Financial Accounting Standard No. (23)

Consolidation

Contents

Preface

The purpose of this standard is to establish the principles for consolidating the financial statements of an Islamic Financial Institution (IFI)[1] and entities under its control that are subject for consolidation.

(1) Referred to hereafter as institution or institutions including Islamic banks.

Statement of the Standard

1. Scope of the Standard

This standard is applicable to the consolidated financial statements prepared and presented by an Islamic financial institution (IFI) as a parent entity. This standard sets out the principles for determining entities that are subject to be included in the consolidated financial statements of a parent and prescribes the accounting for investment in subsidiaries by parent.

Consolidation shall also apply in case of Special Purpose Vehicle (SPV), which is an entity established to carry out specific activities and accomplish specific objectives, except if the SPV is established for the benefit of party or parties other than the IFI.

Should the requirements of this standard be in conflict with an IFI's charter or the laws and regulations of the country in which it operates, a disclosure should be made to that effect. (para. 1)

2. Definitions

Consolidated financial statements: Financial statements for a group of entities prepared and presented as those for a single entity.

Control: The power to govern the financial and operating policies of an entity with the objective of obtaining benefits from its operations.

Group: This includes parents and their subsidiaries.

Non-controlling interest: Interest of owners other than parent.

Parent: The entity that prepared and presented the consolidated financial statements. In the context of this standard, the IFI is regarded as the parent.

Separate financial statements: Financial statements for a parent in which the shareholdings in subsidiaries and associates are accounted for solely as an investment either at cost or fair value.

Subsidiary: An entity that is controlled by the parent.

Voting rights: Rights for voting at an entity's shareholders' meeting or other similar forums. (para. 2)

3. Determination and Scope of Consolidated Financial Statements

3/1 An entity shall be classified as a subsidiary of an IFI if the IFI can exercise control over the investee entity. Control is presumed to exist if an IFI holds, directly or indirectly through its subsidiaries, more than 50% of the voting rights in an entity, unless it can be clearly demonstrated otherwise. Conversely, where the IFI has less than majority voting rights in the said entity, control may also exist through (I) agreement with the entity's other shareholders or the entity itself; (II) rights arising from other contractual arrangements; (III) IFI's voting rights (de facto power); (IV) potential voting rights; or (V) a combination thereof. (para. 3)

3/2 Control attributable to investments funded by the following is considered for determination of a subsidiary and consequently requires consolidation by the IFI:

a) IFI's owners' equity and liabilities,
b) Its unrestricted investment accounts. (para. 4)

3/3 Voting rights in an entity include those that are accorded through shares or other equity or financing instruments as well as those that are obtained through agreement with the entity's other shareholders or the entity itself. An IFI shall consider only substantive voting rights in its assessment of whether the IFI has power over an entity. In order to be substantive, rights need to be exercisable when relevant decisions are required to be made and the holder of such rights must have the practical ability to exercise those rights. For the purpose of this standard, determination of voting rights shall include current substantive voting rights and currently-exercisable voting rights. (para. 5)

3/4 The consolidation of a subsidiary is required regardless of the nature of activities of the said entity. Therefore, consolidation shall apply in cases where the nature of activities of the subsidiary is dissimilar to that of the IFI. (para. 6)

3/5 The IFI shall cease to account for investment in subsidiary when IFI is no longer able to exercise control over the investee entity. Such investment should be accounted for as an associate or investment, as appropriate. (para. 7)

4. Presentation of Consolidated Financial Statements

4/1 An IFI is required to prepare and present consolidated financial statements, consolidating its own separate financial statements with those of its subsidiaries. (para. 8)

4/2 In accordance with local regulations and/or on its own volition, an IFI may also present its own separate financial statements, which do not consolidate those of its subsidiaries. (para. 9)

4/3 With regard to 4/2, the separate financial statement shall be accompanied by the consolidated financial statements in accordance with 4/1. (para. 10)

5. Consolidation Procedures

5/1 Consolidated financial statements shall be prepared by combining the financial statements of the IFI with those of the subsidiaries. This shall be carried out through adding like items line by line. However, the financial statements are not required to be combined on a line by line basis if control is intended to be temporary. (para. 11)

5/2 Intragroup transactions between the IFI and the subsidiaries shall be eliminated. Intragroup losses may indicate impairment that requires recognition in the consolidated financial statements (para. 12)

5/3 The carrying amount of the IFI's investment in the subsidiaries and the IFI's portion of equity in those entities shall be eliminated with a resultant goodwill. (para. 13)

5/4 Non-controlling interests in statement of financial position (the balance sheet) shall be identified and reported as part of total equity. Net profit or loss attributed to non-controlling interest must be disclosed separately from the net profit or loss attributable to the parent on the face of the income statement. (para. 14)

5/5 In preparing the consolidated financial statements, the same accounting policy shall be applied to the financial statements that are subject to consolidation (i.e., those of the parent entity, and the subsidiary) and the consolidated financial statements. (para. 15)

5/6 The financial statements that are subject to consolidation (i.e., those of the parent entity and the subsidiary) shall be prepared as at the same reporting date and for the same length of reporting period. If it is not practicable for all the financial statements to be prepared as at the same reporting date, the difference between the reporting date of the financial statements of subsidiaries and those of the parent shall be no more than three months. In such cases, significant transactions that occur between the reporting dates of the financial statements of subsidiaries and those of the parent shall be adjusted in the consolidated financial statements. (para. 16)

5/7 The income and expenses of a subsidiary must be consolidated in the IFI's consolidated financial statements from the date of the acquisition of that entity by the IFI. (para. 17)

When the IFI fully or partially disposes of the subsidiary entity, the difference between the carrying amount of investment in that entity as at disposal date, and the disposal proceeds shall be recognised in the IFI's income statement. Furthermore, the corresponding goodwill should be derecognised proportionately from IFI's financial statements. IFI shall continue to consolidate the income and expenses of subsidiary until the date of cessation of control by the parent. (para. 18)

5/8 In preparing the consolidated financial statements, reporting of foreign currency transactions and foreign operations shall follow Financial Accounting Standard No. (16): Foreign Currency Transactions and Foreign Operations. (para. 19)

5/9 If a parent ceases to classify a subsidiary as one where control was intended to be temporary, the financial statements of the subsidiary shall be consolidated on a line by line basis for all periods presented. The amounts for prior periods shall be mentioned as restated. (para. 20)

6. Disclosure Requirements

6/1 In addition to disclosures described in paragraphs (5/4, 5/5 and 5/6), the consolidated financial statements shall include the following disclosures:

a) List of subsidiaries with accompanying details including names, nature of business activities, country of incorporation, the IFI's shareholding (directly or indirectly through other entities), the IFI's level of voting rights (directly or indirectly through other entities) attributable to 3/2, and basis of IFI's control over subsidiary. (para. 21)

b) List of entities in which the IFI will potentially have more than 50% of the voting rights (attributable to 3/2) in the future through voting rights that are not currently-exercisable but will be exercisable in the future. These refer to entities that are not yet subject to consolidation, but will be when those voting rights become exercisable. The list shall be accompanied by details including names, nature of business activities, country of incorporation, the IFI's current shareholding (directly or indirectly through other entities), the IFI's current and potential level of those voting rights (directly or indirectly through other entities), and the date when those voting rights will become exercisable. (para. 22)

c) Disclosures on significant restrictions regarding financial or commercial transactions or shareholding relationship between any of the subsidiaries and the IFI as well as between any of the subsidiaries themselves. (para. 23)

d) Disclosure of details of entities where control is intended to be temporary. (para. 24)

6/2 In cases where an IFI's investment in a subsidiary also includes a component funded by restricted investment accounts, such non-controlling interests shall be identified and included as part of the "Non-controlling Interests" in the Consolidated Balance Sheet. In addition, these shall be disclosed as "Non-controlling Interests – Restricted Investment Account" in the notes to the financial statements. (para. 25)

7. Effective Date

This Standard shall be effective for financial periods beginning 1 Muharram 1431 A.H. or 1 January 2010 A.D. (para. 26)

Adoption of the Standard

The revised Standard on Consolidation was adopted by the Accounting and Auditing Standards Board in its meeting No. (35) held on 6 Rabi' II, 1430 A.H., corresponding to 2 April 2009 A.D.

Members of the Board

1. Mr. Muhammad Said Abdul-Wahab	Chairman
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15. Mr. Oliver Agha	
16. Mr. Jalil Al-Aali	
17. Dr. Mohamad Nedal Alchaar	Member / Secretary General / Rapporteur

Appendix (A)
Brief History of the Preparation of the Standard

The Standard on Consolidation was originally approved by the Accounting and Auditing Standard Board in its meeting No. (32) held in Manama, Kingdom of Bahrain on 22 Rabi' II, 1428 A.H., corresponding to 9 May 2007 A.D.

In its meeting No. (33) held in Manama, Kingdom of Bahrain on 24 Jumada I, 1429 A.H., corresponding to 29 May 2008 A.D., the Accounting and Auditing Standards Board decided to review the Standard on Consolidation taking into consideration the development of a new Standard on Investments in Associates.

The review of the Standard on Consolidation was carried out concurrently with the development of a new Standard on Investments in Associates.

Preliminary study and exposure draft of the revised Standard on Consolidation were discussed by the Accounting Standards Committee through a series of meetings and telephone conference calls.

Preliminary study and exposure draft of the revised Standard on Consolidation was also deliberated by the Accounting and Auditing Standards Board at its meeting No. (34) held in Manama, Kingdom of Bahrain on 14 Dhul-Qa'dah 1429 A,H., corresponding to 12 November 2008 A.D.

Listening session of the exposure draft was convened in Manama, Kingdom of Bahrain on 24 Safar 1430 A.H., corresponding to 19 February 2009 A.D., to gather comments from the Islamic finance industry as well as accounting and auditing professions.

The exposure draft was revised in light of the comments made in Accounting and Auditing Standards Board meeting No. (34) and the listening session.

The Accounting and Auditing Standards Board adopted the revised Standard on Consolidation at its meeting No. (35) held on 6 Rabi' II, 1430 A.H., corresponding to 2 April 2009 A.D.

Appendix (B)
Reasons for the Standard

The primary reasons for developing the standard, amongst others, include:

a) Significance of investments in the statement of financial position of the IFIs as compared to other assets.

b) Differences in the determination of entities that are subject to consolidation.

c) Differences in the bases applied in the treatment of investment in entities acquired through IFI's owners' equity, unrestricted investment accountholder's funds, restricted investment accountholders' funds and combination of these.

d) No existing guidance from AAOIFI that addresses the presentation, accounting and disclosure for entities that are subject to consolidation.

Appendix (C)
Basis for Conclusions

The conclusions reached by this standard mainly emanate from the application of the objectives of financial accounting as specified in the previous Financial Accounting Statement No. (1): Objectives of Financial Accounting for Islamic Banks and Financial Institutions, and the concepts of financial accounting as specified in the previous Financial Accounting Statement No. (2): Concepts of Financial Accounting for Islamic Banks and Financial Institutions to the extent applicable.

Furthermore, the core underlying reason for revision of this standard is to enhance quality, transparency and reliability of financial reporting within the permissible limits of Shari'a precepts. In order to achieve the aforesaid objective, not only international best practices available under other financial reporting frameworks were considered but also the revised provisions were thoroughly discussed with Shari'a scholars.

Scope of the Standard

We concluded that the revised standard should cover the principles to be applied when determining entities that are subject to consolidation, and the rules to be followed when preparing and presenting consolidated financial statements.

We considered including the rules for preparing and presenting separate financial statements but concluded that guidance given in the previous Financial Accounting Statement No. (2): Concepts of Financial Accounting for Islamic Banks and Financial Institutions is sufficient and need not be reiterated in this standard.

We also considered including guidance on treatment for business combinations including goodwill and intangibles but concluded to limit this standard to consolidation only and to develop a possible separate standard for business combination at a later phase. In the interim, international practice for assessment of goodwill and intangible assets should be followed.

We also considered giving more explicit guidance on the consolidation of Special Purpose Vehicles. We concluded that such guidance shall be developed at a later phase.

We also considered including additional guidance on treatment for investment in associates and joint venture but concluded that it is more appropriate to cover this in other standard/s.

Determination and Scope of Consolidated Financial Statements

We considered the types of entities that should be considered for consolidation and concluded that determination for consolidation was to be based on the power to control an entity and the power to determine how the control is implemented.

Earlier during the preparation of the previous version of this Standard, it was decided that the power to control rests with the voting rights upon the entity. If a parent, directly or indirectly through other entities, owns more than 50% voting rights in a particular entity, then that parent has the power to control the entity as well as to determine how the control is exercised over that entity.

The revised Standard does not strictly follow the legal form of control; rather, it stipulates a comprehensive criteria for identification of control over subsidiaries. Before revising the standard and broadening the criteria for identification of control, corresponding Shari'a implications were considered in detail and due caution was undertaken in this regard. Through detailed discussions with Shari'a scholars, it was ensured that broadening of criteria for identification of control in accordance with other leading accounting practices does not result in violation of Shari'a precepts.

In the revised Standard, the criteria for determination of control and consolidation have been changed in accordance with the latest best accounting practices. Under the revised Standard, it is not mandatory for an IFI to hold more than 50% of shares of the subsidiary to demonstrate control. Amongst other situations, an IFI holding less than the majority of voting rights may also have de facto power over an entity when it holds significantly dominant voting rights that gives it practical ability to direct the financial and operating policies of an entity unilaterally. For example, if an IFI holds a large proportion of the voting rights and the remainder shareholding is widely dispersed and attendance and voting patterns in previous shareholders meetings indicate that the IFI has the majority of voting rights in the shareholders' meetings. In the absence of other evidence on restrictions on power of the IFI, it may be concluded that the IFI has de facto power over the entity.

Also in the revised FAS (23), it has been stipulated that the voting rights emanating from investments funded by (3/2a) IFI's owners' equity and liabilities, and (3/2b) unrestricted investment accounts, should be taken into account at the time of determination of subsidiary and consolidation thereof.

In cases where consolidation is required owing to voting rights from (3/2a) and (3/2b) mentioned above, but the investment also has a non-controlling interest, the consolidation procedure should take into account the non-controlling interest and -besides ensuring the identification thereof- report the non-controlling interest separately in consolidated financial statements.

In addition, it was concluded that the voting rights should be computed to comprise current voting rights and currently-exercisable rights. In cases where voting rights are only exercisable in the future, consolidation would not be required in the current period but disclosure should be made.

It was also concluded that the above methods of determination for consolidation should be carried out regardless of level of shareholding that an IFI has in an entity and nature of activities of that entity.

It was agreed by the Board to provide an exemption from combining financial statements on a line by line basis where control was deemed to be temporary in nature. Temporary control was construed to mean that it is the intention of the parent to dispose of the entity within twelve months from acquisition and management is actively seeking a buyer.

Consolidation Procedures And Disclosure Requirements

We considered the international leading practices for consolidation procedures and disclosure requirements, and the standard has incorporated the substance of these international practices.