UNIT 4:
CONSOLIDATED FINANCIAL STATEMENTS

4.1 OBJECTIVE

The objective of Ind AS 110 ‘Consolidated Financial Statements’ is to establish principles for the presentation and preparation of consolidated financial statements when an entity (the parent) controls one or more other entities (subsidiaries).

4.2 SCOPE

A parent who controls one or more entities is required to present consolidated financial statements.

However, a parent is not required to present consolidated financial statements if it meets all of the following four conditions.

- **Condition 1:** The parent is either a wholly owned subsidiary or a partially owned subsidiary of another entity. Further its other owners (including those not entitled to vote) have been informed and do not object, to the parent not presenting the consolidated financial statements.

- **Condition 2:** The equity instruments or the debt instruments of the parent are not traded in a public market. The public market could be a domestic or foreign stock exchange or an over the counter market including local and regional markets.

- **Condition 3:** The parent has neither filed nor is 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.

- **Condition 4:** The ultimate or any intermediate parent, of the parent (that is required to present consolidated financial statements), produces financial statements that are available for public use and comply with Ind AS, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with Ind AS 110.
Further, a parent who fulfils the following two conditions is also not required to present consolidated financial statements:

- **Condition 1:** The parent is an investment entity
- **Condition 2:** The parent is required to measure all its subsidiaries at fair value through statement of profit or loss.

Also, Ind AS 110 does not apply to post–employment benefit plans or other long-term employee benefit plans to which Ind AS 19 ‘Employee Benefits’, applies.

### Example: Exemption from preparing consolidated financial statements.

Entity X owns the following other entities:

1. 100% interest in entity Y. Entity Y owns 60% interest in entity Z.
2. 80% interest in entity M. Entity M owns 60% interest in entity N.

The structure is illustrated as follows:

```
  X
 /\  
/  \ 
Y   M
|   /|
|  60% |  
| /  \ |
| Z   N |
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Entity X is a listed company and prepares IND AS compliant consolidated financial statements. Entities Y & M do not have their securities publically traded & they are not in the process of issuing securities in public markets. Entity X does not require its subsidiary M to prepare consolidated financial statements. Entity Y is a wholly-owned subsidiary of entity X. Entity Y is not required to prepare consolidated financial statements.

Entity M is not required to prepare consolidated financial statements provided, the non-controlling interest holders have been informed about, and do not object to Entity M presenting consolidated financial statements.

### Example: Where local regulations govern the participation of consolidated financial statements.

At times local regulations dictate when, and for what periods, an entity must present consolidated or separate financial statements. Local regulations might allow or require an intermediate parent to produce separate financial statements prepared in accordance with Ind AS, instead of consolidated financial statements.

Where local regulations permit an entity not to prepare consolidated financial statements, the entity should still consider the exemptions as per Ind AS 110 and determine whether it is exempt from preparing consolidated financial statements.
4.3 CONCEPT OF CONTROL

a. As per Ind AS 110, consolidation of an investee shall begin from the date the investor (parent) obtains control of the investee (subsidiary);

   Analysis

   Thus:

   (i) Parent (Investor) is an entity that controls one or more entities;
   (ii) Subsidiary (Investee) is an entity that is controlled by another entity;

b. An investor controls an investee if and only if the investor has all the following 3 elements:

   (i) Power over the investee;
   (ii) Exposure, or rights, to variable returns from its involvement with the investee; and
   (iii) The ability to use its power over the investee to affect the amount of the investor’s returns.

   An investor shall consider all facts and circumstances to assess whether it controls an investee. It should re-assess the control when facts and circumstances suggest that there is a change in any of the aforesaid 3 elements.

   There could be situations where no single investor controls an investee. In these types of situation, the interest and relationship of the investor with the investee would be determined in accordance with:

   - Ind AS 111, Joint Arrangements;
   - Ind AS 28, Investments in Associates and Joint Ventures; or
   - Ind AS 109, Financial Instrument.

c. The definition of control is in 3 limbs or elements, all of which should co-exist:

   (i) Power over the investee;
   (ii) Exposure to variable returns;
   (iii) Ability to use power to impact returns.

d. Power over the investee

   (i) An investor has power over an investee when the investor:

      ➢ has existing rights
      ➢ that give it the current ability
      ➢ to direct relevant activities (activities that significantly affect the investee’s returns).

   (ii) In simple situations, control can be demonstrated through voting rights. If an entity controls over 50% of voting rights, entity controls the investee;
(iii) However, in complex situations, voting rights may not be the sole indicator. As required by Ind AS, the principle of substance over form shall prevail.

e. Exposure to variable returns:

(i) An investor is exposed, or has rights, to variable returns from its involvement with the investee when the investor’s returns from its involvement can vary because of investee’s performance. The returns can be only positive, only negative or both positive and negative.

(ii) Even though only one investor can control the investee, more than one party can share the returns of an investee, such as holders of non–controlling interests.

f. Link between power and returns:

(i) An investor should, in addition to power and exposure to variable returns, have the ability to use the power to affect its return from the investee for determining control.

(ii) There could be a situation when a person (agent) may have the decision making rights in an investee and its remuneration is also based on the performance of the investee but it may be acting on behalf of another person (principal). In this situation, the agent does not control an investee.

g. The following seven steps should be adopted to assess control. Steps 1 to 5 assist in establishing whether an investor has power over the investee. Step 6 discusses the exposure to variable returns whereas step 7 deliberates on link between power & returns.

**Step 1:** What is the purpose of the investee?

**Step 2:** What is the design of the investee?

**Step 3:** What are the relevant activities of the investee that significantly affect its returns?
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**Step 4:** How decisions about the relevant activities are made?

**Step 5:** Whether the decision maker is empowered and has the right to take those decisions?

**Step 6:** The investor should examine whether it is exposed to or have variable returns from its involvement with the investee.

Variable returns are returns that are not fixed and have the potential to vary as a result of the performance of an investee. Variable returns can be only positive, only negative or both positive and negative.

**Step 7:** Link between power & variable returns.

This step needs examination whether the investor can use its power to impact the variable returns. If so, this condition is also satisfied.

We will now discuss each of these steps in detail.

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**4.4 ASSESSMENT OF CONTROL**

**4.4.1 Step 1: Purpose of the investee**

It should be determined that why the investee has been formed or incorporated? What is the purpose and objective of the investee? Whether it has been incorporated to implement a vertical or a horizontal expansion program of the investee? Whether the purpose is to enter into a new line of business? Whether it has been formed to comply with a particular regulatory requirement? What is the purpose to enter into collaboration with other entities or persons?

An investor may form a trust to carry out its CSR activities or to implement its ESOP plans or to provide post-employment benefits to its employees. An investee may be incorporated to undertake concession agreements as Public Private Partnership (PPP) model of the government.

**4.4.2 Step 2: Design of the investee**

One has to look at the structure.

- Is it a firm, trust, listed company, public company, private company, society, SPV etc.?
- Is it controlled through voting rights, shareholders’ agreements, convertible instruments, contractual arrangements, exposure to risks & rewards?
- Who takes the decision for the design?

**4.4.3 Step 3: Relevant activities of the investee that significantly affect its returns**

Relevant activities are the range of operating and financing activities that significantly affect the investee’s returns such as (the list is not exhaustive):
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- Selling and purchasing of goods & services;
- Managing financial assets during their life;
- Selecting, acquiring or disposing of assets;
- Researching and developing new products or processes;
- Determining a funding structure or obtaining funding;
- Appointment, remuneration and termination of key managerial person.

Not all activities would be relevant at a particular point of time. It depends on the facts and circumstances of the situation. Judgment has to be applied to determine which of the activities are relevant activities at that point of time that significantly affect the investee’s return.

**Illustration 1: Identification of relevant activities**

*Entity PS Ltd. issues loan notes to investors in Rupees, but it purchases financial assets in Pound Sterling and USD. It hedges cash flow differences through currency and interest rate swaps. What would be its relevant activities?*

**Solution**

Its relevant activities are as under:

- Selling and purchasing of assets
- Managing financial assets during their life
- Determining a funding structure and obtaining funding for its activities
- Hedging the currency and interest rate risks arising from its activities.

These activities are likely to most significantly affect entity PS’s returns

**4.4.4 Step 4: Examining the decision making process for the relevant activities**

After having identified the relevant activities that significantly impact the investee’s return, the next step is to determine how decision about the particular relevant activity is taken and what is the process of making the decision. Thus in step 4, it is identified, ‘Who is the decision maker’.

In some situations, activities both before and after a particular set of circumstances arises or event occurs may be relevant activities. When two or more investors have the current ability to direct relevant activities and those activities occur at different times, the investors shall determine which investor is able to direct the activities that most significantly affect those returns consistently with the treatment of concurrent decision making rights. The investors shall reconsider this assessment over time if relevant facts or circumstances change.

**Example: The relevant activity that may have significant impact on the returns of an investee**

AB Ltd., which is a scientific research organization is going to appointment the Chief Research Officer.
The key determinant will be who is authorized to appoint the Chief Research Officer. Assuming it is the management committee.

Then one should look, who controls the management committee. AB Limited has two shareholders, A Limited (who holds 60% and controls the Board of Directors) and B Limited (who holds 40% but through a shareholder agreement controls the management committee).

In this case, it may be concluded that B Limited controls AB Limited.

**Illustration 2**

*B Ltd. and C Ltd. had incorporated BC Ltd. to construct & operate a toll bridge. Construction of toll bridge will take 3 years. B Ltd. is responsible for construction. The toll bridge will be operated by C Ltd. Can it be concluded during the construction phase that when B Ltd. has all the authority to take decision that B Ltd. controls BC Ltd.?*

**Solution**

It may appear from the question that B Ltd. has the current ability to direct relevant activities, but this may not be correct. When two or more investors have the current ability to direct relevant activities and those activities occur at different times, the investors shall determine which investor is able to direct the activities that most significantly affect those returns consistently with the treatment of concurrent decision making rights. The investors shall reconsider this assessment over time if relevant facts or circumstances change.

**Illustration 3**

*In continuation to the facts given in Illustration 2, further if it is given that the toll bridge will be constructed under supervision of NHAI by B Ltd. NHAI will reimburse the cost of construction. B Ltd. is entitled to a margin on the construction but from the cash flows of the toll collection before any payment to C Ltd. The toll revenue will be fixed by C Ltd. who is entitled to management fee. From the toll revenue amount the toll expenses will be paid, then margin will be paid to B Ltd. and then management fee will be paid to C Ltd. The balance will be shared equally by B Ltd. and C Ltd.*

**Solution**

In this case C Ltd. has power since C Ltd. is able to direct the activities that most significantly affect the returns. Cost of construction of bridge that is the responsibility of B Ltd. is reimbursed by NHAI therefore it does not significantly affect the returns. Whereas the significant return to the investor is through toll collection activities being the responsibility of C Ltd.

**4.4.5 Step 5 : Whether the decision maker is empowered and has the right to take those decisions?**

1. In step 4, it was identified, ‘Who takes the decisions about the relevant activities? It could be the shareholders. It could be the Board of Directors. It could be a contractually appointed person. But the question arises here is that whether the decision maker is empowered?
In simple situations, the answer may be evident but there are complex situations. Whether the person taking the decision is a principal or in fact an agent of the investor; this needs to be examined or the decision making was inherent in the purpose & design of the investee.

The test is - who has the power?

2. Power arises from rights. Here the rights of the investor have to be examined. The investor should have the current ability to direct the relevant activities.

3. The rights of the investor could be substantive rights or protective rights. It is a matter of judgment which shall take into consideration all the facts and circumstances. Only substantive rights are to be considered.

   1. **Substantive rights**

      Ownership of more than fifty percent of the voting rights, generally gives an investor the power. But this could be subject to regulatory restrictions, rights held by the other parties. Thus the voting rights may not be substantive.

      To be substantive, rights also need to be exercisable when decisions about the direction of the relevant activities need to be made. Usually, to be substantive, the rights need to be currently exercisable. However, sometimes rights can be substantive, even though the rights are not currently exercisable.

**Facts**

At the AGM of the investee, decision to direct relevant activities are made. The next shareholders meeting is scheduled in 8 months. However, shareholders individually or collectively holding 5% or more of the voting right can call special meeting to change existing policies or relevant activities, but there is a requirement to give notice to other shareholders atleast 30 days before the meeting. Policies over the relevant activities can be changed only at special or scheduled shareholders' meetings.

Based on the above facts, following three illustrations have been described. Each illustration shall be considered in isolation.

**Illustration 4**

*An investor holds a majority of the voting rights in the investee. Does the investor have current ability to direct the relevant activities given the fact that it takes 30 days to hold shareholder’s meeting to take decisions regarding relevant activities?*

**Solution**

The investor’s voting rights are substantive because the investor is able to make decisions about the direction of the relevant activities when they need to be made. The fact that it takes 30 days before the investor can exercise its voting rights does not stop the investor from having the current ability to direct the relevant activities from the moment the investor acquires the shareholding.

**Illustration 5**

*An investor is party to a forward contract to acquire the majority of shares in the investee.*
The forward contract’s settlement date is in 25 days. Is the investor’s forward contract a substantive right even before settlement of contract?

Solution

The investor becomes majority shareholder in the investee after the settlement of forward contract in 25 days. As per the facts given in the ‘Facts’ above, the existing shareholders are unable to change the existing policies over the relevant activities because a special meeting cannot be held for at least 30 days, at which point the forward contract would have been settled. Thus, the investor has rights that are essentially equivalent to the majority shareholder in Illustration 4 above (i.e. the investor holding the forward contract can make decisions about the direction of the relevant activities when they need to be made). Therefore, the investor’s forward contract is a substantive right that gives the investor the current ability to direct the relevant activities even before the forward contract is settled.

Illustration 6

If in the illustration given above, the investor’s forward contract shall be settled in 6 months instead of 25 days, would existing shareholders have the current ability to direct the relevant activities?

Solution

Since the date of settlement of forward contract is in 6 months, the existing shareholders can hold a meeting within 30 days and direct relevant activities at which point the forward contract would not be settled. Therefore, the existing shareholders have substantive rights currently.

Factors that determine whether rights are substantive or not could be classified into three categories:

- Barriers preventing exercise
  The decision maker has the rights but barriers exists that prevent the right holder to exercise their rights. These could be economic barriers or other than economic barriers. Thus the rights may not in substance be substantive.

Examples of barriers include:

- Heavy financial penalties and incentives
- High exercise price or conversion price
- Restrictive terms and conditions
- Inability to obtain reasonable information for exercising the rights
- Operational barriers or incenting
- Prohibitory legal or regulatory environment
• **Exercise requires agreement of other parties**
  The exercise of right may require agreement of other parties. The agreement could be achieved only through a mechanism where all such parties may agree. Absence of such a mechanism may indicate that the rights are not substantive. Also, existence of a large number of parties whose agreement is required may be an indication that the rights may not be substantive.

• **Benefit accrues to the right holder**
  It has to be identified whether the holder of right is going to be benefitted by exercising the right.

**Example:**
Suppose A Limited holds in a listed entity C Limited, optionally convertible debentures which are currently exercisable. C Limited is in loss and it is not likely to be in profit for some time in future. The conversion price is much higher than the listed price. The holder would prefer redemption rather than conversion as debentures are out of money. The rights may not be substantive.

2. **Protective rights**
Protective rights are designed to protect the interests of their holders without giving that party power over the investee to which those rights relate. An investor that holds only protective rights cannot have power or prevent another party from having power over an investee. Protective rights relate to fundamental changes to the activities of an investee or apply in exceptional circumstances.

**Examples of protective rights include:**
- A 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 party holding a non-controlling interest in an investee to approve capital expenditure greater than that required in the ordinary course of business, or to approve the issue of equity or debt instruments.
- The right of a lender to seize the assets of a borrower if the borrower fails to meet specified loan repayment conditions.

4. The decision maker is thus empowered when he has the substantive rights that gives it current ability to direct the relevant activities. Various indicators of substantive rights, individually or in combination with each other may provide that ability to the investors. These indicators may be clubbed in the following pecking order:

 ➢ **Primary indicators**

**Examples of primary indicators**
- rights in the form of voting rights (or potential voting rights) of an investee;
- rights to appoint, reassign or remove members of an investee’s key management personnel who have the ability to direct the relevant activities;
- 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; and
- other rights (such as decision-making rights specified in a management contract) that give the holder the ability to direct the relevant activities.

**Priority indicators**

**Examples of priority indicators**
- 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.
- 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.
- The investor can dominate either the nomination process for electing members of the investee’s governing body or obtaining of proxies from other holders of voting rights.
- 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).
- The majority of the members of the investee’s governing body are related parties of the investor.

**Economic indicators**

**Example of economic indicators**
- The investee’s key management personnel who have the ability to direct the relevant activities are current or previous employees of the investor.
- The investee’s operations are dependent on the investor, such as in the following situations:
  - 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.

- A significant portion of the investee’s activities either involve or are conducted on behalf of the investor.
- The investor’s exposure, or rights, to returns from its involvement with the investee is disproportionately greater than its voting or other similar rights. For example, there may be a situation in which an investor is entitled, or exposed, to more than half of the returns of the investee but holds less than half of the voting rights of the investee.

5. Voting rights

- Generally, an investor who holds more than half of the voting rights of an investee has the current ability through voting rights to direct the relevant activities in the following situations:
  - the relevant activities are directed by a vote of the holder of the majority of the voting rights, or
  - a majority of the members of the governing body that directs the relevant activities are appointed by a vote of the holder of the majority of the voting rights.

- However, these voting rights should be substantive.

For example, an investor that has more than half of the voting rights in an investee cannot have power if the relevant activities are subject to direction by a government, court, administrator, receiver, liquidator or regulator.

- An investor can have power even if it holds less than a majority of the voting rights of an investee. An investor can have power with less than a majority of the voting rights of an investee, for example, through:
  - a contractual arrangement between the investor and other vote holders;
  - rights arising from other contractual arrangements;
  - the investor’s voting rights;
  - potential voting rights; or
  - a combination of above.
Contractual arrangement with other vote holders:

A shareholder holding less than majority of the voting power may enter into agreement with other holders of the voting power that may enable it to increase its voting power beyond half. The contractual arrangement might ensure that the investor can direct enough other vote holders on how to vote to enable the investor to make decisions about the relevant activities.

Rights from other contractual arrangements:

Other decision-making rights, in combination with voting rights, can give an investor the current ability to direct the relevant activities. For example, the rights specified in a contractual arrangement in combination with voting rights may be sufficient to give an investor the current ability to direct the manufacturing processes of an investee or to direct other operating or financing activities of an investee that significantly affect the investee’s returns.

However, in the absence of any other rights, economic dependence of an investee on the investor (such as relations of a supplier with its main customer) does not lead to the investor having power over the investee.

The investor’s voting rights

An investor with less than a majority of the voting rights has rights that are sufficient to give it power when the investor has the practical ability to direct the relevant activities unilaterally. When assessing whether an investor’s voting rights are sufficient to give it power, an investor considers all facts and circumstances, including:

- the size of the investor’s holding of voting rights relative to the size and dispersion of holdings of the other vote holders, noting that:
  - more the voting rights an investor holds, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities;
  - more the voting rights an investor holds relative to other vote holders, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities;
  - more the parties that would need to act together to outvote the investor, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities;
- potential voting rights held by the investor, other vote holders or other parties;
- rights arising from other contractual arrangements; and
- any additional facts and circumstances that indicate the investor has, or does not have, the current ability to direct the relevant activities at the time that decisions need to be made, including voting patterns at previous shareholders’ meetings.
Illustration 7
A Limited has 48% of the voting rights of B Limited. The remaining voting rights are held by thousands of shareholders, none individually holding more than 1 per cent of the voting rights. None of the shareholders has any arrangements to consult any of the others or make collective decisions. Does A Limited have sufficiently dominant voting interest to meet power criterion?

Solution
In the above case, based on the absolute size of A Limited’s holding (48%) and the relative size of the other shareholdings, A Limited may conclude that it has a sufficiently dominant voting interest to meet the power criterion.

Illustration 8
An investor A Limited holds 45% of the voting rights of an investee. Eleven other shareholders, each holding 5% of the voting rights of the investee. None of the shareholders has contractual arrangements to consult any of the others or make collective decisions. Can we conclude that investor A Limited has power over the investee?

Solution
In this case, the absolute size of the investor’s holding and the relative size of the other shareholdings alone are not conclusive in determining whether the investor has rights sufficient to give it power over the investee. Additional facts and circumstances that may provide evidence that the investor has, or does not have, power shall be considered.

Illustration 9
A Limited holds 48% of the voting rights of B Limited. X Limited and Y Limited each hold 26% of the voting rights of B Limited. There are no other arrangements that affect decision-making. Who has power to take decisions in the present case?

Solution
In this case, the size of A Limited, voting interest and its size relative to the shareholdings of X Limited and Y Limited are sufficient to conclude that A Limited does not have power.

Only two other investors would need to co-operate to be able to prevent investor A from directing the relevant activities of the investee.

Illustration 10
Investor A holds 40% of the voting rights of an investee and six other investors each hold 10% of the voting rights of the investee. A shareholder agreement grants investor A the right to appoint, remove and set the remuneration of management responsible for directing the relevant activities. To change the agreement, a two-thirds majority vote of the shareholders is required. Is the absolute size of the
investor’s holding and the relative size of the other shareholdings alone is conclusive in determining whether the investor has rights sufficient to give it power?

Solution

No, the absolute size of investor’s holding and the relative size of other’s shareholdings are not conclusive in determining whether investor has power. Investor A’s contractual right to appoint, remove and set the remuneration of management is also to be considered to conclude that it has power over the investee. The fact that investor A might not have exercised this right or the likelihood of investor A exercising its right to select, appoint or remove management shall not be considered when assessing whether investor A has power.

Illustration 11

An investor holds 35% of the voting rights of an investee. Three other shareholders each hold 5% of the voting rights of the investee. The remaining voting rights are held by numerous other shareholders, none individually holding more than 1% of the voting rights. None of the shareholders has arrangements to consult any of the others or make collective decisions. Decisions about the relevant activities of the investee require the approval of a majority of votes cast at relevant shareholders’ meetings — 75% of the voting rights of the investee have been cast at recent relevant shareholders’ meetings. Does the investor have ability to direct the relevant activities of the investee unilaterally?

Solution

The active participation of other shareholders at recent shareholders’ meetings indicates that the investor would not have the practical ability to direct the relevant activities unilaterally, regardless of whether the investor has directed the relevant activities because a sufficient number of other shareholders voted in the same way as the investor.

Potential voting rights:

Potential voting rights are rights to obtain voting rights of an investee, such as those arising from convertible instruments or options. Those potential voting rights are considered only if the rights are substantive. When considering potential voting rights, an investor shall consider the purpose and design of the instrument, as well as the purpose and design of any other involvement the investor has with the investee. This includes an assessment of the various terms and conditions of the instrument as well as the investor’s apparent expectations, motives and reasons for agreeing to those terms and conditions. If the investor also has voting or other decision-making rights relating to the investee’s activities, the investor assesses whether those rights, in combination with potential voting rights, give the investor power.

Illustration 12

Entity P Ltd. develops pharmaceutical products. It has acquired 47% of entity S Ltd with an option to purchase remaining 53%. Entity S is a specialist entity that develops
latest technology and does research in pharmaceuticals. Entity P has acquired stake in S Ltd. to complement its own technological research. The remaining 53% is held by key management of P Ltd. who are key to running a major project that will market a medicine with features completely new to the industry. However, if P Ltd. exercises the option the management personnel are likely to leave. They have unique technological knowledge in relation to the specific medicine. Option strike price is 5 times the value of entity’s share price. Is the option substantive?

Solution

The option may not be substantive if entity P would derive no economic benefit from exercising it. High strike price and likely loss of key management indicate that the option may not be substantive.

Illustration 13

AB Ltd holds 40% in BC Ltd. CD Ltd holds 60% in BC Ltd. BC Ltd. is controlled through voting rights. AB Ltd. has call option exercisable in next 3 years for further 40% of investee. The option is deeply out of money and is expected to be the same over the life of the option. Further, investor would not gain any non-financial benefits from the exercise of option. Investor CD has been exercising its votes and is actively directing the relevant activities of the investee. Is right of AB Ltd substantive?

Solution

The option of AB Ltd. is not substantive. This is because although AB Ltd. has current ability to exercise his right to purchase additional voting rights (that, if exercised, would give it a majority of the voting rights in the investee) but option is deeply out of money and is likely to remain so during option period and there are no other benefits gained from the exercise.

Illustration 14

Investor A and two other investors each hold one third of the voting rights of an investee. The investee’s business activity is closely related to investor A. In addition to its equity instruments, investor A also holds debt instruments that are convertible into ordinary shares of the investee at any time for a fixed price that is out of the money (but not deeply out of the money). If the debt were converted, investor A would hold 60% of the voting rights of the investee. Investor A would benefit from realizing synergies if the debt instruments were converted into ordinary shares. Does investor A have power over investee?

Solution

Investor A has power over the investee because it holds voting rights of the investee together with substantive potential voting rights that give it the current ability to direct the relevant activities.

6. There could be situations where it may appear that the investor has no relationship with the investee. Persons controlling investee may have no / distant relationship with the investor. But in fact these persons may be acting as an agent of the investor. The following are
examples of such other parties that, by the nature of their relationship, might act as de facto agents for the investor:

- the investor’s related parties.
- a party that received its interest in the investee as a contribution or loan from the investor.
- a party that has agreed not to sell, transfer or encumber its interests in the investee without the investor’s prior approval (except for situations in which the investor and the other party have the right of prior approval and the rights are based on mutually agreed terms by willing independent parties).
- a party that cannot finance its operations without subordinated financial support from the investor.
- an investee for which the majority of the members of its governing body or for which its key management personnel are the same as those of the investor.
- a party that has a close business relationship with the investor, such as the relationship between a professional service provider and one of its significant clients.

4.4.6 Step 6: Whether investor has exposure, or rights, to variable returns from an investee?

The investor should examine whether it is exposed to or have variable returns from its involvement with the investee. Variable returns are returns that are not fixed and have the potential to vary as a result of the performance of an investee. Variable returns can be only positive, only negative or both positive and negative. An investor assesses whether returns from an investee are variable and how variable those returns are on the basis of the substance of the arrangement and regardless of the legal form of the returns.

For example, an investor can hold a bond with fixed interest payments. The fixed interest payments are variable returns for the purpose of this Ind AS because they are subject to default risk and they expose the investor to the credit risk of the issuer of the bond. The amount of variability (i.e. how variable those returns are) depends on the credit risk of the bond. Similarly, fixed performance fees for managing an investee’s assets are variable returns because they expose the investor to the performance risk of the investee. The amount of variability depends on the investee’s ability to generate sufficient income to pay the fee.

Examples of returns include:

- Dividends, other distributions of economic benefits from an investee (e.g. interest from debt securities issued by the investee) and changes in the value of the investor’s investment in that investee.
- Remuneration for servicing an investee’s assets or liabilities, fees and exposure to loss from providing credit or liquidity support, residual interests in the investee’s assets and liabilities on liquidation of that investee, tax benefits, and access to future liquidity that an investor has from its involvement with an investee.
Returns that are not available to other interest holders. For example, an investor might use its assets in combination with the assets of the investee, such as combining operating functions to achieve economies of scale, cost savings, sourcing scarce products, gaining access to proprietary knowledge or limiting some operations or assets, to enhance the value of the investor’s other assets.

### 4.4.7 Step 7: Is there a link between power & returns?

#### Illustration 15

A decision maker (fund manager) establishes, markets and manages a publicly traded, regulated fund according to narrowly defined parameters set out in the investment mandate as required by its local laws and regulations. The fund was marketed to the investors as an investment in a diversified portfolio of equity securities of publicly traded entities. Within the defined parameters, the fund manager has discretion about the assets in which to invest. The fund manager has made a 10% pro rata investment in the fund and receives a market-based fee for its services equal to 1% of the net asset value of the fund. The fees are commensurate with the services provided. The fund manager does not have any obligation to fund losses beyond its 10% investment. The fund is not required to establish, and has not established, an independent board of directors. The investors do not hold any substantive rights that would affect the decision-making authority of the fund manager, but can redeem their interests within particular limits set by the fund. Does the fund manager have control over the fund?

**Solution**

Although operating within the parameters set out in the investment mandate and in accordance with the regulatory requirements, the fund manager has decision-making rights that give it the current ability to direct the relevant activities of the fund — the investors do not hold substantive rights that could affect the fund manager’s decision-making authority. The fund manager receives a market-based fee for its services that is commensurate with the services provided and has also made a pro rata investment in the fund. The remuneration and its investment expose the fund manager to variability of returns from the activities of the fund without creating exposure that is of such significance that it indicates that the fund manager is a principal.

Consideration of the fund manager’s exposure to variability of returns from the fund together with its decision-making authority within restricted parameters indicates that the fund manager is an agent. Thus, the fund manager concludes that it does not control the fund.

#### Example

A decision maker establishes, markets and manages a fund that provides investment opportunities to a number of investors. The decision maker (fund manager) must make decisions in the best interests of all investors and in accordance with the fund’s governing agreements. Nonetheless, the fund manager has wide decision-making discretion. The fund manager receives a market-based fee for its services equal to 1 per cent of assets under management and 20 per cent of all the fund’s profits if a specified profit level is achieved. The fees are commensurate with the services provided.
Although it must make decisions in the best interests of all investors, the fund manager has extensive decision-making authority to direct the relevant activities of the fund. The fund manager is paid fixed and performance-related fees that are commensurate with the services provided. In addition, the remuneration aligns the interests of the fund manager with those of the other investors to increase the value of the fund, without creating exposure to variability of returns from the activities of the fund that is of such significance that the remuneration, when considered in isolation, indicates that the fund manager is a principal. The above fact pattern and analysis applies to Illustrations 16, 17 and 18 described below. Each illustration is considered in isolation.

Illustration 16

The fund manager also has a 2 per cent investment in the fund that aligns its interests with those of the other investors. The fund manager does not have any obligation to fund losses beyond its 2 per cent investment. The investors can remove the fund manager by a simple majority vote, but only for breach of contract. Considering the facts given, does the fund manager control the fund?

Solution

The fund manager’s 2 per cent investment increases its exposure to variability of returns from the activities of the fund without creating exposure that is of such significance that it indicates that the fund manager is a principal. The other investors’ rights to remove the fund manager are considered to be protective rights because they are exercisable only for breach of contract. Although the fund manager has extensive decision-making authority and is exposed to variability of returns from its interest and remuneration, the fund manager’s exposure indicates that the fund manager is an agent. Thus, in these circumstances we conclude fund manager does not control the fund.

Illustration 17

The fund manager has a more substantial pro rata investment in the fund, but does not have any obligation to fund losses beyond that investment. The investors can remove the fund manager by a simple majority vote, but only for breach of contract. Does the fund manager in this case control the fund?

Solution

The other investors’ rights to remove the fund manager are considered to be protective rights because they are exercisable only for breach of contract. Although the fund manager is paid fixed and performance-related fees that are commensurate with the services provided, the combination of the fund manager’s investment (i.e. substantial pro rata investment) together with its remuneration could create exposure to variability of returns from the activities of the fund that is of such significance that it indicates that the fund manager is a principal. The greater the magnitude of, and variability associated with, the fund manager’s economic interests (considering its remuneration and other interests in aggregate), the more emphasis the fund manager would place on those economic interests in the analysis, and the more likely the fund manager is a principal. Therefore, we conclude that the fund manager controls the fund.
Note: Having considered fund manager’s remuneration and the other factors, we might consider a 20 per cent investment to be sufficient to conclude that it controls the fund. However, in different circumstances (i.e. if the remuneration or other factors are different), control may arise when the level of investment is different.

Illustration 18

The fund manager has a 20% pro rata investment in the fund, but does not have any obligation to fund losses beyond its 20% investment. The fund has a board of directors, all of whose members are independent of the fund manager and are appointed by the other investors. The board appoints the fund manager annually. If the board decided not to renew the fund manager’s contract, the services performed by the fund manager could be performed by other managers in the industry. Does the fund manager control the fund?

Solution

Although the fund manager is paid fixed and performance-related fees that are commensurate with the services provided, the combination of the fund manager’s 20% investment together with its remuneration creates exposure to variability of returns from the activities of the fund that is of such significance that it indicates that the fund manager is a principal. However, the investors have substantive rights to remove the fund manager—the board of directors provides a mechanism to ensure that the investors can remove the fund manager if they decide to do so. In this example, the fund manager places greater emphasis on the substantive removal rights in the analysis. Thus, although the fund manager has extensive decision-making authority and is exposed to variability of returns of the fund from its remuneration and investment, the substantive rights held by the other investors indicate that the fund manager is an agent. Thus, we conclude that it does not control the fund.

Illustration 19

An investee Noor Ltd. is floated to invest in a portfolio of equity oriented mutual funds, funded by fixed rate debentures and equity instruments. The equity instruments will receive any residual returns of the investee. The transaction was marketed to potential debt investors as an investment in a portfolio of asset-backed securities with exposure to the credit risk associated with the possible default of the issuers of the asset-backed securities in the portfolio and to the interest rate risk associated with the management of the portfolio. On formation, the equity instruments represent 15% of the value of the assets purchased by Noor Ltd. A decision maker (the asset manager) of Noor Ltd. manages the portfolio by making investment decisions strictly as per investee’s prospectus. For services rendered by manager, receives a fixed fee (i.e. 0.5 percent of assets under management) and performance-related fee (i.e. 2 percent of profits) if profits exceed 10% over & above of previous financial year. The asset manager holds 40 per cent of the equity in the investee. The remaining 60 per cent of the equity, and all the debentures are held by a large number of widely dispersed unrelated third party investors. The asset manager can be removed, without cause, by a simple majority decision of the other investors.
Solution

The asset manager is paid fixed and performance-related fees that depend on variability of portfolio performance backed by equity oriented mutual funds i.e the remuneration and interest of other investors aligns to increase the value of the fund. The asset manager has exposure to variability of returns from the relevant activities of the fund because it holds 40 per cent of the equity and from its remuneration.

Although operating within the guidelines set out in the investee’s prospectus, the asset manager has the current ability to make investment decisions that significantly affect the investee’s returns—the removal rights held by widely unrelated dispersed investors receive little weighting because those rights are held by a large number of widely unrelated dispersed investors.

In given illustration, the asset manager has greater exposure to variability of returns of the fund from its 40 per cent equity interest, which is subordinate to the debt instruments. Holding 40 per cent of the equity creates exposure to losses and rights to returns of the investee, which are of such significance that it indicates that the asset manager is a principal and not mere an agent.

Therefore, it is concluded that the asset manager controls the investee Noor Ltd.

Illustration 20

A decision maker Aditya Birla Money Ltd. (ABML) sponsors a debt oriented mutual fund, which issues its units instruments to unrelated third party investors. The transaction was marketed as an investment in a portfolio of highly AAA rated long-term & medium-term assets with minimal credit risk exposure of the assets in the portfolio. Various transferors sell above long term & medium-term asset portfolios to the fund. Each transferor services the portfolio of assets that it sells to the fund and manages receivables on default for a market-based servicing fee. Each transferor also provides first loss protection against credit losses from its asset portfolio through over-collateralization of the assets transferred to the fund. The sponsor (ABML) establishes the terms of the fund and manages the operations of the fund for a market-based fee. The sponsor (ABML) approves the sellers permitted to sell to the fund, approves the assets to be purchased by the fund and makes decisions about the funding of the fund. The sponsor is entitled to any residual return of the fund and also provides liquidity facilities to the fund. The credit enhancement provided by the sponsor absorbs losses of up to 5 per cent of all of the fund’s assets, after losses are absorbed by the transferors. The liquidity facilities are not advanced against defaulted assets. The investors do not hold substantive rights that could affect the decision-making authority of the sponsor.

Solution

Even though the sponsor is paid a market-based fee for its services that is commensurate with the services provided, the sponsor has exposure to variability of returns from the activities of the fund because of its rights to any residual returns of the fund and the provision of credit enhancement and liquidity facilities (ie the fund is exposed to liquidity risk by using short-term debt instruments to fund medium-term assets). Even though each of the transferors has decision-making rights that affect the value of the assets of the fund, the sponsor has extensive decision-making authority that gives it the current ability to direct the activities that most significantly affect the fund’s returns (ie the sponsor established the terms of the fund, has the
right to make decisions about the assets (approving the assets purchased and the transferors of those assets) and the funding of the fund (for which new investment must be found on a regular basis). The right to residual returns of the fund and the provision of credit enhancement and liquidity facilities expose the sponsor to variability of returns from the activities of the fund that is different from that of the other investors. Accordingly, that exposure indicates that the sponsor is a principal and thus the sponsor concludes that it controls the fund. The sponsor’s obligation to act in the best interest of all investors does not prevent the sponsor from being a principal.

4.5 COMPARISON OF IND AS WITH THE COMPANIES ACT, 2013

1. Section 2(46) defines holding company as under:
   - “holding company”, in relation to one or more other companies, means a company of which such companies are subsidiary companies;

2. Section 2(87) defines subsidiary as under:
   - “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.

Provided that such class or classes of holding companies as may be prescribed shall not have layers of subsidiaries beyond such numbers as may be prescribed.

Explanation—For the purposes of this clause—
(a) a company shall be deemed to be a subsidiary company of the holding company even if the control referred to in sub-clause (i) or sub-clause (ii) is of another subsidiary company of the holding company;
(b) the composition of a company’s Board of Directors shall be deemed to be controlled by another company if that other company by exercise of some power exercisable by it at its discretion can appoint or remove all or a majority of the directors;

3. Section 2(6) defines associate as under:
   - “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.

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;

Joint venture is not defined in the Companies Act, 2013.
4. Section 2(27) defines control as under:

- “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;

Analysis of ‘Control’ as per the Companies Act, 2013:

“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 rights; or
  - management rights; or
  - shareholders’ agreements; or
  - voting agreements; or
  - in any other manner;

- Certain key attributes of the definition:
  - It is an inclusive definition;
  - 2 situations are mentioned:
    - First: Right to appoint majority of directors. This finds a mention in the definition of subsidiary also;
    - Second: Control the management or policy decisions
  - Control can be exercised individually or with somebody;
  - Control can be exercised directly or indirectly (through somebody who is under control – like in a principal / agent relationship);
  - Control can be obtained in a variety of manners.

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4.6 CONSOLIDATED FINANCIAL STATEMENTS - INVESTMENT ENTITIES

4.6.1 Identification

Parent shall determine whether it is an investment entity.
4.6.1.1 **As per Ind AS 110, Investment entity is an entity:**

a. That obtains funds from investors for providing investment management services to those investors;

b. Whose business purpose is to invest funds solely for returns from capital appreciation, investment income, or both as committed to its investor;

c. Which Measures and evaluates the performance of substantially all of its investments on a fair value basis.

4.6.1.2 **Documents that indicate entity’s objective are:**

i. memorandum,

ii. publications distributed by the entity and

iii. other corporate or partnership documents,

4.6.1.3 **Entity may also participate in many investment related activities:**

i. Providing management services & strategic advice to investee

ii. Providing financial support like giving loan or providing capital commitments or guarantee

4.6.1.4 **In order to demonstrate that it meets this element of the definition, an investment entity:**

i. provides investors with fair value information

ii. reports fair value information internally to the entity’s key management personnel.

4.6.1.5 **For assessing ‘Investment entity’, an entity also has to consider some typical characteristics as declared below (however absence of any characteristic does not necessarily disqualify an entity from being an investment entity):**

a. **Whether it has more than one investment:**

   In some cases, holding one investment does not prevent it from meeting definition if the entity:

   i. is in start-up period;

   ii. has not yet made investment to replace those dispose of;

   iii. is established to pool investor fund to invest in single investment under certain circumstances;

   iv. is in process of liquidation

b. **whether it has more than one investor:**
In some cases having one investor does not prevent the entity from meeting definition if the entity:

i. is within its initial offering period & entity is still identifying suitable investor;

ii. has not identified suitable investor to replace ownership interest that have been redeemed

iii. is in process of liquidation

c. Whether its Investors are not related parties of the entity:

- Having unrelated investors would make it less likely that the entity, or other members of the group containing the entity, would obtain benefits other than capital appreciation or investment income

- However, an entity may still qualify as an investment entity even though its investors are related to the entity.

For example, an investment entity may set up a separate ‘parallel’ fund for a group of its employees (such as key management personnel) or other related party investor(s), which mirrors the investments of the entity’s main investment fund. This ‘parallel’ fund may qualify as an investment entity even though all of its investors are related parties.

d. Whether it has ownership interests in the form of equity or similar interest:

An entity that has significant ownership interests in the form of debt that, may still qualify as an investment entity, provided that the debt holders are exposed to variable returns from changes in the fair value of the entity’s net assets.

In assessing whether an entity is an investment entity the following three steps may be performed.

Step 1: Whether it meets the three elements of the definitions

Step 2: Whether it meets all the four typical characteristics

Step 3: If it does not meet all the four typical characteristics, whether it still is investment entity based on the presumption of substance over form.
Illustration 21

A fund has been set up by its manager; initially the manager is the only shareholder. As at its first period end, the fund has not been successful in receiving funds from other prospective shareholders; but it is actively soliciting new investors. The fund invests in global equities and equity-related derivatives; and it provides its one shareholder with investment management services (as mandated in its prospectus). Its prospectus states that it expects to buy and sell investments regularly, and it expects holding periods of more than one year to be rare.

The fund generates returns from capital appreciations and investment income in the form of dividends. The fund fair values all investments and these valuations are the basis for subscriptions and redemptions into and out of the fund. Subscriptions and redemptions can occur daily.

Is the fund an investment entity?
**Solution**

The fund is an investment entity. It meets the definition of an investment entity:

- It has been set up to provide investment management services to its investors. For this period, it has only one manager-shareholder and so it is providing investment management services to itself, but this is not its longer-term manager intention.

- It is carrying on its investment activities with the objective of capital appreciation and investment income.

- It measures its underlying investments on a fair value basis and fair value is the basis for subscriptions and redemptions into and out of the fund.

The fund displays the following characteristics:

- It holds multiple investments.

- It does not have multiple investors; but, this is expected to be temporary and the fund manager is actively soliciting new investors.

- It does not have unrelated investors, because it has only a single investor.

- It issues ownership interests in the form of redeemable units that entitle the holders to a share of net assets.

Although the fund has a single investor, this is expected to be temporary. Failing to meet this typical characteristic does not mean that the fund is not an investment entity. In the context of the definition and the fund’s overall business purpose, it is an investment entity. The fund is required to make appropriate disclosures in its financial statements on why it qualifies as an investment entity even when it has only one investor.

**Illustration 22**

A fund is set up by a corporate entity that runs a power plant. The corporate entity (which owns all of the units in the fund) needs to keep funds available in case of a technical failure of the power plant. The entity does not have the expertise to manage the fund, so it appoints a third party asset manager. The entity can remove the fund manager on four months’ notice.

The fund invests in traded equity and debt instruments (as set out in the investment management agreement and fund founding documents) and its maximum exposure to one investment is not more than 11% of monies invested. The objective of the fund is to generate returns either from dividends and interest or from selling the instruments. The fund does not invest in the power industry and the corporate entity has no other relationship with the fund; for example, it does not have options to buy any of the investments made by the fund.

The fund reports fair value information internally and to its corporate parent; and its performance is evaluated against a benchmark stock exchange index.

The fund issues units that are redeemable at any time. The redeemable shares pay the net asset value of the fund when liquidated, and they are accounted for by the fund as equity under Ind AS 32. The units do not carry voting rights.
Is the fund an investment entity? How does the corporate entity account for its interest in the fund?

Solution

The fund is an investment entity. It meets the definition of an investment entity to the extent that:

- It provides investment management services to its investor.
- Its business purpose is to invest in debt and equity instruments for capital appreciation and investment income.
- It measures and evaluates the performance of its investments on a fair value basis.

The fund displays two of the four typical characteristics

- The fund holds multiple investments.
- The fund only has one investor but in these circumstances that is not inconsistent with its overall business purpose and with the definition of an investment entity.
- The fund does not have unrelated investors, because there is only one investor; but, again, in these circumstances this is not inconsistent with the definition of an investment entity.
- Units issued by the fund entitle the holder to a proportionate share of the net asset value of the fund.

Two of the characteristics are not satisfied because the fund has a single investor. When examining all the facts and circumstances, however, the fund concludes that it is an investment entity and that the failure to meet two of the typical characteristics is not inconsistent with the definition.

The corporate entity is not an investment entity. It consolidates the fund (including any controlled investments made by the fund).

4.6.2 Reassessing Status of an entity (investment entity or not)

- If there are changes in one or more of the three elements of the definition; or
- If there are changes in one or more of the four typical characteristics

Then,

Account for change (if any in status) prospectively, whether from investment entity to normal entity or vice versa.

Example:

Due to change in market conditions, investors in a fund are redeeming their units. As a result of this redemption, one significant investor remains in the fund. The fund should reassess its investment entity status. In this case, the fund might continue to meet the definition and remain an investment entity, in either of the following situations: if its business continues to be management of investments for capital appreciation and/or income, but now for one investor instead of many; or if it expects that this will be temporary situation.
### 4.6.3 Consolidation not required

- An investment entity shall not consolidate its subsidiaries.
- Instead it shall measure its investment in subsidiaries at fair value through profit or loss in accordance with Ind AS 109.

There are two exceptions to the said rule:

i. An investment entity shall consolidate that subsidiary which provides services related to investment entity’s investment activities.

ii. A parent of an investment entity shall consolidate all entities that it controls, including those controlled through an investment entity subsidiary, unless the parent itself is an investment entity.