Draft Document

Paragraph 9
"Exceptions from Consolidation Requirements"

Table of Contents

1. General Overview

Generally, Consolidated financial statements are the Financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent (company) and its subsidiaries are presented as those of a single economic entity.

One of the challenges in the consolidation process is determining the exceptions from consolidation requirements. In order to address this issue basic concepts drafted in IPSAS can be applied.

"IPSAS" stands for "International Public Sector Accounting Standards" - set of accounting standards issued by the IPSAS Board for use by public sector entities around the world in the preparation of financial statements. IPSAS aims to improve the quality of general purpose financial reporting by public sector entities, leading to better informed assessments of the resource allocation decisions made by governments, thereby increasing transparency and accountability.

International Public Sector Accounting Standard 6 – "Consolidated and Separate Financial Statements", is dedicated to consolidation procedures. IPSAS 6 is drawn primarily from IAS 27, Consolidated and Separate Financial Statements (2003). The scope of IPSAS 6 is that an entity that prepares and presents financial statements under the accrual basis of accounting shall apply this Standard in the preparation and presentation of consolidated financial statements for an economic entity.

In case of Georgia, working on new accounting/reporting instruction is currently under process. Country is intending to implement important aspects of international best practice and particularly concepts drafted in IPSAS Standards, e.g. with respect of issues related to consolidation and exceptions from consolidation, the document will basically refer to IPSAS 6 "Consolidated and Separate Financial Statements". However, there will be some deviations, as well (mentioned in paragraph 3 of Chapter 4 and paragraph 3 of Chapter 8 of this document).

2. Definitions

<u>Consolidated financial statements</u> are the financial statements of an economic entity presented as those of a single entity.

<u>Controlled entity</u> is an entity, including an unincorporated entity such as a partnership, which is under the control of another entity (known as the controlling entity).

<u>Controlling entity</u> is an entity that has one or more controlled entities.

<u>Minority interest</u> is that portion of the surplus or deficit and net assets/equity of a controlled entity attributable to net assets/equity interests that are not owned, directly or indirectly, through controlled entities, by the controlling entity.

<u>Separate financial statements</u> are those presented by a controlling entity, an investor in an associate, or a venturer in a jointly controlled entity, in which the investments are accounted for on the basis of the direct net assets/equity interest rather than on the basis of the reported results and net assets of the investees.

3. Presentation of Consolidated Financial Statements

1. A controlling entity, other than a controlling entity described in next paragraph (paragraph 2), shall present consolidated financial statements in which it consolidates its controlled entities in accordance with this Standard.

2. **A controlling entity need not present consolidated financial statements if and only if:**

(a) The controlling entity is:

  (i) Itself a wholly-owned controlled entity, and users of such financial statements are unlikely to exist or their information needs are met by its controlling entity's consolidated financial statements; or

  (ii) A partially-owned controlled entity of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the controlling entity not presenting consolidated financial statements;

(b) The controlling entity's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);

(c) The controlling entity did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market; and

(d) The ultimate or any intermediate controlling entity of the controlling entity produces consolidated financial statements available for public use that comply with IPSASs.

In the public sector, many controlling entities that are either wholly owned or partially owned, represent key sectors or activities of a government, and the purpose of this Standard is not to exempt such entities from preparing consolidated financial statements. In this situation, the information needs of certain users may not be served by the consolidated financial statements at a whole-of-government level alone. In many jurisdictions, governments have recognized this and have legislated the financial reporting requirements of such entities.

In some instances, an economic entity will include a number of intermediate controlling entities. For example, while a department of health may be the ultimate controlling entity, there may be intermediate controlling entities at the local or regional health authority level. Accountability and reporting requirements in each jurisdiction may specify which entities are required to (or exempted from the requirement to) prepare consolidated financial statements. Where there is no specific reporting requirement for an intermediate controlling entity to prepare consolidated financial statements for which users are likely to exist, intermediate controlling entities are to prepare and publish consolidated financial statements.

3. A controlling entity that elects in accordance with paragraph 2 of this document not to present consolidated financial statements, and presents only separate financial statements, complies with paragraphs 58–64 of IPSAS 6.

4. Scope of Consolidated Financial Statements

1. Consolidated financial statements shall include all controlled entities of the controlling entity, except those referred to in next paragraph (p. 2).

2. **A controlled entity shall be excluded from consolidation when there is evidence that:**

(a) control is intended to be temporary because the controlled entity is acquired and held exclusively with a view to its disposal within twelve months from acquisition, and

(b) management is actively seeking a buyer.

3. In case of Georgia temporary control will not act as a reason for controlling entity to exclude controlled entity from consolidation. For example: Spending entity, e.g. Ministry of Education, controls budget organizations and it is known that one of these budget organizations will be separated from the Ministry of Education and act as a separate spending entity or join another spending entity. Despite the fact, that Ministry of Education may know about such future changes at the moment of preparation of financial statements, it must include this controlled entity in the consolidation. Such kind of deviation from IPSAS 6 will contribute comparability of budget execution reports and financial statements, prepared by Georgian spending entities.

4. An example of temporary control is where a controlled entity is acquired with a firm plan to dispose of it within twelve months. This may occur where an economic entity is acquired, and an entity within it is to be disposed of because its activities are dissimilar to those of the acquirer. Temporary control also occurs where the controlling entity intends to cede control over a controlled entity to another entity – for example a national government may transfer its interest in a controlled entity to a local government. For this exemption to apply, the controlling entity must be demonstrably committed to a formal plan to dispose of, or no longer control, the entity that is subject to temporary control. An entity is demonstrably committed to dispose of, or no longer control, another entity when it has a formal plan to do so, and there is no realistic possibility of withdrawal from that plan.

5. When a controlled entity previously excluded from consolidation in accordance with paragraph 2 is not disposed of within twelve months, it shall be consolidated as from the acquisition date (guidance on the acquisition date can be found in the relevant international or national accounting standard dealing with business combinations). Financial statements for the periods since acquisition are restated.

6. Exceptionally, an entity may have found a buyer for a controlled entity excluded from consolidation in accordance with paragraph 2, but may not have completed the sale within twelve months of acquisition because of the need for approval by regulators or others. The entity is not required to consolidate such a controlled entity if the sale is in process at the reporting date, and there is no reason to believe that it will not be completed shortly after the reporting date.

7. A controlled entity is not excluded from consolidation simply because the investor is a venture capital organization, mutual fund, unit trust, or similar entity.

8. A controlled entity is not excluded from consolidation because its activities are dissimilar to those of the other entities within the economic entity, for example, the consolidation of GBEs with entities in the budget sector. Relevant information is provided by consolidating such controlled entities and disclosing additional information in the consolidated financial statements about the different activities of controlled entities. For example, the disclosures required by IPSAS 18, *Segment Reporting*, help to explain the significance of different activities within the economic entity.

5. Control as a tool of Exceptions from Consolidation Requirements

1. For the purposes of financial reporting, control stems from an entity's power to govern the financial and operating policies of another entity, and does not necessarily require an entity to hold a majority shareholding or other equity interest in the other entity. The power to control must be presently exercisable. That is, the entity must already have had this power

conferred upon it by legislation or some formal agreement. The power to control is not presently exercisable if it requires changing legislation or renegotiating agreements in order to be effective. This should be distinguished from the fact that the existence of the power to control another entity is not dependent upon the probability or likelihood of that power being exercised.

2. Similarly, the existence of control does not require an entity to have responsibility for the management of (or involvement in) the day-to-day operations of the other entity. In many cases, an entity may only exercise its power to control another entity where there is a breach or revocation of an agreement between the controlled entity and its controlling entity.

3. For example, a government department may have an ownership interest in a rail authority, which operates as a GBE. The rail authority is allowed to operate autonomously and does not rely on the government for funding, but has raised capital through significant borrowings that are guaranteed by the government. The rail authority has not returned a dividend to government for several years. The government has the power to appoint and remove a majority of the members of the governing body of the rail authority. The government has never exercised the power to remove members of the governing body, and would be reluctant to do so because of sensitivity in the electorate regarding the previous government's involvement in the operation of the rail network. In this case, the power to control is presently exercisable but under the existing relationship between the controlled entity and controlling entity, an event has not occurred to warrant the controlling entity exercising its powers over the controlled entity. Accordingly, control exists because the power to control is sufficient, even though the controlling entity may choose not to exercise that power.

4. An entity may own (a) share warrants, (b) share call options, (c) debt or equity instruments that are convertible into ordinary shares, or (d) other similar instruments that have the potential, if exercised or converted, to give the entity voting power or reduce another party's voting power over the financial and operating policies of another entity (potential voting rights). The existence and effect of potential voting rights that are currently exercisable or convertible, including potential voting rights held by another entity, are considered when assessing whether an entity has the power to govern the financial and operating policies of another entity. Potential voting rights are not currently exercisable or convertible when, for example, they cannot be exercised or converted until a future date or until the occurrence of a future event.

5. In assessing whether potential voting rights contribute to control, the entity examines all facts and circumstances (including the terms of exercise of the potential voting rights and any other contractual arrangements, whether considered individually or in combination) that affect potential voting rights, except the intention of management and the financial ability to exercise or convert.

6. The existence of separate legislative powers does not, of itself, preclude an entity from being controlled by another entity. For example, the Office of the Government Statistician usually has statutory powers to operate independently of the government. That is, the Office of the Government Statistician may have the power to obtain information and report on its findings without recourse to government or any other body. The existence of control does not require an entity to have responsibility over the day-to-day operations of another entity or the manner in which professional functions are performed by the entity.

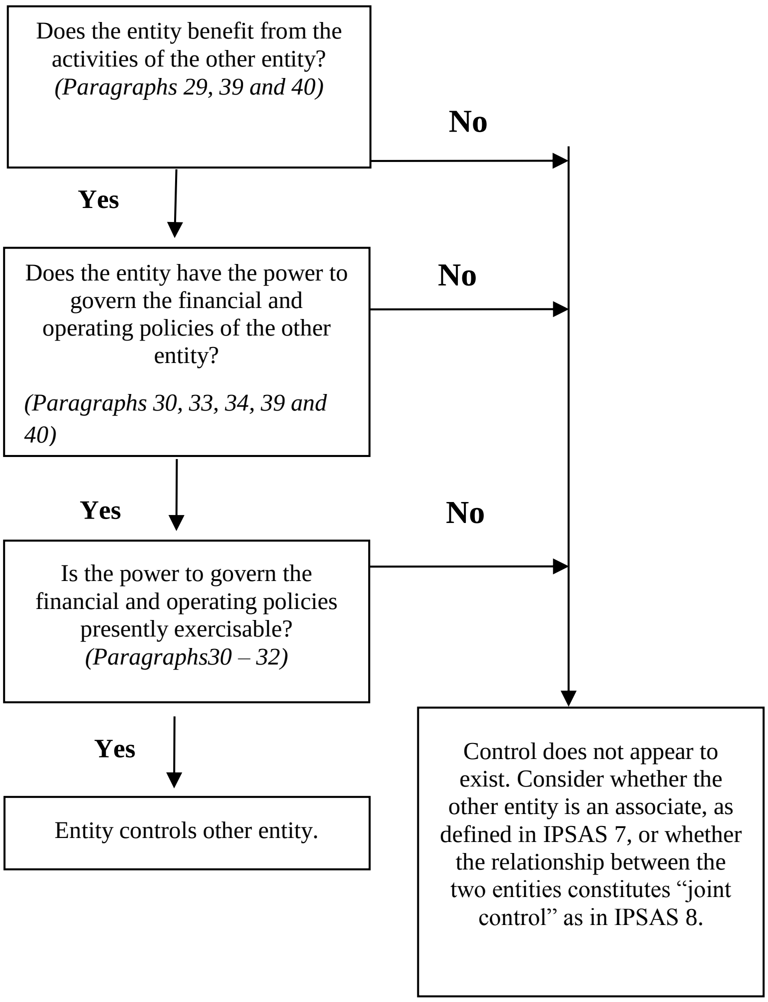
7. The power of one entity to govern decision making in relation to the financial and operating policies of another entity is insufficient, in itself, to ensure the existence of control as defined in this Standard. The controlling entity needs to be able to govern decision making so as to be able to benefit from its activities, for example by enabling the

other entity to operate with it as part of an economic entity in pursuing its objectives. This will have the effect of excluding from the definitions of a "controlling entity" and "controlled entity" relationships that do not extend beyond, for instance, that of a liquidator and the entity being liquidated, and would normally exclude a lender and borrower relationship. Similarly, a trustee whose relationship with a trust does not extend beyond the normal responsibilities of a trustee would not be considered to control the trust for the purposes of this Standard.

Determining Whether Control Exists for Financial Reporting Purposes

The following diagram indicates the basic steps involved in establishing control of another entity. It should be read in conjunction with paragraphs 28 to 40 of IPSAS 6.

Establishing Control of Another Entity for Financial Reporting Purposes



6. Consolidation Procedures and Exceptions

1. In preparing consolidated financial statements, an entity combines the financial statements of the controlling entity and its controlled entities line by line, by adding together like items of assets, liabilities, net assets/equity, revenue, and expenses.
2. **Balances, transactions, revenues, and expenses between entities within the economic entity shall be eliminated in full.**
3. Balances and transactions between entities within the economic entity, including (a) revenues from sales and transfers, (b) revenues recognized consequent to an appropriation or other budgetary authority, (c) expenses, and (d) dividends or similar distributions, are eliminated in full. Surpluses and deficits resulting from transactions within the economic entity that are recognized in assets, such as inventory and fixed assets, are eliminated in full. Deficits within the economic entity may indicate an impairment that requires recognition in the consolidated financial statements. Guidance on accounting for temporary differences that arise from the elimination of surpluses and deficits resulting from transactions within the economic entity, can be found in the relevant international or national accounting standard dealing with income taxes.
4. The revenue and expenses of a controlled entity are included in the consolidated financial statements until the date on which the controlling entity ceases to control the controlled entity. The difference between the proceeds from the disposal of the controlled entity and its carrying amount as of the date of disposal, including the cumulative amount of any exchange differences that relate to the controlled entity recognized in net assets/equity in accordance with IPSAS 4, The Effects of Changes in Foreign Exchange Rates, is recognized in the consolidated statement of financial performance as the gain or loss on the disposal of the controlled entity.
5. **When separate financial statements are prepared for a controlling entity that, in accordance with paragraph 2 (chapt. 3) of this document, elects not to prepare consolidated financial statements, those separate financial statements shall disclose:**
   (a) The fact that the financial statements are separate financial statements; that the exemption from consolidation has been used; the name of the entity whose consolidated financial statements that comply with IPSASs have been produced for public use and the jurisdiction in which the entity operates (when it is different from that of the controlling entity); and the address where those consolidated financial statements are obtainable;
   (b) A list of significant controlled entities, jointly controlled entities, and associates, including the name; the jurisdiction in which the entity operates (when it is different from that of the controlling entity); proportion of ownership interest; and, where that interest is in the form of shares, the proportion of voting power held (only where this is different from the proportionate ownership interest); and
   (c) A description of the method used to account for the entities listed under (b).

7. Transitional Provisions

1. **Entities are not required to comply with the requirement in paragraph 2 (Chapt. 7) concerning the elimination of balances and transactions between entities within the economic entity for reporting periods beginning on a date within three years following the date of first adoption of accrual accounting in accordance with IPSASs.**

2. Controlling entities that adopt accrual accounting for the first time in accordance with IPSASs may have many controlled entities, with a significant number of transactions between these entities. Accordingly, it may be difficult to identify some transactions and balances that need to be eliminated for the purpose of preparing the consolidated financial statements of the economic entity. For this reason, paragraph 1 (chapt. 8) provides relief from the requirement to fully eliminate balances and transactions between entities within the economic entity.
3. In case of Georgia spending entities will not be given such relief. It is believed that there doesn't exist such significant number of transactions between Georgian spending entities, that could make consolidation procedure impossible. Therefore for the purposes of comprehensive financial reporting, entities in Georgia will have to identify and eliminate transactions in the process of preparing financial statements, within three years following the date of first adoption of accrual accounting in accordance with IPSAS.
4. **Where entities apply the transitional provision in paragraph 1 (chapt. 8), they shall disclose the fact that not all balances and transactions occurring between entities within the economic entity have been eliminated.**