Position Paper

‘Full consolidation of partly owned subsidiaries requires additional disclosure’

1. Introduction

Many entities control one or more partly owned subsidiaries[1]. International Financial Reporting Standards (IFRS) requires full consolidation of such subsidiaries. ‘Full consolidation’ produces financial statements that are drafted as if these partly owned subsidiaries are wholly owned. Only two line items reflect partial ownership of certain subsidiaries: ‘net income attributable to common shareholders’ and ‘common equity’. This position paper has two aims:

a) to attest that even a single partly owned subsidiary already causes significant uncertainty for users of financial statements, as it impairs the ability to assess value, leverage, and liquidity;
b) to propose solutions to remove these uncertainties: disclosure of more line items that reflect partial ownership of subsidiaries, just like net income and common equity already do.

Our position is that entities should at least report cash, gross debt, revenue, operating profit and depreciation & amortisation in such a way that it reflects partial ownership of subsidiaries.

2. ‘Non-controlling interest’ can imply very different attributions to outside shareholders

‘Non-controlling interest in group equity’ only specifies what part of group equity is attributable to outside shareholders. However, it does not represent a general claim on the equity of the reporting entity as a whole. On the contrary, it represents the net amount of very specific assets and liabilities located in the partly owned subsidiaries that is attributable to outside shareholders. The table below illustrates how the same net amount, in this example 20, of non-controlling interest in equity of a fictitious entity ‘HoldingCo’ can imply very different attributions to outside shareholders. With the above in mind, there is an infinite number of scenarios resulting in the same net amount of 20.

HoldingCo	**Full consolidation**	**Attributable to outside shareholders**				
		Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario x
Cash	100	20		8	32	0 - 100
Accounts receivable	100		20	32	8	0 - 100
Total assets	**200**	**20**	**20**	**40**	**40**	**20 - 120**
Accounts payable	50			4	16	0 - 50
Interest bearing debt	50			16	4	0 - 50
Non-controlling interest	**20**	**20**	**20**	**20**	**20**	**20**
Common equity	80					
Group equity	100					
Total liabilities & equity	**200**	**20**	**20**	**40**	**40**	**20 - 120**

Differences between types of asset and types of liabilities are relevant for the assessment of the value, leverage, and liquidity of an entity. This relevance is illustrated in Appendix B.

[1] See Appendix A: ‘Many entities have partly owned subsidiaries that are fully consolidated’.

The ‘proportionate share’ of a line item incorporates the partial ownership of subsidiaries. The proportionate share can be found by subtracting the amounts attributable to outside shareholders from the fully consolidated financial statements. These adjustments effectively replace the ‘non-controlling interest’ line items, which are so difficult to interpret. The table below shows the proportionate share for each line item of the balance sheet based on Scenario 3 and 4. To illustrate how very different underlying separate financial statements could be, we assume HoldingCo only consolidates a 100% and a 60% owned subsidiary. Now the separate financial statements for each scenario can be reconstructed as well:

HoldingCo, scenario 3

	<IDENTICAL> Full consolidation	Outside shareholders	Proportionate share	Separate financial statements Subsidiary 'A' 100% owned	 Subsidiary 'B' 60% owned	
Cash	**100**	8	**92**	80	20	(92 =100% * 80 + 60% * 20)
Accounts receivable	**100**	32	**68**	20	80	
Total assets	**200**	40	**160**	100	100	
Accounts payable	**50**	4	**46**	40	10	
Interest bearing debt	**50**	16	**34**	10	40	
Non-controlling interest	**20**		**NM**	-	-	
Common equity	**80**	**20**	**80**	50	30	
Group equity	**100**	20	80	50	30	
Total liabilities & equity	**200**	40	**160**	100	80	
Key figures						
Cash, net of debt	50		**58**	70	(20)	
Net working capital	50		**22**	(20)	70	

HoldingCo, scenario 4

	<IDENTICAL> Full consolidation	Outside shareholders	Proportionate share	Separate financial statements Subsidiary 'A' 100% owned	 Subsidiary 'B' 60% owned	
Cash	**100**	32	**68**	20	80	(68 =100% * 20 + 60% * 80)
Accounts receivable	**100**	8	**92**	80	20	
Total assets	**200**	40	**160**	100	100	
Accounts payable	**50**	16	**34**	10	40	
Interest bearing debt	**50**	4	**46**	40	10	
Non-controlling interest	**20**			-	-	
Common equity	**80**	**20**	**80**	50	30	
Group equity	**100**	20	**80**	50	30	
Total liabilities & equity	**200**	40	**160**	100	80	
Key figures						
Cash, net of debt	50		**22**	(20)	70	
Net working capital	50		**58**	70	(20)	

This example illustrates the significant uncertainty users of financial statements face. A single set of fully consolidated financial statements can imply materially different underlying financial statements: the fully consolidated net cash position (i.e. cash net of debt) of 50 can equally imply a proportionate share in net cash of 58 and 22. In general, fully consolidated financial statements provide no information as to which individual line items add up to the (net!) amount of non-controlling interest on the balance sheet. This is unfortunate as it is very relevant (see appendix B) for the assessment of value, leverage, and liquidity to know for instance what part of the cash is attributable to outside shareholders, and thereby knowing what is the entity’s proportionate share of the cash. Similar to what is done for the balance sheet presentation, non-controlling interest in group income raises the same question for the fully consolidated income statement, as it remains unknown what part of, for example, revenue or operating profit is attributable to outside shareholders.

3. Example AkzoNobel's 2010 annual report

The excellent annual report of AkzoNobel shows that even a 'best in class'[2] annual report does not provide users with necessary information for the assessment of value, leverage, and liquidity. AkzoNobel fully consolidates, amongst others, a 51% owned subsidiary named 'International Paint of Shanghai Co Ltd'. The two tables below illustrate the consequences of the uncertainties resulting from the full consolidation of this partly owned subsidiary. Based on the information available in the annual report, a user of financial statements cannot be sure whether some part of the cash (or even all of it) is located in this 51% owned subsidiary. Similarly, some or all of the operating profit before interest taxes depreciation & amortization (EBITDA) could be generated in this 51% subsidiary and all of the debt could be issued by a 100% owned subsidiary, or vice versa. In the calculations below we assume positive EBITDA in both entities; although it cannot be ruled out that EBITDA is negative in 100% owned entities, offset by positive EBITDA in a 51% entity, or vice versa.

AkzoNobel, Scenario 'Favourable'	Full consolidation	Subsidiaries, % owned 100%	51%	Proportionate share	
EBITDA	1,964	1,964	-	1,964	(1,964 = 1,964 * 100% + 0 * 51%)
Cash	2,851	2,851	-	2,851	
Debt	3,787	-	3,787	1,931	
Net debt	936	(2,851)	3,787	(920)	

AkzoNobel, Scenario 'Unfavourable'	Full consolidation	Subsidiaries, % owned 100%	51%	Proportionate share	
EBITDA	1,964	-	1,964	1,002	(1,002 = 0 * 100% + 1,964 * 51%)
Cash	2,851	-	2,851	1,454	
Debt	3,787	3,787	-	3,787	
Net debt	936	3,787	(2,851)	2,333	

Based on the information in the annual report, a user cannot be sure whether AkzoNobel's proportionate net debt was € 2,333 million, or € 920 million negative, i.e. net cash. The table below shows how the lack of disclosure on this matter results in very wide possible ranges for equity valuation (firm value / EBITDA ratio), leverage (net debt / EBITDA ratio), and liquidity (cash position).

	AkzoNobel Full consolidation	=	AkzoNobel, Scenario 1 Proportionate share	or	AkzoNobel, Scenario 2 Proportionate share	or anything in between?
Cash	**2,851**		**2,851**		**1,454**	
Debt	3,787		1,931		3,787	
Net debt	936		(920)		2,333	
Non-controlling interests	525					
Market value equity	12,280		12,280		12,280	
Firm value	13,741		11,360		14,613	
EBITDA	1,964		1,964		1,002	
Common financial ratios						
Net debt / EBITDA	**0.5x**		**<net cash>**		**2.3x**	
Firm value / EBITDA	**7.0x**		**5.8x**		**14.6x**	

Therefore, the existing disclosure of AkzoNobel, just like nearly all listed companies, that report non-controlling interests, is insufficient to assess value, leverage, and liquidity.

Although this example of AkzoNobel relates to a Dutch company, the insufficient disclosure is not typical for companies listed in The Netherlands, or even companies that produce IFRS financial statements; it is an unaddressed issue in the financial reports of companies reporting according to any

[2] AkzoNobel's annual report 2010 was awarded the Sijthoff price for the best annual report in The Netherlands.

set of standards worldwide where partly owned subsidiaries are fully consolidated. We also encourage enforcers worldwide to follow the example of the Netherlands Authority Financial Markets to make disclosure on non-controlling interests a thematic research priority[3], and challenge reporting entities that provide insufficient disclosure on non-controlling interests.

4. More advanced analysis of cash flows is also hindered

The cash flow statement reconciles the development of fully consolidated cash from the beginning to the end of the year. Therefore, it does not distinguish a cash flow related to a partly owned subsidiary from a cash flow related to a wholly owned subsidiary. More advanced analysis of value, leverage, and liquidity using future cash flows requires modelling the development of non-controlling interests in equity and net income. As indicated before, annual reports rarely provide a reasonable basis for a user of financial statements to model these items.

A limitation of full consolidation is that fully consolidated cash can be easily affected by a rather simple transaction: Company ‘A’ identifies an outside shareholder to jointly incorporate a subsidiary in which Company ‘A’ contributes 50.1% of capital in cash and has control. Company ‘B’ contributes 49.9% of capital in cash, so a total of 200 cash is contributed. Please find below how this rather simple incorporation affects fully consolidated cash:

Company 'A', before	Subsidiaries, % owned		**<Identical> 'A' full consolidation**	**<Identical> 'A' proportionate share**
	100%	50.1%		
Cash	**120**	-	**120**	**120**
Other assets	300	**-**	300	300
Total assets	420	-	420	420
Debt	150	-	150	150
Common equity	270	-	270	270
Total liabilities & equity	420	-	**420**	**420**
Net debt			**30**	**30**

Company 'A', after	Subsidiaries, % owned		**'A' full consolidation**	**<Identical> 'A' proportionate share**	
	100%	50.1%			
Cash	**20**	**200**	**220**	**120**	(120 = 100% * 20 + 50.1% * 200)
Other assets	300	**-**	300	300	
Total assets	320	200	520	420	
Debt	150	-	150	150	
Non-controlling interest			**100**		
Common equity	170	**200**	270	270	
Group equity			370		
Total liabilities & equity	320	200	**520**	**420**	
Net debt (net cash)			**(70)**	**30**	

The result of this transaction is that it increases reported fully consolidated cash from 120 to 220 (and the non-controlling interest in group equity by 100 as well). The column with the proportionate shares complements the insight provided by the fully consolidated balance sheet, as analysing the combination of both balance sheets reveals per line item what part of the fully consolidated balance sheet is attributable to outside shareholders.

[3] http://www.afm.nl/en/nieuws/2011/aug/themaonderzoeken-fv.aspx

5. Small non-controlling interest can also be material

Like any net amount, non-controlling interest could be the net amount of two large amounts, or two small amounts. So even if the non-controlling interests appear in the financial statements as rather small amounts, the example below shows that the uncertainty remains.

		Scenario 1: Tiny			Scenario 2: Net cash			Scenario 3: Net debt		
	Full consolidation	Subsidiaries, % owned 100%	Subsidiaries, % owned 50.01%	**Proportionate share**	Subsidiaries, % owned 100%	Subsidiaries, % owned 50.01%	**Proportionate share**	Subsidiaries, % owned 100%	Subsidiaries, % owned 50.01%	**Proportionate share**
Cash	300	294	6	297	298	2	299	2	298	151
Accounts receivable	200	196	4	198	100	100	150	100	100	150
Goodwill	400	392	8	396	-	400	200	400	-	400
Total assets	**900**	**882**	**18**	**891**	**398**	**502**	**649**	**502**	**398**	**701**
Accounts payable	300	294	6	297	250	50	275	50	250	175
Interest paying debt	500	490	10	495	50	450	275	354	146	427
Total liabilities	**800**	**784**	**16**	**792**	**300**	**500**	**550**	**404**	**396**	**602**
Non-controlling interes	1									
Common equity	99	98	2	**99**	98	2	**99**	98	2	**99**
Group equity	**100**									
Total liabilities & equity	**900**	**882**	**18**	**891**	**398**	**502**	**649**	**502**	**398**	**701**
Key ratios										
Net debt	200	Net debt		198	Net debt		(24)	Net debt		276
Net working capital	(100)	Net working capital		(99)	Net working capital		(125)	Net working capital		(25)

Scenario 1 essentially mirrors the fully consolidated statement, whereas scenario 2 or 3 result in either a net cash, or net debt position if partial ownership is taken into account. Scenario 2 and 3 are two extreme scenarios of an infinite number of scenarios that could be considered.

6. IFRS 12 requires disclosure that removes the uncertainties identified

IFRS 12 'Disclosure of Interests in Other Entities' (effective date 1 January 2013) provides a principle based standard for reporting entities that if correctly applied removes the uncertainties identified. Apart from outlining a number of disclosure requirements per individual 'other entity', it also states as an objective that disclosure should enable users of the entity's financial statements to evaluate the effects of interests in partly owned subsidiaries on its financial position, financial performance and cash flows. Paragraph 3 of IFRS 12 states: 'If the disclosures required by this IFRS, together with disclosures required by other IFRSs, do not meet the objective in paragraph 1, an entity shall disclose whatever additional information is necessary to meet that objective.' This confirms that IFRS 12 requires, insofar other requirements for example on materiality would not already do so, a reporting entity to find a solution that removes the described uncertainties resulting from full consolidation of partly owned subsidiaries. Accordingly, we welcome the initiative of the IASB to introduce this new standard and we encourage companies to consider applying its requirements early.

7. Solutions that remove uncertainties of full consolidation

This position paper does not aim to propose a single final solution. A number of solutions presented below may serve as examples of how the uncertainties described in the previous paragraphs may be removed. The proposed solutions have in common that they allow users of financial statements to assess the entity's proportionate share of the line items based on full consolidation. The scope of proportionate share calculations should mirror the scope of entities included in full consolidation, i.e. entities that were included using the equity method (like, for example joint ventures), remain included using the equity method.

Solution a): ‘not material’ statement

Many entities report rather small levels of non-controlling interests in the financial statements. These amounts may be the net result of rather small amounts themselves (similar to Scenario 1 ‘Tiny’ on page 5). In such a case, a simple note such as ‘The entity’s proportionate shares of each line item in the financial statements do not materially differ from the fully consolidated financial statements.’ could be added as a note to the non-controlling interest line items.

Solution b): notes to ‘non-controlling interest’ line items

If a ‘not material’ statement is not applicable, a financial report could specify the composition of the two line items ‘non-controlling interest in group equity’ and ‘non-controlling interest in group income’ in the notes. Currently, these two line items rarely have notes. Users can combine this disclosure with the fully consolidated statements to calculate the entity’s proportionate share of each line item in the income statement and balance sheet, as shown on page 2. Disclosure for example ‘Scenario 2: Net Cash’ for the balance sheet is provided in this table[4]:

Note to non-controlling interest in group equity

Outside shareholders own a 49.99% stake in our subsidiary 'x'.
The non-controlling interest in group equity of 1 represents the share of outside shareholders in group equity.
This amount represents a net amount of assets and liabilities attributable to those outside shareholders.
The amounts attributable to outside shareholders for each line-item of our fully consolidated balance sheet are:

Balance sheet	Attributable to outside shareholders
Cash	1
Accounts receivable	50
Goodwill	200
Total assets	**251**
Accounts payable	25
Interest paying debt	225
Total liabilities	**250**
Group equity	**1**
Total liabilities & equity	**251**

Note to non-controlling interest in net income

Outside shareholders own a 49.99% stake in our subsidiary 'x'.
The non-controlling interest in group equity of x represents the share of outside shareholders in net income.
This amount represents a net amount attributable to those outside shareholders.
The amounts attributable to outside shareholders for each line-item of our fully consolidated income statement are:

Income statement	Attributable to outside shareholders
…	

Note to cash flow statement

Outside shareholders own a 49.99% stake in our subsidiary 'x'.
Amounts attributable to outside shareholders are included in some, or all, of these line-items.
The amounts attributable to outside shareholders for each line-item of our fully consolidated cash flow statement are:

Cash flow statement	Attributable to outside shareholders
…	

We would welcome any initiative by IASB to more explicitly require disclosure of the composition of the non-controlling interest line items.

[4] Appendix C: ‘Calculating proportionate shares’ shows how this disclosure, combined with the fully consolidated balance sheet allows the calculation of the company’s proportionate shares per line item.

Solution c): Revision of IFRS 8 'Operating segment reporting'

The amounts in operating segment reporting are often presented as if the reporting entity wholly owns all of its subsidiaries, i.e. the presented numbers are based on full consolidation. If an operating segment includes a partly owned subsidiary, it is important for a user of financial statements to know what part of the presented performance indicators is attributable to outside shareholders, even if this is not wholly consistent with the concept of 'through the eyes of the chief operating decision maker'. The International Accounting Standards Board is currently conducting a post implementation review of IFRS 8. A revised IFRS 8 could, for example, require a separate table that presents the entity's proportionate share of the presented performance indicators; insofar these amounts differ materially from the fully consolidated amounts.

However, for a basic insight into value, leverage, and liquidity, the result of any solution should at least be that users of financial statements can assess the entity's proportionate share of the fully consolidated gross debt, cash, revenue, operating profit, and depreciation & amortisation.

8. Conclusion

Full consolidation of partly owned subsidiaries causes significant uncertainty for users in their assessment of value, leverage, and liquidity. Currently, many reporting entities fully consolidate partly owned subsidiaries as required by the standards, but hardly any reporting entity removes the uncertainties identified in this paper. IFRS 12 clearly requires that these uncertainties are addressed, and this paper explores a number of alternative solutions to deliver this.

The 'proportionate share' of a fully consolidated amount reflects both control and partial ownership of subsidiaries, whereas fully consolidated financial statements primarily reflect control only, irrespective of the percentage of ownership. Insight in the entity's proportionate share of the fully consolidated amounts would address the uncertainties identified in this paper.

The position of Eumedion is that for a basic insight into value, leverage, and liquidity, the result of any solution should at least be that users of financial statements can assess the entity's proportionate share of the fully consolidated gross debt, cash, revenue, operating profit, and depreciation & amortisation.

Eumedion therefore encourages:

- reporting entities worldwide address the uncertainties described in this paper;
- standard setters worldwide to more explicitly require disclosure that allows users of financial statements to assess the reporting entity's proportionate share of fully consolidated amounts;
- enforcers worldwide to challenge insufficient disclosure on non-controlling interests.

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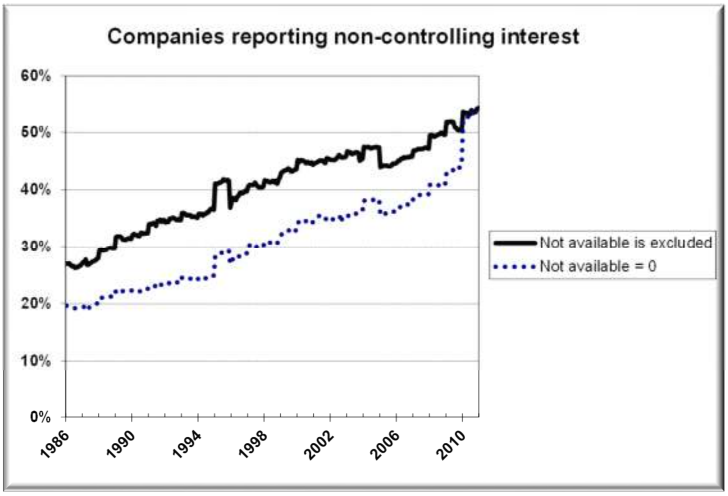
Appendix A: Many entities have partly owned subsidiaries that are fully consolidated

A large sample of listed entities indicates that many of them fully consolidate partly owned subsidiaries. The first column in the table below shows the percentage of entities that report non-controlling interests of any size; the second column shows how many entities have relatively large[5] non-controlling interests.

	% of companies with non-controlling interests		
Region	not nil	> 10%*	**Sample size**
Europe	61%	17%	2,606
North America	33%	8%	2,708
RoW	69%	23%	2,582
Grand Total	**54%**	**16%**	7,896

The percentage of large US entities that fully consolidate partly owned subsidiaries has doubled over the past 35 years[6]:

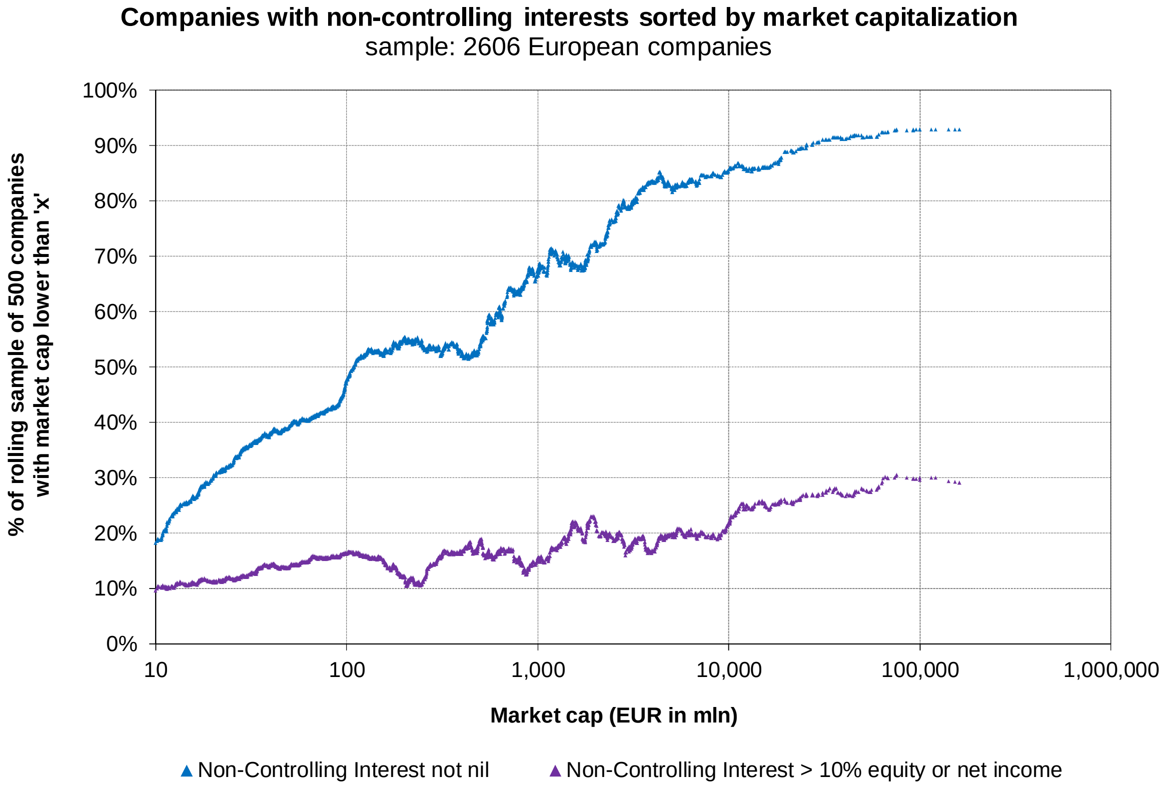


[5] Source: Bloomberg, June 2011. 'Relatively large' is defined as: either larger than 10% of group equity or larger than 10% of group income.
[6] The sample only includes the US constituents of the FTSE World Index. This sample size varies over time between 480 and 750 large US companies. Source: FactSet, June 2011.

Full consolidation of partly owned subsidiaries is not only a common phenomenon across all regions, but also across all sectors. The share of non-controlling interests in group equity or group net income tends to be larger for entities in the sectors Utilities and Financials[7].

Sector (Europe only)	% of companies with non-controlling interests > 10%*	% of companies with non-controlling interests <> 0%*
Utilities	27%	66%
Financials	27%	50%
Consumer Services	19%	63%
Basic Materials	18%	66%
Consumer Goods	17%	66%
Grand Total	17%	60%
Telecommunications	17%	50%
Industrials	16%	54%
Oil & Gas	15%	54%
Technology	13%	54%
Health Care	8%	49%

Larger entities tend to more often control partly owned subsidiaries than smaller entities. The graph below sorted 2606 European entities by market capitalization. Each dot represents an average of 500 entities. The last dark dot indicates that over 90% of the largest 500 European entities fully consolidate partly owned subsidiaries[7].



[7] Source: Bloomberg, June 2011.

Appendix B: Not all assets are equally valuable when assessing the value of an entity

Not all assets on the balance sheet are equally valuable, even though they do all add up to the balance sheet total. This is not to indicate that the valuation on the balance sheet is disputed, but the composition of the assets, all other things being equal, influences expected cash flows, and therefore value.

The relevance of the cash position is undisputed for assessing the value and leverage of an entity. The cash position is also a key input for the assessment of net leverage and liquidity. More cash will always result in a higher value, lower net leverage, and improved liquidity.

Accounts receivable tend to be less valuable than cash for several reasons: there is more uncertainty on actual payment of accounts receivable. If continuity is not at risk, cash continuously stuck in accounts receivable makes a business more capital intensive and, all other things being equal, tends to result in later cash flows, and therefore a lower value, because unlike cash, you cannot use accounts receivable to invest or to pay a dividend to shareholders. If the business grows, accounts receivable tend to grow as well, so even more capital will be tied up in these receivables. The difference between cash and other assets, like accounts receivable, is obviously relevant.

Similarly, not all liabilities are equally valuable. Accounts payable often are a source of capital for entities. Accounts payable may help finance growth. It is often much cheaper than interest bearing debt. The distinction between debt and accounts payable is also very relevant for the assessment of the value, leverage, and liquidity of an entity.

Appendix C: Calculating proportionate shares from requested disclosure

Fully consolidated financial statements can be combined with the breakdown by line item of the non-controlling interest to produce the company's proportionate shares for each line item. The example below shows the calculations for the balance sheet.

	Full consolidation	Less	Non-controlling interest in equity	Equals	Proportionate share
Cash	300		1		299
Accounts receivable	200		50		150
Goodwill	400		200		200
Total assets	**900**		**251**		**649**
Accounts payable	300		25		275
Interest paying debt	500		225		275
Total liabilities	**800**		**250**		**550**
Non-controlling interest	1		1		
Common equity	99				**99**
Group equity	**100**				
Total liabilities & equity	**900**		**251**		**649**

Of course, a reporting entity may help users of financial statements by providing both the full breakdown, together with the resulting proportionate shares.