SCUOLA DOTTORALE INTERNAZIONALE DI DIRITTO ED EDCONOMIA "TULLIO ASCARELLI"

DOTTORATO DI RICERCA IN ECONOMIA AZIENDALE

XXVII CICLO

Consolidated Financial Statements according to IAS/IFRS: Recent Innovations
What's new under IFRS 11? Evidence from an Italian Case Study

Umberto Francese

Dottorando

Prof.ssa Lidia D'Alessio

Tutor

Prof.ssa Maddalena Rabitti

Coordinatore

INDEX

Introduction

1. GROUPS OF COMPANIES

1.1 Overview

1.2 The control concept (Italian Gaap)

1.3 Groups of companies: a classification

2. CONSOLIDATED FINANCIAL STATEMENTS

2.1 Overview

2.2 Purpose, content and relevant law

2.3 Obligation to prepare consolidated financial statements

2.4 Scope of consolidation and control concept (IFRS 10)

2.4.1 Control in accordance with IAS 27

2.4.2 From IAS 27 to IFRS 10: new control definition

2.4.3 Structured entities vs special purpose entities

2.4.4 New control concept: theoretical aspects and business impact

2.4.5 Final observations

2.5 Consolidation theories

2.6 The consolidation process

2.6.1 Accounting phases for the preparation of consolidated financial statements

Appendix - Adoption of IFRS 10: theoretical aspects

3. JOINT CONTROL: WHAT'S NEW UNDER IFRS 11 *JOINT ARRANGEMENTS*?

3.1 Overview

3.2 Literature review

3.3 The weaknesses of IAS 31 and the improvements of IFRS 11

3.4 Joint arrangements

3.5 Joint control

3.5.1 Relevant activities in a joint arrangement

3.5.1.1 Delegated decision-making, related parties and de facto agents

3.5.2 Unanimous consent

3.5.2.1 Implicit joint control

3.6 Types of joint arrangement

3.7 Joint arrangement accounting
3.7.1 Accounting for joint operations
3.7.1.1 Parties to a joint operation without joint control
3.7.1.2 Transaction between a joint operator and a joint operation
3.7.2 Accounting for joint ventures
3.7.2.1 Interest in a joint venture without joint control
3.8 Continuous assessment
3.9 Disclosures
3.9.1 Nature, extend and financial effects of an entity's interest in a joint venture
3.9.2 Risks associated with interests in joint ventures
3.10 Transition
3.10.1 Joint ventures: transition from proportionate consolidation to the equity method
3.10.2 Joint operations: transition from the equity method to accounting for assets and liabilities
3.10.3 From proportionate consolidation to applying the accounting rules for a joint operation
3.10.4 Transition provisions in an entity's separate financial statements
3.11 Business impact
3.12 Final observations
4. Case study
4.1 Overview
4.2 Description of the analysed company
4.3 Activities put in practice by the Group to implement IFRS 11
4.4 Results of the assessment
4.5 Restatement of comparative disclosures
4.6 Impact of IFRS 11 on the main key performance indicators of the Group
Appendix - Checklist: joint arrangement classification assessment
Conclusions
References
Acknowledgements

Introduction

The global economic market, characterised by a growing partnership between companies, is leading the group being increasingly chosen as the most effective organisational form for doing business. In this context, consolidated financial statements are becoming increasingly important as they are the financial reporting documents aimed at the representation of the economical and financial situation of the group as a single entity (Gardini, 2010).

According to the International Financial Reporting Standards (IFRSs) and the Italian GAAP, a group is formed by a parent and its subsidiaries (IFRS 10, Appendix A) and a parent company shall present consolidated financial statements in which it consolidates its investments in subsidiaries. In this regard, it is essential to understand when control exists in order to determine which entities the consolidation area should include. As the control assessment process determines which entities are consolidated in a parent company's financial statements, it affects a group's financial and economic results, cash flows and financial position.

Identifying the consolidation area means identifying the entities of the group whose financial statements must be submitted for the consolidation process (Montrone, 2004); using a mandatory exclusion or optional exclusion process of certain entities within the group it is possible to define the consolidation area (Montrone, 2004).

Identifying this area is not a simple process; this is the reason why different regulations of different countries have provided different solutions. In spite of these multiple solutions, it is still possible to define some common basic conditions that are necessary in order to define the consolidation area.

In accordance with the IFRSs, the key principle through which the consolidation area can be define is the concept of control; therefore, the focus of the attention should be on this concept and on the different meanings it can acquire.

In May 2011 the IASB introduced new requirements on assessing control by issuing IFRS 10 *Consolidated Financial Statements*: this new standard (effective for annual periods beginning on or after 1 January 2013[1]) replaces IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation - Special Purpose Entities*, and it applies both to traditional entities and to SPEs (Special Purposes Entities). IFRS 10 redefines 'control' and provides extensive new guidance on applying the new definition.

[1] 1 January 2014 within the European Union.

Thus, **the first purpose** of this thesis is to analyse the new control definition provided by IFRS 10, pointing out the main differences between the new standard and IAS 27. The need to investigate the aforementioned aspects raise, at first, the following research questions:

1. Is the impact of IFRS 10 significant for what concerns the group's results?
2. Could IFRS 10 produce significant changes in the consolidation area?
3. What are the efforts that companies are making in adopting IFRS 10?

From a methodological point of view, during this **first phase**, a theoretical approach based on an in-depth reading of the current literature on the topic and a qualitative analysis of a range of archival data (such as the official documents available on the IASB website) have been used as the chosen research method. In particular, **the first section** of this study is divided in the following steps: **(i)** a description of the concept of 'group' (Chapter 1); **(ii)** an overview on consolidated financial statements (i.e. purpose, content, consolidation process) - (Chapter 2); **(iii)** a description of the control concept according to IAS 27 in order to point out the main concepts that result from it (Chapter 2); and **(iv)** a deep analysis of the new definition of control and the new control basics, highlighting the main practical and theoretical effects of this new definition (Chapter 2).

Moreover, it is worth noting that IFRS 10 is part of a wider set of IFRSs that, with reference to different aspects, play a crucial role on the preparation of consolidated financial statements. In fact, in May 2011, the IASB issued two further standards which are effective for annual periods beginning on or after 1 January 2013: **(i)** IFRS 11 *Joint Arrangements* and **(ii)** IFRS 12 *Disclosure of Interests in Other Entities*. The European Union (Regulation No. 1254/2012) endorsed these standards and it has established that each company shall apply them, at the latest, from the commencement date of its first financial year starting on or after 1 January 2014.

In particular, IFRS 11 supersedes IAS 31 *Interests in Joint Ventures* and SIC-13 *Jointly Controlled Entities – Non-Monetary Contributions by Venturers*, in order to arrive at an accounting treatment which accurately reflects the true nature of the economic interest held by parties to a joint arrangement.

IFRS 11 applies to all entities that are parties to a joint arrangement, while all of the disclosure requirements for joint arrangements are included in IFRS 12.

By issuing IFRS 11, the IASB introduced an overhaul of the existing accounting for joint arrangements. In this regard, management should carefully evaluate the new requirements,

as they may have a significant impact on how an entity can present its income statement and balance sheet.

As just mentioned, the accounting for interests in joint ventures and alliances, when they are governed by joint control, was formerly covered by IAS 31. The accounting driver of that standard was the structure of the arrangements and, when those were structured in an entity, IAS 31 allowed preparers to have an accounting option. About half of the preparers with an interest in a jointly controlled entity apply the equity method; the other half apply proportionate consolidation (IASB, 2011).

Because of this diversity, the IASB introduced IFRS 11: this new standard, by establishing the new framework for the accounting for joint arrangements, states that the parties recognise their rights and obligations relating to the arrangements. By so doing, this new framework mainly aims to: **(i)** capture the economic substance of the arrangements and **(ii)** enhance comparability of financial statements.

The innovations established under IFRS 11 mainly regard two aspects: **(i)** the classification (and the accounting requirements) now focus on rights and obligations of the parties as criteria for demarcation between joint operations and joint ventures; **(ii)** the accounting option for joint ventures has been eliminated; consequently, all joint ventures have to be recorded in the consolidated financial statements using the equity method (IFRS 11.24).

On the basis of this premise, the **second and main purpose** of this thesis is to analyse the new criteria established under IFRS 11 and to highlight the main 'critical points' that companies are facing by applying the new standard at this stage.

The new accounting requirements established under IFRS 11 and the need to investigate its impact on financial statements raise further research questions:

4. Why did the IASB introduce IFRS 11?
5. What are the main differences between the accounting requirements for joint arrangements under IAS 31 and those established under IFRS 11?
6. What are the effects upon the financial statements of those preparers that are affected by the changes?

From a methodological point of view, during this **second phase**, a theoretical approach based on a non-systematic literature review of the topic has been used as the chosen research method.

Moreover, in order to address the above-mentioned issues, an empirical analysis has been adopted as a further research method. In this regard, it is important to note that since the

application of IFRS 11 is not at full speed (as mentioned before, it is effective within the EU for annual periods beginning on or after 1 January 2014), at the time of writing it is not possible to conduct a complete empirical research on the topic. Despite this limitation, initial empirical evidences of its application are provided in the last chapter of this work through a case study[2] (the interim financial report data of an international Group is used to this end).

[2] For further information see chapter 4.

1. GROUPS OF COMPANIES

1.1 Overview

Consolidated financial statements are the financial reporting documents aimed at the representation of the economic and financial situation of a group as a single entity.

Firstly, in order to understand fully the concept of consolidated financial statements it is therefore necessary to understand what is meant by a ‘group’ of companies.

A group of companies can be defined as "an economic complex consisting of several companies which, while maintaining their legal autonomy, are controlled by the same economic entity that coordinates the activities of each unit of the group according to an unanimous strategy" (translated from Terzani, 2002).

Furthermore, the International Accounting Standards simply define the group as a parent and all its subsidiaries (IFRS 10, Appendix A).

Thus, the main features of the group of companies that distinguish it from other business concentration forms are the following:

1. A plurality of economic units legally distinct. In this regard, a group exists only if there are at least two (or more) economic units that have legal autonomy. This feature refers to the main difference between two (or more) economic units of the same company with divisional organisational structure and a group: in the first situation there are multiple economic units (divisions) lacking legal autonomy (since they come under a single legal entity); in the second (the group), each economic unit maintains its legal autonomy (thus they usually have the form of joint-stock companies, their own boards of governance and control, their own capital and their own financial statements to report on their activity).
2. The existence of a single economic entity ruling many different economic units. In this context, there is a single economic entity that disregards the self-interest of the economic units making up the group. Therefore, there is a single managerial policy over these economic units. This managerial policy is exercised by a superordinate entity that determines, typically in its self-interest, the strategic choices of the hierarchically lower economic units. The economic unit exercising the above-mentioned managerial policy is the so-called ‘parent’ (or holding), while the lower-order units are the subsidiaries. The economic entity of a group, by participating in the decision-making bodies of each company, imprints a single managerial policy to the group.

The opportunity for the parent company to exert its managerial policy comes from the power it can exert on the strategic choices of the subsidiaries. The control concept, with reference to the Italian Gaap, is examined in the next section (the same concept, with reference to the IAS/IFRS, is highlighted in paragraph 2.4).

1.2 The control concept (Italian Gaap)

The Italian Gaap does not foresee a general framework on groups of companies[3]; therefore, in order to define the relationships between the different companies that make up the group, it bases itself on the concept of control. The Italian Gaap (Article No. 2359 *Codice Civile*) defines the subsidiary and associated companies and it establishes that:

- subsidiary companies are: (i) companies whose majority of votes in the ordinary general meeting is held by another company; (ii) companies in which another company has enough of a participation to exert a "dominant influence" in the ordinary general meeting through its votes; (iii) companies under the dominant influence of another company by virtue of special contractual ties (Article No. 2359 *Codice Civile*);
- associated companies are companies on which another company has significant influence (this influence exists when at least one fifth of the votes in the ordinary general meeting, or one tenth of the votes in the case of listed companies, are cast by another company).

Therefore, if a company has at least 50% plus one of the votes in the ordinary general meeting of another company, then it can be said to have 'legal control' over the company it influences (the parent company has the majority of the votes in the ordinary general meeting of the subsidiary). Furthermore, legal control can be direct or indirect.

Direct control happens when the parent holds shares or so-called 'partial rights' (i.e. pledge, usufruct and similar).

Conversely, there is indirect control when there is no ownership of the shareholding or this is not sufficient to directly ensure the majority of the votes (in this case the calculation also includes the voting rights of subsidiary companies and intermediaries). For example, consider the following situation: company "A" holds 60% of the stocks of company "B", which in turn holds 80% of the stocks of company "C". In this case, "A" controls "B"

[3] Although there is no definition of 'group' in the Italian legislation, policy makers have anyway defined the responsibility deriving from the activities of management and coordination. This latter, as per the law (i.e. art. 2497-*sexies* of the Italian *Codice Civile*), is exerted by the controlling entity as per art. 2359 of the Italian *Codice Civile*.

directly and "C" indirectly ("A", although not possessing any stock of "C", controls indirectly "C"). Thus, "A" controls "B" and "C"; in particular "B" is directly controlled by "A" and "C" is indirectly controlled by "A" and directly controlled by "B".

Furthermore, an entity might have control over another entity even when the former has less than the majority of the voting rights of the latter. It is possible to have this type of control, known as '*de facto* control', in the following situations: (i) when a company (parent) has enough votes to determine the outcome of the resolutions adopted by the ordinary general meeting of another company (subsidiary). This can happen when, in a situation where the remaining rights are widely dispersed, the largest block of voting rights is held by a single company; (ii) when the parent is able to exert a 'dominant influence' over another company (subsidiary) by virtue of special contractual ties[4].

1.3 Groups of companies: a classification

In view of the different morphologies that a group can take, it is possible to propose a classification of the group of companies. To this end, it is necessary to identify some criteria in order to carry out a suitable classification. The aspects to be analysed for this purpose can be divided into the following (Marchi et al., 2010):

1) **formal aspects:** these characteristics refer to the structure that a group acquires as a result of the units' management. In this regard, the groups can be divided as follows:
    a. groups with simple structure, characterised by direct control links (i.e. parent that directly controls one or more subsidiaries);
    b. groups with complex structure, characterised by direct or indirect control links (i.e. parent that directly controls a sub-holding company, which in turn controls another company);
    c. groups with chain structure, characterised by mutual links between the different units of the group.

    With reference to the groups with simple structure, the direct control between a parent and its subsidiary is graphically represented with an arrow linking the parent to the subsidiary.

[4] For reasons of completeness, it is important to make reference to the concept of control compliant with D.Lgs. 127/1991 (Art. 26 – controlled companies). In this sense, controlled companies (other than those indicated in no. 1 and 2 of paragraph 1 of art. 2359 *Codice Civile*) are: (i) companies on which another company has the right to exert a dominant influence, by virtue of a contract or an article of incorporation, if the applicable law allows for such contracts or clauses; (ii) companies whose majority of votes is controlled by another company on the basis of agreement with other partners.

Figure n. 1 - Group with simple structure and one subsidiary

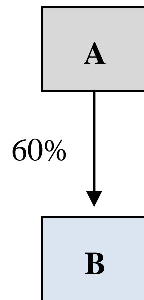
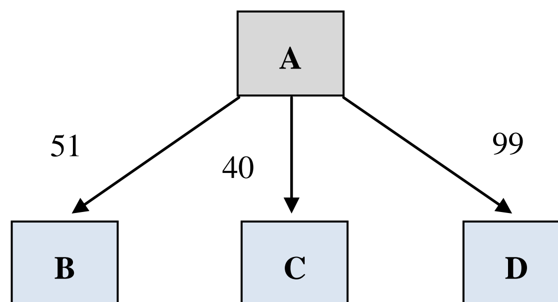


Figure n. 1 shows a group with simple structure consisting of two companies; in particular, company "A" owns 60% of the stock capital of company "B", while the minority shareholders of "B" hold the remaining 40%.

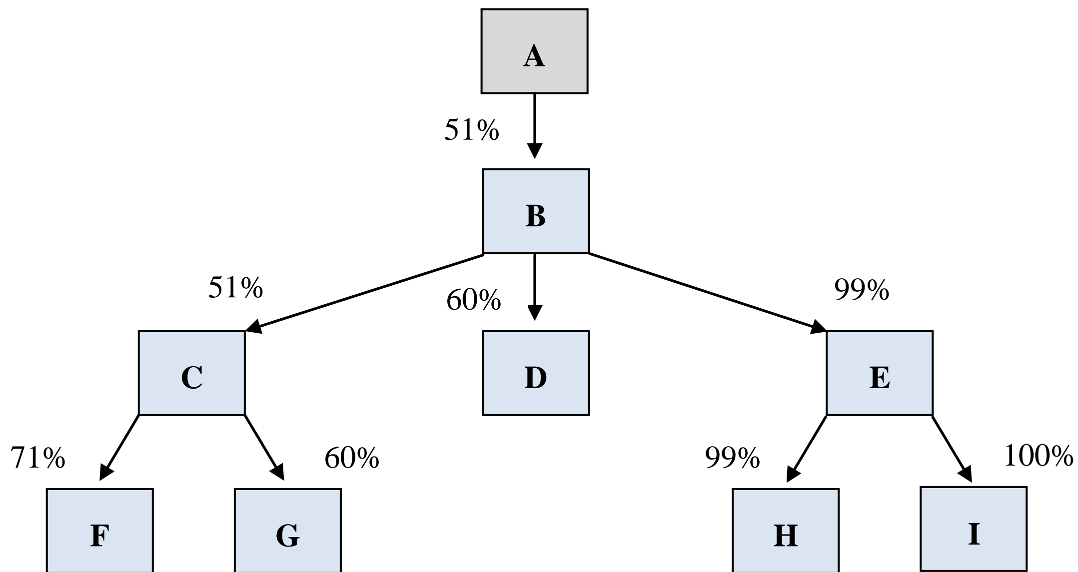
The subsidiaries directly controlled can also be more than one (Figure n. 2). In this case, the group with simple structure is characterised by several controlling shareholdings held by the parent in several subsidiaries.

Figure n. 2 - Group with simple structure and several subsidiaries



With reference to the group with complex structure, this is composed of several levels where there is both direct and indirect control (Figure n. 3).

Figure n. 3 - Group with complex structure



The parent "A" directly controls "B" (sub-holding company), which in turn directly controls the others two sub-holding companies ("C" and "E"). The latter companies control respectively "F" and "G" (company "C") and "H" and "I" (company "E"). The indirect control is exercised by "A" on "C", "D" and "E"; it is also exercised by "B" on all the companies at the base of the pyramid.

The shareholding rate is calculated by multiplying the percentages of shareholding on the arrows that connect the parent and the subsidiary (e.g. the shareholding rate of "A" in "F" is calculated as follows: 51% x 51% x 71% = 18,47%).

It is important to note that the shareholding rate of a parent company in a subsidiary indicates the subsidiary's resources owned by the parent, not the resources governed by it. The latter (by virtue of the control exercised directly or indirectly) constitute the totality.

2) **Substantial aspects**, referring to the following aspects:
   a. characteristics of the productive activities carried out by the companies forming the group;
   b. economic and productive relationships between the companies forming the group;
   c. presence of the companies forming the group in the territory;
   d. nature of the parent company as a legal entity;

e. group size.

With reference to the characteristics of the productive activities carried out by the members of the group, it is possible to distinguish between economic and financial groups. The former is basically characterised by the homogeneity of the productive activities; the latter, conversely, is characterised by the heterogeneity of the activities.

The main feature of the economic group can be observed in a managerial policy that considers any productive restrictions.

In terms of financial groups, on the other hand, the heterogeneity of the productive processes carried out by the subsidiaries makes the unity of the government's action hard to achieve. By consequence, the financial links arising from the shareholding ownership become highly important (Passaponti, 1994).

With reference to the economic and productive relationships between the companies forming the group, it is possible to distinguish between horizontal, vertical and conglomerate groups.

Horizontal groups arise from companies operating in the same economic sector, carrying out similar production processes and distributing similar products and services. These companies, by connecting with each other, tend to concentrate products and services technically similar but economically different in order to: (i) extend the commercial influence areas; and (ii) take advantage of the benefits of some common costs, such as advertising and development.

On the other hand, vertical groups are made of companies that, although operating in the same sector or in related sectors, carry out consecutive stages of the production process. Such groups can realize larger and cheaper economic combinations than those feasible with the single units outside the group (Azzini, 1982).

Finally, conglomerate groups have the features of both horizontal and vertical groups. Contrarily to the previous groups, in which it is possible to easily identify a specific production activity, in the conglomerate groups this is extremely difficult.

With reference to the presence in the territory of the economic units, it is possible to qualify the group as national, international or multinational. International groups are a fairly recent phenomenon (as they started to develop in the last thirty years), so a univocal definition is not available yet. However, it is still possible to consider as international groups those falling within one of the following cases: (i) groups

that develop in foreign markets but, at the same time, retain a prominent role on the national level (to which they devote the majority of resources); (ii) groups that carry out a development strategy worldwide level, but remain in the mono-national ownership of the share capital and in the composition of the governing bodies; (iii) groups in which the capital ownership, the strategy development and the management have extensive international characters; (iv) groups that have their registered office in a specific country but mainly operate abroad in order to obtain fiscal advantages (Pellicelli, 1972).

With reference to the nature of the parent company's legal entity, it is possible to distinguish between public groups and private groups. In general, the group is public when the legal entity is defined by public law; on the other hand, it is private when the legal entity is regulated by private law.

In addition to the public or private nature of the parent company, the distinction between public groups and private groups should be based also on the public or private nature of the group's economic entity.

Lastly, with reference to the group's size, it should be noted that the distinction between small, medium and large is absolutely relative and depends on both a complex of elements to be considered case by case and the sector in which the company operates (Corticelli, 1986). Despite these limitations, the identification of the dimensional parameters is generally based on the level of equity, sales, number of employees and number of units produced by the group.

2. CONSOLIDATED FINANCIAL STATEMENTS

2.1 Overview

This chapter deals with the following aspects of consolidated financial statements from a general point of view: **(i)** purpose, contents and relevant law; **(ii)** scope of consolidation (IFRS 10); **(iii)** consolidation theories **(iv)** consolidation process. These points, and in particular the most recent innovations on the topic (e.g. scope of consolidation), are examined in this chapter from a IAS/IFRS viewpoint. Reference is also made to the relevant Italian GAAP (in particular with regards to definitions) with the required specifications.

2.2 Purpose, content and relevant law

In accordance with the international accounting standards, the set of documents which make up the consolidated financial statements comprises of these elements: (i) balance sheet; (ii) income statement; (iii) statement of changes in equity; (iv) statement of cash flows; (v) notes to the financial statements (IAS 1, § 10). Additionally, entities are encouraged to complement the financial statements with a report from the administrators illustrating the main aspects of the entity's financial position and performance and the main uncertainties it is likely to face (IAS 1, § 12)[5].

The objective of financial statements is the representation of the financial position and performance of the parent and its subsidiaries as a whole (D.Lgs. 127/1991, art. 29, paragraph 2). Since the financial statements of individual entities belonging to a group are not sufficient to provide adequate information on the soundness of the financial position of the group as a whole and on its overall economic performance, it is necessary to produce a document capable of providing a general overview (Caratozzolo, 2002).

Consolidated financial statements can be viewed as the financial statements of a group which are presented as if they were the financial statements of a single economic entity

[5] Regarding the Italian Gaap, the national law on consolidated financial statements was introduced with the D.Lgs. 127/ 1991 which at paragraph 29 established that the consolidated financial statements need to be prepared by the parent's administrators and are made of the balance sheet, the income statement and the notes to the financial statements (D.Lgs. 127/1991, art. 29, paragraph 1). Compliant with the above-mentioned decree, consolidated financial statements need to be complemented by a report of the administrators on the general position of the entities forming the group and on their performance (D.Lgs. 127/1991, art. 40, paragraph 1); these documents should also be integrated with the following additional information: (i) consolidated statement of cash flows; (ii) report on the reconciliation between the result for the period and the net equity of the parent, equity and consolidated net income; (iii) statement of changes in consolidated equity (OIC 17, § 8.1).

(IFRS 10, Appendix A). It is important to underline that consolidated financial statements do not reflect directly the result of transactions internal to the group, but only of those between the parent (or the subsidiaries) and third parties. By way of example, if a subsidiary sells goods to its parent during a certain financial period, the income of the subsidiary and the corresponding cost for the parent are not reflected in the income statement, since they are brought about through an operation internal to the group. The group is thus considered as a single entity and, consequently, the entities belonging to the group lose their individuality. This is the reason why internal operations are not represented in the income statement or in the financial position and income situation of the group.

Regarding the relevant European law, the frame of reference is Regulation 1606/2002, which imposes on all listed companies, which are required to present consolidated financial statements, the adoption of international accounting standards (International Financial Reporting Standards - IFRS).

In Italy, art. 25 of law no. 306 - 31 October 2003 (so-called '*Legge comunitaria 2003*') delegated the government to make a decision on the options outlined by art. 5 of the above-mentioned regulation. D.Lgs. no. 38 - 28 February 2005, based on the *Legge Comunitaria 2003,* stated the obligation for listed companies (and the possibility for non-listed companies) to present consolidated financial statement compliant with IFRS starting from 2005.

In conclusion, the law relevant to the preparation of consolidated financial statements can be categorised as follows:

a. for companies preparing consolidated financial statements compliant with IFRS:
  - accounting standards specifically applicable to issues relevant to the consolidated financial statements: IFRS 10 - *Consolidated Financial Statements*; IFRS 3 - *Business Combinations*; IFRS 11 - *Joint Arrangements*; IAS 28 - *Investments in Associates and Joint Ventures*;
  - other international accounting standards having an impact on the preparation of the financial statements;

b. for companies preparing consolidated financial statements compliant with the national law:
  - D.Lgs. 127/1991;
  - accounting standard OIC 17.

2.3 Obligation to prepare consolidated financial statements

Compliant with international accounting standards, all 'parents' [6] (namely companies controlling one or more companies) are required to prepare consolidated financial statements (IFRS 10, § 4).

Only one exception to this obligation can be made; this applies specifically to the so-called 'sub-holding companies' (namely parent firms which are in turn controlled totally or partially by another firm). Specifically, a sub-holding company is not required to present consolidated financial statements if all the following conditions apply (IFRS 10, § 4a):

- **a.** the sub-holding company is controlled by another firm, partially or totally, and the stakeholders of the controlling firm, including those who have no voting rights, have been informed that the parent does not intend to prepare consolidated financial statements and they do not object to this;
- **b.** the sub-holding company does not have equity or debt instruments listed on a regulated market;
- **c.** the sub-holding company has not presented its financial statements to a supervisory body for admission to trading on a regulated market, and is not about to do so;
- **d.** the firm controlling directly or indirectly the sub-holding company prepares consolidated financial statements compliant with international accounting standards.

The IFRS do not foresee any other grounds of exemption from the preparation of consolidated financial statements other than the ones outlined above. It needs to be underlined that also risk-capital investment funds and private equity companies (or similar organisations) are required to prepare consolidated financial statements. The basis for this obligation, indeed, is brought about by the very relationship of control entertained with a subsidiary (IFRS 10, § 5). The concept of 'control' and the relevant details are discussed later in this chapter along with a complete review of IFRS 10 (see section 2.4).

The Italian GAAP, contrarily to international accounting standards, state that the obligation of preparing consolidated financial statements is subject to the legal form of the parent/subsidiary. With regards to this aspect, the obligation applies to (D.Lgs. 127/1991, art. 25):

- **a.** public limited companies, partnerships limited by shares or incorporated private companies controlling a firm;

[6] For the purposes of this obligation, the legal form of the parent is irrelevant. International accounting standards apply regardless of whether the parent is a company or not (i.e. investment funds or partnerships).

b. economic public bodies, cooperatives and mutual insurance companies controlling a public limited company, a partnership limited by shares or an incorporated private company.

Furthermore, the Italian law foresees two cases of exemption from the obligation of preparing consolidated financial statements, and if a company opts for this possibility it needs to indicate the reason for the exemption in the notes to its financial statements (D.Lgs. 127/1991, art. 27, paragraph 5).

The first case for exemption, just like the one foreseen by IFRS, concerns the so-called 'sub-holding companies'. A sub-holding company is not required to prepare consolidated financial statements when (D.Lgs. 127/1991, art. 27, paragraphs 3[7] and 4):

a. Its parent owns more than 95% of the shares of the sub-holding company; lacking the fulfilment of this condition, the preparation of consolidated financial statements is still not required if it is not requested by shareholders representing at least 5% of the sub-holding company's equity at least six months before the end of the financial year;

b. the sub-holding company has not issued securities listed on regulated markets;

c. the parent prepares and presents for control consolidated financial statements compliant with D.Lgs. 127/1991 or with the relevant law of another member state of the European Union.

A second case for exemption, not detailed by IFRS, concerns the so-called 'small groups'. Specifically, parents which, along with their subsidiaries, have not overcome for two consecutive financial periods two of the limits[8] outlined below are not required to prepare consolidated financial statements (D.Lgs. 127/1991, art. 27, paragraph 1):

a. 17,500,000 EUR in the total of assets of the balance sheets;

b. 35,000,000 EUR in the total of income from sale of goods and services;

c. 250 employees on average during the financial year.

---

[7] In the case foreseen by paragraph 3, the notes to the financial statements (other than indicating the reason for exemption) also need to indicate the name and the registered office of the parent preparing the consolidated financial statements. Furthermore, a copy of said statements, of the director's report and of the report by the control body (in Italian) need to be deposited at the local *Ufficio del Registro delle Imprese* of the subsidiary.

[8] In light of Directive 2013/34, the mentioned limits shall be modified with the inclusion of the possibility, left to the decision of individual member states, not to require the preparation of consolidated financial statements for 'medium-sized groups' (here intended as the ones which do not overcome at least two among the following thresholds: 20,000,000 EUR in the total of assets of the balance sheets; 40,000,000 EUR in the total of income from sale of goods and services; 250 employees on average during the financial year).

It is important to underline that this latter case for exemption does not apply if the parent or one of its subsidiaries has issued securities listed on regulated markets.

2.4 Scope of consolidation and control concept (IFRS 10)

According to the International Financial Reporting Standards (IFRS) and the Italian GAAP, a parent company shall present consolidated financial statements in which it consolidates its investments in subsidiaries.

In this regard, it is important to understand when control exists in order to determine which entities the consolidation area should include (in other words, it is essential to understand when control exists and when the consolidation is required). As said in the introduction of this thesis, identifying the consolidation area means identifying the entities of the group whose financial statements must be submitted for the consolidation process (Montrone, 2004): using a mandatory exclusion or optional exclusion process of certain entities within the group it is possible to define the consolidation area (Montrone, 2004). Identifying this area is not a simple process; that's why different regulations of different countries have provided different solutions. However, it is still possible to define some conditions in order to define the area.

In accordance with the International Accounting Standards, the key principle through which define the consolidation area is the concept of control; therefore, this paragraph focuses the attention on this concept and on the different meanings that it acquires.

Moreover, as the control assessment process determines which entities are consolidated in a parent company's financial statements, it affects a group's financial and economic results, cash flows and financial position.

In May 2011, as said before, the IASB introduced new requirements on assessing control by issuing IFRS 10 *Consolidated Financial Statements*: this new standard replaces IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation - Special Purpose Entities*, and it applies both to traditional entities and to SPEs. IFRS 10 redefines the concept of control and provides extensive new guidance on applying the new definition.

The key principle in this new standard is that control exists only if the investor has power over the investee, has exposure to variable returns from its involvement with the investee and has the ability to use its power over the investee to affect its returns.

Thus, the aim of this paragraph is to analyse the new control definition provided by IFRS 10, pointing out the main differences between the new standard and IAS 27 and

highlighting the main practical and theoretical implications of this new definition. Firstly, it is provided a description of the concept of control according to IAS 27, in order to point out the main concepts that result from it. Secondly, the dissertation is focused on a deep analysis of the new control definition and of the new control basics (also including a short description of the reasons that has led to this change). Lastly, the main differences between IAS 27 and IFRS 10 are analysed, highlighting the theoretical and practical implications of this new standard, pointing out the qualitative/quantitative impact of this new definition and providing examples of practical applications. Is this impact significant for what concerns the group's result? Could IFRS 10 produce significant changes in the consolidation area? What are the efforts that companies are making in adopting IFRS 10?

2.4.1 Control in accordance with IAS 27

IAS 27 provides a definition of control in accordance with the *substance over form* principle, by defining control as the power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities (Azzali, 2006). Therefore, this definition contains both the notion of governance as well as the economic consequence of that governance (Casabona, 2005).

In this context the presentation of consolidated financial statements is required to all parent companies, and the driver through which define the consolidation area is then the control concept.

However, the standard (under certain circumstances) introduces an exception to this general principle. In accordance to this exception a parent need not to present consolidated financial statements if, and only if:

- the parent is itself a wholly or partially-owned subsidiary in which all owners do not object to non consolidation;
- the parent's debt or equity instruments are not traded in a public market;
- the parent did not file, and is not filing, its financial statements to issue publicly-instruments; and
- the ultimate or any intermediate parent of the parent entity produces IFRS consolidated financial statements that are available for public use (IAS 27, §10).

There are no other bases of excluding a subsidiary from consolidation than those mentioned above. In particular the Standard does not allow exclusion of subsidiary from consolidation on the followings grounds: (i) when the subsidiary's business activities are

dissimilar from those of other entities in the group; and (ii) when the investor is a venture capital organization, mutual fund, unit trust, or similar entity.
This statement confirms that a subsidiary can not be excluded from the consolidation area due to the features of its parent (Dezzani, 2012).
Consolidated financial statements presented by a parent, as mentioned previously, must include all subsidiaries under its control. For this purpose, control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity, unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control.
However, there are situations where control also exists even though a parent owns half or less of the voting power of an entity. This occurs when that parent has:

- power over more than half of the voting rights by virtue of an agreement with other investors;
- power to govern the financial and operating policies of the entity under a statue or an agreement;
- power to appoint or remove the majority of the members of the board of directors and control of the entity is by that board; or
- power to cast the majority of votes at meetings of the board of directors and control of the entity is by that board (IAS 27, §13).

The standard also sets that it is essential to consider the potential voting rights in assessing whether an entity has the power to govern the financial and operating policies of an enterprise. An entity may own share call options, debt or equity instruments that are convertible into ordinary shares, or other similar instruments that have the potential, if exercised or converted, to give the entity voting power over the policies of another entity.
IAS 27 specifies that these potential voting rights must be currently exercisable or convertible (not conditional on the occurrence of a future event or exercisable at a future date) and they must include those held by another entity.

2.4.2 From IAS 27 to IFRS 10: new control definition

IFRS 10 supersedes IAS 27 and SIC-12 and is effective for years beginning on or after 1 January 2013[9]. The European Union (Regulation No 1254/2012) endorsed this standard

[9] Earlier application is permitted.

and it has established that each company shall apply it, at the latest, as from the commencement date of its first financial year starting on or after 1 January 2014.
The main intentions of the IASB in issuing this standard were: **(i)** to converge whit US-GAAP (United States-Generally Accepted Accounting Principles); and **(ii)** to deal with divergence in practice in applying IAS 27 and SIC-12.
With reference to the second point, the real issue was a perceived conflict of emphasis between IAS 27 and SIC-12 that had led to inconsistent application of the control concept. This because IAS 27 required the consolidation of entities that are controlled by a reporting entity and, as mentioned, defined control as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. SIC-12, which interpreted the requirements of IAS 27 in the context of special purpose entities, placed grater emphasis on risk and rewards.
As a result of the global financial crisis started in 2007, which highlighted the lack of the transparency about the risk to which investors were exposed from their involvement with "off balance sheet vehicles", the Board reviewed the accounting and disclosure requirements for such "vehicles".
IFRS 10 redefines the principle of control and establishes control as the basis for determining which entities are consolidated in consolidated financial statements.
The new definition of control, based on the relationship between the investor and the investee, predicts that control of an investee exists when an investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee (IFRS 10, IN8).
Thus, an investor controls an investee if, and only if, the investor has all of the following three elements:

- **a.** power over the investee;
- **b.** exposure (or rights) to variable returns from involvement with the investee; and
- **c.** the ability to use power over the investee to affect the amount of the investor's returns.

These three elements together significantly broaden the control definition and, therefore, are intended to result in more instances of consolidation, including instances of de facto control (Gillard, 2011).
IFRS 10 includes guidance on each of these three key control elements (see below). It is worth noting that the three factors are inter-related and that all three must be present to

confer control. The standard also recommends to reassess whether the control persists if facts and circumstances indicate that there are changes to one or more of these three elements [10] (IFRS 10, §8). Below all of these aspects will be analysed.

(a) Power

IFRS 10 explains that power arises from rights and rights grant power when they are sufficient to give the investor the "current ability" to direct the "relevant activities" (IFRS 10, §10) unilaterally. In this context "current ability" does not necessarily require the rights to be exercisable immediately but it is important to assess when the rights can be exercised before decisions about relevant activities need to be taken. In other words, an investor could have power even if its rights to direct have yet to be exercised (IFRS 10, §12).

Assessing power is a simple process for conventional investee where voting rights, usually conferred by share ownership, are the key factor. In such cases ownership of a majority of the voting rights confers power and control.

An investor mainly evaluates four factors in order to determinate if it has power over the investee: **(i)** relevant activities, **(ii)** how the relevant activities are directed, **(iii)** the rights that the investor and other parties have in relation to the investee, **(iv)** the purpose and the design of the investee.

IFRS 10 introduces the concept of "relevant activities" clarifying that relevant activities are activities of the investee that significantly affect the investee's returns (IFRS 10, §10). In this regard, the standard seems to be focused more on the *substance* of the relationship than on the *form* (Shamrock, 2012).

Some of these activities are, for example, selling and purchasing of goods or services, managing financial assets during their life, researching and developing new products or processes.

Assessing relevant activities could be critical when an investor has the current ability to direct only some of an investee's activities and the decisions about other activities are taken by other parties. In such cases the only entity that has power is the investor with current ability to direct the activities that most significantly affect the returns.

It is also important to notice that it is not necessary to identify relevant activities when there are entities with traditional ownership and governance structures whose returns

[10] The principle of continuous reassessment is broad, including a wide variety of circumstances: changes to the investor's decision-making rights, investor becomes or ceases to be entitled to variable returns, lapse of decision-making rights held by other parties.

depend on a wide range of financial/operating activities. This is because directing these activities, such as appoint the majority of the Board of Directors, grants power.

Once identified an investee's relevant activities the next step is to determinate how they are directed. This requires, first of all, understanding the decisions about those activities[11] and, secondly, identifying rights that confer ability to direct those decisions. In this context, according to IFRS 10, there are two types of rights that may confer this kind of ability: voting rights granted by equity instruments and contractual rights (IFRS 10, §11). In a lot of cases that involve entities with conventional governance structure, power arises from voting rights. On the other hand the control assessment is less straightforward when power arises from more specific contractual rights (such as cases that involve special purpose entities).

Moreover, in assessing whether it has power, an investor should analyze the rights that it has in relation to the investee. In this regard it should not consider rights (that it or others held) that are "not substantive" and "purely protective". A right is substantive when an investor has the practical ability to exercise that right[12], conversely protective rights are designed to protect the interest of the party holding those rights without giving that party power over the entity to which those rights relate. Thus, an investor cannot have control if it only holds non-substantive or protective rights.

IFRS 10 takes into account other factors that can help assessing if an investor's rights grant power. For example, the current ability to direct relevant activities grant power even if the rights to direct have yet to be exercised and the evidence that the investor has been directing relevant activities can help determining if the investor has power[13] (IFRS 10, §12).

Lastly, as mentioned above, an investor should considers all fact and circumstances when it assesses control. In this context it also includes the substance and intended purpose of specific structures and arrangements. For this reason IFRS 10 refers to the assessment of the investee's "purpose and design" in order to identify the relevant activities, how the decisions about the relevant activities are made, who has the current ability to direct those activities, who receives returns from those activities.

---

[11] These decisions include, for example, establishing operating/capital decisions of the investee, appointing and remunerating an investee's key management personnel.

[12] Assessing whether rights are substantive can require judgement, considering all facts and circumstances.

[13] This type of evidence is not, in itself, determinant in assessing whether an investor has power.

(b) Exposure, or rights, to variable returns

IFRS 10 defines variable returns as returns that are not fixed and have the potential to vary as the result of an investee's performance. The standard also establishes that these returns can be only positive, only negative or both positive and negative (IFRS 10, §15).
It is clear that this definition is extensive and it is not limited to the benefits obtained thorough equity shares. In fact, even the right to receive fixed interest can be considered a variable return if the payment of interests and the repayment of the debt securities are subject to default risk. Thus the concept of variable returns is linked to the investee's performance and includes all the circumstances wherein the returns are not guaranteed for sure (Quagli, 2011). For example variable returns could include dividends, changes in value of an investee, tax benefits, access to future liquidity, interest from debt securities and many others.

(c) Ability to use power to affect returns

Even with power and exposure to variable returns for there to be control the investor must still be able to use that power (current ability) to affect the amount of returns of the investee.
The linkage between power and returns primarily depends on the decision-making rights. In other words it depends on whether the investor has the current ability to direct the relevant activities on its own (as a "principal") or on behalf of other investors that have delegated their power to it ("as agent").
The basic principle is that an agent does not control the investee when it exercise decision-making rights delegated to it (IFRS 10, §18), by virtue of the fact that it is a party engaged to act on behalf and for benefit of other party (the principal). Thus, if the investor is using its delegated power for the benefit of others, then the investor is acting as agent even though it may be the decision-maker. In such cases the third element (link power-returns) of control is not present and, consequentially, the definition of control is not achieved (Voogt, 2011).
In a conventional parent-subsidiary relationship based on majority share equity, the linkage we are talking about does not require detailed analysis. In other circumstances, such as those in which an investor has some/all of its decision-making rights in the capacity of agent, a more detailed analysis is required. In these cases those rights delegated to investor by other principal do not count towards the control assessment, but only the investor's

decision-making rights held directly and those delegated by that investor to an agent are taken into account for IFRS 10 purposes.

Concluding, IFRS 10 requires the presentation of consolidated financial statements to all entities that meet the "control requirements" set out by the standard, but there are some circumstances in which a parent need not to present consolidated financial statements. This happens when a parent meets all the following conditions:

- it is a wholly or partially-owned subsidiary in which all owners do not object to non-consolidation;
- its debt or equity instruments are not treated in a public market;
- it did not file, and is not filing, its financial statements to issue publicly-traded instruments; and
- its ultimate or any intermediate parent of the parent entity produces IFRS consolidated financial statements that are available for public use (IFRS 10, §4).

2.4.3 Structured entities vs special purpose entities

IFRS 10 and IFRS 12 *Disclosure of Interests in Other Entities* carry forward the concept of a "special purpose entity" from SIC-12, which is now called a "structured entity". However, the risks and rewards model under SIC-12 has been eliminated.

As defined in IFRS 12, a structured entity is an entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements (IFRS 12, Appendix A). Therefore, an entity that is controlled by voting rights is not a structured entity.

In this context, management needs to evaluate whether it controls a structured entity using the same approach as for traditional entities (those that are controlled through voting rights). That is, management evaluates whether an investor has power over the relevant activities, exposure to variable returns and the ability to affect those returns through its power over the structured entity.

Despite the fact that the same approach is used to evaluate control for structured entities and traditional entities, it is still important to identify which entities are structured entities (this is because certain disclosure requirements apply only to structured entities). A structured entity often has some or all of the following features or attributes:

- restricted activities;

- a narrow and well-defined objective, such as to effect a tax-efficient lease, carry out research and development activities, provide a source of capital or funding to an entity or provide investment opportunities for investors by passing on risks and rewards associated with the assets of the structured entity to investors;
- insufficient equity to permit the structured entity to finance its activities without subordinated financial support;
- financing in the form of multiple contractually linked instruments to investors that create concentrations of credit or other risks (IFRS 12.B22).

Moreover, examples of structured entities include: (i) securitisation vehicles; (ii) asset-backed financings; (iii) some investment funds (IFRS 12.B23).

2.4.4 New control concept: theoretical aspects and business impact

IFRS 10 replaces IAS 27 and introduces a new approach to determine which investees should be consolidated, providing a new model to be applied in the control assessment process.

IFRS 10 does not imply substantial changes to the main principles stated by IAS 27: the new control model is based upon concept and principles that already existed in IAS 27 (and in SIC-12 too), but the new standard more fully explains them, also proving more guidance about how to apply them.

Because the main features have not changed dramatically, it is more difficult to isolate effect of the new rules in IFRS 10.

However, it is quite clear that this new standard introduces - from a theoretical point of view - little but significant changes, that could have - in practice - a deep business impact on reporting entities. Here below are briefly illustrated both the main theoretical and practical aspects of adopting the new standard.

Regarding the **theoretical** aspects, the adoption of IFRS 10 implies the need to reconsider the assessments made in accordance with IAS 27/SIC-12, especially for what concerns the following main aspects:

a) *de facto* control;

b) potential voting rights;

c) special purpose entities (SPE);

d) agency relationships;

e) different investors that have rights to direct different relevant activities.

In the appendix of this chapter, all of these aspects will be shortly analysed, providing examples of practical applications in order to highlight the different treatment under IAS 27/SIC-12 and IFRS 10.

Regarding the **practical** impacts, firstly it is necessary to consider that an effect analysis has several restrictions. Since the application of IFRS 10 is not at full speed (it's effective for years beginning on or after 1 January 2014), we cannot be certain about the effects of adopting the standard. Secondly, since IFRS are applied all around the world, we must be borne in mind that the social and the legal context in which entities operate could have a deep impact on the effects of this new rules.

At any rate, we can try to evaluate **(i)** the **business impact** of adopting the new standard and **(ii)** the **costs and benefits** of application of IFRS 10, focusing on the areas where the changes are expected to be most significant.

Regarding the **business impact**, a reporting entity should consider several different aspects: first of all, the effect on financial statements.

IFRS 10 could produce significant changes in the consolidation area, for example, if new entities shall be consolidated, or if formerly consolidated entities are de-consolidated. In other words, total asset and liabilities, revenues, expenses and - obviously - profit or loss may undergo significant changes. Thus, a reporting entity shall consider how key financial and economic results can be affected by this change, considering first of all, how such changes could be presented to stakeholders and secondly several other implications, among which loan covenant compliance, bonuses, share-based payment and other compensation plans based on financial results.

Moreover, this new standard implies a significant increase in the use of judgment. IFRS 10 points out several indicators of control, but gives little guidance on how to weight different indicators, which are likely to be highly judgmental areas. For example, the standard emphasizes the need to understand «*the purpose and design of the investee*», or «*what the relevant activities are and understand how decisions about those activities are made*» (PwC, 2011), but no further indications are provided, so that management is required to analyze all facts and circumstances in order to evaluate if control exists.

Since this new standard introduces certain judgemental areas (such as *de facto* control and principal-agent relationships), entities should consider the availability of resources and plan that make them able to handle the additional volume of work (PwC, 2011).

In this context, it is also important to notice that the initial transition requirements of IFRS 10 and continuous reassessment of control may require changes to the existing processes

and, in consequence, additional time and efforts depending on the number of investees that may require consolidation. In this regard, IFRS 10 may increase the costs of preparing the financial statements but reduce the costs to investor of understanding that group (Accountancy, 2011).

Regarding the **cost-benefit analysis**, we have to start by saying that IFRS 10 is expected to have economic effects, that could be beneficial for some entities and detrimental to others. The IASB itself in September 2011 issued a document illustrating the likely effects of adopting IFRS 10 and IFRS 12 (which sets out disclosure requirements for reporting entities that have an interest in other entities); the paper analyzes the costs and benefits of the main changes introduced by these new standards, focusing on the three areas where those changes are expected to be most significant: **(i)** improved disclosure; **(ii)** control assessment; and **(iii)** transition provisions.

Omitting the first area (which mainly concerns IFRS 12) and the third one (which only implies non-recurring cost/benefits, connected with the transition phase), below it will be briefly analysed the second one, focusing on foreseen consequences from the point of view both of users and preparers of financial statements.

In other words, we will consider the costs that preparers and users should bear when information is not available, and the advantage that preparers have in developing information that users would otherwise have to develop themselves (IASB, 2011).

Regarding the **control assessment**, users will probably enjoy the benefits arising from a significant increase in comparability and usefulness of information, since the single consolidation model provided by IFRS 10 should remove different assessment on the basis of whether an investee is within IAS 27 or SIC-12.

Users should also take advantage from an enhanced verifiability and understandability of the information provided by financial statements: consolidation decisions, under the new consolidation model, should reflect more faithfully the underlying substance of the relationships, rather than the mere percentage ownership interests.

Preparers, on the other hand, will probably bear higher initial costs associated with implementing the new standard. In fact, IFRS 10 requires that a reporting entity should consolidate any investee that it controls: the standard also establishes a new control model, which applies to all entities. Despite this new model is based upon principles that already existed, there are several differences between the requirements of IFRS 10 and the requirements of IAS 27 and SIC-12, and this will probably mean higher preparation costs when initially applying IFRS 10.

At any rate, the IASB believes that after initial implementation there will not be significantly higher costs, since these costs will primarily be “non-recurrent”.
Preparers will also take advantage of the more consistent understanding of control and consolidation requirements: they will be no longer a need to initially assess whether an investee is within the scope of IAS 27 or of SIC-12.

2.4.5 Final observations

IFRS 10 establishes a new control model, which applies to all entities and focuses on the need to have both power and variable returns before control is present. The revised definition of control changes whether an entity is consolidated or not: in other words an investor will consolidate (under IFRS 10) more or fewer investees, as compared to IAS 27. It depends on the nature of the interest held in the investees.
The new control definition provided by IFRS 10 will require management to apply significant judgment in order to decide which entities are controlled and which are not. This is why IFRS 10 seems to be a difficult standard to apply: especially the first-time application will probably imply time and significant efforts for reporting entities.
Moreover, the introduction of this new standard could deeply affect a reporting entity’s financial statements and, consequentially, management should doubtless consider the impact of IFRS 10 on entity’s key financial and economic results.

2.5 Consolidation theories

This section illustrates the manifold consolidation theories which, reflecting different purposes and interpretations of consolidated financial statements, imply differences in the consolidation procedures deployed (and, for this reason, have a significant impact on the preparation of the consolidated financial statements).
In the preparation of consolidated financial statements the starting point is represented by the ‘sum’ of the individual financial statements of the firms belonging to the group. This ‘sum’, defined as the ‘aggregated’ financial statements, needs to be adjusted by means of the so-called ‘consolidation adjustments’ in order to allow the final documents (i.e. the consolidated financial statements) to achieve their informative purposes (Prencipe and Tettamanzi, 2009).
This section is concerned with providing some information regarding some technical aspects of the consolidation process; specifically, the section addresses the following

procedures: **(i)** offsetting the value of shareholding in companies forming part of the scope of consolidation [14] against the relevant part of equity; **(ii)** accounting for possible differences arising from this procedure; **(iii)** determination and transcription of minority interests in the case of minority shareholdings.

These three sequential procedures aim to avoid the presence of duplicated values in the consolidated financial statements (which are based on the aggregated financial statements of the entities within the scope of consolidation).

By way of example, if a company (X) has full ownership (i.e. 100%) of the equity of another company (Y) which is part of the scope of consolidation, the aggregated financial statements will show the value of X's shareholding of Y (derived from the financial statements of X) and Y's assets and liabilities (deriving from the aggregation of Y's and X's financial statements). Since the value of the shareholding refers to the same entity whose assets and liabilities are already represented in the aggregated financial statements, it is necessary to offset the shareholding value against the related share of equity of the subsidiary, as this latter represents the difference between assets and liabilities (which is already represented in the financial statements). Furthermore, given that the possibility of the two values (the shareholding and the subsidiary's equity) being identical is highly unlikely, during the offsetting procedure of the above-mentioned values a positive or negative result will be identified. Such result shall have to be accounted for in the consolidated financial statements.

In a different example in which X has minority shareholding in Y (i.e. less than 100%), part of Y's equity belongs to third parties. In this case the aggregated financial statements need to be adjusted to account for the part of Y which is owned by third parties. Therefore, the problem of determination and transcription of minority interests arises.

Different consolidation theories, discussed in the following pages, suggest different technical solutions to the issues described above. Furthermore, each of these theories is associated with a different definition of 'group'. This implies: **(a)** a different role being assigned to consolidated financial statements; **(b)** a different consolidation process; **(c)** a different way of handling the result determined during the offsetting of the shareholding

[14] The scope of consolidation is composed of all the firms included in the group whose statements require aggregation in order to prepare the consolidated financial statements. This definition is more restricted than the one of 'group' in that there are firms whose financial statements are not deemed useful for the preparation of the consolidated financial statements (for various reasons), although they still form part of the group. While the scope of consolidation is an accounting concept, the idea of group refers to the economic/legal discourse. For further information on the scope of consolidation, please refer to the previous section (2.4).

value against the equity quota of the subsidiary; **(d)** a different handling and transcription of minority interests (Prencipe and Tettamanzi, 2009, p. 23)

Proprietary Theory

Proprietary Theory, whose origin is Anglo-Saxon, considers ownership of other companies by the parent as a discriminant for the existence of a group. The relationship of dependence between subsidiaries and the parent is grounded on the legal right of the parent to exert control on the subsidiaries, whether this right is actually exerted or not.

According to this theory, the consolidated financial statements are an extension of the parent's financial statements, and the so-called 'proportionate consolidation' is deployed. This method prescribes that assets and liabilities of controlled companies be accounted for at fair value for the percentage owned by the parent, that minority interests not be included in the consolidated financial statements and that the income registered after internal transactions be adjusted only for the percentage owned by the parent. Subsidiaries are thus considered as if they were the parent's investments.

Entity Theory

Entity Theory, whose origin is German, considers the group as an economic entity in which the parent is simply one of the entities of the group itself. This theory, in opposition to Proprietary Theory, makes reference to the real state of affairs; for this reason it prescribes the verification of a real integration between different companies (beyond the simple legal right to exert control).

As the entities of the group are influenced in their decisions by the interest of a single economic entity, their consolidated financial statements express both the position of the shareholders of the parent and the one of all other shareholders. In view of this, the method used for consolidation is the so-called 'full consolidation', which takes into account the fair value of 100% of all assets and liabilities of the subsidiaries. Furthermore, this method highlights possible consolidation differences also for the quota that can be ascribed to minority interests, and it prescribes the full elimination of internal operations. Therefore, in this case, the equity of the group includes the parent's equity and that which can be ascribed to minority shareholders of the subsidiaries.

Parent Company Theory

Parent Company Theory considers the group as a single economic entity operating mainly to serve the interests of the parent and of its shareholders. According to this theory, prevalently adopted in north-American countries, all companies managed by the parent on a unified basis form part of the consolidated financial statements and the financial statements provide a picture of the group's situation from the point of view of the parent's interests.
Consolidation happens with the 'full consolidation' method. Elements of assets and liabilities of the subsidiaries are accounted for at fair value uniquely for the part ascribable to the majority; minority interests, which are indicated separately in the income statement and the balance sheet (under liabilities), are calculated on the equity of the subsidiary (internal operations are anyway adjusted in full).

Modified Parent Company Theory

Modified Parent Company Theory is a variation of Parent Company Theory. The entries related to minority interests are highlighted separately both in the balance sheet and in the income statement. However, differently from Parent Company Theory, minority interests are calculated on the equity at fair value (as seen in Entity Theory). With the exception of the difference just outlined, Modified Parent Company Theory is identical to Parent Company Theory.

2.6 The consolidation process

Consolidated financial statements are the result of a long organisational process which can have a different level of complexity (Lenoci and Rocca, 2008) on the basis of the features of each group (size, structure, national or international extension).
This procedure can thus manifest different features mainly due to the complexity of the relationships of control and to the homogeneity of the activities carried out by the parent and its subsidiaries.
An important point to be considered in the preparation of consolidated financial statements is, among others, one connected to the informative needs characterising the group; it is essential to understand whether such financial statements will be used solely as an informative tool for third parties or also as a management-organisational tool (Ipsoa-Francis Lefebvre, 2008). In the first case, the preparation of consolidated financial

statements will focus mainly on the documents meant for publication and on the effects these bring about for stakeholders and opinion leaders. In the second scenario, on the other hand, the preparation process requires also an analysis of the informative flows that are not necessarily linked to events relevant for accounting purposes (e.g. characteristics of the industry, territorial analysis)

Once the objectives are clearly defined, the fundamental steps of the consolidation process can be summarised as follows: **(a)** acquisition of adequate information tools; **(b)** establishment of behavioural rules; **(c)** analysis of the steps of the consolidation procedure.

Regarding **point 'a'**, it is important to underline that the more the consolidation procedure is carried out with adequate IT tools, the higher the chance to obtain an adequate level of data security.

Behavioural rules (**point 'b'**), along with IT tools, constitute a point of reference useful for all entities involved in the consolidation process. The predisposition of consolidation tools and behavioural rules essentially amounts to the establishment of a group data collection system (Agliati, 2000), or group reporting system, capable of guaranteeing quality and timeliness in data collection.

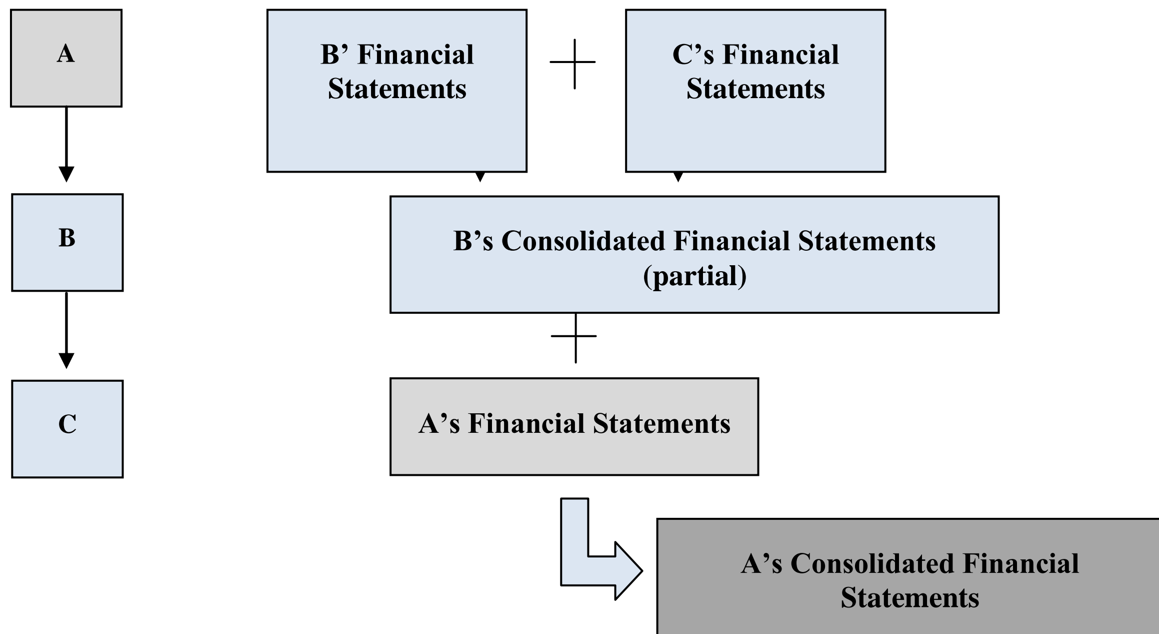
Such system can be structured in various ways on the basis of the options selected in the following areas (Lenoci and Rocca, 2008, p.100):

1. consolidation method;
2. degree of centralisation of the activities of the consolidated companies;
3. documentation produced.

As far as the <u>consolidation method</u> is concerned, this can be a 'step' or 'simultaneous' method.

The step method consists in the preparation of consolidated financial statements in sequential steps starting from the preparation of consolidated financial statements for the sub-holding companies and working bottom-up to ultimately result in the consolidation of the parent (see Fig. 4). During the preparation of partial consolidated financial statements for sub-holding companies it will be necessary to apply consolidation adjustments. This consolidation process is characterised by sequential steps (chain procedure) and for this reason it can be potentially rather time consuming.

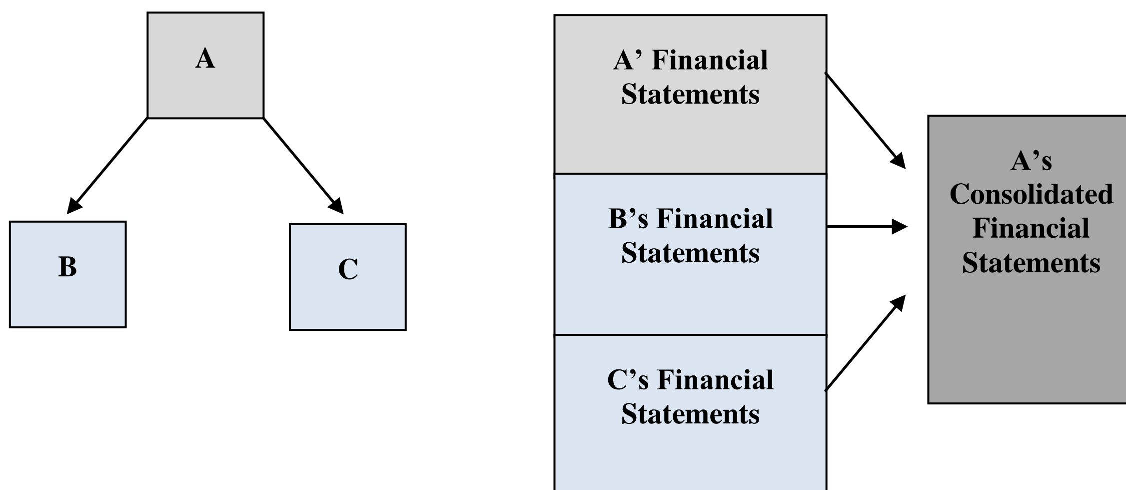
Figure n. 4 – Step consolidation method



Source: Personal adaptation from Prencipe, 2009

With the simultaneous consolidation method, on the other hand, the financial statements of companies belonging to the scope of consolidation are elaborated in a single phase (See Fig. 5). This method is grounded on a group data base which gathers simultaneously from all companies involved all the information required for the preparation of the consolidated financial statements. For this reason it is paramount to standardise the information which will form the data base for the consolidation procedure.

Figure n. 5 – Simultaneous consolidation method



Source: Personal adaptation from Prencipe, 2009

With reference to the degree of centralisation of the activities, the group reporting system can foresee: (i) the centralisation of all activities within the parent company; (ii) the centralisation within the parent company of some of the operations related to consolidation, and, as a result, the de-centralisation of other consolidation activities to the other consolidated companies.

In the first case, the parent will be in charge of the standardisation of the information from other companies included in the consolidated financial statements on the basis of the principles outlined by the group. This approach requires a thorough knowledge of the criteria adopted by the consolidated companies. This knowledge cannot always be inferred and acquired by means of the illustrative notes to the financial statements and the appendices attached to the financial statements by each company.

In the second scenario, on the other hand, the parent will simply gather information that has already been standardised using the principles of the group, and the obligation to respect such principles will be down to the consolidated companies. Among other operations, the de-centralisation of part of the consolidation procedure will require adequate administrative interventions (i.e. standardisation of the chart of accounts within the scope of consolidation, the definition of group accounting standards, the predisposition of standard survey procedure).

Regarding the documentation produced, the group reporting system is generally made of (Ipsoa-Francis Lefebvre, 2008, p. 650): (i) consolidated subsidiaries entry book; (ii) yearly consolidation package; (iii) consolidation manual.

The consolidated subsidiaries entry book is usually made of an identification entry for each subsidiary, the relevant articles of incorporation and the minutes from the shareholders' meetings.

The yearly consolidation package is a set of documents set up by the body in charge of preparing the consolidated financial statements and addressed to the accounting departments of each company within the group in order to ensure that the latter can prepare all the required information in due course. The pack includes parts of the consolidation manual as well as other documents (e.g. the consolidation calendar, the scope of consolidation, the accounting rules and standards adopted, general information on the companies, on the balance sheet and the income statement, the documents regarding intercompany consolidated accounts, transactions in the statement of cash flows).

The consolidation manual is a handbook for the consolidation process (which requires continuous updating) and it is generally distributed to the whole group. The manual is

made of a first section describing the group which includes a description of the roles attributed to different companies, of the calendar of operations required for the consolidation process, of the principles adopted to establish the scope and method of consolidation, of the list of companies (including individual information) and of the structure of the group. The second part of the manual features mainly accounting topics and provides various types of information. Firstly, it includes a description of the chart of accounts chosen for the group; secondly, it summarises the general accounting principles (providing also a more detailed description of the accounting principles and methods adopted for each balance sheet item); finally, it describes the elimination method adopted for intercompany operations.

The operational steps that make up the consolidation process (**point 'c'**), are essentially the following (Ipsoa-Francis Lefebvre, 2008, p. 647):

- defining the scope and method of consolidation;
- selecting the law applicable;
- selecting the consolidated financial statements to be prepared and the relevant deadlines;
- defining the chart of accounts for the group and the set of consolidation documents;
- defining the elaboration tools for consolidation;
- defining the team, the role and the hierarchical position assigned to the body preparing the consolidated financial statements (or other body assigned to this task), as well as its relations with other departments;
- defining the role of points of contact within the subsidiaries;
- defining the order of consolidation operations;
- defining the calendar of consolidation operations;
- establishing the type of internal control required for consolidation;
- formalising the set of options selected for consolidation;
- providing staff with the required training.

The above list refers in particular to the first year of preparation of consolidated financial statements; in the following years these phases will have to be duly revisited (updating the consolidation manual and the consolidation package, if this latter exists). The parent shall also be required to verify possible variations in the scope of consolidation and decide whether to review the consolidation methods applicable to each company (full, proportionate, equity method).

2.6.1 Accounting phases for the preparation of consolidated financial statements

Once the scope of consolidation has been identified (and the companies participating in the consolidation are thus known), a series of operations needs to take place. All together, these form the accounting phases leading to the preparation of consolidated financial statements. Such phases can be summarised as 4 important steps:

- pre-consolidation operations (or standardisation);
- aggregation of standardised financial statements;
- consolidation operations;
- preparation of consolidated financial statements.

The purpose of pre-consolidation operations (or pre-consolidation adjustments) is to standardise the data included in the financial statements of the companies participating in the consolidation. Such operations are: (i) re-classification of balance sheet items of the subsidiaries; (ii) standardisation of the content, form and template of financial statements; (iii) standardisation of dates and criteria adopted for individual financial statements; (iv) translation of financial statements in foreign language/currency of foreign companies in the scope of consolidation; (v) integration of deferred tax payables/receivables. The general pre-consolidation rule is that subsidiaries need to adapt their financial statements to the parent's.

Regarding the standardisation of form and content of statement templates, international accounting standards do not impose rigid templates for the balance sheet or the income statement, but do indicate their minimum compulsory content (IAS 1, §42-126). It has to be underlined that, in opposition to the individual balance sheet, the consolidated balance sheet includes particular entries originating from the consolidation process (i.e. "translation reserve", "share of equity pertaining to third parties"). Furthermore, in opposition to the annual income statement, the consolidated income statement shows separate entries for the profit (or loss) "pertaining to third parties" and "pertaining to the group".

As prescribed by IFRS 10, financial statements to be consolidated need to refer to the same closing date within the group, and the rule applies to the parent as well as its subsidiaries. If the closing date of a subsidiary differs from the parent's, the former shall be required to provide further financial information up to the date of the parent's financial statements for consolidation purposes (IFRS 10, § B92). Should this operation not be possible, the parent shall consolidate the financial information of the subsidiary using its most recent financial statements, duly adjusted to account for the effect of any important operations occurring

between the closing date of said financial statements and the closing date of the consolidated financial statements. In any event, the date difference between the subsidiary's financial statements and the consolidated financial statements cannot be over three months and such difference must be kept constant over time (IFRS 10, § B93).

Another aspect worth highlighting concerns the standardisation of the accounting principles to be adopted. Indeed, if an entity included in the scope of consolidation adopts different principles from the ones used in the consolidated financial statements, adjustments to the financial statements of such entity shall have to be made while preparing the consolidated financial statements in order to guarantee uniformity with the accounting principles adopted by the group (IFRS 10, § B87).

Finally, on the topic of the currency used, it appears sufficient to underline that all values in the consolidated financial statements need to be expressed in the currency used for the financial statements themselves. Multiple currency issues are common for international groups (namely those including in the scope of consolidation foreign entities preparing their annual financial statements with a different currency than the parent's). To resolve such issues, financial statements adopting different currencies than the parent's shall have to be translated for purposes of conformity[15].

Aggregation of standardised financial statements: once the financial statements of companies in the scope of consolidation have been standardised, they need to be aggregated. Such aggregation will result in 'aggregated' financial statements, in which the value of each item equals the sum of the values for such item in the individual financial statements of each company[16]. Standardised financial statements are copied on a worksheet in the first columns and the aggregated financial statements are obtained with the line-by-line sum of the values in the column for each company within the scope of consolidation. The new column obtained through this process becomes the new starting point for the consolidation adjustments. During the aggregation phase, all financial statements of the companies in the scope of consolidation are fully included. This approach is coherent with the adoption of the full consolidation method[17] which is *de facto* the method to be used for subsidiaries.

[15] For further information on translation methods refer to International Accounting Standard No. 21 (IAS 21).

[16] The aggregation of standardised financial statements is therefore the algebraic sum of the account balance of each item in the balance sheet and income statement of all companies within the scope of full consolidation, independently of their shareholdings (but duly integrated and adjusted during the pre-consolidation described above).

[17] See section 2.5.

Consolidation adjustments are then marked in the columns after the aggregated financial statements (the consolidated financial statements will be obtained with the algebraic sum of the values of each line, starting from the aggregated financial statements until the last column of consolidation adjustments).

The consolidation operations (or consolidation adjustments) are the operations performed to move from the aggregated financial statements to the full consolidated financial statements. The main consolidation adjustments are: (i) offsetting of shareholdings from the parent's financial statements against the equity of subsidiaries; (ii) elimination of intercompany assets and liabilities; (iii) elimination of intercompany income, expenditures, profit and loss net of any deferred taxation; (iv) elimination of intercompany dividends (IFRS 10, B86); (v) determination of the group's profit/loss pertaining to third parties (in case of minority interest); (vi) estimate of non-consolidated interests compliant with the law as well as the accounting principles adopted.

The preparation of consolidated financial statements, finally, consists of the algebraic sum of the account balance for each item of the balance sheet and income statement as integrated and adjusted by means of the single consolidation operations mentioned above.

Appendix - Adoption of IFRS 10: theoretical aspects

The adoption of IFRS 10, as said in paragraph 2.4, implies the need to reconsider the assessments made in accordance with IAS 27/SIC-12, especially with reference to the following aspects: **(a)** *de facto* control; **(b)** potential voting rights; **(c)** Special Purpose Entities (SPE); **(d)** agency relationships; **(e)** different investors that have rights to direct different relevant activities.

In this appendix, all of these aspects will be analysed by providing examples of practical applications. By so doing, it is possible to highlight the different treatment they have under IAS 27/SIC-12 and IFRS 10.

a) *De facto* control

An investor might have control over an investee even when it has less than a majority of the voting rights of that investee[18]. This concept, known as "*de facto* control", has led to controversy under IAS 27, since this standard makes no direct reference to this type of control, neither provides an application guidance on how to assess control when no single investor holds more than 50% of the voting rights of the investee. By consequence, many commentators took the view that IAS 27 is based more on a legal approach than on an economic one, (even if the IASB has publicly stated that, in its view, IAS 27 also contemplates effective control). Furthermore, this has sometimes led to different accounting outcomes for similar or identical fact patterns.

On the other side, IFRS 10 includes explicit guidance on "*de facto* control", pointing out that minority voting rights are sometimes sufficient to confer control, as control depends on a reporting entity's practical ability to direct the relevant activities of an investee unilaterally.

This should reduce diversity in practice.

SCENARIO	IAS 27	IFRS 10
An investor holds 46% of the equity (and related voting rights) of an	Under a legal control interpretation, the investor does	Under IFRS 10, given the level of shareholders participation and

[18] An investor with less than a majority of voting rights can also gain power through: contractual arrangements with other vote holders, rights arising from other contractual arrangements, ownership of the largest block of voting rights in situation where the remaining rights are widely dispersed, potential voting rights, a combination of the previous.

investee. The remaining 54% of the equity and voting rights are owned by numerous of other shareholders, none of whom own more than 1% individually. None of the shareholders has arrangements to consult any of the others or make collective decisions. Moreover, past experience indicated that few of the others owners actually exercise their voting rights at all.	not control the investee because more than half of the voting rights is required to confer control. In these circumstances, if the investor consolidated the investee, it would be required to make disclosures about the nature of its relationship with the investee.	considering the size and dispersion of shareholdings, the investor control the investee; its voting rights are sufficient to provide it the practical ability to direct the relevant activities of the investee unilaterally, it has exposure to variable returns and the ability to affects those returns thorough its voting rights.

b) Potential voting rights

When assessing whether it has power over an investee, an investor also considers the potential voting rights that it holds, as well as potential voting rights held by others. While IAS 27 makes clear that potential voting rights have to be «*currently exercisable*» and that management's intention is not considered, IFRS 10 is silent about it, but clarifies that a potential voting right is considered, in control assessment, only if it is substantive.
This will require considerably more judgment than under IAS 27, and could change the control conclusion in some cases: currently exercisable potential voting rights might not be considered substantive, and *vice versa.*

SCENARIO	IAS 27	IFRS 10
Investor A holds 40% of the voting rights of Investee B as well as an option to acquire another 20% of the voting rights from Investor C, who holds 30% of the voting rights. Investor A's option has been acquired recently and it is exercisable in 30 days' time and then at any time in the following 12 months.	In accordance with a "literal" interpretation of IAS 27, the potential voting rights should not be included in the assessment of control because they are not currently exercisable at the reporting date. As a result, Investor A should not consolidate Investee B because it holds only 40% of the voting rights of Investee B	Under IFRS 10, Investor A should consider if the exercise price provides a deterrent or a barrier. For this purpose, Investor A should take into account, first of all, if a 20% premium is reasonable in the context of expected synergy benefits and a typical control premium and, secondly, if the premium is a substantial disincentive at present.

The exercise price is based on a formula that is designed to approximate fair value of the underlying shares at each exercise date.	at the reporting date.	In circumstances such as those of the example, Investor A has an economic incentive to exercise since the potential voting rights are not out-of-the-money (the fee is not a barrier to exercise and exercising would be beneficial to Investor A) and, consequently, it should be considered as "holder" of an influence's power.

c) SPE

IAS 27 and SIC-12 provided two different consolidation models: "*risk and rewards*" for Special Purpose Entities (SPEs) and the "*power to govern the financial and operating policies*" for all other entities.

More in detail, SIC-12 provided a control model including four indicators of control of a SPE, but the interpretation did not provide any guidance about the weighting of this indicators. By consequence, different reporting entities made different judgments in similar fact patterns about how to apply those indicators.

IFRS 10 provides a single consolidation model based on control, regardless the nature of the investee: according to the new standard, the exposure to risk and rewards is only an indicator and is not determinative on its own.

IFRS 10 also provides an application guidance on how the requirements are applied in many situations, including the assessment of control of investees previously within the scope of SIC-12.

SCENARIO	IAS 27	IFRS 10
Investor A transfers receivables to Investee B, which is an entity created just for purchasing and servicing those receivables. Investee B fully funds the acquisition of the receivables by	The assessment of control under SIC-12 would have focused principally on whether Investor A retained a majority of the risks and rewards of Investee B.	In accordance with IFRS 10, Investor A would conclude that it has power over Investee B because it has the ability to manage the receivables upon default (this is the only relevant

issuing two different tranches of debt: the first one (85% of the debt) to the market and the second one (15% of the debt) to Investor A. In this context, Investor A retains the customer relationships and is responsible for managing those receivables in the event of default. A third-party servicer collects the cash flows from the receivables and passes them to the investors.	If investor A it is exposed to a majority of the risks and rewards of Investee B by virtue of the tranche that it holds, A would have consolidated B. If A consolidated B, it would be required to make disclosures about the nature of its relationship with B.	activity that significantly affect Investee B's returns). Investor A would also have exposure to variable returns from Investee B because of the holding of its tranche of debt and its ability to use its power to affect those returns. Thus, A would conclude that it controls B and should consolidate it irrespective of whether it is exposed to the majority of risks and rewards of B.

d) Agency relationships

Neither IAS 27 nor SIC-12 contained specific guidance about situations in which power is delegated to an agent, therefore it was quite difficult to evaluate such agency relationships within the context of assessing control.

On the other side, IFRS 10 provides several indicators to analyze whether a decision-maker acts as a principal or as an agent when directing the activities of an investee.

Moreover, the new standard requires an investor to consider its relationship with other parties and whether they might be acting on the investor's behalf, using its judgement to assess the nature of the relationship and how it operates in practice. Such parties are known as "*de facto* agents". When the asset manager (or those that direct the manager's activities) has the ability to direct another party, it should consider the decision-making rights and exposure to returns of its de facto agent along with its own when assessing control.

Entities in the funds sector, as well as asset managers, are likely to be particularly impacted by this guidance.

SCENARIO	IAS 27	IFRS 10
Fund Manager A has a 43% shareholding in Fund B, which it also manages within defined parameters. The constitution of the fund defines the fund's purpose, the	In this context there were differing views on whether this relationship would be within the scope of IAS 27 or SIC-12. Under IAS 27 Fund Manager A should consolidate Fund B because it had the power to govern the operating and	According to IFRS 10, Fund Manager A controls Fund B because it has the power to direct Fund B's relevant activities through directing the investment decisions, has

investment parameters within which the fund manager can invest and, lastly, requires Fund Manager A to act in the best interests of the shareholders. Within the defined parameters, however, the investment manager A has discretion about the assets in which Fund B will invest.	financing activities of Fund B so as to obtain benefits from those activities. Moreover, if A consolidated B, it would be required to make disclosures about the nature of its relationship with B (because it consolidated B without a majority of voting rights). Under SIC-12 Fund Manager A would not consolidate Fund B because it was not exposed to the majority of the risks and rewards arising from Fund B.	exposure to variable returns from Fund B, and can use its power to affect the amount of its returns.

e) Different investors that have rights to direct different relevant activities

Assessing relevant activities could be a critical process when an investor has the current ability to direct only some of an investee's activities and, consequently, decisions about other activities are taken by other parties. But when two (or more) investors have rights to direct different relevant activities, who has the power? In accordance with IFRS 10 it's required to identify the activities that most significantly affect the returns because is the investor with current ability to direct those activities who has power.

3. JOINT CONTROL: WHAT'S NEW UNDER IFRS 11 *JOINT ARRANGEMENTS*?

3.1 Overview

In May 2011, as mentioned at the beginning of this research, the IASB issued three standards which are effective for annual periods beginning on or after 1 January 2013: **(i)** IFRS 10 *Consolidated Financial Statements*, **(ii)** IFRS 11 *Joint Arrangements* and **(iii)** IFRS 12 *Disclosure of Interests in Other Entities* (Figure n. 6 illustrates the interaction between IFRS 10, IFRS 11, IFRS 12 and IAS 28 *Investments in Associates and Joint Ventures*). The European Union (Regulation No. 1254/2012) endorsed these standards and it has established that each company shall apply them, at the latest, as from the commencement date of its first financial year starting on or after 1 January 2014.

In this chapter the attention is focused on the new requirements established by IFRS 11. This new standard supersedes IAS 31 *Interests in Joint Ventures* and SIC-13 *Jointly Controlled Entities – Non-Monetary Contributions by Venturers*, in order to arrive at an accounting treatment which accurately reflects the true nature of the economic interest held by parties to a joint arrangement.

IFRS 11 applies to all entities that are parties to a joint arrangement (including venture capital organizations[19], mutual funds and similar entities). The scope of this standard was intended to be generally the same as IAS 31, in that it still describes the requirements for arrangements only where there is joint control. However, since the definition IFRS 11's concept of joint control refers to IFRS 10's definition of control (which is broader than the notion of control under IAS 27), there may be more arrangements that qualify as joint arrangements under IFRS 11.

All of the disclosure requirements for joint arrangements are included in IFRS 12. In particular, IFRS 12 requires disclosure of judgments made to determine whether an entity has joint control over another entity and the judgments made to classify joint arrangements. By issuing IFRS 11, the IASB introduced an overhaul of the existing accounting for joint arrangements, then management should carefully evaluate the new requirements (as they may have a significant impact on how an entity can present its income statement and balance sheet).

[19] However, venture capital organizations can chose to measure investments in joint ventures at fair value under IAS 28. To utilise the exemption, the venture capital organization elects to measure the investment in a joint venture at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments*.

This chapter aims to analyse the new criteria established under IFRS 11 and to highlight what are, at this stage, the main "critical points" that companies are facing by applying the new standard.

Joint arrangements are an important tool for business expansion and collaboration. In fact, in order to achieve economic goals, joint ventures have gained international importance in recent years (Stockinger et al., 2014). There are many reasons why entities might use a joint arrangement to conduct business, such as to: (i) enter into new technologies or markets (often necessary when entering markets with restrictions on foreign ownership); (ii) benefit from economies of scale in either joint research or production efforts; (iii) share, and consequently reduce, the costs and risks of efforts beyond the feasibility of the company; (iv) access resources and knowledge beyond the company's capabilities (Betancourt, 2013).

The accounting for interests in joint ventures and alliances, when they are governed by joint control, was formerly covered by IAS 31. The accounting driver of that standard was the structure of the arrangements and, when those were structured in an entity, IAS 31 allowed preparers with an interest in a joint controlled entity to have an accounting option (equity method vs proportionate consolidation).

In order to remedy this difference the IASB introduced IFRS 11. This new standard establishes the new framework for the accounting for joint arrangements and states that parties recognise their rights and obligations relating to the arrangements. By so doing, as mentioned during the introduction of the research, this new framework basically aims to capture the economic substance of the arrangements and enhance comparability of financial statements.

The innovations established under IFRS 11 mainly regard two aspects: **(i)** the classification (and the accounting requirements) now focus on rights and obligations of the parties as criteria for demarcation between joint operations and joint ventures; **(ii)** the accounting option for joint ventures has been eliminated; therefore, all joint ventures have to be recorded in the consolidated financial statements using the equity method (IFRS 11.24).

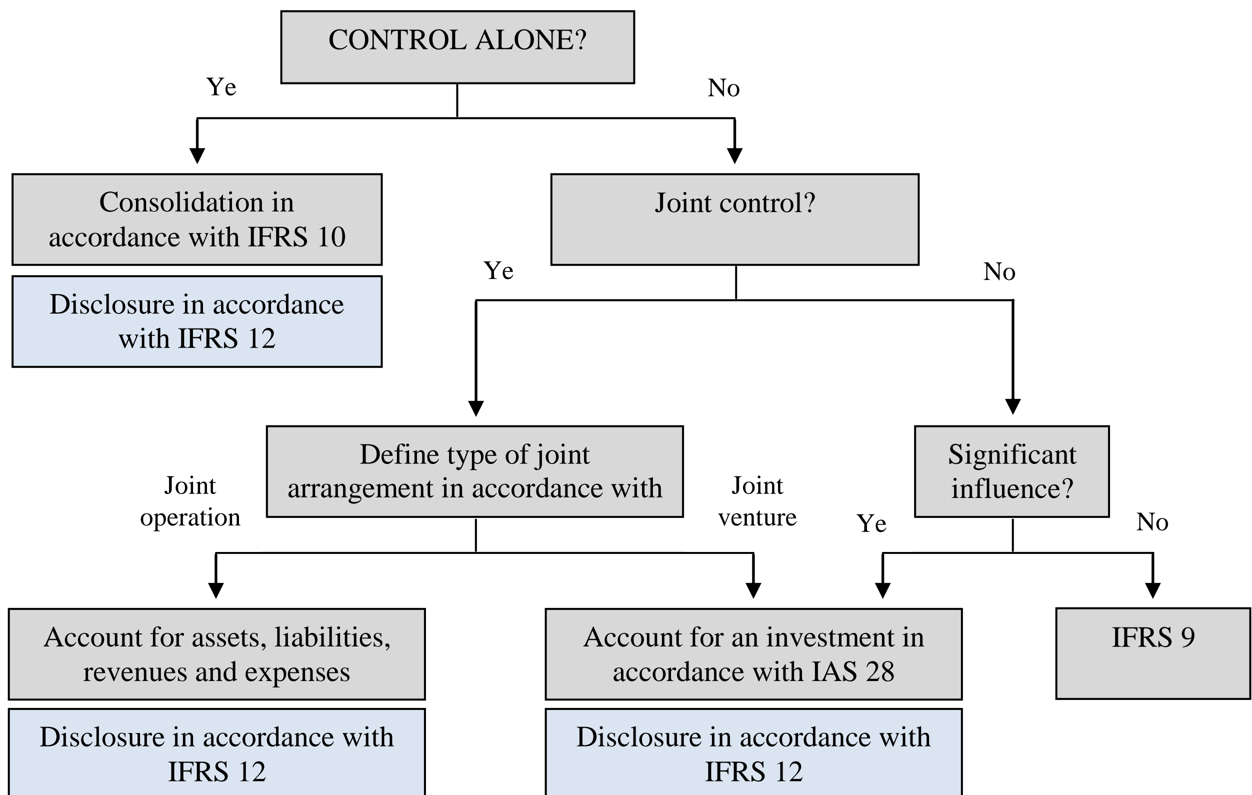
The need to investigate the potential impact of IFRS 11 on consolidated financial statements, as said at the beginning of this thesis, raises the following research questions:

- why did the IASB introduce IFRS 11?
- what are the main differences between the accounting requirements for joint arrangements under IAS 31 and those established under IFRS 11?

- what are the potential effects upon the financial statements of those preparers that are affected by the changes?

In this regard, the aim of this chapter is to analyse, from a theoretical point of view and trough a non-systematic literature review of the topic, the main changes introduced by IFRS 11 in order to highlight the main implications and the potential business impact that may arise from its application[20]. To this end, the chapter is basically divided into three parts: the first one is focused on an overview which highlights the reasons in issuing IFRS 11 and the weaknesses of IAS 31; the second one provides several definitions in order to understand the new meaning of joint arrangements in accordance with IFRS 11 and it also explains the new accounting requirements for joint operations and joint ventures; lastly, the main implications that may arise from this new standard (including its business impact) are illustrated.

Figure n. 6: Interaction between IFRSs 10 - 11 - 12 and IAS 28



Source: IASB, 2011

[20] For what concern the empirical evidences of the IFRS 11 application, they will be provided in the following chapter through a case study.

3.2 Literature review

Not many academic contributions have focused on the International Accounting Standards issued by IASB (IAS 31 and IFRS 11). In particular, some of these papers have analysed, mainly from a theoretical/qualitative point of view, the scope and the new accounting treatments for joint arrangements underlying IFRS 11 (Mazzeo and De Gennaro, 2012; Vergani, 2011).

Moreover some authors, from a theoretical and practical point of view, have analysed the new standard (including the reasons that has led to the transition from IAS 31 to IFRS 11). They highlighted the new features of joint arrangements under IFRS 11, also providing some examples of practical applications with reference to the representation of joint arrangements in financial statements (Quagli, 2011; Mazzeo and De Gennaro, 2011).

In this context, it has been found out just a paper which provides an empirical study with reference to the impact of IFRS 11 on European companies. In particular, this paper examines how the transition from the proportionate consolidation method to the equity method (for the accounting of joint ventures) will affect financial statement figures and key financial ratios of these European companies (Stockinger et al., 2014).

Lastly, important points of reference are, of course, the standards issued by the IASB (IAS 31; IFRS 11) and several practical guides focused on the business impact of IFRS 11 (Deloitte, 2011; E&Y, 2011; E&Y, 2014; IASB, 2011; PwC, 2011).

3.3 The weaknesses of IAS 31 and the improvements of IFRS 11

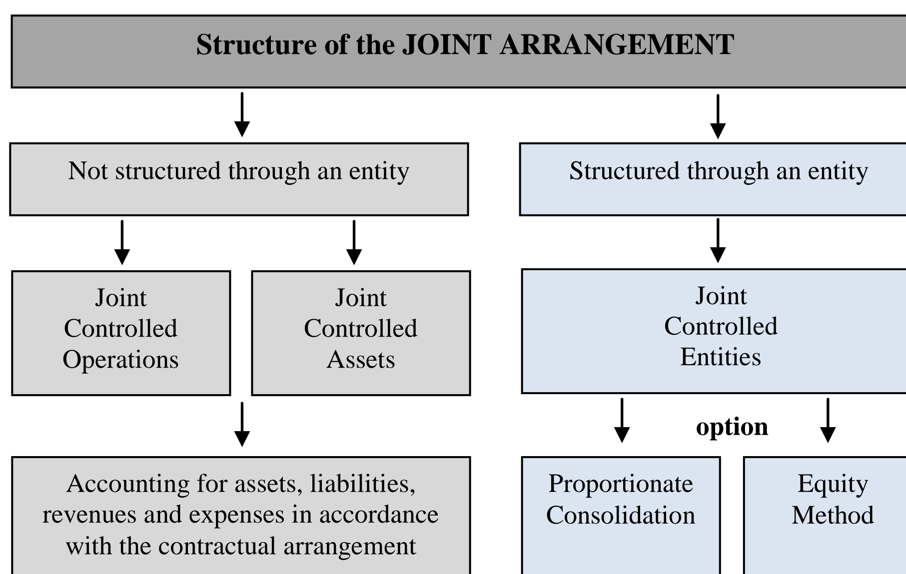
IFRS 11, as mentioned above, was issued by the IASB in May 2011. This new standard (which replaces the previously guidance provided by IAS 31 and SIC-13) establishes principles for the financial reporting by parties to a joint arrangement.

When the IASB undertook the project of reviewing IAS 31, it was concerned with remedying two aspects (or “weaknesses”) of IAS 31 that were considered impediments to high quality reporting of joint arrangement: **(i)** the structure of the arrangement was the only driver for the accounting; **(ii)** the accounting option for jointly controlled entities.

With reference to the first aspect, the accounting requirements in IAS 31 may not have always reflected the rights and obligations of the parties arising from the arrangement in which they were involved. These issues are solved by IFRS 11 because the identification, classification criteria and accounting requirements now focus on rights and obligations of the joint arrangement in which the parties are involved.

Moreover, with reference to the second point, IAS 31 gave a choice to apply either proportionate consolidation or the equity method for the accounting of jointly controlled entities. With the goal to reduce differences between IFRS and US-GAAP (United States-Generally Accepted Accounting Principles) and to improve the comparability of IFRS reports, the IASB eliminated the accounting option for joint ventures in IFRS 11 (which means that the proportionate consolidation method for joint ventures is now prohibited).
To bring to an end, we could say that the structure of the arrangement (which was the only driver for the accounting) and the existence of an accounting option for jointly controlled entities in IAS 31 resulted in inconsistencies in the accounting provided by IAS 31.

Figure n. 7: The weaknesses of IAS 31



Source: personal adaptation from IASB, 2011

IFRS 11 is an improvement of IAS 31 because it establishes a clear principle which is applicable to the accounting for all joint arrangements. In fact, in accordance with IFRS 11, a party to a joint arrangement recognises its rights and obligations arising from the arrangement (IFRS 11.IN5). By virtue of the application of this principle, IFRS 11 tries to achieve the following goals (IASB, 2011):

- enhances verifiability and understandability because the accounting reflects more faithfully the economic phenomena that it purports to represent (i.e. a party's rights and obligations arising from the arrangements);
- enhances consistency because it provides the same accounting outcome for each type of joint arrangement; and

- increases comparability among financial statements because it will enable users to identify and understand similarities in, and differences between, similar arrangements.

3.4 Joint arrangements

A joint arrangement is an agreement where two, or more parties, have joint control. A joint arrangement as the following characteristics: **(i)** the parties are bound by a contractual arrangement; **(ii)** the contractual arrangement gives two or more of those parties joint control of the arrangement (IFRS 11.5).

Some agreements may be referred to as joint arrangements, but are actually arrangements whereby one party has control of an entity. In these arrangements, the entity with control would consolidate it and the other parties would account for their interest in that entity based on the nature of their investment. On the other side, other arrangements may not be referred to as joint arrangements, but may qualify as joint arrangements, as defined by IFRS 11. In other words, the name of the agreement is not important, it only matters whether it meets the definition of a joint arrangement as established by IFRS 11.

The contractual arrangement sets out the terms upon which the parties participate in the arrangement. It generally specifies the following:

- purpose, activity and duration of the joint arrangement;
- appointment of members of the board of directors (or equivalent governing body);
- decision-making processes:
    - matters requiring decisions from the parties
    - voting rights of the parties
    - required level of agreement for those matters;
- capital or other contribution requirements;
- sharing of assets, liabilities, revenues, expenses or profit or loss relating to the joint arrangement.

Understanding the terms of the contractual arrangement is imperative for evaluating whether joint control exists, and if so, the type of joint arrangement.

The contractual arrangement is usually established in writing in the form of a contract between the parties; it can also take the form of a documented discussion, although this is unusual. Joint control can also be established through local legislation, other statutory

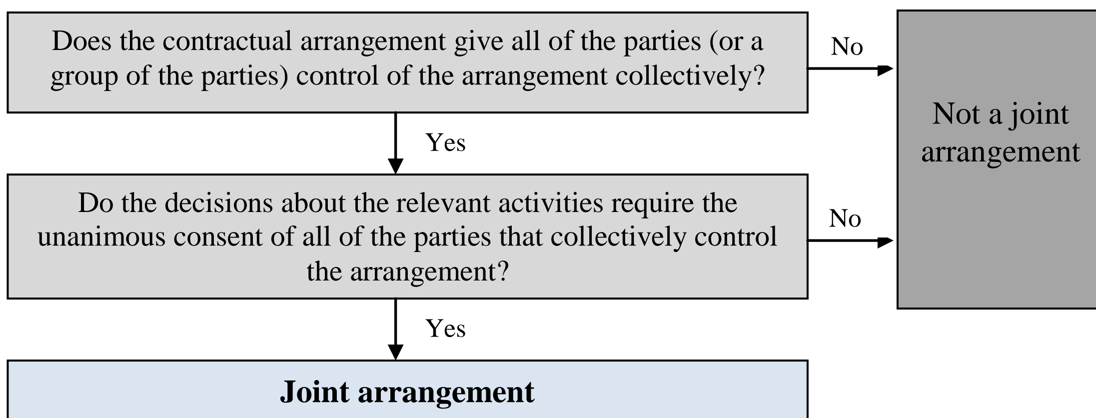
mechanisms or as part of the governing rules of the entity, either individually or in conjunction with other contractual agreements between the parties.
Furthermore, in order to determine the appropriate classification of an arrangement, there is a pre-requisite question of what level of granularity (or aggregation) is the appropriate level at which to perform this analysis. IFRS 11 indicates that joint arrangements should be analysed at the level of the activity that the parties have agreed to control jointly. Applying this concept of “activity” may be simple enough in many instances (for example when the joint arrangement undertakes a single activity that is carried out fully with a single vehicle). However, in some cases, the determination of the unit of account may be less clear-cut.
The standard does not provide a definition of what is considered an activity. In cases where multiple vehicles and/or multiple activities within a single vehicle may be involved, the determination of the appropriate level at which to perform the analysis may be more complex (Deloitte, 2011).

3.5 Joint control

Since the crucial element of having a joint arrangement is joint control, it is important to understand this term. Joint control is defined as the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities (activities that significantly affect the returns of the arrangement) require the unanimous consent of the parties sharing control (IFRS 11.IN6). A party to an arrangement shall assess whether the contractual arrangement gives all the parties, or a group of the parties, control of the arrangement collectively. All the parties, or a group of the parties, control the arrangement collectively when they must act together to direct the relevant activities (IFRS 11.8).
Moreover, in accordance with IFRS 11, it is important to note that an arrangement can be a joint arrangement even though not all of its parties have joint control of the arrangement because this standard distinguishes between parties that have joint control of a joint arrangement and parties that participate in, but do not have joint control of, a joint arrangement. This means that, in order to have a joint arrangement, it is necessary that just two, of all the participants to an agreement, share joint control. At the same time, if one party can control unilaterally the relevant activities of the arrangement, then that agreement would not be a joint arrangement (in a joint arrangement, no single party controls the arrangement on its own).
Therefore, the key aspects of joint control are:

- contractually agreed;
- control and relevant activities: IFRS 10 describes how to assess whether a party has control, and how to identify the relevant activities. In general, relevant activities are defined as those activities that affect significantly the return of an arrangement. Examples of these activities are: selling and purchasing of goods and services; selecting, acquiring or disposing of assets; managing financial assets during their life; researching and developing new products or processes and determining a funding structure or obtaining funding. Even though the term "relevant activities" may be broadly interpreted, it is well understood that it can be aligned to the concept of "financial and operational decisions" of a joint arrangement of IAS 31. More details about these aspects, will be provided in paragraph 3.5.1;
- unanimous consent: unanimous consent means that any party (with joint control) can prevent any of the other parties, or a group of the parties, from making unilateral decisions about the relevant activities without its consent (more details will be provided in paragraph 3.5.2).

Figure n. 8: How to evaluate if joint control exists



Source: E&Y, 2011

Having said that, management should accurately re-examine joint arrangements and re-consider whether they have joint control, control or neither of these. In fact, the change in definition of "joint arrangement" and of "control" may include or exclude different arrangements compared to the past.

3.5.1 Relevant activities in a joint arrangement

To determine whether a contractual arrangement gives parties control of an arrangement collectively, it is necessary first to identify the relevant activities of that arrangement. In other words, it is necessary to identify what are the activities that significantly affect the returns of the arrangement.

When identifying the relevant activities, consideration should be given to the purpose and design of the arrangement. In particular, consideration should be given to the risks to which the joint arrangement was designed to be exposed, the risks the joint arrangement was designed to pass on to the parties involved with the joint arrangement, and whether the parties are exposed to some or all of those risks.

In many cases, directing the strategic operating and financial policies of the arrangement will be the activity that most significantly affects returns. Often, the arrangement requires the parties to agree on both of these policies. However, in some cases, unanimous consent may be required to direct the operating policies, but not the financial policies (or vice versa). In such cases, since the activities are directed by different parties, the parties would need to assess which of those two activities (operating or financing) most significantly affects returns, and whether there is joint control over that activity.

After identifying the relevant activities of an arrangement, it is necessary to determine what rights give a party the ability to direct the relevant activities. This is because, to have joint control, the parties must have collective control. To have control, the parties must collectively have power over the relevant activities.

In many cases, the relevant activities are directed by voting rights that are held in proportion to ownership interests. However, this is not always the case, and attention should be paid to the facts and circumstances in each case.

Moreover, when assessing whether a group of the parties collectively control an arrangement (and therefore whether there is joint control), consideration must be given to whether rights held by any of the parties are:

- protective (in which case, the other parties might collectively control the arrangement);
- substantive (in which case, such rights could prevent the other parties from having joint control, or possibly give the holder of those rights control).

As said in paragraph 2.4.2, protective rights are defined in IFRS 10. They are rights designed to protect the interest of the party holding those rights without giving that party

power over the entity to which those rights relate. Protective rights basically relate to fundamental changes to the activities of the arrangement, or apply in exceptional circumstances. Since power is an essential element of control, protective rights do not give a party control over the arrangement (then, holding protective rights cannot prevent another party from having power over an arrangement).

In this context, other aspects to take into account regard the potential voting rights. IFRS 11 does not explicitly address how potential voting rights are treated when assessing whether there is joint control. However, since the definition of joint control in IFRS 11 is based on the definition of control in IFRS 10, the requirements of IFRS 10 must be considered if potential voting rights exist. In particular, understanding the purpose and design of the potential voting right (including the context in which it was issued or granted) is essential when evaluating whether the potential voting rights are substantive and, if so, whether joint control exists.

Lastly, it is important to note that in some cases (as discussed in paragraph 2.4.2) it may be difficult to determine whether a party's right give it power over an arrangement. In such cases, the party considers other evidence that it has the current ability to direct the relevant activities. This evidence is also considered when evaluating if the parties to an arrangement control that arrangement collectively (E&Y, 2014).

3.5.1.1 Delegated decision-making, related parties and de facto agents

In some cases, one party may be appointed as manager of the arrangement (this commonly occurs, for example, in the extractive and real estate industries) and the other parties to the arrangement may delegate some of the decision-making rights to this manager.

Under IFRS 11, consideration is given to whether the manager controls the arrangement. When decision-making rights have been delegated, IFRS 10 describes how to assess whether the decision-maker is acting as a principal or an agent, and therefore, which party (if any) has control. Careful consideration of the following will be required: (i) scope of the manager's decision-making authority; (ii) rights held by others (e.g., protective rights); (iii) exposure to variability in returns through the remuneration of the manager; (iv) variable returns held through other interests (e.g., direct investments by the manager in the joint arrangement).

Moreover, IFRS 10 notes that, in some cases, one party may act as a de facto agent for another party (IFRS 10. B73); in this context, de facto agents may include related parties (as defined in IAS 24 Related Party Disclosures).

Since the concepts of IFRS 10 extend to IFRS 11, consideration must be given to whether control or joint control exists, when one party is a de facto agent of another. In this regard, determining whether one party is a de facto agent of the other requires careful evaluation of the facts and circumstances.

3.5.2 Unanimous consent

IFRS 11 states that decisions about the relevant activities require the unanimous consent of all the parties, or a group of the parties, that collectively control the arrangement. Accordingly, it is not necessary for every party to the arrangement to agree to have unanimous consent; to have unanimous consent, only those parties that collectively control the arrangement must agree.
The requirement to have unanimous consent ensures that no single party controls the arrangement. IFRS 11 clarifies when unanimous consent exists: for example, in some cases, a contractual arrangement may require a minimum proportion of the voting rights to make decisions about the relevant activities. When that minimum can be achieved by more than one combination of the parties agreeing, the arrangement is not a joint arrangement unless it specifies which parties (or combination of parties) are required to agree unanimously to decisions about the relevant activities of the arrangement (IFRS11.B8). IFRS 11 provides some examples to illustrate this point, which are summarised in Table n. 1.

Table n. 1: Unanimous consent and joint control

	Scenario 1	Scenario 2
Requirement	75% vote to direct relevant activities.	75% vote to direct relevant activities.
Party A	50%	50%
Party B	30%	25%
Party C	20%	25%

Conclusion	Joint control: A and B collectively control the arrangement (since their votes, and only their votes, together meet the requirement). Because they are the only combination of parties that collectively control the arrangement, it is clear that A and B must unanimously agree.	No joint control: multiple combinations of parties could collectively control the arrangement (i.e., A and B or A and C could vote together to meet the requirement). Since there are multiple combinations, and the contractual agreement does not specify which parties must agree, there is no unanimous consent.

Source: E&Y, 2014

Sometimes an arrangement is structured so that all parties have a vote, but in the case of a tie (or disagreement) one party has the deciding vote. If any single party could direct the relevant activities unilaterally, there would not be joint control. For example, consider the following situation: A and B enter into an agreement and set up a joint steering committee. One party has ultimate decision-making authority in cases where the joint steering committee cannot reach an agreement. In this case, there would not be joint control, since the agreement of the other party is not needed.

Furthermore, to evaluate whether the party with the deciding vote has control, one would also need to assess whether it has exposure to variable returns, and the ability to affect those returns through its power, as required by IFRS 10.

3.5.2.1 Implicit joint control

Joint control need not be explicitly stated in the terms of the contractual arrangement to exist. In other words, joint control can exist implicitly (depending on the contractual terms of the arrangement) and whether the terms of the arrangement explicitly (or implicitly) require unanimous consent of the parties.

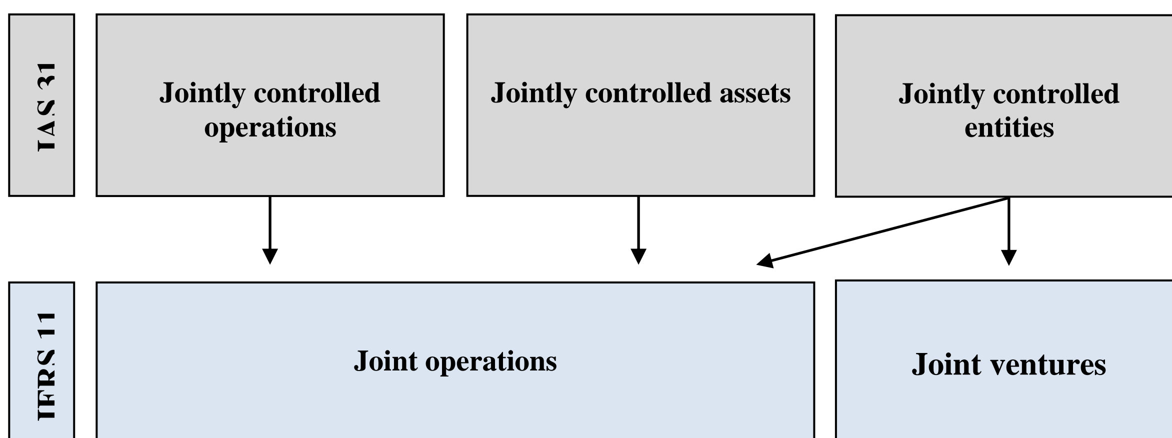
For example, assume that two parties establish an arrangement in which each has 50 % of the voting rights and the contractual arrangement between them specifies that at least 51 % of the voting rights are required to make decisions about the relevant activities. In this case, the parties have implicitly agreed that they have joint control of the arrangement because decisions about the relevant activities cannot be made without both parties agreeing (IFRS 11.B7).

In the situation described above, it is implicit in the arrangement that the two parties must agree. This is because in order for there to be majority agreement, both parties would need to agree, since they each have 50%. Then, this example demonstrates that it is possible to have implicit unanimous consent to have joint control.
In any event, determining whether joint control exists implicitly depends on a careful evaluation of the contractual terms of the arrangement. It is possible that two parties have equal ownership interests, but the relevant activities are directed by one party according to the contractual arrangement between them. In this case, the party that has the contractual right to direct the relevant activities would have control (joint control would not exist).

3.6 Types of joint arrangement

IFRS 11 introduces only two types of joint arrangements, compared with IAS 31. These joint arrangements are: **(a) joint operations**; and **(b) joint ventures**.
Therefore, under IAS 31, joint ventures included jointly controlled entities, jointly controlled assets and jointly controlled operations, whereas under IFRS 11 a joint venture is only one type of joint arrangement. Jointly controlled assets and jointly controlled operations (as defined under IAS 31), are likely to qualify as joint operations under IFRS 11, but each arrangement will need to be assessed to confirm this presumption. On the other side, jointly controlled entities under IAS 31, may be joint operations or joint ventures under IFRS 11, depending on the rights and obligations of the parties to the joint arrangement.

Figure n. 9: From IAS 31 to IFRS 11



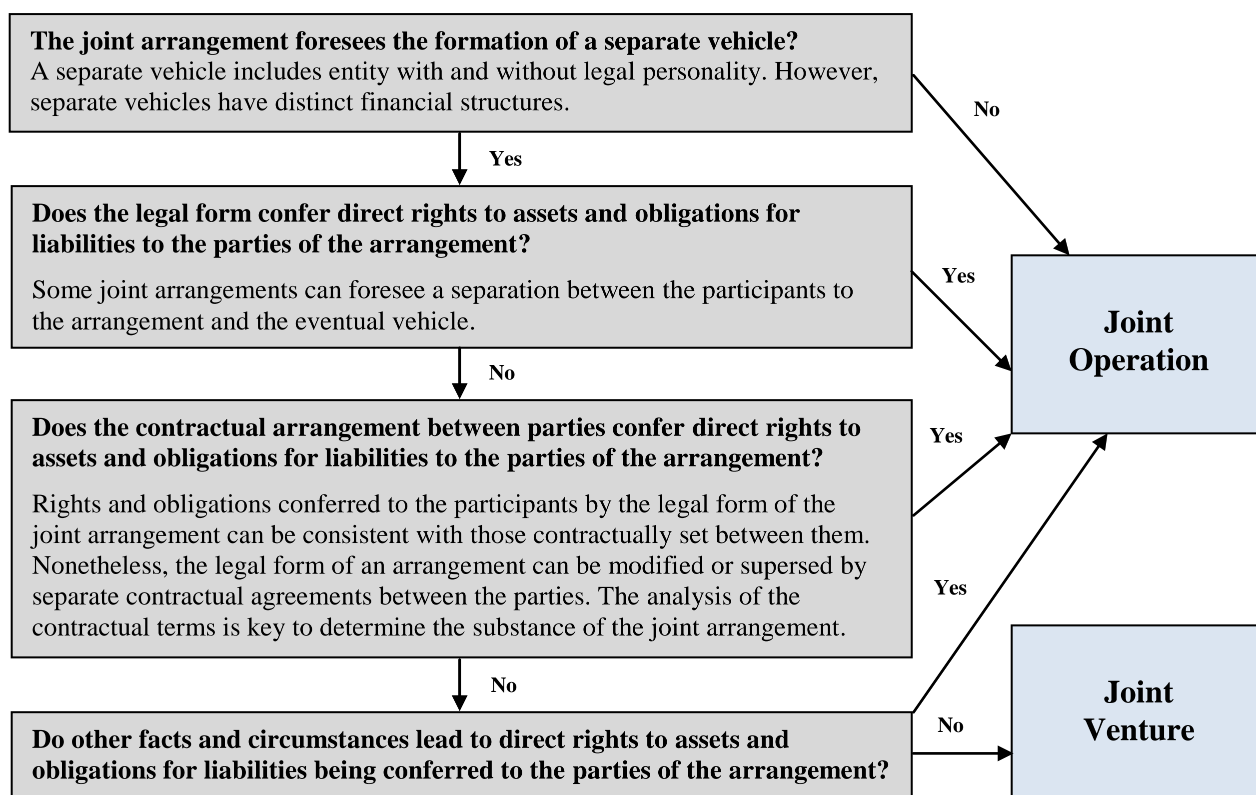
Source: personal adaptation from IASB, 2011

Joint operations are defined as joint arrangements whereby parties that have joint control of the arrangement have **rights to the assets and obligations for the liabilities relating to**

the arrangement [21] (IFRS 11.15). On the other hand, **Joint ventures** are joint arrangements whereby the parties that have joint control of the arrangement have **rights to the net assets of the arrangement**[22] (IFRS 11.16).

A key aspect of the assessment process of a joint arrangement is the determination of what type of arrangement the agreement represents or, in other words, if the arrangement can be configured as a joint operation or a joint venture. The result of this analysis will drive the accounting treatment. IFRS 11 clarifies that an entity shall determine the type of joint arrangement in which it is involved by considering its rights and obligations arising from the arrangement. In this regards, it should assess its rights and obligations by considering the structure and legal form of the arrangement, the terms agreed by the parties in the contractual arrangement and, when relevant, other facts and circumstances (IFRS 11.17).

Figure n. 10: Determining the type of joint arrangement



Source: personal elaboration

As it has shown in the figure above, when determining a joint arrangement as either a joint operation or a joint venture, the first step consists in assessing whether there is a separate

[21]E.g. each party has contractually an interest in individual assets and obligations for specific liabilities of the arrangement.

[22] E.g. the arrangement only gives rights to each party to a share of the net outcome generated by an economic activity.

vehicle[23]. If not, the joint arrangement is automatically a joint operation. However, if there is a separate vehicle, the following factors need to be considered.

a) Legal form of the separate vehicle

Once it is determined that a separate vehicle exists, the second step consists in analysing the legal form of such separate vehicle. This is a significant change from IAS 31, under which the accounting only depended on whether an entity existed. Under IFRS 11, the legal form of the separate vehicle must be assessed to determine whether it gives the parties rights to net assets, or rights to the assets and obligations for the liabilities of the arrangement. In other words, the matter is if the separate vehicle confers separation between the parties and the separate vehicle.

The impact of local laws should be carefully assessed when analysing the form of the separate vehicle. In many countries, for example, a corporation confers separation between the parties and the separate vehicle and also provides the parties with rights to net assets (which are indicators of being a joint venture). That is, the liabilities of the corporation are limited to the corporation and creditors do not have recourse to the investors in the corporation for those liabilities (however, this may not be true in all countries).

Similarly, partnerships that have unlimited liability (which are common in many countries) often do not confer separation between the parties and the separate vehicle. That is, they provide the partners with rights to the assets and obligations for the liabilities, indicating that the arrangement is a joint operation. When creditors of the partnership have direct recourse to the joint arrangement partners, the partners are the primary obligor, which is indicative of a joint operation. However, in a partnership where creditors only have recourse to the partners after the partnership has defaulted, there is separation between the partners and the vehicle. The liability of the partners as secondary obligor is akin to a guarantee (this would be an indicator of a joint venture).

b) Contractual terms and conditions

The next step in classifying a joint arrangement is to examine the contractual terms of the arrangement, to determine whether they provide the parties with rights to the net assets (a joint venture) or rights to the assets and obligations for the liabilities (a joint operation). This is because even if the legal form of the separate vehicle establishes rights for each of the parties, the contractual terms of the joint arrangement may unwind the effects of the

[23] Separate vehicle: a separately identifiable financial structure, including separate legal entities or entities recognised by statute, regardless of whether those entities have a legal personality.

legal form and give the parties rights to the assets and obligations for the liabilities. It is worth noting that this requirement is further evidence that, when classifying a joint arrangement, IFRS 11 focuses on the nature and substance of the rights and obligations of the joint arrangement, as compared with IAS 31 which just looked to the form of the arrangement.

IFRS 11 includes an example of how the contractual terms of the joint arrangement can modify the form of the separate vehicle (IFRS 11.Example 4). In this regard, assume that two parties (A and B) jointly establish a corporation (C) over which they have joint control. The fact that there is a separate vehicle, and the legal form of the separate vehicle (a corporation), indicates that C is a joint venture. However, the contractual arrangement states that A and B have rights to the assets of C and are obligated for the liabilities of C in a specified proportion. Effectively, this contractual term unwinds the effects of the legal form (corporation): C is therefore a joint operation.

IFRS 11 also includes examples of common contractual terms found in joint arrangements (IFRS 11.B27), and indicates whether these are examples of joint operations or joint ventures (see Table n. 2 below).

Table n. 2: Comparison of common features in contractual arrangements

	Joint operation	**Joint venture**
Terms of the contractual arrangement	The parties have rights to the assets and obligations for the liabilities relating to the arrangement.	The parties have rights to the net assets relating to the arrangement.
Rights to assets	The parties share all interests in the assets in a specified proportion.	The assets belong to the arrangement. The parties to the arrangement do not have direct rights, title or ownership of the assets.

Obligations for liabilities	The parties share all liabilities, obligations, costs and expenses in a specified proportion. The parties are liable for claims on the arrangement raised by third parties of the arrangement.	The joint arrangement is liable for the debts and obligations of the arrangement. The parties are liable to the arrangement only to the extent of their respective investments in the arrangement or their respective obligations to contribute any unpaid or additional capital to the arrangement, or both. Creditors of the arrangement do not have any right of recourse against the parties in respect of debts or obligations of the arrangement.
Revenues and expenses and profits or losses	The arrangement establishes an allocation of revenue and expenses based on relative performance of each party (for example, basis of capacity used by each party). This could differ from their ownership interest in the arrangement.	The arrangement establishes each party's share in the profit or loss of the arrangement.
Guarantees	The parties to joint arrangements are often required to provide guarantees to third parties that, for example, receive a service from, or provide financing to, the joint arrangement. The provision of such guarantees, or the commitment by the parties to provide them, does not, by itself, determine that the joint arrangement is a joint operation. The feature that determines whether the joint arrangement is a joint operation or a joint venture is whether the parties have obligations for the liabilities relating to the arrangement (for some of which the parties might or might not have provided a guarantee).	

Source: Personal adaptation from PwC, 2011

c) Other facts and circumstances

If the preliminary assessment of the legal form and the contractual terms of the joint arrangement indicate that a joint arrangement may be a joint venture, then the parties must consider any other facts and circumstances to determine whether the parties have rights to the assets and obligations for the liabilities, which would make it a joint operation.

When classifying a joint arrangement as either a joint operation or a joint venture, it is critical to understand the purpose and design of the joint arrangement. In this regard, it is essential to understand whether the joint arrangement: (i) primarily aims to provide the parties with an output (i.e., the parties have rights to substantially all of the economic benefits of the assets); (ii) depends on the parties on a continuous basis for settling its liabilities. If both of these aspects are characteristics of the joint arrangement, then it is a joint operation (in some cases, judgement will be needed to assess whether these criteria are met). Table n. 3 illustrates how these factors might be present in a joint arrangement.

Table n. 3: Other facts and circumstances

	Joint operation	Joint venture
Restrictions on selling output	Restricted from selling output to third parties	None; may be able to sell output to other parties
Requirements to purchase output	Parties (individually or collectively) must purchase substantially all of output produced	None; other parties might purchase output
Selling price of output to parties	At cost (or designed for joint arrangement to break even)	At market (or designed for joint arrangement to generate a profit)

Source: E&Y, 2014

In order to understand how the facts and circumstances might indicate that the joint arrangement is a joint operation (even if the legal form and contractual terms point towards the joint arrangement being a joint venture), consider the following example.

A and B jointly establish a corporation (C) over which they have joint control. The existence of a separate vehicle (which is in the legal form of a corporation) indicates that the assets and liabilities held in C are the assets and liabilities of C: therefore C is a joint

venture. No contractual terms indicate that A and B have rights to the assets, or obligations for the liabilities, so the arrangement still appears to be a joint venture.
However, the parties also consider the following aspects of the arrangement: (i) they agreed to purchase all the output produced by entity C in a ratio of 50:50; (ii) C cannot sell any of the output to third parties, unless A and B approve it. Because the purpose of the arrangement is to provide A and B with output they require, sales to third parties are not expected to occur; (iii) the price of the output sold to A and B is set by A and B at a level that is designed to cover the costs of production and administrative expenses incurred by C (the arrangement is intended to operate at a break-even level).
In view of all this, it is possible to note that: (i) the obligation of A and B to purchase all of the output produced by C reflects the exclusive dependence of C upon A and B for the generation of cash flows and, thus, implicitly that A and B have an obligation for the liabilities of C; (ii) the fact that A and B have rights to all of the output produced by C means that A and B are consuming, and therefore have rights to, all of the economic benefits of the assets of C. So, in conclusion, these facts and circumstances indicate that the arrangement is a joint operation.

3.7 Joint arrangement accounting

Whit reference to the accounting treatment of a joint arrangement, IFRS 11 distinguishes between the accounting treatment of joint operations and, on the other hand, the accounting treatment of joint ventures.

3.7.1 Accounting for joint operations

A joint operator, which is a party that has joint control in a joint operation, will need to recognise, in its <u>separate and consolidated financial statements</u>, the following in relation to its involvement in the joint operation (IFRS 11.20):

- its assets, including its share of any assets held jointly;
- its liabilities, including its share of any liabilities incurred jointly;
- its revenue from the sale of its share of the output arising from the joint operation;
- its share of revenue from the sale of the output by the joint operation; and
- its expenses, including its share of any expenses incurred jointly.

A joint operator shall account for the assets, liabilities, revenues and expenses relating to its interest in a joint operation in accordance with the IFRSs applicable to the particular assets, liabilities, revenues and expenses (IFRS 11.21).

Having said that, it is important to notice that there is sometimes confusion whether accounting for a joint operation is the same as proportionate consolidation (which an entity could use to account for jointly controlled entities in accordance with IAS 31). In this regard, for former jointly controlled entities that are classified as joint operations under IFRS 11, it may not be clear whether the adoption of IFRS 11 will affect the joint operator's financial statements.

When a joint operator has rights to a specified percentage of all assets and obligations for the same percentage of all liabilities, there would probably not be a difference between the accounting for a joint operation and proportionate consolidation in practice. On the other side, when the joint operator has different rights (and percentages) to various assets, and/or different obligations for various liabilities, the financial statements would look different when accounting for those individual rights and obligations, compared with proportionately consolidating a blended percentage of all assets and liabilities. In fact, a joint operator may have rights and obligations with respect to the assets, liabilities, revenues and expenses relating to a joint operation that might differ from its ownership interest in the joint operation. In such a case, the joint operator has to recognize assets, liabilities, revenues and expenses according to its shares in the assets, liabilities, revenues and expenses of the joint operation as determined and specified in the contractual arrangement, rather than basing this recognition on the ownership interest that it has in the joint operation (see the example below).

Example: joint operation accounting

A and B establish a joint arrangement using a separate vehicle (C), but the legal form of the separate vehicle does not confer separation between the parties and the separate vehicle itself. That is, A and B have rights to the assets and obligations for the liabilities of C (C is a joint operation). Neither the contractual terms, nor the other facts and circumstances indicate otherwise. Accordingly, A and B account for their rights to assets and their obligations for liabilities relating to C in accordance with the IFRSs applicable to the particular assets, liabilities, revenues, expenses.

A and B each own 50% of the equity (e.g., shares) in C. However, the contractual terms of the joint arrangement state that A has the rights to all of Building No. 1 and the obligation

to pay all the third party debt in C. A and B have rights to all other assets in C, and obligations for all other liabilities in C in proportion to their equity interests (i.e., 50%).

C's balance sheet is as follow (Euro):

Assets		**Liabilities and equity**	
Cash	40	Debt	120
Building n.1	120	Employee benefit plan obligation	100
Building n.2	200	Equity	140
Total assets	**360**	**Total liabilities**	**360**

In order to account for its rights to the assets in C and its obligations for the liabilities in C, A would record the following in its financial statements:

Assets		**Liabilities and equity**	
Cash	20	Debt	120
Building n.1	120	Employee benefit plan obligation	50
Building n.2	100	Equity	70
Total assets	**240**	**Total liabilities**	**240**

This situation may differ from the amounts recorded using proportionate consolidation.

3.7.1.1 Parties to a joint operation without joint control

In some cases, a party to a joint operation may not qualify as a joint operator as it does not have joint control over the arrangement. In such a case, IFRS 11 states that to the extent that party has rights to assets and obligations for liabilities, the accounting is the same as that for a joint operator, as indicated in the prior paragraph.

If the party does not have rights to the assets and obligations for the liabilities relating to the joint operation, it accounts for its interest in the joint operation in accordance with the IFRSs applicable to that interest (IFRS 11.23). For example, if it has:

- an interest in a separate vehicle over which it has significant influence: apply IAS 28;
- an interest in a separate vehicle over which it does not have significant influence: account for that interest as a financial asset (apply IAS 39/IFRS 9);

- an interest in an arrangement without a separate vehicle: apply other applicable IFRSs.

Effectively, if the joint arrangement is a joint operation, and the party has rights to the assets and obligations for the liabilities relating to that joint operation, it does not matter whether the parties to that joint arrangement have joint control or not (the accounting is the same).

However, the disclosure requirements will differ as IFRS 12 does not apply to joint arrangements in which a party does not have joint control, unless that party has significant influence.

3.7.1.2 Transactions between a joint operator and a joint operation

When a joint operator enters into a transaction with a joint operation, it is transacting with the other parties to the joint operation. If the transaction is a sale or a contribution of assets to the joint operation, the joint operator shall recognise gains or losses resulting from the transaction only to the extent of the other parties' interest in that joint operation (IFRS 11.B34). When such transactions provide evidence of a reduction in the net realizable value of the assets to be sold or contributed to the joint operation, or of an impairment loss of those assets, those losses shall be recognized fully by the joint operator (IFRS 11.B35).

If the transaction is a purchase of assets from a joint operation, the joint operator shall not recognize its share of the gains and losses until it resells those assets to a third party (IFRS 11.B36). When such transactions provide evidence of a reduction in the net realizable value of the assets to be purchased or of an impairment loss of those assets, a joint operator shall recognize its share of those losses (IFRS 11.B37).

3.7.2 Accounting for joint ventures

One of the main reasons for issuing IFRS 11, as said before, was to eliminate proportionate consolidation as an option for accounting for jointly controlled entities to converge with US-GAAP. As a result, joint ventures (many of which will likely have been jointly controlled entities under IAS 31) will be accounted for using the equity method.

The venturer will measure, in its consolidated financial statements, its investment in the joint venture with the equity method in accordance with IAS 28 unless the entity is exempted from applying the equity method as specified in that standard (IFRS 11.24). The carrying amount of the investment is initially recognized at cost as one-line item and

subsequently adjusted based on changes of the share of the investor in the equity of the investee. The adjustment to the carrying amount is posted, in the consolidated financial statements of the investor, against:

- the income statement, in the measure of its share of the net result of the investee of the period;
- OCI, in the measure of its share of the change in OCI of the investee in the period.

Moreover, the carrying amount of the investment is decreased for any dividends received from the joint venture (Baril and Betancourt, 2013).

Regarding the accounting in the separate financial statements, the venturer will recognize an investment in the joint venture at cost, or in accordance with IFRS 9 *Financial Instruments* (IAS 27.10).

3.7.2.1 Interest in a joint venture without joint control

An investor in a joint venture, which does not hold joint control but significant influence, will account for its investment under the equity method in accordance with IAS 28 (however, the disclosure requirements under IFRS 12 will differ).

If an investor does not have significant influence, its interest in the joint venture would be accounted for as a financial asset in accordance with IFRS 9 (IFRS 11.25).

3.8 Continuous assessment

If facts and circumstances change, IFRS 11 requires a party to reassess whether:

- it still has joint control of the arrangement (IFRS 11.13);
- the type of joint arrangement in which it is involved has changed (IFRS 11.19).

IFRS 11 does not contain any specific points at which a party reassesses whether it has joint control, or the type of joint arrangement. Accordingly, a party reassesses upon any change in facts and circumstances that might be relevant to those conclusions.

In some cases, changes in facts and circumstances might result in a party having control over the arrangement (which would, therefore, no longer be a joint arrangement since one party has control). In other cases, an arrangement may remain under joint control, but the classification might change from joint venture to joint operation (or vice versa).

Reassessment of a joint arrangement should occur upon a change in:

- how activities are directed: for example, A sets up Z to develop a new product or technology. Initially, Z had a board of directors elected by shareholders and the relevant activities were directed by voting rights held exclusively by A. If A enters into an agreement with B so that A and B must agree on all decisions (e.g., they replace the board and make decisions for management), reassessment would be required to evaluate whether A and B have joint control of Z;
- legal form: for example, a separate vehicle that initially did not confer separation between the parties and the vehicle (e.g., a general partnership) is converted into a separate vehicle that now confer separation between the parties and the vehicle (e.g., a limited partnership). In this context, reassessment would be required to evaluate whether this indicates a change in classification from a joint operation to a joint venture;
- contractual terms: for example, the terms of a joint arrangement are renegotiated, such that the parties have rights to the assets, or obligations for the liabilities. In this case, reassessment would be required to evaluate whether this indicates a change in classification to a joint operation;
- other facts and circumstances: for example, the terms and conditions of a joint operation are renegotiated. Initially, a joint arrangement could sell output only to the parties of the joint arrangement; subsequently, the joint arrangement may also sell output to third-party customers. In this context, reassessment would be required to evaluate whether this indicates a change in classification from a joint operation to a joint venture.

3.9 Disclosures

The disclosure requirements for an entity's interests in subsidiaries, joint arrangements, associates and structured entities are combined into one comprehensive disclosure standard (IFRS 12).

The objective[24] of IFRS 12 is for an entity to disclose information that helps users of its financial statements evaluate: **(i)** the nature of, and risks associated with, its interests in other entities, including the contractual relationship with the other parties that have joint

[24] If the disclosures required by IFRS 11, together with disclosures required by other IFRSs, do not meet this objective, an entity shall disclose whatever additional information is necessary to meet that objective (IFRS 11.3).

control; **(ii)** the effects of those interests on its financial position, financial performance, and cash flows (IFRS 12.1).

Many of the disclosure requirements related to joint arrangements are similar to those included in IAS 31. However, others are new, or clarify the requirements that were in IAS 31.

In this paragraph, the attention will be focused on the disclosure requirements of IFRS 12 with respect to joint arrangements. In particular, the disclosure requirements described here are those that apply to parties that have joint control of the joint arrangement (they do not apply to parties in a joint arrangement without joint control).

Firstly, an entity must disclose the significant judgements and assumptions it has made (and changes to those judgements and assumptions) in determining whether or not it has joint control of an arrangement. An entity is also required to disclose significant judgements made in determining the type of joint arrangement (i.e., joint operation or joint venture) when the arrangement is structured through a separate vehicle (IFRS 12.7).

Examples of significant judgements for which disclosure may be required are:

- whether a right is a protective right (which does not give joint control) or a substantive right that gives an entity joint control;
- whether a manager of an arrangement is acting as principal or as agent, which would likely affect the conclusion as to whether the manager has control or joint control;
- whether a joint arrangement is a joint operation or a joint venture, since its classification is not merely based on legal form under IFRS 11.

Moreover, IFRS 12 requires that for each joint arrangement that is material to the entity, the entity must disclose all of the following (IFRS 12.12):

- name of the joint arrangement;
- nature of the entity's relationship with the joint arrangement (by, for example, describing the nature of the activities of the joint arrangement and whether they are strategic to the entity's activities);
- principal place of business (and country of incorporation, if applicable and different from the principal place of business) of the joint arrangement;
- proportion of ownership interest or participating share held by the entity and, if different, the proportion of voting rights held (if applicable).

3.9.1 Nature, extent and financial effects of an entity's interest in a joint venture

In addition to the above mentioned information, an entity is required to disclose additional information about interests in joint ventures (IFRS 12.21-22). The following table (Table n. 4) summarises the disclosures required for material joint ventures, the disclosures required for immaterial joint ventures (in the aggregate), and the disclosures required for both (these disclosures are not required for joint operations).

Table n. 4: Required disclosures for joint ventures

Topic	Individually material joint ventures	Individually immaterial joint ventures
1) Accounting policy (equity method or fair value)	Required	Not required
2) Summarised financial information	Required	Required (in aggregate)
3) Fair value, if quoted market price is available and measured using the equity method	Required	Not required
4) Restrictions on ability to transfer funds	Required	Required
5) Date of financial statements, if different from entity (and reason for different date)	Required	Required
6) Unrecognised share of losses at financial statement date and cumulatively	Required	Required

Source: personal adaptation from E&Y, 2014

With reference to the first topic of the table above, an entity is required to disclose the accounting policy used to account for that joint venture. Although this is typically the equity method, in some cases (as said in the introduction of this chapter), an entity may use fair value. Furthermore, if fair value is used to measure the investment in the joint venture, or if fair value is disclosed, consideration should also be given to the requirements of IFRS 13 *Fair Value Measurement*.

For what concerns the second topic, an entity is required to disclose summarised financial information for joint ventures. IFRS 12 requires information for each joint venture that is material to the entity, and summarised information in the aggregate for individually immaterial joint ventures. However, the scope of the required information varies between the two, as shown in Table n. 5. It is important to note that, to meet the objective of IFRS 12, a joint venturer may need to disclose additional information beyond those items listed in the following table.

Table n. 5: Summarised financial information for joint ventures

	Individually material joint ventures	**Individually immaterial joint ventures**
Amount disclosed	Entire amount	Joint venturer's share
Dividends received	Required	Not required
Carrying amount of investment	Required	Not required
Cash and equivalents included in current assets	Required	Not required
Current assets	Required	Not required
Non-current assets	Required	Not required
Current financial liabilities excluding trade payables and other provisions included in current liabilities	Required	Not required
Current liabilities	Required	Not required
Non-current financial liabilities excluding trade payables and other provisions included in current liabilities	Required	Not required
Non-current liabilities	Required	Not required
Revenue	Required	Not required
Depreciation and amortisation	Required	Not required
Interest income	Required	Not required
Interest expense	Required	Not required
Income tax expense or income	Required	Not required
Profit or loss from continuing operations	Required	Required
Post-tax profit or loss from discontinued operations	Required	Required
Other comprehensive income	Required	Required
Total comprehensive income	Required	Required

Source: personal adaptation from E&Y, 2014

Whit reference to the third topic of Table n. 4, IFRS 12 requires disclosure of the fair value of a joint venturer's investment in a material joint venture that is accounted for using the equity method, if there is a quoted market price for that investment. In this context (when fair value is disclosed), consideration should also be given to the requirements of IFRS 13, which applies even though the entity is using the equity method (although the disclosure requirements are less than if fair value had been used).

For what concerns the fourth topic of Table n. 4, a joint venturer is required to disclose the nature and extent of any significant restrictions on: (i) the ability of the joint venture to transfer funds to the joint venturer in the form of cash dividends or (ii) to repay loans or advances made by the joint venturer. For example, restrictions might result from covenants under borrowing arrangements with third parties, regulatory requirements or contractual arrangements between joint venturers.

Whit reference to the fifth topic of Table n. 4, when the financial statements of a joint venture used in applying the equity method are as of a date or for a period that is different from that of the joint venturer, the joint venturer is required to disclose: (i) the date of the end of the reporting period of the financial statements of that joint venture or associate; and (ii) the reason for using a different date or period.

Lastly, for what concerns the sixth topic of Table n. 4, a joint venturer may have stopped recognising its share of losses of the joint venture when applying the equity method (e.g., because the investment has been reduced to nil due to recognition of past losses, and there is no commitment to finance such losses). In such cases, the joint venturer is required to disclose its unrecognised share of losses of a joint venture, both for the reporting period and cumulatively.

3.9.2 Risks associated with interests in joint ventures

One of the objectives for the disclosures for joint arrangements, as said before, relates to the nature of, and changes in, risks related to that joint venture. In order to meet this objective, a joint venturer is required to disclose: **(i)** commitments that it has relating to its joint ventures, separately from the amount of other commitments; **(ii)** contingent liabilities incurred relating to its interests in joint ventures, separately from the amount of other contingent liabilities[25] (IFRS 12.23).

[25] These disclosure requirements apply only to joint ventures.

Whit reference to the first point, a joint venturer is required to disclose total commitments it has made, but not recognised at the reporting date relating to its interests in joint ventures. This amount includes its share of commitments made jointly with other joint venturers. Commitments are defined as those that may give rise to a future outflow of cash or other resources (IFRS 12.B18).

IFRS 12 lists several examples of items that may create an unrecognised commitment to contribute funding or resources (IFRS 12.B19):

- constitution or acquisition agreements of the joint venture (e.g., those that require an entity to contribute funds over a specific period);
- capital-intensive projects undertaken by a joint venture;
- unconditional purchase obligations, comprising procurement of equipment, inventory or services that the joint venturer is committed to purchasing from, or on behalf of, a joint venture;
- commitments to provide loans or other financial support to a joint venture;
- commitments to contribute resources to a joint venture, such as assets or services;
- other non-cancellable unrecognised commitments relating to a joint venture.

Whit reference to the second point, the disclosure must be in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, which requires disclosure of the following, unless the probability of loss is remote:

- an estimate of the contingent liability;
- an indication of the uncertainties relating to the amount or timing of any outflow;
- the possibility of any reimbursement.

The contingent liability disclosed related to joint ventures includes a joint venturer's share of contingent liabilities incurred jointly with other joint venturers or investors that have significant influence over the joint venture.

3.10 Transition

IFRS 11, as mentioned before (see paragraph 3.1), is effective for annual periods beginning on or after 1 January 2013 (1 January 2014 within the EU). Early adoption is permitted[26], as long as an entity also adopts IFRS 10, IFRS 12, IAS 27 and IAS 28 all as of the same date (IFRS 11.C1).

One exception is that an entity may early-adopt the disclosure provisions for IFRS 12 (without adopting the other new standards), if doing so would be helpful to users of the financial statements. The reason for requiring simultaneous adoption is that all deal with the assessment of, and related accounting and disclosure requirements about, an entity's relationships with other entities (i.e., control, joint control or significant influence over another entity). As a result, the IASB concluded that applying one of these standards, without also applying the others could cause confusion. In addition, it would have been difficult to keep track of the consequential amendments between these standards, and other IFRSs, if the effective dates had differed.

The impact of transitioning to IFRS 11 basically depends on how the arrangement was classified under IAS 31, the accounting method applied under IAS 31, and the classification under IFRS 11 as either a joint operation or a joint venture.

3.10.1 Joint ventures: transition from proportionate consolidation to the equity method

In the event an arrangement is a joint venture under IFRS 11, the application of the standard will entail, in the consolidated financial statements, abandoning the proportionate consolidation method and adopting the equity method, retroactively, at the beginning of the immediately preceding period[27] (hereafter, transition date), (IFRS 11.C2).

The venturer's share of the carrying amount of the net assets will be reported in one line item, denominated 'Investments in joint ventures', which includes any goodwill (currently recognized separately with the proportionate consolidation method).

The amount so determined is the 'opening balance' and represents the deemed cost of the investment, which will be subject to impairment test at the transition date; any impairment will be recognized to equity, through retained earnings at the beginning of the immediately preceding period (IFRS 11.C3).

Where the first application of the standard gives rise to negative net assets:

[26] If an entity applies IFRS 11 earlier, it shall disclose that fact.

[27] For example, effective date: 1 January 2013, transition date: 1 January 2012.

- no investment will be recognized, as its value is equal to zero; and
- where the parties have a constructive or legal obligation to cover the potential loss, a corresponding liability will be accordingly recognized.

If the entity concludes that it does not have legal or constructive obligations in relation to the negative net assets, it shall not recognize the corresponding liability but it shall adjust retained earnings at the beginning of the transition date.

Moreover, an entity shall disclose, on a disaggregated basis, the assets and liabilities that have been aggregated into the single line 'Investments in joint ventures' balance as at the transition date. The disclosure is presented on a totals basis for all joint ventures that have transitioned from proportionate consolidation to equity method.

Subsequently to initial recognition, the entity will measure the investment in the joint venture applying the equity method, in accordance with IAS 28.

3.10.2 Joint operations: transition from the equity method to accounting for assets and liabilities

In the event an investment in a joint arrangement, previously measured with the equity method, is a joint operation:

- the entity will recognize, in the separate and consolidated financial statements, assets and liabilities based on its interest in the joint operation;
- the carrying amount of the investment previously recognized will be derecognised.

An entity shall determine its interest in the assets and liabilities relating to the joint operation on the basis of its rights and obligations in a specified proportion in accordance with the contractual arrangement.

Assets and liabilities are recognized disaggregating the amount of the investment, at the beginning of the first comparative period (i.e. 1 January 2013), in its assets and liabilities (including the eventual goodwill to be separately recognized), (IFRS 11.C7). The information to be used to perform this activity are the same employed to apply the equity method at the beginning of the comparative period (1 January 2013).

In accordance with the equity method the investment is recognized as a single unit of account and as such it is eventually subject to an impairment test. This implies that, for example, if an investment is impaired in periods prior to the transition date (1 January

2013), its carrying amount will be lower than the net amount of the corresponding share of assets/liabilities of the joint operation. In particular:

- where the net carrying amount of assets/liabilities exceeds the carrying amount of the eliminated investment, the eventual goodwill will have to be adjusted (the eventual remaining amount will be recognized against retained earnings at the transition date);
- instead, where the net carrying amount of assets/liabilities is lower than the carrying amount of the eliminated investment, the excess will be recorded against retained earnings at the transition date.

3.10.3 From proportionate consolidation to applying the accounting rules for a joint operation

An investment in an entity accounted for under the proportionate consolidation method in the consolidated financial statements under IAS 31, that is a joint operation under IFRS 11 (which means that the joint operator recognises its assets, liabilities, revenues and expenses), in many cases, will not significantly impact the financial statements of the investor.

For example, under proportionate consolidation, the joint venturer recognized its proportionate share of all assets and liabilities of the joint arrangement. In contrast, in a joint operation, the joint operator may have only a share of certain assets and liabilities.

This situation is not specifically addressed by IFRS 11. Accordingly, if the change in classification from a joint venture using proportionate consolidation to a joint operation results in changes to the financial statements, these changes should be reflected retrospectively, based on IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* guidance.

3.10.4 Transition provisions in an entity's separate financial statements

An entity that, in accordance with IAS 27, was previously accounting in its separate financial statements for its interest in a joint operation as an investment at cost or in accordance with IFRS 9 shall (IFRS 11.C12):

- derecognizes the investment and recognizes its assets and liabilities relating to its involvement in the joint operation; and

- provides a reconciliation between the investment derecognized and the assets and liabilities recognized, together with any balance adjusted in retained earnings, at the beginning of the immediately preceding period (see Table n. 6).

Table n. 6: The impacts of the transition on separate financial statements

	Jointly controlled entities → joint operations	**Jointly controlled entities → joint ventures**
Previous accounting (IAS 31) - separate financial statements	Entities would have previously followed IAS 27 and accounted in their separate financial statements for their involvement in a joint controlled entity as an investment at cost or in accordance with IFRS 9	Entities would have previously followed IAS 27 and accounted in their separate financial statements for their involvement in a joint controlled entity as an investment at cost or in accordance with IFRS 9
Transition (IFRS 11) - separate financial statements	On transition the entity: (i) derecognizes the investment and recognizes its assets and liabilities relating to its involvement in the joint operation; and (ii) provides a reconciliation between the investment derecognized and the assets and liabilities recognized, together with any balance adjusted in retained earnings, at the beginning of the immediately preceding period	No impact

Source: personal elaboration

3.11 Business impact

IFRS 11 mainly represents a change in the accounting for those arrangements that were classified in IAS 31 as jointly controlled entities. In this regard, the change will mainly depends upon the accounting method used by entities when accounting for their jointly controlled entities in accordance with IAS 31 and on the classification of those arrangements in accordance with IFRS 11 (i.e. joint operations or joint ventures).
In particular, the most significant change, which might potentially affect a larger number of arrangements, consists of those jointly controlled entities that were proportionately consolidated in IAS 31 that will now be joint ventures and, in accordance with IFRS 11, will be accounted for using the equity method. The requirements of IFRS 11 might, to a lesser extent, also lead to accounting changes for jointly controlled entities that were accounted for using the equity method in accordance with IAS 31 and will be joint operations in accordance with IFRS 11 (IASB, 2011).
In this context of change, management should evaluate the new requirements of IFRS 11 and the impact that the change in accounting may have upon its financial statements. This change may have a significant impact on the key performance indicators (revenues, EBIT, EBITDA, leverage ratios) used to assess the entity's performance. For example, entities that change from proportionate consolidation to the equity method will generally report lower amounts for assets and liabilities (although the net investment in joint ventures remains unaffected) and lower revenues and expenses (although net income remains unaffected), (IASB, 2011). In view of these considerations, it will become really important a clear communication with stakeholders when significant changes in the presentation of financial results and financial position are expected to occur.
The potential effect that accounting for joint ventures under the equity method could have on some entities is briefly illustrated in the example below.

Example: proportionate consolidation vs equity method[28]

The business of a manufacturer in a foreign country is fully conducted through joint arrangements, because of the legal requirements in that country. Under IAS 31, these joint arrangements were considered jointly controlled entities and the manufacturer accounted for these entities using the proportionate consolidation.
By adopting IFRS 11, the manufacturer concludes that there is joint control between itself and the local government over each of these arrangements. The manufacturer then assesses

[28] Example based on E&Y, 2011.

the legal form of the separate vehicle, the contractual terms of the arrangement and other facts and circumstances, and determines that these former jointly controlled entities are considered joint ventures under the new standard. Accordingly, the manufacturer is required to account for these joint ventures using the equity method (see the impact below).

Balance sheet (Euro)	**Before IFRS 11 adoption**	**After IFRS 11 adoption**
Current assets	100	-
Non-current assets	250	150
Total assets	**350**	**150**
Current liabilities	(50)	-
Non-current liabilities	(150)	-
Total liabilities	**(200)**	-
Total equity	**(150)**	**(150)**

Statement of operations (Euro)	**Before IFRS 11 adoption**	**After IFRS 11 adoption**
Revenue	1500	-
Cost of sales	(1000)	-
Gross margin	**500**	-
Other operating costs	(300)	-
Operating profit	**200**	-
Interest and taxes	(60)	-
Share of profit from joint ventures	-	140
Net income	**140**	**140**

Lastly, it is important to notice that entities may need more detailed financial reporting information from an operator of a joint operation to comply with the new accounting and disclosure requirements. Therefore, changes in existing process and controls may be required to cope with transition requirements and the annual reassessment of the

arrangements. Gathering and analysing the information could take considerable time and effort depending on the number of joint arrangements, the inception dates and the records available (PwC, 2011).

3.12 Final observations

In May 2011 the IASB introduced a new standard, IFRS 11 *Joint Arrangements*. This standard is effective, within the EU, for annual periods beginning on or after 1 January 2014 and replaces the guidance previously provided by IAS 31 and SIC-13.

IFRS 11 redefines the framework for the accounting for joint arrangements. By so doing, the introduction of this new standard could affect a reporting entity's financial statements; consequentially management should doubtless consider the impact of IFRS 11 on entity's key financial and economic results.

Since the application of IFRS 11 is not at full speed within the EU, complete empirical researches are not possible right now. In fact, the annual reports of the entities applying IFRS 11 are not available at this stage, so we cannot be certain about the effects of adopting the standard. However, initial empirical evidences of the application of IFRS 11 are provided in the following section of this research. To this end, it is illustrated how an international Group dealt with all the phases that had led to the implementation of this new standard. Moreover, thanks to the data of the Group interim financial report, it is also illustrated the impact of IFRS 11 on the main performance indicators.

4. Case study

4.1 Overview

This section, as said in the prior chapter, aims to provide initial empirical evidences of the application of IFRS 11. To this end, a case study has been adopted as further research method. In particular, it is highlighted, at first, how an international group (Enel Group) dealt with the different stages that had led to the implementation of IFRS 11, secondly the effects of IFRS 11 on the consolidated financial statements and, lastly, the impact of this new standard on the group's key performance indicators.

Data and information about the organization were mainly collected through interviews with four Managers in charge of Group Administration at Enel over a 8-month period between April 2014 and November 2014. Additional information was collected through the company's website.

The case study is structured as follows: an overview of the analysed company (Enel Group) is presented in **section 2**; a description of the activities put in practice by the group to implement IFRS 11 is provided in **section 3**; the results of the assessment (consolidation made by Enel Group according to IFRS 11) are illustrated in **section 4**; the indication of the adjustments made on consolidated financial statements as a result of the application of IFRS 11 (transition from proportionate consolidation to the equity method) is provided in **section 5**; the impact of IFRS 11 on the main key performance indicators of the Group is illustrated in **section 6**; conclusions and possible further improvements of this study are offered in the last section.

4.2 Description of the analysed company

Enel is Italy's largest power company and Europe's second listed utility by installed capacity. It is a leading integrated player in the power and gas markets of Europe and Latin America, operating in 32 countries across 4 continents overseeing power generation from over 95 GW of net installed capacity and distributing electricity and gas through a network spanning around 1.9 million km to serve approximately 61 million customers.

The Enel mission is to create and distribute value in the international energy market, to the benefit of its customers' needs, its shareholders' investments, the competitiveness of the countries in which it operates and the expectations of all those who work with it. The main Enel values include: **(i)** respect; **(ii)** attention to people; **(iii)** continual improvement to

ensure better results and respond to the expectations of shareholders; **(iv)** ethical rigour; **(v)** social responsibility.

In 2013, Enel posted revenues of around 80.5 billion euros and EBITDA of, approximately, 17 billion euros and net ordinary income of around 3.1 billion euros.

Table n. 7: 2013 Results - Financial Highlights - Consolidated results (€ mn)

	FY 12	**FY 12 Restated[1]**	**FY 13**	**% vs restated**
Revenues	84,889	84,949	80,535	*-5.2*
EBITDA	16,738	15,809	17,011	*+7.6*
- **recurring[2]**	16,738	15,809	16,089	*+1.8*
EBIT	7,735	6,806	9,944	*+46.1*
Group net income	865	238	3,235	*>100*
Group net ordinary income[2]	3,455	2,828	3,119	*+10.3*
Net debt[3]	42,948	42,948	39,862	*-7.2*

Source: Personal adaption based on 2014-2018 Enel Business Plan

1. 2012 restated due to the retrospective application of IAS 19 revised and the "white certificates" accounting policy
2. Excluding capital gains, losses and one-off items
3. Excluding net debt of assets held for sale

As of June 30th, 2014, the Group has over 71,000 employees and operates a wide range of hydroelectric, thermoelectric, nuclear, geothermal, wind, solar and other renewable power plants. Furthermore, over 46% of the power generated by Enel last year was carbon free.

Enel is strongly committed to renewable energy sources: Enel Green Power [EGP] is the Group's publicly listed Company dedicated to the growth and management of power generation from renewable energy, operating more than 9 GW of net installed capacity relying on hydro, wind, geothermal, solar, biomass and co-generation sources in Europe and the Americas.

Enel is the first utility in the world to replace the traditional electromechanical meters with smart meters that make it possible to measure consumption in real time and manage contractual relationships remotely. Today, around 32 million Italian retail customers are

equipped with smart meters installed by Enel (Enel is further deploying an additional 13 million smart meters to its customer base in Spain).

With reference to the shareholding structure, Enel (which is listed on the Milan stock exchange since 1999) has the largest number of shareholders of any Italian company, with 1.1 million retail and institutional investors. The most important Enel's shareholder is the Italian Ministry of Economy and Finance which holds 31.24% of the Company's shares. Fourteen other Group companies are listed on the stock exchanges of Italy, Spain, Russia, Argentina, Brasil, Chile and Peru. Moreover, Enel's commitment to values embodied in its Code of Ethics, its Sustainability Report and the adoption of international best practices promoting environmental protection, transparency and corporate governance has attracted international investment funds, insurance companies, pension funds and ethical funds to its rank of shareholders.

With reference to Enel's global presence, it is structured as follows:

- in Italy, Enel is the largest electricity company. It operates in the field of electricity generation of thermal and renewable power plants with nearly 37 GW of installed capacity. Out of these, more than 3 GW of renewable plants are operated through EGP. Furthermore, Enel manages the majority of the Italian electricity distribution network and offers integrated package of electricity and gas products and services for its 31 million customers;
- in Iberia, Enel owns 92.06% of Endesa's share capital, the leading power company in Spain and Portugal with approximately 24 GW of installed capacity and a strong presence in the distribution sector and in the sale of electricity and gas products to more than 12 million customers. EGP operates 1.8 GW of renewable plants in this region;
- in Europe, Enel is also present in Slovakia, where it owns 66% of Slovenské Elektrárne, the largest electricity generator in the country with a generation capacity of around 5 GW. In France, Enel is active in electricity and gas supply as well as in renewable generation. In Romania, the Group serves 2.7 million customers through its distribution network. In Romania as well as in Greece, EGP owns and operates renewable generation plants. In Russia, Enel operates in the generation sector, where its subsidiary Enel Russia owns more than 9 GW of thermal capacity;

- in Latin America, through Endesa and its subsidiaries in 5 countries, the Enel Group is the largest private player with nearly 18 GW of installed capacity from thermal, hydro and other renewable power plants, and serving 14.5 million customers;
- in North America, EGP North America owns and operates nearly 2 GW of hydroelectric, geothermal, wind, solar and biomass power plants;
- in Africa Enel is present in the upstream gas sector participating in the development of gas fields in Algeria and Egypt. Through Endesa, Enel also operates a thermal power plant in Morocco. In South Africa, Enel Green Power recently completed and connected to the grid its first photovoltaic plant in the country (Upington).

The group evolution in the period 2005-2013 (with reference to some key data) is summarized in the following figure.

Figure n. 11: Group evolution

Source: Personal adaption based on 2014-2018 Enel Business Plan

4.3 Activities put in practice by the Group to implement IFRS 11

After the IASB issued IFRS 11 *Joint Arrangements*, Enel put in practice several activities to implement the standard within the Group. In particular, prior to the end of the endorsement process of the new standard, in April 2012, the Group Accounting Standards and Administrative Rule unit, that is part of the Enel Group Administration, issued a brief note explaining the new standard.

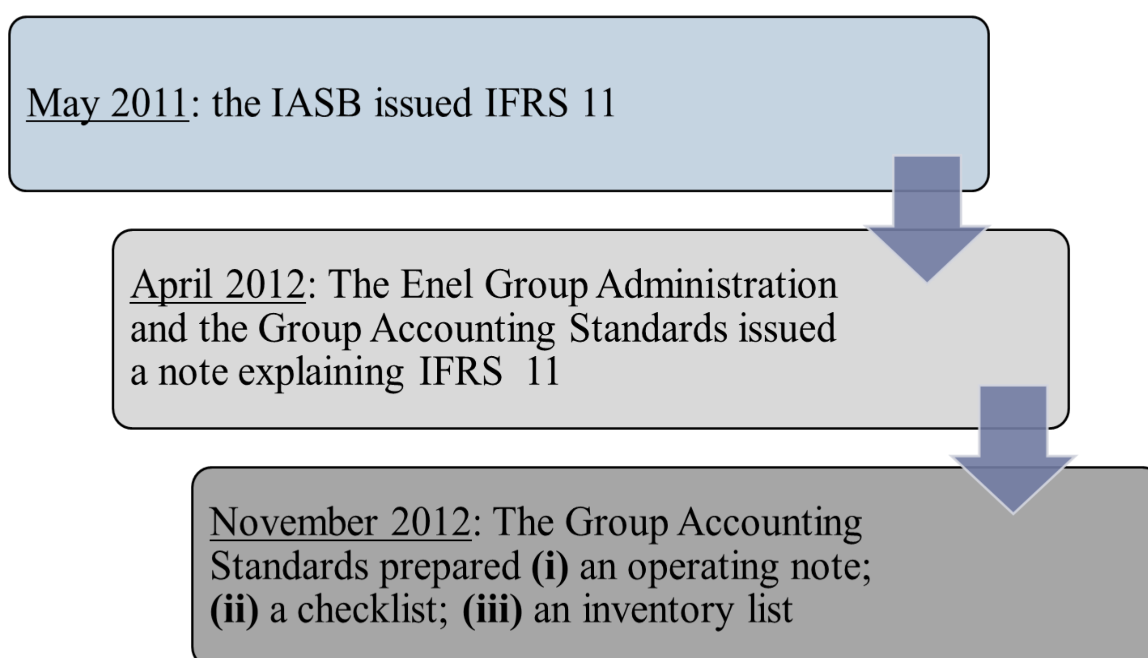
In order to assess the impact on the Group Consolidated Financial Statements, in November 2012, the aforesaid Unit prepared a set of document that included:

- an **operating note**, disclosing IFRS 11 rules, including illustrative examples;
- a brief **checklist** to guide in the joint arrangement classification assessment; and
- an **inventory list**, summarizing accounting impacts arising from the aforesaid assessment (based on arrangements existing as at 30 September 2012).

In this context, each entity of the group was requested to assess if its joint arrangements existing as at 30 September 2012 met features of joint operations or joint ventures under IFRS 11 rules. To this end, they used the above mentioned checklist.

During the Financial year 2013, at each closing date, the Group has checked the eventual change in the perimeter of application of the new standard.

Figure n. 12: Units of the Group involved in implementing the new standard



Source: Personal elaboration

For what concerns the checklist, it is composed of a set of multiple filter questions based on a dichotomous scale (Yes/No). Below, it will be illustrated the composition of the checklist with reference to the main items (the appendix of this chapter will report the entire checklist).

First of all, it has been asked to each entity of the group if the contractual arrangement give all of the parties (or a group of the parties) control of the arrangement collectively. By

asking it, the document specifies, firstly, the meaning of "control" and, secondly, when the parties (or a group of the parties) control the arrangement collectively.

Then, it has been asked if the decisions about relevant activities of the joint arrangement require unanimous consent of all the parties that collectively control the arrangement. In fact, once it has been determined that all the parties, or a group of the parties, control the arrangement collectively, joint control exists only when decisions about the relevant activities require the unanimous consent of those parties (not every party to the arrangement).

Thirdly, the checklist focuses the attention on the protective rights by asking if the requirement for unanimous consent relates only to decisions that give a party this kind of rights. That's because if the requirement for unanimous consent relates only to decisions that give a party protective rights and not to decisions about the relevant activities of an arrangement, that party is not a party with joint control of the arrangement.

The fourth section of the checklist is focused on the assessment of the joint arrangement structure. This section, which is structured in six subsections (to which correspond six questions), specifies that an entity shall determine the type of joint arrangement in which it is involved and that the classification of a joint arrangement as a joint operation or a joint venture depends upon the rights and obligations of the parties to the arrangement.

Once highlighted this aspect, it has been asked, firstly, if the arrangement foresees the formation of a separate vehicle.

Then, if "yes", it has been asked if the legal form of the separate vehicle entails legal personality and financial independence from the parties sharing control.

Even in this case, if "yes", it has been asked if the contractual arrangement between parties confer direct rights to assets and obligations for liabilities to the parties of the arrangement. That's because in many cases, even if the legal form of the separate vehicle establishes rights for each of the parties, the contractual terms of the joint arrangement may unwind the effects of the legal form and give the parties rights to the assets and obligations for the liabilities.

In the event that the answer to the above mentioned question is "no", the arrangement is not clearly a joint operation or a joint venture. Therefore, an entity has to consider other facts and circumstances to assess whether the arrangement is a joint operation or a joint venture.

To this end, it has been requested to proceed to the following question: "Must the parties purchase substantially all of the output produced by the joint arrangement?". In fact, as

said before, when the terms of the contractual arrangement or the legal form of the arrangement do not specify that the parties have rights to the assets, and obligations for the liabilities, relating to the arrangement, the parties shall consider other facts and circumstances to assess whether the arrangement is a joint operation or a joint venture. In this context, it is important to understand whether the joint arrangement primarily aims to provide the parties with an output (i.e., the parties have rights to substantially all of the economic benefits of the assets). If the answer to the above question is "no", it has been requested to proceed to the following question; on the other hand, if "yes", then the joint arrangement would likely be a joint operation (nevertheless, even in this event, it has been requested to proceed to the following question in order to confirm this presumption).
Then, as fifth question of this section, the parties to the joint arrangement should reveal if they are the source of cash flow to pay liabilities on a continuous basis. If "no", it has been requested to move into the last question; if "yes", then the joint arrangement would likely be a joint operation (even in this event, it has been requested to move into the last question in order to confirm this presumption).
Lastly, it has been asked to reveal if the joint arrangement is designed to operate at break-even, or to generate losses that will be funded by the parties.

The results of the assessment, as said at the beginning of this paragraph, had to be presented in the file "inventory list". In particular, each Company or Group, preparing the reporting package for Enel Group consolidating purpose, had to fill in that file with reference to its relevant joint arrangements existing as at 30 September 2012, putting in the cells the requested information. The requested information, for each Company/Group, are the following ones:

- company name (name of the separate vehicle in which the joint arrangement is structured. If a separate vehicle does not exist, the joint arrangement is a joint operation and the Company/group had to indicate the name of the arrangement, if any);
- related sub-node in Enel Group consolidated financial statements (indication of the sub-node in Enel Group consolidated financial statements related to the joint arrangement);
- interest in the joint arrangement (indication of the interests in the ownership of the vehicle);

- current classification of the joint arrangement in accordance with IAS 31 as at 30 September 2012 (jointly controlled entity, jointly controlled operations or jointly controlled assets);
- classification of the joint arrangement based on IFRS 11 (joint venture or joint operation);
- rights to specific assets and obligations for liabilities of the joint arrangement held by Enel Group's party;
- shares in the assets of the joint operation, if possible;
- shares in the obligations of the joint operation, if possible;
- shares in the revenues of the joint operation, if possible;
- shares in the expenses of the joint operation, if possible;
- eventual notes intended to the understanding of the assessment performed.

4.4 Results of the assessment

Following the application, with retrospective effect as from January 1, 2014, of the new IFRS 11 *Joint arrangements*, the investments of the Enel Group in joint ventures (arrangements whereby the parties have rights to a share of the net assets or the profit or loss of the arrangement) must be accounted, as said in chapter 3, for using the equity method rather than proportionate consolidation, which is no longer allowed for such ventures.

Since the Group had accounted for joint ventures using proportionate consolidation prior to the date of application of the new standard as permitted under the previous applicable standard (IAS 31 *Interests in joint ventures*), that change gave rise to the restatement of the consolidated balance sheet at December 31, 2013, and the income statement presented in the half-year financial report at June 30, 2013, reported in the Enel condensed interim consolidated financial statements at June 30, 2014 for comparative purposes only.

In view of the nature of the change, it did not have an impact on Group net income for the previous year and for the 1st Half of 2013 or on shareholders' equity pertaining to the shareholders of the Parent Company at December 31, 2013.

For the Group's interests in joint operations (arrangements in which the parties have prorated rights to the assets, and prorated obligations for the liabilities, relating to the

arrangement), in view of the agreements underpinning those arrangements, the application of IFRS 11 has an impact that is substantially equivalent to proportionate consolidation[29].
In particular, at January 1, 2014, the change made to the consolidation methods adopted for the companies of the Group is summarized in the following table:

Table n. 8: Consolidation made by Enel Group according to IFRS 11

	at Dec. 31, 2013 restated			at Dec. 31, 2013		
	Italy	**Foreign countries**	**Total**	**Italy**	**Foreign countries**	**Total**
Fully consolidated companies	37	474	511	37	474	511
Proportionally consolidated companies / joint operations	1	1	2	15	57	72
Total amount of consolidated companies (a)	**38**	**475**	**513**	**52**	**531**	**583**
Investments accounted for using the equity method (b)	**19**	**143**	**162**	**5**	**87**	**92**
Total (a + b)	**57**	**618**	**675**	**57**	**618**	**675**

Source: Enel Group Administration

With reference to the **72 companies proportionally consolidated**, it can be noted that with the IFRS 11 adoption (and on the basis of the above mentioned considerations), **70 companies** have been classified as joint ventures and therefore consolidated using the equity method (the “b” amount gets on to 162), while **2 companies**, falling into the joint operations category, are still consolidated in proportion to the Group's interest.
Below, in reference to the just mentioned 70 companies which are now accounted for using the equity method, some of their details are provided[30].

[29] Enel - Half-year Financial Report at June 30, 2014 - Condensed interim consolidated financial statements - Explanatory notes - Restatement of comparative disclosures.
[30] Due to confidentiality reasons, the elements that could lead to the identification of these companies have been omitted from this study.

Table n. 9: Investments of the Enel Group in joint ventures - some details

	Country	Percentage of the Group's ownership	Result of the assessment
1	Italy	22,76%	Joint venture
2	Italy	33,33%	Joint venture
3	Italy	27,32%	Joint venture
4	Italy	34,14%	Joint venture
5	Spain	46,03%	Joint venture
6	Spain	78,63%	Joint venture
7	Cayman Islands	17,16%	Joint venture
8	Italy	0,01%	Joint venture
9	Chile	17,07%	Joint venture
10	Chile	17,07%	Joint venture
11	Spain	31,12%	Joint venture
12	Romania	29,93%	Joint venture
13	Italy	0,01%	Joint venture
14	Portugal	46,03%	Joint venture
15	Spain	46,03%	Joint venture
16	Argentine	9,02%	Joint venture
17	Chile	17,07%	Joint venture
18	Spain	46,03%	Joint venture
19	Chile	17,16%	Joint venture
20	Spain	31,12%	Joint venture
21	Spain	46,03%	Joint venture
22	Colombia	13,23%	Joint venture
23	Portugal	45,99%	Joint venture
24	Spain	46,03%	Joint venture
25	Colombia	10,90%	Joint venture
26	Italy	34,14%	Joint venture
27	Italy	34,83%	Joint venture
28	Cayman Islands	17,16%	Joint venture
29	Spain	38,90%	Joint venture
30	Spain	38,90%	Joint venture
31	Morocco	29,46%	Joint venture
32	Argentine	38,90%	Joint venture
33	Spain	38,90%	Joint venture
34	Portugal	38,90%	Joint venture
35	Spain	46,03%	Joint venture
36	Chile	17,16%	Joint venture

37	Chile	17,16%	Joint venture
38	Chile	17,16%	Joint venture
39	Argentine	17,16%	Joint venture
40	Chile	17,16%	Joint venture
41	Chile	17,16%	Joint venture
42	Italy	0,01%	Joint venture
43	Italy	0,01%	Joint venture
44	Chile	17,16%	Joint venture
45	Greece	34,14%	Joint venture
46	Russia	18,93%	Joint venture
47	Greece	34,14%	Joint venture
48	Spain	23,02%	Joint venture
49	Greece	34,14%	Joint venture
50	Spain	46,03%	Joint venture
51	Portugal	46,03%	Joint venture
52	Italy	34,14%	Joint venture
53	Chile	17,16%	Joint venture
54	Spain	25,93%	Joint venture
55	The Netherlands	49,50%	Joint venture
56	Russia	25,25%	Joint venture
57	Russia	49,50%	Joint venture
58	Russia	24,75%	Joint venture
59	Russia	24,75%	Joint venture
60	Argentine	19,98%	Joint venture
61	Spain	38,90%	Joint venture
62	Spain	0,03%	Joint venture
63	Italy	0,01%	Joint venture
64	Spain	38,90%	Joint venture
65	Italy	27,32%	Joint venture
66	Spain	46,03%	Joint venture
67	South Africa	19,46%	Joint venture
68	Portugal	35,80%	Joint venture
69	Chile	17,16%	Joint venture
70	Greece	34,14%	Joint venture

Source: Personal adaption based on Enel - Half-year Financial Report at June 30, 2014 - Attachments

Once identified the companies of the Group whose consolidation methods have been changed following the application of IFRS 11, the next step of this case study consists in highlighting the restatement of the consolidated balance sheet at December 31, 2013, and

the income statement presented in the half-year financial report at June 30, 2013 (both of them, as said before, are reported in the Group condensed interim consolidated financial statements at June 30, 2014). To this end, the following paragraph reports the adjustments made by the Group as a result of the IFRS 11 application.

4.5 Restatement of comparative disclosures

Before to illustrate the effects of IFRS 11 on the Group consolidated financial statements, it is important to note that the Group, at the end of 2013, also adopted a new accounting policy as part of the project to standardize how the different types of environmental certificates (CO2 allowances, green certificates, white certificates, etc.) are recognized and presented in the financial statements. This new model is based on the business model of the companies involved in the environmental certificates incentive mechanism and led only to certain reclassifications in the condensed consolidated income statement for the 1st Half of 2013, reported in the Group condensed interim consolidated financial statements for comparative purposes only.

In addition, the new version of IAS 32, applicable retrospectively as from January 1, 2014, requires that financial assets and liabilities may be offset and the net balance reported in the balance sheet when, and only when, an entity meets certain specific conditions. The application of the new provisions of IAS 32 led to the restatement of a number of items in the consolidated balance sheet at December 31, 2013 (which is also presented in the Group condensed interim consolidated financial statements for comparative purposes only). Those changes did not have an impact on consolidated shareholders' equity.

Finally, as of the date (June 30, 2014) of the Group condensed interim consolidated financial statements, the definitive allocation of the purchase prices for a number of companies in the Renewable Energy Division (including Parque Eólico Talinay Oriente) had been completed. As a result of the allocation, a number of items in the consolidated balance sheet at December 31, 2013, were restated to reflect the fair value of the assets acquired and the liabilities and contingent liabilities assumed in the associated business combinations. The impact on the consolidated income statement of these adjustments made in allocating the purchase price did not result in a restatement of the income statement for the 1st Half of 2013 since they were deemed to be significant[31].

[31] Enel - Half-year Financial Report at June 30, 2014 - Condensed interim consolidated financial statements - Explanatory notes - Restatement of comparative disclosures.

Having said that, the following tables report the Group financial statements for the 1st Half of 2013 and the year ended December 31, 2013, with an indication of the adjustments made as a result of the changes mentioned above (IFRS 11 and others).

Table n. 10: Consolidated income statement

Millions of euro	1st Half			
	2013	Effect of IFRS 11	New environmental certificate policy	2013 restated
Revenues				
Revenues from sales and services	39,184	(862)	(222)	38,100
Other revenues and income	973	(55)	269	1,187
	40,157	(917)	47	**39,287**
Costs				
Raw materials and consumables	20,880	(524)	138	20,494
Services	7,505	(230)	35	7,310
Personnel	2,388	(15)	-	2,373
Depreciation, amortization and impairment losses	3,125	(75)	-	3,050
Other operating expenses	1,495	1	(126)	1,370
Capitalized costs	(659)	1	-	(658)
	34,734	**(842)**	**47**	**33,939**
Net income/(charges) from commodity risk management	**(255)**	**-**	**-**	**(255)**
Operating income	**5,168**	**(75)**	**-**	**5,093**
Financial income	1,446	(2)	-	1,444
Financial expense	2,713	(6)	-	2,707
Share of income/(expense) from equity investments accounted for using the equity method	55	38	-	93
Income before taxes	**3,956**	**(33)**	**-**	**3,923**
Income taxes	1,473	(33)	-	1,440
Net income from continuing operations	**2,483**	**-**	**-**	**2,483**
Net income from discontinued operations	**-**	**-**	**-**	**-**
Net income for the year (shareholders of the Parent Company and non-controlling interests)	**2,483**	**-**	**-**	**2,483**
Pertaining to shareholders of the Parent Company	1,680	-	-	1,680
Pertaining to non-controlling interests	803	-	-	803

Source: Enel - Half-year Financial Report at June 30, 2014 - Condensed interim consolidated financial statements - Explanatory notes - Restatement of comparative disclosures.

As shown in table no. 10, the impact of IFRS 11 on consolidated income statement is highlighted in the second column of the chart. The IFRS 11 application (as a consequence of the change from proportionate consolidation to the equity method when accounting for joint ventures) leads to some adjustments: in particular, revenues decreases by € 917

million and costs decreases by € 842 million (as a consequence the operating income decreases by € 75 million).

Table n. 11: Statement of consolidated comprehensive income

Millions of euro	1st Half		
		IFRS	2013
	2013	11	Restated
Net income/(loss) for the period	**2,483**		**2,483**
Other comprehensive income recyclable to profit or loss:			
- Effective portion of change in the fair value of cash flow hedges	(301)	(6)	(307)
- Income recognized in equity by companies accounted for using equity method	1	4	5
- Change in the fair value of financial investments available for sale	(77)	-	(77)
- Change in translation reserve	(1,371)	2	(1,369)
Other comprehensive income not recyclable to profit or loss:			
Change in net liabilities (assets) in respect of defined-benefit plans	-	-	-
Income/(Loss) recognized directly in equity	**(1,748)**	**-**	**(1,748)**
Comprehensive income for the period	**735**	**-**	**735**
Pertaining to:			
- shareholders of the Parent Company	829	-	829
- non controlling interests	(94)	-	(94)

Source: Enel - Half-year Financial Report at June 30, 2014 - Condensed interim consolidated financial statements - Explanatory notes - Restatement of comparative disclosures.

Table n. 12: Consolidated balance sheet

Millions of euro

	at Dec. 31, 2013	Effect of IFRS 11	Effect of IAS 32	PPA for Renewable Energy	at Dec. 31, 2013 restated
ASSETS					
Property, plant and equipment	81,050	(773)	-	(14)	80,263
Investment property	181	-	-	-	181
Intangible assets	33,229	(225)	-	18	33,022
Deferred tax assets	6,239	(53)	-	-	6,186
Equity investments accounted for using the equity method	647	725	-	-	1,372
Non-current financial assets	6,401	13	-	-	6,414
Other non-current assets	837	(20)	-	-	817
Total non-current assets	**128,584**	**(333)**	**-**	**4**	**128,255**
Inventories	3,586	(31)	-	-	3,555
Trade receivables	11,533	(118)	-	-	11,415
Tax receivables	1,735	(26)	-	-	1,709
Current financial assets	7,877	14	406	-	8,297
Other current assets	2,562	(42)	-	-	2,520
Cash and cash equivalents	8,030	(157)	-	-	7,873
Total current assets	**35,323**	**(360)**	**406**	**-**	**35,369**
Assets held for sale	**241**	**-**	**-**	**-**	**241**
TOTAL ASSETS	**164,148**	**(693)**	**406**	**4**	**163,865**
Share capital	9,403	-	-	-	9,403
Other reserves	7,084	-	-	-	7,084
Retained earnings (loss carried forward)	19,454	-	-	-	19,454
Equity pertaining to the shareholders of the Parent Company	**35,941**	**-**	**-**	**-**	**35,941**
Non-controlling interests	**16,898**	**(7)**	**-**	**-**	**16,891**
Total shareholders' equity	**52,839**	**(7)**	**-**	**-**	**52,832**
Long-term loans	51,113	(208)	-	-	50,905
Post-employment and other employee benefits	3,696	(19)	-	-	3,677
Provisions for risks and charges	8,047	(76)	-	-	7,971
Deferred tax liabilities	10,905	(114)		4	10,795
Non-current financial liabilities	2,257	(41)	-	-	2,216
Other non-current liabilities	1,266	(7)	-	-	1,259
Total non-current liabilities	**77,284**	**(465)**	**-**	**4**	**76,823**
Short-term loans	2,529	(45)	-	-	2,484
Current portion of long-term loans	4,690	(32)	-	-	4,658
Trade payables	13,004	(81)	-	-	12,923
Income tax payable	308	(22)	-	-	286
Current financial liabilities	3,640	(6)	406		4,040
Other current liabilities	9,834	(35)	-	-	9,799
Total current liabilities	**34,005**	**(221)**	**406**	**-**	**34,190**
Liabilities held for sale	**20**	**-**	**-**	**-**	**20**
TOTAL LIABILITIES	**111,309**	**(686)**	**406**	**4**	**111,033**

TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	164,148	(693)	406		4	163,865

Source: Enel - Half-year Financial Report at June 30, 2014 - Condensed interim consolidated financial statements - Explanatory notes - Restatement of comparative disclosures.

Table no. 12 reports, among others, the adjustments on consolidated balance sheet made in accordance with IFRS 11. In particular, with reference to the main items of the chart, it can be noted that:

- total non-current assets decreases by € 333 million;
- total current assets decreases by € 360 million;
- total non-current liabilities decreases by € 465 million;
- total current liabilities decreases by € 221 million.

As a result of the aforementioned adjustments, total assets decreases by € 693 million and total liabilities by € 686 million. Lastly, as a consequence of the reduction of the non-controlling interests, total shareholders' equity decreases by € 7 million.

Table n. 13: Consolidated statement of cash flows

Millions of euro	1st Half		
	2013	IFRS 11	2013 restated
Net income before taxes	**3,956**	**(33)**	**3,923**
Adjustments for:		-	
Amortization and impairment losses of intangible assets	406	(15)	391
Depreciation and impairment losses of property, plant and equipment	2,339	(60)	2,279
Exchange rate adjustments of foreign currency assets and liabilities (including cash and cash equivalents)	(96)	-	(96)
Accruals to provisions	748	4	752
Financial (income)/expense	1,030	1	1,031
(Gains)/Losses and other non-monetary items	375	(41)	334
Cash flow from operating activities before changes in net current assets	8,759	(145)	8,614
Increase/(Decrease) in provisions	(1,157)	18	(1,139)
Increase/(Decrease) in inventories	(59)	(18)	(77)
Increase/(Decrease) in trade receivables	(1,043)	(33)	(1,076)
Increase/(Decrease) in financial and non-financial assets/liabilities	(484)	91	(393)
Increase/(Decrease) in trade payables	(2,759)	69	(2,690)
Interest income and other financial income collected	561	96	657
Interest expense and other financial expense paid	(2,010)	(59)	(2,069)
Income taxes paid	(1,197)	-	(1,197)
Cash flows from operating activities (a)	**610**	**20**	**630**
Investments in property, plant and equipment	(2,162)	15	(2,147)
Investments in intangible assets	(197)	1	(196)
Investments in entities (or business units) less cash and cash equivalents acquired	(152)	4	(148)
Disposals of entities (or business units) less cash and cash equivalents sold	68	-	68
(Increase)/Decrease in other investing activities	50	(4)	46
Cash flows from investing/disinvesting activities (b)	**(2,393)**	**16**	**(2,377)**
Financial debt (new long-term borrowing)	1,071	(6)	1,065
Financial debt (repayments and other net changes)	(3,252)	(36)	(3,288)
Collection of proceeds from sale of equity holdings without loss of control	1,795	-	1,795
Incidental expenses related to sale of equity holdings without loss of control	(45)	-	(45)
Dividends and interim dividends paid	(1,846)	-	(1,846)
Cash flows from financing activities (c)	**(2,277)**	**(42)**	**(2,319)**
Impact of exchange rate fluctuations on cash and cash equivalents (d)	**(129)**	**1**	**(128)**
Increase/(Decrease) in cash and cash equivalents (a+b+c+d)	**(4,189)**	**(5)**	**(4,194)**
Cash and cash equivalents at beginning of the period	9,933	(165)	9,768
Cash and cash equivalents at the end of the period	5,744	(170)	5,574

Source: Enel - Half-year Financial Report at June 30, 2014 - Condensed interim consolidated financial statements - Explanatory notes - Restatement of comparative disclosures.

Moreover, with reference to the most relevant companies[32] among those included in in the joint ventures scope, the same patterns are shown below. By so doing, it is possible to highlight the transition from proportionate consolidation to the equity method when accounting for joint ventures in accordance with IFRS 11. In particular:

- as for the consolidated income statement, it is shown the case of a Russian company operating in the electricity purchase and sale market;
- as for the consolidated balance sheet, it is shown the case of an Italian company operating in the electricity generation from hydroelectric resources.

Table n. 14: transition from proportionate consolidation to the equity method in the consolidated income statement - the case of a Russian company

Millions of euro

	2013	Effect of IFRS 11	2013 restated
Revenues			
Revenues from sales and services	705	(705)	-
Other revenues and income	3	(3)	-
	708	**(708)**	**-**
Costs			
Raw materials and consumables	491	(491)	-
Services	157	(157)	-
Personnel	4	(4)	-
Depreciation, amortization and impairment losses	3	(3)	-
Other operating expenses	-	-	-
Capitalized costs	-	-	-
	655	**(655)**	**-**
Net income/(charges) from commodity risk management	**-**	**-**	**-**
Operating income	**53**	**(53)**	**-**
Financial income	2	(2)	-
Financial expense	1	(1)	-
Share of income/(expense) from equity investments accounted for using the equity method	-	42	42
Income before taxes	**54**	**(12)**	**42**
Income taxes	12	(12)	-
Net income from continuing operations	**42**	**-**	**42**
Net income from discontinued operations	**-**	**-**	**-**
Net income for the year (shareholders of the Parent Company and non-controlling interests)	**42**	**-**	**42**
Pertaining to shareholders of the Parent Company	42	-	42
Pertaining to non-controlling interests	-	-	-

Source: Enel Group Administration

[32] Due to confidentiality reasons, the elements that could lead to the identification of these companies have been omitted from this study.

Table n. 15: transition from proportionate consolidation to the equity method in the consolidated balance sheet - the case of an Italian company

Millions of euro

	at Dec. 31, 2013	Effect of IFRS 11	at Dec. 31, 2013 restated
ASSETS			
Property, plant and equipment	176	(176)	-
Investment property	-	-	-
Intangible assets	101	(101)	-
Deferred tax assets	4	(4)	-
Equity investments accounted for using the equity method	-	210	210
Non-current financial assets	-	-	-
Other non-current assets	1	(1)	-
Total non-current assets	**282**	**(72)**	**210**
Inventories	4	(4)	-
Trade receivables	24	(24)	-
Tax receivables	-	-	-
Current financial assets	-	-	-
Other current assets	21	(21)	-
Cash and cash equivalents	1	(1)	-
Total current assets	**50**	**(50)**	**-**
Assets held for sale	**-**	**-**	**-**
TOTAL ASSETS	**332**	**(122)**	**210**
Share capital	-	-	-
Other reserves	9	-	9
Retained earnings (loss carried forward)	201	-	201
Equity pertaining to the shareholders of the Parent Company	**210**	**-**	**210**
Non-controlling interests	**-**	**-**	**-**
Total shareholders' equity	**210**	**-**	**210**
Long-term loans	-	-	-
Post-employment and other employee benefits	3	(3)	-
Provisions for risks and charges	16	(16)	-
Deferred tax liabilities	62	(62)	-
Non-current financial liabilities	-	-	-
Other non-current liabilities	-	-	-
Total non-current liabilities	**81**	**(81)**	**-**
Short-term loans	15	(15)	-
Current portion of long-term loans	2	(2)	-
Trade payables	9	(9)	-
Income tax payable	12	(12)	-
Current financial liabilities	-	-	-
Other current liabilities	3	(3)	-

Total current liabilities	41	(41)	-
Liabilities held for sale	-	-	-
TOTAL LIABILITIES	122	(122)	-
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	332	(122)	210

Source: Enel Group Administration

4.6 Impact of IFRS 11 on the main key performance indicators of the Group

Once illustrated the effects of the IFRS 11 application on the Group consolidated financial statements, the last step of this section (as said during the introduction) is to highlighting the impact that this new standard had on the group's key performance indicators.

To this end, it is firstly necessary to identify the main key performance indicators used by the Group to monitor its performance.

In order to present the results of the Group and analyze its financial structure, Enel prepared separate reclassified schedules that differ from those envisaged under the IFRS-EU adopted by the Group and presented in the condensed interim consolidated financial statements.

These reclassified schedules contain different performance indicators from those obtained directly from the condensed interim consolidated financial statements. That's because the management believes they are useful in monitoring Group performance and representative of the financial performance of the Group's business[33].

In accordance with Recommendation CESR/05-178b published on November 3, 2005, these indicators (and the criteria used to calculate them) are shown below.

a) Gross operating margin: an operating performance indicator, calculated as "Operating income" plus "Depreciation, amortization and impairment losses";

b) Net non-current assets: calculated as the difference between "Non-current assets" and "Non-current liabilities" with the exception of:
   - "Deferred tax assets"
   - "Securities held to maturity", "Financial investments in funds or portfolio management products at fair value", "Securities available for sale" and "Other financial receivables"
   - "Long-term loans"

[33] Enel - Half-year Financial Report at June 30, 2014 - Interim report on operations - Summary of results – Definition of performance indicators.

- “Post-employment and other employee benefits”
- “Provisions for risks and charges”
- “Deferred tax liabilities”;

c) Net current assets: calculated as the difference between “Current assets” and “Current liabilities” with the exception of:

- “Long-term financial receivables (short-term portion)”, “Receivables for factoring advances”, “Securities”, “Cash collateral” and “Other financial receivables”
- “Cash and cash equivalents”
- “Short-term loans” and the “Current portion of long-term loans”;

d) Net assets held for sale: calculated as the algebraic sum of “Assets held for sale” and “Liabilities held for sale”;

e) Net capital employed: calculated as the algebraic sum of “Net non-current assets” and “Net current assets”, provisions not previously considered, “Deferred tax liabilities” and “Deferred tax assets”, as well as “Net assets held for sale”;

f) Net financial debt: a financial structure indicator, determined by “Long-term loans”, the current portion of such loans and “Short-term loans” less “Cash and cash equivalents”, “Current financial assets” and “Noncurrent financial assets” not previously considered in other balance sheet indicators. More generally, the net financial debt of the Enel Group is calculated in conformity with paragraph 127 of Recommendation CESR/05-054b implementing Regulation (EC) no. 809/2004 and in line with the CONSOB instructions of July 26, 2007, net of financial receivables and long-term securities.

Also in this context, the comparative figures in the Group balance sheet at December 31, 2013 (and the income statement for the 1st Half of 2013), have been restated to reflect:

- the application of the new IFRS 11, applicable since January 1, 2014 with retrospective effect, under which the only permissible method for accounting for joint ventures is the equity method. This change eliminated the option, permitted under the previous IAS 31 and utilized previously by the Group, of consolidating such interests on a proportionate basis, resulting in the restatement of all the income

statement and balance sheet figures, although this did not change the Group's net result or consolidated shareholders' equity;

- the adoption at the end of 2013 of a new accounting policy for the recognition and presentation of different types of environmental certificates (CO2 allowances, green certificates, white certificates, etc.) in the financial statements, resulting in certain restatements in the consolidated income statement for the 1st Half of 2013;
- the application of the new provisions of IAS 32, applicable since January 1, 2014 with retrospective effect, concerning the offsetting of financial assets and liabilities under certain conditions, which led to the restatement of several items in the consolidated balance sheet at December 31, 2013. These changes did not have an impact on consolidated shareholders' equity;
- the definitive allocation of the purchase prices for a number of companies in the Renewable Energy Division (including Parque Eólico Talinay Oriente) in transactions that had been completed after December 31, 2013. As a result, a number of items in the balance sheet at that date were restated.

Having said that, here below are presented some tables which report the effects of the above changes on the main performance and financial indicators used by the Group for the 1st Half of 2013, the 2nd Quarter of 2013 and at December 31, 2013, respectively.

Table n. 16: Impact of IFRS 11 on the main key performance indicators of the Group

Millions of euro	1st Half			
	2013	Effect of IFRS 11	New environmental certificates policy	**2013 restated**
Revenues	40,157	(917)	47	**39,287**
Gross operating margin	8,293	(150)	-	**8,143**
Operating income	5,168	(75)	-	**5,093**
Net capital employed	92,701	(163)	-	**92,538** [(1)]
Net financial debt	39,862	(156)	-	**39,706** [(1)]
Cash flows from operating activities	610	20	-	**630**
Capital expenditure on tangible and intangible assets	2,359	(16)	-	**2,343**

[(1)] At December 31, 2013 restated.

Source: Enel - Half-year Financial Report at June 30, 2014 - Interim report on operations - Summary of results – Restatement of comparative figures.

Table no. 16 shows the effects of IFRS 11 on the group's key performance indicators for the first half of 2013. All the adjustments made in accordance with IFRS 11 lead to a restatement of the aforementioned figures, which are highlighted in the last column of the chart. As it can be noted, the main adjustments regard:

(i) revenues, which decreases by € 917 million;

(ii) net capital employed, which decreases by € 163 million;

(iii) net financial debt, which decreases by € 156 million;

(iv) gross operating margin, which decreases by € 150 million.

Once highlighted the impact of IFRS 11 on the main KPI, the following table reports the impact of the above restatement on the results of the divisions and business areas with respect to revenues, the gross operating margin, operating income and capital expenditure for the 1st Half and 2nd Quarter of 2013.

Revenues

2nd Quarter 2013	Effect of IFRS 11	New environmental certificates policy	2nd Quarter 2013 restated	Millions of euro	1st Half 2013	Effect of IFRS 11	New environmental certificates policy	1st Half 2013 restated
3,779	-	-	3,779	Sales	8,712	-	-	8,712
5,652	(32)	-	5,620	Generation and Energy Management	12,152	(52)	-	12,100
1,931	-	-	1,931	Infrastructure and Networks	3,784	-	-	3,784
7,611	(64)	-	7,547	Iberia and Latin America	15,636	(121)	-	15,515
1,779	(337)	-	1,442	International	3,817	(715)	-	3,102
784	(17)	-	767	Renewable Energy	1,502	(31)	-	1,471
(2,264)	(1)	21	(2,244)	Other, eliminations and adjustments	(5,446)	2	47	(5,397)
19,272	**(451)**	**21**	**18,842**	**Total**	**40,157**	**(917)**	**47**	**39,287**

Gross operating margin

2nd Quarter 2013	Effect of IFRS 11	2nd Quarter 2013 restated	Millions of euro	1st Half 2013	Effect of IFRS 11	1st Half 2013 restated
237	-	237	Sales	477	-	477
363	(26)	337	Generation and Energy Management	667	(39)	628
1,008	-	1,008	Infrastructure and Networks	1,966	-	1,966
1,930	(24)	1,906	Iberia and Latin America	3,614	(48)	3,566
176	(31)	145	International	565	(56)	509
495	(5)	490	Renewable Energy	973	(6)	967
7	(1)	6	Other, eliminations and adjustments	31	(1)	30
4,216	**(87)**	**4,129**	**Total**	**8,293**	**(150)**	**8,143**

Operating income

2nd Quarter 2013	Effect of IFRS 11	2nd Quarter 2013 restated	Millions of euro	1st Half 2013	Effect of IFRS 11	1st Half 2013 restated
109	-	109	Sales	190	-	190
217	(18)	199	Generation and Energy Management	418	(24)	394
761	-	761	Infrastructure and Networks	1,479	-	1,479
1,220	(14)	1,206	Iberia and Latin America	2,176	(28)	2,148
7	(30)	(23)	International	262	(54)	208
319	23	342	Renewable Energy	667	32	699
(19)	(1)	(20)	Other, eliminations and adjustments	(24)	(1)	(25)
2,614	**(40)**	**2,574**	**Total**	**5,168**	**(75)**	**5,093**

Capital expenditure

Millions of euro	1st Half 2013	Effect of IFRS 11	1st Half 2013 restated
Sales	24	-	24
Generation and Energy Management	96	(2)	94
Infrastructure and Networks	483	-	483
Iberia and Latin America	803	(7)	796
International	376	-	376
Renewable Energy	552	(7)	545
Other, eliminations and adjustments	25	-	25
Total	**2,359**	**(16)**	**2,343**

Source: Enel - Half-year Financial Report at June 30, 2014 - Interim report on operations - Summary of results – Restatement of comparative figures.

Appendix - Checklist: joint arrangement classification assessment

<table>
<tr><td colspan="2">Ref. no. (to be the same as indicated in the field “Ref” in the file “IFRS 11 - Inventory”):</td><td>Name of the entity/joint arrangement:</td><td colspan="2">Date:</td></tr>
<tr><td colspan="2">Ref.</td><td>Question</td><td>YES/NO</td><td>Notes</td></tr>
<tr><td>1</td><td></td><td>Does the contractual arrangement give all of the parties (or a group of the parties) control of the arrangement collectively?

All the parties, or a group of the parties, control the arrangement collectively when they must act together to direct the activities that significantly affect the returns of the arrangement (ie the relevant activities). That is if all the parties, or a group of the parties, considered collectively, are exposed, or have rights, to variable returns from their involvement with the arrangement and have the ability to affect those returns through their power over the arrangement.

Please, note that a contractual arrangement can be evidenced in several ways. An enforceable contractual arrangement is often, but not always, in writing, usually in the form of a contract or documented discussions between the parties. Statutory mechanisms can also create enforceable arrangements, either on their own or in conjunction with contracts between the parties.

(For further evidence, refer to paragraph 4.1.1 of the operating note)

If ‘yes’ proceed to question 2
If ‘no’, then the arrangement is outside the scope of IFRS 11</td><td></td><td></td></tr>
</table>

Ref. no. (to be the same as indicated in the field "Ref" in the file "IFRS 11 - Inventory"):	Name of the entity/joint arrangement:	Date:	

Ref.		Question	YES/NO	Notes
2		**Do the decisions about relevant activities of the joint arrangement require unanimous consent of all the parties that collectively control the arrangement?** *Once it has been determined that all the parties, or a group of the parties, control the arrangement collectively, joint control exists only when decisions about the relevant activities require the unanimous consent of those parties (not every party to the arrangement).* The requirement for unanimous consent means that any party with joint control of the arrangement can prevent any of the other parties, or a group of the parties, from making unilateral decisions (about the relevant activities) without its consent. If the requirement for unanimous consent relates only to decisions that give a party protective rights and not to decisions about the relevant activities of an arrangement, that party is not a party with joint control of the arrangement. (Refer to paragraphs 4.1.2, 4.1.3 and 4.1.4 of the operating note) If 'yes' proceed to question 3 If 'no', then the arrangement is outside the scope of IFRS 11		

Ref. no. (to be the same as indicated in the field "Ref" in the file "IFRS 11 - Inventory"):		Name of the entity/joint arrangement:	Date:	
Ref.		**Question**	**YES/NO**	**Notes**
3		**Is the requirement for unanimous consent relates only to decisions that give a party protective rights?** If the requirement for unanimous consent relates only to decisions that give a party protective rights and not to decisions about the relevant activities of an arrangement, that party is not a party with joint control of the arrangement. *Protective rights are assigned exclusively in order to protect the interests of their holders and their exercise is possible only in the event of highly significant changes of the activities of the entity or whenever specific exceptional circumstances occur.* (Refer to paragraph 4.1.4 of the operating note) If 'yes', the arrangement is outside the scope of IFRS 11 If 'no', proceed to question 4		
4		**Assessing the structure of the joint arrangement** An entity shall determine the type of joint arrangement in which it is involved. The classification of a joint arrangement as a joint operation or a joint venture depends upon the rights and obligations of the parties to the arrangement.		
	4.1	**Does the arrangement foresee the formation of a separate vehicle?** (Refer to paragraph 4.3 of the operating note) If 'yes', proceed to question 4.2 If 'no', then the joint arrangement is a joint operation		

Ref. no. (to be the same as indicated in the field “Ref” in the file “IFRS 11 - Inventory”):	Name of the entity/joint arrangement:	Date:	
Ref.	**Question**	**YES/NO**	**Notes**
4.2	**Does the legal form of the separate vehicle entails legal personality and financial independence from the parties sharing control?** The legal form assists in the initial assessment of the parties' rights to the assets and obligations for the liabilities held in the separate vehicle, such as whether the parties have interests in the assets held in the separate vehicle and whether they are liable for the liabilities held in the separate vehicle. (Refer to paragraph 4.3.1 of the operating note) If ‘yes’, then proceed to question 4.3 If ‘no’, then the joint arrangement is a joint operation		
4.3	**Does the contractual arrangement between parties confer direct rights to assets and obligations for liabilities to the parties of the arrangement?** In many cases, even if the legal form of the separate vehicle establishes rights for each of the parties, the contractual terms of the joint arrangement may unwind the effects of the legal form and give the parties rights to the assets and obligations for the liabilities. (Refer to paragraph 4.3.2 of the operating note) If ‘yes’, then the joint arrangement is a joint operation If ‘no’, your arrangement is not clearly a joint operation or a joint venture. Therefore, you have to consider other facts and circumstances to assess whether the arrangement is a joint operation or a joint venture, as indicated in the paragraph 4.3.3 of the operating note. Proceed to question 4.4		

Ref. no. (to be the same as indicated in the field "Ref" in the file "IFRS 11 - Inventory"):	Name of the entity/joint arrangement:	Date:	
Ref.	**Question**	**YES/NO**	**Notes**
4.4	**Must the parties purchase substantially all of the output produced by the joint arrangement?** When the terms of the contractual arrangement or the legal form of the arrangement do not specify that the parties have rights to the assets, and obligations for the liabilities, relating to the arrangement, the parties shall consider other facts and circumstances to assess whether the arrangement is a joint operation or a joint venture. In such a phase, it is important to understand whether the joint arrangement primarily aims to provide the parties with an output (i.e., the parties have rights to substantially all of the economic benefits of the assets) (Refer to paragraph 4.3.3 of the operating note) If 'yes', then the joint arrangement would likely be a joint operation. Proceed to question 4.5 If 'no', then proceed to question 4.5		
4.5	**Are the parties to the joint arrangement the source of cash flows to pay liabilities on a continuous basis?** In assessing other facts and circumstances, it is important to understand whether the joint arrangement depends on the parties on a continuous basis for setting its liabilities (Refer to paragraph 4.3.3 of the operating note) If 'yes', then the joint arrangement would likely be a joint operation. Proceed to question 4.6 If 'no', then proceed to question 4.6		

Ref. no. (to be the same as indicated in the field “Ref” in the file “IFRS 11 - Inventory”):	**Name of the entity/joint arrangement:**		**Date:**	
Ref.	**Question**		**YES/NO**	**Notes**
4.6	**Is the joint arrangement designed to operate at break-even, or to generate losses that will be funded by the parties?** (Refer to paragraph 4.3.3 of the operating note) If ‘yes’, and if your answers to questions 4.4 and 4.5 was “yes” then the joint arrangement is a joint operation If ‘no’, and if your answers to questions 4.4 and 4.5 was “no” then the joint arrangement is a joint venture If you answer to questions 4.4, 4.5 and 4.6 “yes” and “no”, judgement will be needed to assess whether the joint arrangement is a joint operation or a joint venture. You should assess all the features of the arrangement in order to identify if, in substance, the joint arrangement represents a joint operation or joint venture.			

Conclusions

In May 2011the IASB issued a package of three standards that, with reference to different aspects, plays a crucial role on the preparation of consolidated financial statements. These standards, effective within the EU for annual periods beginning on or after 1 January 2014, are: **(i)** IFRS 10 *Consolidated Financial Statements*, **(ii)** IFRS 11 *Joint Arrangements* and **(iii)** IFRS 12 *Disclosure of Interests in Other Entities*.

In particular, this thesis focused on the new requirements established by IFRS 11. This new standard supersedes IAS 31 *Interests in Joint Ventures* and SIC-13 *Jointly Controlled Entities – Non-Monetary Contributions by Venturers* and redefines the framework for the accounting for joint arrangements.

Compared with IAS 31, IFRS 11 introduces only two types of joint arrangements: joint operations and joint ventures. The classification of joint arrangements now focuses on rights and obligations of the parties as criteria of demarcation between joint operations and joint ventures.

Moreover, by eliminating the accounting option for joint ventures established under IAS 31, IFRS 11 states that all joint ventures have to be recorded in the consolidated financial statements using the equity method. Therefore, the introduction of this new accounting requirement could affect a reporting entity's financial statement, and management should doubtless consider the impact of IFRS 11 on entity's key financial and economic results.

In this regard, IFRS 11 mainly constitutes a change in the accounting for those arrangements that were classified in IAS 31 as jointly controlled entities: the change mostly depends upon the accounting method used by entities when accounting for their jointly controlled entities in accordance with IAS 31 and on the classification of those arrangements in accordance with IFRS 11 (i.e. joint operations or joint ventures).

In particular, the most significant change consists of those jointly controlled entities that were proportionately consolidated in IAS 31 that will now be joint ventures and, in accordance with IFRS 11, will be accounted for using the equity method (in this case, entities will generally report lower amounts for assets and liabilities and lower revenues and expenses).

In this context, entities should evaluate the new accounting requirements of IFRS 11 and its impact upon their consolidated financial statements; furthermore, with reference to the just mentioned considerations, this change may have a significant impact upon their key performance indicators.

Given that, the aim of this thesis was to provide initial empirical evidence of the application of IFRS 11 in order to highlight its effects on consolidated financial statements. To this purpose, once having illustrated the main innovations established under IFRS 11 from a theoretical point of view, a case study has been used as the chosen research method. In particular, it has been illustrated how an international Group (Enel) dealt with all the phases that had led to the application of the new standard. In this context, it has initially been highlighted the activities that the Group carried out in order to assess if its joint arrangements met features of joint operations or joint ventures under IFRS 11 rules. Secondly, with reference to the 70 companies of the Group classified as joint ventures (and therefore consolidated using the equity method), the adjustments made by the Group on consolidated financial statements as a result of the application of IFRS 11 have been described. To this end, it has been illustrated the restatement of the consolidated balance sheet at December 31, 2013, and the income statement presented in the half-year financial report at June 30, 2013 (both of them reported in the Group condensed interim consolidated financial statements at June 30, 2014).
Lastly, it has been also pointed out the effects of the IFRS 11 application on the group's key performance indicators for the first half of 2013. In particular, all the adjustments made in accordance with the new standard lead to a restatement of the following performance and financial indicators: (i) revenues; (ii) gross operating margin; (iii) operating income; (iv) capital expenditure.
Therefore, consistent with the initial previsions, it was possible to note how the application of IFRS 11 (as a consequence of the change from proportionate consolidation to the equity method when accounting for joint ventures) led to: (i) lower amounts of revenues and costs in the consolidated income statements; (ii) lower amounts of assets and liabilities in the consolidated balance sheet; (iii) a restatement of the main key performance indicators of the Group.
Since the annual reports of the entities applying IFRS 11 are not available at time of writing, a case study seemed to be a proper method to start investigating the effects deriving from the application of this new standard. Concerning this issue, this research cannot give conclusive evidence about the effects arising from the new accounting requirements established under IFRS 11; therefore, the above-mentioned effects deserve further investigation in the future.

References

Accountancy (2011). Effects of IFRS 10 and 11 Accounting Standards. 148(1419), 57.

Accountig Standard OIC 17.

Agliati, M. (2000). Funzione amministrativa e sistema amministrativo: lo spazio di indagine. Cusl, Milano.

Article No. 2359 Codice Civile.

Article No. 2497 - sexies Codice Civile.

Azzali, S., Allegrini, M., Gaetano, A., Pizzo, M., & Quagli, A. (2006). Principi Contabili Internazionali. Giappichelli, Torino, 386-397.

Azzini, L. (1982). Istituzioni di economia d’azienda. Giuffrè, Milano.

Betancourt, L., & Baril, C. (2013). Accounting for Joint Ventures Moves Closer to Convergence. Are Financial Statement Users Better Off? The CPA Journal, 26-31.

Caratozzolo, M. (2002). Il bilancio consolidato di gruppo. Profili economici e giuridici. Giuffrè, Milano, 75-76.

Casabona, P. A., & Ashwal, A. (2005). Consolidated Financial Statements; The Concept of Control in Consolidated Financial Statements: Convergence U.S. and International Accounting Rules. Review of Business, 26 (2), 38.

Corticelli, R. (1986). La crescita dell’azienda. Armonie e disarmonie di gestione. Giuffrè, Milano, 135-136.

D.Lgs. No. 127/1991.

D.Lgs. No. 38 - 28 February 2005.

De Gennaro, G., & Mazzeo, R. (2011). Lo IAS 31 "Interests in Joint Ventures" lascia il posto all'IFRS 11 "Joint Arrangements". Guida alla Contabilità & Bilancio, (14), 59-64.

De Gennaro, G., & Mazzeo, R. (2012). IFRS 11 "Joint Arrangements": Impatti Applicativi sul Bilancio. Guida alla Contabilità & Bilancio, (4), 62-65.

Deloitte (2011). Moving ahead in an IFRS world. A Practical Guide to Implementing IFRS 11 - Joint Arrangements.

Dezzani, F., Biancone, P., & Bruno, D. (2012). IAS/IFRS. IPSOA.

Directive 2013/34.

Ernst & Young (2011). Challanges in Adopting and Applying IFRS 11.

Ernst & Young (2014). Challanges in Adopting and Applying IFRS 11.

Gardini, S. (2010). Il Bilancio Consolidato secondo i Principi Contabili Nazionali e Internazionali. Giuffrè Editore.

Gillard, G., & Khatri, G.R. (2011). Regaining Control. Financial Reporting-Accountancy Ireland, 43(5), 37.

IASB (2011). Effect Analysis, IFRS 10 Consolidated Financial Statements and IFRS 12 Disclosure of Interests in Other Entities.

IASB (2011). Effect Analysis, IFRS 11 Joint Arrangements and disclosures for joint arrangements ncluded in IFRS 12 Disclosure of Interests in Other Entities.

IASB (2011). Project Summary and Feedback Statement, IFRS 11 Joint Arrangements. IFRS 10, Appendix A.

International Accounting Standard No. 1.

International Accounting Standard No. 27.

International Accounting Standard No. 28.

International Accounting Standard No. 31.

International Financial Reporting Standard No. 10.

International Financial Reporting Standard No. 11.

International Financial Reporting Standard No. 12.

Law No. 306 - 31 October 2003 .

Leitner-Hanetseder, S., Kepler, J., & Stockinger, M. (2014). What Impact does the Application of IFRS 11 have on (European) Companies? An Empirical Study of the Impacts on Selected Financial Statement Figures and Key Financial Ratios. Global Conference on Business and Finance Proceedings, 9(1), 208-214.

Lenoci, F., Rocca, E. (2008). Il bilancio consoldiato. Ipsoa, Milano (2008).

Marchi, L., Zavani, M., & Branciari, S. (2010). Economia dei gruppi e bilancio consolidato. Una interpretazione degli andamenti economici e finanziari. Giappichelli, Torino.

Memento pratico Ipsoa-Francis Lefebvre (2008). Il bilancio consolidato. Ipsoa-Lefebvre, Milano.

Montrone, A. (2004). Il Bilancio Consolidato. Evoluzione Normativa e Metodologia di redazione. Franco Angeli.

Organismo Italiano di Contabilità - OIC (2005). Principi contabili.

Passaponti, B. (1994). I gruppi e le altre aggregazioni aziendali, Giuffrè, Milano.

Pellicelli, G. (1972). La multinazionale: un nuovo modello di impresa? Rivista dei dottori commercialisti.

Prencipe, A., & Tettamanzi, P. (2009). Bilancio consolidato. Tecniche di redazione e di analisi secondo i nuovi principi internazionali. Egea.

PwC (2011). Practical guide - Consolidated Financial Statements - Redefining control.

PwC (2011). Practical Guide to IFRS. Joint Arrangements: a new approach to an age-old business issue.

Quagli, A. (2011). Dalle Joint Ventures ai Joint Arrangements (IFRS 11). Amministrazione & Finanza, 7-11.

Quagli, A. (2011). IFRS 10: nozione di controllo e bilancio consolidato. Amministrazione & Finanza, 9, 10.

Regulation No. 1254/2012.

Regulation No. 1606/2002.

Shamrock, S. E. (2012). IFRS and US GAAP, A Comprehensive Comparison. John Wiley & Soon, New Jersey.

Terzani, S. (2002). Il sistema dei bilanci. Franco Angeli.

Vergani, M. (2011). IFRS 11: “Joint Arrangements”. Guida alla Contabilità & Bilancio, (13), 59-64.

Voogt, M. (2011). Taking Control. Institute of Chartered Accountants, 64.

Web sites

www.enel.com

www.ifrs.org

www.fondazioneoic.eu

Acknowledgements

I would like to express my deepest gratitude to my supervisor, Professor Lidia D'Alessio for her moral and professional support during this my experience as Ph.D. Student and for her guidance. Also I would like to thank all my colleagues, who shared my "university life" during these past three years: Carmela, Lucia, Andrea, Carlo, Maria Francesca, Anita, Cristiana, Massimiliano, Giuseppe, Ornella and Saverio.
A special thank goes to Mr. Andrea Angelino, Mr. Angelo Scipioni, Mr. Danilo Bracoloni, Mr. Michele Rizzi and Mr. Walter Grilli (Enel Group Administration) for their immense assistance in developing this thesis.
Last but not least, I would also like to thank my family and my friends.