Niculae Feleagă
(coordinator)

Liliana Feleagă
Cristina Mioara Vasile
Voicu Dan Dragomir

EDITURA ASE

INTERNATIONAL PERSPECTIVES ON CONSOLIDATED ACCOUNTING

A Monographic Study

COLECȚIA CONTABILITATE

INTERNATIONAL PERSPECTIVES ON CONSOLIDATED ACCOUNTING

A Monographic Study

COLECȚIA CONTABILITATE

Colegiu științific:
Prof. univ. dr. Calu Daniela Artemisa
Prof. univ. dr. Caraiani Chirața
Prof. univ. dr. Feleagă Liliana
Prof. univ. dr. Ioanăş Corina
Prof. univ. dr. Neamțu Horia
Prof. univ. dr. Săcărin Marian
Prof. univ. dr. Ştefănescu Aurelia
Prof. univ. dr. Tuțu Anca
Prof. univ. dr. Țurlea Eugeniu
Conf. univ. dr. Avram Viorel
Conf. univ. dr. Roman Aureliana
Lect. univ. dr. Bunea Ştefan

ACADEMIA DE STUDII ECONOMICE DIN BUCUREŞTI

Niculae Feleagă
(coordinator)

Liliana Feleagă **Cristina Mioara Vasile** **Voicu Dan Dragomir**

INTERNATIONAL PERSPECTIVES ON CONSOLIDATED ACCOUNTING

A Monographic Study

Editura ASE
Bucureşti
2011

Copyright © 2011, Editura ASE
Toate drepturile asupra acestei ediții sunt rezervate editurii.

Editura ASE
Piața Romană nr. 6, sector 1, Bucureşti, România
cod 010374
www.ase.ro
www. editura.ase.ro
editura@net.ase.ro

Referenți:
Conf. univ. dr. Avram Viorel
Lect. univ. dr. Bunea Ştefan

ISBN 978-606-505-467-7

Editura ASE
Tehnoredactare: Carmen Nica
Copertă: Simona Buşoi

CONTENTS

INTRODUCTORY NOTE

Nowadays world economies stretch their networks between the aggressively multinational companies and the barely-surviving small and medium enterprises. When seeing on one side the image of huge financial crisis and scandals agonizing on both sides of Atlantic ocean, as well as on other continents, and on the other side seeing the desperate attempts of small companies, we can still dare to think optimistically within the existing capitalist environment - even though this systems is most familiar with Yin and Yang type of enterprises.

On the bright side of things, capitalism is commonly associated with abundant and efficient productivity, economic welfare and the success of financial globalization. As negative aspects, capitalism reveals starving communities, power abuses, social discrimination and market distortions. Between these two sides of capitalism, the effects of the new world financial crisis are becoming worldwide spread.

Returning to positive side of things, we analyse most spectacular aspects of contemporary accounting policies and practices. It is well known that the evolution of European and international accounting systems and referential are mostly influenced by the interconnection phenomena of national economies and financial markets' globalization.

Regarding consolidated accounts, during past years we assist at significant convergence processes between world's largest international referential (IFRS and US-GAAP), as well as between national and international systems.

Since 2007, Romania is member of European Union, and still applies the international referential, by an extremely reserved manner, letting the national currency Lei into a system formed by European Directives, abusively called the Romanian Accounting Standards (RAS). It will be therefore a normal context in which Romanian listed companies, all banks with no exceptions, and insurance companies, to already have minimum experience in applying the international referential. We hope though these evolutions will take place within the next three or four years.

Our book aims at presenting those modern aspects of accounting policies and procedures pertaining to groups of companies and consolidated accounts. This scenario will essentially include regulatory issues, methodological aspects, and especially case studies. Our readers will find our book as an assembly of methods, techniques, procedures for consolidated accounts. The many case studies presented herein, valorising consolidation methods, are built in the spirit of international accounting standards.

The Authors
August, 2011

CHAPTER 1

DEFINITIONS REGARDING GROUPS OF COMPANIES AND CONSOLIDATED ACCOUNTS

Nowadays, the consolidated groups of companies are considered as important as the single companies. If we are to use a common expression, we may state that consolidated groups are actually the reflection of „networking capitalism”. These groups are formed around a leading company, and further bring together many other juridical-independent companies which interact throughout participations and other contractual relationships within the sane group.

It can be easily affirmed that consolidated groups (or groups of companies) are the reflection of the actual business environments. Setting up groups of companies is a common phenomenon, implemented at large scales in all business fields. That is why the top of the iceberg for developed economies is made out of the world’s largest industrial, commercial, and bank groups – created either on a single business area or by a composite manner. In most common cases we find these industrial groups being listed at the Stock Exchange. Also, even if we frequently see large groups being setup by large companies, nowadays the small and medium enterprises –SMEs also have adopted this business structure.

In order to accomplish their own growth/expansion and concentration group policies, the companies which are called members of the group, continuously buy participation titles in other commercial companies. Such a policy is to be considered both normal and natural for the „genetic” path of companies which are always seeking to become the least vulnerable and the most efficient. That is why these companies perform the following actions:

- **vertical** concentration – through which they integrate all phases of their production and distribution cycles (referring to a certain category of products);
- **horizontal** concentration – they integrate various business activities (either complementary or similar).

Regarding the growth phenomenon, the company leaders are offered two main business expansion options: **internal expansion** – by creating specialized entities with their own juridical identity or not, **and external expansion** – by company acquisitions (fully controlling them), or just by setting up business relationships with other companies. In other words, the creation process for these groups of companies is the direct result of capitalist expansion processes.

The most common group structures present a series of advantages, out of which two are to be considered most special:

(i) **Flexibility:** the differentiation of activities within each of the juridical-distinctive entities allows a clear assignment of responsiveness, this way by minimising group business risks whenever one of the exclusively controlled

companies (to be further called *Subsidiary*) incurred economic and financial difficulties.

(ii) **Control:** by applying majority-control rules and policies in the decision-taking issues, allows full control over the group even without the ownership of all shares; also setting up subsidiaries and subsidiaries controlling other subsidiaries, leads to a power de-multiplication process, in direct relationship with the effectively-owned share capital.

Therefore, whenever the groups of companies are extremely concentrated, the entire economic power/influence is actually held by one company only. There are two possibilities:

- the so-called „group leader” or „parent” exclusively preserves an industrial, commercial or a financial activity, sometimes in connection with other activities performed by companies in which she directly or indirectly owns shares (a certain degree of control), companies also known as „subsidiaries”;
- the parent is a holding company, which owns participation titles as its single asset, and which has portfolio management as unique business target.

Whenever there are many strongly connected companies, with enough relationships to form a group and create an economic entity, it is therefore useful to have sufficient and reliable information about group members, and further to prepare and disclose consolidated account economic and financial reports. The company which controls the entire group of companies, is named **consolidating**, while the other group-member companies are named **consolidated**. Generally speaking, within the Balance Sheet of the consolidating company, the consolidation process eliminates and replaces the members’ (consolidated companies) participation titles, with benefit rights in owner’s equity and the financial result.

We therefore consider that the main consolidation objective is to present the group members’ financial position, performances and the evolution of their financial status, as if they are only one company (even if at year end, each of the members present and disclose their individual financial reports).

Consolidation is a financial accounting technique, which targets the disclosure of financial information, mainly for the benefit of external users.

During the consolidation process, all previous transactions between group members are eliminated and the financial results to be kept are exclusively the ones generated by economic operations with third parties.

All consolidated financial and accounting information are considered complementary to individual accounts (that is members’ year-end individual financial reports). The assembly of this consolidated information allows the analysis of group’s financial structure and profitability.

In the context of a highly competitive business world, seeking shareholder value-adding processes has become the main interactive link between worldwide

listed-groups of companies, while the consolidation process became an **essential managerial and control accounting tool** as follows:

- **as a managerial instrument**

For the associates, the consolidation process represents the possibility to measure the corresponding opportunity and efficiency of the development strategy belonging to the dominant company – this is possible only if the available information is fair and reliable. This in turn involves a certain degree of data and business language uniformity and consistency.

In this context, the companies aim at setting a global business strategy, in which they can only measure their successful steps by using adequate accounting financial statements, allowing in this way the fair anticipation and evaluation of their group structure.

- **as a control instrument**

➢ for the consolidating company, the consolidated accounts allow the correct anticipation of the group's already-implemented strategies, policies and foreseen risks, the ways to better perform;

➢ for the minority interests, the consolidated accounts are the unique disclosure of the ways in which their interests are managed by the group;

➢ for the creditors, the consolidated accounts allow the evaluation of group's solvability and debt rate (and for each member of the group);

➢ for the banks, consolidated accounts allow to see whether the group policies are efficient and if banking operations are due in time, even if the case occurs for a subsidiary to incur financial difficulties.

It is essential therefore to observe that even if the consolidated accounts do not disclose any information regarding the internal group flows between group members; still their analysis represents a powerful tool as to understand a group's overall structure and business strategy.

CHAPTER 2

THE CONSOLIDATION PERIMETER AND SETTING THE CONSOLIDATION METHOD

2.1 Definitions and key issues regarding groups of companies

The consolidation perimeter represents the area which brings together all subassemblies of companies economically linked, in such way that the consolidation of financial statements is efficient. Mainly, the perimeter circles all companies upon which the consolidating company has either exclusive control (the controlled companies are named *subsidiaries*), or has joint control (jointly controlled entities, or *joint ventures*, or *partnerships*), or it may have a significant influence (equity *affiliate*, or *associated undertaking*, or *associates*).

Therefore, given the complexity of terminology herein, we shall follow strictly the recommendations of the international referential.

Regarding the consolidation perimeter, we can state it is basically structured as follows: the group leader (the *parent*) and the consolidated companies (group *members*), which are controlled by the parent (either by an exclusive manner, jointly controlled, or by significant influence). In other words, the consolidation perimeter actually draws the consolidated group chart and clearly states which companies are part of the consolidated assembly. In order to know whether a certain company is member of a group, and if it is eligible for consolidation, one must determine the degree of influence the parent has over this entity.

During the month before account closure, the central consolidation department, within the group leader (parent), sends a courier to all member companies as it requests all data necessary for setting the consolidation perimeter (sales/acquisitions/creation of companies). Further, the consolidating company determines its consolidation perimeter and the corresponding consolidation methods applicable to all and/or each of the consolidated companies.

A **group** represents the assembly formed by the parent and all of its subsidiaries. In other terms, the group is a set of companies, each entity keeping its own juridical identity, but all of them being accountable to a single decision-making nucleus – named group leader. The group forms a distinctive and unified economic entity, but which has no juridical identity.

A **parent** is an entity that has one or more subsidiaries. Generally, a parent holds more than 50% of subsidiary's capital (this capital does not include the preferential dividends, without voting rights). Therefore, the parent holds the absolute majority within the General Assemblies (Shareholders General Meetings) and subsidiary's leading boards (the case of the Rightful Exclusive Control); owing more than two-thirds of capital, the parent has a rightful majority in all Extraordinary General Assemblies.

A **subsidiary** is an entity, including an unincorporated entity such as a partnership that is controlled by another entity (known as the parent).

2.2 The Control

In the International Accounting Referential and within consolidated accounts, control is defined as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Control might be the direct consequence of ownership (but not necessarily). One must clearly distinguish between control and interest (or participation), which in turn represents owning only a part of company's capital/owner's equity.

In matters of consolidated accounts, control can be distinguished as: **exclusive control** and **joint control**[1]. The exclusive control may signify governing either under *rightful control*, or *in-fact control*.

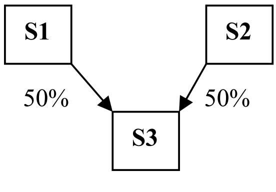
The Rightful Exclusive Control signifies that the parent holds, directly or indirectly, throughout its subsidiaries, more than 50% of voting rights.

The International Referential specifies four **In-fact Exclusive Control** business contexts:

- the parent holds more than half of voting rights, as a follow-up of agreements with other investors; in practice, the parent is usually supposed to have more than 40% of voting rights;
- the parent has the power to govern both exploitation and finance operations of the controlled company, either by group policies or throughout a contractual agreement with the company;
- the parent has the right to revoke or to name the majority of the Administrative Board members, or of an equivalent board; or
- the parent has the power to merge all voting-right majorities, within this council or board.

The **Joint Control** (conjunctive or concomitant) represents the contractual sharing of control over an economic entity (company), between a small number of shareholders, who commonly control this entity, and neither of them can take decisions without previously consulting the others. All business activities which are not dealt within such a joint-control contractual agreements, are not to be considered entities subjected to such type of control; this type of contractual agreement is always both written, and constant.

Example



[1] Conjunctive, or Concomitant control

- S1 and S2 each hold 50% out of S3 voting rights.
- S1 and S2 are named controlling companies/entities.
- S3 is therefore the jointly-controlled company; in terms of consolidated accounts this company is called a joint-venture company (or partnership).

Significant influence represents the power to participate within all decisions referring to financial and operational policies of a company, but without having any control over these decisions. Generally, significant influence is represented by:

- the presence in the company's Administrative Board, or within the equivalent managerial board;
- participation at decision-making processes within the company;
- significant volume of transactions with this company;
- inter-changing members of the administrative boards;
- supply of major technical information and support.

If an investor holds, directly or indirectly, throughout its subsidiaries, at least 20% of a company's voting rights (usually, between 20-50% of voting rights, obviously insufficient to govern with exclusive or joint control), it is therefore considered that the investor has significant influence, excepting situations in which the lack of influence is contractually stated by parties. Therefore, it can be stated that the existence or not, of significant influence is independent from the percentage of voting rights. Significant influence is most common among *associated undertakings* or *associates* (most frequently), or in the case of partnerships (rarely happens; in this case joint control is preferred).

An Associate is a company where the main investor has significant influence, but the company is not to be considered a subsidiary, or a partnership.

2.3 Control Percentage, Interest Percentage and Integration Percentage

The Control Percentage of a parent, in a subsidiary, is given by the number of voting rights hold in the subsidiary's General Assembly.

Within companies by shares, the participation titles (owned shares), no matter if already issued or not, usually offer one voting right, but there are also shares with the following features:

- preferential shares, without voting rights;
- multiple voting-right shares;
- fractionate voting-right (fractional) shares.

The total control percentage over a company may be under 100%, exactly 100% (e.g. 10000 ordinary shares with simple voting right – one vote per share), or higher than 100% (e.g. of 110% resulting from holding 960 ordinary shares, with one voting right per share, and 50 nominative shares, with double voting rights).

In order to determine the General Control Percentage, we cumulate all control percentages for all of group's companies (with participation titles in controlled companies). The control percentage allows choosing the corresponding consolidation method for the group.

In the international referential, the following consolidation methods are prescribed:

(i) for exclusive control: **full consolidation method**;

(ii) for joint control: **proportionate integration method** as reference treatment (default recommendation), or the **equity method** as alternative treatment (the other authorized method);

(iii) for significant influence: the **equity method**.

The Interest Percentage reveals the share of capital, directly or indirectly, owned by the parent, in each of the consolidated companies. This is a purely financial concept, which helps computing parent's quota in the financial result and owner's equity of each company from the consolidated perimeter.

Computational formulas[2]

In order to compute the **control percentage**, all directly-held control percentages of the parent are added, and all control percentages held by member companies that the parent exclusively consolidates. In turn, the control percentages held by the companies, controlled either by conjunctive/joint control, or significantly influenced, should not be taken into consideration for the group.

In order to determine the **interest percentage,** for each chain of group companies, we multiply all interest percentages (owned capital) belonging to each company member of that chain, and the resulting percentages are added for each chain within the group.

The Participations[3]

Participations represent the rights in other companies' share capital, either materialized in shares/titles or not, which create strong business connections with the issuing company and help its activities. In practice, there are several types of participations: direct, indirect, reciprocal, and cross participations. In the Notes, there should always be a disclosure of all subsidiaries and corresponding participations.

- **Direct Participation**:

  - the control percentage equals the percentage of a parent's voting rights in one of its subsidiaries;
  - the interest percentage equals with the capital quota held by the parent in one of its subsidiaries.

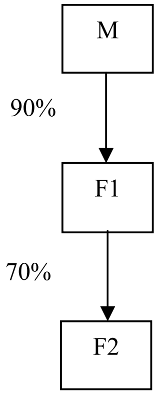
[2] Ropert, E., *Nouvelle pratique des comptes consolidés,* Gualino Editeur, Paris, 2000, p. 30.
[3] Ropert, E., *op. cit.*, pp. 30-35.

● **Indirect Participation:**

a) by a single, unique chain:

- the control percentage is computed in steps; the chain of companies is considered broken, only when a joint venture, or an associate are members of that chain;
- the interest percentage is determined by multiplying the ownership percentages (owned capital), for the companies within the chain.

Example:



- ➢ parent M holds 90% of company F1, which in turn holds 70% of F2;
- ➢ F1 is a subsidiary for parent M;
- ➢ F2 is sub-subsidiary for parent M.

In this case, we summarize the following:

- ➢ M controls F1, for 90%;
- ➢ F1 controls F2, for 70%;
- ➢ M controls sub-subsidiary F2, for the same percentage as F1, for 70%;

The interest percentage of parent M:

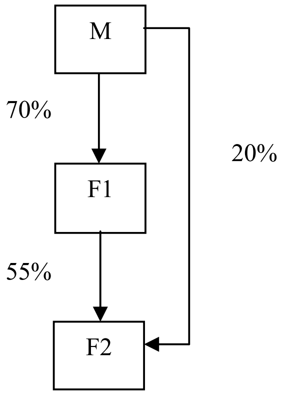
- ➢ in F1: 90%
- ➢ in F2: 90% x 70% = 63%.

b) by multiple chains:

- the control percentage is determined by adding all control percentages, held both directly and indirectly, for each of the companies following the subsidiary, within the corresponding chain and sub-chain;

- the interest percentage: for each chain, we multiply the ownership percentages (owned capital), for each company member of that chain, and further we add the resulting percentages, for each chain and sub-chain.

Example 1



Parent M directly holds 70% of company F1 and 20% of subsidiary F2. Subsidiary F1 holds 55% of its own subsidiary F2. In this case, it is considered that for each share there is only one voting right associated.

Therefore, the control percentage held by the parent in F2 is:

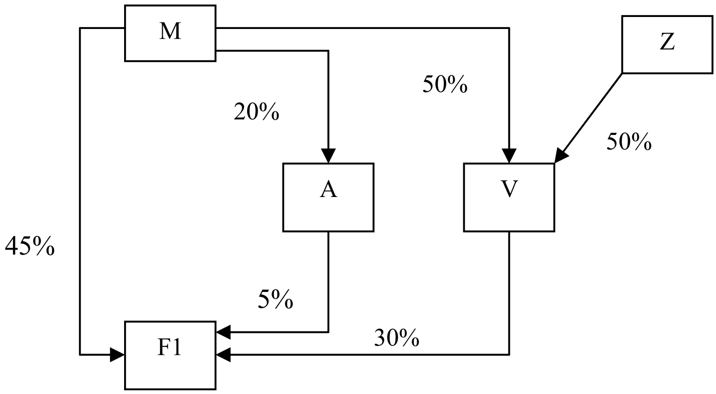
- directly:	20%
- indirectly:	55%
Total:	75%

The parent, hols control over F2, for 75%.

The interest percentage of parent in subsidiary F2:

- directly:	20%
- indirectly:	38.5% (= 70% x 55%)
Total:	58.5%

Example 2



⇨ parent M directly holds 45% out of F1; hypothetically, one share offers one voting right;

⇨ M holds 20% of company A, offering M significant influence over A; this link is not considered for determining the control percentage of M in F1;

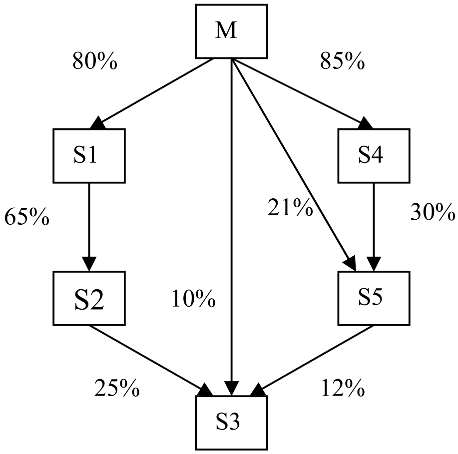
⇨ also, M holds 50% in company V, and jointly controls this company altogether with company Z; as well this connection is not to be considered for computing the control percentage of M in F1;

⇨ the control percentage of M in F1 is 45%; also such a value for the control percentage leads to in-fact exclusive control, only if one of the four previously enumerated criteria is met; according to international referential F1 is a subsidiary, while the American referential does not recognize it as subsidiary and only allows rightful exclusive control.

The interest percentage of parent M, in company F1 (subsidiary), is computed as follows:

- directly:	45%	
- by company A:	5%, that is 20% x 25%	
- by company V:	15%, that is 50% x 30%	
Total interest percentage		65%

Example with a high degree of complexity, used for: control percentage determination, choosing consolidation methods, and computing interest percentages.



Comp.	Computing the Control Percentage	Control %	Consolidation Method	Computing the Interest %	Interest %
S1		**80%**	Full Consolidation		**80%**
S2		**65%**	Full Consolidation	80%x65%	**52%**
S4		**85%**	Full Consolidation		**85%**
S5	Direct link (21%) + Indirect link (30%)	**51%**	Full Consolidation	21% + 85%x30%	**46,5%**
S3	Indirect link (25%) + Direct link (10%) + Indirect link (12%)	**47%**	Equity Method, or Full Consolidation (if the case of in-fact exclusive control)	80%x65%x25% + 10% + 46,5%x12%	**28,58%**

From the analysis of control percentages, according to the international referential, it results that S1, S2, S4 and S5 are under rightful exclusive control. Regarding S3, this company is under significant influence for 47% (10% directly

and 37% indirectly). The issue for S3, is to decide whether or not it might be exclusively controlled by parent M, through in-fact exclusive control. In order to confirm the in-fact exclusive control, governed by M over S3, one of the exclusive control criteria must be met.

The Integration Percentage

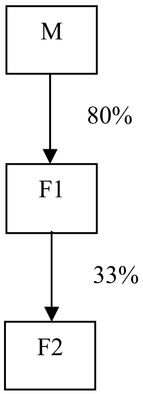
In order to determine the percentage of amounts to be consolidated, first the integration percentages must be fairly computed. Such a percentage is in total conformity with the already chosen consolidation method.

If a company is consolidated by Full Consolidation, the corresponding integration percentage is 100%. Contrary, specialists should take into account the following:

- the integration percentage directly attributable to the company to be consolidated;
- the direct ownership percentage of the company directly holding the company to be consolidated.

For companies in equivalence (under equity method), the integration percentage might be as well named „fraction set in equivalence".

Example 1



Company F2 is jointly controlled, together with two other groups of companies.

(i) **To determine the control percentages**:

- The control percentage of parent M, in F1 subsidiary (full integration) = 80%;
- The control percentage of parent M, in F2 which is jointly controlled (proportionate integration) = 33%.

(ii) **To determine the interest percentages**:

- The interest percentage held by M in F1 = 80%.

The interest percentage held by M in F2 = 80% x3 3% = 26,4%.

(iii) To determine the integration percentages:

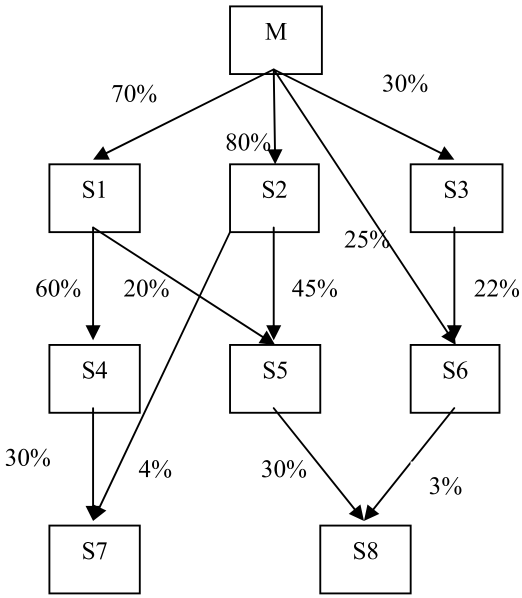
- The integration percentage of subsidiary F1 = 100% (because the full consolidation method is implemented).
- The integration percentage of company F2 (jointly controlled) = 100% (integration percentage of subsidiary F1) x 33% (the ownership percentage of F1 in F2) = 33%.

Notes:

If F2 would not have been jointly controlled, by M altogether with other two groups, then F2 was set in equivalence (equity method). If that were the case, then the corresponding control and interest percentages would have been identical to the above computed ones. The integration percentage (which the international referential names it “fraction set in equivalence”), would also equal to 33%. This in turn, represents the interest of companies which own titles (that is 33% interests of F1 in F2).

The above mentioned “fraction set in equivalence”, is to be split between the group (26.4% = 80% x 33% - multiplication between the interest percentage of M in F2), and minority interests (6.6% = 33% - 26.4% - difference between F2 integration percentage, and the quota corresponding to the group), all this consequently generating *indirect minority interests*.

Example 2, with a higher degree of complexity; let's consider that we are dealing with the following consolidated group chart:[4]



- S3 and S7 are conjunctively held by M, altogether with two other consolidated groups of companies.

[4] This group chat and this example have been inspired from the publication : *Manuel de consolidation Principes et pratiques,* (autor Palou, J.M.), 3[e] édition, Groupe Revue Fiduciaire, Paris, 2003, pp. 70-71.

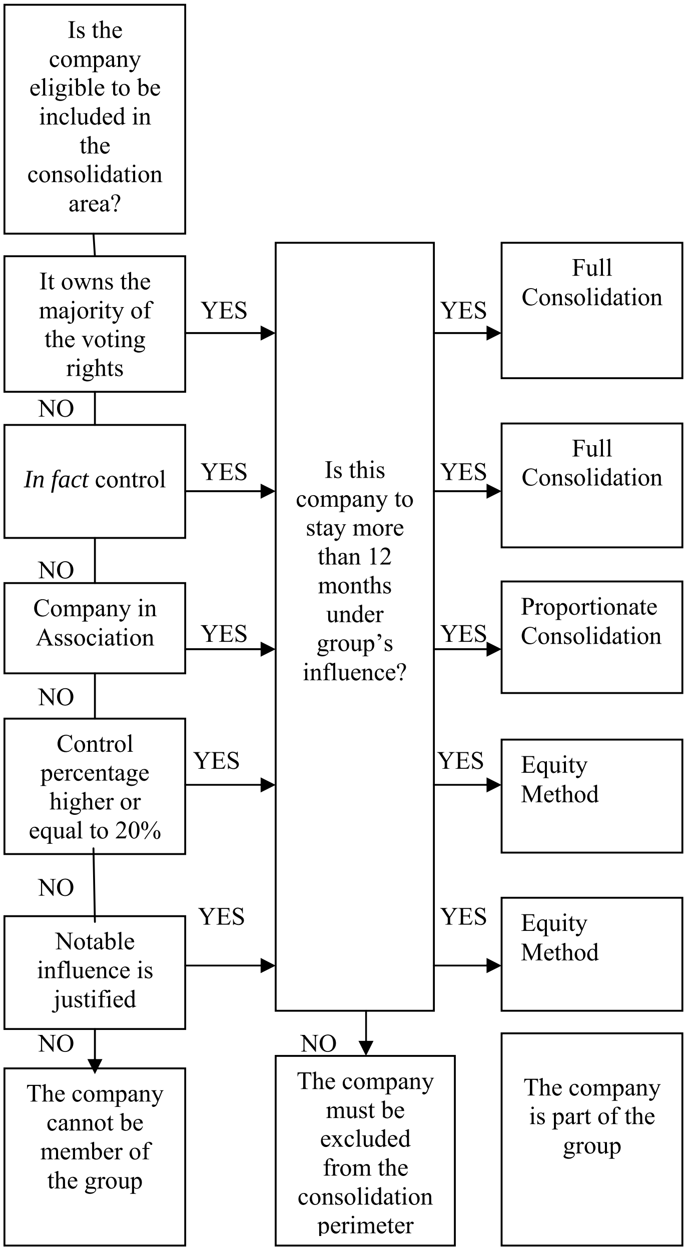
Determining control percentages and corresponding consolidation methods:

Company	Relationship	Control Percentage	Consolidation Method
S1	SM in S1	70%	Full Consolidation
S2	SM in S2	80%	Full Consolidation
S3	SM in S3	30%	Proportionate Consolidation
S4	SM in S1 in S4	60%	Full Consolidation
S5	SM in S2 in S5 SM in S1 in S5	45%+ 20% 65%	Full Consolidation
S6	SM in S6 SM in S3 in S6	25%+ 0% 25%	Equity Method
S7	SM in S1 in S4 in S7 SM in S2 in S7	30%+ 4% 34%	Proportionate Consolidation
S8	SM in S2 in S5 in S8 SM in S6 in S8	30%+ 0% 30%	Equity Method

Determining integration and interest percentages:

Comp.	Relationship	Integration Percentage, or the equivalence fraction	Interest Percentage
S1	SM in S1	100%	70%
S2	SM in S2	100%	80%
S3	SM in S3	30%	30%
S4	SM in S1 in S4	100%	70%x60% =42%
S5	SM in S2 in S5 SM in S1 in S5	100%	80%x45%=36% 70%x20%=14% 50%
S6	SM in S6 SM in S3 in S6	25% 30%x22%=6,6% 31,6%	25% 30%x22%= 6,6% 31,6%
S7	SM in S1 in S4 in S7 SM in S2 in S7	100%x30% =30% 100%x4% = 4% 34%	70%x60%x30%=12,6% 80%x4% = 3,2% 15,8%
S8	SM in S2 in S5 in S8 SM in S1 in S5 in S8 SM in S6 in S8	100%x30%= 30% 31,6%x3% = 0,948% 30,948% (a) (a) Fraction set in equivalence	80%x45%x30%=10,8% 70%x20%x30%= 4,2% (25%+6,6%)x3%=0,948% 15,948%

As a brief description, the rules for setting the consolidation perimeter (in conformity to the international referential), are presented within the following diagram:



2.4 The consolidated perimeter exclusion and non-exclusion issues

The following information is relative when referring to exclusion or non-exclusion cases, due to the large number of international regulations and practices.

If we only refer to the **international referential, in conformity to IAS 27 *Consolidated and separate financial statements,*** we can state the standard synthesises a case study for consolidated perimeter exclusion. In summary, companies which are temporarily controlled should not be consolidated, mainly because the corresponding participations have been acquired with the sole purpose of resale within the next 12 months.

Some subsidiaries perform activities, different than the ones of member companies (usually banks and other financial institutions). Up to recent date, these subsidiaries were excluded from the consolidation perimeter[5], on the main reason that they do not comply with the fair view criteria for the preparation of consolidated financial statements. IASB though does not agree anymore to such an exclusion provision.

2.5 Premises for entry/exit in the consolidated perimeter

a) Entry premises

The date of first consolidation corresponds to the date at which the consolidating company must integrate the financial result generated by the subsidiary, into its own Profit and Loss Account, as well as all identifiable acquired assets and liabilities, and the positive or negative acquisition difference.

The entry of a company within the consolidated perimeter is considered effective on the following basis:

- either at the date the consolidating company acquired participation titles;
- or at the date the consolidating company started control, or significant influence, if the acquisition was settled in various phases.

The retrospective aspect of a contract is insufficient as to consider the transfer of control being different than the titles' transfer date. Normally, the entry date is the same as the contractual date. Therefore, it is presumed this is the same with the date of titles' transfer. In order to eliminate this presumption, it is necessary that the transfer of control to be foreseen and clearly stated within the contract, as a different date than the one for transferring the titles.

b) Exit premises

A company is excluded from the consolidation perimeter, at the date it loses control or significant influence.

In case of disposal, the transfer of control or significant influence is generally associated to the transfer of titles' voting rights. That is why, even if the

[5] Burlaud, A., (coordonator), *Comptabilité et droit comptable Intelligence des comptes et leur cadre légal,* Gualino éditeur, 1998, p. 230. We adapted this chart, by taking into consideration the latest 2003 provisions of the international referential.

disposal arrangements have occurred at the end of a financial year, the disposing company continues to consolidate that entity, mainly because it still holds control. Though, the controlled entity may be excluded from the consolidated perimeter within exceptional contexts – when the transfer of control is made before transferring the corresponding titles, within a bilateral contract made before the closure of accounts. In such cases, the selling company must be able to justify (with facts), that losing control is effective before the transfer of voting rights.

Temporary disposal (cession), without losing control over the consolidated company's titles, followed by repurchase options within a short time interval, must not influence in any way the preparation of consolidated accounts at the end of year.

2.6 Date for closing accounts

In conformity to the international referential, the date for closing the consolidating accounts must be the same with the one for closure of individual/separate accounts of the consolidating company. Whenever, a consolidated company's date of account closure occurs after officially closing the consolidated accounts, though without exceeding 3 months, then its separate accounts may be withheld (after previously evaluating the impact of significant operations, which occurred between the two closure dates).

Example:

Company M holds 80% control percentage, over entity F. The date for M's closure of separate accounts is the 31st of December, N. The date for closing the consolidated financial statements is the 31st of December, N.

- **Case A:** The closure date for F's separate/individual accounts is the 30th of November, N. *Solution*: Then, the consolidated financial statements are prepared either by starting with F's separate accounts (at 30.11.N), further retreated with the significant operations occurring between 30.11.N and 31.12.N; or it can start with the drafts of F's individual accounts at 31.12.N.
- **Case B**: The closure date for F's separate accounts is on the 30th of June, N. *Solution*: The consolidated financial statements shall be prepared, with the drafts of F's individual accounts as presented at 31.12.N.
- **Case C:** The closure date for F's separate accounts is on the 28th of February, N+1. *Solution:* The consolidated financial statements shall be prepared with the drafts of F's individual accounts, retreated with any significant transactions occurring between 31.12.N and 28.02.N+1.
- **Case D**: The closure date for F's separate accounts is on the 31st of May, N+1. *Solution*: It is then compulsory that consolidated financial statements are prepared on the basis of F's drafted individual accounts as of December, the 31st, year N.

CHAPTER 3

CONSOLIDATION METHODS AND INTERNATIONAL STANDARDS FOR CONSOLIDATED ACCOUNTS

3.1 The case of full consolidation method and of the standard for Separate and Consolidated Financial Statements: special issues

The relationship between a parent company and a subsidiary materializes when the former is able to control exclusively the latter. In this case, consolidation implies the application of international standard IAS 27 Consolidated and Separate Financial Statements.

A parent company drafts and submits the consolidated financial statements except for the case when it is itself a subsidiary of another parent company. The consolidated accounts must comprise, aside of the parent company, all subsidiaries except for those controlled temporarily because those participations have been purchased and are owned, for the sole purpose of being sold in the next 12 months. The consolidated financial statements must be disclosed by using some uniform accounting policies. The gap between the reporting data of the parent company and the reporting data of consolidated subsidiaries must not be above three months. The balances, operations, gains or losses unachieved within the group must be fully eliminated.

The accounting information presented refer to the group making up (name, registration or residency country, percentage of shares held and number of votes held, if they differ) and to the reasons for consolidating a company in which less than half votes are held (case of de facto exclusive control). Also, there must be presented the consequences of the purchase and assignation of subsidiaries.

In most countries, the publication requirements concerning the parent companies comprise the individual financial statements of the parent company as well as the consolidated financial statements. In some countries, the parent company's individual financial statements are not published generally. In others, the sole statement that the parent company publishes is the balance sheet. Lastly, in the third category of countries, the parent company is requested a complete set of financial statements for being disclosed, presented and published.

There must be said that part of the shares have voting rights only sometimes or for certain matters only. In such a circumstance, there must be considered only the shares that take part in the vote for all significant matters, during the future annual general meeting. When any party, including the investor, may execute currently some operations, they must be considered except for the case when the economic cost estimated for their exercising is very high thus rendering them improbable in the predictable future. In the circumstance when a company holds part of its own shares, they must be excluded fully from calculus.

As mentioned in the previous chapter, the definition of control has two elements

a) power to lead the financial and exploitation policies of a company;
b) ability to obtain benefits from that entity's activities.

The benefits acquired from controlling the subsidiary might be higher than the net revenues that might lead to diminishing competition, reducing costs, etc. Using a general formula, assessment of control indicators and identifying the sources for obtaining economic advantages requires a thorough professional reasoning. SIC 12[1] Consolidation – Special Purpose Entities (interpretation connected to IAS 27) approaches the cases when an entity is made up in order to enter one or several transactions with its "sponsor". The question asked is if the relationship generates control from an accounting point of view. This would have a significant consequence on recognizing the revenues and financing transactions. SIC 12 supplies a plea for consolidating special purpose entities.

Because drafting consolidated financial statements is made based on individual financial statements of companies within the group, they must be subject to **restatement** before beginning the consolidation operations per se. Such **restatements** refer to<

- homogenizing the closing data and accounting policies used;
- eliminating fiscal effects.

A. **Homogenization retreatment**

The purpose of restatements is to apply homogenous accounting registration and assessment policies in the consolidation.

In the consolidation process per se, the accrual of items cannot be made correctly if inside the group there is no uniformity concerning the accounting registration and assessment policies. The uniformization process goes further and expands also to the level of presentation methods of financial statements.

B. **Restatement for fiscal effects elimination**

The restatements prior to consolidation per se refer also to the elimination of applying some legal and fiscal limitations in order to achieve a faithful image of accounts, firstly of the financial position and performance of the group, upon considering fully the economic reality (applying the principle of economic environment prevalence on the legal environment). Such a restatement leads to the fiscal cleaning of financial statements. Cleaning has in view mainly waiving the regulated provisions practice[2] and eliminating fiscal influences in accounting

---

[1] SIC is an interpretation, an element of the international reference list that completes the comprehension degree of international accounting standards.

[2] Presented in the accounts plan's structures, used in Romania during the 1990s, the regulated provisions have never been a fiscal policy used by Romanian normalizators. Although usually I had a critical position concerning some solutions proposed by normalization representatives, this time they must be congratulated for their choice.

of subsidies for investments, by passing from the joint method (balance sheet-related and relying on result) applied in Romania to the first phase of reform, the method based on result (according to standard IAS 20 Accounting for Government Grants and Disclosure of Government Assistance).

The consolidation per se assumes going through the following steps:

(i) **Taking over and cumulating elements in the balance sheets and profit and loss accounts of the group leader and subsidiaries that define the whole group, by using one of the two consolidation technical supports.**

For the full consolidation method, the elements in balance sheets and profit and loss accounts are taken over 100%.

(ii) Eliminating mutual (internal) accounts

Such elimination is absolutely necessary in order to give to consolidated financial statements the possibility to supply the financial position and performance of the group as against its external environment.

(iii) Eliminating internal results

The unearned resulting profits must be fully eliminated. As well, the unachieved losses resulting following the transactions among group members must be eliminated in principle, except for the case when the costs may be recovered. Thus, the deduction is that no matter who owns the internal results (parent company or its subsidiaries) their elimination is an operation absolutely necessary.

(iv) **Allocation of subsidiary's own equity within the group (parent company) and minority shareholders**

Supported subsequently by numerous practical applications, the own equity allocation assumes the following paths, calculus and registrations:

a) at balance sheet level:

- eliminating the titles held by parent company in a consolidated subsidiary, according to their accounting value;
- computation and registration of quota in the consolidated subsidiary's equity (share capital + reserves) that participates in the consolidated reserve;
- calculus and registration of quota in the consolidated subsidiary's result that participates in the consolidated result;
- calculus and registration of minority interests.

b) at profit and loss account level: the allocation of a subsidiary's result is made between a consolidated result and the minority interests.

The consolidation process ends by **presenting the consolidated financial statements.**

Some parent companies are exempted from drafting consolidated financial statements, especially when the group leaders are fully or almost fully (90% or more) owned by another parent company and if the shareholders holding the minority interest approve this.

In some countries, the requirements concerning drafting, presenting and publishing consolidated financial statements are limited to certain types of companies. This is the case, for example, of companies included in groups that surpass a certain size, such as those that have a number of employees above a certain limit. Standard IAS 27 does not analyze such exceptions.

The actual (practical) problems in presenting consolidated financial statements will be subject of some future chapters.

Example of applying the full consolidation method

Company M purchased 40,000 shares of company F, at the time of its setup. The share capital of companies M and F is made up of ordinary shares having a nominal value of 1 currency unit. I will assume that, given an agreement with other investors, company M holds more than half of the voting rights in company F. On December 31, N, the companies M and F have the following status:

Balance Sheet of Company *M*

Fixed Assets	200.000
Participation Titles	40.000
Inventories	20.000
Clients	80.000
Cash & Cash Equivalents	60.000
Total Assets	400.000
Share Capital	120.000
Reserves	30.000
Financial Result	20.000
Suppliers	230.000
Total Owner's Equity and Liabilities	400.000

Profit and Loss Account of Company *M*

Total Revenues	600.000
Total Expenses	580.000
Financial Result	20.000

Balance Sheet of Company *F*

Fixed Assets Inventories Clients Cash & Cash Equivalents	120.000 60.000 100.000 20.000
Total Assets	300.000
Share Capital Reserves Financial Result Suppliers	100.000 20.000 10.000 170.000
Total Owner's Equity and Liabilities	300.000

Profit and Loss Account of Company *F*

Total Revenues Total Expenses	400.000 390.000
Financial Result	10.000

For simplification purposes, I will assume that no mutual operations existed between the companies M and F.

Choosing the consolidation method used in group M:

Control Percentage held by M in F	Interest Percentage held by M in F	Type of Control	Consolidation Method
40%	40%	*De facto* Exclusive Control	Full Consolidation

➡ Taking over 100% items from the balance sheet of company M:

Fixed Assets		200.000
Participation Titles		40.000
Inventories		20.000
Clients		80.000
Cash & Cash equivalents		60.000
	Share Capital	120.000
	Reserves	30.000
	Financial Result	20.000
	Suppliers	230.000

➡ Taking over 100% items from the balance sheet of company F:

Fixed Assets		120.000
Inventories		60.000
Clients		100.000
Cash & Cash equivalents		20.000
	Share Capital	100.000
	Reserves	20.000
	Financial Result	10.000
	Suppliers	170.000

➡ Taking over 100% of the items from the profit and loss account of M:

%	= Total Revenues	600.000
Total Expenses		580.000
Financial Result		20.000

➡ Taking over 100% of the items from the profit and loss account of the company F:

%	= Total Revenues	400.000
Total Expenses		390.000
Financial Result		10.000

- Eliminating mutual operations and accounts: none in this example
- Sharing the equity of company F and eliminating the titles M holds in F:

Owner's Equity F	**Amount**	**Company M (40%)**	**Other Associates[3] (60%)**
Share Capital	100.000	40.000	60.000
Reserves	20.000	8.000	12.000
Financial Result	10.000	4.000	6.000
Total	130.000	52.000	78.000

Share Capital F		100.000
Reserves F		20.000
Financial Result F		10.000
	Participation Titles	40.000
	F Reserve for M	8.000
	F Financial Result for M	4.000
	Minority Interests	78.000

[3] In this case, we are considering the Minority Interests.

- Drafting the consolidated financial statements:

The Consolidated Balance Sheet for Group M

Fixed Assets (200.000+120.000) Inventories (20.000+60.000) Clients (80.000+100.000) Cash & Cash equivalents (60.000+20.000)	320.000 80.000 180.000 80.000
Total Assets	660.000
Share Capital (120.000+100.000-100.000) Reserves (30.000+20.000-20.000+8.000) Financial Result (20.000+10.000-10.000+4.000) Total Owner's Equity for the Group Minority Interests Total Owner's Equity Suppliers (230.000+170.000)	120.000 38.000 24.000 182.000 78.000 260.000 400.000
Total Owner's Equity and Liabilities	660.000

The Consolidated Profit and Loss Account for Group M

Total Revenues (600.000+400.000) Total Expenses (580.000+390.000) Minority Interests in the Financial Result	1.000.000 970.000 6.000
Financial Result (20.000+10.000-10.000+4.000)	24.000

3.2 The case of proportionate consolidation method and of standard Interest in Joint Ventures (reference processing): special discussions

The **proportionate consolidation method** applies in the case of interests in joint ventures. A **joint venture** is a contractual arrangement according to which two or several parties agree to undertake an economic activity subject to joint (conjunctive) control. **A venturer** is a party to a joint venture that has joint control over that joint venture. An **investor** in a joint venture is a party to a joint venture that does not have joint control over that joint venture.

Joint ventures refer to a great range of forms and structures. Standard IAS 31 presents for this three main categories:

- activities subject to joint control;
- assets subject to joint control;
- entities subject to joint control.

The first two categories (forms) do not require the incorporation of a different legal entity by the venturers involved. However, the third category assumes the incorporation of a legal person whose venturers are owners at the same time.

The activities subject to joint control

They are the simplest form of joint venture. Each venturer bears its own expenses, uses its own assets and resources for achieving the activities subject to joint control, together with other venturers. The contractual arrangement provisions especially the manner for dividing the revenues generated by selling production, as well as the common expenses.

For example, the standard brings to discussion the case of companies that put together their resources and competences for manufacturing and selling a plane. Each venturer is responsible for a part of the manufacture process; as such, it bears costs and receives in exchange a part of the revenues achieved from selling the plane.

Given that all assets, debts, expenses and revenues are registered in separate financial statements, the financial statements corresponding to the group must not be adjusted as regards these elements when a venturer of that joint venture submits consolidated financial statements. A venturer may not be bound to hold different accounting books and it may not draft financial statements. Still, generally, venturers may disclose managerial accounts (statements) for being able to assess the joint venture's performances.

Assets subject to joint control

This joint venture form assumes the exploitation of one or several assets subject to joint control. Each venturer is entitled to part of the goods manufactured and services supplied by using these assets and it takes in exchange the part it is worthy of from the expenses generated by using them.

As example, the ducts are assets subject to joint control when exploited by several oil companies that use them for selling their production and that divide the exploitation expenses among them.

From the accounting point of view, each venturer records in its separate financial statements and, consequently, in its consolidated financial statements the following:

- its quota in assets subject to joint control, classified according to the assets type;
- its quota in the debts made in common with the other venturers;
- any revenues generated by selling or using its quota in the joint venture's production;
- any expense made on behalf of that joint venture.

Because it is well known that assets, debts, revenues and expenses are already registered in the separate financial statements of the joint venture venturer and consequently, in its consolidated financial statements, no adjustment or other consolidation procedure is requested as regards these elements when the venturer submits its consolidated financial statements.

Processing assets subject to joint control takes into account the economic reality and, in general, the legal form of that joint venture. A different accounting of the joint venture may limit to the expenses made in common by venturers, assumed in the quotas agreed. The joint venture may not draft financial statements even if the venturers draft administration accounts for being able to assess the joint venture's performance.

Entities subject to joint control

An entity subject to joint control is a joint venture that assumes creating a joint stock company, non-stock professional corporation or of another entity in which each venturer holds a participation. In other words, the common activity is undertaken within an independent legal entity controlled jointly by venturers. The entity created controls the assets, bears the expenses and achieves the revenues. It may conclude and develop contracts on its own behalf and may acquire the necessary resources for achieving its objective. Dividing the results is made according to the necessities set out in the articles of association.

This formula is often used for investments achieved abroad, the foreign companies entering a venture, voluntarily or due to a obligation, together with a company or a local public body in order to undertake their activities in that country.

All assets, debts, expenses and revenues are accounted within the entity subject to joint control. Specifically, in the venturers' balance sheets is presented just their participation to the entity's capital. The deduction is that, given the context of drafting and presenting the consolidated financial statements, the matter of processing this participation will arise.

The **proportionate consolidation method** for the joint venture is, in the context of applying standard IAS 31, **the reference processing.**

Difference to the full consolidation method refers to the fact that the values in the financial statements of the joint venture are considered at the pro rata level of venture's participation.

The proportionate consolidation assumes going through the same work phases used for the full consolidation method.

If the joint venture is a foreign entity, its accounts (main financial statements: profit and loss account and the balance sheet) must be converted to the consolidation currency.[4]

The effects of mutual accounts between venturer and the entity subject to joint control must be eliminated in the same manner used for the full consolidation method. The only difference is that elimination is limited at the level of the consolidation percentage of the joint controlled company. At the end of year,

[4] The matter of financial statements belonging to foreign companies being converted to foreign currency is subject of a different chapter in this paper.

the internal profits included in some asset elements of a company are eliminated also at the level of the consolidation percentage of the joint controlled company.

If questions appear concerning a registration and the reliability of last year's result or previous years' result its (their) influence on the deferred taxes must be taken into account.

Similar to the case of full consolidation, the internal losses are eliminated when they do not represent a final value loss, but are due to using some transfer prices that deviate (significantly) from market values.

As regards the elimination of that venturer's participation in the entity subject to joint control, the operation is simpler than in the case of full consolidation because as stated previously, cumulating the elements in financial statements is limited to the venturer's part in assets and debts of the joint venture and, as such, the minority interests must be showed.

As a conclusion, the joint venture is an expression that when used generally applies to any activity, economic or of another type that is undertaken in common by a group of legal or natural persons (companies). The fact that an arrangement may be named joint venture, from a legal point of view, does not mean by default that it must be considered a venture from an **accounting** point of view. **Considering the latter point of view, this venture relies on the economic essence of arrangement between the parties and not on the legal structure or form.**

The three general types of joint venture identified according to the letter and spirit of standard IAS 31 merge in practice. Some ventures (this being an economic activity subject to joint control taken into account on its whole) may involve all three types of venture.

Also, there may be noticed that the distinction between operations subject to joint control and assets subject to joint control is not significant when accounting the venturer's participation: one set of accounting rules may cover both types.

Accounting the participation in an entity subject to joint control may differ, according to the financial statement to which it refers: separate financial statements of the venturer (individual accounts) or its consolidated statements.

If the main trait of a joint venture is the economic activity in which two or several parties concerned **are able to undertake and have committed contractually to undertake joint (concomitant) control**, it **must not** be translated into the fact that **each venturer has an equal financial interest in the venture.** It is well known that the venturers have **different** participations in the net assets (equities) and in the profit or loss of a joint venture, but they are **equal** from the point of view of **control undertaking**.

Usually, for ensuring the fact that no venturer decides independently what the joint venture will or will not do and in order to minimize the misunderstandings on the intentions in the arrangements agreed, **the recommendation is to use an official contract.**

It is not necessary for each party involved in an activity to undertake joint control. One or several parties involved in the activity may be able to undertake an important influence, but not also a joint control on the financial and exploitation policy decisions. Further, other parties may not undertake any joint control and any important influence. In standard IAS 31, such parties are named investors.

In practice, **confusion occurs often between joint ventures and partnerships.** Naturally, a partnership is a legal form for incorporating a company. Developing an activity under the partnership form does not mean necessarily that the activity is a venture. If the elements agreed between partners determine a joint control on the activity, there is the probability for it to be a venture. However, in many of the partnerships, the elements agreed by partners do not determine the joint control undertaken by all partners on the activities. Nevertheless, the situation when a group of partners agrees to be able to undertake joint control may be encountered. In such a circumstance, considering their position, the activities of the partner may create a joint venture.

Example of applying the proportionate consolidation method

We will take into account the companies M and F in the previous example. However, we will assume that M and venturer A undertake a joint control on company F.

The policy of group M is to use the reference processing in the international accounting standards. Choosing the consolidation method used by group M:

Control Percentage held by M in F	**Interest Percentage held by M in F**	**Type of Control**	**Consolidation Method**
40%	40%	Joint Control	Proportionate Consolidation

➟ Taking over 100% items from the balance sheet of company M:

Fixed Assets		200.000
Participation Titles		40.000
Inventories		20.000
Clients		80.000
Cash & Cash Equivalents		60.000
	Share Capital	120.000
	Reserves	30.000
	Financial Result	20.000
	Suppliers	230.000

➡ Taking over 40% items from the balance sheet of company:

Fixed Assets		48.000
Inventories		24.000
Clients		40.000
Cash & Cash Equivalents		8.000
	Share Capital	40.000
	Reserves	8.000
	Financial Result	4.000
	Suppliers	68.000

➡ Taking over 100% items from the profit and loss account of company M:

%	= Total Revenues	600.000
Total Expenses		580.000
Financial Result		20.000

➡ Taking over 40% items from the profit and loss account of company F:

%	= Total Revenues	160.000
Total Expenses		156.000
Financial Result		4.000

- Eliminating the mutual operations and accounts: none in this example

- Eliminating the titles M holds in F:

Share Capital	= Participation Titles	40.000

- Drafting the consolidated financial statements:

The Consolidated Balance Sheet for Group M

Fixed Assets (200.000+48.000)	248.000
Inventories (20.000+24.000)	44.000
Clients (80.000+40.000)	120.000
Cash & Cash Equivalents (60.000+8.000)	68.000
Total Assets	480.000
Share Capital (120.000+40.000-40.000)	120.000
Reserves (30.000+8.000)	38.000
Financial Result (20.000+4.000)	*24.000*
Total Owner's Equity	182.000
Suppliers (230.000+68.000)	298.000
Total Owner's Equity and Liabilities	480.000

The Consolidated Profit and Loss Account for Group M

Total Revenues (600.000+160.000) Total Expenses (580.000+156.000)	760.000 736.000
Financial Result (20.000+4.000)	24.000

3.3 The case of the equity method and of standards Investments in Associates and Interests in Joint Ventures (the other authorized processing): special discussions

The equity method is an accounting method (according to many persons, mainly from the point of view of American experts, an assessment method) according to which the participation is registered initially at the cost level and then adjusted in order to consider the changes occurred after purchasing the investor's quota in the net assets of the company owned.

The method is applied in the case of **associate companies** (on which a significant influence is undertaken), as reference processing (standard 28), and of **joint ventures**, under the aegis of the other authorized processing (standard IAS 31).

A participation in an associate company must be accounted in the consolidated financial statements according to the equity method, except for the case when it has been purchased and is owned for assigning it in the next 12 months.

For the individual accounts of the investor, IASB lets one choose because it can

- account its participation at its cost level;
- use the method used in the context of consolidated accounts (that usually is the equity method).

If we compare what happens in the case of full consolidation method or proportionate consolidation method and as against them, the elements of financial statements belonging to the associate company or to the joint venture are not cumulated with those of the company that owns the participation. Like this, the fact that equity is not a consolidation method, but more of an assessment method is emphasized. This is the reasons why this method may be used for drafting separate financial statements.

If we compare it with the subsidiary definition, the definition of associate company shows there must be an investment in an entity for it to be considered such a company. Standard IAS 28 does not supply a minimum value of the amount invested, but states just that the investor has an important (significant) influence that means its power to participate in making financial or exploitation-related decisions, and not the control over them. In other words, in reality what matters is firstly the right to participate or to influence and not actually exercising the power.

Within standard IAS 28, paragraph 6 mentions the 20% quota of the voting power in a company that is the minimum limit of the important influence existence. For participation below 20%, certifying the investor's influence may be achieved only if the company in which it invested makes a declaration that would certify such an influence. It is obvious that participation above the 20% quota does not certify mandatory a significant influence if there is a majority stock held or controlled by another party, although such an influence is not restricted necessarily from occurring in such circumstances. The significant influence may be challenged also in the case when the investor does not manage to materialize its attempt to be elected in the administration board or to acquire on time financial information on the entity in which it invested or if the latter opposes to the investor's intention to exercise its influence.

The investments in associate companies are subject to standard IAS 36 Impairment of Assets. If there are impairment indications of such investments, the company recognizes impairment by applying this standard. According to IAS 36, impairment is first recognized by diminishing the value of any goodwill involved by the associate company.

As regards **presenting the information** on the investments in associate companies and in joint ventures, describing the significant data and the proportion of voting rights owned is necessary. The investments accounted by using the equity method are recognized as long-term assets in the consolidated balance sheet, and the investor's profit and loss share from this type of investments must be identified as special element in the consolidated profit and loss account.

Example of applying the equity method

I will take into account companies M and F in the previous example. I will assume that Y is an associate that owns more than half of the voting rights in company F.

Choosing the consolidation method used by group M:

Control Percentage held by M in F	**Interest Percentage held by M in F**	**Type of relationship**	**Consolidation Method**
40%	40%	Significant Influence	Equity Method

The items in the balance sheets and profit and loss accounts of companies M and F will not be cumulated.

The mutual operations will not be eliminated.

- Applying the equity method to titles:

Titles in equivalence =	%	52.000
	Participation Titles	40.000
	Consolidated Reserve	8.000
	The share in the Financial Result of companies in equivalence	4.000

- Drafting the consolidated financial statements:

The Consolidated Balance Sheet for Group M

Fixed Assets	200.000
Titles in equivalence	52.000
Inventories	20.000
Clients	80.000
Cash & Cash Equivalents	60.000
Total Assets	412.000
Share Capital	120.000
Reserves (30.000+8.000)	38.000
Financial Result (20.000+4.000)	*24.000*
Total Owner's Equity	182.000
Suppliers	230.000
Total Owner's Equity and Liabilities	412.000

The Consolidated Profit and Loss Account for Group M

Total Revenues (600.000+4.000)	604.000
Total Expenses	580.000
Financial Result	24.000

After analyzing the examples supplied previously, the following conclusion can be drawn: in the consolidated financial statements the size of own equity and results is the same, no matter the consolidation method used.

CHAPTER 4

RETREATING SEPARATE FINANCIAL STATEMENTS FOR COMPANIES IN THE CONSOLIDATION PERIMETER

In many cases there are significant differences between the revaluation and presentation rules used by the member companies of the same group in order to prepare their separate financial statements. But, the consolidated financial statements should enable a uniform representation of the assembly constituted by the companies included in the consolidation perimeter. For this reason, before any mere consolidation operation itself, a range of homogenization procedures are necessary, which remove the differences between the accounting rules used to prepare the individual financial statements and the financial statements applicable to the consolidated accounts.

Also, to benefit from certain facilities or to comply with the regulations in force in the country of domicile, a group's member companies sometimes record tax elements in their individual financial statements. But, in order to prepare the consolidated financial statements, it is necessary to eliminate the incidence of the records outcome from the enforcement of the fiscal laws.

The homogenization retreatment and the retreatments for the removal of the fiscal effects may result into the adjustment of the income tax expense, as had they been taken into consideration in the individual financial statements, the tax computation basis would have changed. In other words, the withdrawal operations generate a range of future differences between the accounting and the fiscal outcome, presently used as deferred taxes.

Practically, the consolidation prior retreatment's are made in a different way, according to the consolidation method used: based on balances or based on flows.

The balance-based consolidation uses the data from the consolidated companies' financial statements, at the end of each financial period. These data are accumulated, retreated and adjusted taking into account the elements of the current financial period and of the previous financial periods.

The flow-based consolidation requires the preparation of the consolidated financial statements for each financial period, taking over the balances when opening the following financial period and finding the previous financial period's accounting operations. In this case, the incidence of retreatment over the previous financial periods is already consolidated in the balances at the opening of the financial period, and consequently, only the incidence of the current financial period retreatment's shall be recorded.

Therefore we will mainly use the **flow-based consolidation method**. In other words, the retreatment of the individual financial statements shall focus only on the current financial period and shall bear only upon the same.

4.1 Recognition of deferred taxes[1]

The deferred tax means the value of the taxes on the overcome, payable or recoverable during future accounting periods, in terms of temporary differences, the carrying forward of the unused fiscal losses and the carrying forward of the unused tax credits.

The temporary differences shall be computed by extracting its fiscal tax from the book value of an asset or a liability in the balance sheet.

The book value is the value the asset or of the liability recorded in the consolidated balance sheet.

An asset's or liability's fiscal basis is the value assigned thereto for fiscal purposes. It shall be determined starting with the individual fiscal statements of the entity included in the consolidation perimeter or with the fiscal group's statements, when a fiscal integration regime shall apply.

The fiscal basis of an asset means the value to be deducted for fiscal purposes, out of the economic benefits that the company will generate when it recovers the book value of the same. Shall any such benefits be untaxable; the fiscal bases of the asset shall be equal to its book value.

The fiscal basis of a liability means its book value reduced by any amounts that will be deducted for fiscal purposes, on the account of any such liability. As for deferred revenues, the fiscal basis is equal to the book value of the deferred revenues reduced with the value of the revenues which will not be taxable in the following periods.

When the book value of an asset exceeds its tax basis, a temporary taxable difference shall outcome, since the economic benefits generated by the asset recovery, i.e. taxable economic benefits, exceed the amount to be allowed as deductions for tax purposes. Conversely, shall the book value of an asset be lower than its tax basis; the temporary difference shall be deductible.

The book value of a liability shall be settled in the following periods through a resource output incorporating economic benefits. When resources exit a company, part or their entire value is deductible from the taxable profit for those financial periods. The favourable differences between the book value of the liabilities and the fiscal basis thereof are deductible. Any potential unfavourable differences between the book value and the taxable basis of the liabilities shall be considered taxable.

A liability regarding deferred tax shall be recognized for all the taxable temporary differences, except where the deferred tax liability is generated by the initial accounting of an asset or a liability within a transaction which is not a group

[1] The assessment, estimation and computation issues regarding deferred tax will be analyzed pursuant to IAS 12 Income Taxes.

of companies and does not affect the accounting benefit or the taxable benefit, on transaction date.

Any receivables for deferred tax shall be recognized for all the deductible temporary differences, insofar it is likely for a taxable benefit, these temporary deductible differences could be charged on, to be available, unless the deferred tax asset is generated by the initial accounting of an asset or of a liability within a transaction which is not a group of companies and does not affect the accounting benefit or the taxable benefit, on transaction date.

The deferred tax receivables and liabilities shall be determined by multiplying the temporary differences with the tax quotas which are to be applied when the asset is realized or the liability is settled, based on the tax rates enacted or quasi-enacted until the close-down of the current financial period.

Example 1

At the beginning of financial period N, company M commissioned a 20.000 MU machinery. In year N, the amortization was 2.000 MU and the fiscal amortization was 2.800 MU. The profit tax quota in year N was 16%.

Book value of the asset as for 31.12.N:	18.000 MU
Fiscal basis of the asset as for 31.12.N:	17.200 MU
Temporary taxable difference:	800 MU

Deferred tax liability to be recorded in the financial period N: 800x 16% = = 128 MU.

Example 2

As for 31.12.N, company M made a 10,000 MU provision for its employees. Provisions are tax deductible for 9,000 MU. The enforceable profit tax quota in N was 16%.

Book value of the liability:		10,000 MU
Fiscal basis of the liability	(10,000 – 1,000):	9,000 MU
Deductible temporary difference:		1.000 MU

Deferred tax asset to be recorded in the financial period N: 1.000x 16% = = 160 MU.

The deferred tax must be recorded under income or under expenses and is included in the financial period's outcome, except when the tax is generated either by an event or by a transaction which is accounted for directly under equity, in the same financial period or in a different financial period, either in a group of companies or as an acquisition.

Example 3

As for 31.12.N the following items of information are known about company M:

(1) The basis of taxation for the tangible assets is 1,410,000 MU.

(2) The gross value of the client-receivables is 324,000 MU and there is a 24,000 MU receivables impairment provision. The provision is not tax deductible.

(3) We assume that interests are fiscally recognized over the financial period when they generate cash flows.

(4) Fines are not tax deductible.

The profit tax quota: 30%.

Information	Book values
Fixed Assets (1)	1.500.000
Clients (2)	300.000
Interests receivable (3)	30.000
Fines payable (4)	33.000
Interests payable (3)	15.000

At the beginning of the financial period N, there is a deferred tax liability of 6,000 MU.

Computation of temporary differences:

Information	Book value	Fiscal Basis	Temporary Difference	
			taxable	deductible
Fixed Assets	1.500.000	1.410.000	90.000	-
Clients	300.000	324.000	-	24.000
Interests receivable	30.000	-	30.000	-
Fines payable	33.000	33.000	-	-
Interests payable	15.000	-	-	15.000
TOTAL			**120.000**	**39.000**

Deferred tax liability as for 31.12.N = 120,000 x 30% = 36,000 MU.

Deferred tax liability existing when opening up the financial period N: 6,000 MU.

Deferred tax liability to be recorded in the financial period N = 36,000 – – 6,000 = 30,000 MU.

Deferred tax asset as for 31.12.N = 39,000 x 30% = 11,700 MU

- The accounting records regarding the deferred tax are the following:[2]

Deferred Tax Expenses	= Tax Liability	30.000

Tax Receivable	= Deferred Tax Revenues	11.700

The major difference between the recognition of the deferred tax assets and liabilities is that for the assets, the recognition may be made up to the limit where it is likely for a taxable benefit to be available, the deductible temporary differences can be charged on.

Example 4

There are given the following items of information, in MU:

Information	Case A	Case B
Tax Liabilities	60.000	24.000
Tax Receivables	40.000	32.000
Net amounts	20.000	(8.000)

In case A, the deferred tax related liability ensures the recovery of the deferred tax asset. Accordingly, the deferred tax asset shall be fully accounted.

In case B, the company recognizes a 24.000 um deferred tax asset and shall carefully analyze the recovery of the 8,000 MU net debtor position.

In addition, when closing down each financial period, the accounted for deferred tax assets have to be reassessed. The company has to reduce them whenever the availability of a sufficient taxable profit is no longer likely for the use of these assets. Any such reduction is required to be resumed if proven that there is enough taxable profit available.

The deferred tax receivables and liabilities shall not be updated. Realizing a credible update of receivables and liabilities requires the detailed planning of resuming each temporary difference. In many situations, such planning is very complex or even impossible. Allowing the update would result in receivables and liabilities which could not be compared between companies. Therefore, IAS 12 does not require and or allow the updating of deferred tax related receivables and liabilities.

[2] IAS 12 requires a company to compensate the deferred tax receivables with the deferred tax liabilities belonging to the same taxable entities strictly if they are related to the income tax charged by the same tax authority, and the company is legally entitled to compensate its current tax assets with the current tax liabilities.

4.2 Homogenization retreatment

Tangible and intangible[3] assets retreatments

Any tangible or intangible asset meeting the necessary conditions to be recognized as assets, must be initially assessed at **cost**.

The cost of an asset consists of its purchase price, plus customs duties, the non-recoverable taxes and all direct attributable costs incurred to bring the asset to the provided use status. The attributable direct costs relate to: site fitting costs; initial transport and handling costs; set-up costs; fees due to architects and engineers; legal services fees; estimated cost of dismantling and moving the asset, site restoration costs, insofar the cost is recognized as a provision under IAS 37 Provisions, contingent liabilities and contingent assets.

Example 1

On 30.12.N, company F purchased a tangible asset under the following conditions: 80.000.000 MU purchase price, 5.000.000 u.m. expenses with transportation and set-up invoiced by the supplier.

The policy of the group F belongs to is to include in the tangible assets the estimated expenses for their dismantling. The value of the estimated expenses for the dismantling of the asset is 15,000,000 MU.

In the individual financial statements presented by company F as for 31.12.N, the tangible asset is recorded at the value of 85,000,000 MU.

For consolidation purposes, the estimated expenses committed for the dismantling of the asset shall be included in the cost of the asset:

Fixed Assets	=	Provisions for the decommissioning of tangible non-current assets and other similar actions	15.000.000

As for the tangible assets created by the company, the cost is determined by using the same operational principle used for the purchased asset. Consequently, all internal profits are removed. Also, the abnormal costs arising from the waste of raw materials or by the inefficient use of labour and other resources involved in the manufacturing of the asset *per se*, are not included in its cost.

For the internally generated intangible assets, one shall proceed to a two-stage analysis:

- a research phase; and
- a development phase.

No intangible asset arising from the research should be recognized. The research expense should be recognized as an expense when incurred. Any

[3] The assessment, estimation and computation issues regarding tangible and intangible assets are subject to IAS 16 Tangible assets and IAS 38 Intangible assets.

intangible assets arising from development shall be recognized strictly provided that the company can demonstrate the following:

- the technical feasibility for the completion of the intangible asset so that the same may be available for use or sale;
- its intention to finalize the intangible asset for use or sale;
- its ability to use or sell the intangible asset;
- the way in which the intangible asset will generate potential future economic benefits;
- existence of technical and financial resources and other adequate resources to bring its development to an end in order to use or sell the intangible asset; and
- its ability to accurately assess the expense attributable to the intangible asset during its development.

The cost of an internally generated intangible asset is the expense borne starting with the date the intangible asset meets the recognition criteria.

Example 2

During the financial period N, company F capitalized research expenses in the amount of 10,000,000 MU, which are to be straight-line depreciated, effective with the 1st of January N+1, over a 5-year period.

The policy of the group F belongs to is to consider the research expenses as expenses of the period. The individual balance sheet prepared by F, as for 31.12.N, records research expenses in the amount of 10,000,000 MU.

In terms of preparation of the consolidated financial statements, the research expenses shall be eliminated from the category of intangible assets:

Revenues from the production of intangible assets	=	Development Costs	10.000.000

The retreatment of the research expenses generates deferred taxes. We assume a 16% tax quota.

Book value of the intangible assets (the value recorded in the consolidated financial statements):	0 MU
Fiscal basis (the value recorded in the individual financial statements of F):	10,000,000 MU
Deductible temporary difference:	10,000,000 MU
Deferred tax asset: 10,000,000x16%=	1,600,000 MU

Tax Receivables	=	Deferred Tax Revenues	1.600.000

After its initial accounting for as an asset, any tangible of intangible asset must be recorded at **its cost reduced by the accumulated impairment** (reference

treatment) or at its **revalued value**, i.e. its fair value on revaluation date, reduced by the subsequent accumulated impairment and subsequent accumulated losses of value (alternative treatment).

If alternative treatment applies, in principle, all goods in the same category must be simultaneously revalued to avoid excessive disparity in the assessment method of various positions in the financial statements.

When the book value of an asset increases due to revaluation, the increase shall also **increase equity,** especially **the revaluation reserves.** To the extent a **positive revaluation offsets a negative assessment** of the same asset, previously accounted for as an expense, the positive revaluation shall be accounted for as **revenues**.

When the book value of an asset decreases after revaluation, this revaluation shall be recorded under **expenses**. Nevertheless, a negative revaluation shall be directly charged on the related revaluation reserves insofar such reduction does not exceed the size of the reserves from revaluation related to the same asset.

One of the following two methods shall be used in order to account for the revaluation of the tangible and intangible assets:

a) method 1: simultaneous revaluation of gross values and cumulated impairment;

b) method 2: revaluation only of the net accounting value, established by deducing depreciations from the cost of the assets.

Example 3

Company F hold constructions purchased for the price of 600 billion MU and depreciated for the amount of 150 billion MU.

The policy of the group F belongs to is to assess the building to a revalued value. The fair value of the buildings determined by the experts as for 31.12.N is 675 billion MU.

In the individual balance sheet presented by F as for 31.12.N, buildings are assessed to the net historical value of 450 billion MU.

The buildings shall be revalued for consolidation purposes.

According to the first revaluation method:

- o It shall be computed the ratio between the fair value and the net book value of the buildings: 675 billion / (600 billion – 150 billion) = 1.5
- o The cost of the non-current assets and the accumulated depreciations are revalued by applying the increase coefficient, which leads to:

- revaluation cost of the buildings: 600 billion x 1.5 = 900 billion *less*
- revaluation accumulated depreciations: 150 billion x 1.5 = <u>225 billion</u>

675 billion

- The revaluation operation shall be accounted as follows:

Buildings	=	%	<u>300 billion</u>
		Depreciation of Buildings	75 billion
		Revaluation Reserves	225 billion

According to the second method:

- The historical amortization is cancelled and the amortization value is deduced from the value of the cost of the buildings:

Depreciation of Buildings	= Buildings	150 billion

- Revaluation of buildings:

Buildings	= Revaluation Reserves	225 billion

Debit	Buildings		Credit
Initial Balance	600 billion	150 billion	
	225 billion		
	Final Balance on Debit 675 billion		

Regardless of the revaluation method used, buildings are assessed in the consolidated balance sheet at the value of 675 billion MU.

The buildings assessment difference between the two categories of financial statements generates deferred taxes. We assume a 16% tax quota.

Book value of the buildings (the value in the consolidated financial statements):	675,000,000,000 MU
Fiscal basis (the value in the individual financial statements of F):	450,000,000,000 MU
Temporary taxable difference:	225,000,000.000 MU

Deferred tax liability: 225.000.000.000x16% = 36,000,000.000 MU, which generates the record:

Revaluation Reserves	= Tax Liabilities	36 mld.

The depreciable value of any tangible or intangible asset shall be systematically distributed during its utility period. There is an assumption which can be challenged that the term of the utility of intangible assets may not exceed twenty years from the date the asset is ready to be operational.

The amortization method should reflect the rhythm and the manner in which future economic benefits are consumed as a result of using the asset. Unless the rate of consumption by the enterprise of the economic benefits of the asset may be determined in a reliable way, the linear method shall apply.

The amortization expense for each financial period should affect the profit and loss account, unless it is incorporated into the book value of another asset.

Example 4

For the amortization of a category of machineries, subsidiary F uses the digressive amortization method, while the policy of the group is to amortize these assets in a linear way. The subsidiary had purchased such equipment on 1.01.N, at the acquisition cost of 200,000,000 MU. Its management estimated a nil residual value and a 5 year term of utility (linear impairment rate = 20%, digressive amortization rate = 30%).

In year N, the amortization in the individual accounts of F is 200,000,000x30% = 60,000,000 MU. According to the policy of the group, the amortization of the equipment, in the first year, should be 200,000,000x20% = = 40,000,000 MU.

For consolidation purposes, the amortization shall be brought to the level required by the group, which generates a reduction of the recorded amortization by 60,000,000-40,000,000 = 20,000,000 MU:

Depreciation of tangible assets	=	Depreciation of non-current assets – operating expenses	20.000.000

The previous record generates a taxable temporary difference and, implicitly, a deferred tax liability of 20,000.000x16% = 3,200,000 MU:

Deferred Tax Expenses	=	Tax Liability	3.200.000

In year N+1, the amortization in the individual accounts of F is 140,000,000x30% = 42,000,000 MU. According to the policy of the group, the amortization of the equipment shall be 200,000,000x20% = 40,000,000 MU.

Shall the consolidation be made based on flows, in N+1 there shall be taken into account the difference of 42,000,000 – 40,000,000 = 2,000,000 MU.

Depreciation of tangible assets	=	Depreciation of non-current assets – operating expenses	2.000.000

The previous record generates a taxable temporary difference and, implicitly, a deferred tax liability of 2,000,000x16% = 320,000 MU:

Deferred Tax Expenses	=	Tax Liability	320.000

Shall the consolidation be made based on balances, the retreatment of the amortization in N shall be accounted for again N+1 through reserve accounts,

as the individual accounts transmitted every year to the mother-company do not take these corrections into account:

Depreciation of tangible assets	=	Reserves	20.000.000

Reserves	=	Tax Liabilities	3.200.000

In addition, in N+1, there are recognised, based on the outcome, the amortization difference for the current financial period and the deferred tax liability thereto:

Depreciation of tangible assets	=	Depreciation of non-current assets – operating expenses	2.000.000

Deferred Tax Expenses	=	Tax Liability	320.000

Retreatment related to the impairment of the assets[4]

The impairment of an asset occurs when the **recoverable value** thereof **is lower than its book value**.

The book value is the value at which an asset is accounted for in the balance sheet after deducting the amount of depreciations and the amount of losses of value related to that asset, and the recoverable value is the higher value of the fair value of that asset minus the estimated costs of sale and its utility value.

The fair value is the amount that can be obtained from the sale of an asset during a transaction, under normal competition conditions, between well-informed parties who agree thereon.

The utility value is an updated value obtained by estimating the expected future cash flows expected from the continuing use of an asset and from its cession at the end of its use term.

The book value of an asset must be brought to its recoverable value if, and only if, the recoverable value of the asset is lower than its book value.

A loss of value must be immediately recorded in the profit and loss account (under expenses) except where the asset is accounted for at its revaluation amount.

Example 1

Company F holds a piece of machinery purchased at the beginning of financial period N, at the cost of 700,000,000 MU. The utility term was estimated upon acquisition at 10,000 operating hours. During the financial period N, the

[4] The issues regarding the impairment of the assets are subject to IAS 36 Impairment of assets.

machinery operated 1.000 hours. The policy of the group F belongs to, is to enforce the provisions of IAS 36 standard.

At the end of the financial period N, there is evidence that the machinery had depreciated. Managers estimate that during each of the following 4 years, the machinery will operate 2,250 hours. The number of products manufactured will be 4 pieces per hour. The net cash flows the enterprise will obtain by selling a product, are estimated at 15,000 MU/piece. The updating rate of the cash flow is 10%.

We assume that there is an active market the machinery may be traded on. Its fair value will be 610,000,000 MU, and the expenses determined by the output will be 10,000,000 MU.

In the financial period N, in the individual accounting of company F, it was accounted for an amortization of: 700,000,000 x 1,000/10,000 = 70,000,000 MU.

The value of the machinery in Company F's individual financial statements is: 700,000,000 – 70,000,000 = 630,000,000 MU.

In order to prepare the consolidated financial statements as for 31.12.N the impairment test provided by IAS 36 shall be carried out:

Book value: 630.000.000 MU.

The fair value reduced with the estimated sale expenses:

610,000,000 – 10,000,000 = 600,000,000 MU.

The utility value = $(2,250 \times 4 \times 15,000)/1,1 + (2,250 \times 4 \times 15,000)/1,1^2 + (2,250 \times 4 \times 15,000)/1.1^3 + (2,250 \times 4 \times 15,000)/1.1^4$ = 427,931,835 MU

Recoverable value = maximum (600,000,000; 427,931,835) = 600,000,000 MU

The impairment = 630,000,000 – 600,000,000 = 30,000,000 MU

Impairment losses on non-current assets	= Impairment of plant and machinery, motor vehicles, animals and plantations	30.000.000

The value of the machinery in the consolidated financial statements is 600,000,000 MU.

The recognition of the impairment in the consolidated financial statements generates deferred taxes. We assume a 16% tax quota.

Book value of the machinery (the value in the consolidated financial statements):	600,000,000 MU
Fiscal basis (the value in the individual financial statements of F):	630,000,000 MU
Deductible temporary difference:	30,000,000 MU

Deferred tax asset: 30,000,000 x 16% = 4,800,000 MU, which generates the record:

Tax Receivables	= Deferred Tax Revenues	4.800.000

A loss of value of a revalued asset is accounted for by the deduction from the reserve from the revaluation of that asset, to the extent that the loss of value does not exceed the size of the revaluation reserve corresponding to that asset.

Example 2

Company F owns a plot of land bought in the financial period N-4, at the cost of 400,000,000 MU. The land was revalud in the financial period N-2, at 550,000,000 MU. Meanwhile (from N-2 until present), the reserve from revaluation accounted for has not been modified. The policy of the group F belongs to. is to apply the provisions o regulation IAS 36.

At the end of the financial period N, there is evidence that the land has depreciated. The real value of the land, considered to be equal to the recoverable value, is 350,000,000 MU.

In the individual financial statements prepared by company F for the financial period N, the value of the land is 550,000,000 MU.

In order to prepare the consolidated financial statements it is recognized a loss of value of 550,000,000 – 350,000,000 = 200,000,000 MU. This is accounted for as follows:

- on account of reserve from revaluation: 150,000,000 MU; and
- on account of the expenses: 50,000,000 MU

Revaluation Reserves	= Land	150.000.000

Impairment losses on non-current assets	= Impairment of land and land improvements	50.000.000

The value of the land in the consolidated financial statements is 350,000,000 MU. The recognition of the impairment in the consolidated financial statements generates deferred taxes. We assume a 16% tax quota.

Book value of the land (the value in the consolidated financial statements):	350,000,000 MU
Fiscal basis (the value from the separate[5] financial statements of F):	550,000,000 MU
Deductible temporary difference:	200,000,000 MU

[5] or *individual*

Deferred tax receivable: 200.000.000x16% =32,000,000 MU.
Deferred tax receivable shall accounted for as follows:

- on the account of equity: 150.000.000 x 16% = 24.000.000 MU
- on the account of income: 50.000.000 x 16% = 8.000.000 MU

Tax Receivables	%	32.000.000
	Revaluation Reserves	24.000.000
	Deferred Tax Revenues	8.000.000

When there is any evidence that an asset could lose value, the recoverable value of the isolated asset shall be estimated. Unless this is possible, the enterprise shall determine the recoverable value of the cash generating unit the asset belongs to.

A cash generating unit is the smallest identifiable group of assets which generates cash inputs from perpetual use, which are highly independent from the cash inputs generated by other assets or groups of assets.

For a cash generating unit, a loss of value must be accounted for if and only if its recoverable value is lower than its accounting value. The loss of value must be distributed in the following order, in order to reduce the book value of the unit's assets:

- first of all, to the goodwill attributable to the cash generating unit (if applicable);
- then, to the other assets of the unit according to the proportion of the book value of each of the unit's assets.

These reductions of the book value must be treated as losses of value of the isolated assets.

Example 3

Company F has a piece of technical equipment whose net book value is 40,000,000 MU. The policy of the group F belongs to, is to apply the provisions of IAS 36.

As for 31.12.N there is evidence that the equipment lost its value. The equipment does not produce any cash flows independent from other assets, belonging to the same cash generating unit as a building whose net book value is 120,000,000 MU and a plot of land whose book value is 80,000,000 MU. There is no goodwill which may be rationally attached to the cash generating unit. We assume that the recoverable value of the cash generating unit is 216,000,000 MU.

In the individual financial statements the three non-current assets are recorded with the above-mentioned book values.

In order to prepare the consolidated financial statements the impairment test provided by IAS 36 shall be carried out. The book value of the cash generating unit is:

40,000,000 + 120,000,000 + 80,000,000 = 240,000,000 MU

The loss of value = 240,000,000 – 216,000,000 = 24,000,000 MU

As there is no goodwill, the loss is charged on the assets from the cash generating unit, according to the proportion of the book value:

- for the equipment: 24,000,000 x 40,000,000/240,000.000 = 4,000,000 MU;
- for the building: 24,000,000 x 120,000.000/240,000,000 = 12,000,000 MU;
- for the land: 24,000,000 x 80,000,000/240,000,000 = 8,000,000 MU

The loss of value shall be accounted for as follows:

Impairment losses on non-current assets	=	%	24.000.000
		Impairment of plant and machinery, motor vehicles, animals and plantations	4.000.000
		Depreciation of non-current assets – operating expenses	12.000.000
		Impairment of land and land improvements	8.000.000

In the consolidated financial statements the value of the tangible assets is 216,000,000 MU.

The recognition of the impairment in the consolidated financial statements generates deferred taxes. We assume a 16% tax quota.

The book value of the tangible assets (the value in the consolidated financial statements):	216,000,000 MU
Fiscal basis (the value in the individual financial statements of F):	240,000,000 MU
Deductible temporary difference:	24,000,000 MU

Deferred tax asset: 24,000,000x16% = 3,840,000 MU

Tax Receivables	= Deferred Tax Revenues	3.840.000

Retreatment regarding lease contracts

A lease contract is a contract wherein the lessor assigns to the lessee the right to use a certain asset for a limited period of time, in exchange of a payment or a range of payments.

The international accounting referential divides lease contracts into two categories: finance lease contracts and operating lease contract.[6]

A finance lease is a lease contract whose effect is the transfer to the lessee of the quasi-all risks and inherent advantages of the property of an asset. At the end of the contract, the transfer of property may or may not occur.

[6] IAS 17 Lease contracts.

An operating lease is any lease contract which does not comply with the definition of a finance lease.

Classifying a lease contract under one of the two categories depends rather on the reality of the transaction than on the form of the contract. The standard sets forth examples of situations that could normally lead to classifying a contract as a finance lease:

- the contract transfers the property over the asset to the lessor, upon completion of the lease period;
- the contracts grants the lessee the option of purchasing the asset for an obviously lower price than its fair value, for which the option shall be high; in other words, from the beginning of the contract, there must exist the rational certitude that the option will be executed:
- the term of the contract covers most of the economic life of the asset, regardless of the transfer of ownership thereof;
- at the beginning of the contract, the updated value of minimum payments on behalf of the lease, amounts at least to almost the entire fair value of the asset taken into finance lease;
- the assets taken into finance lease are specific, so that only the lessee may use them without major modifications thereto;
- if the lessee may terminate the lease contract, the losses incurred by the lessor relating to the termination thereof, shall fall within the responsibility of the lessee;
- the profits and losses arising from the variation of the fair value of the residual value are to be borne by the lessee;
- the lessee has the ability to track the lease for a second period of time, through a well below the market price royalty.

To account a finance-lease contract, the following rules shall be observed:

a) In the lessee's financial statement:

- at the beginning of the finance-lease contract, the asset received by the lessee shall be accounted for, in counterpart with the obligation to make future payments on account of the lease; the non-current asset and the liability shall be recorded to the lower value between the fair value of the asset and the updated value of the minimal payments;
- the update rate shall be the default rate of the interest related to the lease contract, if it may be determined; otherwise, the marginal borrowing rate of the lessee shall be used;
- the payments on account of the lease must be divided into two parts: the financial expense and the amortization of the liability balance;
- the assets received in lease should be depreciated consistently with the other depreciable assets the lessee possesses, if there is no reasonable certainty that the lessee will become the owner of the asset at the end of the lease contract, the asset must be fully amortized during the

shortest period of time between the lease term and its term of utility; otherwise, the asset will be amortized during its utility period.

b) In the lessor's financial statement:

- for the lessor, the operation generated by a finance-lease shall be treated as an investment operation; it shall account for in its balance sheet, the assets owned on the basis of the contract and present them under receivables;
- the collectings on account of the lease (royalties) shall be distributed on two components: the receivables recovery part and the financial income, for the remuneration of the investment and its services

Example[7]

Company F (lessee) signed a lease contract with the following characteristics:

- effective date of the contract: 1.01.N+1;
- term of the contract: 3 years;
- subject matter of the contract: an item of technical equipment;
- the fair value of the equipment: 135,000 MU;
- there are estimated 3 annual royalties 50,000 MU each, payable on the last day of the contract year;
- at the end of the lease period, the equipment shall be returned to the lessor;
- the lessee shall guarantee to the lessor a residual value of 10,000 MU as for 31.12.N+3;
- the lessee's marginal loan rate is 10%.

In the individual financial statements, company F used a juridical approach to account for the finance-lease contract. In other words, during the financial period N, F fully accounted for the payments made on the account of the lease contract as expenses.

The policy of the group F belongs to is to observe the principle of substance over form. Consequently, in order to prepare the consolidated financial statements in the financial period N, there are necessary retreatments to reach the image required by the economic approach.

The updated value of the minimal payments shall be determined according to the ratio:

$$\sum_{t=1}^{3} \frac{50.000}{1{,}1^t} + \frac{10.000}{1{,}1^3} = 131.858 u.m.$$

[7] The example is taken over from Feleagă, N., Malciu, L., *Recunoaştere, evaluare şi estimare în contabilitatea internațională*, CECCAR Print House, 2004.

The record of the asset and of the liability generated by the finance-lease contract:

Pland and machinery	= Royalties, rents and similar debts – lease contracts	131.858

Table of liability amortization towards the lessor:

Date	Cash Flows (1)	Interest Payable (2) =(4)x10%	Loan Reimbursements (3)=(1)-(2)	Share of Loan to be paid $(4)_{n+2} = (4)_{n+1} - (3)$
1.01.N+1	-	-	-	131.858
31.12.N+1	50.000	13.186	36.814	95.044
31.12.N+2	50.000	9.504	40.496	54.548
31.12.N+3	50.000	5.452	44.548	10.000
Total	150.000	28.142	121.858	-

The record of the liability towards the lessor, regarding interests for the entire term of the contract (28,142 MU):

Prepayments	= Interests Payable for Royalties, rents and similar debts – lease contracts	28.142

Removing the expenses for royalties recorded by company F and the recognition of the two components of the royalties:

%	= Royalties and rental expenses	50.000
Royalties, rents and similar debts – lease contracts		36.814
Interests Payable for Royalties, rents and similar debts – lease contracts		13.186

Recording interest expenses (financial expense) for the first year of the contract:

Royalties and rental expenses	= Prepayments	13.186

We assume that the residual value at the end of the lease period is estimated at 1,000 MU. The amortization in the financial period N+1 is:[8]

$$\frac{131.858-1.000}{3ani}=43.619u.m.$$

Depreciation of non-current assets – operating expenses	= Depreciation of plant and machinery	43.619

The realized retreatments generate taxable temporary differences of 116,381 MU and deductible temporary differences of 110,000 MU, which leads to a net liability of deferred tax of (116,381-110,000)x16% = 1,021 MU[9]

Deferred Tax Expenses	= Tax Liabilities	1.021

Retreatment regarding inventories[10]

When entering the business, inventories are assessed, especially in terms of historical cost, whether acquisition costs, production costs and other costs incurred to bring the goods to the place and to their current status.

The acquisition costs include: the purchase price; customs duties and other taxes (other than the taxes subsequently recoverable by the enterprise from the tax authorities); freight and handling costs, and other costs directly attributable to the acquisition of goods, materials and services.

Production (transformation) costs include: expenses directly related to production units, such as direct labour; a share of indirect production costs, fixed and variable, incurred in processing raw materials into finished products. There may not be included in the production cost of the inventories, items such as: abnormal quantities of waste production, labour or relating to other costs of production; storage costs, unless these costs are necessary for the production process prior to entering a new manufacturing phase; general administrative expenses which do not contribute to bringing these inventories in the place and to their current status; marketing costs.

Example 1

During the financial period N, company F included in the production cost of the final products, general administrative expenses in value of 20,000,000 MU.

---

8 The equipment is depreciated according to the estimated residual value, not to the guaranteed residual value.

9 Taxable temporary differences = 131,858 + 28,142 – 43,619 = 116,381 u.m.
Deductible temporary differences = 131,858 + 28,142 – 50,000 = 110,000 u.m.

10 The inventories assessment issues shall be analyzed in accordance with IAS 2 Inventories.

We assume that by the end of financial period N, the final products have not been sold.

The policy of the group F belongs to, is to consider administrative expenses as expenses of that period.

In order to prepare the consolidated financial statements the administrative expenses shall be removed from the inventories production cost.

Sales of Finished Goods	= Finished Goods	20.000.000

Reducing the value of the inventories generates a deductible temporary difference of 20.000.000 MU and a deferred tax asset of 20,000,000x16% = 3,200,000 MU.

Tax Receivables	= Deferred Tax Revenues	3.200.000

When exiting the enterprise, inventories shall be assessed at their cost. The cost of inventories of elements which, usually, are not mistakable and of the inventories of goods and services produced or supplied and related to specific projects, must be determined by a distinct identification of their individual costs. The cost of other inventories different from the identifiable ones shall be determined by using one of the following methods: first in - first out (FIFO) or weighted average cost (WAC).

Example 2

Company F assesses its exiting inventories by FIFO method. The policy of the group F belongs to, is to use the WAC method.

At the end of the financial period N, in the individual financial statements of company F the merchandise inventory is assessed at 150,000,000 MU. If WAC method had been used, the same inventory would have had a value of 120,000,000 MU.

For consolidation purposes, the inventory shall be brought to the level required by the policy of the group.

Expenses with goods for resale	= Goods purchased for resale	30.000.000

The retreatment of the inventories generates a deductible temporary difference of 30,000,000 MU and a deferred tax asset of 30,000,000 x 16% = = 4,800,000 MU.

Tax Receivables	= Deferred Tax Receivables	4.800.000

When closing down the financial period, inventories must be assessed at **their cost** or at **their net realizable value**, if the latter is smaller.

Usually, the realization net value must be determined **separately, for each item**. Nevertheless, **regroupings** of **interrelated** resembling elements, may be realized. It is the case of the elements belonging to the same range of products, with similar purposes or uses, manufactured and traded in the same geographic area, which cannot be assessed separately from the other elements of the same range of products.

Example 3

The subject matter of company F's activity is selling merchandise. As for 31.12.N, the company has the following items o stock. The policy of the group F belongs to is, to assess the inventories upon inventory at the minimum value between the cost and the realization net value.

In the individual balance sheet of company F, inventories are assessed at 540.000 MU.

Items	Acquisition Cost (in m.u.)
Merchandise M1	100.000
Merchandise M2	90.000
Merchandise M3	300.000
Merchandise M4	50.000
Total	540.000

In order to prepare the consolidated financial statements, the test of the minimum value between the cost and the realization net value must be carried out.

The net realization value was established by a professional assessor:

Items	Net Realisable Value (in m.u.)
Merchandise M1	95.000
Merchandise M2	93.000
Merchandise M3	310.000
Merchandise M4	46.000
Total	544.000

The test of the minimum value between the cost and the realization net value leads to the following value of the inventory, in the consolidated balance sheet upon termination of the financial period N:

Items	Minimum between *Cost* and *Net Realisable Value* (in m.u.)
Merchandise M1	95.000
Merchandise M2	90.000
Merchandise M3	300.000
Merchandise M4	46.000
Total	531.000

It outcomes a loss of value of 540,000 – 531,000 = 9,000 MU, which shall be accounted for as impairment provision.

Write-down of current assets	= Impairment of current assets	9.000

The impairment of inventories generates a deductible temporary difference of 9,000 MU and a deferred tax asset of 9,000x16% = 1,140 MU.

Tax Receivable	= Deferred Tax Revenues	1.140

Retreatment regarding construction contracts

The accounting for of the construction contracts shall be conducted by different methods, according to the moment when the result of the work is established.

The international accounting referential admits two accounting records of the construction contracts: the percentage of completion method and the work completion method.[11]

The percentage of completion method enables the distribution of revenues and costs of the contract, according to the percentage of work completed during each financial period, which leads to determining the estimated benefit, in the same way.

The level of completion of a contract may be determined in several ways. The indicator selected to determine the level of completion shall enable a reliable measurement of the completed work. Depending on the nature of the contract, the methods may include:

- the percentage of costs incurred related to the estimated total contract costs, or
- completion of a physical proportion of the contract work.

The work completion method limits the value of the completed work (revenues) to the level of the expenses incurred and likely to be recovered from the beneficiary. As the contract is not finalized, no profit is recognised and accounted for. It shall be subject to recognition and it shall be accounted for in the financial period works shall be completed in

IAS 11 Standard sets forth that whenever the outcome of a contract may be estimated reliable, the method to be used is the percentage of completion method.

[11] IAS 11 Construction contracts.

As for a **fixed price contract**[12]:

- the total revenue of the contract shall be measured reliably;
- high likeliness that the contractor obtain the economic advantages thereto;
- the necessary costs for the completion of the agreement and the proportion of work completion, on balance sheet date, may be accurately measured;
- the attributable costs (assignable) of the contract shall be clearly identifiable and measurable, to enable comparisons with the estimates.
- The necessary conditions for a **cost plus contract** refer to:
- high likeliness for the contractor to obtain the economic advantages thereto;
- the opportunity to clearly identify and accurately measure all contract-related expenses, reimbursable or not.

When the previous conditions **may not be met**, the outcome of the contract may not be estimated reliably enough. In such cases, the **work completion method** shall be used. But if, subsequently, the contract-related uncertainties diminished very much, so that the outcome thereto may be reliably estimated, the work completion percentage method shall be used.

Example

Company F committed itself to a contract signed on 10.07.N, to supply one of its clients with a specialized piece of machinery. Upon execution of the contract, it was provided that the asset should be delivered in May N+2. Upon execution of the contract, a reviewable sale price of 4,800,000 MU was settled and a total production cost of 3,800,000 MU was estimated. As for 31.12.N the cost of the outgoing production was 1,292,000 MU.

In the individual financial statements published in N, company F accounted for the contract using the work completion method.

In order to prepare the consolidated financial statements, the outcome related to the current financial period shall be included in the cost of the works, since the conditions to apply the percentage of completion method are met.

[12] According to IAS 11, construction contracts classify as follow:

- fixed price contracts, in which the contractor agrees to a fixed contract price,
- or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses;
- cost plus contracts, in which the contractor is reimbursed for allowable or

Total estimated outcome = 4,800,000 – 3,800,000 = 1,000,000 MU
The work completion percentage as for
31.12.N = (1,292,000/3,800,000) x 100 = 34%.
Financial period outcome N = 34%x1,000,000 = 340,000 MU

Work in progress	= Capitalised costs of tangible non-current assets – own work capitalised	340.000

Passing from the work completion method to the percentage of completion method generates a taxable temporary difference and a deferred tax liability of 340,000x16% = 54,400 MU.

Deferred Tax Expenses	= Tax Liabilities	54.400

Retreatment regarding Borrowing Costs

The borrowing costs include the interests and other costs incurred by an enterprise in relation with the fund borrowing.

The international accounting referential[13] sets forth the obligation to include the borrowing costs directly attributable to the acquisition, construction or production of a **qualifying asset**, in the cost of that asset. **A qualifying asset** is an asset that takes a substantial period of time to get ready for its intended use or sale.

The identification of capitalizable expenses is easier or harder to realize, according to the nature of the funding of the asset: by special loan or from the borrowed capitals at the level of the entire enterprise.

To the extent borrowed funds are intended to obtain a qualifying asset, the size of the borrowing costs incorporated into the cost of the asset must correspond to the real borrowing costs incurred during the financial period, reduced by any revenues obtained from the temporary investment of the borrowed funds.

When the financing of the asset is not subject to a particular loan, the dimension of the **capitalizable expenses** is determined by applying a capitalisation rate to the expenditure on that asset. The capitalisation rate will be the weighted average of the borrowing costs applicable to the loans of the enterprise, which are not reimbursable during the period, others than the funds borrowed specifically for obtaining a qualifying asset.

The value of the **capitalized expenses** shall not exceed the actual borrowing costs incurred during the period.

Example

At the beginning of the financial period N-1, company F started up the construction of a warehouse for its own needs. According to the provisions in the

[13] IAS 23 Borrowing costs.

national accounting referential, the managers decided to recognize as expenses of that period, the interests generated by the borrowed funds related to this construction. These interests were: 1,800 MU, in the financial period N-1, and 2,000 MU, in the financial period N.

The policy of the group F belongs to, is to apply IAS 23.

In order to prepare the consolidated financial statements, the interests related to the borrowed funds for the construction, shall be capitalized as follows:

➡ in year N-1, interests of 1,800 u.m shall be capitalized:

Tangible assets in progress	=	Own work capitalised – revenues Capitalised costs of tangible non-current assets	1.800

The prior record generates a taxable temporary difference and, implicitly, a deferred tax liability of: 1,800x16% = 288 MU:

Deferred Tax Expenses	=	Tax Liabilities	288

➡ in the financial period N, capitalization is different depending on the consolidation method used:

a) consolidation be based on flows, in N, interest of 2,000 u.m shall be capitalized:

Tangible assets in progress	=	Own work capitalised – revenues Capitalised costs of tangible non-current assets	2.000

The prior record generates a taxable temporary difference and, implicitly, a deferred tax liability of: 2,000x16% = 320 MU:

Deferred Tax Expenses	=	Tax Liabilities	320

b) consolidation be based on balances, the interests from N-1 shall be capitalized again in N, in the reserve account, as the individual accounts transmitted each year to the mother-company do not take previous corrections into account:

Tangible assets in progress	=	Reserves	1.800

Reserves	=	Tax Liabilities	288

In addition, in N, there shall be capitalized the interests related to the current financial period and the deferred tax thereto:

Tangible assets in progress	= Own work capitalised – revenues Capitalised costs of tangible non-current assets	2.000
Deferred Tax Expenses	= Tax Liabilities	320

Retreatment regarding provisions for risks and expenses

A provision for risks and expenses is a liability with uncertain dimension and due date.

In accordance with the international referential[14], a provision shall be recognized only when: a) the enterprise has a current obligation generated by a prior event; b) it is likely that an output of recourses which may affect the economic benefits may be necessary to honour that obligation; and c) a good estimation of the value of the obligation may be achieved.

The obligation may result from legal provisions (from a contract, legal or regulating provisions, from elements of jurisprudence) or from the enterprise's actions when, by previous practice, by its policy made public or by a declaration, it showed to third parties and consequently, it created the hope that it would assume certain responsibilities (default obligation).

Example 1

Company F specializes in automotive production. In the financial period N, on the occasion of an international fair, it launched a new model on the market and sold 3 items thereof. After sale, malfunctions of a certain sub-assembly were noticed.

The company informed the buyers on the malfunctions and committed to repairing them free of charge. The repair expenses are estimated at 4,000,000 MU.

Company F did not recognize any provision in its individual financial statements as there is no legal obligation to replace the defect sub-assembly.

In order to prepare the consolidated financial statements it shall be checked whether the provision recognition conditions are met. On this occasion, the following are found:

- there is a present obligation as a result of a past event: the company's commitment towards its buyers to remedy the malfunctions – implicit obligation;

[14]The provisions for risks and expenses shall be analyzed in accordance with IAS 37 Provisions, contingent liabilities and contingent assets.

- it is likely the output of resources generating future economic advantages: expenses with the repairs;
- a provision is necessary for the best estimation of the expenses for repairs: 4,000,000 MU.

Depreciation of Provisions for risks and charges – operating expense	=	Provisions for risks and charges	4.000.000

The recognition of the provision of risks and expenses generates a deductible temporary difference and a deferred tax asset of 4,000,000x16% = 640,000 MU:

Tax Receivables	=	Deferred Tax Revenues	640.000

Shall a **contract** become **onerous**, a provision for the present obligation thereto shall be generated. A contract is considered onerous when the inevitable costs involved in fulfilling the contractual obligations are greater than the estimated economic benefits to be derived from the contract. Unavoidable costs of a contract are represented by the lower value between the cost of fulfilling the contract and any compensation or penalty caused by the failure of the contract.

Example 2

At the beginning of financial period N-2, company F signed a lease contract for a building to be used for headquarters. The term of the contract is 6 years. The annual royalty is 10,000 MU. The contract specifies that the space may not be sub-leased to another beneficiary, and in case of cancellation, penalties of 6,000 MU shall be paid for each year of contract failure. At the end of the financial period N, the company moved its headquarters to an administrative centre in a central area which better matches the new image the company wants to promote.

Company F did not recognize in its individual financial statements any provision for the onerous contract.

In order to prepare the consolidated financial statements it shall be checked whether the conditions to recognize a provision are met. On this occasion, the following shall be found:

- there is a present obligation as a result of a past event: signing a lease contract which entails a legal obligation;
- it is likely the output of resources generating future economic advantages: royalties for the last 3 financial periods or penalties in case of cancellation of the contract;
- a provision is necessary for best estimating the inevitable contract-related payments: 3x6.000 = 18.000 MU.

Depreciation of Provisions for risks and charges – operating expense	=	Other provisions for risks and charges	18.000

The recognition of the provision for risks and expenses generates a deductible temporary difference and a deferred tax asset of 18,000x16% = 2,880 MU:

Tax Receivables	=	Deferred Tax Revenues	2.880

There shall be recorded as provisions only those obligations arising from past events which are beyond the company's future actions. There are cases where a company intends or is forced to make expenses in order to act in a certain way. As the enterprise can avoid future costs by various actions such as modifying the manufacturing process, it has no current obligation related to those future expenses and, therefore, it will not recognize any provision.

Example 3

Company F conducts its activity in steel industry. As steel industry companies are bound every 5th year to replace their furnace lining, F recognized in its individual financial statements of financial period N a provision for risks and expenses in value of 10,000 MU.

In order to prepare the consolidated financial statements the provision shall be removed as the company has no current review obligation, independent from its future actions. By its way of acting, it can avoid future expenses (for example, taking some furnaces out of use).

Other Provisions for risks and charges	=	Depreciation of Provisions for risks and charges - operating expense	10.000

The removal of the provision for risks and expenses generates a taxable temporary difference and a deferred tax liability of 10,000x16% = 1,600 MU:

Deferred Tax Expenses	=	Tax Liabilities	1.600

A **provision for restructuring** is found when the enterprise is irrevocably committed to restructuring. This happens when:

- the enterprise has a detailed restructuring plan and
- the restructuring plan was started up or its characteristics were notified in such a way as to inflict to the affected parties (employees, clients and suppliers) the expectation that the enterprise will implement the restructuring process.

Example 4

Company F supplies passenger airway transportation services. On the 5th of December N, the board of directors decides that effective from the 1st of January N+1, it shall cancel the international transportation activities. By the end of financial period N, no detailed restructuring plan was prepared and the restructuring decision was not made public.

In the individual financial statements published in the financial period N, company F presented a provision for restructuring the transportation activities in value of 1,000,000 MU.

In order to prepare the consolidated financial statements, the 1,000,000 MU shall be eliminated as company F is not irrevocably committed to the restructuring:

Provisions for restructuring costs	=	Depreciation of Provisions for risks and charges – operating expense	1.000.000

The removal of the provision for risks and expenses generates a taxable temporary difference and a deferred tax liability of 1,000,000x16% = 160,000 MU:

Deferred Tax Expenses	=	Tax Liabilities	160.000

4.3 Retreatments to remove the incidence of the records outcome from applying tax laws

There are situations when the member companies of a group make individual accounting records in order to observe certain tax regulations enforceable in their country of residence or in order to benefit from a range of tax advantages. For example, for tax reasons, French companies may make provisions to increase prices and regulated provisions or may account for derogatory amortization. In our country, tax records are related mainly to the impairment of tangible assets.

In order not to distort the image presented in the consolidated financial statements, the member companies of a group have to remove the incidence of the records outcome from applying tax laws.

Example

On 30.06.N, company F purchased an item of equipment in value of 100,000 MU. The machinery was 80% subsidized.

In its individual accounting records, company F amortized the machinery according to the tax regulations in force: linear method, 5 year amortization term. The subsidy for investments was initially recognized as deferred revenues and was wired under current financial period revenues at the same rhythm as the amortization of the machinery. The policy of the group F belongs to, is to apply the linear amortization for this category of equipment, on a 4 year term.

In the individual financial statements presented as for 31.12.N, company F accounted for values computed in accordance with the tax regulations:

- amortization of the machinery for 10,000 MU;
- wiring the subsidy under revenues for 8,000 MU.

According to the policy of the group, in the financial period N, the amortization should be 12,500 MU and the subsidies wired under revenues, of 10,000 MU.

In order to prepare the consolidated financial statements, the incidents of the tax records shall be removed and the economically justified values shall be recognized:

Depreciation and provisions – operating expenses	=	Depreciation of tangible assets	2.500

Subsidies	=	Subsidies for operating activities	2.000

The removal of the tax records incidence generates a deductible temporary difference of 2,500 MU, for machineries, and a taxable temporary difference of 2.000 MU, for investment subsidies. Consequently, it is recognized a net asset of deferred tax of 500x16% = 80 MU:

Tax Receivables	=	Deferred Tax Revenues	80

CHAPTER 5

TRANSLATION OF FINANCIAL STATEMENTS FOR FOREIGN OPERATIONS

5.1 Translation principles

The translation of a foreign company's accounts is basically made by the following two steps:

1) the translation of foreign entity's accounts from the local currency into the functional currency (if these are different), by applying the historical cost method;
2) the translation of the accounts from the functional currency into the presentation currency (if different), by applying the closing rate method.

The **local currency** is defined as the currency of the country in which the consolidated company is located, and most often it is the same with the currency used to disclose its individual financial statements.

The **functional currency** is the one recommended by the entity's primary economic environment, in which it performs all business activities; therefore it is the currency for generating and managing the company's own cash flows.

Foreign operation: a subsidiary, associate, joint venture, or branch whose activities are based in a country or currency other than that of the reporting entity.

IAS 21 *The Effects of Changes in Foreign Exchange Rates* imposes two criteria for identifying the functional currency: (i) the currency directly influencing the selling price for all goods and services, and the currency of the country whose competitiveness and commercial provisions also influence the selling prices for those goods and services; (ii) the currency strongly influencing the manufacturing, raw material, and other operating costs for rendering goods and services.

Whenever these two basic criteria are insufficient for setting the functional currency, one must take also into consideration auxiliary influence factors. We are talking about: the currency used to generate all financing activities, and the currency for disclosing all operational cash-ins.

IAS 21 foresees as well some other factors for determining the functional currency of a foreign company, and the extent to which its functional currency is similar to the currency of the reporting entity.

Amongst these factors we mention: the degree in which the foreign entity's operations represent an economic extension of reporting entity's own activities; the share of transactions with the reporting entity, in total amount of foreign company's own transactions; the degree of influence of foreign company's own cash flows, over the reporting entity's cash flows, and their readily availability; the degree in which foreign entity's cash flows are sufficient for settling all of its debts, but without financially supporting the reporting entity.

In order to evaluate the degree of accomplishment for the above mentioned criteria, strong expert opinion is needed, as to professionally determine the functional currency - which fairly translates all economic effects of transactions and company events.

Regarding these considerations, one must prioritize the importance of the basic criteria, and keep in mind that all auxiliary-influence factors are not part of the company's primary economic environment.

The presentation currency is the currency for the preparation and presentation of company financial statements.

Example 1:

A Romanian company: F is 60% owned by an American company: M, which prepares all financial statements in US Dollars.

Case *a*: The Romanian company invoices all of its sales in Lei. Therefore, this company's functional currency is Lei, and it is the same with the local/national currency. In order to integrate F into the consolidated group set by M, it is sufficient to follow one step only: to convert all F accounts from Lei into US Dollars, by using the closing rate method.

Case *b*: The Romanian company predominantly invoices its sales in US Dollars. Therefore its functional currency is the US Dollar, which is different than local currency, but it is the same with the presentation currency. In order to integrate F into group M, one step is sufficient: converting all of its accounts from Lei into US Dollars, by applying the historical cost method.

Case *c*: To the information in *Case b*, we also add the fact that the American company is the subsidiary of another French company which discloses financial statements in Euro. In this case, the translation (conversion) is to be made following two phases: first, the translation of all accounts from Lei into US Dollars, by applying the historical exchange-rate method; secondly, converting the accounts from US Dollars into Euro, throughout the closing rate method.

Example 2:

The Romanian company M holds a Romanian subsidiary F which has the US Dollar as functional currency. The presentation currency is in Lei.

Case I: The functional currency for M is Lei. Therefore, all of F's financial statements are converted from Lei into the functional currency (US Dollar), by applying historical exchange-rate method. Further, all of F's financial statements are converted from the functional currency „Lei", by applying the closing rate method.

Case II: The functional currency of company M is the US Dollar.

Therefore, all financial statements for both F and M are to be converted from Lei, into the functional currency US Dollar, by historical exchange-rate method. Further, both sets of financial statements are converted from the functional currency into Lei, through the closing rate method.

Example 3:

The Romanian company M holds a Romanian subsidiary F which uses Euro as functional currency. But, the functional currency of M is the US Dollar, while the group presentation currency is in Lei.

The F financial statements are convertible from Lei into the functional currency (Euro), through historical exchange-rate method. Further, F's financial statements are converted from Euro to Lei, by closing rate method.

M's financial statements are converted from Lei into the functional currency (US Dollar) by historical exchange-rate method. Finally, M financial statements are converted from the functional currency into Lei, by closing rate method.

5.2 Presentation of the Translation Methods Historical Exchange-rate Method

The historical exchange-rate[1] method is basically used to convert foreign-companies' financial statements, from their local currency into the functional currency. This method's main target is to obtain a fair image of the converted financial statements, as if these were originally prepared by directly using the functional currency.

According to this method, in order to convert the Balance Sheet, a company must follow:

- that all non-monetary items (assets, liabilities and owner's equity) are being converted at their acquisition-moment exchange rates, or if the case, at the exchange rates at the moment of their value adjustments;
- that monetary items are converted at the end-of-year exchange rates;
- for all recorded asset depreciations (amortizations or provisions) already converted at historical exchange-rate, should be further converted throughout the same method;
- all asset depreciation provisions, having a non-monetary substance, are valued at net realizable values, and must be converted by the closing rate method.

The distinction between monetary and non-monetary Balance Sheet items is made according to **IAS 29** *Financial Reporting hyperinflationary economies*. It is true that most Balance Sheet items are by an obvious manner either monetary or non-monetary. There are some contexts where defining an element either as monetary or non-monetary, exclusively depends upon its fundamental characteristics. For example, the Provisions for Doubtful Customers is mainly considered a monetary element because Customers (accounts receivable) are monetary items. Or, the Provision for Depreciation of Current Assets (inventories) is a non-monetary item, because inventories are considered non-monetary.

[1] at the dates of the transactions

Examples of monetary items:

- monetary asset items: cash and cash equivalents; accounts receivable (clients/customers); other receivables;
- monetary liability items: suppliers and similar debt accounts; accounts payable; other operating liabilities; fiscal debts; financial liabilities (loans).

All of the other Balance Sheet items are considered as non-monetary items.

Examples of non-monetary items:

- assets: prepayments; advance payments to suppliers of inventories; long-term investments; participation titles; fixed assets; intangible assets; deferred tax receivables;
- liabilities and owner's equity: deferred revenues from sales; subsidies; tax liabilities; owner's equity.

In order to convert the Profit and Loss Account, all revenues and expenses must be converted on the basis of the current exchange-rate in the day of the generating transaction, but some average exchange rates are also allowed. An exception is the case of the depreciation and amortization expenses (or *provisions for depreciation and amortization*), which due to homogeneity considerations must be converted at the same exchange rate used for similar assets in the Balance Sheet; this is also the case of *revenues from subsidies* which must be converted only by historical exchange-rates.

The translation differences generated by financial statement translation, by using the historical exchange-rate method, are to be considered exchange-rate gains or losses from transactions, and should be recorded as revenues or expenses in the Profit and Loss Account for the period. The incurrence of these translation differences are generated by the following events:

- Profit and Loss Account evaluation differences, occurring for all expenses and revenues converted by applying either average exchange-rates, or historical exchange-rate method (not closing rate); and also occurring for the Financial Result stated in the Balance Sheet and not converted by applying the closing rate;
- Balance Sheet evaluation differences, occurring for non-monetary items which have been already converted by historical exchange-rates, and not closing rate.

The Closing Rate Method

The Closing Rate Method is used as to convert financial statements belonging to foreign companies, from the functional currency into the presentation currency.

According to this translation method:

- Asset and Liability items, both monetary and non-monetary, belonging to the foreign entity, must be converted at closing rates;
- Revenue and Expense items, belonging to the foreign entity, must be converted on the basis of the transaction-date exchange rates; with the exception of the situation in which the foreign company presents its own accounts by using the currency of a hyperinflationary economy, a case in which all of its revenues and expenses must be converted at the closing rate; and
- all translation differences occurring form the translation of the above mentioned items, must be disclosed separately within Owner's Equity.

Even though IAS 21 does not particularly refer to the translation of Owner's Equity items, we must say these elements are convertible only by applying the historical exchange-rate method.

Due to practical reasons, a certain existing exchange rate which is close to the effective exchange rates (for example a median exchange rate for a certain time scale), is often used to convert revenue and expense items, belonging to a foreign commercial entity. Also, for this case as well, there is an exception applicable to depreciation provisions and amortizations, which will be converted on the basis of the same exchange rate as other similar Balance Sheet asset items.

Example 4

Romanian company M, controls subsidiary F which is located in Germany. At the end of year N, the corresponding F Balance Sheet and Profit and Loss Account are disclosed as follows:

Balance Sheet of Company F, at the 31st of Dec., N

(in Euro)

Assets	**Amounts**	**Owner's Equity and Liabilities**	**Amounts**
Fixed Assets	720.000	Share Capital	360.000
(-) Depreciation of tangible assets	(120.000)	Reserves	135.000
		Financial Result	36.000
Goods purchased for resale – Merchandise	156.000	Liabilities	609.000
(-) Provisions for the depreciation of tangible assets	(6.000)		
Clients	360.000		
Cash & Cash Equivalents	30.000		
Total	140.000	Total	1.140.000

Profit and Loss Account for Company F, at the 31st of Dec., N

(in Euro)

Items	Amounts
Sale of Merchandise	720.000
Expenses with goods for resale	(576.000)
Amortization Expenses	(72.000)
Depreciation of provisions for current assets – operating expenses	(6.000)
Other expenses	(30.000)
Financial Result	36.000

Additional information:

- F subsidiary started activities on the 31st of Dec. N-3;
- M company owns 100% of F's equity;
- the value of Reserves at the end of year N, have been generated by two previous financial years N-2 (60.000 Euro) and N-1 (75.000 Euro);
- all fixed assets have been acquired on the 28th of Feb. N-2;
- at the closure of exercise N, provisions have been setup for the depreciation of current assets (merchandise);
- the Euro exchange rate incurred time variations as follows:

Date	Exchange Rate for LEI
31.12.N-3	3,2
28.02.N-2	3,3
31.12.N-2	3,6
31.12.N-1	3,8
31.12.N	4,0

- the average exchange rate for year N: (4,0 + 3,8)/2 = 3,9 lei;
- the average exchange rate for year N-1: (3,6 + 3,8)/2 = 3,7 lei;
- the average exchange rate for year N-2: (3,2 + 3,6)/2 = 3,4 lei.

Case Study 1: The functional currency for subsidiary F is in Lei. Consequently, its individual financial statements are to be converted from the local currency (Euro), into the functional currency (Lei), by applying the historical exchange-rate method.

Balance Sheet for F	Amounts in Euro	Exchange Rate	Amounts in Lei
Fixed Assets	720.000	3,3 (1)	2.376.000
(-)Depreciation of tangible assets	(120.000)	3,3 (1)	(396.000)
Goods purchased for resale - Merchandise	156.000	4,0 (2)	624.000
(-)Provisions for the depreciation of tangible assets	(6.000)	4,0 (2)	(24.000)
Clients	360.000	4,0 (3)	1.440.000
Cash & Cash Equivalents	30.000	4,0 (3)	120.000
Total Assets	1.140.000	-	4.140.000
Share Capital	360.000	3,2 (4)	1.152.000
Reserves	135.000	(5)	481.500
Financial Result	36.000	(6)	70.500
Liabilities	609.000	4,0 (3)	2.436.000
Total Owner's Equity and Liabilities	1.140.000	-	4.140.000

(1) The exchange-rate at the moment of fixed assets' acquisition.
(2) The exchange-rate at the moment of setting up the provision for depreciation of current assets (merchandise).
(3) End-of-year N exchange rate.
(4) Existing exchange rate at company-setup moment.
(5) All Reserves are computed based on the following average exchange rates (for N-2 and N-1): 60.000x3,4 + 75.000x3,7 = 481.500 lei.
(6) The Financial Result is computed by difference.

Profit and Loss Account for F	Amounts in Euro	Exchange/ Translation Rate	Amounts in Lei
Sale of Merchandise	720.000	3,9 (1)	2.808.000
Expenses with goods for resale	(576.000)	3,9 (1)	(2.246.400)
Amortization Expenses	(72.000)	3,3 (2)	(237.600)
Depreciation of provisions for current assets – operating expenses	(6.000)	4,0 (3)	(24.000)
Other expenses	(30.000)	3,9 (1)	(117.000)
Financial Result before the exchange-rate loss	36.000	-	183.000
Exchange-rate loss		(4)	(112.500)
Financial Result		(5)	70.500

(1) The average exchange rate for year N.
(2) The exchange-rate at the moment of fixed assets' acquisition.
(3) The exchange-rate at the moment of recording the provision.
(4) Computed as the difference between the Financial Result based on Balance Sheet information, and the Financial Result before the translation loss.

(5) Financial Result based on Balance Sheet information.

The analysis of exchange differences:

Items	Amounts in Euro	Amounts in Lei	Differences
SHARE CAPITAL translation at historical rate translation at closing rate	360.000	 1.152.000 1.440.000	 288.000
RESERVES translation at historical rate translation at closing rate	135.000	 481.500 540.000	 58.500
FIXED ASSETS (net value) translation at historical rate translation at closing rate	600.000	 1.980.000 2.400.000	 (420.000)
REVENUES translation at historical rate translation at closing rate	720.000	 2.808.000 2.880.000	 72.000
EXPENSES translation at historical rate translation at closing rate	684.000	 2.625.000 2.736.000	 (111.000)
Full-exchange difference			(112.500)

Case Study 2: The functional currency for subsidiary F is Euro. Consequently, all of its financial statements are converted from the functional currency (Euro), into the presentation currency (Lei) – by applying the **closing rate** method.

Profit and Loss Account for F	Amounts in Euro	Exchange/ Translation Rate	Amounts in Lei
Sale of Merchandise Expenses with goods for resale Amortization Expenses Depreciation of provisions for current assets – operating expenses Other expenses	720.000 (576.000) (72.000) (6.000) (30.000)	3,9 (1) 3,9 (1) 4,0 (2) 4,0 (2) 3,9 (1)	2.808.000 (2.246.400) (288.000) (24.000) (117.000)
Financial Result	36.000	-	132.600

(1) The average exchange rate for year N.
(2) End-of-year N exchange rate.

Balance Sheet for F	Amounts in Euro	Exchange Rate	Amounts in Lei
Fixed Assets	720.000	4,0 (1)	2.880.000
(-)Depreciation of tangible assets	(120.000)	4,0 (1)	(480.000)
Goods purchased for resale - Merchandise	156.000	4,0 (1)	624.000
(-)Provisions for the depreciation of tangible assets	(6.000)	4,0 (1)	(24.000)
Clients	360.000	4,0 (1)	1.440.000
Cash & Cash Equivalents	30.000	4,0 (1)	120.000
Total Assets	1.140.000	-	4.560.000
Share Capital	360.000	3,2 (2)	1.152.000
Reserves	135.000	(3)	481.500
Exchange/ Translation Reserves	-	(4)	357.900
Financial Result	36.000	(5)	132.600
Liabilities	609.000	4,0 (1)	2.436.000
Total Owner's Equity and Liabilities	1.140.000	-	4.560.000

(1) End-of-year N exchange rate.

(2) Existing exchange rate at F company-setup moment.

(3) Computed on the basis of yearly average exchange rates (years N-2 and N-1): 60.000x3,4 + 75.000x3,7 = 481.500 lei.[2]

(4) The Translation Reserve is computed as a difference between *total after-translation assets* and *total after-translation owner's equity and liabilities*.

(5) Financial Result for the year, in Lei, computed on the basis of Profit and Loss Account information.

The analysis of exchange differences:

Items	Amounts in Euro	Amounts in Lei	Differences
SHARE CAPITAL	360.000		
translation at historical rate		1.152.000	
translation at closing rate		1.440.000	288.000
RESERVES	135.000		
translation at historical rate		481.500	
translation at closing rate		540.000	58.500
REVENUES	720.000		
translation at historical rate		2.808.000	
translation at closing rate		2.880.000	72.000
EXPENSES	684.000		
translation at historical rate		2.675.400	
translation at closing rate		2.736.000	(60.600)
Full- exchange difference			357.900

[2] There are experts who prefer to convert Reserves on basis of the exchange-rates at the end of financial years (those end-of-year rates which generate the Financial Result included into the Reserve). If we had used precisely this method, then the Reserves amounted to: 60.000x3, 6 + 75.000 x 3,8 = 501.000 lei.

CHAPTER 6

FINAL CONSOLIDATION OPERATIONS

The retreatment of separate financial statements and their conversion/translation are followed by the effective consolidation operations. These operations must follow the steps:

- The takeover and cumulating the Balance Sheet and Income Statement items of the parent and consolidated companies (both by full and proportionate consolidation methods);
- The elimination of reciprocal operations and accounts;
- The elimination of participation titles, altogether with the corresponding quota of existing capitals at moment of the acquisition.

6.1 The takeover and cumulation of Balance Sheet and Income Statement items of the parent and consolidated companies (both by full and proportionate consolidation methods)

The Balance Sheet and Income Statement items of the parent and consolidated companies (both by full and proportionate consolidation methods), are to be cumulated in steps.

Whenever a consolidated assembly is formed by maximum of 7 or 8 companies, the Consolidation Statement is used as support tool. Besides this, the fairness and transparency of consolidation operations require as well to record all operations into a Consolidation Journal.

In the case of consolidation statement, this must contain at least the following elements: the detailed version of all asset, owner's equity, liability, expense and revenue items; a special dedicated field for the parent; a separate field for each of the consolidated companies (both fully and proportionately consolidated); a field for total amounts; a field for eventual corrections; and a field for effects over the Consolidated Balance Sheet and Consolidated Income Statement (the same as Consolidated Profit and Loss Account).

CONSOLIDATION STATEMENT FOR GROUP M

Assets, Owner's Equity, Liabilities, Revenues, Expense Items	Parent M	Comp. F1	…	Comp. Fn	Total	Corrections		Consolidated Balance Sheet, or Profit and Loss Account
						+ or -	- or +	
ASSETS … OWNER'S EQUITY … LIABILITIES … REVENUES … EXPENSES	…	…	…	….	…	…	…	…

When using the consolidation journal, for both cases of the parent and consolidated companies (both fully and proportionately consolidated), we must proceed to the takeover of all Balance Sheet entries referring to assets, in the Debit side, and the owner's equity and liability items, on the Credit side, including the financial results. Further we implement the takeover and cumulation of expense accounts (on the Debit side), and revenue accounts (on Credit), which are reopened for consolidation procedures.

After all account takeovers, the financial result disclosed in the Profit and Loss Account, should match the one disclosed in the **Ba**lance Sheet. Therefore, in the consolidation journal, all balance sheet and expense and revenue accounts are to be kept, except the "financial result for the year" which shall be eliminated.

The takeover of the Balance Sheet and Income Statement items is made as follows: in a 100% proportion for the parent and consolidated companies (full consolidation), or in a proportion equal to the corresponding interest percentage for the companies proportionately consolidated.

Example:

Company M purchased participation titles in companies: X, Y and Z, at their setup dates, as follows:

- 210.000 X shares, nominal value 40 m.u.;
- 126.000 Y shares, nominal value 20 m.u.; M and associate A, jointly control company Y;
- 75.000 Z shares, nominal value 20 m.u.

At the 31st of December, N their separate financial statements (for X, Y and Z) disclosed the following:

Balance Sheet for Company M

Fixed Assets	210.000.000
Participation Titles	12.420.000
X: 8.400.000	
Y: 2.520.000	
Z: 1.500.000	
Other Assets	156.000.000
Total Assets	378.420.000
Share Capital	90.000.000
Reserves	180.000.000
Financial Result	60.000.000
Liabilities	48.420.000
Total Owner's Equity and Liabilities	378.420.000

Profit and Loss Account for Company M

Total Revenues	600.000.000
Total Expenses	540.000.000
Financial Result	60.000.000

Balance Sheet for Company X

Fixed Assets	30.000.000
Other Assets	19.200.000
Total Assets	49.200.000
Share Capital	12.000.000
Reserves	18.000.000
Financial Result	3.600.000
Liabilities	15.600.000
Total Owner's Equity and Liabilities	49.200.000

Profit and Loss Account for Company X

Total Revenues	72.000.000
Total Expenses	68.400.000
Financial Result	3.600.000

Balance Sheet for Company Y

Fixed Assets	48.000.000
Other Assets	30.000.000
Total Assets	78.000.000
Share Capital	8.400.000
Reserves	32.400.000
Financial Result	1.200.000
Liabilities	36.000.000
Total Owner's Equity and Liabilities	78.000.000

Profit and Loss Account for Company Y

Total Revenues Total Expenses	108.000.000 106.800.000
Financial Result	1.200.000

Balance Sheet for Company Z

Fixed Assets Other Assets	15.000.000 12.000.000
Total Assets	27.000.000
Share Capital Reserves Financial Result Liabilities	6.000.000 8.400.000 600.000 12.000.000
Total Owner's Equity and Liabilities	27.000.000

Profit and Loss Account for Company Z

Total Revenues Total Expenses	30.000.000 29.400.000
Financial Result	600.000

Choosing the corresponding consolidation methods for Group M:

Company	Control Percentage of M	Interest Percentage of M	Type of control	Consolidation Method
X	70%	70%	Rightful Exclusive Control	Full Integration
Y	30%	30%	Joint Control	Proportional Integration
Z	25%	25%	Significant Influence	Equivalence

No matter the technical support utilized, all Balance Sheet and Income Statement accounts are taken over and cumulated for all three companies (X, Y and Z).

Case 1: The Consolidation Statement is used as technical tool

CONSOLIDATION STATEMENT FOR GROUP M

Assets, Owner's Equity, Liabilities, Revenues, Expense Items	Parent M (100%)	Company X (100%)	Company Y (30%)	Total	Corr + -	Total
Fixed Assets	210.000.000	30.000.000	14.400.000	254.400.000		
Participation Titles	12.420.000	-	-	12.420.000		
Other Assets	156.000.000	19.200.000	9.000.000	184.200.000		
Total Assets	378.420.000	49.200.000	23.400.000	451.020.000		
Share Capital	90.000.000	12.000.000	2.520.000	104.520.000		
Reserves	180.000.000	18.000.000	9.720.000	207.720.000		
Financial Result	60.000.000	3.600.000	360.000	63.960.000		
Liabilities	48.420.000	15.600.000	10.800.000	74.820.000		
Total Owner's Equity and Liabilities	378.420.000	49.200.000	23.400.000	451.020.000		
Total Revenues	600.000.000	72.000.000	32.400.000	704.400.000		
Total Expenses	540.000.000	68.400.000	32.040.000	640.440.000		
Financial Result	60.000.000	3.600.000	360.000	63.960.000		

Case 2: The Consolidation Journal is considered as technical tool for the consolidation:

- The takeover of Balance Sheet items for M, in proportion of 100%:

Fixed Assets		210.000.000
Participation Titles		12.420.000
Other Assets		156.000.000
	Share Capital	90.000.000
	Reserves	180.000.000
	Financial Result	60.000.000
	Liabilities	48.420.000

- The takeover of Balance Sheet items for M, in proportion of 100%:

Fixed Assets		30.000.000
Other Assets		19.200.000
	Share Capital	12.000.000
	Reserves	18.000.000
	Financial Result	3.600.000
	Liabilities	15.600.000

- The takeover of Balance Sheet items for Y, in proportion of 30%:

Fixed Assets		14.400.000
Other Assets		9.000.000
	Share Capital	2.520.000
	Reserves	9.720.000
	Financial Result	360.000
	Liabilities	10.800.000

- The takeover of Profit and Loss Account items for M, in proportion of 100%:

%	= Total Revenues	600.000.000
Total Expenses		540.000.000
Financial Result		60.000.000

- The takeover of Profit and Loss Account items for X, in proportion of 100%:

%	= Total Revenues	72.000.000
Total Expenses		68.400.000
Financial Result		3.600.000

- The takeover of Profit and Loss Account items for Y, in proportion of 30%:

%	= Total Revenues	32.400.000
Total Expenses		32.040.000
Financial Result		360.000

6.2 The elimination of reciprocal accounts and operations

Eliminating reciprocal accounts and operations represents an important activity, due to the fact that consolidated financial statements must fairly disclose group financial status and performances, in comparison to its business environment. Setting in practice such procedures requires first reconciliation procedures for the reciprocal accounts and operations, belonging to members of the same group. The reconciliation procedures are meant to record and count all

existing reciprocal accounts and operations; identification of any gaps between the separately declared amounts and the corresponding elimination of such informational disturbances.

6.2.1 The reconciliation of reciprocal accounts

The separate financial statements disclosed by group members, contain reciprocal accounts (clients – amounts to be received, liabilities towards suppliers, loans to and from third parties, s.o.), whose ending balances are not always equal. Any occurring differences might be justified by: differences between disclosure dates, law suits, exchange rate differences, significant financial errors, commercial effects not due yet, and different dates for financial year closure.

Each of the member companies performs an individual/separate analysis for all transactions with other members of the same group, and verifies the operational reciprocity. If there are any differences, first causes are identified, which are further retreated by an appropriated manner. This retreatment is usually made through account homogenization, set at level of seller company/member.

Example 1

F subsidiary trades inventories bought from parent M. At the 31st of December year N, in M's separate financial statements there is an account receivable from customer F, amounting to 10.000 m.u., while in F‘s separate financial statements there is a liability towards M supplier, valuing 9.000 m.u. This difference is due to an existing invoice of 1.000 m.u. issued by M, and which was not received by F (by the time of financial year closure).

The retreatment of this difference, is made through the homogenization of accounts according to seller's bookkeeping, and involves F recording the second invoice:

Inventories	= Suppliers	1.000

As a follow up to the retreatment procedure, these accounts become reciprocal and will further be eliminated within the consolidation process.

Example 2

During year N, parent M, discounted a commercial letter amounting to 2000 mu, destined to subsidiary F. In F's separate financial statements, as disclosed at 31.12.N, there ia an account named "Accounts Payable - Company M".

The reconciliation of these reciprocal accounts involves the reintegration of account "Accounts Receivable - Company F", into M's separate financial statements, as follows:

Accounts Receivable	= Cash at Bank	2.000

Example 3

During year N, foreign operation[1] F, rendered services for Romanian company M, amounting to 1,000 Euro. The exchange rate for the European currency, varied as follows: at the invoicing date equalled 4 Lei, while the average exchange rate for year N was set to 3,9 Lei.

In M's separate financial statements, there are expenses with services rendered by third parties, amounting 1.000 x 4 = 4.000 Lei.

At 31.12.N, the revenues from services rendered to third parties, within F separate financial statements, are converted to the parent's currency, by using the average exchange rate for N: 1.000 x 3,9 = 3.900 Lei.

The reconciliation treatment involves recording the exchange rate differences, Worthing 100 Lei, as follows:

Foreign-exchange difference expenses	= Revenues from services rendered to third parties	100

6.2.2 The elimination of reciprocal accounts

Reciprocal accounts refer to accounts receivable and reciprocal accounts (clients and suppliers; loans given/received to/from third parties; other receivables and payables), as well as reciprocal expense and revenue accounts (revenues from services rendered to/by third parties; revenues and expenses from/with interests).

Eliminating the reciprocal accounts is performed in different ways, in accordance to the implemented consolidation method, as follows:

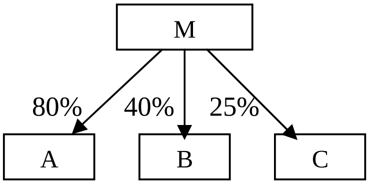
- Full elimination of reciprocal accounts between fully consolidated companies;
- Reciprocal accounts between a proportionately consolidated company and a fully consolidated entity, are to be eliminated in conformity to the integration percentage of the jointly-controlled company
- The reciprocal accounts existing between proportionally consolidated entities, are eliminated at the quota of their smallest integration percentage
- The reciprocal accounts between a fully, or proportionally, consolidated company and an associated undertaken (equity method), are not eliminated.

The elimination of reciprocal accounts does not affect the financial result, a reason for which such an operation does not generate deferred taxes.

[1] Foreign company.

Example:

There is the following group chart:



Company M and associate X, perform a joint control over company B. Let's suppose that between members of this group, there were the following transactions during financial year N:

- company M sold merchandise (goods for resale) to company A, worth 100.000 m.u., which will be paid in January N+1;
- company B sold raw material to company M, amounting to 40.000 m.u., to be paid in February N+1;
- company M lent company B with the amount of 50.000 m.u., due in N+2; company X also lent B with 10.000 m.u.; the interests paid by B during year N, valued 600 m.u. (out of which 500 m.u. corresponded to loan from M);
- company B sold raw materials to company C, Worthing 10.000 m.u., to be paid during February N+1;
- company M sold merchandise to C, worth 20.000 m.u., to be paid in January N+1.

Choosing the corresponding consolidation methods for Group M:

Company	Control Percentage of M	Interest Percentage of M	Type of control	Consolidation Method
A	80%	80%	Rightful Exclusive Control	Full Consolidation
B	40%	40%	Joint Control	Proportionate Consolidation
C	25%	25%	Significant Influence	Equity Method

Eliminating reciprocal accounts:

- the 100% elimination of accounts receivable and liabilities generated by sale of merchandise between M and company A:

Suppliers	= Clients	100.000

- the elimination of accounts receivable and commercial debts, generated by the sale of raw materials from company B, to M, at the quota of the interest percentage (40.000 x 40% = 16.000 u.m.):

Suppliers	= Clients	16.000

- the elimination of the loan given by company M to B; also account “Loans” amounting to 60.000 m.u. (disclosed in the separate Balance Sheet of entity B) has been undertaken and transferred into the consolidation statement (or, if the case, into the consolidation journal), for the amount of 24.000 m.u., while total elimination of loan could not be performed:

Loans (received)	= Loans to third parties	24.000

- the elimination of revenues and expenses from interests; the account “Interest Expenses”, worth 600 m.u. from B’s separate Income Statement, has been transferred into the consolidation statement (or, if the case, into the consolidation journal), for the amount of 600 x 40% = 240 u.m.; the elimination of interest expenses is though limited to 240 m.u., full elimination not being allowed (total amount 500 m.u.), as follows:

Interest Revenues	= Interest Expenses	240

All reciprocal accounts generated by transactions of M and B, with company C are not eliminated, because asset, equity, liability, revenue and expense items belonging to C are not undertaken/transferred into the consolidation statement/journal.

6.2.3 The elimination of internal results

All operations during the financial year, occurring between member companies of the same group, may generate as well profits or losses. We are talking here especially about dividends payable and asset disposals. Within separate financial statements of member companies, participants in such operations, the financial results are considered as earned (realized). From the group perspective though, some of these results are not validated by third parties outside the group, a reason for which these are to be eliminated during the effective consolidation process.

The general rules for eliminating internal results are similar to the ones of reciprocal accounts, as follows:

- Full elimination of internal results between fully consolidated companies;
- internal results between a proportionately consolidated company and a fully consolidated entity, are to be eliminated in conformity to the integration percentage of the jointly-controlled company
- The internal results existing between proportionally consolidated entities, are eliminated at the quota of their smallest integration percentage
- The internal results between fully consolidated company and an associated undertaken (equity method), are eliminated at the quota of

the product of participation percentages, according to available information;

- The internal results between proportionally consolidated company and an associated undertaken (equity method), are eliminated at the quota of the group's participation percentage within the equity consolidated company;

Note: The financial results generated by transactions between a fully consolidated company (or proportionate), and an entity set in equivalence, are to be eliminated if and only if these results are considered significantly important.

The elimination of internal results also triggers a series of future differences between the accounting financial result and the fiscal result, which according to current international provisions, should be recorded as deferred taxes.

Dividends distribution:

Dividend distribution, to be performed by the parent, does not generate any retreatment within the consolidation process. Though, dividend distribution should be stated within the Consolidated Statement of Changes in Owner's Equity, due to the fact it diminishes the consolidated reserves for the current financial year, as compared to the previous year consolidated reserves.

Dividends distributed by subsidiaries and jointly-controlled companies should be eliminated from the financial revenues disclosed by the parent, while reserves should be increased.

Example 1

During financial year N, parent M recorded 100.000 m.u. as dividends from subsidiary F. During the consolidation process, all cashed-in dividends are eliminated:

Dividend Revenues	= Reserves	100.000

Note: Sometimes, during the consolidation process, specialists prefer taking the operation's effects over the Balance Sheet and Income Statement. Therefore, elimination of internal dividends requires the following corrections:

- in the Balance Sheet:

Financial Result	= Reserves	100.000

- in the Income Statement:

Dividend Revenues	= Financial Result [2]	100.000

[2] The Income Statement's Financial Result account has opposite function, as compared to the same account contained in the Balance Sheet.

If the subsidiary, paying the dividends, happens to be a foreign operation (company), than there is also an exchange rate difference between the value of last year's dividends (considered at that year's average exchange rate), and the value of dividends currently paid to the parent (computed at the exchange rate of the day the payment took place). Such a difference is either revenue, or expense, to be recorded for the current financial year.

Example 2

Romanian company M holds control over subsidiary F, which is located in France. On the 10^{th} of June year N, company M cashed-in dividends from F, amounting to 1.000 Euro. The exchange rate of the European currency varied as follows: average exchange rate in N-1 = 4,0 lei; exchange rate at 10.06.N = 4,1 lei.

Therefore, in M's separate financial statements, the received dividends have been recorded at the value of: 4.100 lei = 1.000 x 4,1.

The Result out of which dividends have been distributed, at the beginning of the year amounted to 1.000x4,0 = 4.000 lei.

The resulting difference of 4.100 – 4.000 = 100 lei represents a profit from the difference of exchange rates:

Dividend Revenues	=	%	4.100
		Reserves	4.000
		Foreign-exchange difference revenues	100

Financial Results incorporated in the value of Inventories

Inventories generated by sales and purchase operations, between member companies of the same group, also contain the financial results corresponding to such operations (sales/acquisitions).

Therefore, if by the end of the financial year, these inventories have not been exchanged with entities outside the group, than the corresponding financial results are considered unearned (not realized), during the consolidation process should be fully eliminated from the value of total inventories. As a follow up to the above aspects, the group's consolidation manual should define and clearly state the intervals for financial results and the corresponding computational formulas.

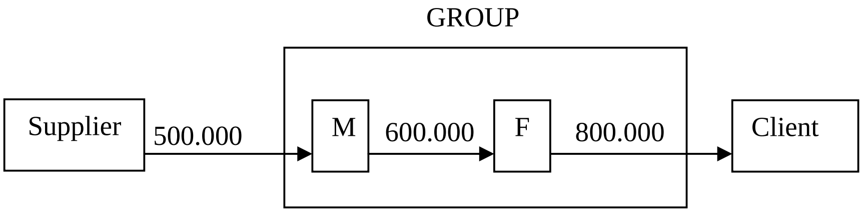
Example 3

During year N, parent M bought merchandise from a supplier outside the group perimeter, at an acquisition cost of 500.000 m.u.

Further, M sells the previously bought merchandise to subsidiary F, at a price of 600.000 m.u.

F sells the merchandise bought form M, to a client located outside the group, at the selling price of 800.000 m.u.

The resulting commercial relationships are designed as follows:



The sale and acquisition operations lead to the following image of profits, presented within members' separate financial statements:

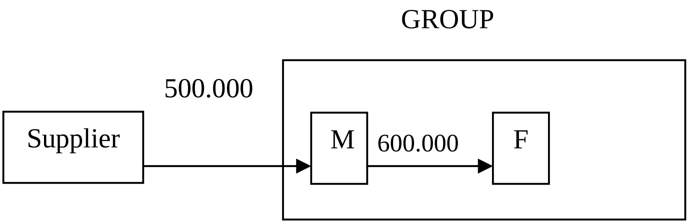
- for parent M: 600.000 – 500.000 = 100.000 u.m
- for subsidiary F: 800.000 – 600.000 = 200.000 u.m

Therefore, in the cumulated/consolidated financial statements we consequently record a total profit of: 100.000 + 200.000 = 300.000 u.m.

Also, if we consider the impact of these operations at group level, taking into consideration the purchase of inventories for 500.000 m.u., and their sale at 800.000 m.u., the resulting profit is then 300.000 m.u. (800.000 – 500.000) Consequently, we shall not eliminate this profit (within consolidation process), because it is earned.

Example 4

Consider the same data as in Example 3, except the fact that subsidiary F did not sell, by the end of year N, the merchandise inventory bought form M.



The sale and purchase operations lead to the following image for group profits:

- ➢ for parent M: 600.000 – 500.000 = 100.000 u.m;
- ➢ for subsidiary F: profit = 0 m.u., because merchandise has not been sold.

Therefore, in the cumulated financial statements we shall record a profit of 100.000 m.u. + 0 = 100.000 m.u. At group level, there was no profit though, because merchandise was not sold. As a result, the 100.000 m.u profit belonging to M, also included in F's inventories amount, must be eliminated:

Sale of Goods for Resale	=	%	600.000
		Expenses with Goods for Resale	500.000
		Goods for Resale[3]	
			100.000

[3] meaning *Merchandise*.

Note: Sometimes, these results are eliminated by diminishing the inventory amount, and simultaneously either diminishing revenues, or increasing expenses:

Sale of Goods for Resale	= Goods for Resale	100.000

or:

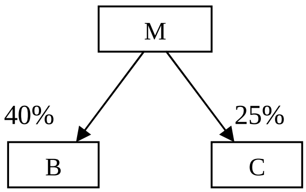
Expenses with Goods for Resale	= Goods for Resale	100.000

Removing the profit from the sale of goods generates a deductible temporary difference of 100,000 um and deferred tax asset of: 100,000 x 16% = 16,000 um:

Deferred Tax Receivable	= Deferred Tax Revenues	16.000

Example 5

You are given the following group chart:



Company M, and company X, jointly-control company B.

During exercise N, company M sold merchandise to B and C, at a selling price of 40.000 m.u., and 30.000 m.u. The profit recorded by M represents 20% out of total selling price. By the end of year N, neither of companies B or C, sold this merchandise to companies outside the group.

In order to perform the consolidation, we must eliminate M's profit (from the sale of merchandise to B and C), as follows:

- elimination of profits included in B's ending balance for inventories, in accordance to the interest percentage held by M in B (40.000x20%x40% = 3.200 u.m.), and in the same time diminishing the sale revenue (40.000x40% = 16.000 u.m.) and the merchandise expense (40.000x80%x40% = 12.800 u.m.):

Sale of Goods for Resale	= %	16.000
	Expenses with Goods for Resale	12.800
	Goods for Resale	
		3.200

- elimination of profits included in C’s ending balance for inventories (30.000x20%x25% = 1.500 u.m.), performed in accordance to existing deferred revenues, because by using the equity method, C’s inventories are not integrated in the consolidated accounts; in the same time M’s sale revenues (30.000x25% = = 7.500 u.m.) and sale expenses (30.000x80%x25% = 6.000 u.m.) are diminished:

Sale of Goods for Resale	=	%	7.500
		Expenses with Goods for Resale	6.000
		Deferred Revenues	
			1.500

If the consolidation will be performed based on beginning and ending balances, than it is compulsory to eliminate all profits incorporated into the beginning balance of inventories.

Example 6

At the beginning of financial exercise N, subsidiary F had merchandise amounting to 100.000 m.u., purchased from parent M. The profit recorded by M represented 10% out of the selling price. We suppose that Group M considers all inventory beginning/ending balances, when consolidating.

The elimination of the profit contained by F’s initial balance for inventories (100.000x10% = 10.000 u.m.), is made by affecting the Reserves:

Reserves	= Goods for Resale	10.000

Results incorporated in the value of property

The results generated by the transfer of property between the member companies of the same group must be eliminated like the results incorporated into inventories. In addition, if the property is depreciable, depreciation is necessary to be corrected in order to bring it to the size that it would have had if the property transfer had not taken place.

Example 7

At the begining of financial year N, company M sold to subsidiary F, a tangible asset, within the following commercial terms: selling price 40.000 u.m., book value 100.000 u.m, cumulated amortization 70.000 u.m, remaining number of years of useful life: 4, linear amortization method.

Company F decides to linearly amortize the fixed asset, based on remaining number of useful life.

During the consolidation procedure, we eliminate M's profit generated by the sale of the fixed asset to company F [40.000-(100.000-70.000) = 10.000 u.m.], and also the extra-depreciation amount recorded by F [(40.000-30.000)/4 = = 2.500 u.m.]:

Revenues on disposal of non-current assets	=	%	40.000
		Expenses on disposal of non-current assets	30.000
		Non-current Assets[4]	10.000

Depreciation of tangible assets	=	Provisions for the depreciation of tangible assets	2.500

All of the above eliminations generate deferred taxes. We suppose the Income Tax is 16% (at 31.12.N), and present the following:

Book value of Tangible Assets (consolidated financial statements):		22.500 u.m.
Fiscal Basis (book value from individual financial statements of F):		30.000 u.m.
Deductible Temporary Difference:		7.500 u.m.
Deferred Tax Receivable:	7.500x16% =	1.200 u.m.

Deferred Tax Receivable	=	Deferred Tax Revenues	1.200

Example 8

During financial year N, company M sold a land item to company X, within the following commercial terms: selling price 50.000 u.m; book value 42.000 u.m. M jointly controls company X, and holds a 30% interest percentage.

Also, during the consolidation procedure, we eliminate the profit recorded by M (from sale of land), at the quota of its interest percentage in X (8.000 x 30% = 2.400 u.m.), and in the same time we decrease the revenues from disposal of non-current assets (50.000 x 30% = 15.000 u.m.), and the corresponding expenses (42.000 x 30% = 12.600 u.m.):

Revenues on disposal of non-current assets	=	%	15.000
		Expenses on disposal of non-current assets	12.600
		Non-current Assets[5]	2.400

[4] meaning Fixed Assets, or Tangible Assets
[5] meaning Fixed Assets, or Tangible Assets

The decrease in land value, generates a temporary deductible difference and a corresponding deferred tax receivable of 2.400x16% = 384 u.m.

Deferred Tax Receivable	= Deferred Tax Revenues	384

Member companies' Provisions

In the separate financial statements of consolidated companies, there may be records of Depreciation Provisions or Other Provisions for Risks and Charges, generated by relationships with other member companies within the same consolidated group. During the consolidation process, all these provisions must be eliminated, except the situation in which members acknowledge an existing depreciation or a certain risk at the level of the consolidated assembly.

Example 9:

Company M acquired participation titles in company F, at a cost of 10.000 m.u. At the 31st of December N, F's owner's equity items have negative values, and M had setup a 10.000 m.u. provision (write-down) for shares owned in F. During the consolidation process, the write-down of shares must be eliminated, and simultaneously a deferred tax is recognized 10.000x16% = 1.600 u.m.:

Write-down of shares	= Reversal of Write-down of financial assets	10.000

Deferred Tax Expenses	= Tax Liability	1.600

6.3 The elimination of participation titles, according to the ownership quota at the moment of acquisition

Consolidation also means the substitution of participation titles existing in the separate Balance Sheet of the consolidating company, reflecting the ownership quota into the consolidated company's owner's equity. This is performed as follows:

- for subsidiaries, all remaining owner's equity items, after eliminating reciprocal operations, are split between the group and minority interests, according to the interest percentage; this split is made with the elimination of participation titles;
- for joint ventures (proportionate consolidation), there is no splitting of their owner's equity items, but the corresponding participation titles are eliminated together with owner's equity items of the consolidated company; in such a case, there may exist some minority interests attached which will not be disclosed in the Consolidated Balance Sheet;

- ➢ for joint ventures and associates (both cases consolidated by equity method), titles' revaluation is first performed by taking into account the consolidated company's financial changes after the control (or significant influence) takeover; as well as in proportionate consolidation, the corresponding minority interests are not disclosed in the group Consolidated Balance Sheet.

Example 1

Company M purchased participation titles in companies A, C and C, at the moment of their setup, as follows: 80% in A, 30% in B and 25% in C. The control over company B is contractually performed altogether with other two companies (together these two hold 70%).

In M's separate Balance Sheet, the participation titles account amounts to 23.700.000 u.m (out of which participation titles in A: 12.800.000 u.m, in B : 8.400.000 u.m, in C: 2.500.000 u.m).

At 31.12.N, after previously eliminating reciprocal operations, owner's equity for A, B and C, are presented as follows:

Owner's Equity & Liabilities for company A:

Share Capital	16.000.000 u.m.
Reserves	6.000.000 u.m.
Financial Result	3.000.000 u.m.
Total Owner's Equity and Liabilities	25.000.000 u.m.

Owner's Equity & Liabilities for company B:

Share Capital	28.000.000 u.m.
Reserves	10.000.000 u.m.
Financial Result	6.000.000 u.m.
Total Owner's Equity and Liabilities	44.000.000 u.m.

Owner's Equity & Liabilities for company C:

Share Capital	10.000.000 u.m.
Reserves	4.000.000 u.m.
Financial Result	1.000.000 u.m.
Total Owner's Equity and Liabilities	15.000.000 u.m.

Splitting Owner's Equity & Liabilities belonging to A:

Owner's Equity & Liabilities of A	**Amounts**	**Company M (80%)**	**Minority Interests (20%)**
Share Capital	16.000.000	12.800.000	3.200.000
Reserves	6.000.000	4.800.000	1.200.000
Financial Result	3.000.000	2.400.000	600.000
Total	25.000.000	20.000.000	5.000.000

At the 31st of December year N, owner's equity items belonging to A are split in two components:

a) The parent's share, as follows:
   - acquired owner's equity items, balanced by the participation titles from the parent's Balance Sheet (12.800.000 u.m.); and
   - cumulated owner's equity items (reserves and result), at the moment of A entering in the consolidated perimeter (4.800.000+2.400.000 = 7.200.000 u.m.).

The parent's cumulated owner's equity items are further considered as consolidated reserves and consolidated financial result. The general computational formulas for these issues are the following:

Subsidiary's share of owner's equity participating to the **consolidated reserve** = interest percentage x (subsidiary's share capital + subsidiary's reserves) – book value of participation titles held by the parent in the subsidiary = 80% x x (16.000.000 + 6.000.000) – 12.800.000 = 4.800.000 u.m.

Share of subsidiary's owner's equity, participating to the **consolidated financial result** = interest percentage x subsidiary's financial result = 80% x x 3.000.000 = 2.400.000 u.m.

b) Minority interests' share = minority interests quotas x total owner's equity of the subsidiary = 20% x 25.000.000 = 5.000.000 u.m.

Share Capital of A		16.000.000
Reserves of A		6.000.000
Financial Result of A		3.000.000
	Participation Titles	12.800.000
	Consolidated Reserve	4.800.000
	Consolidated Financial Result	2.400.000
	Minority Interests	5.000.000

Note: The above book entry normally affects both the Balance Sheet and the Income Statement. There is also the option of separate disclosure of effects over each of these financial statements; therefore, the previous book entry is attached directly to the Balance Sheet, while the Income Statement is affected by the following:

%	= Financial Result	3.000.000
Consolidated Financial Result		2.400.000
Minority Interests		600.000

Elimination of Participation Titles held by M, in company B:

Owner's Equity & Liabilities of B	Amounts	Company M (30%)	Minority Interests (70%)
Share Capital	28.000.000	8.400.000	19.600.000
Reserves	10.000.000	3.000.000	7.000.000
Financial Result	6.000.000	1.800.000	4.200.000
Total	44.000.000	13.200.000	30.800.000

At 31.12.N, company B owner's equity items are split in two elements:

a) M's share, as follows:
   - acquired owner's equity items, balanced by the participation titles from the parent's Balance Sheet (8.400.000 u.m); and
   - cumulated owner's equity items (reserves and result), at the moment of B entering in the consolidated perimeter (3.000.000+1.800.000 = 4.800.000 u.m.) ;

b) other third parties share = third parties' percentage x total B owner's equity = 70% x 44.000.000 = 30.800.000 u.m. This amount will not be disclosed in the Balance Sheet of Group M.

Share Capital of B		8.400.000
Reserves of B		3.000.000
Financial Result of B		1.800.000
	Participation Titles	8.400.000
	Consolidated Reserve	3.000.000
	Consolidated Financial Result	1.800.000

Setting in Equivalence the Participation Titles held by M, in company C:

Owner's Equity & Liabilities of C	Amounts	Company M (25%)	Minority Interests (75%)
Share Capital	10.000.000	2.500.000	7.500.000
Reserves	4.000.000	1.000.000	3.000.000
Financial Result	1.000.000	250.000	750.000
Total	15.000.000	3.750.000	11.250.000

At 31.12.N, company C owner's equity items are split in two elements:

c) M's share; this represents the new value of titles held by M in C, as follows:
   - acquired owner's equity items, balanced by the participation titles from the parent's Balance Sheet (2.500.000 u.m.); and

- cumulated owner's equity items (reserves and result), at the moment of C entering in the consolidated perimeter (1.000.000+250.000 = 1.250.000 u.m.) ;

d) other third parties share = third parties' percentage x total C owner's equity = 75% x 15.000.000 = 11.250.000 u.m.; this amount will not be disclosed in the Balance Sheet of Group M.

Participation Titles set in = Equivalence	%	3.750.000
	Participation Titles	2.500.000
	Consolidated Reserve	1.000.000
	Consolidated Financial Result[6]	250.000

If there is a negative quota corresponding to minority interests, in a fully consolidated company, the amount exceeding their contribution, as well as any other further losses due to minority interests, are subtracted from total majority interests, excepting the case where minority interests are obliged to cover such losses. If subsequently, the consolidated entity manages to create profit, the majority interests are further credited with profit amounts, in order to eliminate the payment obligation of minority interests.

Example 2

Company M purchased 60% of F's capital, at the moment of its setup.

At 31.12.N, after eliminating reciprocal accounts, F owner's equity items were disclosed as follows:

Share Capital	500.000 u.m.
Reported Result	(390.000) u.m.
Financial Result	(150.000) u.m
Total Owner's Equity and Liabilities	(40.000) u.m.

Any losses from (390.000 u.m.) and from current financial year (150.000 u.m.), are not considered exclusively minority interests' obligation, over their quota in F's capital (500.000x40% = 200.000 u.m.). Therefore the minority interests' share takes over losses as follows:

- previous years' financial losses: 390.000x40% = 156.000 u.m.;
- current financial year losses: 200.000-156.000 = 44.000 u.m.

[6] Usually, parent's quota in members' financial result, is recorded in a separate account named „Percentage in the financial result of companies set in equivalence", in the Profit and Loss Account..

Distribution of F's owner's equity items:

Total Owner's Equity and Liabilities of F	Amounts	Company M (60%)	Minority Interests (40%)
Share Capital	500.000	300.000	200.000
Reported Result	(390.000)	(234.000)	(156.000)
Financial Result	(150.000)	(106.000)	(44.000)
Total	(40.000)	(40.000)	-

Eliminating the participation titles held by M in F:

Share Capital of F		500.000
Consolidated Reserves(1)		234.000
Consolidated Financial Result		106.000
	Participation Titles	300.000
	Reported Result of F	390.000
	Financial Result of F	150.000

(1) M's share in F's share capital and reported result (300.000-234.000 = 66.000 u.m.) – book value of participation titles held by M in F (300.000 u.m.) = (234.000) u.m.

Whenever, there is a negative group's share, into owner's equity items belonging to a company set in equivalence, this in turn is usually considered fur a null value. Though, in the case where the group has the obligation or the intention of recognizing its own financial accountability, then a provision for risks and charges is recorded, corresponding to the negative share of owner's equity. This provision is further adjusted at the closure of each financial year, accordingly to the parent's quota in that company's owner's equity (consolidated by equity method).

Example 3

Company M purchased 30% out of entity B owner's equity items, at the moment of B's setup operation.

At 31.12.N, B's owner's equity items were disclosed as follows:

Share Capital	50.000 u.m.
Reported Result	(50.000) u.m.
Financial Result	(20.000) u.m
Total Owner's Equity and Liabilities	(20.000) u.m.

Option 1: Company M intends to take *no* financial accountability, corresponding to its participation. In this case, all participation titles are eliminated at their book value (15.000 u.m.).

Consolidated Reserves	= Participation Titles	15.000

Option 2: Company M is financially accountable, corresponding to its participation in company B:

In this case, the negative amount of owner's equity, belonging to M, is recorded as a provision for risks and charges

Consolidated Reserves	=	%	21.000
		Participation Titles	15.000
		Provisions for risks and charges	6.000

Example 4

Company M purchased 60% of F's capitals, at a cost of 60.000 u.m., at the moment of F setup. The separate financial statements for companies M and F, at the 31st of December N, are disclosed as follows:

Balance Sheet for company M

Participation Titles	60.000
Non-current Receivables	80.000
Goods for Resale	40.000
Cash	20.000
Total Assets	200.000
Share Capital	90.000
Reserves	30.000
Financial Result	20.000
Suppliers	60.000
Total Owner's Equity and Liabilities	200.000

Profit and Loss Account for company M

Sale of goods for resale	400.000
Expenses with goods for resale	300.000
Dividend revenues	5.000
Interest Revenues	6.000
Interest Expenses	2.000
Other Expenses	89.000
Financial Result	20.000

Balance Sheet for company F

Fixed Assets Goods for Resale Clients Cash	120.000 80.000 70.000 30.000
Total Assets	300.000
Share Capital Reserves Financial Result Financial Debt Suppliers	100.000 40.000 6.000 110.000 44.000
Total Owner's Equity and Liabilities	300.000

Profit and Loss Account for company F

Sale of goods for resale Expenses with goods for resale Interest Revenues Interest Expenses Other Expenses	500.000 400.000 1.000 11.000 84.000
Financial Result	6.000

Additional Information:

- F's share capital is formed by ordinary shares only;
- During year N, company M borrowed F the amount of 70.000 u.m., due in N+2; interests due in N amounted to 5.000 u.m.;
- All of M's merchandise has been purchased from F; from the sale of these goods, F recorded a 2.000 u.m. sale profit;
- During year N, M cashed in dividends from F, amounting to 5.000 u.m.;
- At the end of exercise N, company M has a commercial liability towards supplier F, amounting to 30.000 u.m.

Due to the fact that entity M holds 60% of F's owner's equity items, it controls it by a rightful and exclusive manner. In this context, the adequate consolidation method is full consolidation.

The interest percentage equals the control percentage, which is 60%.

The cumulation of Balance Sheet and Income Statement elements, or both M and F:

- Cumulation of M’s Balance Sheet items, in proportion of 100% :

Participation Titles		60.000
Non-current receivables		80.000
Goods for resale		
Cash		40.000
		20.000
	Share Capital	90.000
	Reserves	30.000
	Financial Result	20.000
	Suppliers	60.000

- Cumulation of F’s Balance Sheet items, in proportion of 100% :

Fixed Assets		120.000
Goods for resale		80.000
Clients		70.000
Cash		30.000
	Share Capital	100.000
	Reserves	40.000
	Financial Result	6.000
	Financial Debt	110.000
	Suppliers	44.000

- Cumulation of M’s Profit and Loss Account items, in proportion of 100% :

Expenses with goods for resale		300.000
Interest Expenses		
Other Expenses		2.000
Financial Result		89.000
		20.000
	Sale of goods for resale	400.000
	Dividend Revenues	5.000
	Interest Revenues	6.000

- Cumulation of F’s Profit and Loss Account items, in proportion of 100% :

Expenses with goods for resale		400.000
Interest Expenses		
Other Expenses		11.000
Financial Result		84.000
		6.000
	Sale of goods for resale	500.000
	Interest Revenues	1.000

Elimination of reciprocal accounts and operations:

- elimination of loan to F:

Financial Debt	= Non-current Receivables	70.000

- elimination of interest revenues and expenses:

Interest Revenues	= Interest Expenses	5.000

- elimination of sale profits recorded by F:

Sale of goods for resale	=	%	40.000
		Expenses with goods for resale	38.000
		Goods for resale	2.000

- recognition of deferred tax receivables 2.000x16% = 320:

Deferred Tax Receivables	= Deferred Tax Revenues	320

- elimination of dividends received by M (from F):

Dividend Revenues	= Reserves of M	5.000

- elimination of all commercial liabilities and accounts receivable:

Suppliers	= Clients	30.000

Elimination of participation titles, corresponding to M's ownership quota in owner's equity, at the moment of F's setup:

After eliminating all reciprocal accounts, F's owner's equity is disclosed as follows:

Social Capital	100.000 u.m.
Reserves	40.000 u.m.
Financial Result (6.000-2.000+320)	4.320 u.m.
Total Owner's Equity and Liabilities	144.320 u.m.

Splitting Total Owner's Equity and Liabilities of F:

Total Owner's Equity and Liabilities of F	Amounts	Company M (60%)	Minority Interests (40%)
Share Capital	100.000	60.000	40.000
Reserves	40.000	24.000	16.000
Financial Result	4.320	2.592	1.728
Total	144.320	86.592	57.728

Eliminating the participation titles held by M in F:

Share Capital of F		100.000
Reserves of F		40.000
Financial Result of F		4.320
	Participation Titles	60.000
	Consolidated Reserve	24.000
	Consolidated Financial Result	2.592
	Minority Interests	57.728

After the consolidation procedures end, the consolidated financial statements for Group M are presented as follows :

The Consolidated Balance Sheet for Group M:

Fixed Assets	120.000
Non-current Receivables	10.000
Deferred Tax Receivables	320
Goods for Resale	118.000
Clients	40.000
Cash	50.000
Total Assets	338.320
Share Capital	90.000
Consolidated Reserves	59.000
Consolidated Financial Result	17.592
Total Total Owner's Equity for mother-company	166.592
Minority Interests	57.728
Total Owner's Equity	224.320
Financial Debts	40.000
Suppliers	74.000
Total Liabilities	114.000
Total Owner's Equity and Liabilities	338.320

The Consolidated Profit and Loss Account for Group M :

Sale of goods for resale	860.000
Expenses with goods for resale	(662.000)
Dividend Revenues	0
Interest Revenues	2.000
Interest Expenses	(8.000)
Other Expenses	(173.000)
Deferred Tax Revenues	320
Minority Interests in the Result	(1.728)
Financial Result	17.592

CHAPTER 7

CONSOLIDATED FINANCIAL STATEMENTS

In a modern accounting referential, the main purpose of consolidated financial statements is to offer users a fair and well-structured financial image of the group and its transactions. In other words, the consolidated financial statements must supply data regarding a company's financial status, performances and all cash flows, a set of information meant to be useful for various users in their decision-making processes. In order to accomplish this, the consolidated financial statements must supply information which allows users to forecast cash flows, especially degree of accomplishment and attached probabilities. This is why all information must refer to the following:

- Assets controlled by the group, that is resources which will generate cash flows;
- Group's liabilities, that is all external debts and capital elements at the origin of all payment obligations;
- Owner's equity items, under the form of shareholders' residual interest for group's assets;
- Group's financial result and its financial performance, throughout the disclosure of owner's equity variation (net assets) – excluding the operations with the owners;
- Past cash flows, considered as basis for determining future cash flows.

All these information must allow account users to evaluate a company's ability to pay dividends, interests and generally speaking, to repay debts in due time.

According to IAS 1 „Presentation of Financial Statements[1]", a full set of financial statements includes the following:

- A Statement Of Financial Position (Balance Sheet) At The End Of The Period
- A Statement Of Comprehensive Income For The Period (or An Income Statement and A Statement Of Comprehensive Income)
- A Statement Of Changes In Equity For The Period
- A Statement Of Cash Flows For The Period
- Notes, comprising a summary of accounting policies and other explanatory notes.

Beyond the list of financial statements to be disclosed, companies (and groups) are recommended to supply as well any existing managerial critical opinions, throughout describing and explaining each of the main performance features, and possible economic and social threats.

---

[1] IAS 1 regulations refer to both financial and consolidated financial statements.

Such a disclosure must include the following data:

- The main influencing factors for company performance, including changes in business environment, its feedback in such contexts, its investment policies for maintaining and increasing performances (and separately disclosing the dividend policy);
- All financing sources used by the entity, the corresponding policies referring to debt rates and managerial risk-taking;
- The on-going concern of company's financing and resources, elements which are not disclosed in the Balance Sheet (according to the international referential).

Moreover, companies may disclose additional financial statements, as well as environmental reports and statuses referring to value-adding processes, especially in cases where environmental factors are significant for the industry, and employees are considered an important group of users.

Companies (either stand-alone entities or groups), are recommended to present additional financial statements, to the extent managers consider this a useful process for decision-taking processes.

Regarding the structure and content of financial statements, IAS 1 presents a minimum list of accounts to be disclosed. Additional information, are contained within the Notes. In the standard Annex are disclosed optional models for preparation of Balance Sheet, Income Statement, Statement of Cash Flows and the two methods for presenting Statement of Changes in Equity (e.g. the content and structure of Statement of Cash Flows for the Period are foreseen by IAS 7).

7.1 The Consolidated Balance Sheet

According to IAS1, the structure and content of the Balance Sheet must make difference between current and non-current items. Each group of companies applying the international referential, must decide (according to nature of its business activities) whether it is useful or not to differentiate between the non-current and current Balance Sheet items – for both liabilities and assets.

Whenever such a difference is not performed, out of various reasons, all of their assets and liabilities are mainly classified according to their due date and liquidity.

No matter the disclosure policy used by the consolidated group, it must though present (within its own consolidated financial statements) all asset and liability items due/liquid under one year, for all of accounts and categories supposed to contain both long and short term elements.

Current/ Non-current Assets

In the context of the Balance Sheet, the following are to be considered *current asset items:*

- items destined to be held, due, or consumed within company's regular operational time-interval; or
- items mainly destined to be traded on different markets; or

- items held on a short term basis – that is the company (herein, the consolidated group) is expecting to valorise them within one year from closure of the financial exercise; or
- liquidities or equivalents of liquidities – only if their usage is not restricted by any means.

All the other assets are therefore considered non-current items. These include: tangible and intangible assets, as well as long-term operational and financial assets.

Current/Non-current Liabilities

A liability represents a current item of external equity and liabilities, whenever due on the following basis:

- within the regular operational time-interval;
- or at a certain date within the next twelve months from the closure of the financial year.

Therefore, all of the other liabilities are considered to be non-current.

Some current liabilities, (e.g. commercial liabilities, wages, other operational costs) are part of the net working capital used within the regular operational time-interval. Such items (this is the case of assets as well) should be classified in the category of *current*, even if these are due within more than one year.

Other current liabilities are non-reimbursable (considering the regular exploitation time-scale), but must be discounted within the next twelve months, following the closure of the financial year. This is the case of the short-term (current) share of long/medium term loans, as well as: dividends payable, income taxes due and other non-commercial creditors.

The liabilities bearing interest, which generate a long term financing of the net working capital (NWC), are considered to be non-current items/liabilities, but only for the share due in more than one year.

A company must record all interest-bearing long term liabilities, as non-current liabilities, on a regular basis, even if these are to be discounted within next twelve months following the end of the financial year. This is the case of:

- liabilities classified as long-term items at the moment of the transaction;
- the company intends to perform re-financing procedures, throughout a long-term liability;
- the above procedure is confirmed by the existence of a refinancing contract (or redesign of payment intervals), signed before the validation of financial statements to be disclosed.

As mentioned above, associated values for all current liabilities included in the non-current category, are disclosed in the Notes, as well as all information relating to type of disclosure.

IAS 1 does not prescribe a specific structure, nor the design for disclosing the above mentioned items, but it only states a minimum-requirement list of information which is compulsory to be presented within the Balance Sheet:

(a) property, plant and equipment;
(b) investment property;
(c) intangible assets;
(d) financial assets (excluding amounts shown under (e), (h), and (i));
(e) investments accounted for using the equity method;
(f) biological assets;
(g) inventories;
(h) trade and other receivables;
(i) cash and cash equivalents;
(j) assets held for sale;
(k) trade and other payables;
(l) provisions;
(m) financial liabilities (excluding amounts shown under (k) and (l));
(n) liabilities and assets for current tax, as defined in IAS 12;
(o) deferred tax liabilities and deferred tax assets, as defined in IAS 12;
(p) liabilities included in disposal groups;
(q) non-controlling interests, presented within equity and;
(r) issued capital and reserves attributable to owners of the parent.

7.2 Statement of Comprehensive Income

Comprehensive income for a period includes profit or loss for that period plus other comprehensive income recognized in that period.

All items of income and expense recognized in a period must be included in profit or loss unless a Standard or an Interpretation requires otherwise. Some IFRSs require or permit that some components to be excluded from profit or loss and instead to be included in other comprehensive income.

The components of other comprehensive income include:

- changes in revaluation surplus (IAS 16 and IAS 38)
- actuarial gains and losses on defined benefit plans recognized in accordance with IAS 19
- gains and losses arising from translating the financial statements of a foreign operation (IAS 21)
- gains and losses on remeasuring available-for-sale financial assets (IAS 39)
- the effective portion of gains and losses on hedging instruments in a cash flow hedge (IAS 39).

An entity has a choice of presenting:

a) a single statement of comprehensive income or

b) two statements:

  - an income statement displaying components of profit or loss and

- a statement of comprehensive income that begins with profit or loss (bottom line of the income statement) and displays components of other comprehensive income.

Minimum items on the face of the statement of comprehensive income should include:

(a) revenue;
(b) finance costs;
(c) share of the profit or loss of associates and joint ventures accounted for using the equity method (set in equivalence);
(d) tax expense;
(e) a single amount comprising the total of (i) the post-tax profit or loss of discontinued operations and (ii) the post-tax gain or loss recognized on the disposal of the assets or disposal group(s) constituting the discontinued operation;
(f) profit or loss;
(g) each component of other comprehensive income classified by nature;
(h) share of the other comprehensive income of associates and joint ventures accounted for using the equity method;
(i) total comprehensive income.

The following items must also be disclosed in the statement of comprehensive income as allocations for the period:

- profit or loss for the period attributable to non-controlling interests and owners of the parent
- total comprehensive income attributable to non-controlling interests and owners of the parent

Certain items must be disclosed separately either in the statement of comprehensive income or in the notes, if material, including:

- write-downs of inventories to net realizable value or of property, plant and equipment to recoverable amount, as well as reversals of such write-downs
- restructurings of the activities of an entity and reversals of any provisions for the costs of restructuring
- disposals of items of property, plant and equipment
- disposals of investments
- discontinuing operations
- litigation settlements
- other reversals of provisions.

Expenses recognized in profit or loss should be analyzed either by nature (raw materials, staffing costs, depreciation, etc.) or by function (cost of sales, selling, administrative, etc). If an entity categorizes by function, then additional information on the nature of expenses – at a minimum depreciation, amortization and employee benefits expense – must be disclosed.

7.3 Statement of Cash Flows for the Period

The Balance Sheet discloses balances for company's cash and cash equivalents, at the end of the financial year. By examining Balance Sheets attached for two consecutive financial years, we may state whether cash and cash equivalents have increased or decreased during the determined time-interval. It should be mentioned that the Balance Sheet does not offer any information regarding **why** the balances attached to cash and cash equivalents accounts, have incurred variations during a financial year. The Profit and Loss Account discloses information regarding revenues, expenses and financial results generated by various activities – clues for analyzing sources and destinations of cash and cash equivalents accounts, but this financial statement does not present either **why** these items augmented or decreased.

Moreover, a fake-result Income Statement may hide severe errors for company's cash flows.

The Statement of Cash Flows for the Period discloses such cash flows, also known as inflows and payments incurred during the period. In other words, these reveal **the origins of liquidities and corresponding expenditures**, explaining the generating events for their variations.

The structure foreseen by the international referential, for the Statement of Cash Flows, is based on IAS 7 "Statement of Cash Flows for the Period".

The standard's objective is to present all policies for preparation, presentation and disclosure of the financial statement, both at the level of separate companies and consolidated groups. These policies follow some specific informational purposes: (i) supplying financial information useful to various users, mainly because such information offer a good image on company's ability to generate cash and cash equivalents; (ii) covering the company's or the group's informational demands. All of users' economic decisions require a fair evaluation of the latter informational ability, as well as disclosure of due terms and insuring the effectiveness of cash flows.

● Advantages for usage of Cash Flow data

Whenever a Statement of Cash Flows is used together with the rest of the other financial statements, it therefore generates data allowing users to evaluate changes in company's net assets, its financial structure (including liquidity rate and solvability), as well as its capacity to modify cash flow values and due terms, in order to adapt to new business contexts and opportunities.

In the same time, cash flow information are useful to users in elaborating their evaluation and comparative models for the net present value of future cash flows, for various companies. Such information validates once more data comparability regarding performances and operational activities of various entities, mainly because they eliminate the effects of different accounting treatments, regarding same events and operations.

● Key terms and nature of cash-flow items

The concept of **cash flows** refers to the set of entries (increases) and exits (decreases) of cash and cash equivalents.

Cash refers to all readily-available funds and bank accounts.

Cash equivalents are short-term investments, extremely liquid, easily convertible into a predetermined measure of cash, and which bears a small risk for changes in value.

The purpose for holding cash equivalents is represented by company's solvability for short-term payments. Therefore, their due terms are generally under three months. Though holding cash equivalents, is not the purpose for investment objectives.

Participation titles are excluded from the cash equivalents category. An exception is represented by the preferred shares, acquired exactly before their due term, with a predetermined reimbursement date.

Cash flows do not include movements between items generating cash and cash equivalents, because these are elements of cash flow management, and also because a Statement of Cash Flows must disclose all funds' entries and exits, generated on types of activities: operating, investing and financing.

Regarding the management of cash flows, these procedures involve investing surpluses of cash and cash equivalents.

● Statement of Cash Flows – Disclosure

The Statement of Cash Flows for the Period must present all cash flows incurred within one financial year, classified according to categories of activities: operating, investing and financing.

Some transactions may include cash flows classified and split between categories of activities. For example, whenever repayment of a loan occurs (by exits of cash flows), the payment refers to both interests owed and loaned capital. The share corresponding to interests might be classified within operating activities, while the quota of loaned capital is disclosed in financing activities.

(a) Cash Flows from operating activities

All cash flows generated by operational activities are essentially the consequence of main revenue-generating processes and therefore are generated by events and other elements also influencing the net financial result.

The value of operational cash flows is a key indicator for measuring the operational performance of the company and the corresponding positive cash flows necessary for loan reimbursements, maintaining operational performance, payment of dividends and performing investments, all these without supplementary financing sources. Also, using past values for operational cash flows together with other financial data might be useful in predicting values for future cash flows. IAS 7 discloses a series of examples meant to clarify the previous definition for operational cash flows:

- all inflows generated by sale of goods and rendering services;

- all inflows from royalties, fees, commissions and other revenues;
- payments to suppliers of goods and services;
- wages paid and other employee payments;
- inflows and relative payments regarding insurance premiums and/or catastrophic events, annuities and other insurance policies (insurance companies);
- income tax payments and/or reimbursements, only if these are not attached to financing or investing activities.

A company may own participation titles for commercial purposes only, a case in which these are similar to inventories purchased for resale. That is why cash flows generated by titles' acquisition (held for commercial purposes only) are included in operational activities. Also, advance payments and loans received from financial institutions are classified (from the latter's perspective) as operational activities as well, knowing they refer to the main revenue-generating activity.

(b) Cash Flows from investing activities

IAS 7 presents that cash flows from investing activities show the measure in which payments were made as to purchase revenue and cash flow-generating assets.

Cash flows from investing activities offer information regarding a company's on-going concern and growth. These refer to the following:

- payments made for purchase of tangible and intangible assets, as well as other non-current assets, including capitalized research and development expenses, and payments generated by production of fixed assets for internal use only;
- inflows from sale of tangible and intangible assets, as well as disposal of other long term assets;
- payments for acquisition of participation titles and debt titles from/to other companies, as well as payments for purchase of associate titles (other than payments made for cash equivalents, or titles held for commercial purpose only);
- inflows from the sale of participation and debt titles from/to other companies, as well as other inflows from the sale of associate titles (other than inflows made for cash equivalents, or titles held for commercial purpose only);
- advance cash flows and loans to third parties (other than financial institutions, which are considered by them as operational activities);
- inflows from reimbursement of advance cash flows and loans to third parties (other than advance inflows and loans from financial institutions), etc.

The impact of changes in the consolidation perimeter over cash flows must be presented separately in the category of investing activities. Such impact equals a company's total acquisition/sale cost, less the sum of all cash and cash equivalents held by the acquired/sold company.

Example:

During year N, consolidated group M acquired 90% out of company F capital, at a cost of 100.000 m.u. At the moment of the purchase, F's cash flows amounted to 20.000 m.u.

The impact of purchasing company F (over group M cash flows): 100.000 – 20.000 = 80.000 u.m.

(c) Cash Flows from financing activities

Financing activities are those activities generating changes in the size and structure of company's both lent and owned equity.

The separate disclosure of these cash flows, within the Statement of Cash Flows for the Period, is recommended by their usefulness in forecasting the capital/funding amounts to be taken back by investors.

Changes in cash flows, generated by financing activities, refer to the following aspects:

- inflows from the issuance of shares and other owner's equity financial instruments;
- cash payments to shareholders for buying/rebuying company's own shares;
- inflows from issuance of debt loans, as well as: bank loans, promissory notes and bills, mortgage loans, and other short/long term loans;
- cash reimbursements of due loans;
- cash repayments performed by the lessee, or to reduce the account balance of a finance/operational lease contract.

● Special issues regarding the disclosure of Statement of Cash Flows for the Period:

Presentation of cash flows, as net amounts

Generally speaking, cash flows must be disclosed at gross values. In other words, **compensation of inflows and payments is not possible** within same category, or even different categories.

IAS 7 foresees though, two exceptions for the above rule; some operational, investing or financing cash flows **may** be presented (this is not compulsory) at **net amounts**. We are talking here about the following contexts:

(i) inflows and payments from/to clients, whenever these cash flows are generated by client's activities, and not attached to company's own processes; and

(ii) inflows and payments for high-speed rotating, large-value and readily-due items.

Foreign currency cash flows

Unrealized (delayed) gains and losses, resulting from variations between the date of cash flows and end of year moment, are **not cash flows.** We should consider though the effect of exchange rate variation for cash and cash equivalents

(either held or owed to third parties), must be presented within the Statement of Cash Flows as to allow comparison between cash and cash equivalents at the beginning and end of financial year. Such a disclosure is to be performed separately from operational, investing and financing cash flows.

Interests and dividends

Cash flows generated by interests and dividends cashed-in, must be presented separately by interest and dividend payments. In the same time, these must be eliminated according to the categories of activities, while their association to types of activities must be maintained from one year to the other.

The total size of interests paid during the financial year (no matter if recorded as expenses in the Income Statement, or included in an asset's cost) must be presented in the Statement of Cash Flows for the Period.

For financial institutions, inflows and payments to/from interests and dividends represent operational cash flows. For all the other economic entities, their classification is less clarified in this context.

Dividends paid and **interests and dividends received** ***may*** be classified as operational cash flows, because these are included in the net financial result. As alternative, **interests paid** and **interests and dividends received** ***may*** be considered both as **financing** cash flows, and **investing** cash flows, because they represent financing sources or gains from investments.

Payments with dividends may be classified as **financing** cash flows, because these represent the financing cost. Similarly, payments with dividends ***may*** be classified as **operational** cash flows with the purpose of helping users to determine a company's ability to pay dividends, after settlement of exploitation (operational) payments.

The Income Tax

IAS 7 states that any income-tax payments (or repayments) are attributable to operational cash flows, except the context in which these are specifically attached to investing or financing activities.

Operations with no effects over Cash & Cash Equivalents accounts

All transactions referring to investment and financing activities, and not involving any cash and cash equivalents, must be excluded from the Statement of Cash Flows for the Period. Such operations must be disclosed in the Notes, as to supply all relevant data regarding company's investing and financing activities.

IAS 7 supplies few examples of transactions with no effect over cash flows:

- asset acquisition, by takeover of attached debt, or by means of a finance lease;
- company acquisition, by issuance of shares;
- equity conversion of debts.

● **Methods for disclosing operational cash flows:**

A company must disclose corresponding operational cash flows for the period, by using one the following methods:

- either the direct method, according to which all information supplied refers only to gross amounts for inflows and payments;

- or the indirect method, according to which the financial result is corrected in connection with the following: (i) the influence of non-monetary operations; (ii) revenues and expenses associated to investing or financing cash flows; (iii) effects of variation in net working capital, over cash flows for the period.

Regarding the variation of net working capital (NWC), in order to better understand its effects, we present the following computational formula:

Net Working Capital = Operational Assets/Equity & Liabilities

Operational assets are delimited by: inventories, clients/receivables and similar accounts, other operational receivables and prepayments.

Operational liabilities and equity items are setup by the following accounts: suppliers and similar accounts, other operational liabilities'/debts, and only a share of the deferred revenues.

Each item of the NWC varies between the beginning of the period and the ending moment, while the various increases and/or decreases influence the net cash flows for the period from operating activities.

IAS 7 recommends companies to disclose operational cash-flow information, by applying the direct method. This method exclusively uses cash flow data (only inflows and payments), which may be useful as to foresee cash flows. This method is preferred by investors, even if accountants and specialists consider the indirect method as more efficient for preparing Statement of Cash Flows for the Period.

Following the path of examples offered by IAS 7, we therefore present the following templates for applying each of the disclosure methods:

Cash Flows from Operating Activities (direct method)

(+) Operational cash-in from Clients
(+) Inflows from royalties, fees and other income
(-) Payments to Suppliers
(-) Payments to Employees
(-) Interests and Dividends Paid[1]
(-) VAT Payments
(+) Other inflows from operational activities
(-) Other payments from operational activities
(-) Income Tax Payments [2]
= Net Cash Flows from operating activities

[1] These cash flows may be included as well in Financing Activities.
[2] Such cash flows may be divided between Operating, Financing, and Investment Activities.

In fact, the indirect method represents a statement for reconciliation of financial result before tax, with net cash flows from operating activities.

Cash Flows from Operating Activities (indirect method)

(±) Financial Result before taxes[2]
Elimination of revenues and expenses with no effects on cash flows
(+) Amortization and Provision Expenses
(-) Revenues from Provisions
Elimination of revenues and expenses with no connection to operating activities
(±) Result from fixed asset disposal
(±) Result from sale of of Participation Titles
(+) Interest expenses
(-) Revenues from Interests and Dividends
(-) Investment Subsidies, recognized as revenue
= (±) The Operating Result, before variation of the Net Working Capital
(±) Inventories variation
(±) Clients and other operational accounts variation
(±) Prepayments variation
(±) Suppliers and other operational liability variation
(±) Deferred Revenue variation (from operating activities only)
Other retreatments regarding inflows and payments
(-)Interests and Dividends Paid[1]
(-) Income Tax payments[2]
= Net Cash Flows from operating activities

[1] These flows may be as well included in Financing Activities.
[2] Such cash flows may be divided between Operating, Financing, and Investment Activities.

Supplementary notes regarding the indirect method:

(i) Eliminated expenses are presented with positive sign (+), while revenues are with negative sign (-), because whenever computing the financial result (in the Income Statement), these have already been listed with minus (-) for expenses and (+) for revenues.
(ii) The sale/disposal financial result is considered as net revenue or expense and follows the provisions mentioned at (i).
(iii) Whenever the NWC has a variations, we follow the rules:
  - for assets, the increase has a negative influence over cash flows, while a decrease has a positive effect;
  - for liabilities and equity items, the effects are the opposite.

[2] We are talking about financial results of companies within the consolidation perimeter.

● Methods for preparing Statement of Cash Flows for the Period

There are two models for preparing the Consolidated Statement of Cash Flows:

- by consolidation of separate (members') Statements of Cash Flows for the Period;
- starting with variations in Balance Sheet accounts.

In practice, we use a combination of the two models mentioned above, while the consolidation management information system[3], automatically generates the following:

- the individual Consolidated Statement of Cash Flows belonging to each subsidiary, starting with Balance Sheet account variation and other additional information;
- cumulation of all subsidiaries' Statements of Cash Flows, with the purpose of obtaining the Consolidated Statement of Cash Flows for the Group.

● Other consolidation issues:

The main accounting retreatment and operations, other than changes in consolidation perimeter, requesting a special focus in the Statement of Cash Flows are the following:

a) share in financial results of companies accounted for using the equity method, and dividends paid

The element of „share in financial results of companies set in equivalence", disclosed in the Consolidated Income Statement, does not correspond to a variation in the Balance Sheet, because assets and liabilities belonging to companies set in equivalence (accounted for using the equity method) are not transferred into the Consolidated Balance Sheet for the Group.

The single impact of companies accounted for using the equity method, over group's cash flows, is generated by distribution of dividends towards their parent. For this reason, net cash flows from operating activities will also include the financial results of consolidated companies (except the share in companies accounted for using the equity method), as well as dividends received by the parent from companies set in equivalence.

b) minority interests

In the context of consolidation procedures, splitting a subsidiary's financial result between the Group and Minority Interests, is not a monetary operation.

Cash flows accounts belonging to fully-consolidated companies disclose 100% of their transactions. Because of this, the financial result used as start-point in computing operational cash flows, must be the financial result of consolidated companies before the distribution between group and minority interests.

---

[3] Ropert, E., *Nouvelle pratique des comptes consolidés,* Gualino Publishing House, Paris, 2000, pp. 222-223.

When disclosing operational cash flows, if there's an option for starting with Group Financial Result, , then it is compulsory to add Minority Interests in the Financial Result – within the book entry „elimination of expenses and revenues with no effect on operating activities". In other words, the financial result of consolidated companies is to be computed as follows:

Group Financial Result
(+) Minority Interests in the Financial Result
(-) Share in the Financial Result of companies set in equivalence
= Financial Result of consolidated companies

The general template for disclosure of Statement of Cash Flows may be designed by the following manner:

Cash Flows from Operating Activities
Either we use the direct or indirect method, the final data to be disclosed is the following:
…
…
I. Net Cash Flows from operating activities

Cash Flows from Investing Activities
Companies use only information related to effective payments and cashings.
…
…
II. Net Cash Flows from Investing Activities

Cash Flows from Financing Activities
Companies use only information related to effective payments and cashings.
…
…
III. Net Cash Flows from Financing Activities
IV. Net variation of cash and cash equivalents (I+II+III)
V. Foreign currency exchange-rate variation
VI. Cash and cash equivalents – Beginning Balance (according to Balance Sheet)
VII. Cash and cash equivalents – Ending Balance (VI+IV+V)

Example:

On the 2nd of January year N, company M acquired 70% of titles belonging to entity F, at a cost of 5.600 m.u. The Balance Sheet items for F, are expressed in fair values only. The corresponding two Balance Sheets, both at the beginning and end of year N, are presented as follows:

Balance Sheet of Company F	Beginning Balance	Increases	Decreases	Ending Balance
Tangible Assets	580	140	-	720
- Depreciation of tangible assets	(180)	(20)	-	(200)
	400	120	-	520
Inventories	1.200	200	300	1.100
Clients	700	300	200	800
Short-time financial investments	1.000	200	60	1.140
Cash	200	220	60	360
Prepayments	60	10	-	70
Total Assets	3.560	1.050	620	3.990
Share Capital	2.000	-	-	2.000
Reserves	640	160	-	800
Financial Result	160	200	160	200
Financial Loans	480	-	80	400
Suppliers	160	200	40	320
Other operating expenses	120	240	130	230
Deferred Revenue	-	40	-	40
Total Owner's Equity & Liabilities	3.560	840	410	3.990

Balance Sheet of Company M	Beginning Balance	Increases	Decreases	Ending Balance
Tangible Assets	1.200	200	240	1.160
- Depreciation of tangible assets	(400)	(40)	0	(440)
	800	160	240	720
Participation titles (F)	-	5.600	-	5.600
Inventories	1.600	-	400	1.200
Clients	1.200	700	620	1.280
Short-time financial investments	680	100	-	780
Cash	8.000	2.000	6.500	3.500
Prepayments	80	20	-	100
Total Assets	12.360	8.580	7.760	13.180
Share Capital	6.000	1.000	-	7.000
Reserves	2.700	200	-	2.900
Financial Result	300	480	300	480
Financial Loans	1.600	300	100	1.800
Suppliers	1.200	200	860	540
Other operating expenses	560	-	100	460
Total Owner's Equity & Liabilities	12.360	2.180	1.360	13.180

Additional information:
- M increased its share capital by contribution in cash, fully paid on the 1st of April, N;
- on the 1st of June, M sold a land item, selling price 360 m.u., book value 240 m.u.;
- during year N, company M distributed dividends amounting to 100 m.u.

Computing the acquisition difference:

Acquisition cost of titles:	5.600 u.m.
(-)M's share in F: 70% x (2.000 + 640 + 160) =	1.960 u.m.
= Acquisition Difference (Goodwill)	3.640 u.m.

Determining the impact of F entering the consolidation perimeter, over cash flows for the period:

(-) Acquisition price for F titles:	5.600 u.m.
(+) Items purchased from F (short-term investments and cash): (1.000 + 200)	1.200 u.m.
= Impact over cash flows:	-4.400 u.m.

Statement of Cash Flows for Year N

Cash Flows from Operating Activities (indirect method):	
(±) Financial result of member companies (200+480)	680
(+) Depreciation Expenses (20+40)	60
(±) Result from Land sale (360-240)	(120)
(±) Inventory Variation (1.100+1.200-1.200-1.600)	500
(±) Clients Variation (800+1.280-700-1.200)	(180)
(±) Prepayments Variation (70+100-60-80)	(30)
(±) Suppliers Variation (320+540-160-1.200)	(500)
(±) Variation in Other Operating Expenses (230+460-120-560)	10
(±) Variation in Deferred Revenue (40-0)	40
= Net Cash Flows from Operating Activities	460
Cash Flows from Investing Activities:	
(-) Acquisition of Tangible Assets (140+200)	(340)
(+) inflows from sale of tangible assets	360
(-) Variation in consolidation perimeter	(4.400)
= Net Cash Flows from Investing Activities	(4.380)
Cash Flows from Financing Activities	
(+) inflows from new Loans	300
(-) Loan Repayments (80+100)	(180)
(+) inflows from share capital increase	1.000
(-) Payments with dividends (for M)	(100)
= Net Cash Flows from Financing Activities	1.020
Net Variation of Cash Flows (460-4.380+1.020)	(2.900)
Cash – Beginning Balance (680+8.000)	8.680
Cash – Ending Balance (1.140+360+780+3.500)	5.780

7.4 Accounting policies and Notes (Annexes)

Specialists state that the informative role of Annexes is extremely important for consolidated accounts, due to the following aspects:

- the existence of numerous evaluation and disclosure alternatives; and
- preparation work team's relative freedom of interpretation when preparing consolidated statements, as to decide whether applying or not procedures as a function of the significance principle (charting the consolidation perimeter, account retreatment and elimination of reciprocal operations, etc.).

The Annexes are not set to some inflexible preparation and disclosure rules.

Practice demonstrates that the number and nature of information may significantly vary between consolidated groups of companies. There is a series of minimum data to be disclosed in the Notes, as to allow external users to understand and interpret all criteria used when preparing financial statements. We are therefore talking about:

a) the accounting referential used, the provisions not applied and the corresponding reasons for such an action;
b) the consolidation methods, the accounting treatment for acquisition differences, conversion methods and closing date for accounts;
c) evaluation methods and rules used for important accounts in both Consolidated Balance Sheet and Income Statement (intangible and tangible assets, inventories, receivables and debts in foreign-currency, financial lease contracts, provisions for risks and charges, etc.);
d) the consolidation perimeter: indicate all criteria for charting the consolidation perimeter, nominalization of consolidated companies, justification for all cases when full consolidation was set for less than 50% of control percentage, exclusion cases, etc.;
e) informational comparability: the Annex must present all circumstances not allowing data comparability from one period to the other; for example whenever a subsidiary is acquired, all data referring to titles' acquisition cost, acquisition differences, the impact of the purchase over Balance Sheet, Income Statement accounts and Statement of Cash Flows for the acquisition period;
f) values and corresponding variations for all Balance Sheet and Income Statement accounts;
g) sector information;
h) other information: events occurring after closure of Balance Sheet, remunerations for managers and leaders etc.

CHAPTER 8

STEPS FOR THE CONSOLIDATION PROCESS

In order to begin the consolidation process, the consolidating company must follow several compulsory steps, as follows:

- generating a specific organizational structure by creating a consolidation managerial job*, or a unique accountable organizational cell, taking into account group size;
- the definition and statement of all consolidation principles and methods to be applied, by disclosing a consolidation manual;
- acquiring harmonized group data.

Also, as to setup the group accounting policies and procedures, the consolidating company (parent) must:

(i) define the eligible users and the destination of consolidated accounts;

(ii) define the group's consolidation perimeter, as needed.

Setting up a specific and unique group structure also involves implementing three consolidation steps:

- creating a consolidation work team (experts and specialists);
- defining all necessary management information systems: by choosing the adequate software for the consolidation process;
- planning: disclosing a consolidation calendar containing all steps and action phases.

* The employee accountable for the consolidation process (consolidation supervisor) has as main task to assure group inside communication activities. It is true that besides the main role of defining objectives, conceiving consolidation procedures, choosing necessary consolidation instruments and procedures, organizing labour activities and maintaining HR support, this employee must work together with other inside-group structures:

⇨ group managers (for the informational disclosure policy);

⇨ accounting departments of all subsidiaries and other affiliated/ consolidated companies;

⇨ managerial accounting and internal audit structures (as to check the available financial data);

⇨ the other financial departments of subsidiaries and other consolidated entities (as to assess risks associated to participations);

⇨ the fiscal services belonging to subsidiaries and other consolidated entities (as to measure the impact of any delayed fiscal issue);

⇨ the juridical departments of subsidiaries and other consolidated entities (as to measure and assess the impact of various law provisions);

⇨ the consolidating entity's informatics department (assessing whether it is involved or not in the main consolidation process, and if the case, statement of associated activities);

⇨ the auditors of parent financial statements (as to evaluate their professional opinion on group's policies, which in turn may affect the consolidated accounts' management and fair image, and as to foresee the final group-audit reports).

Also, whenever necessary there might be the case of decentralized departments, especially if needed to assure the fairness of the available consolidation information, or just to be able to accomplish the pre-consolidation and the effective-consolidation steps.

All employees accountable for the consolidation process, both at the level of subsidiaries, and other consolidated entities, must assure the continuous communication process between the accounting department(s) of the consolidating company, and the central consolidation department (the so-called *top conso*), within group headquarter. That is why their main job-description tasks refer to:

- receiving and sending any information coming from, or addressed to the consolidation department;
- signalling to the central consolidation department, any existing accounting or fiscal procedure belonging to the parent (e.g. the accounting policies referring to: the pension funds, lease contracts, amortization methods, s.o.);
- the centralization and analysis of all necessary information for the consolidation process, and assuring their conformity with parent principles, policies and procedures;
- coordinating their activities with the ones of internal and external auditors (mandated to verify the validity of the consolidation documentation);
- assuring that all of the consolidation processes are following the consolidation calendar, and if the case occurs, signalling to the central consolidation department any existing process-delays or lack of process-validity issues.

In practice, all of the above mentioned tasks are usually attributed to the subsidiary's chief accountant, who is accountable for the instant validity of consolidation procedures.

The Consolidation Calendar

The consolidation calendar is meant to set deadlines for preparing and disclosing the consolidation documentation, for all of the consolidated entities (group members), and in the same time it defines deadlines for the disclosure of consolidated accounts.

This calendar must be communicated to all employees accountable for preparing the consolidated accounts statements, as follows:

- to all group members' accounting departments;
- to all internal audit and managerial accounting departments;
- to consolidating companies' auditors and to all consolidated entities.

Generating the Consolidation Manual

The consolidation manual is mainly considered an official document used within the consolidation department of the consolidating (the parent) company, and its main purpose is to define all options and procedures this company uses in the context of current law provisions and standards.

The manual is transmitted to all subsidiaries, and these should take into account its provisions whenever performing sub-consolidation procedures. Also, the content of the manual is formal and is being periodically revised and validated by the auditors who in turn express their professional opinion on consolidated accounts' status.

The consolidation manual should at least disclose the following information:

- presentation of the consolidated financial statements (The Consolidated Balance Sheet, The Consolidated Profit and Loss Account, The Consolidated Cash Flow Statement, The Consolidated Statement of Changes in Owner's Equity, Annexes for accounting options and policies, and corresponding Notes);
- the group chart;
- clear presentation of the central consolidation department attributions, and the role of the consolidated entities;
- the consolidation calendar, as to state the specific time-scale for all of the group's end-of-year, quarterly and/or biannual operations;
- the presentation in detail of all consolidation principles and methods, chosen and recommended by the consolidating company.

The consolidation manual is to be updated within small time-intervals, in order to keep up with any principle, methods, or procedure changes at the level of the consolidated group.

Also, all rules referring to: the disclosure of the consolidated accounts, the specific content of any book entry; the rules for evaluating assets, liabilities, expenses and revenues; as well as all procedures and rules for preparing and disclosing the Annexes must be uniform for the entire group. Therefore, it is necessary to have homogeneous, end-of-year, group financial information.

All accounting principles used for preparing the consolidated companies' financial statements cannot always be aligned to the ones of the parent, and this may occur due to various reasons:

- the companies located in other countries are usually obliged to follow their residence-country specific accounting and fiscal laws;
- the highly-diversified consolidated groups may have in their structure different companies in different business fields, resulting in the necessity of adequate accounting retreatment and homogenization operations;
- some accounting retreatments are compulsory: for example eliminating any occurring fiscal effects on transactions, and recording deferred taxes.

In all of the above mentioned situations, preparing and disclosing a consolidation manual, containing group accounting principles, is no doubt a fundamental and vital business aspect.

REFERENCES

Burlaud, A. (coordonator), *Comptabilité et droit comptable. Intelligence des comptes et leur cadre légal,* Gualino éditeur, 1998.

C**ollette, C. Richard, J.**, *Comptabilité générale. Les systèmes français et anglo-saxons*, Dunod, Paris, 2000.

Epstein, J.B.; Mirza, A.A., *Interpretation and Application of International Accounting Standards*, John Wiley§Sons Inc., 2005.

Feleagă, L.; Feleagă, N., *Contabilitate financiară: o abordare europeană şi internaţională*, volumele 1 şi 2, Editura Economică, 2007.

Feleagă, N.; Feleagă, L., *Contabilitate consolidată: o abordare europeană şi internaţională*, Editura Economică, 2007.

Feleagă, N., *Sisteme contabile comparate*, Ediţia a II-a, volum 3, „Norme contabile internaţionale”, Editura Economică, 2000.

Feleagă, N.; Ionaşcu, I., *Tratat de contabilitate financiară,* volumul 2, Editura Economică, 1998.

Feleagă, N.; Malciu, L., *Politici şi opţiuni contabile (Fair Accounting versus Bad Accounting*), Editura Economică, 2002.

Feleagă, N.; Malciu, L.; Săcărin, M.; Gîrbină, M., *Ghid pentru înţelegerea şi aplicarea IAS 21 Efectele variaţiilor cursurilor monedelor străine,* Editura CECCAR, 2003.

Malciu, L., *Contabilitate aprofundată*, Editura Economică, 2000.

Malciu, L.; Feleagă, N., *Reglementare şi practici de consolidare a conturilor, Din orele astrale ale Europei contabile,* Editura CECCAR, 2004.

Mistral, J., *Rendre compte fidèlement de la réalité de l'entreprise, La Documentation française,* Paris, 2003.

Palou, J.M., *Manuel de consolidation. Principes et pratiques,* 3[e] édition, Groupe Revue Fiduciaire, Paris, 2003.

Raffournier, B., *Les normes comptables internationales (IFRS/IAS),* 2[e] édition, Economica, 2005.

Ropert, E., *Nouvelle pratique des comptes consolidés*, Gualino éditeur, Paris, 2000.

Tournier, J.C., *La révolution comptable. Du coût historique à la juste valeur*, Éditions d'Organisation, 2000.

*** * *** International Accounting Standards 2009, International Accounting Standards Board.