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Mind the GAAP

A new control test to determine group entities



ILLUSTRATION: ROHINI PHOENIX

Starting April 1, 2015, over 600 listed companies will adopt new accounting standards. These could dramatically alter revenues, profit and financial ratios. The new accounting standard on consolidation determines which entity is or is not part of the business group. Under Indian GAAP, ownership of over 50% voting rights or control over the Board of Directors amounts to control. But Indian Accounting Standard 110 defines control as power over an investee and exposure or rights to variable returns from involvement with the investee as well as the ability to use that power over the investee to affect returns.

CNBC TV18's Menaka Doshi talks to VS Parthasarathy, group CFO & group CIO, M&M; Sai Venkateshwaran, partner & head, Accounting Advisory Services, KPMG, and Sumit Seth, partner & IFRS leader, Price Waterhouse, about the impact of this new standard.

Doshi: Let's identify different control scenarios and then look at whether entities under those control scenarios need to get consolidated or not? What is de facto control? How does this play out?

De facto control
Seth: If you think about Indian promoter group companies, they may for example, hold 40% or 45% equity interest. And remaining investors are dispersed, having small share holdings. Now, typically, this dominant investor has the practical ability to make the decisions, to get the resolutions passed, set the meeting and so forth. So, really, this investor is the one who probably has the de facto control and, therefore, this investor would consolidate the entity. So, under Indian GAAP, you would need to have more than 50% voting rights. Now, even if you have 40% or 45% and other investors are dispersed with small shareholdings, then this investor will actually consolidate the other entity.

Venkateshwaran: This becomes very judgemental because there are 24 judgements that are involved here. First is, when is it that you determine you have significant shareholdings? So, for instance, if you have increased your shareholding over a period of time... when is it that you have reached that threshold that you say, "Okay, now I am the most significant shareholder?" The second is, to determine at what threshold do you say that the remaining shareholders are dispersed? The third is to see who those remaining shareholders, have they organised themselves in a manner to act together?

Doshi: Give me an illustration?

Venkateshwaran: Say, you have 40% ownership. The remaining 60% is spread between 20 different shareholders, each holding less than 5%. Would you say that because there are only 20 in number and they are relatively spread out that you are probably the single-most dominant shareholder? On the other hand, if these 20 have an agreement amongst themselves that they will act together in concert, then potentially you do not have control.

Parthasarathy: If you are very close to being in control, but you do not have 51%, consolidate it. That is easy. The judgemental part comes here. If I have 45%? Easy. What if I have 40%? What if I have 35%? What if I have 30%? What if I have 25%? Where do we draw the line? So, that is where the judgemental part is. So, it is easy when it is closer to 50%, it is more difficult and more subjective otherwise.

Doshi: What are the implications? Because you may have created this entity and you may have capped your shareholding at less than 50%, because you wanted it to be an off-balance sheet entity. Now you discover that you are going to have to consolidate it within the group?

Venkateshwaran: Let's say this company where you have maintained a minority ownership is probably a loss-making entity. It has got a significant amount of debt which you don't want to bring up which is your share of profits or losses.

Contractual arrangements
Seth: One example could be in auto companies. You have manufacturers and you have ancillary components suppliers. Typically, you have supply arrangements with these suppliers and also the auto company may be funding these other entities. Based on contractual arrangements and depending on how these agreements are worded, you could get to a situation where the auto company may need to consolidate the components supplier.

Parthasarathy: I don't think there are many such arrangements, but if they were, the point is valid. What we don't do is to give them equity but we help them in all manners. If we can support them by saying "I can give you this much of debtors which I have, creditors which have..."

Doshi: So, would such a funding arrangement qualify as a loan? I would also see other contractual arrangements, who has the rights on key decisions, who is able to appoint the board of directors...

Parthasarathy: We have this unique situation in a real estate kind of business, that everything is an SPV and there is always a core investor along with it who brings either land or something and they will always have some say in the matter. Commercially it is absolutely legitimate, so then in this new situation will nobody consolidate?

Venkateshwaran: In the power and infrastructure business, we have dealt with similar situations, where the Listco probably does not have much operations. All operations are done through SPVs and almost everyone may have private equity or other investors, where you have ended up sharing some of these participative rights. It could come to a point where you are not going to consolidate any of them. You will only have your equity pick

Potential voting rights
Venkateshwaran: Effectively, one is your current ownership rights and one is what you could have in the future... by virtue of let's say call options or convertible instruments, which if when exercised could give you control, then the entity has to be consolidated.

Seth: The other important point is whether these call options, warrants... are they in the money or not? So, if they are clearly deep out of the money, you don't have substantive potential voting rights. But if they are in the money, then they are something you would consider in evaluating whether you have control, because if it is in the money, it is likely that the investor will exercise that and be able to get more than 50% voting interest.

Doshi: But it does mean a renegotiation?

Parthasarathy: We have to ex-

aminal contracts under the new regime anyway. Because sometimes in PE investments, the PE may have this protective right that the legal system says it is a participative right.

therefore, this 70% investor will not be able to consolidate and they will have to do an equity method accounting. So, this is one area where when companies are entering into financing arrangements, shareholder agreements, they should look into what rights they are giving away to other investors.

Parthasarathy: There is one way practically this can be resolved. What you can put in is a deadlock mechanism. I.e. the 70% guy says that, "listen, if you finally disagree with me and I can't operate and therefore it is a deadlock, I will buy your shares out at that point of time." If you provide that mechanism, then I believe you can consolidate. This is easier in PE. In joint venture it may not be easy to get this agreement done.

Doshi: But it does mean a renegotiation?

Parthasarathy: We have to ex-

answer that they wanted. But today they would end up with very different situations. It could possibly be joint control.

Parthasarathy: This is where the problem is. Therefore, it will be a JV, therefore neither can consolidate the revenues, so you can only do equity consolidation.

Parthasarathy: Suppose I had structured an entity to be 50% plus one owned by somebody and 50% minus one owned by somebody but the other person who has a lower stake had board control. Both could consolidate, if it was possible under the regime (Indian GAAP). But the new rule (IND-AS) says only one person can consolidate.

Venkateshwaran: Earlier it was easy to say, okay the Indian entity has got 51% control, so therefore consolidate. The other entity probably looked at it from an International Financial Reporting Standards (IFRS) framework and said that I probably have a lot of the operating control, so will like to consolidate. So, both got the an-

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