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A web series of 30 episodes covering different areas of corporate, securities and financial laws for the corporate professionals across the country.

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CONSOLIDATION- OVERVIEW

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WHAT DO WE MEAN BY CONSOLIDATION?

- In case of group entities, when a parent company has subsidiaries/associates and JV(s), there arises a need to present consolidated financial statements along with separate financial statements.
- While consolidating the financial statements, the assets, liabilities, equity, incomes and expenses of subsidiaries, associates and JV(s) are combined with that of the parent company.

- Previously the accounting for consolidation was only governed by-

✓ AS 21-Consoldiated Financial Statements
✓ AS 23- Accounting for Investments in Associates in Consolidated Financial Statements
✓ AS 27- Financial Reporting of Interest in Joint Ventures

- With the implementation of Ind AS, companies falling in the roadmap are required to follow-

✓ Ind AS 110- Consolidated Financial Statements
✓ Ind AS 111- Joint Arrangements
✓ Ind AS 112- Disclosure of Interests in Other Entities
✓ Ind AS 28- Investments in Associates and Joint Ventures

DRIVERS TO CONSOLIDATION

Control

Ind AS 110- Consolidated Financial Statements

Significant Influence- Equity Investing

Ind AS 28- Investments in Associates and Joint Ventures

BIRD'S EYE VIEW OF CONSOLIDATION

- Consolidation
  - Investor has controlling interest
    - Investment entity
      - Check whether the conditions for Investment entity are satisfied
    - Non investment entity
      - Check whether control is there?
        - Power over investee
        - Exposure to or right over variable returns from its involvement with the investee
        - Ability to use its power over the investee to affect the amount of variable return
  - Investor has non-controlling interest
    - Consolidate as joint ventures/ associates

EMBARKING ON "CONTROL"

Consolidation of Subsidiaries

Ind AS 110 vs AS 21 – Control perspective

Control

AS 21- Consolidated Financial Statements

- ✓ Control established if-Ownership and/or Composition
- ✓ No consolidation required if Temporary Control is established or if the subsidiary operates under severe and long term restrictions.
- ✓ The definition of control is objective

Ind AS 110 - Consolidated Financial Statements

- ✓ Control established if –Power+ exposure to variable returns+ use of power to affect returns
- ✓ No such exemption is there under Ind AS 110
- ✓ Substance preferred over form. Hence, use of judgement is required

WHEN IS A PARENT NOT NEEDED TO CONSOLIDATE ITS FINANCIAL STATEMENTS

It is a wholly owned/ partially owned subsidiary of another parent and its owners are informed of and do not object to non- consolidation

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Its debt/equity instruments are not traded in public market

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It did not file its financial statements with a securities commission or other regulatory organization for the purpose of issuing any instrument in a public market

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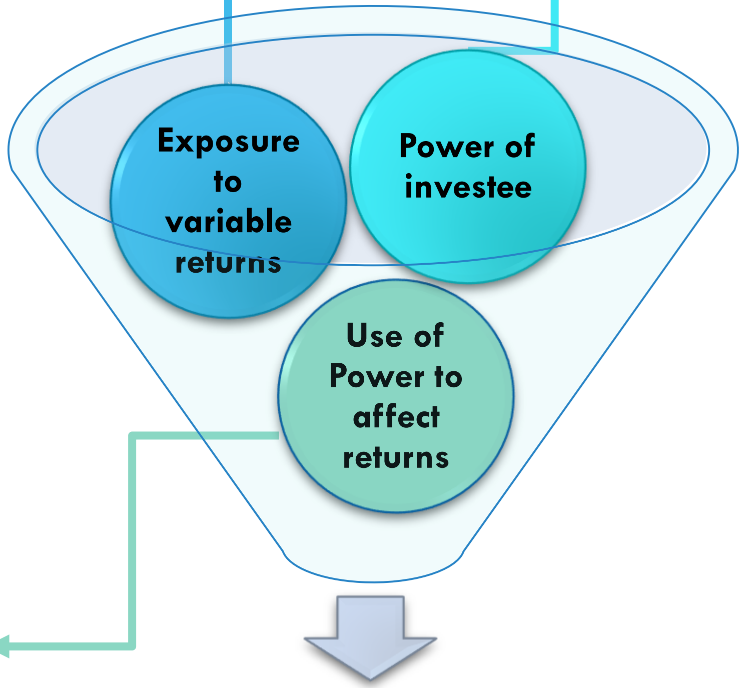
Its ultimate or any intermediate parent produces financial statements that are available for public use and comply with Ind AS 110

Determining "Control" over an entity

- An investor is said to have Exposure to or rights to variable returns of the investee, if its returns are affected due to investee's performance.
- Although only one person can have control over the investee, but more than one investor can share in the returns from the investee.
- Example: Minority shareholders getting their share in investee's profits.



- The investor should have the ability to use its power to affect investor's returns from its involvement with the investee.

- Investor has Power when it has "existing" rights that gives it the "current" ability to direct the ***relevant activities-*** activities that significantly affects the investee's returns.
- Examples:- Voting power from equity holding; Contractual agreement that signifies power.
- *Substantive rights* mean power but *Protective rights* do not.
- In case of multiple investors, the investor(s) whose current ability to direct the activities most significantly affects the returns of the investee, shall mean to have power over the investee.

Control

- Investor should consider all facts and circumstances for control assessment
- Control principles are equally applicable to structured entities (SPEs)

DRILLING DOWN THE CONCEPT OF "POWER"

Power: Discussion on "Relevant Activities"

What can be the relevant activities?

Examples of relevant activities:
Sale and purchase of goods and services; management of financial assets; research and development of new products; selection and disposition of assets, etc.

What decisions about relevant activities can be made?

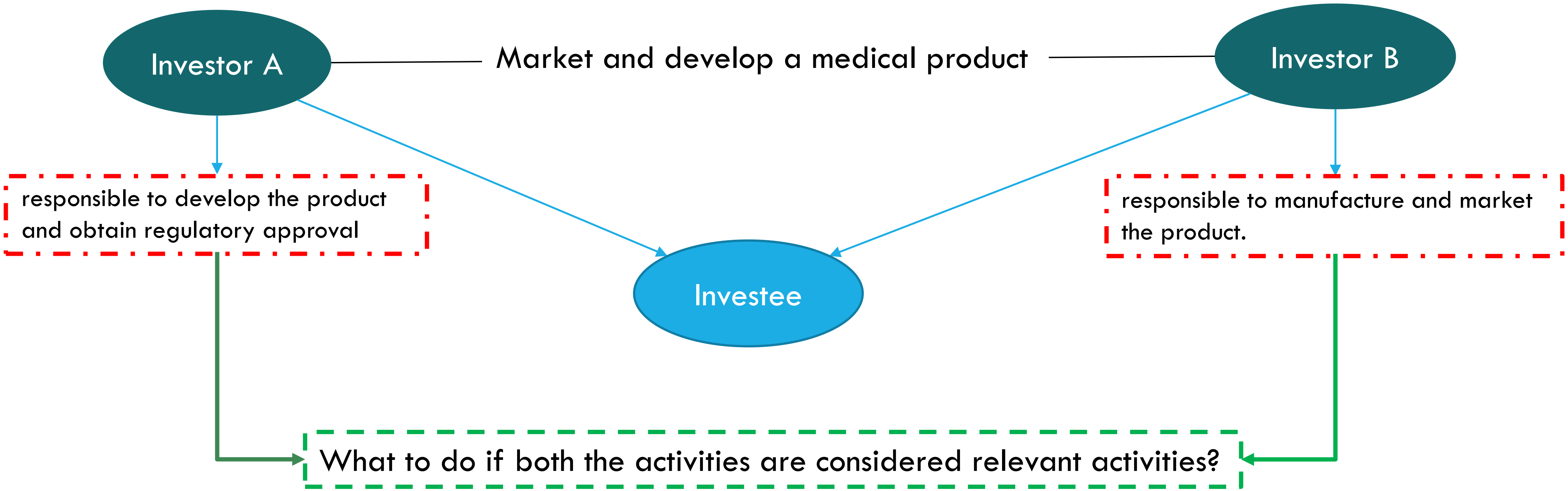
Examples of decisions in relevant activities:

i. Establishing capital and operating decisions.
ii. Appointment, remuneration and termination of investee's KMP or other service providers.

What happens when two or more investors have the current ability to direct relevant activities?

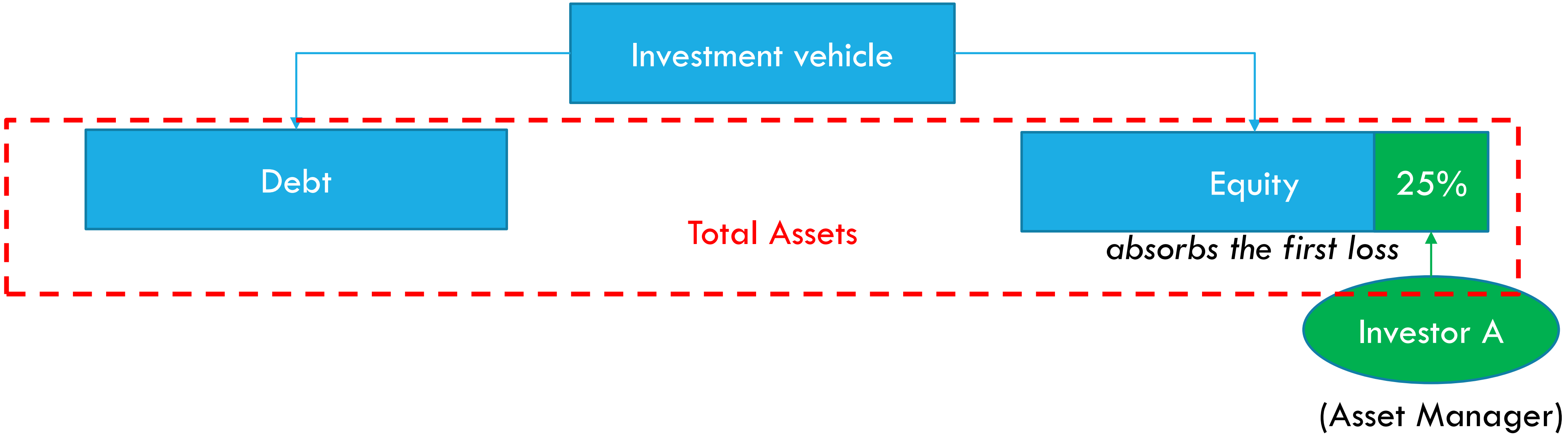
In such a case, the investors will have to determine who is able to direct the activities that most significantly affects the returns of the investee.

EXAMPLES OF RELEVANT ACTIVITIES (1/2)



Giving consideration to the purpose and design of the investee, it would be required to figure out which activity most significantly affects the returns of the investee and whether the investor has the ability to direct that activity.

EXAMPLES OF RELEVANT ACTIVITIES (2/2)



- The returns of the investee are significantly affected by the management of the investee's asset portfolio, which includes decisions about the selection, acquisition and disposal of the assets .
- Till the point the equity tranche is consumed by asset default, the asset manager manages the above activities. After that mark, debt investor has the right to direct the relevant activities.
- Considering the design and purpose of investee and their rights to variable returns, it has to determined who has the ability to direct the relevant activity that most significantly affects the investee's returns.

RIGHTS OF AN INVESTOR- RESULTING IN POWER

Examples/Factors of such rights

- Voting rights
- Rights to appoint, reassign or remove members of an investee's KMP who have ability to direct relevant activities
- Other rights that give holder the ability to direct relevant activities

  Eg. decision-making rights specified in a management contract.
- Rights to appoint or remove another entity that directs the relevant activities
- rights to direct the investee to enter into, or veto any changes to, transactions for the benefit of the investor

Power

Indicators of such rights are:

- The investee depends on the investor to fund a significant portion of its operations.
- The investor guarantees a significant portion of the investee's obligations.
- The investee depends on the investor for critical services, technology, supplies or raw materials
- The investor controls assets such as licences or trademarks that are critical to the investee's operations
- The investee depends on the investor for key management personnel, such as when the investor's personnel have specialised knowledge of the investee's operations.
- The investee's key management personnel who have the ability to direct the relevant activities are current or previous employees of the investor.
- A significant portion of the investee's activities either involve or are conducted on behalf of the investor.

VOTING RIGHTS- RESULTING IN POWER

Power

Power with majority of voting rights

- Holders voting rights should be more than one-half of the investee resulting in power of directing the Relevant activities
- The rights should be substantive
- Must give the holder the ability to direct relevant activities mostly by financial and operating ways
- Also, the power may be establised even by appointing majority of governing body that direct the relevant activities.

Power without majority of voting rights

- Contractual arrangement between investor and vote holders- enabling the investor to make decisions about relevant activities
- Rights from other contractual arrangements having decision making rights coupled with voting rights giving sufficient ability to the investor to direct relevant activities
- Investor’s voting rights
- Potential voting rights in combination with voting rights(but not majority of it)
- Combination of the above

INVESTOR'S VOTING RIGHTS

Facts and circumstances may be considered to determine whether investor's voting rights suffice power or not:

- Size and dispersion of voting rights of the investor *vis a vis* other holders. The following represent more ability on the part of investors to direct relevant activities:
  - *More voting rights(absolute basis)*
  - *More voting rights in relation to other vote holders(relative basis)*
  - *More parties required to act together to outvote the investor*
- Potential voting rights held by other vote holders
- Rights arising from other contractual arrangements- the existence of such rights are important, whether exercised or not
- Additional facts and circumstances- indicating the current ability to direct relevant activities

Less than majority voting power

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practical ability to direct relevant activities *unilaterally*

If the above joint criteria are non-conclusive, then the following additional facts and circumstances are seen:

- If shareholdings are widely dispersed- direction of relevant activity decided by majority votes- investor holds significantly more voting rights than others- then power is established.
- If the above factors are not conclusive, then attention can be drawn to additional facts and circumstances including passive nature of shareholders as demonstrated by earlier shareholders meetings. Also, the majority of voting powers with the investor, lesser number of parties required to outvote the investor, shall give more weight to the decision making of power.

Still, if it cannot be said conclusively that investor has power, then it can be concluded that control is not there.

EXISTENCE OF POWER : IN CASE VOTING RIGHTS/SIMILAR RIGHTS DO NOT HAVE A SIGNIFICANT EFFECT ON THE INVESTEE'S RETURNS

Example 1:

Consider an example where the business activity of investee is to purchase receivables and service the asset. The design is such that on a day to day basis , the entity collects principal and interest and passes them on to the investors. However, there is a put agreement in place, wherein on the event of default of receivable, the investee automatically puts the receivable to an investor. It is on the happening of this specific event only that the decision making activity of directing the relevant activity comes into play. Otherwise, there is no decision making authority required.

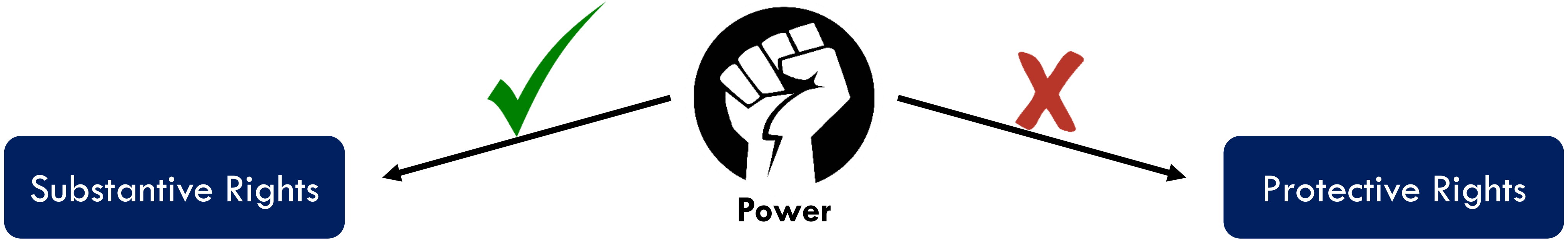
Terms of put agreement + founding document together suggest power over the investee.

Example 2:

Consider another example, where the only asset that the investee has are receivables. Thus the design of the business is such that the receivables are to be managed without the happening of any specific event like default of the borrower.

Here the investor shall have power over the investee by virtue of the ability to direct the relevant activity that will affect the investee's returns.

ALL ABOUT RIGHTS



- Substantive rights mean that the holder has practical ability to exercise the right.
- Mostly the rights need to be currently exercisable with some exceptions.

Barriers in rights being substantive:

- financial penalty
- legal barrier
- operational barrier
- terms and conditions preventing holder from exercising the right.
- Rights exercisable by more than one party as per the agreement.
- holders do not benefit from the exercise of the rights.

- Rights given with the intent to protect the interest of the holders, not to give power to them.
- Generally exercisable in exceptional circumstances or to make fundamental changes to the activities.
- Potential Voting rights alone do not give power.

Examples include:

- 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
- the right of a lender to seize the assets of a borrower if the borrower fails to meet specified loan repayment conditions.
- approve the issue of equity or debt instruments

EXPOSURE, OR RIGHTS, TO VARIABLE RETURNS FROM AN INVESTEE

What are variable returns?

- Returns that are not fixed and vary as a result of the performance of the investee.
- Can be positive only, negative only, both positive and negative.

Substance over form

- Ex: Fixed interest payments on bonds are variable for Ind AS as they are subject to the default risk of borrower and credit risk of issuer.
- Ex: Fixed performance fees for managing investee's assets are variable as it exposes the investor to the performance risk of investee.

Examples of returns

- Dividends, interest, change in value of investment in the investee
- Servicing fee of asset/liability, fees/loss for credit or liquidity support, residual interest in investee's assets on liquidation, tax benefits, etc
- Returns not available to other interest holders. For example, using investors' assets in combination with the assets of the investee to obtain cost cutting, economies of scale.

ABILITY TO USE ITS *POWER OVER INVESTEE* TO AFFECT INVESTOR'S RETURNS- LINK BETWEEN POWER AND RETURNS

A decision maker should assess the following:

Whether it is a "principal" or "agent"

An *agent* acts on behalf and for the benefit of other party/ies

A *principal* shall treat the decision making rights given to the agent as held by him directly

A decision maker shall evaluate the following factors:

- ✓the scope of its decision-making authority over the investee
- ✓the rights held by other parties
- ✓the remuneration to which it is entitled in accordance with the remuneration agreement
- ✓exposure to variability of returns from other interests that it holds in the investee

Scope of decision making authority:

For this it is required to consider:

- Permitted activities according to agreement and law

- Discretion made when making decision about those activities

- Purpose and design of investee, risks retained, risks passed on, level of involvement of the decision maker.

Rights held by other parties:

Factors affecting are:

- Substantive rights held by other parties/removal of substantive rights

-When a single party, holding substantial removal rights, can remove a decision maker, without cause, in isolation proves that the decision maker is an agent

-Rights exercised by investee's board of directors and its effect on the decision maker

Remuneration:

-The greater the *magnitude* and *variability* of the decision maker's remuneration relative to investee's returns, the more likely that the is a principal

- The following suggests that he is an agent:

* Remuneration commensurate with services provided

*Agreement contains customary terms & conditions and the amount is at arm's length

Exposure to variability of returns from other interests:

Such variability may be from interests like guarantee for investee's performance. It is generally suggestive of a principal.

The decision maker shall evaluate its exposure relative to the total variability of returns of the investee. The following should be considered:

- Magnitude and variability of its economic interests considering its remuneration and other interests.

-whether exposure to variability of returns is different from other investors and, if so, whether this might influence its actions

RELATIONSHIP WITH OTHER PARTIES- DE FACTO AGENT

The determination of whether other parties are acting as de facto agents(acting on investor's behalf) requires judgement, considering not only the nature of the relationship but also how those parties interact with each other and the investor. Such a relationship need not involve a contractual arrangement.

Examples of other parties that by their very nature might act as de facto agents

- Investor's related parties
- party that received its interest in the investee as a contribution or loan from the investor
- party that has agreed not to sell its interests in the investee without the investor's prior approval
- party that cannot finance without subordinated financial support from the investor
- party that has a close business relationship with the investor

SPECIAL CASE-FRANCHISE

Franchisor → Franchise business → Franchisee

Franchisor

- ❖Rights given to franchisor are generally protective in nature with some decision making rights.
- ❖There are other parties who can have rights to affect investee's returns. It is also possible that franchisor does not have the ability to direct relevant activities.
- ❖It would be necessary to distinguish between having ability to make decisions that significantly affect the franchisee's returns and one that protects the franchise brand.

Franchisee

By entering into the franchise agreement the franchisee has made a unilateral decision to operate its business in accordance with the terms of the franchise agreement, but for its own account

INVESTMENT ENTITY- ITS CONSOLIDATION

What are the criteria of an Investment entity?

- Obtain funds from investors for providing them with investment management services.
- Business purpose- returns from capital appreciation or investment income(dividend, interest, rental income) or both
- Performance evaluation and measurement of investments on fair value basis.

Characteristics of an investment entity

- More than one investment
- More than one investor
- Investors are not related parties
- Ownership in the form of equity or similar instrument

INVESTMENT ENTITY- ITS CONSOLIDATION (2/2)

- If the investment entity has a subsidiary that provides services related to its investment activities, then it needs to be consolidated as per Ind AS 110 and apply Ind AS 103 wherever applicable. All other investments by investment entities need to be valued at fair value through profit or loss as per Ind AS 109.

- In case facts and circumstances change, then it shall be re assessed whether the entity is still an investment entity or whether it has now become an investment entity. This change shall be accounted for on a prospective basis.

- Investment related services include investment advisory services, investment management, investment support and management services.

- Investment entity does not intend to hold the assets indefinitely. It must have an exit plan in place for its equity and debt instruments.

- An investment entity measures and evaluates its investment performance in terms of fair value as it portrays more relevant information.

ACCOUNTING REQUIREMENTS- FOR CONSOLIDATION

Step 1:

Combine like items of asset, liability, income and expenses of subsidiary with parent

Step 2:

Offset parent's investment in subsidiary and parent's share of equity in subsidiary.

Step 3:

Eliminate intra group transactions of assets, liabilities, incomes and expenditures between the parent and subsidiary.

Requisites:

There should be uniformity in accounting policies on a group wide basis.

The reporting dates of both the companies should be same for the purpose of consolidation. If it is not, then additional financial information should be given to align the dates with that of the parent, until its impracticable to do so. If it is impractical then the latest financial statements should be used after adjusting for significant events between the two dates.

Non Controlling interest should be shown

Loss of Control:

A parent may lose control either as a single transaction or in two or more arrangements. In either case, the assets, liabilities in subsidiary and non controlling interest are all de recognised. Fair value of consideration received shall be recognised and any resulting gain or loss shall be booked.

DECODING “SIGNIFICANT INFLUENCE”

Equity Investing

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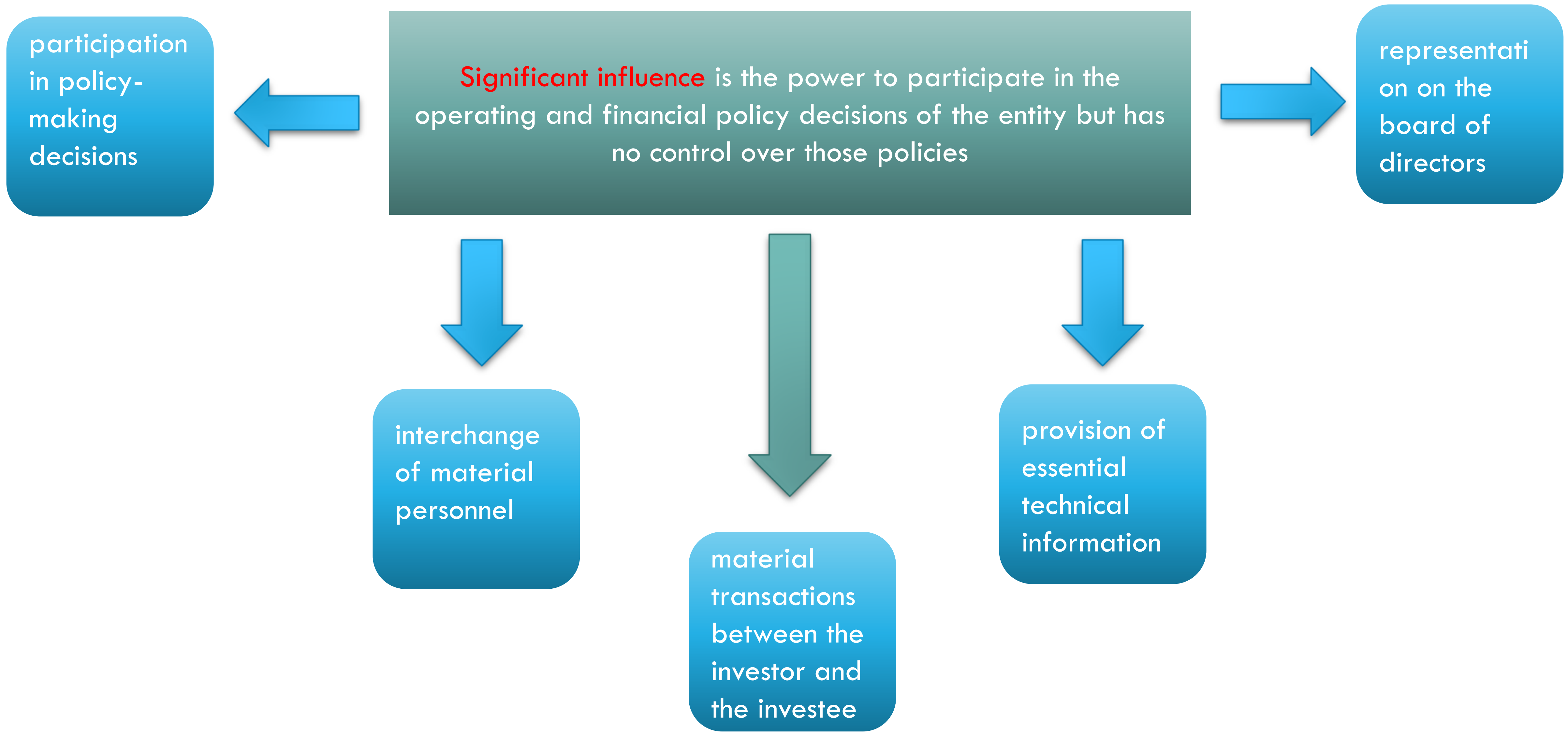
Ind AS 28 states that there is a presumption that the investor has significant influence over the entity where it holds, directly or indirectly, 20 per cent or more of the voting rights, unless it can be clearly demonstrated that it is not the case

IND AS 28:Investments in Associates and Joint Ventures

Conversely, if an investor holds, directly or indirectly, less than 20 per cent of the voting rights, significant influence cannot be presumed unless it can be clearly demonstrated that it is not the case


Significant influence is the power to participate in the operating and financial policy decisions of the entity but has no control over those policies
participation in policy-making decisions
representation on the board of directors
interchange of material personnel
material transactions between the investor and the investee
provision of essential technical information

The investment in associate or joint venture is Equity Accounted and the investment shown in financial statement will include the investing entity's share of the gains of the associate from the date the investment was made.

Under the equity method, on initial recognition:

- the investment in an associate or a joint venture is recognized at cost, and
- the carrying amount is increased or decreased to recognize the investor's share of the profit or loss of the investee after the date of acquisition.
- The investor's share of the investee's profit or loss is recognized in the investor's profit or loss.
- Distributions received from an investee reduce the carrying amount of the investment.
- Adjustments to the carrying amount may also be necessary for changes in the investor's proportionate interest in the investee arising from changes in the investee's other comprehensive income.
- Such changes include those arising from the revaluation of property, plant and equipment and from foreign exchange translation differences.
- The investor's share of those changes is recognized in the investor's other comprehensive income (refer Ind AS 1, Presentation of Financial Statements).

If an entity's ownership interest in an associate or a joint venture is reduced, but the entity continues to apply the equity method, the entity shall reclassify to profit or loss the proportion of the gain or loss that had previously been recognized in other comprehensive income relating to that reduction in ownership interest if that gain or loss would be required to be reclassified to profit or loss on the disposal of the related assets or liabilities.

Exemptions from applying the equity method

The entity is a wholly-owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the entity not applying the equity method

The ultimate or any intermediate parent of the entity produces financial statements available for public use that comply with Ind ASs, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with Ind AS 110

The entity's 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).

The entity did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organization, for the purpose of issuing any class of instruments in a public market.

EXEMPTIONS FROM APPLYING THE EQUITY METHOD

It is a wholly owned/ partially owned subsidiary of another parent and its owners are informed of and do not object to not apply equity method

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Its debt/equity instruments are not traded in public market

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It did not file its financial statements with a securities commission or other regulatory organization for the purpose of issuing any instrument in a public market

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Its ultimate or any intermediate parent produces financial statements that are available for public use and comply with Ind AS 110

DISCONTINUING THE USE OF THE EQUITY METHOD

An entity shall discontinue the use of the equity method from the date when its investment ceases to be an associate or a joint venture as follows:

If the retained interest in the former associate or joint venture is a financial asset, the entity shall measure the retained interest at fair value. The fair value of the retained interest shall be regarded as its fair value on initial recognition as a financial asset in accordance with Ind AS 109. The entity shall recognize in profit or loss any difference between:

- the fair value of any retained interest and any proceeds from disposing of a part interest in the associate or joint venture; and
- the carrying amount of the investment at the date the equity method was discontinued

If the investment becomes a subsidiary, the entity shall account for its investment in accordance with Ind AS 103, Business Combinations, and Ind AS 110, Consolidated Financial Statements.

ABOUT US

Vinod Kothari & Co.,

- Based in Kolkata, Mumbai, Delhi

We are a team of consultants, advisors & qualified professionals having over 30 years of practice.

Our Organization's Credo:

Focus on capabilities; opportunities shall follow