CONSOLIDATION POLICY: PAST, PRESENT AND FUTURE APPROACHES TO THE CONCEPT OF CONTROL

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Preparing consolidated financial statements has been a common practice for groups of companies around the world for a relatively long time, going back one century in the USA and tens of years in different European countries.A far-reaching issue regarding consolidation accounting policy is the concept of control, as it holds a crucial role in determining the basis of consolidation and the applicable method of consolidation and subsequently in influencing the content of the group financial statements. We focus in our article on the concept of exclusive control as it is approached by the relevant International, American and European standards, casting light also on possible future developments of this concept. The objective of our study is to acknowledge the differences and similarities between the approaches to the control concept, closing with the presentation of the influences of these approaches on the basis of consolidation.

Keywords: Group, Consolidation, Control, IFRS

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1. INTRODUCTION

Preparing consolidated financial statements has been a common practice for groups of companies around the world for a relatively long time, going back one century in the USA and tens of years in different European countries. Within the EU, groups of companies have to publish consolidated statements in accordance with the 7th European Directive. Moreover pursuant to EU Regulation 1606/2002, listed groups have to publish (in addition) a set of consolidated statements prepared in accordance with IFRS (Tiron-Tudor & Müller, 2007: p. 66). A far-reaching issue regarding consolidation accounting policy is the concept of control, as it holds a crucial role in determining the basis of consolidation and the applicable method of consolidation and subsequently in influencing the content of the group financial statements. In other words, the objective of identifying the situation in which a company has to include in its consolidated financial statements the assets, liabilities and income pertaining to another company gravitates to a major extent towards the concept of control. The accounting literature and practice encounters a large diversity of opinion regarding the issue of control of another company (Henry, 1999: p. 39).

The objective of our study is to acknowledge the differences and similarities between the approaches to the control concept, closing with the presentation of the influences of these approaches on the basis of consolidation. We focus in our article on the concept of exclusive control as it is approached by the relevant International, American and European standards, casting light also on possible future developments of this concept. Thus we planed for our research to study the appropriate technical literature, the relevant legislation in the field of consolidations as well as the IASB's discussions chronology of its Project "Consolidations" and FASB's ED for the proposed Standard on Consolidated Financial Statements.

2. THEORETICAL SETTING OF THE CONCEPT OF CONTROL

Presently there is no standard definition of control. However there are common coordinates of the existing definitions, which focus basically on the ability to direct the financial and operating policy of a company and on the possibility to obtain benefits which originate from the respective company. A definition with a large international acceptance, which includes the two mentioned elements presents control as being the power to govern (direct) the financial and operational policy of an entity in such a manner as to receive benefits from its activities (Feleagă & Feleagă, 2007: p.24) This definition is based on the following two cumulative criteria for the existence of control: A) the power criterion and B) the benefits criterion.

A. The power to direct the financial and operating policies of an entity has the meaning of strategic power (IASB, 2006a: p. 5). The operating policies consist in the those policies which direct activities such as sales, acquisitions, marketing, production and human resources and the financial policies refer to those policies which direct the accounting policies: budget approval, credit policy, dividend policy, bond policy, cash management etc. (Ashwal, 2005: p. 7). The owner of this strategic power has the possibility to determine the way one entity's assets are used (either directly within its activities or indirectly by selling them), and has also the possibility to determine that entity to contract supplementary loans, to raise ore pay its debts (IASB, 2006a: p. 5). An important issue in this context is whether this strategic power must necessarily have an exclusive character or not. We believe that this power cannot be shared or divided, in other words in our opinion only one entity can control another entity. Where directing the financial and operational policies of an entity can take place only together (in common) with other entities involved, control is not present.

B. Deriving benefits from the activities of a controlled entity are mainly (and in most cases) linked to the ownership of capital instruments issued by that entity. The holder of such instruments can benefit a) directly through any returns on the shares in the form of dividends and through changes in the value of the shares (especially if they are listed) that are a result of those shares absorbing the variability of the entity's assets and liabilities or b) indirectly from any proceeds from selling that capital instruments. The range of possible benefits can be extended, as these derive from being able to utilize or deal with the assets and liabilities of the controlled entity.

According to the definition of control presented above, the control concept has an exclusive character (Matiş, 2003: p. 313). This exclusive control can have two forms: legal control and effective control (Malciu & Feleagă, 2002: p.22).

3. ASSESSING THE EXISTENCE OF CONTROL AS THE BASIS OF CONSOLIDATION

3.1 The US GAAP Approach to Control as the Basis of Consolidation

The FASB consolidation policy project has for many years focused on developing new standards to determine which entities should be included in consolidated financial statements (Ashwal, 2005: p. 2). This project is aimed at reconsidering the consolidation principles included in Accounting Research Bulletin No. 51, Consolidated Financial Statements (ARB 51), which was issued in 1959. ARB 51 describes the purpose of group financial statements and the general rule of consolidation policy. According to ARB 51 consolidated financial statements are required when one of the companies in the group directly or indirectly has a controlling financial interest in the other entities. Within this context control is considered as having ownership of a majority voting interest (i.e., over 50% of the outstanding voting shares of another company). Accordingly, only the existence of legal control is considered as the basis of consolidation. SFAS 94 amended ARB 51 to eliminate all of the exceptions to consolidation, except when control is likely to be temporary or if it does not rest with the majority owner (e.g. if the subsidiary is in legal reorganization or in bankruptcy. However, SFAS 144 eliminated this exception.) Actually neither ARB 51 nor SFAS 94 define control. The notion of control has always been in the American accounting literature but it was never defined (Henry, 1999: p. 39).

The declared purpose of group financial statements and the general rule of consolidation displayed in ARB 51 focus on companies that issue voting shares, which generally are business enterprises organized as for-profit corporations. Under these requirements consolidation is based on control, where control is generally measured as owning (directly or indirectly) more than 50% of an entity's outstanding voting shares of equity. However, during the years since ARB 51 has been issued, both business enterprises and not-for-profit organizations have continued to conduct a growing and diverse range of activities through increasingly complex organizational structures (Ashwal, 2005: p. 2). Therefore, FASB issued in 1995 an *Exposure Draft on Consolidated Financial Statements: Policy and Procedures*, where it arrived at a definition of control and outlined procedures for CPAs to use in preparing consolidated financial statements. Opposition to the ED was strong enough to cause FASB to vote it down (Henry, 1999: p. 41).

During 1999, the FASB issued a revised ED on consolidation policy, Consolidated Financial Statements: Purpose and Policy. The concept of control is defined as the ability to direct the policies and management that guide the ongoing activities of another entity so as to increase the benefits and limit the losses from those activities.

The FASB determined in 1999 that there was not sufficient Board member support to proceed with a final statement on the consolidation policy ED, although it believed that improved guidance in this area is desirable (Ashwal, 2005: p. 7). Six years later, the FASB issued an exposure draft, Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries, which should replace ARB 51. The ED carries forward the 50% plus one – bright line rule of ARB 51. This indicates clearly that the US GAAP is continuing the rule based approach to the concept of control.

3.2 The IASB Approach to Control as the Basis of Consolidation

International accounting consolidation rules (including the application of the concept of control) are included in IAS 27 (issued in 1989 and last revised in 2007), Consolidated and Separate Financial Statements (IAS 27) and SIC 12, Consolidation - Special Purpose Entities, an interpretation relating to IAS 27, which provides further indicators of control over SPEs.

Among other things, IAS 27 prescribes the requirements for preparing and presenting consolidated financial statements for entities under the control of a parent. Under IAS 27 consolidated financial statements should include all subsidiaries, which are defined as entities controlled by another company (parent). IAS 27 defines control as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. This definition involves the two cumulative criteria (power and benefits) presented in the beginning of this paper. It encompasses both the notion of governance (power) and the economic consequence of that governance (i.e., benefits and risks). Governance is related to the power to make decisions through the selection of financial and operating policies, which does not require active participation or ownership of equity instruments. Benefits may be related to present or future cash inflows either directed to the controlling entity or remaining in control of the controlling entity or may involve non-monetary increases in value to the controlling company. Risks may relate to present or future cash or non-monetary outflows either paid by the controlling entity or through assets controlled by the enterprise (Ashwal, 2005: p. 7).

Control is presumed to exist when an investor owns (directly or indirectly) more than 50% of voting interest in an entity. However, in particular cases it may be possible to demonstrate that such ownership does not mean control, especially when a significant minority interest exists or when another party has the ability to dominate the board of directors of the entity. The substance of the arrangement has to prevail, as it may provide evidence to rebut the presumption. In addition, control can exist even when an entity owns less than 50% of an entity's voting power when one or more of the conditions enumerated in IAS 27.13 exist.

It is obvious that the scope of control is broader than in the US GAAP world: IAS 27 covers both legal and effective control (including the statute control), whereas ARB 51 considered only legal control (based on the 50% threshold). In addition to the indicators in IAS 27.13 for the assessment of control, the potential voting rights identified in IAS 27.14 should also be considered in evaluating whether or not control exists.

3.3 The EU Approach to Control as the Basis of Consolidation

The EU accounting consolidation policy is laid down in the Seventh Council Directive, issued in 1983. This Regulation has been the main harmonization instrument in the field of consolidation policy on EU level. The Directive does not define the concept of control but displays (within Article 1) the following situations when a (subsidiary) undertaking (entity) has to be included in the consolidated financial statements of its parent:

- has a majority of the shareholders' or members' voting rights in another entity; or
- has the right to appoint or remove a majority of the members of the administrative, management or supervisory body of another entity and is at the same time a shareholder in or member of that entity; or
- has the right to exercise a dominant influence over an entity of which it is a shareholder or member, pursuant to a contract entered into with that entity or to a provision in its memorandum or articles of association; or
- is a shareholder in or member of an entity, and a majority of the members of the administrative, management or supervisory bodies of that entity have been appointed solely as a result of the exercise of its voting rights (this is not applicable if another entity has the rights referred to in the first three subparagraphs above with regard to that entity); or
- is a shareholder in or member of an entity and controls alone, pursuant to an agreement with other shareholders in or members of that entity, a majority of shareholders' or members' voting rights in that entity.

Furthermore, apart from these situations the Directive allows Member States to require an entity to be included in the consolidated financial statements if its parent: has the power to exercise, or actually exercises, dominant influence or control over that entity; or together with that entity are managed on a unified basis by the parent undertaking.

These situations are in fact indicators of the existence of control. The scope of control within the European Directive is very similar to that presented in IAS 27. It is clearly that the situations presented above encompass both legal and effective control. The contractual or statute control (as a form of the effective control) is also taken into consideration.

4. THE CONTROL BASED MODEL OF IASB'S AGENDA PROJECT "CONSOLIDATIONS"

In June 2003, the IASB added a project on Consolidation to its agenda, whose goal is to publish a single IFRS on consolidation to replace IAS 27 Consolidated and Separate Financial Statements and SIC-12 Consolidation – Special Purpose Entities such that the control criteria within a single IFRS should be developed for all entities (IASB, 2006a: p.1). This project forms part of the Memorandum of Understanding between the IASB and the FASB which sets out a Roadmap of Convergence between IFRSs and US GAAP 2006-2008. Most standard setters (including the IASB) have identified control as the appropriate basis for consolidation; however, there appear to be differences in the way control is interpreted in deciding whether consolidation is required. As a result, there may be differences in how a reporting entity is defined (Deloitte, 2007). Within this context, the IASB "Consolidations" project will provide more rigorous guidance around the concept of "control", which is the basis for consolidation under IAS 27.

4.1 Updating the Definition of Control

The Board has tentatively agreed to define control as the ability to direct the strategic financing and operating policies of an entity so as to access benefits flowing from the entity and increase, maintain or protect the amount of those benefits (IASB, 2006a: p.4). This definition contains three tests:

1) the ability to direct the strategic financing and operating policies of the entity (the 'Power Criterion');
2) the ability to access the benefits flowing from the entity (the 'Benefits Criterion'); and
3) the ability to use its power so as to increase, maintain or protect the amount of those benefits (the 'Link Criterion').

The first two tests correspond to the cumulative conditions presented in the definition of control at the beginning of this paper. The third test is the new element. This condition should be usually met (if the first two conditions are complied with). However, situations might occur when a company (A) has the abilities to direct the strategic financing and operating policies of another entity (B) and to access the benefits flowing from that entity (thus fulfilling the Power and Benefits Criteria) but pursuant to a contract entered into with that entity or to a provision in its memorandum or articles of association is not able to increase, maintain or protect the amount of the benefits flowing from that entity. In our opinion such situations should be rather exceptional.

4.2 Shifting the Focus of Control to the Assets and Liability

The staff basically agreed with the definition the Board has tentatively approved upon, but wished to amend it in order to focus on the assets and liabilities of the entity rather than the entity per se. Thus the considered type of wording is An entity has a controlling interest in another entity when it has exclusive rights over that entity's assets and liabilities which give it access to the benefits of those assets and liabilities and the ability to increase, maintain or protect the amount of those benefits.

We consider this change as being suitable and agree with the IASB staff who argues that the use of the assets and liabilities of an entity are, ultimately, what power over the strategic financing and operating policies is intended to capture. According to the staff, this characterization of control also provides a stronger link with benefits. It also avoids implying that control over assets and liabilities can only be achieved by directing the strategic financing and operating policies of an entity—control might be achieved other than through strategic power (IASB, 2006a: p. 5).

4.3 Assessing the Existence of Control by Considering Indicators

In many situations establishing whether an entity controls another entity is easy, because the rights are clear. This is especially the case when an entity owns (directly or indirectly) more than 50% of voting interest in another entity. This fact is consistent with the property rights literature which notes that, apparently, as the power over assets increases the evidence of that power should also become more apparent, because the rights should become better defined (IASB, 2006b: p. 8). In these situations the identification of control is based on the existence of *presumptive indicators*.

Possibly the most obvious presumptive indicator is the right to cast a majority of the votes of an entity, giving the holder the right to appoint that other entity's board of directors. However even if a company holds less than a majority voting rights in another entity, other presumptive indicators of control may be applicable such as (IASB, 2006a: p.11):

- it has the dominant voting power at meetings of the entity's governing body, when the balance of voting interests is widely dispersed and disorganized;
- it has exclusive rights to exercise more than half of the entity's voting rights by virtue of an agreement with other investors;
- it has exclusive rights under a statute or an agreement to determine the entity's strategic operating and financing policies.
- it has exclusive rights to appoint or remove the majority of the members of the entity's board of directors or equivalent governing body and control of the entity is by that board or body.

In the absence of presumptive indicators assessing control might require more judgment. The IASB staff believes that in such circumstances control should be assessed by considering the indicators that evidence the nature of the relationship between the investor and the investee. They might indicate that the dominant investor (but holder of less than the majority of voting rights) is participating in the activities of that other entity. Such indicators (considered collectively) could be structured into the following three categories (IASB 2006b: p. 11):
- The ability to dominate the governing body, and therefore the strategic policy decision process;
- The ability to participate in the management of an entity;
- The ability to access the residual assets of an entity.

5. CONCLUSIONS

From an International (IFRS) and European perspective (7^{th} Directive), the concept of control is much broader than under US GAAP. The US GAAP approach towards control is rule-based (50% bright line rule) and many analysts argue that this approach opens the door for creative accounting as it can be used to shape the basis of consolidation. For example, if companies need to get debt off their consolidated balance sheet, they get their equity ownership in a subsidiary under 50%. If the subsidiary prospers, they turn around and get that entity on the other side of the bright line (Henry, 1999: p. 40). The Enron debacle demonstrates best the need for a principle based approach of the concept of control: it did not consolidate hundreds of off-balance-sheet entities and failed for this reason to recognize the associated liabilities (Kivi, Smith & Wagner, 2004). However the convergence with IFRS will probably determine FASB to issue in the relatively near future a standard which will embrace the principle based approach to the concept of control, thus abandoning the 50% bright line rule and relying more on the accountant's judgment. The European perspective of the concept of control is somehow similar to the IFRS perspective. However the translation into Member States legislation of the options allowed by the 7^{th} Directive regarding effective control (Article 1.2) can influence the basis of consolidation of groups pertaining to different EU Members, especially when the conditions explicitly stated in the Directive (Article 1b,c,d) are not present.

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