Introduction to Consolidated Financial Statements: Group Theories and Control (Ref. IFRS 10)

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Consolidated Financial Statement: definition (IFRS 10)

«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».

A group is a parent and its subsidiaries.
## Group’s Theories

<table>
<thead>
<tr>
<th>Theory</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PROPRIETARY THEORY</strong></td>
<td>The group is considered as the consequence of equity investments owned by the parent company. The subsidiaries’ net assets corresponding to minority interests don’t pertain to the group and are, therefore, not consolidated.</td>
</tr>
<tr>
<td><strong>ENTITY THEORY</strong></td>
<td>The group is seen as a single entity and no distinction is made between the minority interests and the equity owned by the parent company.</td>
</tr>
<tr>
<td><strong>PARENT COMPANY THEORY</strong></td>
<td>The group represents an extension of the parent company; nevertheless, it includes also the capital invested in subsidiaries by other investors (minority interest).</td>
</tr>
</tbody>
</table>
Glossary

Definitions

The following terms are used in this Standard with the meanings specified:

- **Control** (for the purpose of this Standard) is the power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities.

- A **subsidiary** is an enterprise that is controlled by another enterprise (known as the parent).

- A **parent** is an enterprise that has one or more subsidiaries.

- A **group** is a parent and all its subsidiaries.

- **Consolidated financial statements** are the financial statements of a group presented as those of a single enterprise.

- **Minority interest** is that part of the net results of operations and of net assets of a subsidiary attributable to interests which are not owned, directly or indirectly through subsidiaries, by the parent.
### Possible effects of the three theories

#### Separated Balance Sheet

<table>
<thead>
<tr>
<th>Company P (parent)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Equity inv. in S</strong></td>
<td>100</td>
</tr>
<tr>
<td>Equity</td>
<td>800</td>
</tr>
<tr>
<td>Non curr. Ass.</td>
<td>1,200</td>
</tr>
<tr>
<td><strong>Curr. Assets</strong></td>
<td>800</td>
</tr>
<tr>
<td>Liabilities</td>
<td>1,300</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>2,100</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Company S (subsidiary)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Non curr. Ass.</td>
<td>600</td>
</tr>
<tr>
<td>Equity</td>
<td>150</td>
</tr>
<tr>
<td>Current assets</td>
<td>150</td>
</tr>
<tr>
<td>Liabilities</td>
<td>600</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>750</strong></td>
</tr>
</tbody>
</table>

P holds 2/3 of company S (no goodwill)

#### Consolidated Balance Sheet

##### PROPRIETARY THEORY

<p>| | |</p>
<table>
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<td>Non curr. asset</td>
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</tr>
<tr>
<td>Equity</td>
<td>800</td>
</tr>
<tr>
<td>Current Assets</td>
<td>900</td>
</tr>
<tr>
<td>Liabilities</td>
<td>1,700</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>2,500</strong></td>
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##### ENTITY THEORY

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Non curr. asset</td>
<td>1,800</td>
</tr>
<tr>
<td>Equity</td>
<td>850</td>
</tr>
<tr>
<td>Current Assets</td>
<td>950</td>
</tr>
<tr>
<td>Liabilities</td>
<td>1,900</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>2,750</strong></td>
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##### PARENT COMPANY THEORY

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</tr>
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<td>Current Assets</td>
<td>950</td>
</tr>
<tr>
<td>Minor. Int.</td>
<td>50</td>
</tr>
<tr>
<td>Liabilities</td>
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<tr>
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Role of IFRS 10

IFRS:
(a) requires an entity (the parent) that controls one or more other entities (subsidiaries) to present consolidated financial statements;

(b) defines the principle of control, and establishes control as the basis for consolidation;

(c) sets out how to apply the principle of control to identify whether an investor controls an investee and therefore must consolidate the investee; and

(d) sets out the accounting requirements for the preparation of consolidated financial statements.
IFRS 10: Definition of Control

“An investor controls an investee when it 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.”

Thus, the principle of control sets out the following three elements of control:
(a) power over the investee;
(b) exposure, or rights, to variable returns from involvement with the investee; and
(c) the ability to use power over the investee to affect the amount of the investor’s returns.
Power

- An investor has power over an investee when the investor has existing rights that give it the current ability to direct the relevant activities, i.e. the activities that significantly affect the investee’s returns.

- Power arises from rights.
  - Sometimes assessing power is straightforward: for instance, when power is obtained directly and solely from the voting rights granted by equity instruments such as shares, and can be assessed by considering the voting rights from those shareholdings.
  - In other cases, the assessment will be more complex: for example, when power results from one or more contractual arrangements.
Direction of the relevant activities

- An investor with the current ability to direct the relevant activities has power even if its rights to direct have yet to be exercised.

- Evidence that the investor has been directing relevant activities can help determine whether the investor has power, but such evidence is not, in itself, conclusive.

- An investor can have power over an investee even if other entities have existing rights that give them the current ability to participate in the direction of the relevant activities, for example when another entity has significant influence.
Relevant Activities

Examples of activities that, depending on the circumstances, can be relevant activities include, but are not limited to:

a) selling and purchasing of goods or services;
b) managing financial assets during their life (including upon default);
c) selecting, acquiring or disposing of assets;
d) researching and developing new products or processes; and
e) determining a funding structure or obtaining funding.

Examples of decisions about relevant activities include but are not limited to:

a) establishing operating and capital decisions of the investee, including budgets; and
b) appointing and remunerating an investee’s key management personnel or service providers and terminating their services or employment.
Evidence of whether the investor has the practical ability to direct the relevant activities unilaterally.

Consideration is given, but is not limited, to the following:

a) The investor can, without having the contractual right to do so, appoint or approve the investee’s key management personnel who have the ability to direct the relevant activities.

b) The investor can, without having the contractual right to do so, direct the investee to enter into, or can veto any changes to, significant transactions for the benefit of the investor.

c) The investor can dominate either the nominations process for electing members of the investee’s governing body or the obtaining of proxies from other holders of voting rights.

d) The investee’s key management personnel are related parties of the investor (for example, the chief executive officer of the investee and the chief executive officer of the investor are the same person).

e) The majority of the members of the investee’s governing body are related parties of the investor.
Variable Returns

- An investor is exposed, or has rights, to variable returns from its involvement with the investee when the investor’s returns from its involvement have the potential to vary as a result of the investee’s performance.

- An investor controls an investee if the investor not only has power over the investee and exposure or rights to variable returns from its involvement with the investee, but also has the ability to use its power to affect the investor’s returns from its involvement with the investee.
First consolidation date

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

- If a parent loses control of a subsidiary, the parent:
  (a) derecognises the assets and liabilities of the former subsidiary from the consolidated statement of financial position.
  (b) recognises any investment retained in the former subsidiary at its fair value when control is lost.
Collective Control

- Two or more investors collectively control an investee when they must act together to direct the relevant activities.

- In such cases, because no investor can direct the activities without the co-operation of the others, no investor individually controls the investee.

- Each investor would account for its interest in the investee in accordance with the relevant IFRSs, such as IFRS 11 Joint Arrangements, IAS 28 Investments in Associates and Joint Ventures or IFRS 9 Financial Instruments.
Principles for Consolidation

1. When preparing consolidated financial statements, an entity must use uniform accounting policies for reporting like transactions and other events in similar circumstances.

2. Intragroup balances and transactions must be eliminated.

3. Non-controlling interests in subsidiaries must be presented in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent.
Exceptions

An entity that is a parent shall present consolidated financial statements.

This IFRS applies to all entities, except as follows:

(a) a parent need not present consolidated financial statements if 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.

(b) post-employment benefit plans or other long-term employee benefit plans to which IAS 19 Employee Benefits applies.
Who presents the Consolidated Financial Statements?

- **PARENT**
  - **SUBSIDIARY A**: 60%
  - **SUBSIDIARY B**: 100%
  - **D**: 40%
  - **SUBSIDIARY C**: 90%
  - **SUBSIDIARY E**: 60%
Scope of Consolidated Financial Statements

The consolidated financial statements include all controlled entities, other than those subsidiaries excluded for the reasons mentioned in the accounting standard.
Exclusions according to former IAS 27

According to IAS 27, a subsidiary had to be excluded from consolidation when:

(a) control is intended to be temporary because the subsidiary is acquired and held exclusively with a view to its subsequent disposal in the near future; or

(b) it operates under severe long-term restrictions which significantly impair its ability to transfer funds to the parent.

We can reasonably affirm that the notion of control of IFRS 10 would not encompass these cases. Therefore, these companies would be excluded from consolidation also according to IFRS 10.
Loss of control

If a parent loses control of a subsidiary, it shall:

a) Derecognise:
   i. the assets (including any goodwill) and liabilities of the subsidiary at their carrying amounts at the date when control is lost; and
   ii. the carrying amount of any non-controlling interests in the former subsidiary at the date when control is lost (including any components of other comprehensive income attributable to them).

b) Recognise:
   a) the fair value of the consideration received, if any, from the transaction, event or circumstances that resulted in the loss of control;
   b) if the transaction, event or circumstances that resulted in the loss of control involves a distribution of shares of the subsidiary to owners in their capacity as owners, that distribution; and
   c) any investment retained in the former subsidiary at its fair value at the date when control is lost.

c) Reclassify to profit or loss, or transfer directly to retained earnings if required by other IFRSs, the amounts recognised in other comprehensive income in relation to the subsidiary.
Reporting Date

- The financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements shall have the same reporting date.

- When the end of the reporting period of the parent is different from that of a subsidiary, the subsidiary prepares, for consolidation purposes, additional financial information as of the same date as the financial statements of the parent to enable the parent to consolidate the financial information of the subsidiary, unless it is impracticable to do so.

- If it is impracticable to do so, the parent shall consolidate the financial information of the subsidiary using the most recent financial statements of the subsidiary adjusted for the effects of significant transactions or events that occur between the date of those financial statements and the date of the consolidated financial statements.

- In any case, the difference between the date of the subsidiary’s financial statements and that of the consolidated financial statements shall be no more than three months, and the length of the reporting periods and any difference between the dates of the financial statements shall be the same from period to period.
Non-controlling interests

- A parent shall present non-controlling interests in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent.

- An entity shall attribute the profit or loss and each component of other comprehensive income to the owners of the parent and to the non-controlling interests.

- The entity shall also attribute total comprehensive income to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance.
Intragroup Transactions and Balances

- Intragroup balances and intragroup transactions and resulting unrealised profits should be eliminated in full. Unrealised losses resulting from intragroup transactions should also be eliminated unless cost cannot be recovered.

- Intragroup balances and intragroup transactions, including sales, expenses and dividends, are eliminated in full. Unrealised profits resulting from intragroup transactions that are included in the carrying amount of assets, such as inventory and fixed assets, are eliminated in full. Unrealised losses resulting from intragroup transactions that are deducted in arriving at the carrying amount of assets are also eliminated unless cost cannot be recovered.