

## CONCEPTUAL TRANSFORMATION OF “DE FACTO” CONTROL IN PREPARING CONSOLIDATED FINANCIAL STATEMENTS: THE EXPERIENCE OF RUSSIAN COMPANIES

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### Abstract

The paper serves as a continuation of a previously conducted research in the area of consolidated financial statements. The research focuses on two aspects: the concept of “control” and accountant’s judgement. The authors’ analysis focuses on the impact of the transition from the previous standard texts to an amended (improved) wording of the standard in the absence of changes to the original (formulated as the basis) concept by the example of transition from IAS 27 to IFRS 10. The research was carried out and based on a dynamic quantitative and qualitative analysis of 250 consolidated financial statements in accordance with IFRS for 2015 and 2012. The paper presents the results of the confirmation of hypothesis regarding the substantial influence of the judgement on determining the scope of consolidation within the concept of “de facto” control: 41.54% of Russian companies declared their application of the judgment in determining the scope of consolidation in consolidated financial statements for 2015 (37.50% in consolidated financial statements for 2012, respectively). The paper also reveals factors which have had the greatest impact on accountant’s decision-making regarding to the forming the scope of consolidation (the scale and an industry of the company).

**Keywords:** consolidated financial statements, judgement in determining de facto control, IFRS, creative accounting.

**JEL code:** M410, M400

### 1. Introduction

The paper serves as a continuation of the third stage of the authors’ research that is focused on the problem of the assessment of the *professional judgement impact on the decision on identification of subsidiaries (their inclusion or non-inclusion in the scope of consolidation)*. This identification is based on the concept of “control”.

The results of the first stage of the study were reported at the international conference “IFRS Global Rules & Local Use 2016” which was held in Prague (Czech Republic) on 30 September 2016. The specified problems were studied through the analysis of consolidated financial statements of 130 Russian companies for 2015. (Generalova, N., Popova, E., 2016). The conclusions obtained at the second stage of the study were presented at the international conference “ICAAT 2016” in Tallinn (Estonia) and were based on the analysis of data from 107 European companies for 2015. The second stage of the research also included the comparison of Russian and European experience of consolidation. (Generalova, N., Popova, E., 2016). Thus, “static” (within 2015) and comparative (Russia and European countries) analysis have been carried out at the first and the second stages of the authors’ research in regard with raised issue.

The third stage of the research is the implementation of the “dynamic” analysis of the problem of “the professional judgement impact on the scope of consolidation” by the example of studying the sample of Russian companies. At the third stage of the research, *the scope of consolidation of Russian groups of companies for 2015 and 2012 has been compared* (according to consolidation financial statements in accordance with IFRS for 2015 and 2012). *For financial data for 2015 and 2012 a different international standards on consolidation have been applied* (in 2013 there was a transition to IFRS 10 “Consolidated financial statements” from IAS 27 “Consolidated and Separate Financial Statements” (as amended 2008)).

The prerequisites for the issuance of IFRS 10 “Consolidated Financial Statements” were the following circumstances: disadvantages preferential application of the concept of “*legal*” control in accounting practices, the financial crisis, as well as a continued convergence of US GAAP and IFRSs (EFRAG, 2012, p.23). With the issuance of IFRS 10, the definition of “*de facto*” (“*factual*”) control has been clarified. So, with the introduction of IFRS 10 the concept of “*de facto*” control has superseded the concept of “*legal*” control due to certain disadvantages of IAS 27 and the concept of “*legal*” control (that had been predominantly used in accounting practices in qualifying the company as a subsidiary and in subsequent including of its financial data in the consolidated financial statements).

#### *The research issue*

The transition to the new wording of the standard is often able to change the understanding the company’s financial position by its users. Having given this circumstance authors were interested in the issue of impact of the transition from IAS 27 to IFRS 10: “what impact will clarifying the concept of “*factual*” control (according to IFRS 10) be placed on the financial data, as well as how much the accountant’s judgement regarding to the scope of consolidation will affect the indicators of financial statements?”. The criteria introduced in IFRS 10 serve as a basis for determining the existence of “*factual*” control. At the same time, judgement is an inherent and, in most cases, an important (determining) stage for decision whether the investor controls the investee in preparing consolidated financial statements in accordance with IFRSs.

#### *Literature review*

Publications have been observed by authors that devoted to the issues of the preparation of consolidated financial statements and judgement application as well as the conceptual framework implementation. Among American authors, scientific works of such scientists and researchers have been observed as: E.L. Kohler, Moonitz M., Paul J. Graber, T. W. Leland, James R. McCoy, Hale L. Newcomer, E. L. Kohler and H. C. Miller. Publications of the American Association of Accountants have also been analyzed. Among Russian authors: Sokolov Ya.V., Sokolov V.Ya., Kovalev V.V. , Kovalyov Vit.V., Pyatov M.L., Generalova N.V., Soboleva G.V., Sokolova N.A., Karelskaia S.N., Plotnikov V.V., Moderov S.V., Volkova E.Yu. , Mikhailova O.A., Sukonnikov V.V., Karimova E.R., Gorshkova N.V.

A number of publications analyzed indicate that there is a problem and uncertainties in forming of the scope of consolidation. Authors propose the theoretical solutions (mainly, in conjunction with other problems of preparation of consolidated financial statements). However, the authors of the current publication have not found empirical study, which is entirely devoted to the problem of determining “*factual*” control on the basis of the professional judgement. As a result of the literature review, the authors of the current publication concluded that it is necessary to carry out empirical research in the application of the concept of “*factual control*” in accounting practice. Also, the authors of the current publication have identified the key points that should be taken into

account in reading the financial data of companies on their consolidated financial statements.

## 2. Introduction to the terminology: the concept of “factual” and the concept of “legal” control

Solving the problem of a terminological uncertainty is one of the most urgent objective to be solved by present scientific community both at the local and at the global level. In the paper authors use the term “*factual*” / “*economic*” control (“*the concept of “factual” control*”). The term of “*legal*” control (“*the concept of “legal” control*”) is contrasted to the term “*factual*” / “*economic*” control. In IFRS, as well as GAAP US the term “*de facto*” control is applied. The term “*de facto*” control is used predominantly in publications for practical purpose (see such as (PWC, 2011, pp. 1-37); (Deloitte, 2011, pp. 1-20)). The professionals widely use the notion of “*factual*” control at the practice of business and academic communication.

The Table 1 contains the author's interpretation of two opposing concepts (with the identification of characteristics that allow dividing “*the concept of “factual” control*” and “*the concept of “legal” control*”).

Table 1. The comparison of the “factual” control and the “legal” control” concepts

Characteristic	The concept of “factual” control	The concept of “legal” control
1	2	3
<b>The basis and the nature of the concept</b>	Accounting concept “substance over form”	The legal right of investor to control through the controlling ownership interest
<b>The criterion for including an investee in the scope of consolidation</b>	<p><b><i>Matching several criterion simultaneously</i></b></p> <p>an investor controls an investee if and only if the investor:</p> <ol style="list-style-type: none"> <li>1) power over the investee;</li> <li>2) exposure, or rights, to variable returns from its involvement with the investee</li> <li>3) the ability to use its power over the investee to affect the amount of the investor’s returns</li> </ol> <p>(IFRS 10, par. 7, 10-18, Appendix B)</p>	<p><b><i>Ownership interest amounting to 50% + 1 shares in investee</i></b></p> <p><i>by the example of Russian accounting rules and other laws:</i></p> <p><i>The indicator is:</i> the presence of a majority interest in the share capital or having the contractual right to have an opportunity to determine the decisions made by the subsidiary.</p> <p>(Civil Code, par. 67.3); (208-FZ “On Joint-Stock Companies”, par 6.2)</p>

Source: prepared by the authors

According to “economic” interpretation of the term “control” a company can be classified as a subsidiary even in the absence of prevailing voting share in it. That is, the “*factual*” control means essential, not formal compliance with the definition and criteria for existence of control provided by IFRS 10. The “*legal*” control means the investor control over the investee in the presence of more than half of the voting shares. The fundamental factors for existence of “*factual*” / “*economic*” control are: the substance, the nature and the purposefulness of gaining benefits from the acquisition of power authority over the investee. These factors of “*factual*” control require the expression of professional judgment to a greater extent than in the application of “*legal*” control (see Table 2). Thus, accountant for preparing current consolidated financial statements according to IFRS determines the presence of “*factual*” control over investee through the analysis the

principles (criteria) for existing control provided by IFRS 10, as well as professional judgement.

### **3. Research methodology**

#### *The aim*

The paper aims to research the impact of the transition from the previous standard texts to a new wording of the standard in the absence of changes in the original (formulated as the basis) concept by the example of influence the transition from IAS 27 to IFRS 10.

In other words, the scope of consolidation of companies' groups according to consolidation financial statements for 2012 and 2015 has been compared. In these years a different standards have been applied (because in 2013 the transition from IAS 27 "Consolidated and Separate Financial Statements" (edit. 2008) to IFRS 10 "Consolidated Financial Statements" were occurring.

#### *Hypotheses*

During the study the following hypothesis had been formulated and tested by authors:

**H1** Standard changes occurred (clarifying the current accounting concept regarding to consolidation) influence accountant's decision taken out to those accounting areas that require the implementation of professional judgement. This hypothesis has been tested for changes in adjustments in the "control concept" (the transition from IAS 27 to IFRS 10).

**H2** The scope of consolidation depends on the term of "control". The treatment of "control", in its turn, depends on the accountant's professional judgement.

**H3** Belonging to certain business field (industry) has a significant influence on the accountant's judgement in determining whether de facto control exists.

**H4** Company size is a factor which determines the decision about the consolidation.

#### *Sampling and grouping*

Verification of listed hypotheses has been carried out on the empirical data of Russian companies. Companies sampled were divided into two groups: "GRus-2015" and "GRus-2012". The group "GRus-2015" has been formed from the largest Russian companies and their consolidated financial statements for 2015. The group "GRus-2012" has been formed from the same companies (and their consolidated financial statements for 2012) which have been included into the group "GRus-2015" excepting ten firms that had not published consolidated financial statements for 2012 at the time of authors' study (mainly, due to non-entry the mandatory requirement about preparing consolidated financial statements for these companies according to par. 2 and par. 8 of the Federal Law "On Consolidated Financial Statements" dated 27.07.2010) (208-FZ, 2010, par. 2, par. 8).

#### *The basis of sampling*

The basis for sampling of "GRus-2015" and for "GRus-2012" is the rating of 600 largest Russian companies in 2015 (RAEX 600) ([http://www.raexpert.ru/rankingtable/top\\_companies/2015/main/](http://www.raexpert.ru/rankingtable/top_companies/2015/main/)). The research is **solely** based on the data contained in the consolidated financial statements **in accordance with IFRS**.

#### *The sample size*

The group "GRus-2015" includes **130 companies** and their consolidated financial statements for 2015. The group "GRus-2012" consists of **120 companies** and their consolidated financial statements for 2012. **The total number** of study observations is **250 companies** and their

consolidated financial statements.

#### 4. Research results

The final results of the quantitative analysis of marked problem are presented in Table2.

Table. 2. The results of the study the problem of implementation of “factual” control by Russian companies in 2015 and 2012

<b>Assertion (thesis)</b>	<b>The percentage of Russian companies according to CFS* for 2012, %</b>	<b>The percentage of Russian companies according to CFS* for 2015, %</b>	<b>Growth, %</b>
<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
<b>COMPANIES APPLIED JUDGEMENT in determining the scope of consolidation</b> <i>i.e. the companies which have included (not included) into the group investees under presence (absence) “de facto” control or have pointed out about the judgement application in forming the scope of consolidation in the section “Key judgement and estimates”</i>	<b>37.50</b>	<b>41.54</b>	<b>10.77</b>
The share of sampled companies which have pointed out about the judgement application in forming the scope of consolidation in the section “ <b>Key judgement and estimates</b> ”	<b>14.17</b>	<b>17.69</b>	<b>24.89</b>
The share of sampled companies which <b>have included into the group</b> investees under presence “ <b>de facto</b> ” control	<b>35.83</b>	<b>36.92</b>	<b>3.04</b>
The share of sampled companies which <b>have not included into the group</b> investees because of absence “ <b>de facto</b> ” control	<b>4.17</b>	<b>4.62</b>	<b>10.77</b>
The share of sampled companies which consolidated or not consolidated investees according to “de facto (factual) control” concept <i>(calculated by the number of companies, not cases)</i>	<b>36.67</b>	<b>40.00</b>	

Source: prepared by the authors on the basis of the conducted research

\* CFS – Consolidated financial statements have been analyzed by authors.

#### *Confirmation of hypothesis H1u H2*

As a result of the analysis of consolidated financial statements of Russian companies for 2012 (application IAS 27), it has been found that 37.50% of companies applied the judgement in regard with the scope of consolidation and pointed out about it either in the section “*The list of subsidiaries*” or in “*Key judgement and estimates*”. In 2015 the percentage of such companies amounted to 41.54%. Thus, thanks to the transition to IFRS 10, (1) the percentage of companies applied judgement in determining the scope of consolidation has been increased by 10.77%; (2) the percentage of companies which consolidated their subsidiaries based on the “factual control concept” in the absence of “legal” control has been increased too. *Consequently, hypothesis H1 on the impact of changes in wording of the standard on the accounting practice (in regard to the forming the scope of consolidation) is confirmed.* Nevertheless, this influence is insignificant: within the selected companies and by the example of study the practice of consolidation by Russian companies it has been found that the growth of “degree of application judgments” regarding this issue amounted to 10.77% according to conducted analysis. Because the percentage of companies which applied judgement in determining the scope of consolidation (as a result of the analysis of

the consolidated financial statements both: for 2015 and for 2012) is significant (i.e. 41.54% and 37.50%, respectively), the *hypothesis H2* is confirmed.

*Disclosure in the section “Key judgement and estimates” of the consolidated financial statements: 2015 and 2012*

14.17% of the companies studied pointed out in the section “Key judgement and estimates” that the determining whether investor controls an investee is a matter requiring judgement. In 2015 the share of such companies increased by 24.89% and amounted to 17.69% of sampled companies.

*Consolidation (non-consolidation) based on the presence (absence) of “factual” control: 2015 and 2012*

In 2012, 35.83% of sampled companies included into the scope of consolidation their investees with ownership interests less than half of voting rights. In 2015 the share of sampled group of companies consolidating “factually” controlled investees had been increased by 3.04% compared with 2012 and had amounted to 36.92%.

In 2012, 4.17% of sampled companies did not included investees on the scope of consolidation because of the lack of “factual” control, despite the presence of “legal” control. In 2015 the share of such companies remained roughly the same (the percentage of such sampled companies in 2015 was 4.62%).

*The results of qualitative analysis across industries for 2015 and 2012: the confirmation of hypothesis H3 and H4*

Table 3 presents the results of qualitative study across industries of determination the scope of consolidation conducted on the analysis of consolidated financial statements of Russian companies for 2015 and 2012.

Table. 3. Application of professional judgement by Russian group of companies in determining the scope of consolidation in 2012 and 2015

Industry	The percentage of Russian companies according to CFS* for 2012			The percentage of Russian companies according to CFS* for 2015			$\Delta$ , by what %	$\Delta$ , by what %	$\Delta$ , by what %
	The proportion of companies, Consolidation, % <sup>(1)</sup>	The proportion of companies, Judgement, % <sup>(2)</sup>	The average number of consolidated subsidiaries, % <sup>(3)</sup>	The proportion of companies, Consolidation, % <sup>(1)</sup>	The proportion of companies, Judgement, % <sup>(2)</sup>	The average number of consolidated subsidiaries, % <sup>(3)</sup>	The proportion of companies, Consolidation, % <sup>(1)</sup>	The proportion of companies, Judgement, % <sup>(2)</sup>	The average number of consolidated subsidiaries, % <sup>(3)</sup>
1	2	3	4	5	6	7	8	9	10
Trading and services	25.00	6.25	13.01	31.25	18.75	29.43	25.00	200.00	126.18
Oil and gas, chemical industry	35.29	<b>29.41</b>	24.61	11.76	17.65	15.66	-66.68	-39.99	-36.37
Financial companies	40.00	12.50	<b>43.56</b>	47.50	<b>25.00</b>	<b>45.28</b>	18.75	100.00	3.95
Electric energy industry	30.00	0.00	7.83	30.00	0.00	8.17	0.00	x	4.37
Transport	14.29	14.29	4.00	28.57	14.29	6.93	99.99	0.03	73.25

Industry	The percentage of Russian companies according to CFS* for 2012			The percentage of Russian companies according to CFS* for 2015			$\Delta$ , by what %	$\Delta$ , by what %	$\Delta$ , by what %
	The proportion of companies, Consolidation, % <sup>(1)</sup>	The proportion of companies, Judgement, % <sup>(2)</sup>	The average number of consolidated subsidiaries, % <sup>(3)</sup>	The proportion of companies, Consolidation, % <sup>(1)</sup>	The proportion of companies, Judgement, % <sup>(2)</sup>	The average number of consolidated subsidiaries, % <sup>(3)</sup>	The proportion of companies, Consolidation, % <sup>(1)</sup>	The proportion of companies, Judgement, % <sup>(2)</sup>	The average number of consolidated subsidiaries, % <sup>(3)</sup>
1	2	3	4	5	6	7	8	9	10
Construction	<b>50.00</b>	0.00	9.49	25.00	0.00	4.26	-50.00	x	-55.09
Telecommunication	40.00	20.00	6.87	<b>60.00</b>	20.00	5.27	50.00	0.00	-23.28
Industrial production	30.00	15.00	15.14	35.00	25.00	16.09	16.67	66.67	6.26
Mechanical engineering	30.00	10.00	7.23	50.00	0.00	6.98	66.67	-100.00	-3.52
<i>The average of sample</i>	<i>32.73</i>	<i>11.94</i>	<i>14.64</i>	<i>35.45</i>	<i>13.41</i>	<i>15.34</i>	<i>8.32</i>	<i>12.32</i>	<i>4.80</i>

Source: compiled by the authors on the basis of the conducted research.

(1) The proportion of the company groups which consolidated entities with the investment share in them less than 50%.

(2) The proportion of the company groups within an industry, which indicated control in the sphere of "Professional judgement" in the section "Key judgement and estimates".

(3) An average number of subsidiary companies in an industry which might be rolled up and which the group consolidated but has less than 50% share in them (the proportion of the consolidated companies in compliance with de facto control in the total number of consolidated companies).

\* CFS – Consolidated financial statements have been analyzed by authors.

Judging from the comparison of column 2 and column 5 of Table 3, it is stated that there was an insignificant fluctuation within industry the percentage of groups of companies which included the "de facto" controlled subsidiaries into the scope of consolidation. This fact serves as a confirmation of hypothesis H3 and H4: a type of the company business as well as company size have an important influence on the likelihood of consolidation (non-consolidation) of investees based on the "factual control" concept by groups of companies belonging to certain types of business activities. A clear example is the tendency (which has been noticed during the study) of financial companies to consolidation of structured entities to a greater extent than companies of other type of industries (in the terminology of IAS 27 it is called as "special purpose entities").

## 5. Conclusion

The practical application of the adopted theoretical concept and consequences of its application are very considerable factors for Accounting. So, authors of the paper have studied and tested the issue of application of the "factual control" concept (adopted by international community at the present time) in determining the scope of consolidation by Russian companies. Based on the conducted research, the following conclusion has been formulated: a clarification of the wording of the original (formulated as the basis) concept in the standard has a significant influence on the accountant's understanding the specific issues. Nevertheless, the unified understanding of the nature and essence of the adopted concept in accounting and the unified adherence to the principle which the concept contains are more important (the problem of

verification).

As a result of the conducted research of consolidated financial statements of Russian companies for 2015 (130 consolidated financial statements) and for 2012 (120 consolidated financial statements), four hypotheses have been tested and proved and the following conclusions have been obtained:

1. Changes in the wording of the standards affect the accountant's understanding of the inherent (basic) concept, despite the fact that the fundamental concept has not been changed. Regarding to principles of consolidation in IFRS, the "*factual control*" concept had been originally established as a basis in the first standard on consolidation (IAS 3). In subsequent international standards on consolidation (IAS 27, IFRS 10), the "*factual control*" concept was expanded, but the basic principle has not been changed. It is stated on the basis of the conducted research, that changes in the wording of the standards may affect the accountant's decision which requires a significant application of the professional judgement (in particular, regarding to the scope of consolidation).

2. Determination of the scope of consolidation based in IFRS on the concept of "control" (IFRS 10, p. 7–9, Appendix B) is at large dependent on the accountant's judgement.

3-4. Such factors (which are beyond accountant's control) as the type of the company business (an industry) and the company size have a significant impact on accountant's judgement in determining whether "de facto (factual)" control exists.

Further research is planned to conduct in two areas. Firstly, it is necessary to explain a significance of the identified factors (the belonging to industry, the company size and others) and the nature of their influence on the accountant's decision in regard to determination of the scope of consolidation in the absence of ownership interest amounting to a majority voting shares. To implement of this study, it is appropriate to carry out the correlation and regression analysis for sampled data which have been obtained during the previous stages of the authors' research (Data from consolidated financial statements for 2015 and 2012 of sampled Russian companies and from consolidated financial statements for 2015 of European companies. So, total observations are 357 companies and their consolidated financial statements in accordance IFRS). The second area for further research belongs to the issue of 'creative accounting' in determining the scope of consolidation on the basis of the determination whether de facto control exists, as well as an analysis of degree of judgement influence on consolidated financial statements indicators and decision made by users in the result of financial analysis of consolidated financial statements.

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