IMPACT OF NON-CONTROLLING INTERESTS ON THE CREDIBILITY OF CONSOLIDATED FINANCIAL STATEMENTS

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„There are more things in heaven and earth,
Than are dreamt of in your philosophy"

William Shakespeare

Or maybe…

„There are more things in heaven and earth,
Than are dreamt…by auditors and analysts"

Definition of CONTROL and consolidated financial statements

Vast majority of public corporations operate as groups of companies, composed of a parent company (listed on a stock exchange) and one or more subsidiaries (which might by either public or private). The key aspect for determining the composition and structure of a group of companies is a CONTROL (or lack of it) of a parent company over other entities, in which this parent company owns shares.

The financial results of entities which are controlled by the parent company (so-called subsidiaries) are fully consolidated with the financial results of the parent company, regardless of the parent company's share in the equity of these controlled entities. The full consolidation entails summing all the items of assets, liabilities, revenues, expenses and cash flows of the parent company and its subsidiary (with the exclusion of the intra-group transactions).

Definition of CONTROL and consolidated financial statements

Such a full summation of the individual items of the financial statements is applied also when the parent company controls its subsidiary by owning less that 100% of share in the subsidiary's equity (e.g. 51%).

In such cases the only consolidation adjustments which account for a less-than-full share of the parent company in the equity of its subsidiary are:

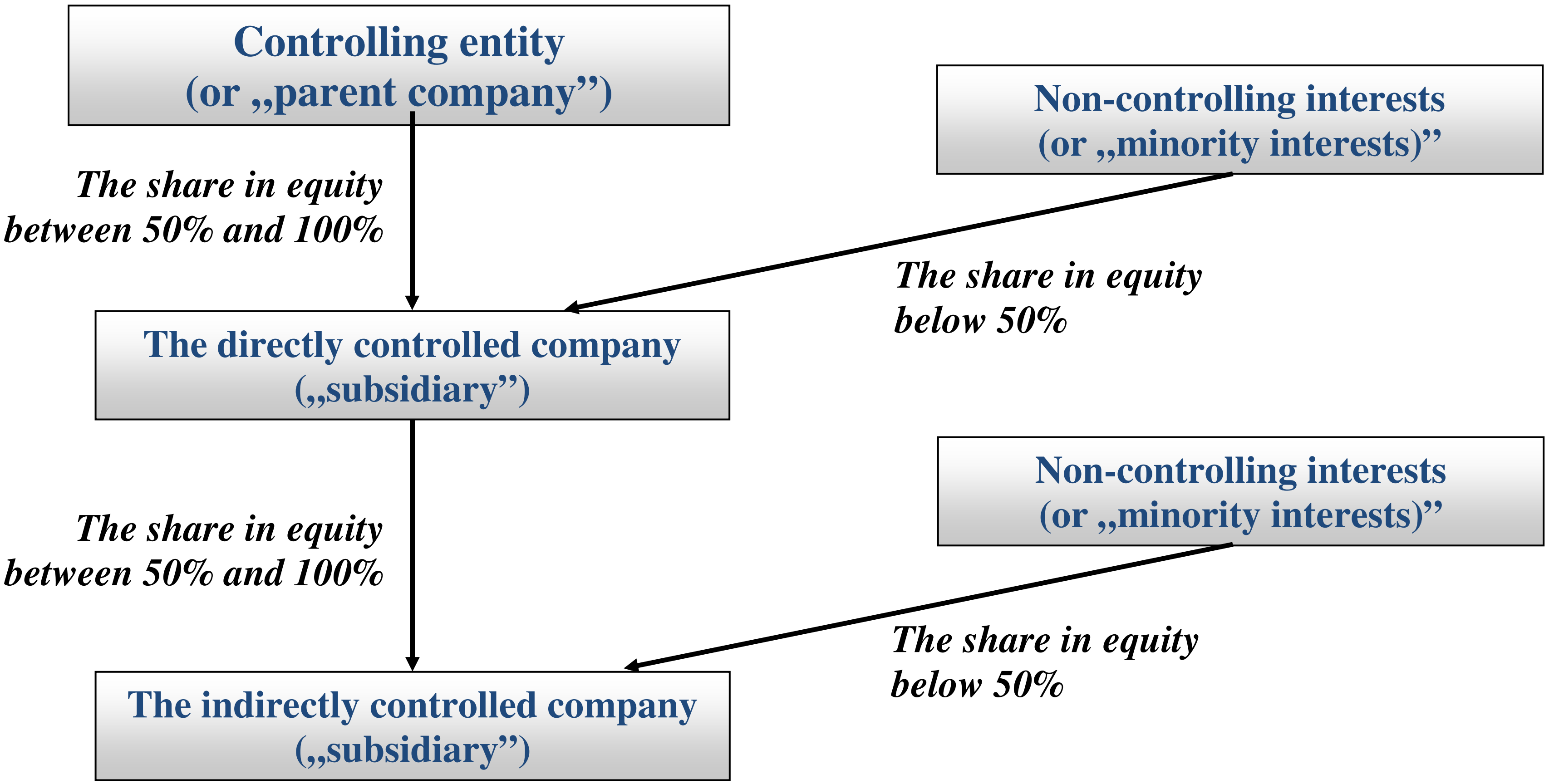
- **adjustment of the consolidated shareholders' equity by presenting the share of the entities other than the parent company in the equity of its subsidiary in the item labeled as „*non-controlling interests*" (also called „*minority interest*"),**
- **adjustment of the consolidated net earnings and consolidated total comprehensive income by presenting the share of the entities other than the parent company in the earnings of its subsidiary in the items labeled as „*net earnings attributable to non-controlling interests*" and „*total comprehensive income attributable to non-controlling interests*".**

Definition of CONTROL and consolidated financial statements

It should be noted that the adjustments for the non-controlling interests impact only one item of the consolidated balance sheet (i.e. shareholder's equity) and only two items of the consolidated income statement (i.e. net earnings and total comprehensive income).

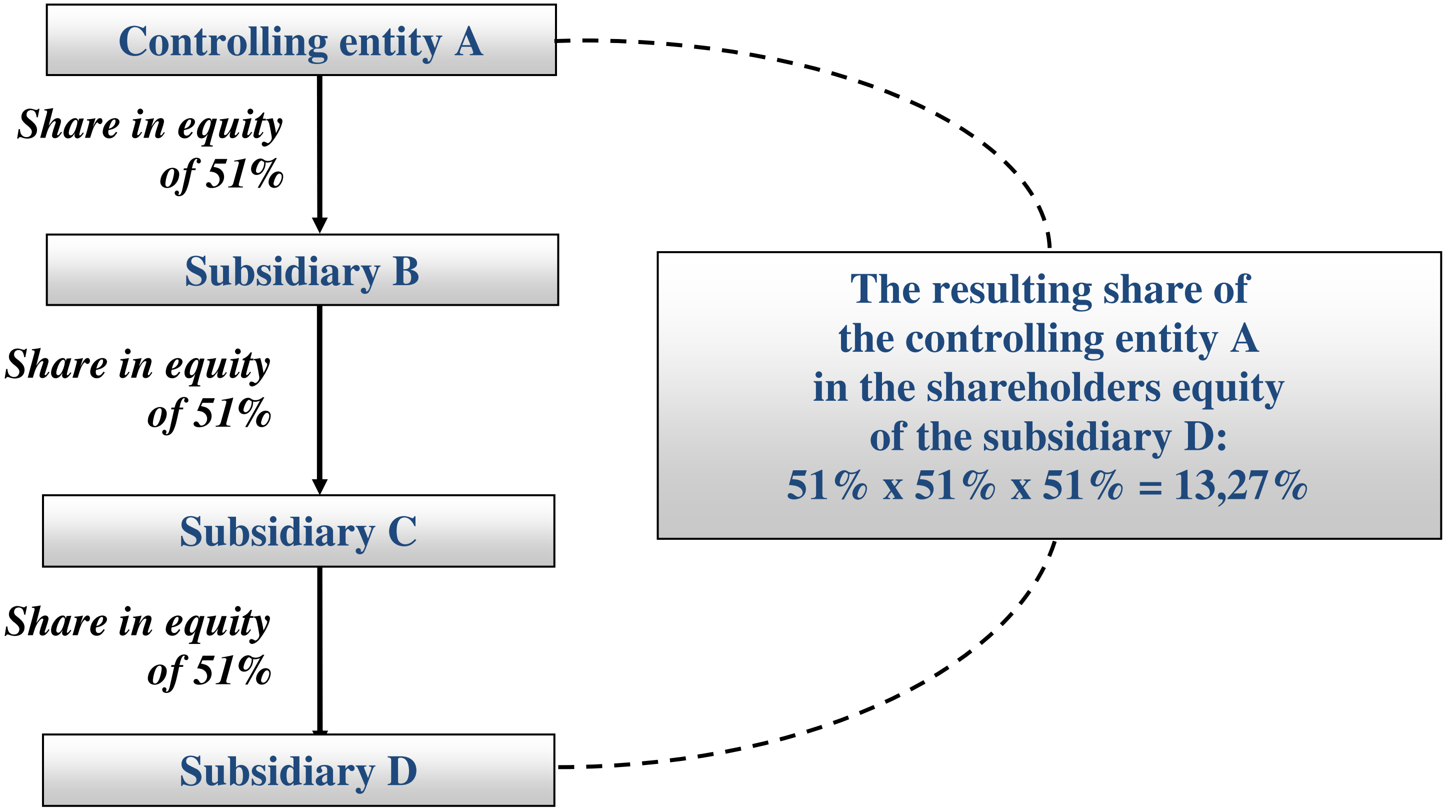
All the other items of the consolidated balance sheet and the consolidated income statement, and particularly THE WHOLE CASH-FLOW STATEMENT, are distorted and may significantly limit the usefulness of the consolidated financial statement in the company's analysis and valuation.

The typical structure of relationships between the parent company and its subsidiaries (resulting from the majority interests)



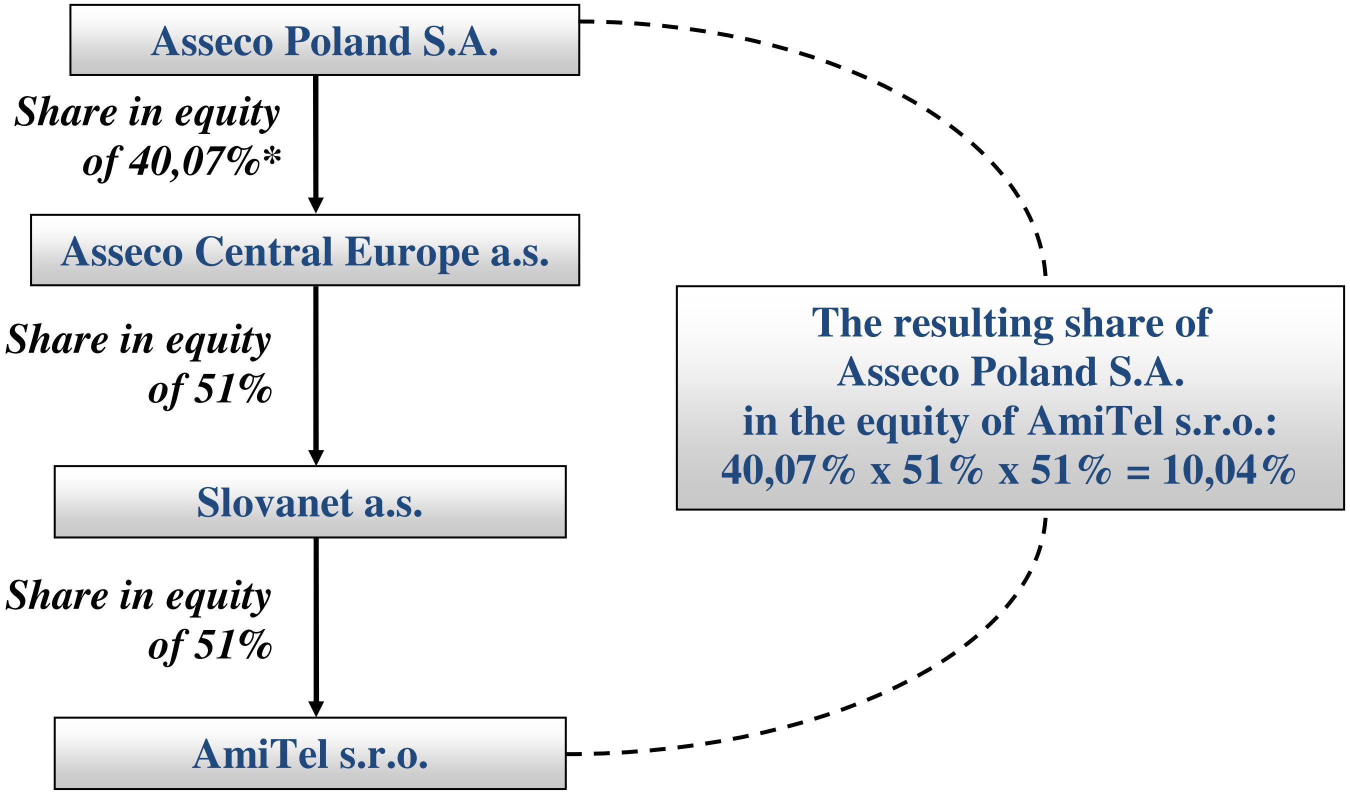
Source: author.

The hypothetical example of a „*cascading dilution of shareholding*”



Source: author.

Asseco Poland S.A. – a real-life example from the Warsaw Stock Exchange



** „The Parent Company maintains control over Asseco Central Europe a.s. despite holding less than 50% of its common stock […] because, according to the Articles of Association of Asseco Central Europe a.s., 3 out of the total 5 members of the Supervisory Board of that company are appointed by Asseco Poland S.A.”*
Source: Consolidated Financial Statements of the Asseco Group […] for the Year Ended 31 December 2011.

Asseco Poland S.A. – extract from the consolidated income statement for 2013

	PLN millions	
	2013	2012
Sales revenues	**5,898.1**	**5,529.1**
Gross profit on sales	**1,454.7**	**1,477.4**
Selling costs	(387.5)	(399.3)
General administrative expenses	(453.7)	(434.3)
Net profit on sales	**613.5**	**643.8**
Other operating income	18.7	18.5
Other operating expenses	(21.7)	(10.5)
Operating profit	**610.5**	**651.8**
Financial income	221.0	88.2
Financial expenses	(79.5)	(75.4)
Pre-tax profit and share in profits of associates	**752.0**	**664.6**
Net profit for the reporting period	**639.0**	**557.8**
Attributable to:		
Shareholders of the Parent Company	**393.9**	**370.6**
Non-controlling interests	245.1	187.2

Source: Consolidated Financial Statements of the Asseco Group […] for the Year Ended 31 December 2013.

Asseco Poland S.A. – extract from the consolidated balance sheet for 2013

	PLN millions	
	31 Dec. 2013	31 Dec. 2012
Non-current assets		
Property, plant and equipment	690.0	686.2
Intangible assets	869.7	937.9
Goodwill	4,670.6	4,907.2
Investments in associates accounted for using the equity method	495.8	20.5
Other	220.3	243.4
	6,946.4	**6,795.2**
Current assets		
Inventories	95.9	77.2
Prepayments and accrued income	93.0	99.3
Trade receivables	1,155.1	1,182.2
Other receivables	388.5	319.4
Financial assets	97.6	114.9
Cash and short-term deposits	756.4	959.9
Other	84.8	94.7
	2,671.3	**2,847.6**
TOTAL ASSETS	**9,640.4**	**9,642.8**

Source: Consolidated Financial Statements of the Asseco Group […] for the Year Ended 31 December 2013.

Asseco Poland S.A. – extract from the consolidated balance sheet for 2013

	PLN millions	
	31 Dec. 2013	31 Dec. 2012
Equity		
Attributable to shareholders of the Parent Company	5,318.0	5,157.5
Non-controlling interests	1,946.6	2,066.7
Total equity	**7,264.6**	**7,224.2**
Liabilities		
Non-current liabilities	856.4	896.6
Current liabilities	1,519.4	1,522.0
Total liabilities	**2,375.8**	**2,418.6**
TOTAL EQUITY AND LIABILITIES	**9,640.4**	**9,642.8**

Source: Consolidated Financial Statements of the Asseco Group […] for the Year Ended 31 December 2013.

Asseco Poland S.A. – extract from the consolidated statement of cash flows

	PLN millions	
	31 Dec. 2013	31 Dec. 2012
Cash flows - operating activities		
Pre-tax profit	752.0	664.6
Depreciation and amortization	264.5	239.0
Changes in working capital	(6.2)	(67.0)
Other financial income / expenses	(193.4)	0.7
Corporate income tax paid	(125.6)	(167.4)
Other	61.1	9.7
Net cash provided by (used in) operating activities	**752.4**	**679.6**
Net cash provided by (used in) investing activities	**(484.1)**	**(248.4)**
Net cash provided by (used in) financing activities	**(463.7)**	**(389.9)**
Net increase (decrease) in cash and cash equivalents	**(195.4)**	**41.3**

Source: Consolidated Financial Statements of the Asseco Group […] for the Year Ended 31 December 2013.

Impact of full consolidation on the credibility of indebtedness and liquidity analysis

Three hypothetical scenarios of differing distribution of assets between a parent company and its subsidiary (parent company owns 51% share in subsidiary's shareholders equity)

SCENARIO 1 – Current assets are equally distributed between parent and subsidiary					
	Parent	Subsidiary	Consolidation adjustments	NCI*	Consolidated balance sheet
Fixed assets**	13 630	7 000	-6 630***		14 000
Current assets	7 500	7 500			15 000
TOTAL ASSETS	21 130	14 500	-6 630***		29 000
Equity, including:	1 000	13 000	-6 630***		7 370
*NCI**	*0*	*0*		*6 370*** **	*6 370*
Short-term liabilities	20 130	1 500			21 630
TOTAL EQUITY AND LIABILITIES	21 130	14 500	-6 630***		29 000

** non-controlling interests*
*** it was assumed for simplicity that obtaining control of the parent over its subsidiary has not created any "goodwill" in the consolidated balance sheet*
**** consolidation adjustment for the carrying value of 51% shares of the parent in the subsidiary's equity*
***** reclassification of 49% of the carrying amount of the subsidiary's equity to non-controlling interests*
Source: author.

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Three hypothetical scenarios of differing distribution of assets between a parent company and its subsidiary (parent company owns 51% share in subsidiary's shareholders equity)

SCENARIO 2 – Current assets are concentrated mostly in a subsidiary					
	Parent	Subsidiary	Consolidation adjustments	NCI*	Consolidated balance sheet
Fixed assets**	20 630	0	-6 630***		14 000
Current assets	500	14 500			15 000
TOTAL ASSETS	21 130	14 500	-6 630***		29 000
Equity, including:	1 000	13 000	-6 630***		7 370
*NCI**	*0*	*0*		*6 370*** **	*6 370*
Short-term liabilities	20 130	1 500			21 630
TOTAL EQUITY AND LIABILITIES	21 130	14 500	-6 630***		29 000

** non-controlling interests*
*** it was assumed for simplicity that obtaining control of the parent over its subsidiary has not created any "goodwill" in the consolidated balance sheet*
**** consolidation adjustment for the carrying value of 51% shares of the parent in the subsidiary's equity*
***** reclassification of 49% of the carrying amount of the subsidiary's equity to non-controlling interests*
Source: author.

Three hypothetical scenarios of differing distribution of assets between a parent company and its subsidiary (parent company owns 51% share in subsidiary's shareholders equity)

SCENARIO 3 – Current assets are concentrated mostly in a parent					
	Parent	Subsidiary	Consolidation adjustments	NCI*	Consolidated balance sheet
Fixed assets**	6 630	14 000	-6 630***		14 000
Current assets	14 500	500			15 000
TOTAL ASSETS	21 130	14 500	-6 630***		29 000
Equity, including:	1 000	13 000	-6 630***		7 370
*NCI**	*0*	*0*		*6 370*** **	*6 370*
Short-term liabilities	20 130	1 500			21 630
TOTAL EQUITY AND LIABILITIES	21 130	14 500	-6 630***		29 000

** non-controlling interests*
*** it was assumed for simplicity that obtaining control of the parent over its subsidiary has not created any "goodwill" in the consolidated balance sheet*
**** consolidation adjustment for the carrying value of 51% shares of the parent in the subsidiary's equity*
***** reclassification of 49% of the carrying amount of the subsidiary's equity to non-controlling interests*
Source: author.

Impact of non-controlling interests in subsidiary's equity on total indebtedness ratio computed under three alternative scenarios presented above

	SCENARIO 1	SCENARIO 2	SCENARIO 3
„Raw" indebtedness ratio (consolidated liabilities / consolidated total assets)	74,6%	74,6%	74,6%
Adjustment of the indebtedness ratio for non-controlling interests:			
1) the parent's total assets excluding shares held in the subsidiary	14 500	14 500	14 500
2) the share (51%) of the parent in net assets of its subsidiary	6 630	6 630	6 630
3) total assets at disposal of the parent (1 + 2)	21 130	21 130	21 130
4) the parent's total liabilities	20 130	20 130	20 130
Adjusted indebtedness ratio (4 / 3)	95,3%	95,3%	95,3%

Source: author.

Impact of non-controlling interests in subsidiary's equity on current liquidity ratio computed under three alternative scenarios presented above

	SCENARIO 1	SCENARIO 2	SCENARIO 3
„Raw" current liquidity ratio (consolidated current assets / consolidated short-term liabilities)	0,69	0,69	0,69
Adjustment of the current indebtedness ratio for non-controlling interests:			
1) the parent's current assets	7 500	500	14 500
2) the share (51%) of the parent in current assets of its subsidiary	3 825	7 395	255
3) total current assets at disposal of the parent (1 + 2)	11 325	7 895	14 755
4) the parent's total liabilities	20 130	20 130	20 130
Adjusted current liquidity ratio (3 / 4)	**0,56**	**0,39**	**0,73**

Source: author.

Conclusions:

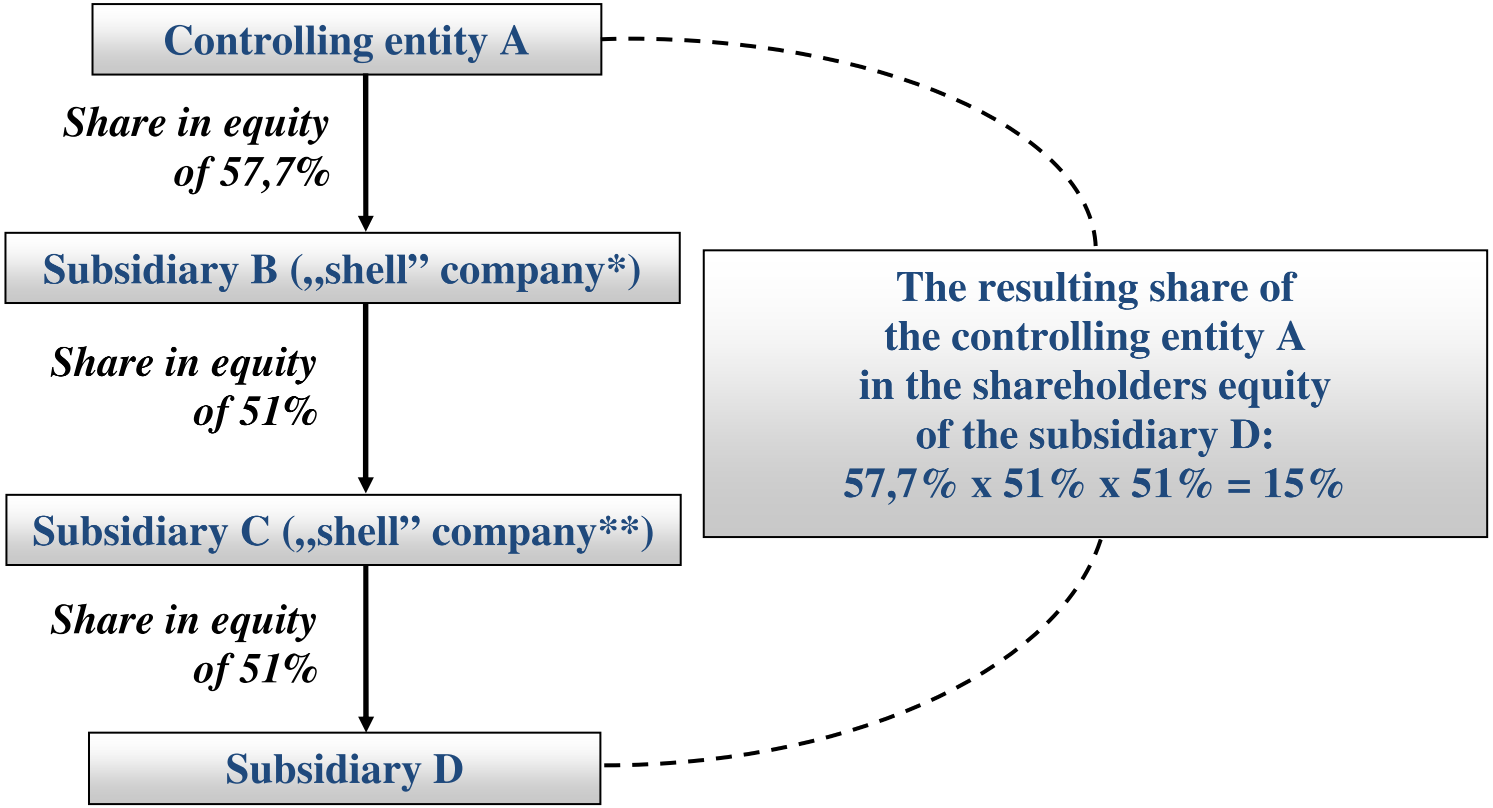
- **the full consolidation of financial statements is based on a notion of „control" of a parent company over its subsidiary,**
- **According to IAS / IFRS the control may be stated at any (even zero) share of a parent company in the subsidiary's equity, provided that there exist other (than share in equity) circumstances confirming the control (e.g. investor's agreements),**
- **In the case of control the balance sheets of all the companies within the group are fully consolidated, which means that all individual line items of their separate balance sheets are simply summed (with adjustments for effects of intra-group transactions, if any),**
- **In the consolidated balance sheet the only „trace" of less-than-full share of the parent company in the subsidiary's equity are non-controlling interests (also labeled as „minority interests"), reported as part of consolidated shareholder's equity,**

Conclusions:

- Thus, in the consolidated balance sheet, the individual items of the subsidiary's assets and liabilities are reported at their full carrying amounts, regardless of the parent's share in the subsidiary's equity,
- Meanwhile, the control of the parent over its subsidiary does not entail its entitlement to fully participate in the economic benefits generated by the assets belonging to the subsidiary (because this participation is proportional to the parent's share in the subsidiary's equity),
- The hypothetical case-studies presented above show that at the less-than-full share of the parent in the subsidiary's equity the full consolidation of the balance sheet may significantly distort conclusions derived from financial statement analysis (including indebtedness and liquidity ratios),
- Unfortunately, adjusting the reported consolidated balance sheets is practically unfeasible, even with extensive notes to the consolidated financial statements.

Impact of full consolidation on the credibility of cash flow statement

Imagine the following hypothetical ownership structure



** the only assets held are shares in C*
*** the only assets held are shares in D*
Source: author.

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Impact of full consolidation on the credibility of the income statement

INCOME STATEMENT	Parent Company A	Subsidiary D (owned in 15%)	Full consolidation	Proportional consolidation
Sales revenues	10 000	8 000	18 000	11 200
Operating expenses	12 000	5 500	17 500	12 825
Operating profit before extraordinary items	**-2 000**	**2 500**	**500**	**-1 625**
Gains from sale of land (with zero carrying value)	3 000	0	3 000	3 000
Operating profit	**1 000**	**2 500**	**3 500**	**1 375**
Financial income (revaluation of shares)	1 500	0	1 500	1 500
Financial expenses (interest on debt)	1 500	0	1 500	1 500
Pre-tax earnings	**1 000**	**2 500**	**3 500**	**1 375**
Income tax (20% tax rate)	200	500	700	275
Net earnings:	**800**	**2 000**	**2 800**	**1 100**
attributable to shareholders of the Parent Company	-	-	*1 100*	-
attributable to non-controlling interests	-	-	*1 700*	-

Source: author.

Impact of full consolidation on the credibility of the cash flow statement

CASH FLOW STATEMENT	Parent Company A	Subsidiary D (owned in 15%)	Full consolidation	Proportional consolidation
Operating profit	1 000	2 500	3 500	1 375
Income tax	-200	-500	-700	-275
Gains from sale of land	-3 000	0	-3 000	-3 000
Change of inventory	-2 000	2 500	500	-1 625
Net operating cash flows	**-4 200**	**4 500**	**300**	**-3 525**
Gains from sale of land	3 000	0	3 000	3 000
Net investing cash flows	**3 000**	**0**	**3 000**	**3 000**
Interest on debt	-1 500	0	-1 500	-1 500
Net financing cash flows	**-1 500**	**0**	**-1 500**	**-1 500**
TOTAL CASH FLOWS	**-2 700**	**4 500**	**1 800**	**-2 025**

Source: author.

Conclusions:

- **in the case of the consolidated balance sheet and the consolidated income statement we obtain at least SOME (although very limited) information about the real (that is adjusted for the percentage of ownership) participation of the parent company in the subsidiary's profits and net assets,**
- **In contrast, in the case of the consolidated cash-flow statement, which is deemed to be the most credible of all three basic financial statements, WE KNOW NOTHING about where the individual categories of cash flows are generated,**
- **At less-than-full share of the parent company in the subsidiary's equity the full consolidation of the cash-flow statement may dramatically distort the credibility of the financial statement analysis,**
- **Unfortunately, adjusting the reported consolidated numbers is in most cases impossible, due to insufficient scope of required footnote disclosures.**

THANK YOU FOR YOUR ATTENTION