investee
- fixed interest payments from a bond, as they expose the investor to the credit risk of the issuer of the bond, namely the investee
- fixed performance fees for management of the investee's assets, as they expose the investor to the performance risk of the investee.

20.2.3 Ability to use power to affect returns

Besides having power to direct the activities of the investee and rights to variable returns from the investee, a parent must have the ability to use its power over the investee to affect the returns received from the investee. This requires that the parent be able to use its power to increase its benefits and limit its losses from the subsidiary's activities. There is then a link between the holding of the power and the returns receivable. However, there is no specification of the level of returns to be received. IFRS 10 only requires that some variable returns be receivable and that the investor by its actions can affect the amount of those returns.

20.2.4 Agents

In determining whether control exists over an investee, an investor with decision-making rights needs to assess whether it is a principal or an agent.

Paragraph B58 of IFRS 10 explains that an agent is a party primarily engaged to act on behalf and for the benefit of another party or parties, being the the principal and therefore does not control the investee when it exercises its decision-making authority. The agent has a fiduciary relationship to the principal.

Paragraph B60 of IFRS 10 provides a number of factors to consider in determining whether a decision maker is a principal or an agent:

- the scope of its decision-making authority over the investee — this relates to the range of activities that the decision maker is permitted to direct
- the rights held by other parties; for example, whether another entity has substantive removal rights over the decision maker
- the remuneration to which it is entitled in accordance with the remuneration agreement — the remuneration of an agent would be expected to be commensurate with the level of skills needed to provide the management service while the remuneration agreement would contain terms and conditions normally included in arrangements for similar services
- the decision maker's exposure to variability of returns from other interest that it holds in the investee — the greater the decision maker's exposure to variable returns from its involvement in the investee, the more likely it is that the decision maker is not an agent.

An agent cannot be a parent. Where a controlling decision maker is determined to be an agent, it is the principal that would be considered to be the parent.

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20.3 PREPARATION OF CONSOLIDATED FINANCIAL STATEMENTS

Paragraph 4(a) of IFRS 10 requires *all* parents to prepare consolidated financial statements, except in those circumstances where it meets *all* the following conditions:

(i) it is a wholly owned subsidiary or is a partially owned subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;

(ii) its debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);

(iii) it did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and

(iv) its ultimate or any intermediate parent produces consolidated financial statements that are available for public use and comply with IFRSs.

The essence of these conditions is to ensure that only companies with no public accountability are exempted from the requirement to prepare consolidated financial statements.

Consider the group structure in figure 20.4. A Ltd is a parent entity with two subsidiaries. According to paragraph 4 of IFRS 10, A Ltd is required to prepare consolidated financial statements, combining the financial statements of A Ltd, B Ltd and C Ltd. B Ltd is also a parent with C Ltd being its subsidiary. Is B Ltd also required to prepare consolidated financial statements?

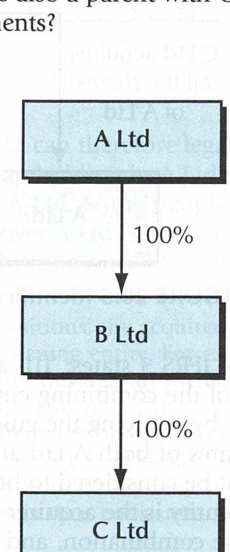

FIGURE 20.4 A parent and its subsidiaries

If B Ltd meets all the conditions in paragraph 4(a), it does not have to prepare consolidated financial statements. To determine this the following questions are asked:

- *Is B Ltd itself a wholly owned subsidiary?* In figure 20.4, B Ltd is itself a wholly owned subsidiary of A Ltd, hence this meets the first condition in paragraph 4(a)(i). Note also in paragraph 4(a)(i), that even if A Ltd owned only, say, 80% of B Ltd, making B Ltd a partially owned subsidiary, B Ltd may still be exempted from preparing consolidated financial statements if the 20% non-controlling interest in B Ltd has been informed about and do not object to the parent not presenting consolidated financial statements.
- *Has B Ltd filed its financial statements with a regulatory agency for the purpose of issuing any debt or equity instruments in a public market or are the debt and equity instruments of B Ltd traded in a public market?* If B Ltd intends to issue such instruments of if they are traded in a public market, then there are potential users for a set of consolidated financial statements from B Ltd. Where B Ltd is a wholly owned subsidiary, it is unlikely that its equity instruments would be traded in a public market.
- *Has A Ltd produced consolidated financial statements complying with IFRS® Standards?*

20.4 BUSINESS COMBINATIONS AND CONSOLIDATION

As noted in chapter 14, accounting for a business combination under the acquisition method requires the identification of an acquirer. The acquirer is the combining entity that obtains *control* of the other combining entities or businesses. Hence, as the criterion for identification of a parent–subsidiary relationship is control, it is expected that when a business combination is formed by the creation of a parent–subsidiary relationship, the parent will be identified as the acquirer. As noted in paragraph 3 of IFRS 10, the accounting requirements for business combinations and their effect on consolidation, including goodwill arising on a business combination, are set out in IFRS 3 *Business Combinations*.

However, there are situations where the parent entity is not the acquiring entity. In paragraph B19 of Appendix B to IFRS 3, a distinction is made between the legal acquirer/acquiree and the accounting acquirer/acquiree. The parent entity is usually the legal acquirer as it issues its equity interests as consideration in the combination transaction, with the subsidiary being the legal acquiree. This parent has control of the group subsequent to the business combination occurring. However, the accounting acquirer in a business combination is determined based on which entity participating in the business combination is the entity that obtains control of the other entities.

20.4.1 Formation of a new entity

Consider the situation in figure 20.5 in which A Ltd and B Ltd combine by the formation of a new entity, C Ltd, which acquires all the shares of both of these entities with the issue of shares in C Ltd. C Ltd controls both A Ltd and B Ltd.

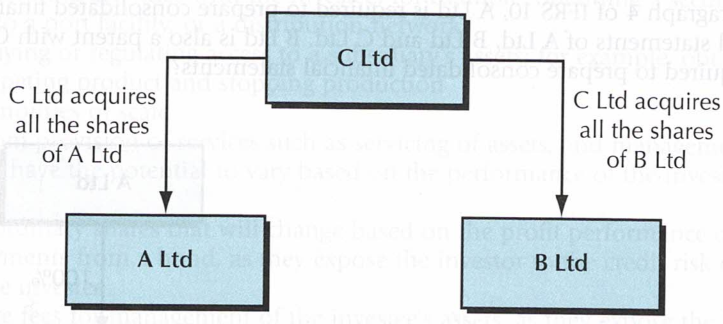

FIGURE 20.5 Identification of an acquirer where a new entity is formed

Paragraph B18 of IFRS 3 states: '[I]f a new entity is formed to issue equity interests to effect a business combination, one of the combining entities that existed before the business combination shall be identified as the acquirer by applying the guidance in paragraphs B13–B17.' In other words, even though C Ltd is acquiring the shares of both A Ltd and B Ltd, it is not to be considered the accounting acquirer; either A Ltd or B Ltd must be considered to be the accounting acquirer.

Deciding which entity is the acquirer involves a consideration of factors such as which of the combining entities initiated the combination, and whether the assets and revenues of one of the combining entities significantly exceed those of the others. The reasons for this decision by the International Accounting Standards Board (IASB®) are given in paragraphs BC98–BC101 of the Basis for Conclusions on IFRS 3

Business Combinations. The key reason for the standard setter's decision is in paragraph BC100. The argument is that the new entity, C Ltd, may have no economic substance, and the accounting result for the combination of the three entities should be the same if A Ltd simply combined with B Ltd without the formation of C Ltd. It is argued in paragraph BC100 that to account otherwise would 'impair both the comparability and the reliability of the information'.

However, the problem that then arises in the scenario in figure 20.5 is that a choice has to be made: is A Ltd or B Ltd the acquirer? In deciding on which entity is the acquirer, paragraphs B14–B18 of Appendix B to IFRS 3 provide some indicators to consider in situations where it may be difficult to identify an acquirer. The entity likely to be the acquirer is the one:

- that has a significantly greater fair value
- that gives up the cash or other assets, in the case where equity instruments are exchanged for cash or other assets
- whose management is able to dominate the business combination.

In this circumstance, although C Ltd is the legal parent of the subsidiaries A Ltd and B Ltd, it is not the acquirer in the business combination.

20.4.2 Reverse acquisitions

A further situation considered in paragraphs B19–B27 of IFRS 3 is the 'reverse acquisition' form of business combination. Consider the situation in figure 20.6.

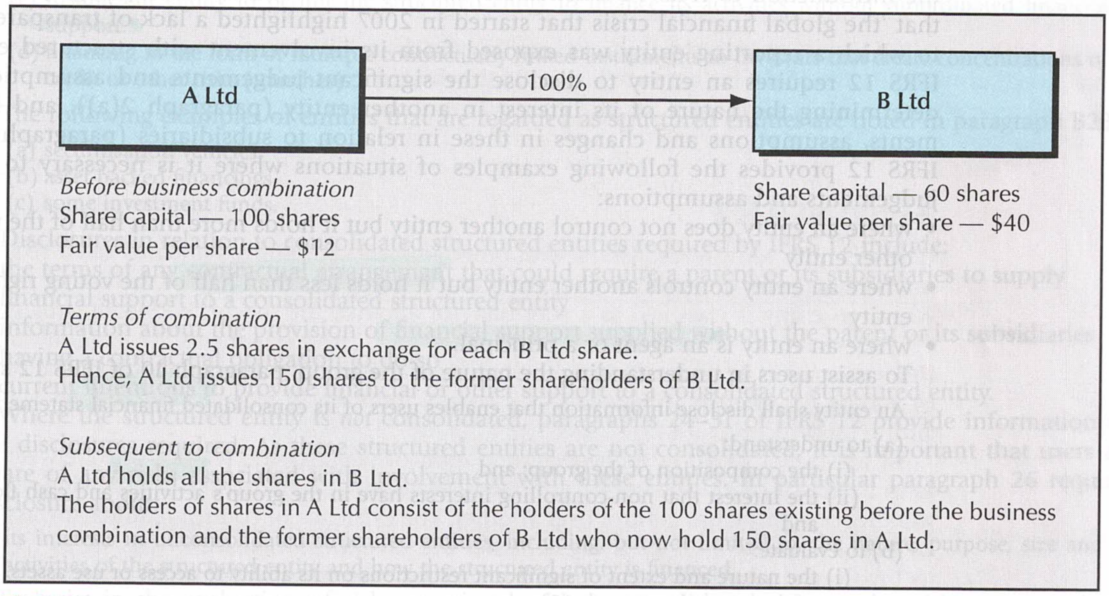

FIGURE 20.6 Reverse acquisition

A Ltd acquired all the shares in B Ltd, and A Ltd can therefore legally control the financial and operating policies of B Ltd. However, an analysis of the shareholding in A Ltd shows that the former shareholders of B Ltd hold 60% (i.e. 150/250) of the shares of A Ltd. Some people argue that the substance of the business combination is that B Ltd has really taken over A Ltd because the former shareholders of B Ltd are in control. Paragraph BC96 of the Basis for Conclusions on IFRS 3 provides a further example of a reverse acquisition:

> The IASB also observed that in some reverse acquisitions, the acquirer may be the entity whose equity interests have been acquired and the acquiree is the issuing entity. For example, a private entity might arrange to have itself 'acquired' by a smaller public entity through an exchange of equity interests as a means of obtaining a stock exchange listing. As part of the agreement, the directors of the public entity resign and are replaced by directors appointed by the private entity and its former owners. The IASB observed that in such circumstances, the private entity, which is the legal subsidiary, has the power to govern the financial and operating policies of the combined entity so as to obtain benefits from its activities. Treating the legal subsidiary as the acquirer in such circumstances is thus consistent with applying the control concept for identifying the acquirer.

The problem with the reverse acquisitions argument is that it relies on an analysis of which shareholders control the decision making — that is, the acquiring entity is the one whose owners control the combined entity and who have the power to govern the financial and operating policies of the entity so as to obtain benefits from its activities.

20.5 DISCLOSURE

There are no disclosures specified in IFRS 10. IFRS 12 *Disclosure of Interests in Other Entities*, issued in 2011 at the same time as IFRS 10, outlines the disclosures required in the consolidated financial statements for subsidiaries. IAS 27 *Separate Financial Statements*, also issued in 2011, sets out disclosures required in the separate financial statements of the parent.

20.5.1 Disclosures required by IFRS 12

The key objective of IFRS 12 is stated in paragraph 1:

> The objective of this IFRS is to require an entity to disclose information that enables users of its financial statements to evaluate:
> (a) the nature of, and risks associated with, its *interests in other entities*, and
> (b) the effects of those interests on its financial position, financial performance and cash flows.

Notice the emphasis on the ability of users of financial statements to be able to evaluate risks. In the introduction to IFRS 12 *Disclosure of Interests in Other Entities*, in paragraph IN5, the IASB noted that 'the global financial crisis that started in 2007 highlighted a lack of transparency about the risks to which a reporting entity was exposed from its involvement with structured entities'. As a result, IFRS 12 requires an entity to disclose the significant judgements and assumptions it has made in determining the nature of its interest in another entity (paragraph 2(a)), and in particular judgements, assumptions and changes in these in relation to subsidiaries (paragraph 7). Paragraph 9 of IFRS 12 provides the following examples of situations where it is necessary to disclose significant judgements and assumptions:

- where an entity does not control another entity but it holds more than half of the voting rights in the other entity
- where an entity controls another entity but it holds less than half of the voting rights of the other entity
- where an entity is an agent or a principal.

To assist users in understanding the nature of the group, paragraph 10 of IFRS 12 states:

> An entity shall disclose information that enables users of its consolidated financial statements
> (a) to understand:
> (i) the composition of the group; and
> (ii) the interest that non-controlling interests have in the group's activities and cash flows (paragraph 12); and
> (b) to evaluate:
> (i) the nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the group (paragraph 13);
> (ii) the nature of, and changes in, the risks associated with its interests in consolidated structured entities (paragraphs 14–17);
> (iii) the consequences of changes in its ownership interest in a subsidiary that do not result in a loss of control (paragraph 18); and
> (iv) the consequences of losing control of a subsidiary during the reporting period (paragraph 19).

Where the financial statements of a subsidiary are as of a date that differs from that of the parent, the entity must disclose both the date used by the subsidiary as well as the reason for using a different date (paragraph 11). As the parent controls the subsidiary, the choice of a different date must be one made by the parent and not the subsidiary.

Where a non-controlling interest exists in a subsidiary, paragraph 12 of IFRS 12 requires that an entity disclose for each such subsidiary:

(a) the name of the subsidiary.
(b) the principal place of business (and country of incorporation if different from the principal place of business) of the subsidiary.
(c) the proportion of ownership interests held by non-controlling interests.
(d) the proportion of voting rights held by non-controlling interests, if different from the proportion of ownership interests held.
(e) the profit or loss allocated to non-controlling interests of the subsidiary during the reporting period.
(f) accumulated non-controlling interests of the subsidiary at the end of the reporting period.
(g) summarised financial information about the subsidiary (see paragraph B10).

Paragraph B10 of IFRS 12 states:

For each subsidiary that has non-controlling interests that are material to the reporting entity, an entity shall disclose:

(a) dividends paid to non-controlling interests.

(b) summarised financial information about the assets, liabilities, profit or loss and cash flows of the subsidiary that enables users to understand the interest that non-controlling interests have in the group's activities and cash flows. That information might include but is not limited to, for example, current assets, non-current assets, current liabilities, non-current liabilities, revenue, profit or loss and total comprehensive income.

Paragraph B11 notes that the summarised financial information is required *before* adjusting for intragroup transactions. Paragraph 13 of IFRS 12 provides disclosures required where an entity has significant restrictions on its ability to access or use the assets or settle the liabilities of the group. Paragraph 14 of IFRS 12 deals with consolidated structured entities. In Appendix A, a structured entity is defined as:

An entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements.

Paragraphs B22–B24 provide further information about structured entities.

According to paragraph B22, a structured entity may have the following features:

(a) restricted activities.

(b) a narrow and well-defined objective, such as to effect a tax-efficient lease, carry out research and development activities, provide a source of capital or funding to an entity or provide investment opportunities for investors by passing on risks and rewards associated with the assets of the structured entity to investors.

(c) insufficient equity to permit the structured entity to finance its activities without subordinated financial support.

(d) financing in the form of multiple contractually linked instruments to investors that create concentrations of credit or other risks (tranches).

The following examples of entities that are regarded as structured entities are noted in paragraph B23:

(a) securitisation vehicles.

(b) asset-backed financings.

(c) some investment funds.

Disclosures in relation to consolidated structured entities required by IFRS 12 include:

- the terms of any contractual arrangement that could require a parent or its subsidiaries to supply financial support to a consolidated structured entity
- information about the provision of financial support supplied without the parent or its subsidiaries having a contractual obligation to do so
- current intentions to provide financial or other support to a consolidated structured entity.

Where the structured entity is *not* consolidated, paragraphs 24–31 of IFRS 12 provide information on the disclosures required. As these structured entities are not consolidated, it is important that users are aware of any risks associated with involvement with these entities. In particular paragraph 26 requires disclosure about:

its interests in unconsolidated structured entities, including, but not limited to, the nature, purpose, size and activities of the structured entity and how the structured entity is financed.

To assist in the evaluation of risks associated with unconsolidated structured entities, paragraph 29 requires an entity to disclose in tabular format, unless another format is more appropriate, a summary of:

(a) the carrying amounts of the assets and liabilities recognised in its financial statements relating to its interests in unconsolidated structured entities.

(b) the line items in the statement of financial position in which those assets and liabilities are recognised.

(c) the amount that best represents the entity's maximum exposure to loss from its interests in unconsolidated structured entities, including how the maximum exposure to loss is determined. If an entity cannot quantify its maximum exposure to loss from its interests in unconsolidated structured entities it shall disclose that fact and the reasons.

(d) a comparison of the carrying amounts of the assets and liabilities of the entity that relate to its interests in unconsolidated structured entities and the entity's maximum exposure to loss from those entities.

Paragraphs 18 and 19 set out disclosures required where there are changes in the parent's ownership interest in a subsidiary as well as when a parent loses control of a subsidiary.

20.5.2 Disclosures required by IAS 27

Paragraph 4 of IAS 27 contains the following definition of separate financial statements:

Separate financial statements are those presented by a parent (ie an investor with control of a subsidiary) or an investor with joint control of, or significant influence over, an investee, in which the investments are accounted for at cost or in accordance with IFRS 9 *Financial Instruments*.

There are two situations where separate financial statements are prepared:

1. *Where a parent is exempted from preparing consolidated financial statements in accordance with paragraph 4(a) of IFRS 10.*

   In this case, paragraph 16 of IAS 27 requires the parent to supply the following information in the separate financial statements prepared by the parent:

   (a) the fact that the financial statements are separate financial statements; that the exemption from consolidation has been used; the name and principal place of business (and country of incorporation, if different) of the entity whose consolidated financial statements that comply with International Financial Reporting Standards have been produced for public use; and the address where those consolidated financial statements are obtainable;

   (b) a list of significant investments in subsidiaries, jointly controlled entities and associates, including the name, country of incorporation or residence, proportion of ownership interest and, if different, proportion of voting power held; and

   (c) a description of the method used to account for the investments listed under (b).

2. *Where a parent prepares separate financial statements in addition to consolidated financial statements.*

   Paragraph 17 of IAS 27 requires the following information to be disclosed in the separate financial statements:

   (a) the fact that the statements are separate financial statements and the reasons why those statements are prepared if not required by law;

   (b) a list of significant investments in subsidiaries, joint ventures and associates, including:

      (i) the name of those investees.

      (ii) the principal place of business (and country of incorporation, if different) of those investees.

      (iii) its proportion of the ownership interest (and its proportion of the voting rights, if different) held in those investees.

   (c) a description of the method used to account for the investments listed under (b).

The parent or investor shall also identify the financial statements prepared in accordance with IFRS 10, IFRS 11 or IAS 28 (as amended in 2011) to which they relate.

SUMMARY

Where entities form relationships with other entities, accounting standards often require additional disclosure so that users of financial statements can understand the economic substance of the entities involved. Where an entity is classified as a subsidiary of another, the parent, IFRS Standards establish principles for the preparation of consolidated financial statements. These statements are in addition to those prepared for either the parent or a subsidiary as separate legal entities. The consolidated financial statements are prepared by adding the financial statements of a parent and each of its subsidiaries, with adjustments being made during this process.

An important decision is the determination of whether the relationship between two entities is such as to be classified as a parent–subsidiary relationship. The existence of this relationship is determined by whether one entity has control over another. The existence of control requires the assessment of the power an entity has over another entity, whether the investor is exposed or has rights to variable returns from its involvement in the investee, and the ability of the investor to use its power over the investee to affect the amount of those returns. This analysis requires the accountant to exercise judgement in analysing the specific relationships between entities, since the existence of control is not simply a matter of determining whether an entity owns a majority of shares in another.

In general, parent entities are responsible for the preparation of the consolidated financial statements. However, IFRS 10 exempts parent entities that meet specified criteria from the preparation of these statements. For those parents preparing consolidated financial statements, IFRS 3 will need to be applied as the formation of a parent–subsidiary relationship is normally also a business combination.

IFRS 10 does not contain disclosure requirements for consolidated financial statements. The disclosure requirements are found in IFRS 12 and IAS 27.

Discussion questions

1. What is a subsidiary?
2. What is meant by the term 'control'?
3. When are potential voting rights considered when deciding if one entity controls another?
4. Are only those entities in which another entity owns more than 50% of the issued shares classified as subsidiaries?
5. What benefits could be sought by an entity that obtains control over another entity?