International Journal of Recent Technology and Engineering (IJRTE)
ISSN: 2277-3878 (Online), Volume-8, Issue-1, May 2019

Methodology for Assessing Control in The Formation of Financial Statements of a Consolidated Business

Natalia Alekseevna Prodanova, Liudmila Borisovna Trofimova, Aleksandr Aleksandrovich Adamenko, Elmira Arsenovna Erzinkyan, Natalia Victorovna Savina, Lyudmila Nikolaevna Korshunova

***Abstract*: In order to develop the Russian consolidated statements, adapted to the new requirements of the international standard IFRS 10, the authors have conducted a study of its main requirements in relation to the assessment of control in the preparation of the financial statements of the consolidated business. Through the use of a methodology for testing investors for control over an investment object, the authors have developed a flowchart aimed at identifying the main criteria for control assessment. The testing performed is to help one choose the right solution for composing financial reports and either generate a consolidated company report controlled by the parent company, or compile reports using the equity method and so on.**

The research results can be used in the transformation of statements, as well as in the construction of consolidated financial statements generated in Russia in accordance with the requirements of IFRS.

***Index Terms*: IFRS 10, consolidated financial statements, control, assessment, privilege, principal, agent, voting right.**

I. INTRODUCTION

In the conditions of publication and adoption of international financial reporting standards (hereinafter IFRS) on the territory of the Russian Federation, another crucial step has been taken - the adoption of the law on consolidated reporting, which has been amended until the end of 2017 [1]. According to this law, Russian consolidated financial statements should be prepared in accordance with the rules and regulations of IFRS [2]. The document published on the website of the Ministry of Finance of the Russian Federation on December 8, 2017, containing a summary of the practice of applying IFRS in Russia [3], outlines the features of forming consolidated financial reporting (hereinafter CFS) in accordance with the new requirements of IFRS [4]. The document states that, depending on the conditions for creating a new controlling organization in the group, variability in the composition of the CFS is possible. The choice of the formation of a CFS depends on whether a new controlling organization is created by combining business, or by creating common control over the investee for the parent company, therefore the study of the main IFRS requirements for the assessment of control in the context of integration processes is particularly important.

II. LITERATURE REVIEW

Consolidation of financial statements is a complex process of preparing a report on the overall financial performance of a group of companies. The description of the consolidation process is reflected in the works of many Russian and foreign scientists. The specifics of terminological differences between IFRS and Russian accounting practices, including the terms “financial reporting”, “subsidiary” and “non-controlling interest” were studied by Italian scientists Sotti, F. Rinaldi, L. Gavana, G. [5]. Economists D.S. Usanova and R.Z. Mukhametzinov [6] from Kazan have examined topical issues of primary business consolidation. South African scientists van Zijl, W. Maroun, W. dedicated their research to assessment options for non-controlling interest and their impact on the sequence of consolidated financial statements [7]. Features of recognition of non-controlling interest in consolidated financial statements based on property rights were investigated by German scientists Casajus, A. Labrenz, H. [8] and by Gluzová, T. [9] from Czech.

The analysis of goodwill accounting In accordance with IFRS was conducted in research works of economists from Austria and Australia d'Arcy, A. Tarca, A. [10], from Spain Amorós Martínez, A. Cavero Rubio, J.A. [11], from Italy, Switzerland and England Mazzi, F. André, P. Dionysiou, D. Tsalavoutas, I. [12].

Revised Manuscript Received on 30 May 2019.
* Correspondence Author

Natalia Alekseevna Prodanova*, Plekhanov Russian University of Economics, Moscow, Russian Federation.

Liudmila Borisovna Trofimova, Plekhanov Russian University of Economics, Moscow, Russian Federation.

Aleksandr Aleksandrovich Adamenko, Kuban State Agrarian University named after I.T. Trubilin, Krasnodar, Russian Federation.

Elmira Arsenovna Erzinkyan, State Academic University for Humanities (GAUGN), Moscow, Russian Federation.

Natalia Victorovna Savina, Financial University under the Government of the Russian Federation, Moscow, Russian Federation.

Lyudmila Nikolaevna Korshunova, Moscow University by S.U. Witte, Moscow, Russian Federation.

The issues of technology consolidation of financial statements and analysis were investigated by many Russian scientists [14-17], however, economists have paid insufficient scientific attention to the study of new IFRS requirements regarding the assessment of control.

III. METHODOLOGY

In 2006, the Norwalk Agreement was confirmed by the adoption of a rapprochement roadmap, in which two regulatory bodies announced their short-term and long-term plans for the convergence process. The convergence process regarding the consolidated financial statements resulted in the release of a new version of IFRS 3, IAS 27, and the adoption of IFRS 10, IFRS 11 and IFRS 12. A number of US GAAP standards are devoted to issues of evaluating control, consolidation and business integration.

In this regard, we will analyze the main requirements and definitions of the international standard IFRS 10 “Consolidated financial statements” [18], since it contains a new methodology for assessing the control compared with previous international standards.

The latest edition of the IFRS 10 standard is published on the website of the Ministry of Finance of the Russian Federation in February 2016. Its goal is to determine the principles of CFS formation in the situation when a company controls one or several other companies. This standard has replaced the previous standard IAS 27, as well as the Interpretation of SIC-12. We define the main changes reflected in the IFRS 10 standard in relation to the previous standard IAS 27 in terms of the basic requirements for the formation of consolidated financial statements.

Control was taken as the basis for consolidation in both standards, but attention should be paid to the fact that IFRS 10 defines control as the sole basis for consolidating financial statements. At the same time, the investor must determine, according to certain criteria enshrined in the standard, the right to manage significant activities.

IFRS 10 provides specific guidance on assessing the availability of control with less than half of the voting rights in an investee, and IAS 27 does not contain clear instructions on this issue, although it also assumes the possibility of such control.

Potential voting rights under IFRS 10 are taken into account in case of control only if they are significant. The significance is determined by applying judgements about the right to vote. IAS 27 defines that when assessing the control, only those voting rights that can be exercised at the moment are taken into account. In contrast to IAS 27, which does not provide specific guidance regarding agency relations, IFRS 10 describes in detail the relationship between principal and agent when delegating authority for decision-making [19].

The main requirement of IFRS 10, the starting point for reporting, is that all elements of the group's financial statements, including cash flows, are presented as those belonging to a unified economic entity.

Clause B86 of IFRS 10 contains a description of the consolidation procedure, which includes the following steps:

1) the summation of homonymous reporting lines is done;

2) in the consolidated balance sheet, investments in subsidiaries and shares of the parent organization in the equity capital of the parent company are eliminated;

3) non-controlling interest lines are added, as well as goodwill;

4) mutual settlements between group members are subject to elimination;

5) the only financial result shown is the one obtained from the external sale of goods, works and services, i.e. to third parties.

To find out whether the investor is the parent company, it is necessary to determine the degree of control in relation to the investee. IFRS 10 provides guidance on assessing the fact of control. In clause 7 of the standard it is indicated that control must simultaneously have all three components of the criterion for its assessment by the investor:

- the powers of the investor;
- the right to receive income from the object;
- power management for revenue generation.

The first criterion is that the presence of management authority may include the possession of a voting right, or a potential voting right, such as an option, the right to appoint or remove management, etc. Authority for an investee is determined by two important factors: the management of significant activities and the possession of voting rights.

A significant activity is the presence of powers of choice and influence on the economic policy of the company, this may be:

- production management, namely the sale and purchase of goods and services;
- management of assets and liabilities;
- the impact on income and expenses;
- investment policy management, etc.

The powers with respect to the investee are determined from the voting shares and are divided into substantial rights and rights of protection. If the investor has substantial rights, then he has such powers. Such rights, as a rule, can be exercised at the current moment, however, IFRS 10 allows cases where they can be substantial, even if they cannot be exercised at the current moment. For example, an investor owns an option that is to be exercised within two weeks in case his financial situation is stable. Substantial rights allow to impose the right of veto to change the terms of transactions, allow to deal with personnel issues of management staff and other.

Factors of assessing the substantiality of rights include:

- the presence of obstacles to the execution of rights, like fines, regulatory conditions prohibiting the exercise of the rights, etc.;
- a practical opportunity for the investors to exercise their rights without the consent of other investors.

An investor has authority by virtue of ownership of ordinary shares of an investee. The easiest way to check the control is possible when the investor has more than half of the voting rights. In a significant number of cases, control is determined by the right to vote, so a further assessment of the presence of control may no longer apply.

If an investor has authority in the absence of most voting rights, he has “actual control” over the investee.

The reasons for the existence of authority in the absence of the advantage of voting rights are specified in paragraph B42 of IFRS 10, these include:

- the larger the investor's package with the right to vote, in relation to other holders of voting rights, the greater the likelihood of having substantial rights;

- the greater the number of parties acting together, the greater the likelihood that an investor will have substantial rights;

- any additional reasons indicating that the investor has substantial rights and the ability to manage significant activities at the right time, etc. [20].

If an investor has potential voting rights (options, forward contracts), then only substantial rights will be considered for determining control. In assessing the substantiality of potential voting rights, an investor should consider the purpose and structure of the instrument being analyzed.

Let us consider in the following examples whether the investor has control in the event that he has a substantial stake in another company with voting rights.

1. Company B holds 49% of the voting shares of Company A, the remaining 51% of the shares are distributed among the shareholders, owning 1% of the voting shares (Fig. 1).

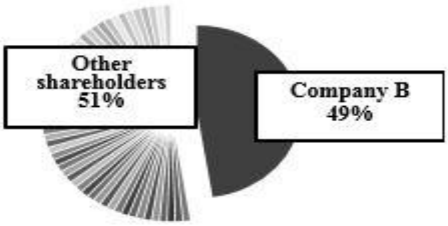

Fig. 1: Distribution of voting rights among 51% of shareholders

In this case, company B has authority over company A, because company B holds the majority of voting shares, and the remaining voting shares are distributed among a large number of shareholders each owning no more than 1% of the shares.

2. Company B holds 43% of voting shares of company A, 26% of voting shares are allotted for each of the 2 shareholders C and D, and the remaining 5% are distributed among five shareholders owning 1% each (Fig. 2).

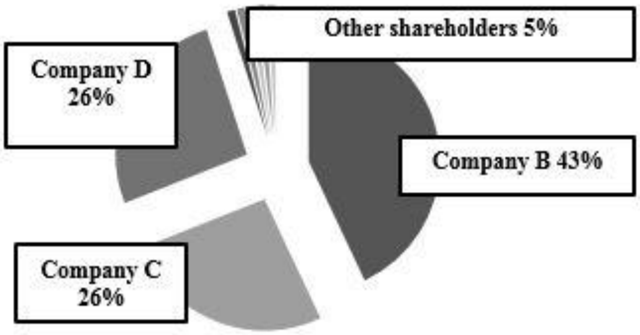

Fig.2: Distribution of voting rights among 57% of shareholders

In this ratio of shares, company B does not have authority over company A, since company B has a 43% voting interest, and shareholders with a substantial share of 52% can arrange a majority of votes over company A.

3. Company B owns 30% of voting shares of company A, 50% of voting shares are distributed among 50 shareholders, each owning 1% of the shares, half of whom participate in the annual meeting of shareholders, and the remaining 10% between two shareholders C and D owning 5% each (Figure 3).

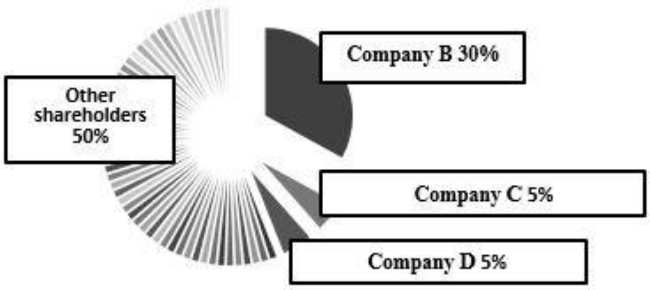

Fig. 3: Distribution of voting rights among 80% of shareholders

In this case, a judgment is required regarding the voting rights of company B. Since half of the remaining share of the shareholders participating in the annual meeting of shareholders is 25%, then together with the shareholders of companies C and D they will be 35%, which exceeds the share of company B. Company B will not have authority over company A.

4. Company B owns 42% of the voting shares of company A, 38% of the voting shares are distributed among 40 shareholders owning 1% of the shares each, half of which participate in the annual meeting of shareholders, and the remaining 20% between two shareholders C and D owning 10% each (Fig.4).

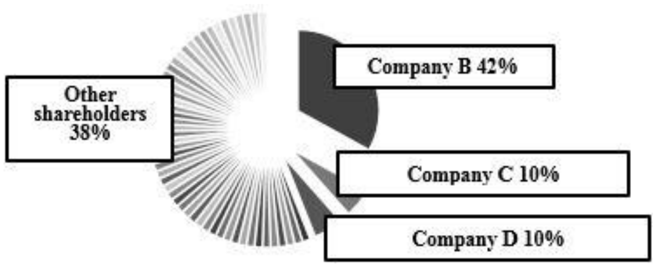

Fig. 4: Distribution of voting rights among 58% of shareholders

This case requires the application of judgment regarding the voting rights of company B. Since half of the remaining share of shareholders participating in the annual meeting of shareholders is 19%, together with shareholders of companies C and D they will be 39%, which is less than share of company B. Company B may have authority over company A when all criteria for control are met.

The main conclusion following from the examples is this: one of the most important changes resulting from the adoption of IFRS 10 is that for the first time this standard considers the issues of actual control of the investee by the investor.

The concept of the right of protection has been first introduced by IFRS 10 as follows: “Rights whose purpose is to protect the interest of a party with these rights, without granting such party authority over the company with which such rights are associated” IFRS 10, 2016, app. A).

Defensive rights include:

- the right to approve the capital costs of the investee;
- the right to seize assets if the investor fails to comply with the terms of the loan;
- the right to veto between the investor and the related, or associated party.

In other words, the protection rights are rights of a narrow nature, relating only to the field of management of one's own company and not affecting the control of the whole group [21].

However, the IFRS 10 standard contains many details. In particular, with respect to the first criterion, the presence of authority is possible in the absence of the majority of voting rights (actual control).

The second criterion for the presence of control is the determination of the investor's exposure to the risk of changes in income from participation; such income will be variable. Some fixed payments may also be related to variables, for example, they include interest payments, since they entail credit risk. The investor's variable income includes:

- dividends;
- risk of loss from loans and credits;
- income not available to other shareholders.

The risk of income volatility can be a sign that an investor has authority: the more opportunities there are to change the return on an investment, the greater the incentive for an investor to get the rights that give him authority [22].

Consider these provisions on the following example.

Two investors are developing an object of investment with the aim of producing new products that create a future for all technologies: smartphones, computers, laptops, computing equipment, computer components, software, etc. In this context, one investor is responsible for the development and successful introduction of innovations, and the second for production activities. These types of activities are significant, therefore the investors, by judgment, choose the most significant one. Assume that the first investor has a greater influence on the possibility of changing the income from participation in the investee, since his successful introduction of innovations leads to the release of the newest brand products that generate the most income [23]. Based on this provision, the first investor will have control over the investee.

The next criterion for the possession of control is the availability of the use of powers to influence the amount of income of an investor. For this assessment of influence, the concept of "principal - agent" is introduced. Clause 58 of the standard states that an agent is a party engaged primarily to carry out activities on behalf of and in the interests of the other party, the principal, the agent having no control over the object of investment. An agent is not necessarily bound to the principal by contractual relationship. The term “de facto agent” applies to those agents acting on behalf of the principal in the absence of a contractual relationship. For example, a party can act as a de facto agent if the investors are related parties.

IV. RESULTS

Fig. 5 shows a flowchart, the use of which will help to get tested for the presence of control in relation to the investee, control, and accordingly, the investor’s authority with respect to the investment object must meet three criteria simultaneously.

For clarity, the basic criteria are included in the flowchart giving a general picture of control degree. Formation of consolidated financial statements, in accordance with the requirements of the IFRS 10 standard, will be carried out if the investor has control over the investment object, which will be assessed in case of meeting the three above conditions.

In the event that at least one of the criteria is not met, the investor will record the equity interest using the equity method as jointly controlled companies or as associated companies. When conducting a test on the use of the powers of the investee in the study of the impact on the amount of income of the investor (the third criterion), the status of the investor is determined. If the investor is the principal, the formation of consolidated financial statements will be subject to the requirements of IFRS 10. If the investor is an agent, the reporting will be formed using the equity method according to the rules of the following standards: IFRS 11, IAS 28, IAS 27, IFRS 12, IAS 39 and IFRS 9, as indicated by the direction of the arrow in the flowchart.

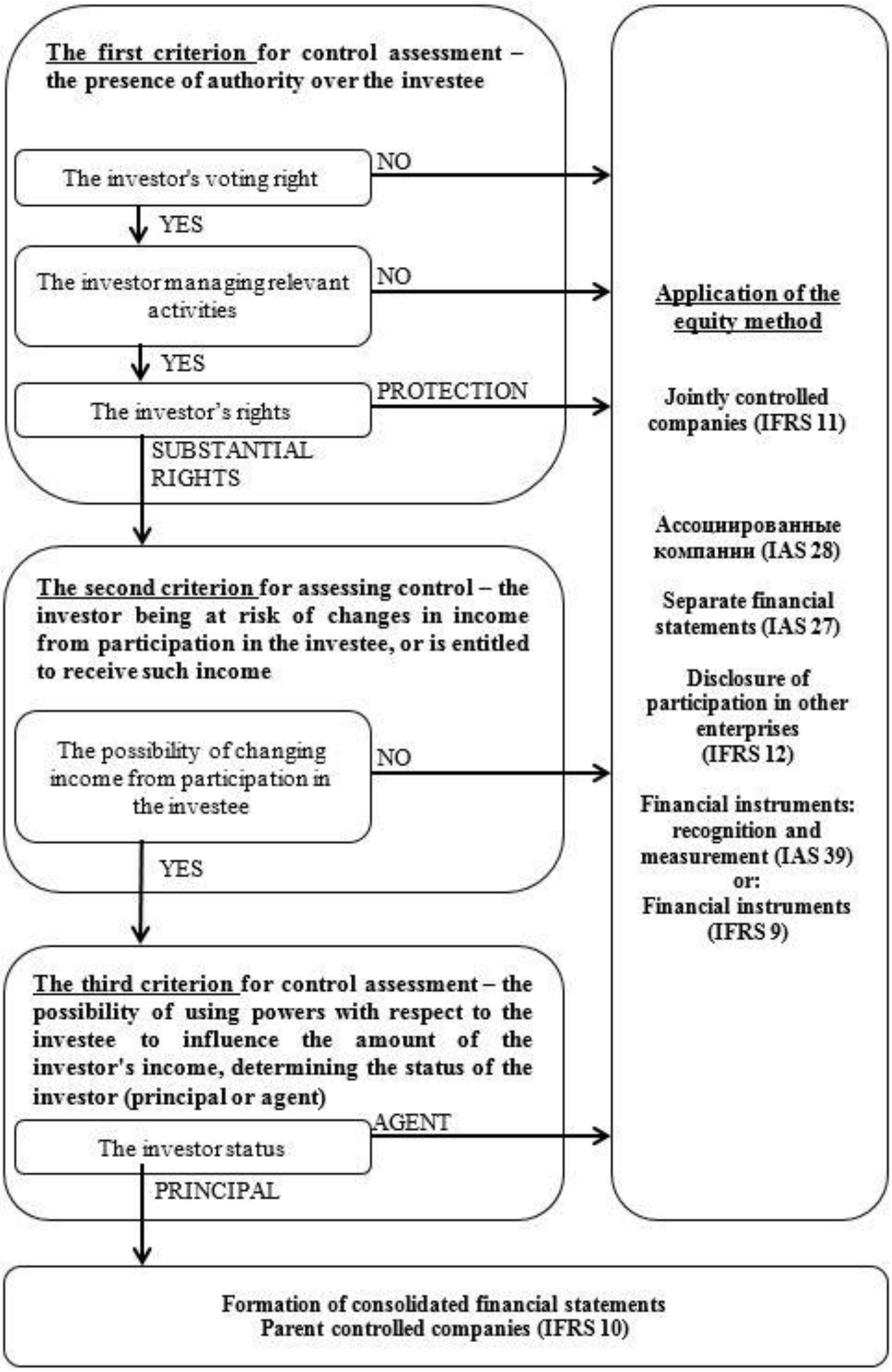

Fig. 5: Criteria for comparing the presence of investor control over the investee Flowchart for testing the evaluation of control in relation to the investee

V. DISCUSSION

Economists Cirstea, A. and Carmen Baltariu, A. [24] have made a comparison of similarities and differences in the assessment of control in the formation of the consolidated financial statements of IFRS and US GAAP standards according to the following criteria:

- the presence of the direct control concept;
- the presence of the indirect control concept;
- control of ownership while owning less than 50% of the property;
- the requirement of contractual support to control less than 50% of the property;
- the requirement of legal support to control less than 50% of the property;
- the presence of a de facto control concept;
- availability of specific guidelines for the de facto control concept;
- consideration of economic dependencies in assessing the availability of control over the investee;

- accounting of the size of the block of shares in comparison with other holders when assessing the presence of control over the investee;

- the existence of the concept of separation of powers, etc.

We believe that the proposed assessment criteria detail the basic requirements of the standard and are applicable in practice.

Some interesting research has been conducted by Israeli scientists Ben-Shahar, D., Sulganik, E., Tsang, D. [25] to study the requirements of IFRS 10. As the scientists note, this standard provides new principles for determining investor control over an investee in order to prepare CFS, while the scientists have pointed out the contradiction between the principles of the control assessment and principles for building the Banjaf index and the Shapley-Shubik index. According to the indices of Banjaf and Shapley-Shubik, one unit of a participant in a vote can affect the odds in one direction or another. In other words, according to Shapley-Shubik, the party in the future can turn the winning coalition into a loser, which formalizes the concept of "balance of power" in the process of creating a coalition. Commenting on this point of view, we believe that the principles for evaluating controls set out in IFRS 10 do not bear significant contradictions with the calculation of the mentioned indices, since to define such concepts as significant activities, distribution of voting rights, etc., to a certain extent, the participants have to rely on economic and legal judgements.

VI. IMPLEMENTATIONS

Noting that a number of the above criteria are not consistent with the latest edition of the IFRS 10 standard, we therefore propose to carry out this comparison in the areas shown in Fig. 6.

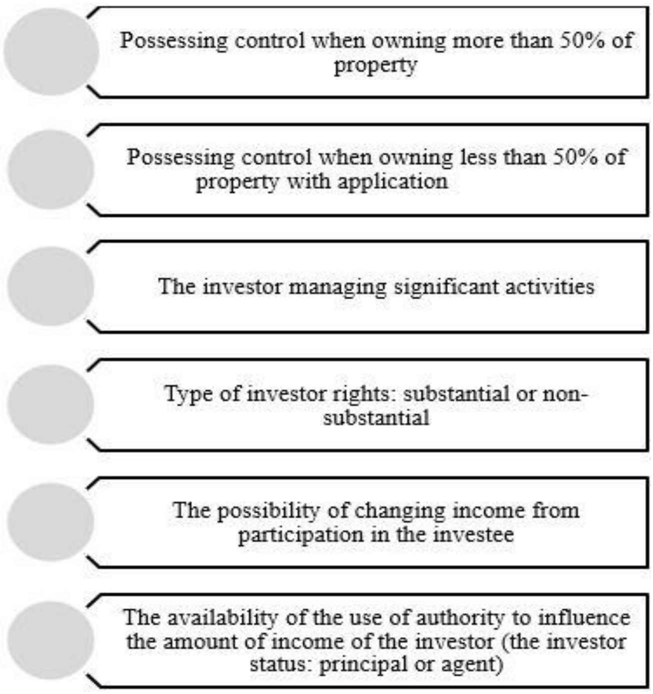

Fig. 6: Criteria for comparing the presence of investor control over the investee

The key differences in the assessment of control in the formation of consolidated financial statements of IFRS and US GAAP standards are in the use of a methodology to determine whether the use of authority is possible to influence the amount of the investor income (the investor status: principal or agent). The criteria for comparing the presence of investor control over the investee, shown in Figure 6, are based on the proposed flowchart and its description.

VII. CONCLUSION

As a result of the study of the basic requirements of the IFRS 10 standard regarding the control assessment, practical examples show the method for determining the presence of control in the ownership of various percentage of shares with voting rights. Also, the need for judgement is stated in considering various situations.

The proposed flowchart for testing control assessment contains a method of phased verification of compliance with investor control in relation to the investee. The application of the proposed flowchart will help to choose the right decision regarding the composition of financial reports and either to form CFS companies controlled by the parent company, or to make reports using the equity method, etc. The proposed testing methodology will help optimize checking the compliance with IFRS requirements by the accounting services regarding the evaluation of control over the investee.

REFERENCES

1. Federal law N 208-FL (version of 31.12.2017) “On Consolidated Financial Statements”, July 27, 2010. Legal reference system “Consultant Plus”. Retrieved April 29, 2019, from http://www.consultant.ru/document/cons_doc_LAW_103021/
2. L.B. Trofimova, “Relevant financial statements in the context of the development of integration processes”, Moscow: Infra-M, 2015. DOI: 10.12737/14656 (In Russ.)
3. “Generalization of IFRS applying practice in the Russian Federation”. Official site of Ministry of Finance of the Russian Federation, 2017. Retrieved April 29, 2019, from https://www.minfin.ru/ru/perfomance/accounting/mej_standart_fo/legalframework/#
4. E.M. Akhmetshin, E.A. Osadchy, “New requirements to the control of the maintenance of accounting records of the company in the conditions of the economic insecurity”, *International Business Management*, 9(5), 2015, pp. 895-902. DOI:10.3923/ibm.2015.895.902
5. F. Sotti, L. Rinaldi, G. Gavana, “Measurement options for non-controlling interests and their effects on consolidated financial statements consistency. which should the disclosure be?”, Corporate Ownership and Control, 12(2-3), 2015, pp. 293-302.
6. D.S. Usanova, R.Z. Mukhametzyanov, “Initial consolidation of financial statements of Russian companies: Actual issues. Paper presented at the Social Sciences and Interdisciplinary Behavior”, Proceedings of the 4th International Congress on Interdisciplinary Behavior and Social Science, ICIBSOS 2015, 2016, pp. 249-252.
7. W. Van Zijl, W. Maroun, “Discipline and punish: Exploring the application of IFRS 10 and IFRS 12”, Critical Perspectives on Accounting, 44, 2017, pp. 42-58. DOI:10.1016/j.cpa.2015.11.001
8. A. Casajus, H. Labrenz, “Recognition of non-controlling interest in consolidated financial statements based on property rights”, *Review of Law and Economics*, 13(3), 2017. DOI:10.1515/rle-2015-0050

9. T. Gluzová, “Disclosure of subsidiaries with non-controlling interest in accordance with IFRS 12: Case of materiality”, *Acta Universitatis Agriculturae Et Silviculturae Mendelianae Brunensis*, 64(1), 2016, pp. 275-281. doi:10.11118/actaun201664010275
10. A. d'Arcy, A. Tarca, “Reviewing IFRS goodwill accounting research: Implementation effects and cross-country differences”, *International Journal of Accounting*, 53(3), 2018, pp. 203-226. DOI:10.1016/j.intacc.2018.07.004
11. A. Amorós Martínez, J.A. Cavero Rubio, “The economic effects of IFRS goodwill reporting”, *Australian Accounting Review*, 28(3), 2018, pp. 309-322. DOI:10.1111/auar.12200
12. F. Mazzi, P. André, D. Dionysiou, I. Tsalavoutas, “Compliance with goodwill-related mandatory disclosure requirements and the cost of equity capital”, *Accounting and Business Research*, 47(3), 2017, pp. 268-312. DOI:10.1080/00014788.2016.1254593
13. N.V. Generalova, D.N. Olenkov, “The consolidated financial statements according to IFRS: voluntary or mandatory?”, *Accounting. 1C*, 5, 2014, pp. 31-35.
14. L.V. Sotnikova, “The consolidated financial statements are: the need to build”, Accounting in construction organizations, 8, 2014, pp. 44-49.
15. S.I. Puchkova, “Business combinations and consolidated financial statements in the period of transition to IFRS”, *Accounting*, 5, 2015, pp. 26-29.
16. Y.U. Tikhonova, “The consolidated accounts as the basis for determining the financial condition of the corporation”, Master's Herald, 12-2(51), 2015, pp. 65-67.
17. L.B. Trofimova, “Application coefficient diagnosis in factor analysis of the consolidated financial statements”, *Financial analytics: problems and solutions*, 38, 2014, pp. 39-50.
18. IFRS 10 Consolidated Financial Statements. Official site of Ministry of Finance of the Russian Federation. Retrieved April 29, 2019, from https://www.minfin.ru/common/upload/library/2016/02/main/RU_BlueBook_GVT_2015_IFRS_10.pdf
19. E.A. Osadchy, E.F. Amirova, T.N. Bochkareva, Y.Y. Gazizyanova, A.V. Yumashev, “Financial statements of a company as an information base for decision-making in a transforming economy”, *European Research Studies Journal*, 21(2), 2018, pp. 339-350.
20. D.E. Weinstein, “New IFRS on consolidation and fair value measurement”, Moscow: Alpina Publishers LLC, 2013.
21. L.K. Gurieva, A.N. Savicheva, V.I. Kataeva(Sventa Yarvik), A.N. Norkina, “Theoretical foundations of management of the organization: Development, types of structures, management methods of control”, *International Business Management*, 10(22), 2016, pp. 5406-5416. DOI:10.3923/ibm.2016.5406.5416
22. E.A. Osadchy, E.M. Akhmetshin, “Accounting and control of indirect costs of organization as a condition of optimizing its financial and economic activities”, *International Business Management*, 9(7), 2015, pp. 1705-1709. DOI:10.3923/ibm.2015.1705.1709
23. E.M. Akhmetshin, “The System of Internal Control as a Factor in the Integration of the Strategic and Innovation Dimensions of a Company’s Development”, *Journal of Advanced Research in Law and Economics*, 8(6), 2017, pp. 1684-1692. DOI:10.14505/jarle.v8.6(28).03
24. A. Cirstea, A. Carmen Baltariu, “Convergence of Consolidated Financial Statements Regulations: Are we there Yet?”, Procedia Economics and Finance, 15, 2014, pp. 1297-1303.
25. D. Ben-Shahar, E. Sulganik, D. Tsang, “Does IFRS 10 on consolidated financial statements abandon accepted economic principles?”, *Australian Accounting Review*, 26(4), 2016, pp. 341-345. DOI:10.1111/auar.12135