CHAPTER 1

# Assessment of control and significant influence for consolidated financial statements

**This article aims to:**

- Highlight the requirements relating to assessment of control and significant influence and
- Provide a brief overview for classification of an investment as a subsidiary or an associate.

The business environment in which entities operate is dynamic as one company can have business interests and investments in other entities in the form of joint ventures, associates, or subsidiaries. The stakeholders such as investors, promoters, lenders, government authorities, etc. are interested in knowing the complete overview of the operations and profitability of the group as a whole. Although separate financial statements of each entity would provide the financial position of an individual entity, but the consolidated financial statements would present the financial position of the entire group. Therefore, it is of utmost importance that the investments in other entities are accounted and disclosed appropriately by the parent entity in accordance with the applicable accounting standard framework.

Over a period of time, the business structures have become more complex. There have been instances wherein such complex business structures are misused to represent and misstate the financial statements to achieve certain outcome. As a result, the regulators time to time amend the regulatory provisions to ensure that the classification of investments as a subsidiary or an associate is based on the substance of the transaction and not merely its form. Over the past few years, regulators are closely monitoring the basis as per which an investor company is accounting its investment as a subsidiary or as an associate.

Following section provides an overview of regulatory requirements relating to preparation of consolidated financial statements.

## Regulatory framework

As per Section 129 of the Companies Act 2013 (2013 Act), if a company has one or more subsidiaries or associate companies, then such a company is required to prepare consolidated financial statements. In addition to this, as per Regulation 33[1] and Regulation 52[2] of the Securities Exchange Board of India (SEBI) (Listing Obligations and Disclosure Requirements) Regulations, 2015 (LODR Regulations), a listed entity having subsidiaries is required to submit consolidated financial results and statements in addition to standalone financial results and statements to the stock exchange.

To prepare consolidated financial statements, it is imperative to first understand whether the investment in a company falls in the category of a subsidiary or an associate, as the accounting treatment and presentation requirements is different for a subsidiary and an associate.

The following table prescribes the regulatory conditions for distinguishing between a subsidiary and an associate:

| Subsidiary | Associate |
|---|---|
| As per the Section 2(87) of the 2013 Act, a subsidiary company is a company in which the holding company:<br><br>i. **Controls** the composition of the Board of Directors; or<br><br>ii. Exercises or controls more than one-half of the total share capital either at its own or together with one or more of its subsidiary companies:<br><br>It is further clarified that:<br><br>a. A company shall be deemed to be a subsidiary company of the holding company even if the control referred in clause (i) or (ii) above, is of another subsidiary company of the holding company<br><br>b. The composition of a company's Board of Directors shall be deemed to be controlled by another company if that other company by exercise of some power exercisable by it at its discretion can appoint or remove all or a majority of the directors. | As per Section 2(6) of the 2013 Act, an associate company means a company in which the other company has a **significant influence**, but which is not a subsidiary company of the company having such influence and includes a joint venture company. |

*(Source: KPMG in India's analysis, 2023)*

Thus, as demonstrated in the above table, to distinguish between subsidiary and an associate its important to determine the level of of influence i.e. to decide if there is an existence of control or significant influence. The determination of level of influence i.e. control or significant influence

1. SEBI provisions applicable to a listed entity which has listed specified securities Regulation 33(3)(b) clarifies that that a listed entity having subsidiaries is required to submit quarterly/year-to-date consolidated financial results.
2. SEBI provisions applicable to a listed entity which has listed its non-convertible securities on a recognised stock exchange

is an important area of evaluation which may require judgement depending on the facts and circumstances of each case. The table below provides an overview of the distinction between the two elements as per the provisions of the 2013 Act and Ind AS:

| Control | Significant influence |
|---|---|
| **Provisions of the 2013 Act** | |
| As per Section 2(27) of the 2013 Act control includes:<br>a. The right to appoint majority of the directors or<br>b. To control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders' agreements or voting agreements or in any other manner;". | As per the explanation to Section 2(6) of the 2013 Act, significant influence means control of at least 20 per cent. of total voting power, or control of or participation in business decisions under an agreement. |
| **Principles of the applicable Ind AS** | |
| AS 110, *Consolidated Financial Statements*, further states that, an investor controls an investee if the investor satisfies all the following conditions:<br>a. Power over the investee and current ability to direct the relevant activities<br>b. Exposure, or rights, to variable returns from its involvement with the investee; and<br>The ability to use its power over the investee to affect the amount of the investor's returns | Ind AS 28, *Investments in Associates and Joint Ventures states* that significant influence refers to the power to participate in the financial and operating policy decisions of the investee but is not a control or a joint control.<br>It is further stated that, the existence of significant influence by an entity is usually evidenced in one or more of the following ways:<br>a. Representation on the board of directors or equivalent governing body of the investee<br>b. Participation in policy-making processes, including participation in decisions about dividends or other distributions<br>c. Material transactions between the entity and its investee<br>d. Interchange of managerial personnel; or<br>e. Provision of essential technical information. |

*(Source: KPMG in India's analysis, 2023)*

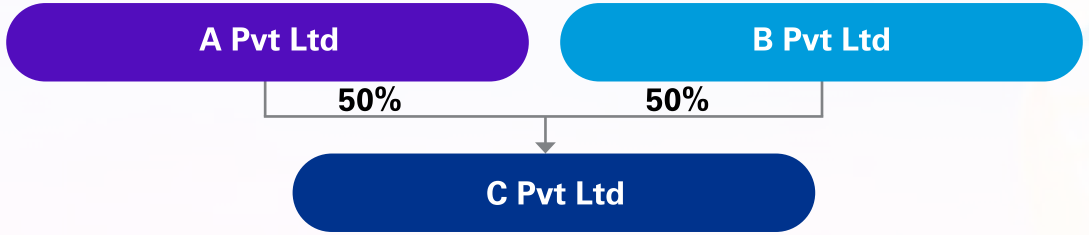
Therefore, while assessing whether an entity is a subsidiary or an associate, the threshold for shareholding is an important factor for identification but a deeper analysis and an enhanced understanding of the facts of the case is required to assess whether an entity is to be considered as a subsidiary or an associate.

Accordingly, basis the above evaluations, if the investee company is considered as a subsidiary then the procedure for consolidation as stipulated in Ind AS 110 is required to be followed by the parent entity. In such a scenario, the parent entity, *inter alia*, is required to consider the requirements for elimination of inter-company transactions, accounting of non-controlling interest and accounting for loss of control of subsidiaries, if any. In case the investee company is determined to be an associate, then the principles of application of equity method of accounting, as stipulated in Ind AS 28, is required to be followed by the investor company.

Further, the regulators in the recent past have also made certain observations relating to non-compliance with the regulatory requirements relating to determination of control, correct classification of an entity as subsidiary or an associate. We have discussed the key criteria relating to determination of relation between subsidiary and parent through an illustration below which has also been highlighted by the regulators:

## Illustration

A Pvt Ltd and B Pvt Ltd entered into a Memorandum of Understanding (MOU) to jointly operate the business of C Pvt Ltd. As a result, A Pvt Ltd and B Pvt Ltd, each held 50 per cent of the total shareholding of C Pvt Ltd.




**Key facts from the MOU are as follows:**

- *Board of directors:* The board of directors of C Pvt Ltd would consist of five directors out of which
  - Three directors would be nominated by A Pvt Ltd and
  - Two directors by B Pvt Ltd.
- Additionally, two independent directors are to be appointed, out of which
  - One director would be appointed by A Pvt Ltd and
  - One by B Pvt Ltd.
- *Chairman and managing director:* From the board of directors of C Pvt Ltd, A Pvt Ltd will appoint a chairman. The managing director is to be appointed by B Pvt Ltd.
- *Control:* The control relating to operations, management, supervising, service & directions, etc. of the business of C Pvt Ltd lies with A Ltd. Further, A Pvt Ltd also has the capacity of taking major decisions with respect to the business projects of C Pvt Ltd.
- *Working capital:* B Pvt Ltd will provide certain initial working capital to C Pvt Ltd.
- *Auditor appointment:* The statutory auditor of C Pvt Ltd is to be appointed by A Pvt Ltd whereas the internal auditor is to be appointed by B Pvt Ltd.
- *Expenses:* A Pvt Ltd has rights/exposure to get management fee of 2 per cent of the turnover and further earning of 6 per cent of the gross profit. Further, A Pvt Ltd is also required to bear the repair and maintenance expenses.
- *Treatment of surplus:* The surplus remaining after deducting the management fee and after reducing a reasonable allowance of working capital is to be transferred to B Pvt Ltd.

**Relevant facts from Articles of Association (AoA) of C Pvt Ltd are as follows:**

- In case of an equality of votes, the chairman shall be entitled to a second or casting vote.
- C Pvt Ltd may increase or reduce the number of directors from time to time by passing an ordinary resolution
- C Pvt Ltd has empowered A Pvt Ltd to appoint majority of the directors

**Other key points to consider:**

- C Pvt Ltd appointed two independent directors
- The key personnel who head the operations of C Pvt Ltd and are also the employees of A Pvt Ltd

In order to determine if A Pvt Ltd should recognise C Pvt Ltd as a subsidiary or an associate, a deeper analysis is required.

On the face of this illustration, it appears that both, A Pvt Ltd and B Pvt Ltd hold 50 per cent equity in C Pvt Ltd and have equal rights in C Pvt Ltd - however, there is a need to look into the substance of the transaction considering the key clauses in the MOU and AOA, and a detailed evaluation of the regulations to understand the relationship between A Pvt Ltd and C Pvt Ltd.

The following factors should be considered for this assessment:

a. **A Pvt Ltd's control/power over the composition of the Board of Directors of C Pvt Ltd:**

- **Voting rights:** In addition to 50 per cent voting rights of C Pvt Ltd, it is important to note that A Pvt Ltd appointed the chairman of C Pvt Ltd. The chairman has a casting vote in case of equality of voting shares indicating that A Pvt Ltd also has control over casting vote through the Chairman.
- **Right to appoint majority of directors:** The AOA empowers A Pvt Ltd to appoint majority of the directors.
- **Right to removal of directors:** As A Pvt Ltd has a second or casting vote, through the Chairman of C Pvt Ltd, by exercising such a casting vote, A Pvt Ltd holds a decisive voting right and therefore has the power to pass an ordinary resolution to remove a director from C Pvt Ltd's board at its discretion.

  Further, Section 169[3] of the 2013 Act, *inter alia*, states that in case an independent director is re-appointed for a second term as per Section 149[4] of the 2013 Act, then such an independent director shall be removed by the company only by passing a special resolution. In the given case, the independent directors of C Pvt Ltd. have been appointed through ordinary resolution. Therefore, unless they are re-appointed for a second term as per Section 149 of the 2013 Act, they can be removed through ordinary resolution, which is within the rights and control of A Pvt Ltd.

Thus, above point implies that majority representation on the Board of Directors of C Pvt Ltd is of A Ltd. so it is able to control various decisions.

b. **A Pvt Ltd's current ability to direct the relevant activities of C Pvt Ltd:** As per the MOU between A Pvt Ltd and B Pvt Ltd, A Pvt Ltd had the capacity of taking major decisions with respect to the business projects of C Pvt Ltd and also control the operations, management, supervising, service & directions, etc. of the business of C Pvt Ltd. Therefore, since the critical and significant decisions of C Pvt Ltd's operations lie with A Pvt Ltd, it can be construed that A Pvt Ltd is able to direct the relevant activities of C Pvt Ltd.

c. **A Pvt Ltd's exposure/rights to variable returns from involvement with C Pvt Ltd:** As stated in MOU, A Pvt Ltd not only has rights with respect to the operations and management of the business of C Pvt Ltd but also entitled to two per cent of turnover as management fee and six per cent of the gross profit as further earning and A Pvt Ltd is also required to bear the expenses relating to repair and maintenance. Therefore, A Pvt Ltd is exposed or has rights, to variable returns from its involvement with C Pvt Ltd.

d. **A Pvt Ltd's ability to use its powers to affect returns:** Considering the list of rights vested with A Pvt Ltd, as stated above, and the number of its employees working in senior positions of C Pvt Ltd, it is evident that A Pvt Ltd has rights/powers to affect the returns.

Based on the above analysis, A Pvt Ltd controls C Pvt Ltd and would need to consolidate it in financial statements.

## Bottom line

As companies are growing and expanding their operations, the corporate structures are also becoming more complex and complicated. Therefore, it is important for management to consider existence of control or significant influence in addition to the percentage of shareholding for the purpose of ensuring correct classification of an investment into a subsidiary or an associate. The regulators are also highlighting lapses in the classification and identification of an investment into a subsidiary or an associate. Therefore, this is an important area of evaluation and continuous assessment.

3. Section 169 of the 2013 Act stipulates the provisions with respect to removal of directors
4. Section 149 of the 2013 Act lays down the provisions with respect to Board of Directors of a company