

International Financial Reporting Standard 10 (IFRS 10), Consolidated Financial Statements

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This article is part of a series on the move to International Financial Reporting Standards published on PD Net.¹

Snapshot

Overview of IFRS 10

Differences from Canadian GAAP

Snapshot

First released (as IAS 27)	April 1989
Latest revision	May 2011
Subsequent amendments	None
Effective date (IASB basis)	January 1, 2013
Expected Effective date (Canadian basis)	January 1, 2013
Outstanding Exposure Drafts and issues under consideration	None

Overview of IFRS 10

IAS 27

IAS 27, entitled *Consolidated and Separate Financial Statements*, was issued in 1989. The goal of IAS 27 was to enhance the relevance, reliability, and comparability of the information contained in

- consolidated financial statements that a parent prepared for the group of entities it controlled;
- separate (non-consolidated) financial statements that a parent, investor, or venturer elected to provide, or was required by local regulation to provide.

¹ Some of the material related to the section on consolidation procedures in this article is drawn from the 2009 version of the PD Net article entitled *International Accounting Standard 27 (IAS 27), Consolidated and Separate Financial Statements*, written by Brian and Laura Friedrich, as updated by Stephen Spector.

Over the years subsequent to its release, the inherent flaw in IAS 27 became more and more troublesome. This flaw was the notion of *control*. IAS 27 required the consolidation of entities that were controlled by a reporting entity. To meet this objective, paragraph 4 of IAS 27 defined control as “the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.” During the 1990s, this definition was manageable. However, when companies such as Enron began to make use of special purpose entities, the notion of control was “flexible.”

Accordingly, in 1998, the Standards Interpretation Committee of the International Accounting Standards Committee released Issue No. 12 (SIC 12) focusing on the requirements of IAS 27 within the context of special purpose entities. The problem was that SIC 12 placed emphasis on risks and rewards in the analysis of assessing control, an approach that was not quite the same as the definition of control in IAS 27. The result was inconsistent application of the concept of control, exacerbated by a lack of clear guidance as to how to determine which entities were within the scope of IAS 27 and which were within the scope of SIC 12.

Why did this matter? Instead of focusing on “substance,” the assessment of control relied on “form.” Specifically, the assessment of “whether an investor had a majority of the risks and rewards” became the defining question. Reliance on “bright line” distinctions turned the cart before the horse, so to speak, as entities structured opportunities to achieve particular accounting outcomes.

Subsequent developments

In 2003, the IASB (jointly with the FASB) began a project to examine consolidation accounting with the aim of developing a single set of principles that would apply to investees that were either voting-interest or non-voting interest entities (for example, structured entities and/or special purpose entities). The plan was to clarify the conditions for assessing the existence of control of an entity irrespective of its business purpose or means of ownership. This was considered critical because of the divergence in practice in the application of the control concept, particularly for less than majority-owned voting interest entities and for structured entities. In addition, the IASB planned to improve the disclosure about investees that are consolidated and those that are unconsolidated.

Halfway through the project, the global financial crisis emerged. This led to increased pressure on the IASB and FASB to deal with consolidation issues, especially as they applied to structured entities. Constituents were concerned about the ability of firms to defend off-balance sheet financing structures by arguing these structures were not specifically proscribed by IFRSs (or SFASs by the FASB). Furthermore, constituents argued that the need for new disclosure requirements to provide investors with better information was obvious.

IFRS 10

Based on the issues discussed above, it should not be surprising that IFRS 10’s objective is quite straightforward — to establish principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities.

To meet the objective, IFRS 10

- a) requires an entity (the parent) that controls one or more other entities (subsidiaries) to present consolidated financial statements;
- b) defines the principle of control, and establishes control as the basis for consolidation;
- c) sets out how to apply the principle of control to identify whether an investor controls an investee and therefore must consolidate the investee;
- d) sets out the accounting requirements for the preparation of consolidated financial statements [¶2].

IFRS 10 does *not* deal with the accounting requirements for business combinations and their effect on consolidation, including goodwill arising on a business combination. That goal remains with IFRS 3 *Business Combinations* [¶3].

Scope

As with all International Financial Reporting Standards, there are exceptions. Given that the basis for the consolidation model in IFRS 10 rests on assessing whether a reporting entity has control of another entity regardless of its nature, this results in the main scope exemption [¶4(a)] being based on two criteria: is the entity a “public” entity in the context of financial reporting or is the entity the ultimate “reporting entity”?

Paragraph 4(a) states that a parent need not present consolidated financial statements if it meets all the following conditions:

- i) It is a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements.
- ii) Its debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets).
- iii) It did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market.
- iv) Its ultimate or any intermediate parent produces consolidated financial statements that are available for public use and 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 financial statements addressed in IAS 27, *Separate Financial Statements (2011)*².

There is a second scope exemption to IFRS 10 for post-employment benefit plans or other long-term employee benefit plans to which IAS 19, *Employee Benefits*, applies.

Highlights of the standard

Control

As noted earlier, the basis for the single consolidation model of IFRS 10 rests on assessing whether a reporting entity has control of another entity regardless of its nature. Paragraph 6 stipulates that 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.

In other words, there are three criteria for assessing control:

- power over an investee — does the reporting entity have the current ability to direct activities that significantly affect an investee’s returns;

² Issues related to consolidated financial statements were originally part of IAS 27, *Consolidated and Separate Financial Statements*, as released in 1989. Subsequent revisions to IASs have usually resulted in the new IFRSs being issued. Given that IFRS 10 carved out material related to consolidated financial statements, the IASB chose to reissue IAS 27 as *Separate Financial Statements*, limiting its scope to separate financial statements.

- exposure to, or rights to, variable returns from involvement with an investee;
- linkage between power and returns — whether the investor has the ability to affect its returns through its power [¶7].

Power

An investor has power over an investee when the investor has existing rights that give it the current ability to direct the relevant activities — specifically, the activities that significantly affect the investee’s returns. Power arises from rights. Sometimes assessing power is straightforward, such as when power over an investee is obtained directly and solely from the voting rights granted by equity instruments, such as shares, and can be assessed by considering the voting rights from those shareholdings. In other cases, the assessment will be more complex and require more than one factor to be considered, for example, when power results from one or more contractual arrangements [¶s 10 and 11].

Returns

An investor is exposed, or has rights, to variable returns from its involvement with the investee when the investor’s returns from its involvement have the potential to vary as a result of the investee’s performance. The investor’s returns can be only positive, only negative or wholly positive and negative [¶15].

Linkage

An investor controls an investee if the investor not only has power over the investee and exposure or rights to variable returns from its involvement with the investee, but also has the ability to use its power to affect the investor’s returns from its involvement with the investee [¶17].

Consolidation procedures

Overview

IFRS 10 requires that consolidation of an investee begins from the date the investor obtains control of the investee and ceases when the investor loses control of the investee. Moreover, a parent must prepare consolidated financial statements using uniform accounting policies for like transactions and other events in similar circumstances.

A parent is to present non-controlling interests in the consolidated statement of financial position within equity, but separately from the equity of the owners of the parent. Furthermore, changes in a parent’s ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary are equity transactions. That is, transactions with owners in their capacity as owners.

Paragraphs B86 to B93 of IFRS 10 set out guidance for the preparation of consolidated financial statements. The requirements aim to ensure relevance, reliability, and comparability of the resulting financial information.

Consolidated financial statements are prepared by combining the financial statements of the parent and its subsidiaries line by line. At each line, like items of assets, liabilities, equity, income, and expense are added together to present financial information about the group as that of a single economic entity. The income and expenses of a subsidiary are included in the consolidated financial statements from the acquisition date until the date when the parent ceases to control the subsidiary.

General guidance

During consolidation, the following guidelines apply:

- The carrying amount of the parent’s investment in each subsidiary and the parent’s portion of equity of each subsidiary are eliminated, with any resultant goodwill accounted for as required by IFRS 3, *Business Combinations*.

- Non-controlling interests in the profit or loss of consolidated subsidiaries for the reporting period are identified.
- Non-controlling interests in the net assets of consolidated subsidiaries (including the NCI at the original combination date and the NCI's share of changes in equity since the combination) are identified separately from the parent's ownership interests in them.
- Intra-group balances, transactions, income, expenses, and dividends are eliminated in full, including profits and losses resulting from intra-group transactions that are recognized in assets (such as inventory and fixed assets). Note that intra-group losses may indicate an impairment that requires recognition in the consolidated financial statements [¶B86].

Consolidated financial statements are prepared using uniform accounting policies for like transactions and other events in similar circumstances. If needed, appropriate adjustments are made to the financial statements of the group members to reflect the accounting policies used in preparing the consolidated financial statements [¶B87].

The parent and subsidiary financial statements that are used in the preparation of the consolidated financial statements should all be prepared as of the same reporting date, even if this means that the subsidiaries prepare extra financial statements as of the parent's reporting date, to be used for consolidation purposes. If this is impracticable, adjustments need to be made for significant transactions or events that occur between the date of the subsidiary's financial statements and the date of the parent's financial statements [¶s B92 and B93].

If differently dated parent and subsidiary financial statements are used for consolidation, the difference between the end of the reporting period of the subsidiary and that of the parent must be no more than three months, regardless of any adjustments made. Furthermore, in the interest of comparability, the length of the reporting periods and any difference between the ends of the parent and subsidiary reporting periods must stay the same from period to period [¶B93].

Non-controlling interests

Non-controlling interests are presented in the consolidated statement of financial position within equity, but separately from the equity of the owners of the parent [¶22]. Rather than showing the non-controlling interest in net income as a deduction in arriving at consolidated net income or other comprehensive income, IFRS 10 requires that net income and each component of other comprehensive income be allocated to the controlling interest and the NCI (based on proportion of ownership unless a contractual agreement specifies a different allocation). Total comprehensive income is also attributed to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance [¶B94].

Note that, if a subsidiary has outstanding cumulative preferred shares that are classified as equity, the parent computes its share of profit or loss after adjusting for the dividends on preferred shares held by non-controlling interests, regardless of whether dividends have been declared [¶B95].

Changes in the parent's ownership — No loss of control

Accounting for changes in a parent's ownership interest in a subsidiary depends on whether the change results in a loss of control. Changes that do not result in a loss of control are accounted for as equity transactions [¶23]. This includes situations where the parent acquires additional shares in the subsidiary after control was obtained, or where the parent sells part of its investment in the subsidiary without losing control.

If the parent purchases additional shares of the subsidiary, it is accounted for as an equity transaction with the owners (conceptually similar to the acquisition of treasury shares). Similarly, if a parent partially disposes of an investment in a subsidiary but retains control, this is accounted for as an equity transaction, and no gain or loss is recognized.

In these situations, the carrying amounts of the controlling and non-controlling interests are adjusted to reflect the changes in their relative percentage interests in the subsidiary. If there is a difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received, this difference is recognized directly in equity and attributed to the owners of the parent [¶B96].

Changes in the parent’s ownership — Loss of control

Loss of control normally occurs when the parent disposes of part of its investment in the subsidiary, but paragraph B97 notes that a parent can lose control of a subsidiary with or without a change in absolute or relative ownership levels (for example, if a subsidiary becomes subject to the control of a court or regulator, or as a result of a contractual agreement).

If loss of control occurs, the parent goes through the process set out in paragraphs B98 and B99:

- Derecognize the assets, liabilities, and goodwill of the subsidiary at their carrying amounts on the date when control is lost.
- Derecognize the carrying amount of any non-controlling interests on the date when control is lost.
- Recognize the fair value of any consideration received and any distribution of shares of the former subsidiary.
- Recognize any investment retained in the former subsidiary at its fair value on the date when control is lost.
- Reclassify to profit or loss (or transfer directly to retained earnings if required in accordance with other IFRSs) the amounts needed to account for all items recognized in other comprehensive income in relation to that subsidiary on the same basis as would be required if the parent had directly disposed of the related assets or liabilities³.
- Recognize any resulting difference in profit or loss, attributable to the parent.

As an example, assume Parent owns 75% of Sub’s voting shares and loses control of Sub by selling 40% of Sub’s shares for \$400,000. The fair value of Parent’s remaining investment in Sub is \$335,000. At the time of the sale, the carrying amount of the NCI is \$220,000, and the carrying amount of Sub’s net assets is \$870,000.

Parent’s gain or loss would be calculated as follows (assume there are no previously recognized items to reclassify to profit or loss):

Proceeds of sale of 40% investment	\$ 400,000
Fair value of retained 35% investment	335,000
Carrying amount of NCI at time of sale	<u>220,000</u>
	955,000
Less: Carrying amount of Sub’s net assets at time of sale	<u>(870,000)</u>
Gain recognized by Parent	<u>\$ 85,000</u>

After accounting for the loss of control, an entity applies IFRS 28, *Investments in Associates and Joint Ventures (2011)*, IFRS 11 *Joint Arrangements*, or IFRS 9 *Financial Instruments*, as appropriate, to the remaining holdings.

Paragraph B97 notes that control of a subsidiary may be lost over two or more transactions. In some cases, however, it requires these multiple transactions to be accounted for as a single

³ Suppose a subsidiary has available-for-sale financial assets and the parent loses control of the subsidiary. The parent will have to reclassify to profit or loss the gain or loss that was previously recognized in other comprehensive income in relation to those assets (paragraph B99).

transaction, based on the terms and conditions of the arrangements and their economic effects. If, for example, the transactions are entered into at the same time or in contemplation of each other, this may be an indication that the parent should account for the multiple arrangements as a single transaction.

The same situation may arise if multiple transactions are interdependent, or were designed to achieve an overall commercial effect, or if the transactions must be considered together in order to be economically justifiable (for example, if a disposal of shares priced below market is compensated for by a subsequent disposal priced above market). The requirement to recognize the economic substance of a single transaction is meant to remove the potential motivation for an entity to structure a transaction or arrangement as multiple steps to maximize gains (or minimize losses) when disposing of its controlling interest in a subsidiary.

Presentation and disclosure

The comprehensive review of consolidation issues referred to at the beginning of this article affected more than IAS 27. Presentation and disclosure requirements for consolidated financial statements, previously part of IAS 27, are now found in IFRS 12, *Disclosure of Interests in Other Entities*.

Differences from Canadian GAAP

The adoption by Canada of International Financial Reporting Standards for publicly accountable enterprises means that changes to IFRS are changes to Canadian GAAP. Note that prior to January 1, 2011, the accounting requirements required by IFRS 10 did not exist to the detail required by IFRS 10, nor were those that did exist in one section alone.

However, it bears repeating that IFRS GAAP is Canadian GAAP. Therefore, with the release of IFRS 10, “Canadian” GAAP will change, but there will be no IFRS/Canada differences. However, for those familiar with pre-changeover Canadian GAAP, listed below are some of the key differences that existed prior to January 1, 2011.

- The IFRS 10 definition of “control” differs from the old *Handbook* definition in Section 1590, *Subsidiaries*, where control was defined as “the continuing power to determine its strategic, operating, investing, and financing policies, without the co-operation of others.”
- IFRS Interpretation SIC-12, “Consolidation — Special Purpose Entities,” was not the same as Accounting Guideline AcG-15, *Consolidation of Variable Interest Entities*.
- IAS 27 did not (and neither does IFRS 10) include guidance on investment companies that is comparable to Accounting Guideline AcG-18, *Investment Companies*.
- Under pre-changeover Canadian GAAP, when the fiscal periods of a parent and a subsidiary were not coterminous, events relating to, or transactions of, the subsidiary that occurred during the intervening period and significantly affected the financial position or results of operations of the group needed to be recorded or disclosed, as appropriate. There was no specification of what is an acceptable gap. However, IFRS 10 (and IAS 27) sets the limit as no more than three months.
- IFRS 10 (and IAS 27) requires that consolidated financial statements be prepared using uniform accounting policies for like transactions and other events in similar circumstances. Pre-changeover Canadian GAAP did not contain specific guidance on whether uniform accounting policies should be used in the preparation of consolidated financial statements.

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