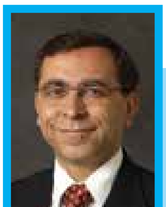
Financial Reporting Challenges in the New Era – Consolidation of Financial Statements

This article touches upon one of the many interesting challenges for the accounting profession – consolidation of financial statements, which has been made mandatory by The Companies Act, 2013. Dramatic change of reversing position by making accounting standards (AS) prevail over the law has an enormous impact, as you will see. Presently, AS applicable on corporate entities are prepared by The Institute of Chartered Accountants of India (ICAI) and have been notified by The National Advisory Committee on Accounting Standards (NACAS). The decision of the Indian Government to implement IFRS through converged accounting standards (Ind AS) is like adding cherry on the icing. Let us have a closer look at these regulations...

The Companies Act, 2013 ("Act") marks a new era in corporate regulations in India. This legislation attracted criticism for implementation in pieces and in haste with unreasonably high penalties, putting both private and public companies on the same pedestal for non-compliance. Lack of clarity around Corporate Social Responsibility (CSR) regulations was one of the most favourite topics of debate in meetings of trade chambers, besides regulations related to responsibilities of independent directors and auditors. On the brighter side, few intellectuals appreciated a rule-based approach bringing flexibility into the game and an attempt to make presentation of financial statements closer to international standards. Contemporary concepts like dormant company, one person company and provisions for easy mergers and acquisitions of smaller companies are other areas liked by the corporate community. Being able to reopen previous financials and having the Tribunal are also the welcome steps. With more clarifications coming and issues of drafting errors getting creased out, the corporate world is settling down and has started adjusting to the change.



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Law versus Standards

Section 129(1)[1] of the Act establishes the principle that financial statements shall comply with Accounting Standards as notified under Section 133 of the Act. Clause 1 and 2 of General instructions in Schedule III[2] quite clearly state that the requirements of Accounting Standards will prevail in case of conflict between Schedule III and requirements of Accounting Standards. The previous Companies Act, 1956, had Section 211(3), which provided that the financial statements shall comply with the requirements of Accounting Standards and in case of deviation, disclosure of the same would be required along with reason and impact.

While applying international reporting style, one must keep in mind that local laws will need to provide priority to the Standards. While framing this new Companies Act, the regulator kept this aspect in mind and provided for such paradigm shift in the approach. This position has to be kept in mind while reading further.

Consolidation of Financial Statements

The Act makes it compulsory for the companies to consolidate financial statements of its subsidiary companies, if any, as per Section 129 (3)[3]. There is provision in the Section to have Rules to explain the manner of consolidation and the explanation to the Section clarifies that associates and joint ventures will also be included in consolidated financial statements. The word "subsidiary" has been defined in Section 2 (87)[4] of the Act. The terms "associate company" and "joint ventures" are defined in Section 2 (6)[5] as the entities where the company has "significant influence". Explanation to the same Section mentions that "significant influence" means control of at least 20 % of the total share capital or of business decisions under an agreement.

Let us understand this concept with the help of an example. If company Y controls the board of directors of company ABC or has more than half of the total share capital of company ABC, then company ABC will be a subsidiary of company Y and company Y will need to consolidate the financials. We shall ignore the applicability of any exception or complication.

As provided in the Act, the rules for manner of consolidation also need to be considered. Clause 6[6] of the Companies (Accounts) Rules, 2014 brings another dimension to the picture. On reading this Clause (in case of a company covered under sub-Section (3) of Section 129 which is not required to prepare consolidated financial statements under the accounting standards), one gets an impression that it is the accounting standards, which defines which company has to prepare consolidated financial statement. Whereas, the accounting standards have a different role to play. Different accounting standards deal with different situations.

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[1] *Section 129 (1) "The financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III... Provided that the items contained in such financial statements shall be in accordance with the accounting standards"*

[2] Schedule III to the Act *"1. Where compliance with the requirements of the Act including Accounting Standards as applicable to the companies require any change in treatment or disclosure including addition, amendment, substitution or deletion in the head or sub-head or any changes, inter se, in the financial statements or statements forming part thereof, the same shall be made and the requirements of this Schedule shall stand modified accordingly. 2. The disclosure requirements specified in this Schedule are in addition to and not in substitution of the disclosure requirements specified in the Accounting Standards prescribed under the Companies Act, 2013. Additional disclosures specified in the Accounting Standards shall be made in the notes to accounts or by way of additional statement unless required to be disclosed on the face of the Financial Statements. Similarly, all other disclosures as required by the Companies Act shall be made in the notes to accounts in addition to the requirements set out in this Schedule."*

[3] *Section 129 (3) "Where a company has one or more subsidiaries, it shall, in addition to financial statements provided under sub-section (2), prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own which shall also be laid before the annual general meeting of the company along with the laying of its financial statement under sub-section (2)....."*
....."Provided further that the Central Government may provide for the consolidation of accounts of companies in such manner as may be prescribed."....
Explanation: For the purposes of this sub-section, the word "subsidiary" shall include associate company and joint venture."

[4] Refer Table 2

[5] Refer Table 2

[6] *Companies (Accounts) Rules, 2014 - "6. Manner of consolidation of accounts.- The consolidation of financial statements of the company shall be made in accordance with the provisions of Schedule III of the Act and the applicable accounting standards:*
Provided that in case of a company covered under sub-section (3) of section 129 which is not required to prepare consolidated financial statements under the Accounting Standards, it shall be sufficient if the company complies with provisions on consolidated financial statements provided in Schedule III of the Act."

- AS-21 (Consolidated Financial Statements) deals with consolidation of subsidiary companies;
- AS–23 (Accounting for Investments in Associates in Consolidated Financial Statements) deals with associates; and
- AS – 27 (Financial Reporting of Interests in Joint Ventures) deals with interests in Joint Ventures.

Methods and procedures of consolidation are different according to different situations. Line by line consolidation, equity method or proportionate consolidation; which of these methods should be applied is determined by the accounting standards.

Clause 6 of The Company (Accounts) Rules 2014 appears to be dependent on the accounting standards to decide the case in which consolidation will become applicable. Whereas, the Section 129 (3) itself dictates that where consolidation will be done. Accounting standards on the other hand, lay down principles and procedures for preparation and presentation of consolidated financial statements (refer objective clause of AS-21[7]). This contradiction attracts difference of opinion.

While comparing with the Act, the accounting standard has a different approach. AS-21 mentions that consolidation will be done where a company has more than half of the voting power or controls the board of directors. This position is different from the Act, which takes into consideration more than half of the total shareholding. Now, one will need to make a professional judgement on whether consolidation will be applicable or not.

Let us understand this situation with the help of an example, assuming no other complication (power in board of directors) or exceptions:

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In this example, when one looks at Section 129(3), read with Section 2(87) of the Act, company Y will become the holding company and will need to consolidate financials of ABC. From the perspective of AS-21, company X will become the holding company by virtue of holding more than half of the voting rights.

One must be extremely careful before taking a view about applicability of consolidation clauses in the absence of a clear understanding, especially when transactions are large and their impact is significant.

The situation becomes more complex from current year as some of the companies will need to apply Ind-AS 110, which has a different approach altogether. This new standard is more substance based and defines control from perspective of power and returns from operations besides ownership of risk (read Clause 6 of Ind-AS 110)[8].

Ind-AS 24 also defines "control" differently and focuses on power to govern financial and operating policies from a point view of disclosures of related party contracts. These definitions are directly

TABLE 1

Position of shareholding of Company ABC			
		Company X Holds	Company Y Holds
Equity share capital (With voting rights)	100,000 shares of ₹10 each issued at par	99,000 shares	1,000 shares
Preference share capital	100,000 shares of ₹10 each issued at par	Nil	100,000 shares
Total share capital	200,000 shares	99,000 shares	101,000 shares
% of Total share capital	100%	49.5% (99,000/200,000)	50.5% (101,000/200,000)
% of voting rights (with only equity)		99% (99,000/100,000)	1% (1,000/100,000)

[7] *AS-21 "The objective of this Standard is to lay down principles and procedures for preparation and presentation of consolidated financial statements. Consolidated financial statements are presented by a parent (also known as holding enterprise) to provide financial information about the economic activities of its group. These statements are intended to present financial information about a parent and its subsidiary (ies) as a single economic entity to show the economic resources controlled by the group, the obligations of the group and results the group achieves with its resources"*

[8] Refer Table 2

replicating what was mentioned in International Accounting Standard (IAS) 27 before IFRS 10 came into picture. Ind-AS 110 carries the new definition of IFRS 10.

In the example of company ABC in Table 1 above, in case Ind-AS is applicable, one will need to examine the situation from a different perspective and consider other conditions or components which may affect the decision whether X or Y has control over ABC and whether consolidation is required.

At this juncture, let me draw your attention to the fact that terms like "control", "subsidiary" and "associates", *etc.* have been defined differently in the Act and various accounting standards. Table below gives you an indicative example of how some of the terms have been defined differently at various places:

TABLE 2

Definitions Contradictions – The Companies Act versus Accounting Standards			
Companies Act	Section 2(87)	Subsidiary	*"subsidiary company" or "subsidiary", in relation to any other company (that is to say the holding company), means a company in which the holding company - (i) controls the composition of the Board of Directors; or (ii) exercises or controls more than one-half of the* ***total share capital*** *either at its own or together with one or more of its subsidiary companies.*
	Section 2(6)	Associate	*"Associate company", in relation to another company, means a company in which that other company has a significant influence, but which is not a subsidiary company of the company having such influence and includes a joint venture company.*
	Section 2 (26)	Significant Influence	*Explanation.—For the purposes of this clause, "significant influence" means control of at least twenty per cent of total share capital, or of business decisions under an agreement.*
	Section 2 (27)	Control	*"Control" shall include the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner;*
AS - 21	Consolidated Financial Statements	Control	*"5.1 Control: (a) the ownership, directly or indirectly through subsidiary/ subsidiaries, of more than one* ***half of the voting power*** *of an enterprise; or (b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from its activities.*
		Subsidiary	*5.2 A subsidiary is an enterprise that is controlled by another enterprise (known as the parent)."*
AS-23	Accounting for Investments in Associates in Consolidated Financial Statements	Control	*3.3 Control: (a) The ownership, directly or indirectly through subsidiary/ subsidiaries, of more than one* ***half of the voting power*** *of an enterprise; or (b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from its activities.*

AS-23	Accounting for Investments in Associates in Consolidated Financial Statements	Subsidiary	*3.4 A subsidiary is an enterprise that is controlled by another enterprise (known as the parent).*
		Associate	*3.1 An associate is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor.*
		Significant Influence	*3.2 Significant influence is the power to participate in the financial and/ or operating policy decisions of the investee but not control over those policies.*
AS – 18	Related Party Disclosures	Control	*10.3 Control – (a) ownership, directly or indirectly, of more than one half of the voting power of an enterprise, or (b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise, or (c) a substantial interest in voting power and the power to direct, by statute or agreement, the financial and/or operating policies of the enterprise.*
		Significant Influence	*10.4 Significant influence -participation in the financial and/or operating policy decisions of an enterprise, but not control of those policies.*
		Subsidiary	*10.11 Subsidiary - a company: (a) in which another company (the holding company) holds, either by itself and/or through one or more subsidiaries, more than one-half in nominal value of its equity share capital; or (b) of which another company (the holding company) controls, either by itself and/or through one or more subsidiaries, the composition of its board of directors.*
Ind-AS 110	Consolidated Financial Statements	Control	*6. 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.*
		Subsidiary	*An entity that is controlled by another entity*
Ind-AS 27	Consolidated and Separate Financial Statements	Control	*Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. A group is a parent and all its subsidiaries.*
		Subsidiary	*A subsidiary is an entity, including an unincorporated entity such as a partnership that is controlled by another entity (known as the parent).*
Ind-AS 24	Related Party Disclosures	Control	*Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.*

Conclusion

As we can see, on the one hand, the definition in Ind-AS is substance-based and defines "control" based on risk and returns, whereas on the other, the Act has a rule-based approach basing it on more than half of the shareholding or control in the board. One may take the view that Schedule III of the Act itself mentions that requirement of accounting standard will prevail. And, thus, each shareholding in such cases will be tested according to the conditions mentioned in Ind-AS.

The matter of where to consolidate will certainly be under debate and discussions and careful consideration will be required in all aspects and dimensions. It will not be out of place here to emphasise the need for strong documentation both at the corporate level and at the auditor's end. Impact on income tax (read minimum alternate tax and deferred tax) also has to be kept in mind. The auditors may have a different view from that of the management. In such cases, they will need to include relevant comments in their audit report based on materiality and auditing standards. ■