1

Text objectives and introduction to consolidation

LEARNING OBJECTIVES

After studying this chapter you should be able to:

- Explain the concept of a group.
- Describe the different classifications for investments in other entities and the accounting methods that apply to each.
- Outline the historical development of consolidated financial reporting and demonstrate the importance of proper consolidation accounting.
- Determine the entities that must prepare consolidated financial statements.
- Describe the definition of control and the indicators of control as set out in AASB 10 *Consolidated Financial Statements*.
- Apply the definition of control to examples likely to be found in practice (including in the not-for-profit sector).
- Identify the main uses and limitations of consolidated financial statements.

AASB standards referenced in this chapter

AASB *Framework for the Preparation and Presentation of Financial Statements*
AASB 3 *Business Combinations*
AASB 5 *Non-current Assets Held for Sale and Discontinued Operations*
AASB 9 *Financial Instruments*
AASB 10 *Consolidated Financial Statements*
AASB 11 *Joint Arrangements*
AASB 12 *Disclosure of Interests in Other Entities*
AASB 101 *Presentation of Financial Statements*
AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*
AASB 119 *Employee Benefits*
AASB 127 *Separate Financial Statements*
AASB 128 *Investments in Associates*
AASB 139 *Financial Instruments: Recognition and Measurement*
AASB 1057 *Application of Australian Accounting Standards*

1.1 Introduction

This book describes and explains how to account for, and report upon, inter-entity investment relationships. An 'entity' is defined in paragraph 6 of SAC 1 *Definition of the Reporting Entity*, as "any legal, administrative, or fiduciary arrangement, organisational structure or other party (including a person) having the capacity to deploy scarce resources in order to achieve objectives". Entities can include companies, partnerships and trusts, as well as other types of arrangements as indicated in the SAC 1 definition. Entities can have many different types of relationships with each other. For example, they can buy and sell goods and services from each other, borrow or lend money to each other, combine to jointly produce a good or service, or one entity can take an ownership interest in another by way of purchasing the latter entity's equity (for instance, A Ltd (the 'investor') may purchase 100% of the issued shares of B Ltd (the 'investee')). In this book our main focus is the situation in which two or more entities combine in some way, usually but not exclusively through equity ownership, to conduct operations. For ease of exposition, this book will typically explore accounting for investor–investee relationships using corporate entities, although the principles throughout the book can be applied to any type of entity.

In the next section we provide a broad overview of some of the key concepts and basic terminology that are relevant to understanding these inter-entity relationships. In later sections of this chapter and throughout this book, these basic concepts will be explored in greater detail.

1.2 Some basic concepts and terminology

The nature of the relationship between two or more entities can vary greatly. For example, if X Ltd held only 5% of the issued shares of Y Ltd, then it would be very unlikely that X Ltd could use its shareholding to impact upon how Y Ltd conducted its operations. On the other hand, if X Ltd held 100% of the issued shares of Y Ltd, then it could effectively direct Y Ltd to behave in any manner X Ltd wished. Clearly, the nature of X Ltd's asset—its investment in Y Ltd—is very different depending upon which of these two types of investment relationship it has. If X Ltd has 100% of the issued shares of Y Ltd, then it can effectively employ not only its own net assets, but it can also use its voting power in Y Ltd to use the net assets of Y Ltd in X Ltd's operations. Consequently, the central accounting problem that is explored in this book is, *if two or more entities operate together, how should the economic impacts of that relationship be reflected in financial reporting?* Another way of stating this problem is to ask if we should prepare two sets of general purpose financial statements: one for X Ltd and a separate set for Y Ltd, or is the economic substance of the relationship between X Ltd and Y Ltd so close that they effectively operate as if they were only one entity and so only one set of financial statements should be prepared based on the *combined* net assets of X Ltd and Y Ltd? The short answer to this problem depends on the *extent* to which the investor entity can direct the key relevant activities of the investee. In the case where the investor can 'control' the investee, then for accounting purposes we treat the two separate entities as though they were one 'economic entity' and prepare one set of financial statements for the economic entity, often called the 'group' financial statements. Figure 1.1 explains the nature of the economic entity.

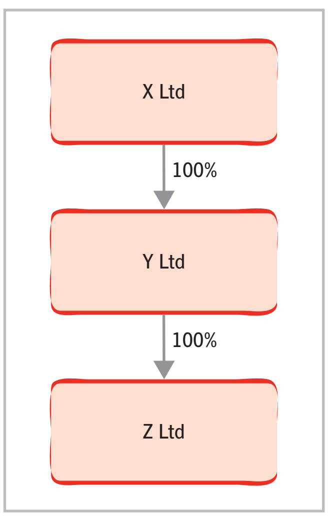

FIGURE 1.1 The X Ltd group

As X Ltd, Y Ltd and Z Ltd are companies, they each are recognised as separate entities under the law. In principle, X Ltd, Y Ltd and Z Ltd could each present their own set of general purpose financial statements. However, X Ltd owns 100% of the issued voting shares of Y Ltd and Y Ltd owns 100% of the issued voting shares of Z Ltd. As X Ltd can use its voting power to direct Y Ltd's activities, it can effectively also direct Z Ltd's activities because of Y Ltd's power over the voting shares of Z Ltd. Consequently, X Ltd controls the net assets of *both* Y Ltd and Z Ltd. As a result, for accounting purposes, X Ltd, Y Ltd and Z Ltd are viewed as though they are one economic entity. The economic entity is represented by the shaded boxes in Figure 1.1. We would call this economic entity the 'X Ltd group'.

Take a moment to consider more deeply the membership of the X Ltd group and the relationships between the three companies that make up the group. If we begin from the bottom of the group, Z Ltd is called the 'subsidiary' of Y Ltd because Y Ltd has control over Z Ltd due to its holding of 100% of Z Ltd's voting shares. In the Y Ltd/Z Ltd relationship, Y Ltd is the 'parent' of Z Ltd (see AASB 10 *Consolidated Financial Statements*, Appendix A). However, if we then go further up the group, we can see that this relationship is repeated between X Ltd and Y Ltd. As X Ltd controls the voting shares of Y Ltd, X Ltd is the parent of Y Ltd and Y Ltd is X Ltd's subsidiary. If we take the whole group together, X Ltd is called the 'ultimate' parent and both Y Ltd and Z Ltd are subsidiaries of X Ltd because X Ltd can effectively control both Y Ltd and Z Ltd. If we assume for the moment, that the X Ltd group is a reporting entity, then it must prepare general purpose financial statements for the economic entity that is the X Ltd group. As will be described in more detail throughout this book, only one set of general purpose financial statements are prepared for the X Ltd group based on the combined net assets of the parent and its subsidiary. The financial statements of the group are called 'consolidated financial statements'. In practice, X Ltd, Y Ltd and Z Ltd would likely prepare individual financial statements for *internal* use by management but when preparing general purpose financial reports for use by parties external to the X Ltd group, it would be usual to prepare only consolidated general purpose financial reports. In other words, the example in Figure 1.1 is treating the X Ltd group as the reporting entity responsible for preparing general purpose financial reports rather than X Ltd, Y Ltd and Z Ltd being treated as separate reporting entities in their own right. As an aside, if Y Ltd was also deemed to be a reporting entity, then it would prepare its own consolidated financial statements for the Y Ltd group (consisting of Y Ltd and Z Ltd's net assets). The issue of identifying reporting entities is examined in more depth in Section 1.6.2 of this chapter.

It should also be noted that a group does not necessarily need to take the structure shown in Figure 1.1. Many different types of structures could be groups for accounting purposes. As just one example, X Ltd may own 100% of Y Ltd's voting shares and directly own 100% of Z Ltd's voting shares as shown in Figure 1.2. The X Ltd group still consists of three entities but the structure of their interrelationships is different. The common element in both Figure 1.1 and Figure 1.2 is that X Ltd controls Y Ltd and Z Ltd.

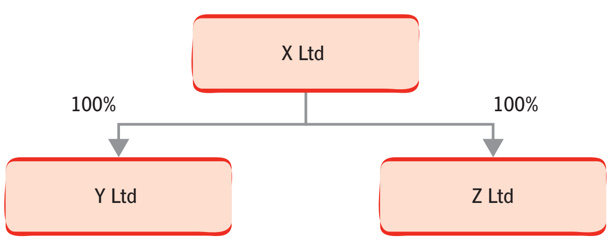

FIGURE 1.2 The X Ltd group

1.3 Why do entities form groups?

A group such as that depicted in Figure 1.1 may arise following takeover activity undertaken to control a larger share of market activity and reduce costs per unit of output. Motivations for a takeover include vertical or horizontal integration to increase the scale of operations and market share. Alternatively, sometimes the companies in a group are formed (incorporated) for a specific purpose, such as to undertake a new business opportunity or to operate in a new location. It is possible for companies in a group to operate in the same industry, related industries or unrelated industries. In addition, the companies may operate in different or similar geographical regions.

The Australian Companies and Securities Advisory Committee (2000), Ramsay and Stapledon (2001) and Dean and Clarke (2005) identified the following potential benefits of conducting economic activity through a group structure, including:

- Reducing commercial risk or maximising potential returns by diversification.
- Attracting capital without forfeiting control. Management may not wish to allow outside investors to increase their level of ownership in the parent company, but want outside investment as part of their overall business.
- Lowering the risks of legal liability, including environmental and consumer liability. By setting up a number of separate subsidiaries, certain assets can be isolated and protected from high-liability risks. Effectively, this amounts to using the 'corporate veil' to manage risk.
- Providing better security for proposed loans. By transferring assets into a separate company, a potential lender will have the opportunity to obtain a first charge over specific assets. This could benefit the group by facilitating a lower cost of borrowing, particularly through project financing.
- Complying with regulatory requirements. Some multinational groups need to comply with the domestic rules that require business operations to be conducted through local subsidiaries.
- Minimising taxation. Different countries have different company tax rates, which can be exploited (within certain constraints) using transfer pricing.

The survey by Van der Laan and Dean (2010) reports that the average number of controlled entities for ASX-listed companies is approximately 12. Not surprisingly, the median is much lower at four (the distribution is positively skewed). Large companies tend to have a large number of subsidiaries—for the largest 10% of companies by market capitalisation the mean number of controlled entities is 62 (median is 33).

While a group structure may provide significant benefits to its stakeholders, there are potential abuses of such a structure. In Australia there have been a number of well-publicised cases recently, such as the one involving James Hardie, which have raised issues about the structuring and restructuring of corporate groups and 'asset shuffling' to achieve the strategic aims of management (see Clarke and Dean, 2007). More generally, the global financial crisis (GFC) of 2008 provided further examples of how structuring inter-entity relationships could be used to transfer risk and avoid transparency in financial reporting. Such practices have challenged accounting standard setters around the world to develop accounting rules that minimise the ability of financial statement preparers to exploit structured entities for opportunistic purposes. Accounting standard setters' responses to this behaviour are explored in more detail in Section 1.5.

1.4 Overview of accounting for different investor–investee relationships

In Section 1.2 the focus was upon an inter-entity relationship in which the investor entity had control over the investee entity. This gave rise to a parent/subsidiary relationship with the result that for accounting purposes the two separate legal entities were treated as though they were one economic entity. Of course, not all inter-entity relationships are based on one entity controlling another. Relationships between investor and investee entities range across a continuum from control to no special interaction (e.g., an investor may be holding an equity interest in an investee only for short-term speculation). As stated in Section 1.2, as the strength of the relationship between the investor and investee changes, the economic substance of the investor's asset (i.e., its investment in the investee) changes. The investor's accounting for that asset should also differ as a result. In their efforts to ensure that general purpose financial statements present decision-useful information, accounting standard setters have identified four types of investor–investee relationships and specified the different accounting policies that must be adopted for each of these four categories of relationship. Table 1.1 provides a high-level summary of the relevant accounting requirements for investor–investee relationships.

TABLE 1.1 Summary of accounting for investor–investee relationships

Nature of relationship between investor & investee	Name given to investee entity	Name given to investor entity	Relevant accounting standard(s)	Accounting method for investor's interest
No special relationship	Investee	Investor	AASB 139 OR AASB 9	Fair value
Significant influence	Associate	Investor	AASB 128	Equity method—proportional share of associate's profits
Joint control	Joint arrangement	Venturer or operator	AASB 11/AASB 128	Proportional share of joint arrangement's assets, liabilities & expenses or the equity method
Control	Subsidiary	Parent	AASB 10	Consolidation–combination of all entities' financial statements

Table 1.1 shows that as the strength of the investor's relationship with the investee grows, the appropriate accounting method changes to reflect the greater level of interest the investor has in the investee's net assets. In the case where there is no special relationship, the investor shows its interest in the investee as a mere 'one-line' asset (e.g., 'Investment in Y Ltd') but at the other extreme where the investor controls the investee, the investor's one-line asset in the investee is effectively replaced by all the individual assets and liabilities of the investee. As the investor–investee relationship becomes more complex, so does the investor's associated accounting method. These complexities are explored in detail in later chapters but a brief summary is provided in the following sections. In practice, an investor may have a range of investees, some of which are 'controlled', some subject to joint control, some significantly influenced by the investor,

and some for which there is no special relationship. In such cases consolidated general purpose financial statements would be prepared that include not only the combined financial statements of the investor and its subsidiaries but also interests in joint arrangements and associates that are accounted for using either the line-by-line method or the equity method.

1.4.1 Investments in controlled entities (subsidiaries)

Figure 1.1 depicts a group that comprises three companies, X Ltd, Y Ltd and Z Ltd. It was noted in Section 1.2 that since X Ltd owns 100% of the issued capital of Y Ltd and Y Ltd owns 100% of the issued capital of Z Ltd, X Ltd is able to control the economic resources owned by Y Ltd and Z Ltd. X Ltd is also in a position to direct how those resources are used in operating activities. Consequently, where X Ltd controls Y Ltd and Z Ltd, one set of consolidated financial statements will be prepared for the X Ltd group.

Section 1.2 indicated that the companies in Figure 1.1 represent three separate legal entities. A question arises as to whether the needs of users desiring information on the economic activities of X Ltd are satisfied by a financial report based on the financial position and financial performance of X Ltd (only) or whether financial information relating to the group is more relevant. The relevance of group information can be demonstrated by using the example of the X Ltd group in Figure 1.1. The assets of the parent X Ltd include a 100% interest in the net assets (assets less liabilities) of Y Ltd and Z Ltd. The parent entity controls the resources and operations of all companies in the group and investors in the parent entity need financial information based on the group to hold management of the parent company responsible for the financial performance of the group.

X Ltd's control over Y Ltd and Z Ltd implies the following for the investors in X Ltd:

- Since X Ltd owns 100% of the net assets of its two subsidiaries, it owns all of the equity of the subsidiaries. For example, if Y Ltd were wound up, then X Ltd would be entitled to 100% of any surplus of Y Ltd's assets remaining after its liabilities were settled or extinguished.
- Any increase in the net assets of a controlled company, as represented by profits and other comprehensive income, ultimately benefits its shareholders as residual claimants. For example, if Y Ltd earned a profit of $10million the portion distributed as a cash dividend would increase X Ltd's net assets (and cash balance). This, in turn, could be distributed to X Ltd's shareholders, provided the legal test of solvency is met. The portion of the profit reinvested by Y Ltd, rather than being distributed as dividends, would expand Y Ltd's operations, increasing the value of the parent company's investment asset and indirectly the value of the shares held by investors in X Ltd.
- The cash flows of the parent company are related to the cash distributions that it may receive from a controlled (subsidiary) company.

It follows that relevant information for the shareholders of X Ltd includes the financial performance, financial position and cash flows of its controlled investments, Y Ltd and Z Ltd, that is, the economic entity as a whole. Financial statements that include financial information relating to subsidiaries (i.e., the controlled entities) assist stakeholders in the group in making rational economic decisions by releasing information about the underlying assets, liabilities and profits relating to investments in subsidiaries. Such information also allows an assessment of how management has discharged its accountability for the use of controlled economic resources. If this information were given by attaching the separate financial statements of each subsidiary to the parent's financial statements it would be difficult to use, particularly if the parent had numerous subsidiaries and there were numerous transactions between entities within the group. The solution is to summarise the financial information of the parent company and all its subsidiaries into one consolidated report that includes consolidated financial statements reporting on the financial performance, financial position, changes in equity and cash flows of the group. Consolidation accounting in Australia is regulated by AASB 10 *Consolidated Financial Statements*. Although a number of (sometimes complex) adjustments are required to avoid double-counting of the group's net assets, consolidated financial statements are in principle created by adding together the financial statements of the individual entities within the group. For example, the consolidated Statement of Financial Position of the X Ltd group in Figure 1.1 would be obtained by adding the Statement of Financial Position of X Ltd, to that of Y Ltd, and to that of Z Ltd. The consolidation process is explained in detail in later chapters.

The importance of the consolidated financial statements can be seen by noting that the financial press focuses on the profit reported by the group when commenting on the accounting results reported by management. Indeed, such is the focus on group (compared to parent) income that the financial press most commonly omits the reference to 'group' when discussing the income number. Financial journalists focus on the group's performance and how this compares to expectations. Similarly, analysts forecast group rather than parent entity earnings and earnings per share.

Subsequent to the release of results for the year, the chairman of the board of directors of a listed parent entity and the CEO of the listed parent entity will review and comment on the results of operations for the period. These are normally referred to as the 'Chairman's Review' and the 'Chief Executive Officer's Report'. Comments on results and strategies are also at the level of the group. In conclusion, analysts, the financial press, management and the board are all focused on the measure of group earnings, which is the outcome of the consolidation process.

1.4.2 Investments in jointly controlled entities and operations

A company will sometimes share control of economic resources with another or other entities. For accounting purposes, shared control becomes 'joint control' only when there is a contract between the controlling parties stating that all strategic decisions relating to the jointly controlled economic resources must have the unanimous consent of all the controlling parties. Note that joint control is necessarily a lower level of power than the unilateral control that creates a parent–subsidiary relationship. Joint control of economic resources is often necessary or desirable because the scale of some projects is so large that one entity does not wish to absorb all of the business risks of a project. Joint control may also be preferred to control because it enables two or more entities to bring different economic resources to a project that enable the overall value of that project to be maximised through their joint participation. For example, one entity may have acquired an intangible such as a mining licence and another entity may have experience and expertise in conducting mining operations. In some cases, joint control is necessary because the government of a particular country may prefer that a foreign company operates in that country by way of a joint arrangement with a local company. A joint arrangement with a local company can also bring valuable knowledge and expertise about differences in legal and cultural aspects of conducting business in that country. For example, in September 2014, Telstra and Telkom Indonesia entered into a joint arrangement to provide Network Application and Services (NAS) to Indonesian enterprises, multinationals and Australian companies operating in Indonesia. In a Telstra media announcement, a Telstra executive noted: "By partnering with Telkom Indonesia in the fast growing NAS market we leverage local expertise, a respected brand and service capabilities. The JV will deliver locally supported managed data network and security services, as well as cloud and unified communications services" (see http://www.telstraglobal.com/newsitem/telstra-and-telkom-indonesia-sign-joint-venture, accessed 24 August 2015).

One way of sharing economic resources is for all parties involved to transfer resources into a jointly controlled entity. For example, in the Telstra and Telkom Indonesia NAS joint arrangement, a company was formed in which Telkom Indonesia owns 51% of the new company and Telstra owns 49%. Note that the fact that the two parties own 100% of the voting shares between them is not enough to establish joint control—there must also be a contract between the two shareholders requiring unanimous consent to major decisions (AASB 11 *Joint Arrangements*, paragraph 7).

It is also possible for companies to share economic resources in a joint arrangement without transferring the resources to a separate legal entity. For example, one company may agree to share the production of an oil and gas site with another company that offers financial resources and experience in successful site development. These arrangements are based on contractual agreements that determine the rights and obligations of the participants. Once again, the contract must establish that the parties have joint control.

AASB 11 classifies joint arrangements into two categories: (1) joint operations; and (2) joint ventures. A joint operation is a joint arrangement in which the parties (known as joint operators) have joint control over the rights to the assets and obligations for the liabilities of the arrangement. A joint operator accounts for its interest in the joint operation using the line-by-line method. The line-by-line method involves recognising the operator's proportionate share in each asset, liability and expense that relates to the contractual arrangements. Where, for example, the jointly controlled asset is a wharf with a cost of $10million an operator with a 40% interest will recognise a carrying amount of $4million (its share) for the wharf on its statement of financial position.

Unlike a joint operation, a joint venture is a joint arrangement in which the parties (known as joint venturers) have control over the rights to the net assets of the arrangement. For example, two telecom companies may decide to form a third company with which they will conduct a joint venture. Each of the telecom companies owns 50% of the shares in the third company and receives a return based on profits generated by the third company. As the rights of the telecom companies extend only to the net assets of the third company, the arrangement is a joint venture. It should be noted that although the creation of a separate entity for the joint arrangement might normally be a signal that a joint venture has been formed, this is not always the case and the classification of a joint arrangement as a joint operation or a joint venture depends on a detailed examination of the specific facts in each case. Chapter 9 provides detailed coverage of accounting for joint arrangements.

1.4.3 Investments in significantly influenced entities (associates)

An investee may be subject to significant influence as opposed to control or joint control. If A Ltd has the power to participate in the financial and operating policy decisions of B Ltd, but does not have either control or joint control over the financial and operating policies of B Ltd, then A Ltd has significant influence over B Ltd and B Ltd is an 'associate' of A Ltd. Significant influence normally occurs when one entity has a substantial ownership interest in another entity. In practice, investments in associates are quite common, particularly for listed companies. Investments in associates are accounted for using the equity method of accounting. This involves the initial recognition of the investment at cost. The investment asset carrying amount is later increased (or decreased) by the investor's percentage share of the post-acquisition profits (or losses) and other comprehensive income of the associate. Changes in the investment asset carrying amount lead to associated changes in the profits and reserves of the investor. The equity method reports income and investment asset values that provide more information on investment performance and investment value than the cost method, which records revenues when dividends are received (or receivable) and restates the carrying amount in the case of impairment or disposal of the investment. However, there is controversy over whether the equity method is a valid form of accounting. Some commentators argue that it is unclear whether the equity method is a form of measuring the value of an investment in an associate or whether it is a form of consolidation because the application of the equity method requires some of the adjustments that are associated with preparing consolidated financial statements (Miller and Leo, 1997). In addition, given that the equity method involves the investor bringing onto its financial statements net assets over which it only has significant influence, it is debatable whether the equity method breaches the definition of an asset in the AASB *Framework for the Preparation and Presentation of Financial Statements*, which requires that an entity *control* economic resources (paragraph 49(a)). Chapter 9 provides detailed coverage of the application of the equity method of accounting for investments in associates.

1.4.4 Investments in other equity interests

An investor can also hold an equity interest in an investee without attaining control, joint control or significant influence over that entity. This will commonly be the case when a company holds a relatively small stake in the equity of another entity. It is a very common form of investment and is usually undertaken with the objective of achieving a return on the investment (i.e., capital gains and dividends) as a passive investor. Investments of this type may precede further investments that eventually result in the investor achieving significant influence and even control. Normally, small equity investments are classified as 'financial assets'. At present, financial assets could be accounted for using either AASB 139 *Financial Instruments: Recognition and Measurement* or AASB 9 *Financial Instruments*. AASB 139 was issued in July 2004 and is currently the mandatory standard with regard to the recognition and measurement of financial assets. However, as a result of reforms instituted by accounting standard setters in response to the GFC, the various provisions of AASB 139 are being incrementally replaced by those in AASB 9 and other standards. AASB 9, first issued in 2009, has a mandatory application date for annual reporting periods beginning on or after 1 January 2018. Entities have the option to 'early adopt', but if they do so they must apply all the requirements of that standard (AASB 9 Aus1.3). Many entities have made the choice to early adopt AASB 9 and so the broad requirements of both of those standards are described here. Note that under AASB 139.2 and AASB 9.2.1, equity investments that are subsidiaries, associates or joint arrangements are excluded from the scope of AASB 139 and AASB 9.[1]

AASB 139 has the following relevant requirements. Except for investments, the fair value of which cannot be reliably measured and must be measured at cost (AASB 139. 46(c)), equity investments are measured at fair value. The accounting for changes in fair value required by AASB 139 depends on the classification of financial assets into one of four possible categories. In the case of small equity investments only the following two categories are relevant.

1 Financial asset at fair value through profit or loss (AASB 139.9).

   This classification applies if the investment is either held for trading or is designated at fair value through profit or loss on initial recognition. This class of financial assets is measured at fair value with changes in fair value forming part of the profit or loss for the period (AASB 139.55(a)).

2 Available-for-sale financial assets (AASB 139.9).

This classification applies to investments that are designated as available-for-sale or are investments that cannot be included in any other category. These assets are measured at fair value. However, unlike assets classified as fair value through profit or loss, changes in fair value are initially included as part of other comprehensive income for the period. The gain or loss is transferred to profit or loss when either sold or written off (AASB 139.55(b)).

If an entity adopts AASB 9 for the recognition and measurement of its equity investments, then paragraph 5.1.1 requires that those financial assets be initially measured at the fair value of acquisition plus any direct acquisition costs. However, direct acquisition costs are expensed at the time the financial assets are acquired if those financial assets meet the definition of fair value 'held for trading'. Held for trading is defined in AASB 9.A and, in essence, means that the financial asset has been acquired principally for the purpose of selling or repurchasing in the short term. AASB 9 classifies financial assets as being one of two categories, "measured at amortised cost" or "measured at fair value". Paragraph 4.1.2(b) makes it clear that equity investments do not satisfy the definition of "measured at amortised cost" and so they must be classified as "measured at fair value". After initial recognition, any movements in the fair value of the equity investments must be recognised in the entity's current profit or loss (AASB 9.5.7.1) unless the entity makes a choice to take the movements through other comprehensive income. This choice cannot be changed later and cannot be applied to equity investments that are "held for trading" (AASB 9.5.7.5).

1.5 The importance of consolidation accounting

Section 1.4.1 described some of the reasons why aggregated financial information about the group may be more decision-useful than simply the provision of financial information about the individual members of the group. As a practice, the preparation and presentation of consolidated financial statements has had a long history. Initially, consolidation accounting was unregulated and entities made their own choices about whether they would provide consolidated financial statements. However, over time it became recognised that some managers chose to structure their groups in various ways so as to provide less accountability and transparency than would be desired by investors, creditors and other financial statement users. For example, managers have employed group structures to try to boost profits and asset values, hide underperforming subsidiaries, transfer risk from one entity to another, and hide risks such as high leverage. These undesirable practices have prompted a variety of regulatory reforms that have sought to minimise managers' ability to use entity structures as a means of reducing the decision usefulness of their group's financial statements. These reforms continue to the present day where recent high-profile corporate collapses and the GFC revealed certain inadequacies in accounting regulations relating to consolidation. This section details a history of the development of regulation associated with consolidation as a means of demonstrating how managers have tried to use entity structures inappropriately. It also highlights some of the key methods used to structure groups of related entities. Understanding this history will provide a better understanding of why the current standard, AASB 10, contains the requirements that it does and why it employs a definition of a group based on the principle of 'control' rather some other more clear-cut definition such as, for example, percentage of voting shares owned by the investor.

1.5.1 The historical development of consolidation reporting regulations

The concept of 'holding company' (now described as a parent company) existed in the US prior to 1850. In Australia, holding companies have been traced back to 1882 when Elder Smith and Co Ltd acquired a subsidiary (Spence, 1949). Whittred (1987a) argues that changes in Australian taxation laws provided one of the incentives for the growth in the formation of Australian groups.

In the US, the preparation of consolidated accounts as a means of financial reporting on the activities of a group can be traced back to the beginning of the 20th century. During the period from 1900 to 1940, consolidated accounts appear to have become increasingly popular. Similarly, in the UK, consolidation accounting was widely adopted by the late 1940s (Bircher, 1988). Walker (1978) attributes the UK's adoption of consolidated reporting to the inadequacies of conventional accounting methods for accounting for inter-corporate investments, specifically in relation to asset measurement and revenue recognition.

The development of groups and consolidated reporting in Australia largely follows the experience of the US and the UK. Table 1.2 builds on a chronology prepared by Walker and Mack (1998) and provides a summary of the evolution of Australian regulatory requirements encouraging or requiring the presentation of consolidated financial statements.

TABLE 1.2 Development of Australian regulatory requirements for consolidated reporting

Year	Reporting development
1925	Sydney and Melbourne stock exchanges require listed companies to provide statements of financial position and profit and loss accounts of subsidiaries as supplements to reports of holding companies
1927	Melbourne Stock Exchange (MSE) allows the choice of either separate accounts of subsidiaries or aggregate statements of subsidiaries as supplements to the reports of holding companies
1928	Sydney Stock Exchange (SSE) also allows the use of aggregate statements (as above)
1936	The *Victorian Companies Act* requires 'group accounts', which could take the form of consolidated accounts or separate accounts for subsidiaries
1941	SSE and MSE listing rules require newly listed companies to provide consolidated statements or separate statements for subsidiaries
1961	Australian uniform Corporations Law requires holding companies to provide consolidated accounts or separate accounts for all subsidiaries
1966	Australian Associated Stock Exchanges (AASE) require listed companies to provide notices of annual results in consolidated form
1971	AASE require annual accounts to be in consolidated form (unless an alternative presentation has been approved by the AASE)
1987	The Australian Accounting Research Foundation (AARF) issued ED 40 *Consolidated Financial Statements*
1990	The Accounting Standards Review Board (ASRB) issued ASRB 1024 *Consolidated Financial Statements*; ASRB 1024 did not take effect because of legal impediments in the Companies Code at that time
1990	AAS 24 *Consolidated Financial Statements* issued
1990	AASB 1024 *Consolidated Accounts* issued (gazetted in 1991)
1991	The Corporations Law (as it was then called) was amended so that it did not conflict with the requirements of AASB 1024—particularly the definition of a subsidiary for the purpose of financial reporting and the requirement to produce group accounts, which, prior to this amendment, did not necessarily mean consolidated accounts. These amendments were necessary before AASB 1024 could be gazetted
1992	AASB 1024 and AAS 24 were revised and reissued, requiring a consolidated cash flow statement instead of a consolidated funds statement

Continued

Year	Reporting development
2002	ED 139 *Business Combinations* was issued; it prescribed the accounting treatment of goodwill
2004	AASB 127 *Consolidated and Separate Financial Statements* and AASB 3 *Business Combinations* were issued
2005	ED 141 *Proposed Amendments to AASB 127* and ED 139 *Proposed Amendments to AASB 3* were issued in July
2008	Revised AASB 3 and IAS 27 were issued. These revisions allowed for the use of the full goodwill approach as an alternative to the purchased goodwill approach
2010	ED 171 *Consolidated Financial Statements* was issued
2011	AASB 10 *Consolidated Financial Statements* was issued
2013	AASB 10 amended to exempt certain 'investment entities' from consolidating their subsidiaries
2013	AASB 10 amended to include new Appendix E to provide implementation guidance for not-for-profit entities

The issue of Accounting Standard AASB 1024 *Consolidated Accounts* in 1991 is pivotal to the history of consolidation accounting in Australia. From the commencement of AASB 1024, group accounts were legally required to be in the form of a single set of consolidated financial statements that covered all members of the group. It was no longer possible to consolidate some members of the group but selectively omit to consolidate others.

1.5.2 The debate over voluntary consolidated reporting in Australia

Table 1.2 indicates that in the decades prior to 1991, when AASB 1024 mandated accounting requirements for consolidated financial statements, there had been a progressive strengthening of the regulatory requirements and a narrowing of reporting options available to holding companies. It is interesting to note that many Australian holding companies prepared consolidated accounts before legal requirements to do so were introduced. The 1966 Australian Associated Stock Exchanges listing rules were the first formal requirement for consolidated reporting. However, as documented by Whittred (1986) and Walker and Mack (1998), the provision of consolidated financial information by Australian listed companies was commonplace by the 1950s.

Whittred (1987b) attributes the evolution of consolidated reporting and its voluntary adoption by Australian parent entities as, in part, a result of the emergence of an innovative debt market that used cross-guarantees for debt obligations among the members of a corporate group. Typically, a cross-guarantee would involve each company in the group becoming jointly and severally liable for the debt obligations of some or all of the other companies in the group. This meant that a debt provider could claim against the assets of other companies in the group if the borrowing company defaulted on its loan payments. In addition, the debt obligations of the other companies in the group became relevant to the debt provider because of the possibility of claim dilution (a reduction in the probability of payment to a debt holder). Therefore, the effect of cross-guarantees was to remove the advantage of limited liability of the individual companies within the group. Consequently, the constraints in debt covenants, such as leverage ratios, were defined on a group basis by including the assets and debt obligations of other group companies that were guarantors. It follows that the most relevant financial information for the debt provider concerned not the individual company to whom the loan had been made but the combined financial information of the group (i.e., the consolidated financial statements). This assumes that all companies in the group are parties to the cross-guarantee. In practice, the situation can be more complex as debt might be guaranteed by some, but not all, members of the group, in which case consolidated data for this sub-group becomes relevant to the lender.

In addition to the incentives to consolidate relating to lending contracts, Whittred (1987b) also argues that the level of management ownership affected the incentives to prepare consolidated financial statements. The profits of a parent entity are likely to be an inferior measure for monitoring managerial performance relative to the consolidated profits. This is because the profits of the parent company include dividends that are received from subsidiaries and may also be affected by other transactions with group companies that are not at arm's length. Therefore, management can opportunistically manipulate the profits of the parent company by exercising control over intragroup dividend transactions and the terms and conditions of other transactions (e.g., management fees and inventory transfers). In contrast, the combined or consolidated profits of the group are based solely on transactions with parties that are external to the group. The effects of intragroup dividends and other intragroup transactions are removed.

Walker and Mack (1998) contest Whittred's (1987b) conclusions about the importance of debt and management contracts to the evolution of consolidated reporting. They conclude instead that the wider adoption of consolidated reporting in Australia was explained by statutory and other forms of regulation.

The differences between the analyses of Whittred (1986, 1987b) and Walker and Mack (1998) result from, at least in part, different interpretations of the early stock exchange rules. Hence, the extent to which consolidation accounting in Australia was voluntarily adopted versus externally imposed remains contentious.

1.5.3 Lessons from the corporate practices of the 1980s

Arguably the most important event in the history of consolidated financial reporting in Australia was the issue of AASB 1024 in 1990. AASB 1024 grew out of a 1980s perception that a legally backed accounting standard on consolidated reporting was essential to ensure that relevant and reliable aggregate financial information was available to capital market participants.

The use of certain controversial business practices in the 1980s brought the matter of consolidated reporting to a head. In particular, several high-profile Australian companies were circumventing the spirit of the existing companies' legislation and avoiding a full consolidation of all controlled activities. This was possible at that time because the *Companies Act 1981* (and the *Companies Act 1961* before it) defined a group of companies subject to consolidation as one comprising a holding company and one or more other companies that were its subsidiaries. Three practices developed in the 1980s to avoid the consolidation of certain types of subsidiaries. Each of these avoidance practices was justified by arguments relying on legal form rather than economic substance and the three practices were described collectively as "one of Australia's great accounting loopholes" (Blue, 1990, p. 81).

The first avoidance practice was to interpose a non-corporate entity between a holding company and a subsidiary company. For example, a holding company could set up a unit trust in which it held all the units, with the unit trust used to hold the shares in a controlled company. This practice relied on the *Companies Act 1981* defining the group in terms of corporate entities only. Under the prevailing legislation, a trust was not a 'subsidiary' (because a trust is not a company) so it did not have to be consolidated and any companies in which the trust held shares also

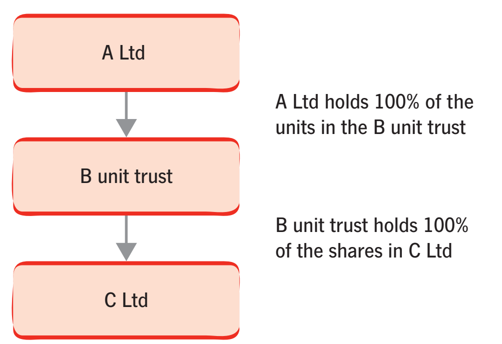

FIGURE 1.3 The case of the interposed unit trust

escaped consolidation. Figure 1.3 illustrates the use of an interposed unit trust to break the nexus between a holding company and a subsidiary company.

If A Ltd had held the shares in C Ltd directly, then A Ltd would have been a holding (parent) company and C Ltd its subsidiary company, resulting in C Ltd being included in the consolidated group. However, the interposition of the B unit trust meant that C Ltd no longer qualified as a subsidiary company of A Ltd and did not have to be included in the group consolidation. The interposed unit trust technique would often be applied to a controlled company that had high gearing and/or was loss-making. This was because the consolidation of such a company could significantly increase the debt ratios (e.g., debt-to-equity ratio) of the group. In some cases, the extent of the impact of the controlled company on the overall group position may have been so damaging as to put the holding company in default of its borrowing agreements with banks and other lenders (Sullivan, 1985).

The second avoidance practice was based on the fact that the term 'consolidation' under the 1981 Companies Code (and in the Corporations Law briefly until July 1991) did not necessarily mean consolidated accounts. As a consequence, it was common practice to omit subsidiaries with operations in the finance industry from the group as long as adequate justification was given. Their omission was justified on the dubious grounds that their operations were fundamentally different from other companies in the group. The omitted finance subsidiaries were typically highly geared and their inclusion in the consolidated accounts would have significantly worsened the reported gearing of the group. The introduction of AASB 1024 *Consolidated Financial Statements*, in June 1990, struck down this practice of excluding finance entities from consolidated financial statements. This position continued in all successive consolidation accounting standards until 2013 when the International Accounting Standards Board (IASB) issued amendments to IFRS 10 *Consolidated Financial Statements*, allowing exemptions to certain investment entities from consolidating their subsidiaries. The Australian Accounting Standards Board (AASB) was not supportive of this change as it viewed the exception as being without conceptual basis and that the exemption could lead to inconsistent reporting practices (AASB, 2011). However, given Australia's policy of adoption of IASB standards, the AASB was obliged to amend AASB 10 nonetheless. Happily, the exemption is quite limited and most entities are not able to use it.

The third avoidance practice relied on a legalistic interpretation of the definition of 'subsidiary' in the *Companies Act 1981*. That interpretation required ownership of more than half of the ordinary voting shares of another company for that company to be a 'subsidiary' as defined. In practice, it became generally accepted that a company holding 50% or (say) 49.8% of the ordinary voting shares in another company did not have to classify that other company as a subsidiary. Whether one company had *de facto* control over another company was frequently treated as being irrelevant to the subsidiary definition. Majority share ownership was central to consolidation practice and corporate managers with incentives to exclude or remove a company from the consolidation needed only to arrange a shareholding of 50% or less.

Sometimes a company would use a series of interlocking shareholdings in order to achieve its control over other companies and, at the same time, protect them from being taken over by an external party. None of these companies would be deemed subsidiaries because of the absence of majority share ownership. Of particular notoriety was the Adelaide Steamship Company ('Adsteam'), which, in the 1980s, was one of Australia's major conglomerate organisations. The structure of the 1980s Adsteam group is shown in Figure 1.4. It should be noted that Adsteam's group structure has been simplified by the omission of a number of subsidiaries.

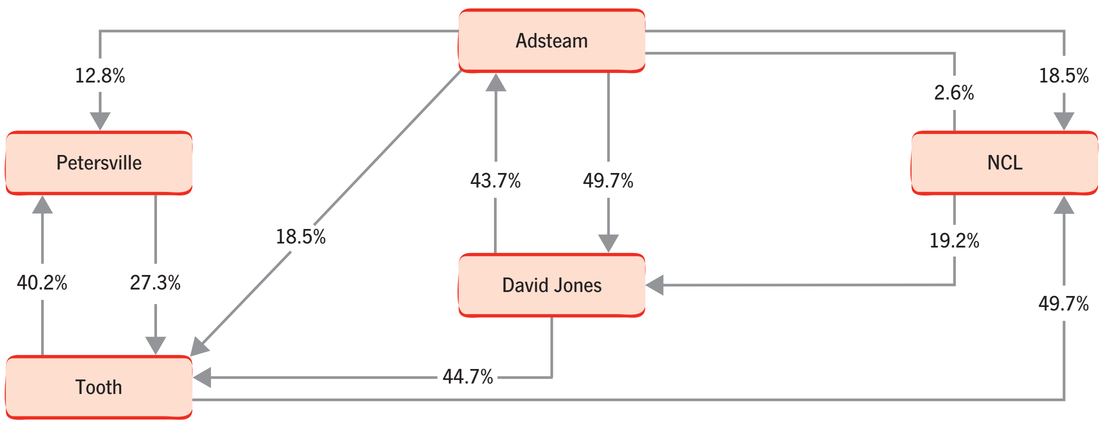

FIGURE 1.4 The Adsteam case

The interlocking shareholdings conveyed the impression that the Adsteam group had lower gearing and higher profits than was actually the case (Hadden, 1992). When the Australian Stock Exchange finally demanded that Adsteam prepare consolidated financial statements for 1991 and the financial position of the Adsteam group was revealed, the company went into a dramatic decline that was halted only by the systematic disposal of major assets. Adsteam survived—very much reduced in size—as Adsteam Marine Ltd until 2007.

1.5.4 Overcoming consolidation loopholes

In order to remedy the loopholes in the *Companies Act 1981* and generally improve the usefulness of consolidated financial statements, the Australian accounting profession issued AAS 24 *Consolidated Financial Statements* in June 1990. AAS 24 made three fundamental changes to consolidation accounting. First, it substituted 'parent entity' for 'holding company' and redefined 'subsidiary' as an entity (not necessarily a company) controlled by another entity. This meant that controlled non-corporate entities, such as trusts and partnerships, had to be consolidated in addition to companies controlled by a parent entity. Therefore the interposed unit trust technique could no longer be used to avoid consolidating less performing and/or highly geared companies. Second, AAS 24 required that all subsidiaries be consolidated. There were to be no exceptions to this basic principle. Third, AAS 24 stated the criterion that control, rather than majority ownership, would become the major trigger to determine whether consolidation would take place. The control criterion established economic substance rather than legal form as determining the boundaries of the consolidated group.

Following the introduction of the *Corporations Legislation Amendments Act 1991*, AASB 1024 *Consolidated Accounts* was gazetted on 20 September 1991 and made effective for financial years ending on or after 31 December 1991. For the corporate sector, this gave the force of law to the consolidation principles first issued as AAS 24, including the group concept and the control criterion.

Hazelton (1994) compared the consolidated financial statements of Australian parent companies listed on the Australian Stock Exchange pre-AASB 1024 and post-AASB 1024. As shown in Table 1.3, Hazelton found that AASB 1024 was accompanied by a significant increase in the number of listed companies consolidating non-corporate entities and less-than-majority-owned companies.

The information in Table 1.3 shows that there was only a 2% increase in the number of majority-owned companies consolidated between 1990 and 1992. However, in the same period, there was

TABLE 1.3 Consolidation of non-corporate entities and less-than-majority-owned companies

	1993	1992	1990	1989
Number of entities consolidated				
Non-corporate entities	205	186	96	92
Majority-owned companies	7037	7253	7094	6894
Less-than-majority-owned companies	93	87	23	21
Number of listed companies consolidating				
Non-corporate entities	37	37	17	18
Majority-owned companies	190	190	187	186
Less-than-majority-owned companies	40	41	16	14

an increase of 278% in the number of less-than-majority-owned companies consolidated and an increase of 94% in the number of unincorporated entities consolidated. Both these increases were largely attributable to the introduction of AASB 1024. AASB 1024 also introduced greater uniformity to consolidation accounting practices.

1.5.5 Special purpose entities

Although AASB 1024 represented a major improvement in the regulation of accounting practices, developments in financial engineering and innovative group structures revealed serious limitations in AASB 1024 and other similar accounting standards around the globe. The 1990s onwards saw an exponential growth in the use of so-called ‘special purpose entities’ (SPEs) that were created to give effect to various new forms of financial risk management. SPEs had various names and forms including ‘structured entities’ and ‘variable interest’ entities. One major objective of the development of SPEs was to allow groups to essentially move debt or risk ‘off-balance sheet’ by putting in place arrangements that would give the appearance (and sometimes the substance) that an entity was not part of the group, that is, the SPE was not ‘controlled’ by the group and so could be ‘de-consolidated’. This would mean that the SPE’s financial statements would not appear in the group’s consolidated financial statements and, in turn, this would make it difficult for users of the group’s financial statements to fully assess any potential risks faced by the group.

The use of SPEs was not entirely new. For example, the Australian property developer Hooker Corporation had created a special trust as an SPE in the late 1980s as a means to implement a debt defeasance arrangement. The objective was to transfer to the trust a large amount of the liabilities of Hooker Corporation and some financial assets such as accounts and loans receivable. It was hoped that the cash flows generated from the receivables would be sufficient to pay off the liabilities. The management of Hooker Corporation argued that the company had effectively transferred responsibility for the liabilities to the SPE trust and so the liabilities could be taken off the statement of financial position of Hooker Corporation, thus improving the company’s leverage position. Such a practice would be legitimate provided that the company no longer had any responsibility for repaying the liabilities if the SPE trust could not meet the obligations. Ultimately, Hooker Corporation collapsed leaving huge losses for investors and creditors.

Since that time the use of SPEs has become widespread and controversial. One of the largest corporate collapses in history, Enron Corporation (Enron), took the use of SPEs to unprecedented extremes as described in Exhibit 1. Enron was able to exploit the rules-based consolidation accounting standards in the US to keep its SPEs off-balance sheet. It has been argued that Enron

1

EXHIBIT

ENRON'S USE OF 'RAPTOR' SPEs

The failure of the US company Enron was one of the world's most high-profile corporate collapses. The company entered into bankruptcy in December 2001 causing widespread losses to thousands of employees, investors and others. Enron employed many misleading accounting practices to boost its revenues and hide risks. One of these practices was the use of SPEs. From 1993–2001 Enron created over 3000 SPEs (in Australia at August 2015, the whole Australian Stock Exchange consisted of only 2205 listed entities). It was determined that Enron's use of these SPEs led to an overstatement of its net assets by $US1.2 billion. One sub-set of these SPEs was the so-called 'Raptor' SPEs (named after various birds of prey). Essentially, the Raptor SPEs were created to act as a hedge against falls in Enron's portfolio of e-commerce investments but the assets transferred to the SPEs to act as if the hedge were Enron's own shares. That is, Enron was using the SPEs to hedge itself. Not surprisingly, when the market value of Enron's portfolio of e-commerce investments ultimately fell, so did the value of Enron's own shares, making the hedge ineffective. This led to losses of $US700million. The financial position of the Raptor SPEs was largely unknown outside Enron because the company exploited the 'bright line' rules used by the relevant US consolidation accounting standard. Enron structured the ownership interests in the Raptor SPEs in such a way that a sufficient portion of that ownership was held by a partnership controlled by Mr Andrew Fastow, the Chief Financial Officer of Enron! As a result, the Raptor arrangements were not presented in Enron's consolidated financial statements. Critics of the US accounting standards pointed to Enron's ability to put 'form over substance' as an example of the limitations of 'rules-based' accounting standards. It was argued that 'principles-based' standards that employed a test for consolidation based on 'control' would be superior standards because they emphasised the reporting of the substance of such structured arrangements. *Source:* Adapted from Baker and Hayes, 2004.

would not have been able to do this if the US had adopted a 'control'-based test such as that now found in AASB 10 (Baker and Hayes, 2004).

One of the key reasons for the extensive growth in SPEs has been the practice of 'securitisation'. In brief, securitisation is a process in which financial assets are bundled together in saleable parcels (i.e., they are 'securitised'), which are then sold to an SPE, which in turn sells them to investors. In practice, securitisation arrangements can be highly complex but a simplified example is provided in Figure 1.5.

FIGURE 1.5 A simple securitisation arrangement

In Figure 1.5 Bank X transfers some financial assets such as mortgage or credit card receivables to a trust that the bank has created as an SPE (this is shown as arrow A in Figure 1.4). Bank X treats the transfer as a 'sale' of the financial assets, taking them off its statement of financial position and potentially recognising a gain or loss on the sale. The SPE then bundles these receivables into saleable packages and, in turn, sells them to various investors (shown as arrow B). The cash flows received from the investors are used by the SPE to pay Bank X for the receivables (shown as arrow C). The SPE then manages the cash flows from the receivables (i.e., it collects the payments made by the mortgagees or credit card holders as they pay their debts) and transfers these cash flows to the investors, which is their return on their investment (shown as arrow D). It can be seen that, in principle, Bank X is able to transfer the credit risk associated with the receivables to the investors. By 'selling' the receivables to the SPE, Bank X has no obligations to the investors if the receivables become impaired. In addition, Bank X enjoys a cash flow advantage in that it does not have to wait the life of the receivables to collect the associated cash flow. The key issue with regard to consolidation accounting is that the SPE must not be a subsidiary of Bank X, that is, Bank X must not 'control' the SPE otherwise it would have to consolidate the SPE's financial statements with its own and the financial reporting advantages of creating the SPE would be lost. In practice, a variety of arrangements are put in place to try to ensure that the SPE is not perceived to be 'controlled' by the bank. In any specific securitisation arrangement, it is a question of fact as to whether the terms and conditions result in an effective separation between the bank and the SPE or whether the SPE in substance remains controlled by the bank. For instance, if the investors could obtain recourse from the bank in the event that the receivables became impaired, then this would indicate that the bank has not been able to transfer the risks to the SPE and that a true 'sale' had not occurred. Securitisation arrangements and their associated SPEs were a major component of the lack of transparency regarding financial risk during the GFC and this was a key motivation for accounting standard setters around the world to revise consolidation accounting standards. These revisions led to our current standard, AASB 10. It is worth noting that the use of SPEs is not restricted to financial institutions. In 2013, for example, it was reported that the Australian supermarket chain Coles was able to use an SPE to acquire a highly desirable piece of real estate without alerting its rival Woolworths. It was reported that "Coles concealed its involvement in the deal by using a $10 company ultimately owned in the British Virgin Islands tax haven to purchase the 4282 square metre site in the well-heeled lower north shore suburb" in Sydney (Ferguson and Vedelago, 2013).

1.5.6 Changes introduced by AASB 127 and AASB 3

AASB 1024 regulated the preparation of 'consolidated accounts'—the financial statements of the consolidated group. AASB 127 *Consolidated and Separate Financial Statements* extended the scope of AASB 1024 by including both group financial statements and the 'separate' financial statements of the parent entity. In addition, AASB 127 introduced other subtle but significant differences—in both the application provisions and in the steps taken to determine the existence of 'control'—from similar provisions in AASB 1024. While in AASB 127 basic consolidation procedures did not change from those in AASB 1024, there were changes in more advanced consolidation issues. AASB 1024 relied on AASB 1013 *Accounting for Goodwill* and AASB 1015 *Acquisition of Assets* for (i) the measurement of the cost of acquisition, (ii) the measurement of net identifiable assets acquired, and (iii) the measurement of and the accounting treatment for goodwill or discount (later labelled 'excess') on acquisition.

From 2005, the role of AASB 1013 and AASB 1015 was superseded by AASB 3 *Business Combinations*. AASB 3 introduced marked changes to former consolidation procedures and resulted in the recognition of more identifiable intangibles (such as patents and trademarks) that are acquired as part of a business combination. Chapters 2 and 3 examine issues relating to the recognition and measurement of assets acquired as part of a business combination.

AASB 127 took the view that consolidated financial statements were prepared to enable reporting on the activities of a group to external users. In line with this emphasis, consolidated financial statements include the consolidated assets and liabilities of *all* members of the group, and group equity shows the respective shares attributable to the two categories of owners—the parent interest and the non-controlling interest. This is known as the 'entity concept' to consolidation accounting. AASB 10 continues AASB 127's approach of adopting the entity concept.

It was noted in Section 1.5.5 that the GFC exposed limitations to consolidation accounting standards such as AASB 127. Consequently, the IASB revised its consolidation standard and Australia followed suit in 2011 with AASB 10 *Consolidated Financial Statements*. These changes resulted in the guidance on consolidation being removed from AASB 127 and that standard was renamed *Separate Financial Statements*. The objective of the revised AASB 127 is to set out the requirements for accounting and disclosure of a parent or an investor entity's interests in a joint arrangement or associate where that parent or investor entity prepares its own financial statements rather than consolidated financial statements. These requirements are explored further in Section 1.6.3. AASB 10 now contains the relevant accounting requirements for consolidation. The basic consolidation procedures are largely unchanged from those that were originally in AASB 127 but AASB 10 introduced a revised definition of 'control' and provided extensive guidance on the practical implementation of that definition. Unlike its IASB counterpart, AASB 10 was also amended in 2013 to add implementation guidance for entities in the not-for-profit sector as described in Section 1.7.7. Disclosure requirements relating to investments in subsidiaries, joint arrangements and associates are set out in AASB 12 *Disclosure of Interests in Other Entities*. The requirements of AASB 12 will be explained where relevant in other chapters of this book.

Before considering the underlying concepts and techniques of consolidation accounting it is necessary to understand the scope of AASB 10; that is, which companies must prepare consolidated financial statements and the meaning of the term 'separate financial statements'. This is considered below in Section 1.6.

1.6 Application and scope of AASB 10

The application of AASB 10 is governed by paragraph 5 of AASB 1057 *Application of Australian Accounting Standards*. In relation to such compliance it is worthwhile remembering that the application of AASB standards not only applies to companies but also to entities other than companies, including not-for-profit organisations and public sector entities. AASB 10.E provides direct guidance on the application of the concept of control in the not-for-profit sector. Although the emphasis in this text is on the application of AASB standards to companies, the application of the control concept in the not-for-profit sector is briefly revised in Section 1.7.2.

AASB 10 refers to consolidated financial statements and AASB 127 refers to separate financial statements. Previous sections of this chapter outlined the nature of consolidated financial statements, but there has been no discussion of 'separate' financial statements; this concept will be explained in Section 1.6.3.

1.6.1 The requirement to prepare consolidated financial statements

Australian accounting regulations embrace the concept of differential reporting as described in SAC 1 *Definition of the Reporting Entity*, paragraphs 34–37.[2] The idea behind differential reporting is that it is unreasonable to expect the same level of accounting disclosure in the financial statements of a private family company as would be required in the report of a publicly listed company. The implementation of differential reporting depends on the interaction between the requirements of the *Corporations Act 2001* (hereafter referred to as the *Corporations Act* or 'the Act') and the application provisions in AASB accounting standards.

CORPORATIONS ACT

Provisions of the *Corporations Act* include:

- Part 2M.3, s. 292 specifies the entities that must prepare annual financial reports. In general, small proprietary companies are exempted from the requirement to lodge financial reports. Section 292 applies to various types of individual companies.
- Section 295 outlines the content of the annual financial report prepared by the companies specified in s. 292. The required content of a financial report includes the financial statements required by AASB accounting standards *or*, where required by accounting standards, financial statements of the consolidated entity (s. 295(2)(b)). The 'financial report' is defined to include notes to the financial statements (consisting of notes required by accounting standards, the regulations and other information necessary to give a true and fair view) and the directors' declaration about the financial statements and notes. Detailed requirements about format and content of financial statements and notes thereto are prescribed by AASB standards rather than by the Act.
- Since revisions to the Act in 2010, annual financial statements are required to be prepared for a company unless accounting standards require consolidated financial statements. In this case only consolidated financial statements are required to be provided to shareholders of the parent company.
- Section 296 requires that financial statements comply with accounting standards and s. 297 requires that financial statements and notes must give a true and fair view, but does not allow any departure from the requirements of accounting standards. This means that any additional information necessary for a true and fair view is included in notes to financial statements (s. 295(3)(c)).

AASB ACCOUNTING STANDARDS

Provisions of the AASB accounting standards include the following:

- The *Corporations Act* requires that financial statements comply with accounting standards. The application of an accounting standard to a particular class of entity is stated in AASB 1057.5.
- Generally, AASB standards apply only to 'reporting entities' (as defined in Table 1.4). The application provisions in AASB standards implement differential reporting in accordance with the AASB's Reduced Disclosure Requirements (RDR).
- Reporting entities are defined in terms of the financial information needs of external users so that closely held, equity-financed, unlisted public companies and/or large private family companies are not normally reporting entities.
- Only reporting entities are exposed to the full weight of accounting disclosure.

TABLE 1.4 Relevant definitions[3]

Term	Definition	Reference
Parent	An entity that controls one or more entities	AASB 10A
Entity	Any legal, administrative or fiduciary arrangement, organisational structure or other party (including a person) having the capacity to deploy scarce resources in order to achieve objectives	SAC 1.6
Subsidiary	An entity that is controlled by another entity	AASB 10A
Group	A parent and its subsidiaries	AASB 10A
Reporting entity	An entity (including an economic entity) in respect of which it is reasonable to expect the existence of users dependent on general purpose financial reports for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources. A reporting entity prepares general purpose financial statements	SAC 1.40
General purpose financial statements	Financial statements that are intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs	AASB 101.7

The financial statements required by s. 295 are prescribed in AASB 101.10. The following financial statements must be included as part of the content of a set of financial statements:

- A statement of financial position.
- A statement of profit or loss and other comprehensive income.
- A statement of changes in equity.
- A cash flow statement.
- Notes.

An additional statement of financial position is required in certain cases where there has been a retrospective accounting policy change, a restatement or reclassification (AASB 101.10(f)).

The standard with the power to require the preparation of consolidated financial statements (pursuant to s. 295) is AASB 10. Since AASB 10 must be read in conjunction with other AASB standards, consolidated financial statements are therefore required under AASB 101.10. Only companies caught by the application provisions of AASB 10 need to prepare consolidated financial statements.

In determining the application of AASB 10, an understanding of the terms 'parent entity', 'group', 'subsidiary', 'reporting entity' and the related terms 'entity' and 'general purpose financial statements' is necessary. Most of these terms were introduced in Section 1.2 but formal definitions are given in Table 1.4.

While it is clear that AASB 10 applies to entities other than companies, the discussion here concerning the application of AASB 10 is restricted to companies since parent entities in this text will be companies. More generally, the application of AASB 10 is governed by AASB 1057 *Application of Australian Accounting Standards.* AASB 1057.5 requires AASB 10 to be applied to:

a. each entity that is required to prepare financial reports in accordance with Part 2M.3 of the Corporations Act and that is a reporting entity;

b. general purpose financial statements of each other reporting entity; and

c. financial statements that are, or are held out to be, general purpose financial statements.

The general requirement to prepare consolidated financial statements arises where the entity is a parent (AASB 10.4). A limited exemption is provided by AASB 10.4(a). This is the special case where the parent is itself a subsidiary (i.e., part of a larger group), its securities are not publicly traded, the entity is not in the process of filing statements for the purpose of issuing instruments in a public market and its parent produces consolidated financial statements that comply with International Financial Reporting Standards (IFRS). This would generally exempt, for example, an unlisted parent company that was a subsidiary of a parent listed on the London Stock Exchange (but generally not if the parent was listed on the New York Stock Exchange). There are two other exemptions that relate to long-term employee benefit plans that are subject to AASB 119 *Employee Benefits* (AASB 10.4A) and investment entities if they measure all of their subsidiaries at fair value through profit or loss (AASB 10.4B).

There is significant international variation in the requirement to prepare consolidated financial statements. In Australia, the requirement to present consolidated financial statements is stated in AASB 10.Aus4.2:

> Notwithstanding paragraphs 4(a) and Aus4.1, the ultimate Australian parent shall present consolidated financial statements that consolidate its investments in subsidiaries in accordance with this Standard when either the parent or the group is a reporting entity or both the parent and the group are reporting entities.

The interaction of paragraph Aus4.2 in AASB 10 requires that either the parent company or the group be reporting entities for the standard to apply. In the rare case where the parent is a non-reporting entity but the group is a reporting entity, AASB 10 does not apply to either the parent or the group in the strict legal sense. In this case, the parent company is not obliged to present either separate general purpose financial reports (GPFRs) for itself or consolidated financial statements for the group, though there is no barrier to the parent voluntarily submitting GPFRs for the parent and for the group in the form of consolidated financial statements. It is never incorrect to disclose *more* than the minimum information required by accounting regulations.

If the parent entity is a reporting entity, it would be unusual for the group to be classified as a non-reporting entity. It could occur if all subsidiaries were wholly owned and the parent's investments in subsidiaries were relatively unimportant to other activities of the parent—that is another way of saying the information in consolidated financial statements is not material (see AASB 108.5).

In practice, the usual situation would be for both the parent and the group to be either reporting or non-reporting entities. Where both the parent and the group are non-reporting entities, the parent will prepare either special purpose financial reports or GPFRs and can also present special purpose or general purpose consolidated financial statements if it chooses to do so. In all practical illustrations and end-of-chapter exercises in this text, both parent and group will be reporting entities required to prepare GPFRs. We will also assume that the effect of consolidation is material and that consolidation adjustments are material.

1.6.2 A group that is a reporting entity

A group is classified as a reporting entity when it meets the definition of 'reporting entity' given in Table 1.4. In determining whether a group is a reporting entity, it is necessary to ask: Are there users who require regular financial reports about the entity?

If the answer to the above question is yes, then ask: Are some of these users unable to command the financial information they require for decision-making and accountability purposes?

If the answer is yes to this second question as well, then the group is a reporting entity.

To assist in deciding whether a group is a reporting entity, SAC 1 *Definition of the Reporting Entity* provides the following factors, which should be considered in determining whether the entity is a reporting entity.

- Separation of management from economic ownership interest—tightly held and controlled entities (e.g., private family companies) are normally not reporting entities. Widely held companies will normally be reporting entities as shareholders of such companies are normally not in a position to demand financial information specific to their own needs and therefore must rely on GPFRs (SAC 1.20).
- Economic or political importance/influence—economically large and politically significant entities have a 'public accountability' function that may make them reporting entities (SAC 1.21).
- Financial characteristics—entities that are large by reference to value of assets or sales, number of employees or level of indebtedness can also be deemed to be reporting entities. In such cases there may be non-shareholder financial interests that need to be served by GPFRs (SAC 1.22).

The inclusive nature of the definition of a group should also be considered when determining if a group is a reporting entity. For example, if the parent entity is listed on a stock exchange, offers debt securities to the public or is a corporate subsidiary of a foreign-listed company, then the parent is a reporting entity and, as discussed previously, the group, by implication, is normally also a reporting entity.

It is important to remember that the factors noted in SAC 1 are provided for guidance only and should not be seen as a substitute for applying the definition to all the available facts concerning each potential reporting entity.

As described in Section 1.2, a group that is a reporting entity can take a number of different forms. Figure 1.6 depicts the simple case of a group with one subsidiary.

The A Ltd group comprises the parent entity, A Ltd, and its subsidiary, B Ltd. If A Ltd or the A Ltd group are reporting entities, then A Ltd must include consolidated financial statements prepared in accordance with AASB 10 as part of its annual financial reports.

Sometimes it is possible to identify more than one parent entity and more than one group. Figure 1.7 depicts a chain of companies similar to that in Figure 1.1 where this is the case.

As discussed in Section 1.2, a company like B Ltd is the parent entity of C Ltd and the B Ltd group comprises B Ltd and its subsidiary, C Ltd. However, A Ltd controls B Ltd and, through it, also C Ltd. Therefore, A Ltd is the parent entity of both B Ltd and C Ltd and the A Ltd group comprises A Ltd and its subsidiaries, B Ltd and C Ltd. Where there is a chain of companies or entities, the parent entity at the top of the chain (A Ltd in this case) is often referred to as the 'ultimate parent entity'. Unlike the example in Section 1.2 we now extend our analysis by asking whether both the A Ltd group and the B Ltd group are reporting entities. The answer to this question will depend on the facts. If A Ltd and B Ltd are both listed on the Australian Securities Exchange, both companies will be reporting entities and both the A Ltd group and the B Ltd group would usually be reporting entities. The position would be different, for example, if A Ltd was a listed company and B Ltd was a non-listed, wholly (100%) owned subsidiary of A Ltd. In this case, B Ltd and the B Ltd group are less likely to be reporting entities because B Ltd is not a listed company and A Ltd, as its only shareholder, will be able

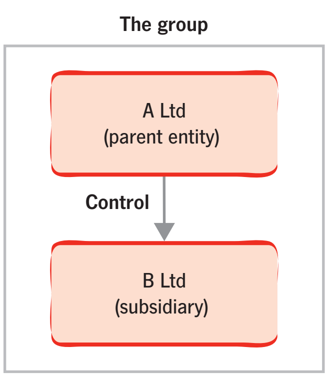

FIGURE 1.6 Parent entity in a group with one subsidiary

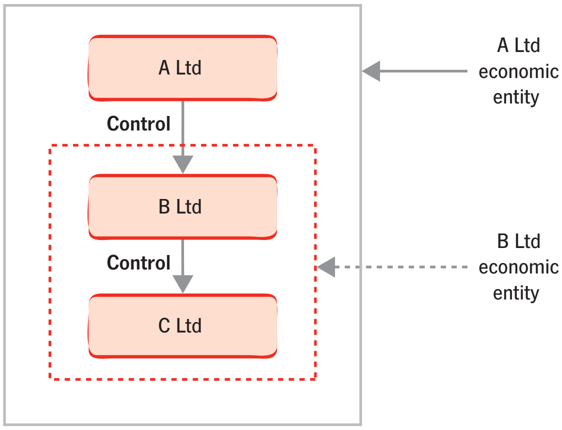

FIGURE 1.7 A chain of controlled companies

to command specific financial information. Of course the needs of users other than shareholders must also be considered. In this situation, A Ltd would have to prepare consolidated financial statements for the A Ltd group but B Ltd would not have to report on the B Ltd group.

1.6.3 Accounting for investments in separate financial statements

Accounting for investments in subsidiaries, jointly controlled entities and associates in separate financial statements are addressed in AASB 127.9–127.14, which refers to the case where the parent prepares financial statements for the parent in addition to, or instead of, consolidated financial statements. Under Australian legislation and accounting standards, in most cases a parent will prepare consolidated financial statements alone. In this case, footnote disclosure is provided about the parent entity's financial position (e.g., total assets), performance (e.g., profit) and the methods outlined below for accounting for investments in the separate financial statements of the investor, which affect these measures. These methods were described in Section 1.4.

'Separate financial statements', as defined in AASB 127.4, are financial statements of a parent, an investor in an associate or an investor in a jointly controlled arrangement in which the investments are accounted for on the basis of the direct equity interest. The separate financial statements (if prepared) show the financial performance, financial position and cash flows of the parent entity as a single entity. On the parent's statement of financial position, equity investments in other entities are treated as investment assets and must not be measured on a consolidated or equity accounted basis.

'Separate financial statements' is a term that relates only to the parent entity—as opposed to 'consolidated financial statements' that are based on the combined activities of every entity in the group.

In the separate financial statements of a parent entity, investments in subsidiaries, jointly controlled entities and associates are accounted for in one of two ways:

1. Investments not classified as held for sale are accounted for:
   —at cost (the 'cost method')
   —in accordance with AASB 9 *Financial Instruments*; or
2. Investments classified as 'held for sale' are accounted for in accordance with AASB 5.

The fair value method provides information that is relevant to investors about the value of investments. The IASB has recently decided to allow the option to use the equity method for an associate entity in separate financial statements. The use of the fair value method provides information that might be relevant to the parent shareholders about the value of investments. The fact that its use was not mandated is noteworthy as it emphasises the importance of consolidated accounts (relative to parent entity accounts) to gain information about financial position and management performance. The IASB acknowledged that the cost method might provide relevant information where the accounts of the parent provide information about the ability of the parent to pay dividends to its shareholders. In many jurisdictions the directors of the parent may be constrained to paying dividends out of realised earnings, which are a function of, for example, dividends received (as opposed to capital gains). Note, however, that the case for the cost method in providing relevant information is now weaker in Australia, as amendments to the *Corporations Act 2001* in the *Corporations Amendment Act 2010* removed the 'profit test' for the payment of dividends and retained just the 'solvency' test.

Investments initially accounted for at cost may later be classified as 'held for sale'. In this case the investments are then measured at the lower of their carrying amounts and fair values less costs to sell (AASB 5.15).

As discussed in Section 1.4.4, AASB 9 requires that financial assets be recorded at fair value. One important exception is the case of equity instruments if there is insufficient evidence to reliably measure the fair value (refer to AASB 9B.5.4.14). This is an important exception in the context of corporate groups as, in most cases, the listed entity (if any) is the parent and the subsidiaries are all unlisted.

As indicated in Section 1.4.4—and excluding investments where fair value cannot be reliably measured—AASB 9 requires changes in fair value to be reflected either in profit or loss, or in certain circumstances the entity can choose to have these changes taken directly to other comprehensive income. In the latter case, gains and losses cannot be subsequently transferred to profit or loss on realisation (generally on disposal of all or part of the investment) (AASB 9B.5.7.1).

In the consolidated financial statements, the amount recorded in the parent's separate statement of financial position will be treated as shown below.

INVESTMENTS IN SUBSIDIARIES

In the case of investments in subsidiaries, the parent's recorded investment will be eliminated in full (irrespective of its measurement basis) and the underlying assets, liabilities and post-acquisition equities of subsidiaries will be included in the consolidated statement of financial position in place of the original investment asset. Subsequent chapters will illustrate this procedure.

INVESTMENTS IN JOINTLY CONTROLLED ENTITIES AND ASSOCIATES

Investments classified as 'held for sale' will continue to be measured at the amount required by AASB 5 *Non-current Assets Held for Sale and Discontinued Operations*. Consequently there will be no difference between the carrying amount in the parent's separate financial statements and the group's consolidated financial statements.

The equity method of accounting, described in Section 1.4.3, must be applied to investments in associates other than those held for sale. The equity method, including the consequences of adopting the fair value basis in the parent's separate financial statements, is the basis of the content of Chapter 8. Discussion of the accounting treatment of investments in associates and jointly controlled entities held by a company that is not a parent entity is also covered in Chapter 8.

Having specified the entities that must prepare separate financial statements and/or consolidated financial statements and that the concept of control is used to identify parents and subsidiaries, now let's look at the definition of 'control' and discuss how the existence of control is determined.

comprehensively addressed by IFRS 10 and AASB 10. One additional advantage that AASB 10 has over the previous version of AASB 127 is that it now includes detailed implementation guidance for the not-for-profit sector. AASB 127 had very little guidance for this sector and even that was restricted to public sector entities only.

From the above discussion it would seem that the major criticisms in applying the control criteria arise from the reliance upon accountants' professional judgement. While these criticisms have some merit, most accounting practitioners seem to acknowledge that the control criterion is effective and accept that it is necessary to eliminate dubious consolidation practices. Indeed, the control criterion for consolidation matches the generally accepted objective of consolidated accounts, which is to show the resources under the control of the parent entity and how well the parent entity deploys those resources. Further, it should be remembered that the experience from Enron and similar examples of corporate misbehaviour suggests that a principles-based approach to consolidation can be more difficult to circumvent than a rules-based approach.

1.8 SUMMARY

This chapter has provided an introduction to the methods used for accounting for and reporting upon investor–investee relationships. The chapter has concentrated on those relationships where the investor exercises control over the investee (parent–subsidiary relationships) but it has also been shown that such relationships can be based on joint control, significant influence or, indeed, there may be no special relationship operating between the investor and investee. The accounting method applied depends upon the nature and strength of the investor–investee relationship.

The chapter has shown that getting the 'right' accounting for investor–investee relationships is vital to ensuring financial statement users receive decision-useful information. This is because there has been a long history of attempts by unscrupulous managers to structure their investments in a way that exploits loopholes in relevant accounting standards. Some of this corporate misbehaviour has resulted in enormous losses and other negative impacts on investors, employees and other stakeholders and seriously damaged public confidence in capital markets and the accounting profession.

A key factor in identifying parent–subsidiary relationships is the concept of control and the chapter has explored how this concept is defined in AASB 10. Three components must be identified for control to exist: the investor must have power over the investee; the investor must be exposed or have rights to variable returns from the investee; and the investor must be able to use its power to affect the amount of returns generated by the investee. Applying the control concept demands the exercise of professional judgement and each situation must be assessed based on its particular facts. The not-for-profit sector can provide especially challenging contexts for assessing control because many of the obvious mechanisms by which control is demonstrated in the for-profit sector are absent in the not-for-profit sector (e.g., equity instruments are less frequently issued by not-for-profit entities).

The remaining chapters build on this one and provide detailed information about the methods of accounting for, and reporting upon, the investor–investee relationships that were introduced here.

1.9 CONSOLIDATION QUESTIONS

Q1.1 Important terminology in AASB 10 *(Section 1.4.1)*

Define what is meant by the terms 'parent entity', 'ultimate parent entity', 'subsidiary' and 'group'. Construct a simple organisational design in which there is a parent entity, a subsidiary directly controlled by the parent entity and a subsidiary indirectly controlled by the parent entity. Identify the relationships and groups in this design.

Q1.2 Rationale for groups *(Section 1.3)*

Explain why some of Australia's largest entities conduct their business activities through a complex group structure of controlled entities, associates and joint ventures rather than through a single corporate entity.

Q1.3 Consolidated financial statements *(Section 1.4.1)*

Describe the objectives of consolidated financial statements.

Q1.4 Entity concept of consolidation *(Section 1.5.6)*

Define the 'entity' concept of consolidation and explain how it has been incorporated into the provisions of AASB 127.

Q1.5 Adoption of consolidation accounting in Australia *(Section 1.5)*

According to Whittred (1987b), what was the dominant factor that explained the emergence of consolidated financial reporting by Australian companies? What is the contrary view presented by Walker and Mack (1998)?

Q1.6 Consolidation accounting loopholes *(Sections 1.5.3 and 1.5.4)*

Describe some of the practices used by corporate managers during the 1980s to avoid the consolidation of a subsidiary. Explain how Australian consolidation and other related accounting standards have evolved in an attempt to close these loopholes.

Q1.7 Special Purpose Entities (SPEs) *(Section 1.5.5)*

What are SPEs and why is their use controversial? What challenges do SPEs create for the preparation of consolidated financial reports?

Q1.8 When consolidated financial statements must be prepared *(Section 1.6.1)*

State which entities must prepare consolidated financial statements in order to comply with Part 2M.3 of the *Corporations Act* and name the financial statements that must be included in a consolidated financial report.

Q1.9 Preparation of consolidated financial statements *(Section 1.6.1)*

You are a manager within a firm of accountants. You have been approached for advice. Determine whether or not consolidated financial statements need to be prepared in the following scenarios:

a. Mr P holds 100% of the voting shares in See Pty Ltd (See), which is a large proprietary company. See owns 100% of the voting shares of Q Pty Ltd, which is a small proprietary company. The directors of both companies are Mr P and his sons. The only external user of the financial statements of See is BMI Ltd (BMI), the company's bankers. See owes a substantial amount to BMI and this is secured against the assets of See. As part of the terms of the loan, See provides BMI with detailed monthly cash flow information.

b. The Smith family owns 80% of the ordinary voting shares of A Ltd (A), a public company listed on the Australian Securities Exchange. A owns 100% of the ordinary shares of B Pty Ltd, a large proprietary company with no external borrowings and no known users of its financial statements other than its holding company.

c. B Pty Ltd is a large proprietary company that is owned by Mr B and his three children. B Ltd has 10 subsidiaries and is the largest building contractor in Victoria, employing a workforce of over 700 people. B Ltd provides its bankers with special purpose financial reports.

d. B Ltd is an investment company that has entered into significant borrowing arrangements with several financial institutions. Owing to the current economic climate, it recently defaulted on a principal payment of $500million and related interest payments to Northpac. With the consent of the other financial institutions, Northpac has acted under the terms of the loan contract and appointed a receiver to protect the interest of Northpac and the other secured creditors.

Q1.10 Relevance of parent entity's financial statements *(Section 1.6.3)*

> ***Financial statement users are of the opinion a parent entity's financial statements are irrelevant and should not be included as part of the consolidated financial statements.***

Evaluate this statement with regard to the *Corporations Amendment (Corporate Reporting Reform) Act 2010.*

Q1.11 Definition and indicators of control *(Section 1.7.2)*

Outline the elements of control as defined in AASB 10 and discuss the factors that are relevant in determining whether one entity has the power to control another entity.

Q1.12 Determining the power to control *(Section 1.7)*

Target Ltd has recently made some strategic investments. The finance director is concerned about whether AASB 10 will require the financial statements of some or all of the investee entities to be consolidated. Details of these investments are as follows:

a. Target Ltd has a 30% interest in the issued capital of ABC Pty Ltd, which is a company involved in the same industry as Target Ltd. The remaining 70% of the shares are owned by Mr and Mrs M, who are the founding shareholders. Mr and Mrs M have given Target Ltd five out of the seven seats available on the board of directors. Target Ltd takes the lead on all decisions, but Mr and Mrs M hold the other two board positions and monitor the business closely.

b. Target Ltd has provided HHQ Pty Ltd with a substantial loan. Because of the current economic climate, HHQ Pty Ltd has experienced significant trading problems. HHQ Pty Ltd has failed to make its regular payments under the loan agreement. Target Ltd came to an agreement with the management of HHQ Pty Ltd that Target Ltd executives will take control of the company's finances for a period of five years. Target Ltd now controls HHQ Pty Ltd's chequebook and authorises all cash payments.

c. Target Ltd owns 50% of X Pty Ltd with the other 50% being owned by Y Pty Ltd. Both companies have equal voting rights and an equal share of seats on the board of directors. By agreement with Y Pty Ltd, Target Ltd supplies the finance to the company on normal commercial terms. The loan is fully secured against the assets of the company. Y Pty Ltd provides the management and entrepreneurial flair to X Pty Ltd. Under the agreement, Y Pty Ltd receives a management fee in respect of the net profits of X Pty Ltd after allowing for interest payments on the Target Ltd loan. In periods of no profits, the interest payments will still be met, but Y Pty Ltd will not receive a management fee.

d. Target Ltd operates as the trustee for the King Arthur trading trust. The trust is a discretionary trust with the nominated beneficiaries being the directors of Target Ltd, Mr F, Mrs X and Mr L. Mrs X and Mr L are relatives of Mr F. Under the terms of the trust deed, Target Ltd has complete control over the operating and financing decisions of the trust, but acts in accordance with instructions from the settlor Mr F. In the current year, Target Ltd distributed the income of the trust in the following proportions: Mr F 70%, Mrs X 20% and Mr L 10%.

e. Target Ltd holds an 80% interest in BIJ Pty Ltd. The interest was created when Target Ltd converted a substantial loan it made to BIJ Pty Ltd into equity. BIJ Pty Ltd has a large deficiency in net assets. Target Ltd is a passive investor, having no seats on the board of directors and does not contribute to the financial or operating decisions of BIJ Pty Ltd.

f. Target Ltd holds 40% of the voting shares of HTE Ltd and it has appointed four executive directors to the board of HTE Ltd. In addition, four independent directors of Target Ltd are also independent directors of HTE Ltd. Under the articles of association of HTE Ltd, the total number of board seats is a maximum of 13 and each director has one vote at board meetings.

REQUIRED

Advise the finance director as to whether these investments satisfy the control criteria in AASB 10 and whether Target Ltd will need to consolidate the relevant entity in each case.

Q1.13 Determining the power to control *(Section 1.7)*

A Ltd is a Japanese entity that has successfully developed a scarce raw material called 'Aquatan'. It is an essential input for B Ltd and C Ltd's manufacturing processes and both of these companies are customers of A Ltd. Below are details of A Ltd's shareholders and directors.

Name of shareholder	% of ordinary voting shares owned	Number of positions held on A Ltd board of directors
B Ltd	30%	4
C Ltd	22%	2
D Ltd	25%	2

The remaining shares of A Ltd are widely held by several independent unrelated individuals. B Ltd is not related to C Ltd or D Ltd, but C Ltd is a wholly owned subsidiary of D Ltd. The other three of the 11 seats on A Ltd's board of directors are held by independent directors.

REQUIRED

PART A

On the basis of the above information and the requirements of AASB 10, discuss whether A Ltd is a subsidiary of B Ltd. Provide reference to AASB 10 to support your answer.

PART B

Further to the above information, B Ltd has acquired call options over all of the shares held by the individual shareholders (i.e., other than C Ltd and D Ltd). The call options are exercisable at any time at a fixed price and, if exercised, would give B Ltd the voting rights relating to the shares. Considering the shareholder spread in A Ltd and the need to ensure a continuous uninterrupted supply of Aquatan, B Ltd management does not intend to exercise the call options even if D Ltd and C Ltd do not vote in the same manner as B Ltd. On the basis of this further information, the information in Part A and the technical requirements of AASB 10, discuss whether A Ltd could be considered a subsidiary of B Ltd. Provide reference to AASB 10 to support your answer.

Q1.14 Control in the not-for-profit sector *(Section 1.7.7)*

Like other Australian states, South Australia is divided into a number of local government (LG) regions, which are responsible for providing some infrastructure and community services to their particular region. Such services include the provision and maintenance of roads, parks and gardens, drainage, libraries and rubbish collection. Funding for the operations of a LG come from a mix of Commonwealth and state government grants and from rates (taxes) levied upon property owners in the LG region. The operations of each LG are overseen by a council consisting of several local residents (councillors). At regular intervals, the members of a LG council are elected to their position by property owners in the relevant LG region. The councillors perform similar roles to those of directors on a company board. LG activities are regulated by an Act of Parliament, the *Local Government Act 1999*. Under Part 3 of the Act, the Minister for Local Government has the ability to recommend to the State Governor that the members of a LG council be dismissed under certain very limited circumstances (e.g., where the councillors have breached an Act of Parliament or have acted improperly in their management of the council's affairs). Should the Governor accept the Minister's recommendation, the councillors would be replaced by an administrator who manages the LG's activities until local property owners can vote for a new set of councillors. Apart from these requirements in the Act, the Minister does not have a general power to overturn a decision that has been properly made by councillors.

REQUIRED

A matter of regular debate is whether local government councils are entities that are controlled by the state government for the purposes of preparing the consolidated financial statements of the Government of South Australia. Based on the facts provided above, provide an analysis of whether local government councils are controlled by the state government in accordance with the provisions of AASB 10. Your analysis must be supported by reference to relevant paragraphs of AASB 10 and should address all the relevant criteria for assessing control.