Consolidation – Subsidiaries, Joint arrangements and Associates

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Introduction

Standards and their scope

Ind AS 110, Consolidated financial statements

- Establishes principles for the presentation and preparation of consolidated financial statements when an entity controls one or more entities

Ind AS 111, Joint arrangements

- Establishes principles for financial reporting by entities that have an interest in arrangements that are controlled jointly

Ind AS 28, Investments in associates and joint ventures

- Requires that interests in such entities are accounted for using the equity method of accounting

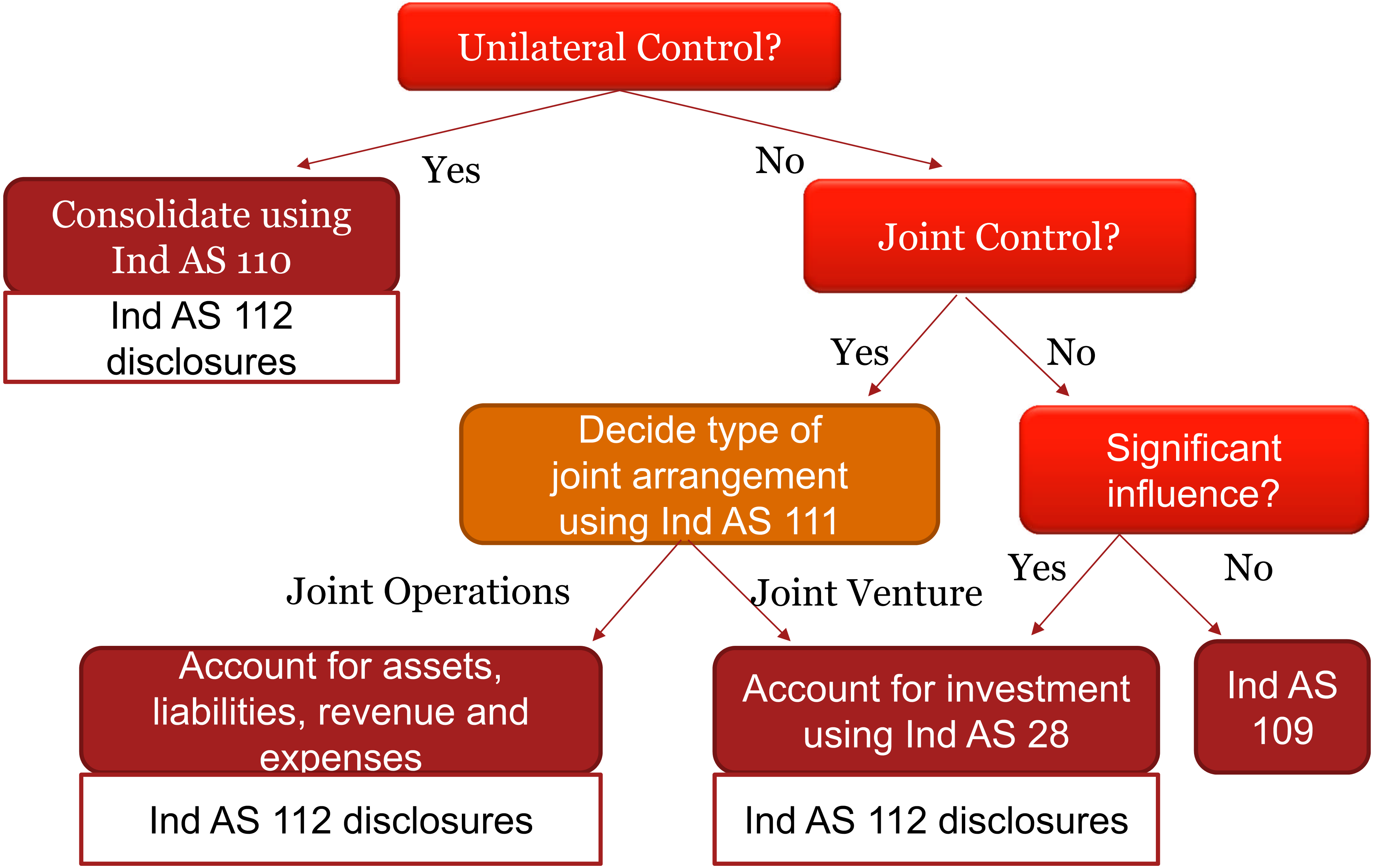
Ind AS 112, Disclosure of interests in other entities

- Requires an entity to disclose information about:
  a) the nature of, and risks associated with, its interests in other entities; and
  b) the effects of those interests on the financial position, financial performance and cash flows

Ind AS 27, Separate financial statements

- Applied in accounting for investments in subsidiaries, joint ventures and associates when an entity elects, or is required by law, to present separate financial statements

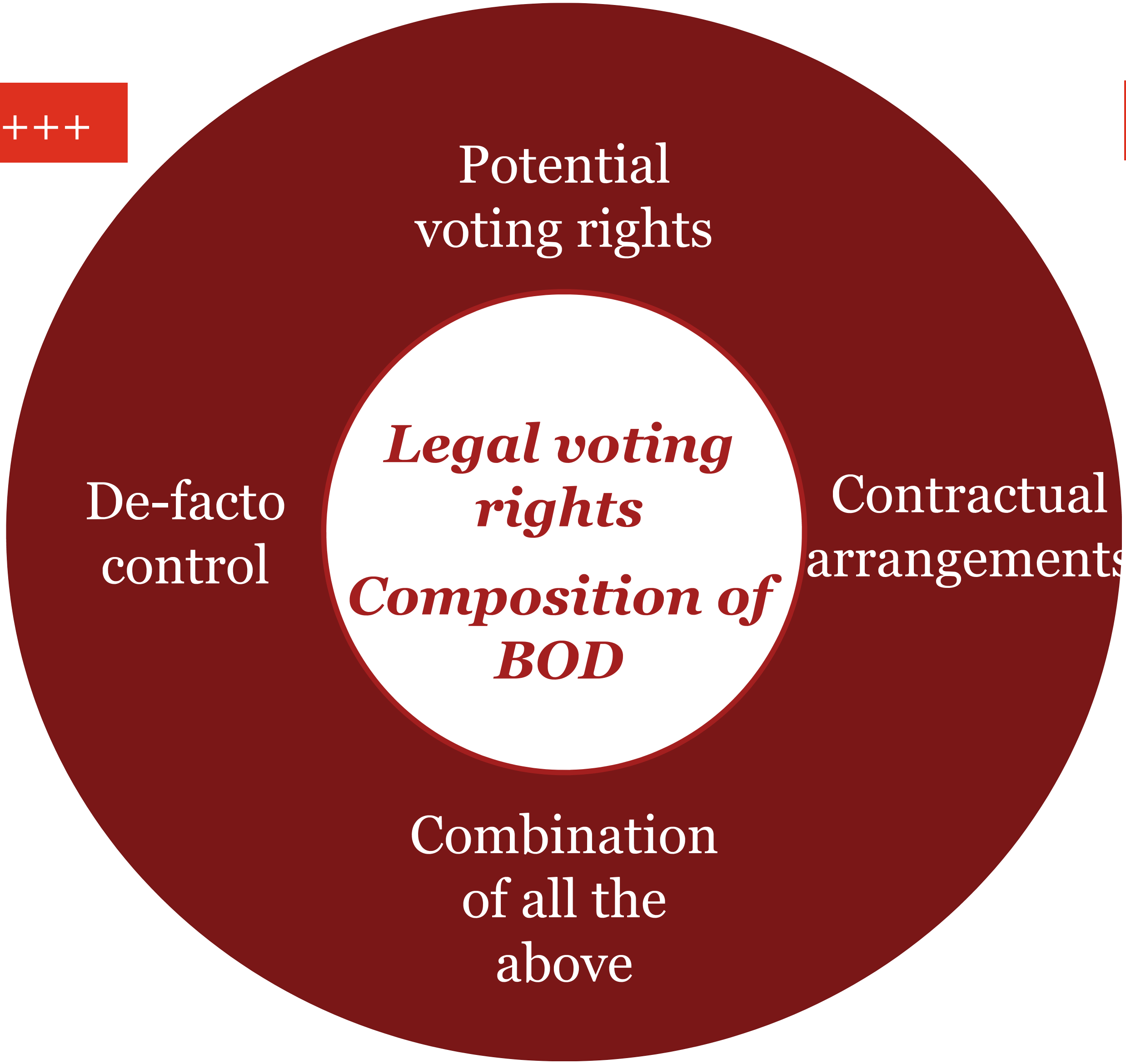
Key concepts



Ind AS versus Indian GAAP

Ind AS ++++

Indian GAAP



Consolidation - Ind AS 110

Scope of Ind AS 110

An entity that is **a parent** shall present consolidated financial statements and consolidates all entities that it **controls** (subsidiary).

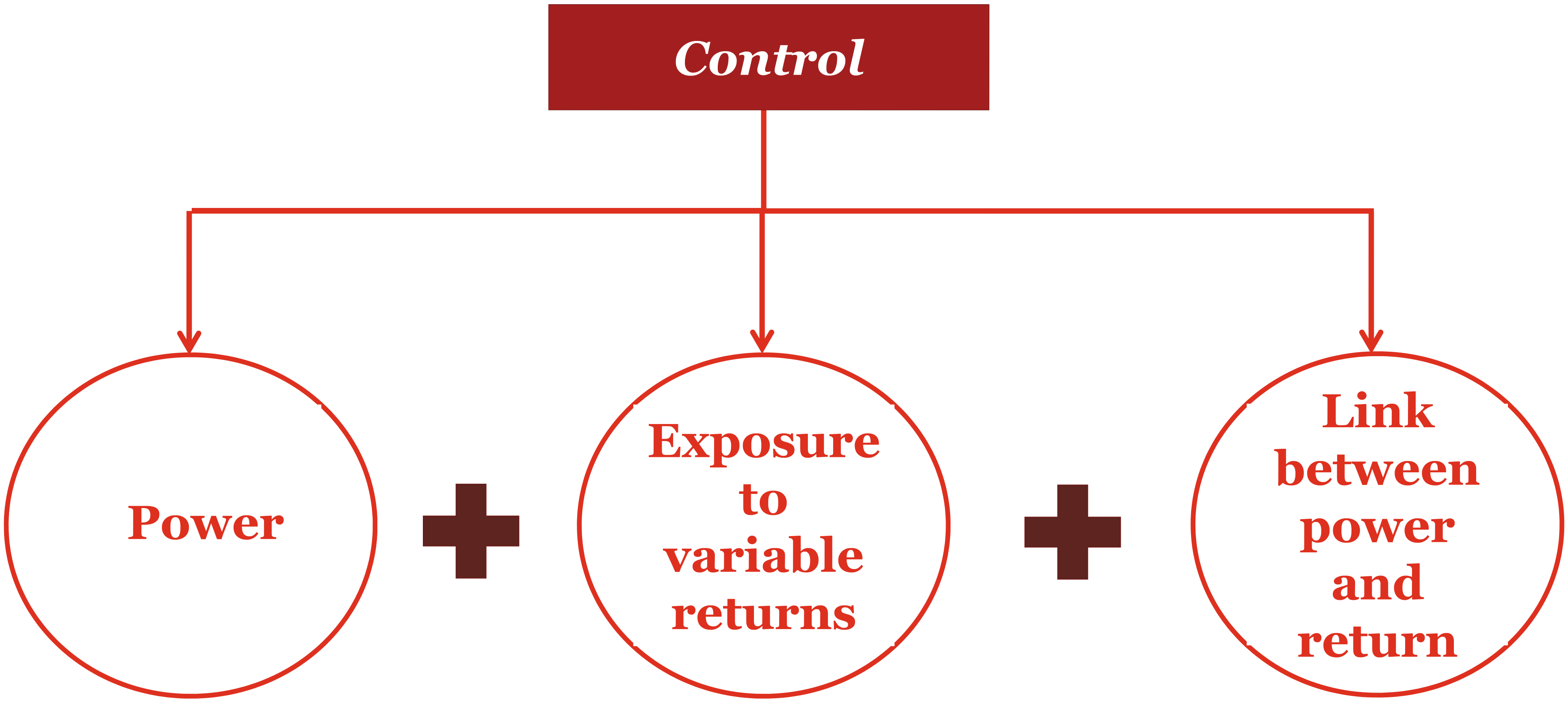
Exceptions:

- **Intermediate holding company**
  - Wholly owned or partly owned subsidiary
  - Debt or equity not listed
  - Not files or in the process of filing securities in public market
  - Its ultimate or immediate Parent produce Ind AS CFS available for public use
- **Investment entity**
  - measure all its subsidiaries at fair value through profit or loss
- **Exempted by law**
  - Wholly owned subsidiary (incorporated in India)
  - Entities who do not have subsidiaries but associate and JV

Structured Entity

The concept of control

...if and only if the investor has all the following...



The "Control" Model

Control = Power + Exposure to variable return + Link between power and return

Power

Rights that give investor current **ability to direct** "Relevant activities"

Rights include:

- ✓ Voting rights
- ✓ Potential voting rights
- ✓ Contractual rights
- × Protective rights

Exposure to variable return

Returns vary with investee performance

Returns include

- ✓ Dividends
- ✓ Changes in value of investment
- ✓ Synergistic benefits

Link between power and return

Requires analysis of:

- Investor as principal vs agent
- Delegated authority

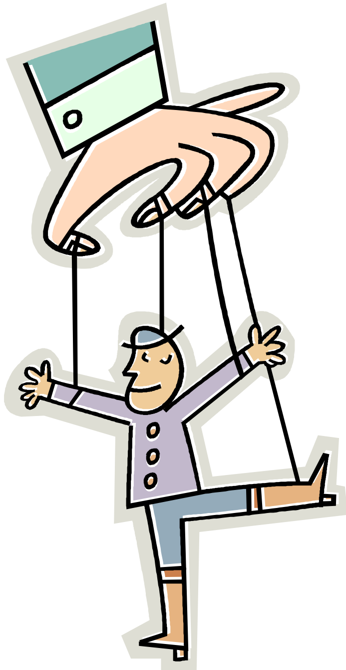
Assessing control

Purpose and design of the investee

What are relevant activities

How decisions regarding relevant activities are made

Nature of relationship with other parties



Ability to direct relevant activities

Ability to use the power

Exposure to variable returns

A combination of all these factors needs to be considered

Relevant activities - of the investee that significantly affect the investee's returns

Selling and purchasing goods/services

Selecting/acquiring/ disposing assets

Appointing key management

Obtaining funding

Researching/developing new products/processes

Managing financial assets

Establishing budgets

The determination of relevant activities is driven by facts and circumstances, purpose and design of each entity.

Relevant activities - example

Manufacturing entity

Investor A

Selecting vendors for key input material

Approving purchase of patent for production process

√

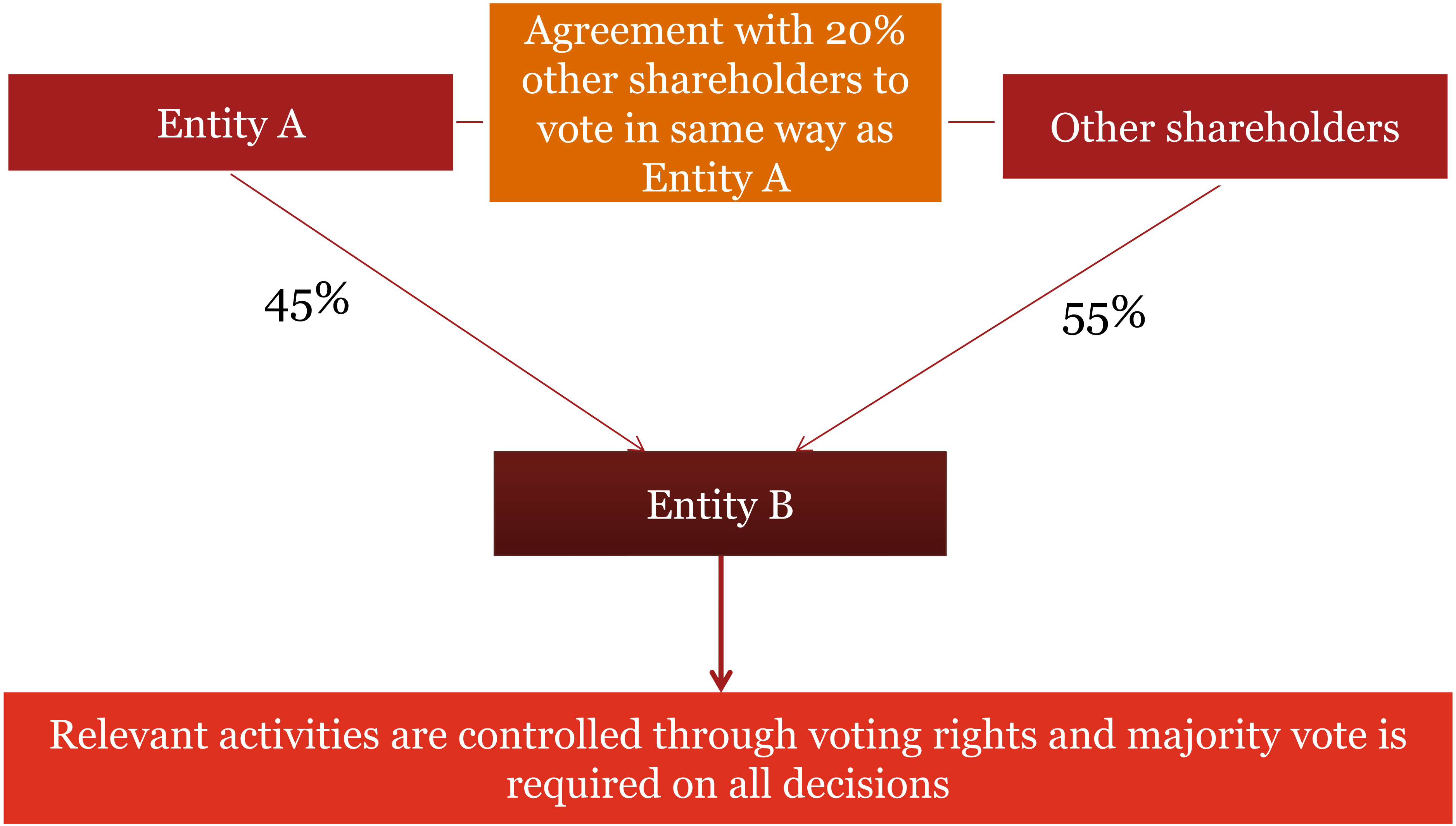
Investor B

Payroll processing

Managing the accounting function

X

Contractual arrangements



De-facto control - example

Entity A

Nominates majority of directors that are approved due to A's presence at general meetings.

48%

Widely dispersed shareholders

- Many shareholders, each with <5% of votes.
- No arrangements to vote collectively.
- General representation at general meetings <30% for many years.

52%

Entity B – Listed

- No history of shareholder activism in listing country.
- Hostile takeovers unusual.

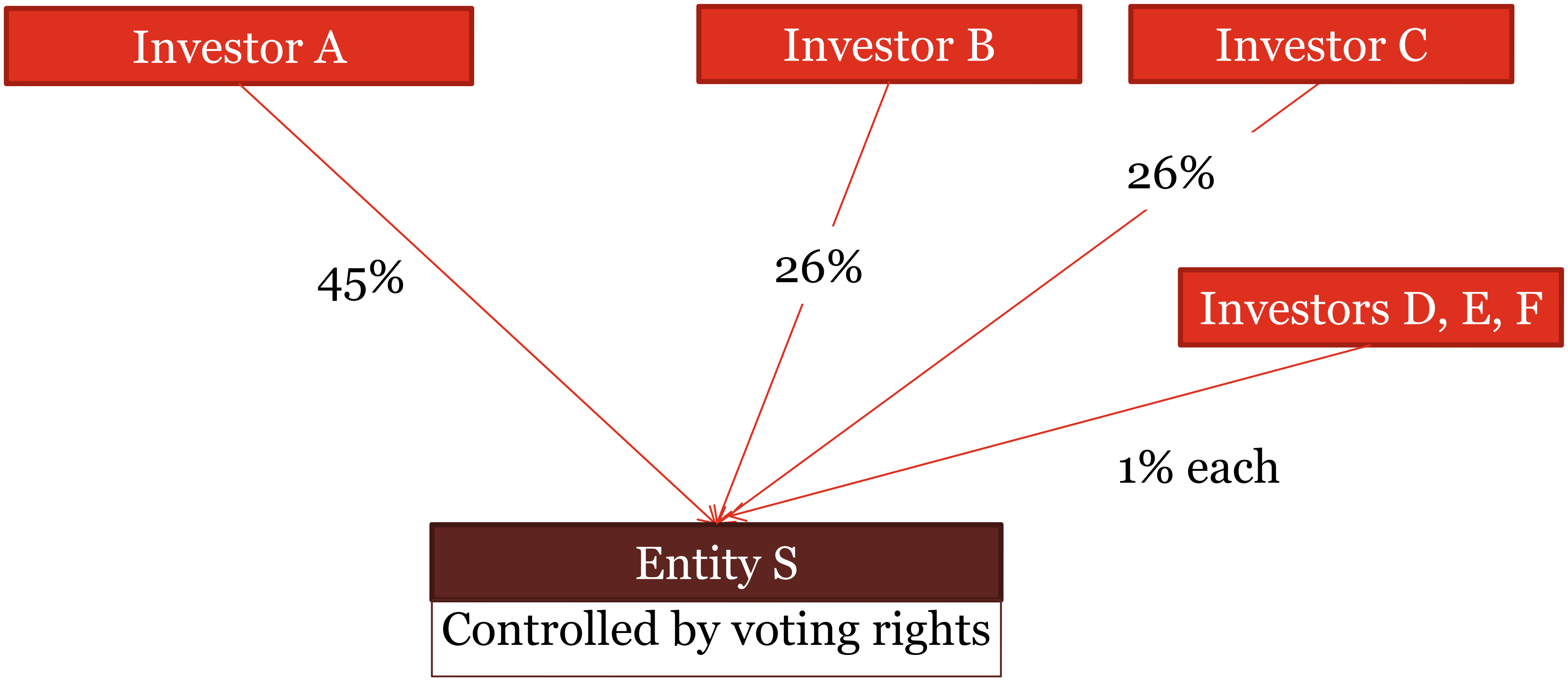
Does entity A control entity B?

De-facto control

- Control with less than 50% of the voting rights ?
- Factors to consider include:
  - The more rights the investor holds, the more likely it will have rights needed to direct relevant activities
  - The more rights the investor holds relative to other vote holders, the more likely it will have rights needed to direct relevant activities
  - The number of other investors that must act together to outvote the investor

A highly judgmental area

De-facto control - example



Does investor A control entity S?

Potential voting rights

Evaluate whether rights are substantive:

- Whether there are <u>any barriers that prevent</u> the holder from exercising the rights
- Whether a mechanism is in place that provides parties with <u>practical ability to exercise</u> their rights collectively if they choose to do so
- Whether the party or parties that hold the rights would <u>benefit from the exercise</u> of those rights.

Examples:

Warrants

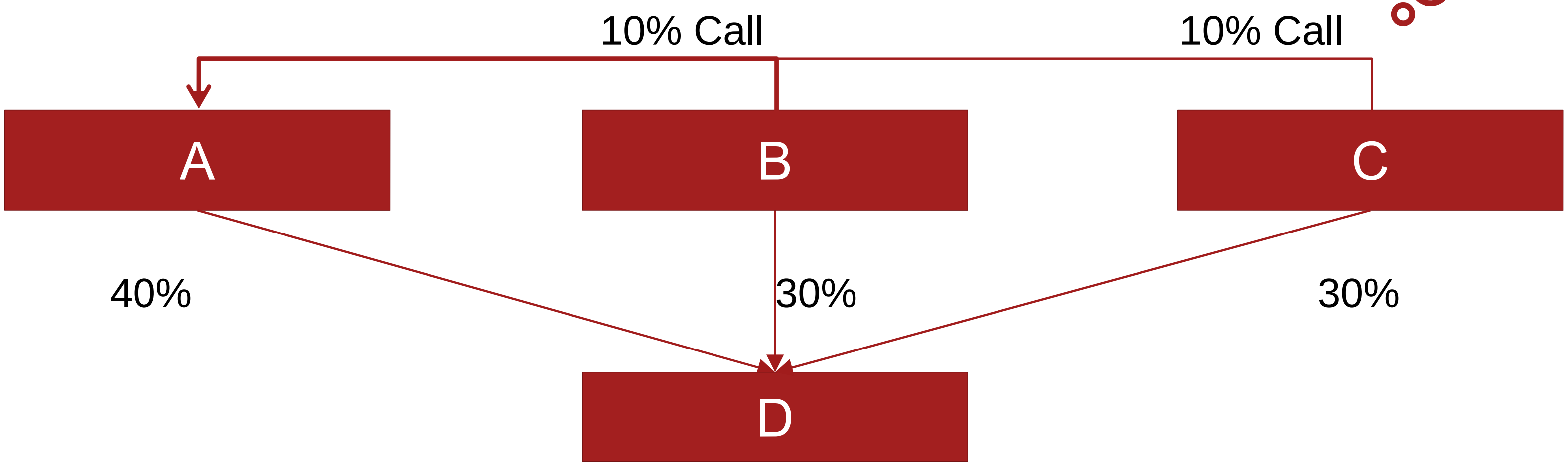
Convertible debts

Purchased options to acquire voting interest

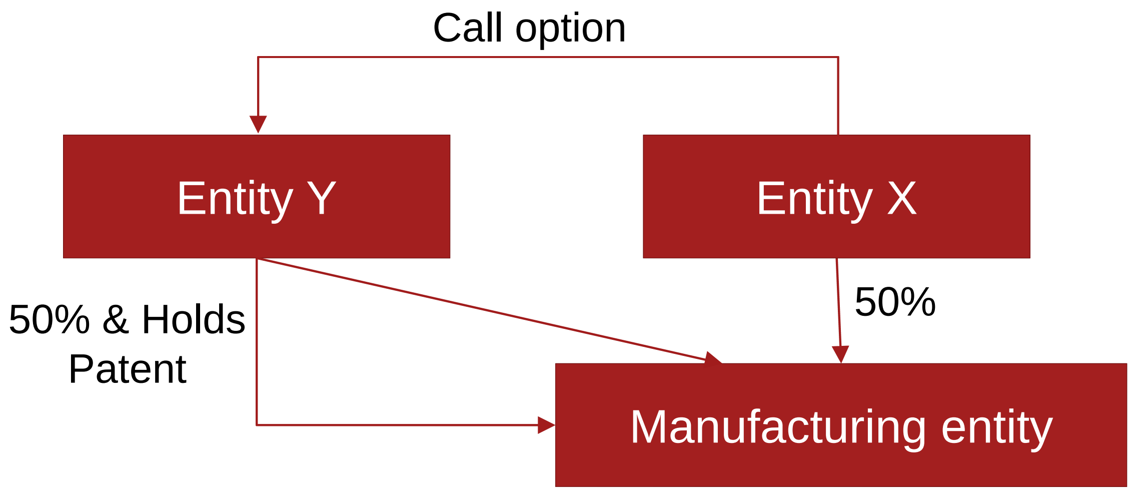
Potential voting rights - example

- Entities A, B and C own 40%, 30% and 30% respectively of entity D.
- Entity A also owns call options that are exercisable at any time and if exercised would give it an additional 20% voting rights in entity D & reduce entity B's and entity C's interests to 20% each.
- Call options were entered into a year earlier.
- The exercise price is lower than the fair value.

Does entity A controls entity D?



Potential voting rights - example



- Entity X has an out of the money call option over the shares held by entity Y.
- The patent will revert to entity Y if the call option is exercised. The product cannot be manufactured without the patent.
- Neither party expects the call option to be exercised. The purpose is to allow entity X to take control of the entity in exceptional situations.

Who controls the manufacturing entity?

Criteria	Principal	Agent
[redacted]	Significant involvement & discretion	[redacted]
Rights held by other parties	Many parties are required to act together to remove	Single party has the ability to remove the decision maker
Remuneration and exposure to variability of returns	[redacted]	[redacted]

√

Principal vs Agent - example

- A fund manager establishes, markets and manages a fund that provides investment opportunities to a number of investors. He has extensive decision-making authority to direct the relevant activities of the fund. He makes decisions in the best interests of all investors and in accordance with the fund's governing agreements.
- The investors can remove the fund manager by a simple majority vote.
- A market-based fee of 1% of assets under management and 20% of profits if a specified profit level is achieved is paid to the fund manager.
- The fund manager also has a 2% investment in the fund that aligns its interests with those of the other investors.

Is the fund manager a principal or an agent?

Structured entities

Voting or similar rights are NOT dominant factor in deciding control!

- Voting rights may only relate to administrative tasks
- Relevant activities directed by contractual arrangements

Restricted activities

Thin capitalisation

Financing

Narrow & well defined objectives

Professional directors, trustees or partners

Non profit making motive

Domiciled in offshore tax havens

Specified life

Specific financial objective

Consolidate as a single economic entity

Consolidation begins when investor obtains control

Uniform accounting policies

Combine like items

Same reporting date

Loss of control

Non controlling interest

Special consideration to NCI…

- Consideration is given to existing percentage of control and Non Controlling Interest (‘NCI’);
- Profit or loss and each component of other comprehensive income is attributed to NCI;
- Changes in proportion held by NCI which does not result in loss of control should be treated as an equity transaction and should not be charged to comprehensive income;
- In case of loss of control:
  - De-recognise all assets and liabilities of subsidiary and NCI at carrying amount
  - Recognise fair value of consideration received
  - Re-classify to profit or loss the amount recognised in other comprehensive income
  - Recognise any gain or loss in profit or loss attributable to the parent

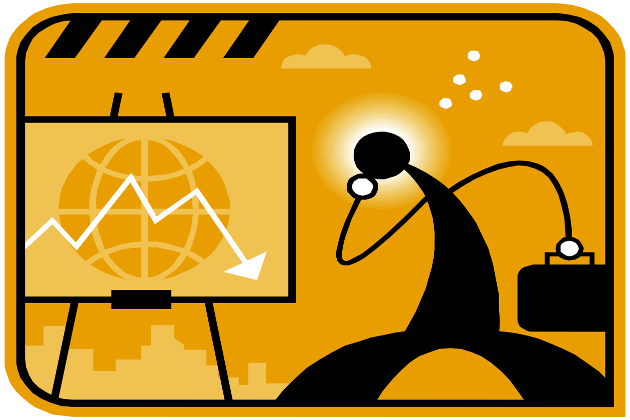
Special consideration to NCI..

Group financial statements single economic entity.

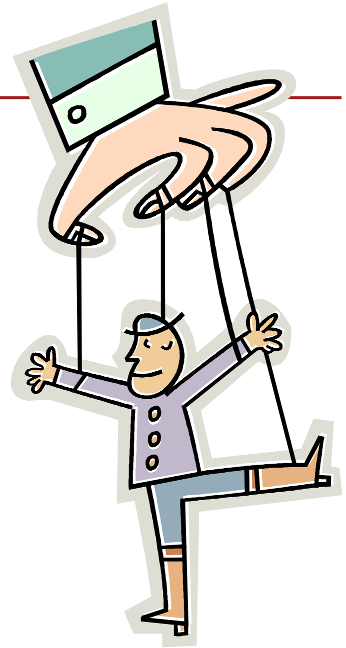
Equity providers include parent company shareholders & NCI

TRANSACTIONS WITH EQUITY HOLDERS
- no goodwill and no gain/loss in income statement.

Losses can be allocated to NCI even if result in debit balance



Principles of losing control



De-recognise assets (inc. goodwill) and liabilities

De-recognise NCI

Recognise consideration received

Recognise at FV any investment retained

Difference to income statement

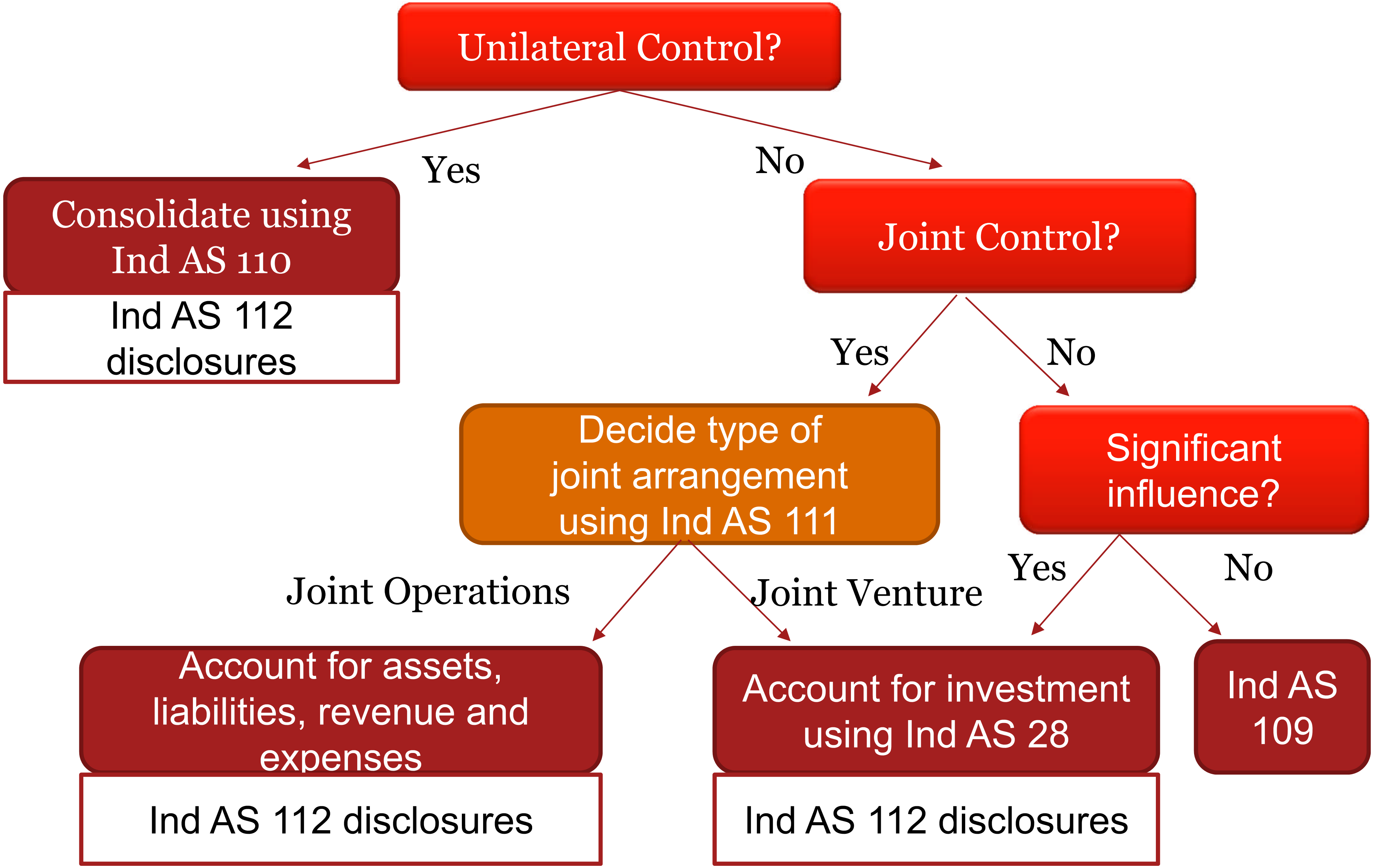
NEW!!

Reclassify to income statement any gain or loss previously recognised in other comprehensive income

IMPORTANT CLARIFICATION

Consolidation - Ind AS 111

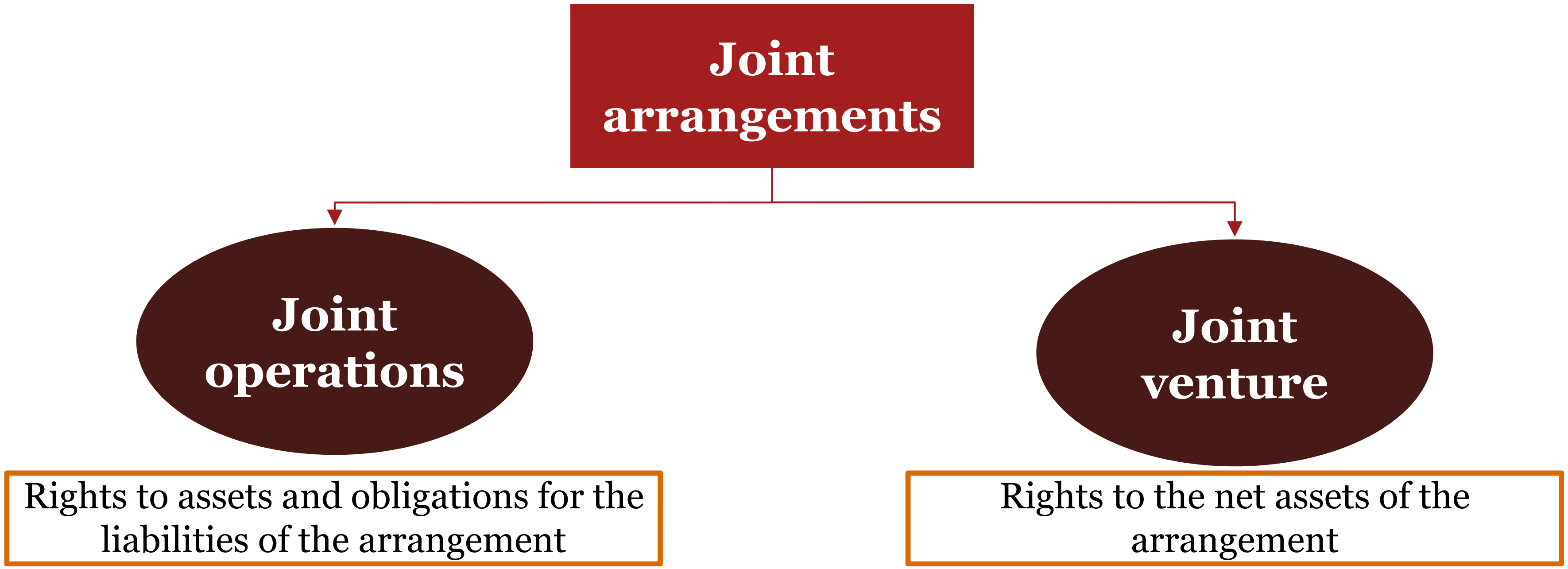
Key concepts



Joint arrangements

When two or more parties have joint control

- contractually agreed sharing of control
- unanimous consent over ‘relevant activities’



Determination of type of a joint arrangement

Is the arrangement structured through a separate vehicle?

No → Joint Operation

Yes ↓

Does the legal form confer direct rights to assets and obligations for liabilities to parties of the arrangement?

Yes → Joint Operation

No ↓

Does the contractual arrangement between parties confer direct rights to assets and obligations for liabilities to the parties of the arrangement?

Yes → Joint Operation

No ↓

Do other facts and circumstances lead to direct rights to assets and obligations for liabilities being conferred to the parties of the arrangement?

Yes → Joint Operation

No ↓

Joint Venture

Joint Operation

Ind AS versus Indian GAAP – Joint Venture

Ind AS	**Equity method of accounting**
Indian GAAP	**Proportionate consolidation method of accounting**

Accounting for joint arrangements

Parties that share joint control	Consolidated financial statements	Separate financial statements
Joint Operations	Recognise interest in the direct rights & obligations, and share of those assets, liabilities and transactions incurred jointly	
Joint Ventures	Equity method	Investment measured at cost or in accordance with Ind AS 109

Joint ventures-Transition from proportionate consolidation to equity method

Equity accounted investment in joint venture = total of the carrying amounts of the assets and liabilities previously proportionately consolidated by the entity (includes goodwill arising from the acquisition)

↓

The opening balance of the investment is regarded as the deemed cost for the investment. The entity then considers impairment which will be an adjustment to retained earnings at the beginning of the earliest period presented.

↓

After initial recognition, the entity should account for its investment in the joint venture using the equity method in accordance with Ind AS 111.

Accounting of associates

When	**Investment in associates even when there is no subsidiary**
Who	**Power to participate in the financial and operating policy decisions**
How	**Equity method of accounting including share in OCI**

Consolidation - Ind AS 112

Disclosure of interests in other entities

Significant judgements and assumptions

Interest in subsidiaries

Investment entity

Joint arrangements and associates

Consolidation - Recap

Consolidation

Recap

Ind AS 110

Control, Power,
Variable returns

Relevant activities,
de facto control &
contractual arrangements

Potential Voting Rights,
Principal vs Agent,
Structured entity

Single economic activity

Ind As 111

Collective/ Joint control

Joint operations- recognise
interest/assets/liabilities

Joint venture- equity
method of accounting

Joint venture- transition
provisions

Ind AS 112-Disclosures: Judgements, assumptions, interests

Questions

Thank You