IAS 27 Consolidated and Separate Financial Statements - A Closer Look

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International Accounting Standard (IAS) 27, *Consolidated and Separate Financial Statements,* provides guidance on the preparation and presentation of consolidated financial statements for a group of entities under the control of a parent. The standard also provides guidance on the presentation of investments in subsidiaries, jointly controlled entities and associates in separate financial statements. In September 1987, the International Accounting Standards Committee (IASC) issued the Exposure Draft E30, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*. In April 1989, the IASC issued IAS 27, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries,* effective from January 1, 1990. In 1994, the IASC reformatted IAS 27. In December 1998, IAS 27 was amended by IAS 39, *Financial Instruments: Recognition and Measurement,* effective from January 1, 2001. In April 2001, the International Accounting Standards Board (IASB) resolved that all Standards and Interpretation issued under previous Constitutions continued to be applicable unless and until they were amended or withdrawn. On December 18, 2003, the IASB issued the revised version of IAS 27, effective from January 1, 2005. On June 25, 2005, the IASB issued the Exposure Draft of *Proposed Amendments to IFRS 3 and IAS 27*. On January 10, 2008, the IASB issued the revised IAS 27 (2008), effective from July 1, 2009. The January 2008 revisions to IAS 27 are closely related to the revisions to IFRS 3, *Business Combinations*. On May 22, 2008, IAS 27 was amended for *Cost of a Subsidiary in the Separate Financial Statements of a Parent on First-time Adoption of IFRSs.* On the same day, IAS 27 was also amended for *Annual Improvements to IFRSs 2007* relating to measurement of investments held for sale under IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations,* in separate financial statements. The effective date of these two May 2008 amendments was fixed as January 1, 2009.

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Objective

The objective of IAS 27 is to enhance the relevance, reliability, and comparability of the information contained in:

• consolidated financial statements that a parent prepares for the group of entities it controls; and

• separate (non-consolidated) financial statements that a parent, investor, or venturer elects to provide, or is required by local regulation to provide.

IAS 27 specifies the circumstances in which consolidated financial statements are required, as well as providing guidance on the required accounting for changes in ownership levels, including changes that result in the loss of control of a subsidiary. IAS 27 also includes requirements for disclosure of information to allow financial-statement users to evaluate the nature of the relationship between the parent entity and its subsidiaries.

IAS 27 requires parent undertakings to provide financial information about the economic activities of their group in consolidated financial statements. These consolidated financial statements should present the financial information of the group as a single economic entity. IAS 27 defines subsidiaries and prescribes the circumstances in which a parent is required to prepare consolidated financial statements. It also prescribes the rules for the preparation of consolidated financial statements and the separate financial statements of a parent, and prescribes disclosure requirements in respect of investments in subsidiaries.

Scope and Application

IAS 27 shall be applied in the preparation and presentation of consolidated financial statements for a group of entities under the control of a parent. In addition, when an entity presents separate financial statements (by choice or to comply with local regulations), the standard must be applied in accounting for the investments in subsidiaries, jointly controlled entities, and associates.

IAS 27 does not deal with the methods for accounting for business combinations and their effects on consolidation, including the treatment of goodwill arising from the business combination (see IFRS 3, *Business Combinations*).

Key Definitions

Paragraph 4 of IAS 27 provides definitions for the following key terms (among others):

Consolidated financial statements are the financial statements of a group presented as those of a single economic entity.

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.
Minority interest is that portion of the profit or loss and net assets of a subsidiary attributable to equity interests that are not owned, directly or indirectly through subsidiaries, by the parent.
Non-controlling interest is the equity in a subsidiary not attributable, directly or indirectly, to a parent.
A **parent** is an entity that has one or more subsidiaries.
Separate financial statements are those presented by a parent, an investor in an associate or a venturer in a jointly controlled entity, in which the investments are accounted for on the basis of the direct equity interest rather than on the basis of the reported results and net assets of the investees.
A **subsidiary** is an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent). Note: a subsidiary may have dissimilar business activities from those of the other entities within the group.

Presentation and scope of consolidated financial statements

IAS 27 requires the preparation and presentation of consolidated financial statements that include all subsidiaries under the control of a parent. Control is the principal concept which underpins this standard. There are exceptions to the rule if subsidiaries that, on acquisition, meet the criteria to be classified as held for sale in accordance with IFRS 5.
These subsidiaries shall be accounted for in accordance with IFRS 5. In addition, a parent need not present consolidated financial statements if and only if:
• the parent is itself 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 parent not presenting consolidated financial statements
• the parent'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 parent did not file nor in the process of filing, its financial reports with a securities commission or other regulatory organization, for the purpose of issuing any class of instruments in a public market
• the ultimate parent (or any intermediate parent) of the parent produces consolidated financial statements available for public use that comply with IFRSs

If a parent meets these criteria, consolidated financial information is being provided at a higher level by either the ultimate parent or an intermediate parent; consequently, it is not needed at the entity's level and the reporting entity can elect not to present consolidated financial statements. The entity would then present only separate financial statements in accordance with the guidance for separate statements.

Consolidation involves:
• line-by-line adding together like items of assets, liabilities, equity, income and expenses of the financial statements of the parent and its subsidiaries

• elimination of the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary
• elimination in full of intragroup balances and transactions (e.g. profits and losses resulting from sale of inventory within the group), and including income, expenses and dividends; note intragroup losses may indicate an impairment that requires recognition in the consolidated financial statements
Note: IAS 12, *Income taxes* applies to temporary differences that arise from the elimination of profits and losses resulting from intragroup transactions.
• identification of minority interests in the profit or loss and net assets of consolidated subsidiaries for the reporting period
• if a subsidiary has outstanding cumulative preference shares that are held by minority interests and classified as equity, the parent computes its share of profits or losses after adjusting for the dividends on such shares, whether or not dividends have been declared
• losses applicable to the minority in a consolidated subsidiary may exceed the minority interest in the subsidiary's equity, the excess is allocated against the majority interest except to the extent that the minority has a binding obligation and is able to make an additional investment to cover the losses
• on ceasing to be a subsidiary, an investment in an entity shall be accounted for in accordance with IAS 39, *Financial instruments: recognition and measurement* using its carrying value at that date as the cost on initial measurement, unless it becomes an associate or jointly controlled entity which have dedicated applicable accounting standards that apply.

Dissimilar Reporting Dates and Accounting Policies

IAS 27 requires the financial statements of the parent and its subsidiaries to have the same reporting date. If the reporting dates of the parent and subsidiaries differ, the subsidiary must prepare additional financial statements for consolidation purposes with the same reporting date as the parent. If it is impracticable to prepare additional financial statements, the subsidiary's financial statements used for consolidation purposes with a different reporting date is acceptable provided:
• its financial statements are adjusted for the effects of significant transactions or events that occur between the subsidiary's reporting date and that of its parent
• the difference between the reporting dates is no more than three months
Consolidated financial statements must be prepared using uniform accounting policies for like transactions and other events in similar circumstances. If a member of the group uses dissimilar accounting policies, appropriate adjustments shall be made to the financial statements before consolidation.

Separate Financial Statements of a Parent

When a parent prepares separate financial statements, investments in subsidiaries, jointly controlled entities and associates that are not classified as held for sale in accordance with IFRS 5 are to be accounted for either at cost or in accordance with IAS 39. The accounting treatment must be consistently applied to each category of investments. Investments classified as held for sale in accordance with IFRS 5 are accounted for in accordance with that Standard. Investments in jointly controlled entities and associates that are accounted for in accordance with IAS 39 in the consolidated financial statements shall be accounted for in the same way in the parent entity's separate financial statements.

Identification of Subsidiaries

Consolidated financial statements are required to include all of the parent's subsidiaries.
Subsidiaries are identified based on control by the parent. Control over an entity is presumed to exist when the parent entity has direct or indirect ownership of more than half of the voting power of an entity unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control.
Control also exists when the parent owns half or less of the voting power of an entity when there is:
• power over more than half of the voting rights by virtue of an agreement with other investors
• power to govern the financial and operating policies of the entity under a statute or an agreement
• power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body
• power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body
Factors to be considered when determining the existence of control include:
• substance rather than form
• the effect of potential voting rights that are currently exercisable or convertible
Note: This excludes potential voting rights which lack economic substance e.g. the exercise price which is set in a manner that makes the conversion commercially unrealistic.
• the role of dominance can be passive and not necessarily actively exercised
majority ownership interest in an entity is not necessary for control to exist (e.g. in the absence of another entity dominating the composition of the board of directors, voting rights of less than 50 per cent held by the reporting entity may constitute control)
• the power to govern may be direct or indirect
• whether the parent derives benefit from the actions of the subsidiary
• a loss of control may occur without selling an ownership interest in the subsidiary

Prescribed Disclosures

IAS 27 requires disclosure of information regarding the nature of the relationship between the parent entity and its subsidiaries. Disclosure requirements are divided into three categories:

Disclosures required in consolidated financial statements

• the nature of the relationship between the parent and a subsidiary when the parent does not directly or indirectly own more than half of the voting power (for example, explaining how control has been determined)
• justification in cases where an entity directly or indirectly through subsidiaries owns more than half of the voting or potential voting power of an investee but this ownership does not constitute control

• the reporting date and period of the financial statements of a subsidiary when they are using a reporting date or period that is different from that of the parent, along with the reason for the use of different dates (for example, justifying why it was impracticable to prepare all statements as of the same date)
• the nature and extent of any significant restrictions (e.g. resulting from borrowing arrangements or regulatory requirements) on a subsidiary's ability to transfer funds to the parent in the form of cash dividends or to repay loans or advances
• a schedule showing the effects on the equity attributable to owners of the parent of any ownership changes that do not result in a loss of control
• if control of a subsidiary is lost, specific details on the gain or loss

Disclosures required in separate financial statements that are prepared for a parent that is permitted not to prepare consolidated financial statements

When separate financial statements are prepared for a parent that meets the criteria in paragraph 10 of IAS 27 and elects not to prepare consolidated financial statements, those separate financial statements must disclose
• the fact that the exemption from consolidation has been used and the financial statements are separate rather than consolidated
• the name and country of incorporation or residence of the entity (that is, the ultimate or intermediate parent) whose IFRS-compliant consolidated financial statements have been produced for public use, and the address where those consolidated financial statements are obtainable
• 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
• a description of the method used to account for the investments disclosed

Disclosures required in the separate financial statements of a parent, investor in a jointly controlled entity, or investor in an associate

When a parent (other than a parent that is permitted not to prepare consolidated financial statements), a venturer with an interest in a jointly controlled entity, or an investor in an associate prepares separate financial statements, those separate financial statements must disclose
• the fact that the statements are separate rather than consolidated, and the reasons why those statements are prepared (if the reason is other than legal requirements)
• 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
• a description of the method used to account for the investments disclosed

Because the separate financial statements do not meet the entity's reporting requirements (the disclosure requirements in paragraph 43 relate to entities that are **not** exempt from filing consolidated statements), the entity must also identify the consolidated financial statements that have been prepared to meet IAS 27 (or IAS 28 *Investments in Associates* or IAS 31 *Interests in Joint Ventures*, as the case may be).

Interpretations

The Standards Interpretations Committee (SIC) of the IASC and the International Financial Reporting Interpretations Committee (IFRIC) of the IASB has issued the following three Interpretations relating to IAS 27:

• SIC 12, *Consolidation – Special Purpose Entities* (issued in November 1998, effective from July 1, 1999 and amended by IFRIC in November 2004 to remove the equity compensation plans from the scope of SIC 12)

• SIC 33, *Consolidation and Equity Method – Potential Voting Rights and Allocation of Ownership Interest* (SIC 33 was superseded by 2003 revision of IAS 27)

• IFRIC 17, *Distributions of Non-cash Assets to Owners* (issued in November 27, 2008, effective from July 1, 2009)

SIC 12: This interpretation addresses when a special purpose entity should be consolidated by a reporting enterprise under the consolidation principles in IAS 27. Under SIC 12, an entity must consolidate a special purpose entity (SPE) when, in substance, the entity controls the SPE. The control of an SPE by an entity may be indicated if:

- The SPE conducts its activities to meet the entity's specific needs
- The entity has decision-making powers to obtain the majority of the benefits of the SPE's activities
- The entity is able to obtain the majority of the benefits of the SPE's activities through an 'auto-pilot' mechanism
- By having a right to the majority of the SPE's benefits, the entity is exposed to the SPE's business risks
- The entity has the majority of residual interest in the SPE

Examples of SPEs include entities set up to effect a lease, a securitisation of financial assets, or R&D activities. The concept of control used in IAS 27 requires having the ability to direct or dominate decision making accompanied by the objective of obtaining benefits from the SPE's activities.

Some enterprises may also need to separately evaluate the topic of derecognition of assets, for example, related to assets transferred to an SPE. In some circumstances, such a transfer of assets may result in those assets being derecognised and accounted for as a sale. Even if the transfer qualifies as a sale, the provisions of IAS 27 and SIC 12 may mean that the enterprise should consolidate the SPE. SIC 12 does not address the circumstances in which sale treatment should apply for the reporting enterprise or the elimination of the consequences of such a sale upon consolidation.

IFRIC 17: This interpretation applies to the entity making the distribution, not to the recipient. It applies when non-cash assets are distributed to owners or when the owner is given a choice of taking cash in lieu of the non-cash assets. IFRIC 17 clarifies that:

- a dividend payable should be recognised when the dividend is appropriately authorised and is no longer at the discretion of the entity
- an entity should measure the dividend payable at the fair value of the net assets to be distributed
- an entity should remeasure the liability at each reporting date and at settlement, with changes recognised directly in equity
- an entity should recognise the difference between the dividend paid and the carrying amount of the net assets distributed in profit or loss, and should disclose it separately
- an entity should provide additional disclosures if the net assets being held for distribution to owners meet the definition of a discontinued operation

IFRIC 17 applies to pro rata distributions of non-cash assets (all owners are treated equally) but does not apply to common control transactions.

Comparative Indian Standard

The Accounting Standard issued by the Institute of Chartered Accountants of India (ICAI) comparative to IAS 27 is AS 21, *Consolidated Financial Statements.* AS 21 is based on IAS 27 (revised 2000). AS 21 is presently under revision to converge with IAS 27. The major differences between these two standards are:
1. Difference due to legal and regulatory environment: Keeping in view the requirements of the law governing the companies, AS 21 defines control as ownership of more than one-half of the voting power of an enterprise or as control over the composition of the governing body of an enterprise so as to obtain economic benefits. This definition is different from IAS 27, which defines control as "the power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities".
2. Conceptual Differences: Goodwill/Capital reserve is calculated by computing the difference between the cost to the parent of its investment in the subsidiary and the parent's portion of equity in the subsidiary in AS 21 whereas in IAS 27 fair value approach is followed.

January 2008 Revised Standard

On January 10, 2008, the IASB revised the IFRS 3 and IAS 27. The revisions will result in a high degree of convergence between IFRSs and US Generally Accepted Accounting Principles (GAAP), although some inconsistencies remain, which may result in significantly different financial reporting. The revised Standards promise significant change, including:
• a greater emphasis on the use of fair value, potentially increasing the judgement and subjectivity around business combination accounting, and requiring greater input by valuation experts;

- focussing on changes in control as a significant economic event – introducing requirements to remeasure interests to fair value at the time when control is achieved or lost, and recognising directly in equity the impact of all transactions between controlling and non-controlling shareholders not involving a loss of control; and
- focussing on what is given to the vendor as consideration, rather than what is spent to achieve the acquisition. Transaction costs, changes in the value of contingent consideration, settlement of pre-existing contracts, share-based payments and similar items will generally be accounted for separately from business combinations and will generally affect profit or loss.

Conclusion

The revised IAS 27 resolves many of the more contentious aspects of business combination accounting by restricting options or allowable methods. As such, they should result in greater consistency in accounting among entities applying IFRSs.

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