

## **Query No. 5**

**Subject:** *Consolidation of joint venture company (JVC) wherein the relevant economic activity and the purpose of formation of JVC got ceased.*<sup>1</sup>

### **A. Facts of the Case**

1. A company (hereinafter referred to as the 'company') is a wholly owned Government of India company under the Department of Atomic Energy. It was established in 1967 primarily to meet the control and instrumentation requirements of India's nuclear power program. The company has played a pioneering role in spurring the growth of indigenous electronic industry in the country. It is a multi-product, multi-disciplinary and multi-technology organisation providing cutting edge technology solutions to the strategic users in defence, atomic energy, aerospace, electronic security, information technology and e-Governance.
2. The company having net worth of more than Rs. 500 crore is required to adopt Indian Accounting Standards (Ind ASs) and accordingly, the company has adopted Ind ASs in accordance with Notification dated February 16, 2015 issued by the Ministry of Corporate Affairs (MCA), Government of India, with effect from April 01, 2016 with transition date on April 01, 2015.
3. A joint venture between M/s XYZ, an organisation under the laws of the State of California, U.S.A and the company, a corporation organised under the laws of India, was formed and incorporated as a company ('JVC') under the Companies Act, 1956 in May, 1995. (Copy of the Joint Venture Agreement, Memorandum of Association and Articles of Association of the JVC have been furnished by the querist for the perusal of the Committee). The company is a shareholder in ABC Ltd., being the JVC, with 49% equity. Also, out of six directors on the Board of the JVC, two directors are nominated from the company.
4. The very purpose of setting up the JVC is to manufacture, assemble, test, market, sell and service the products, i.e., single and multi-energy X-ray baggage inspection systems, explosive detectors, walk-through metal detectors and related security products by the company on the technical know-how transferred by XYZ to the company. The said products will be sold to the joint venture and the JVC will market and sell the products to the ultimate customers. Since 2012-13 onwards, the said technology has become obsolete and the company is not manufacturing the above said products and is not selling to the JVC. However, the company is availing the services of the joint venture for execution of its projects based on its experience and is placing the purchase orders at arms' length price just like any other supplier (creditor). To this extent, the company has been disclosing the transactions with JVC in its related party disclosure requirements in the Notes forming part of the accounts.
5. The querist has stated that with the commencement of Companies Act, 2013 (hereinafter referred to as the 'Act'), joint venture is included in the provisions dealing with consolidation of subsidiaries and hence, the provisions of section 129(3) on consolidated financial statements have to be adhered to. However, on 14<sup>th</sup> October, 2014, the MCA had notified Companies (Accounts) Amendment Rules, 2014 and granted exemption to companies not having a subsidiary or subsidiaries but having one or more associate companies or joint ventures or both from consolidation of financial statements in respect of associate companies or joint ventures or both, as the case may be, for the financial year 2014-15 (copy of the exemption notification has been supplied by the querist for the perusal of the Committee).

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<sup>1</sup> Opinion finalised by the Committee on 9.4.2019.

6. The querist has further stated that owing to the cessation of envisaged economic activity due to obsolescence of the technology, the relevant activity i.e., supply of the single and multi energy X-ray baggage inspection systems, explosive detectors, walk-through metal detectors and related security products could not be made and hence, the subject matter of formation of JVC diminished over the years. Accordingly, the company is left with no power to exercise control on JVC. Also, the joint venture partner M/s XYZ has proposed for dissolution of the JVC. In this context, the company, in the annual reports for financial years 2015-16 and 2016-17, has disclosed the above-mentioned fact in its related party disclosure requirements and stated about the fact of non-consolidation of its accounts with that of JVC (copy of extracts of Annual Reports for F.Y. 2015-16 and 2016-17 have been provided by the querist for the perusal of the Committee).

7. Section 129(3) of the Act<sup>2</sup> states as follows:

“(3) Where a company has one or more subsidiaries, it shall, in addition to financial statements provided under sub-section (2), prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own which shall also be laid before the annual general meeting of the company along with the laying of its financial statements under sub-section (2):

...

*Explanation.*-For the purposes of this sub-section, the word “subsidiary” shall include associate company and joint venture.”

The second proviso to section 129(3) states as follows:

“Provided further that the Central Government may provide for consolidation of accounts of the companies in such manner as may be prescribed.”

The manner of consolidation has been set out in Rule 6 of the Companies (Accounts) Rules, 2014<sup>3</sup> which reads as under:

“The consolidation of financial statements of the company shall be made in accordance with the provisions of Schedule III of the Act and the applicable accounting standards:

Provided that in case of a company covered under sub-section (3) of section 129 which is not required to prepare consolidated financial statements under the Accounting Standards, it shall be sufficient if the company complies with provisions on consolidated financial statements provided in Schedule III of the Act.

...”

Further, paragraphs 3 and 4 of Part III - General Instructions for the Preparation of Consolidated Financial Statements, contained in Division II of Schedule III to the Act read as under:

“3. All subsidiaries, associates and joint ventures (whether Indian or foreign) will be covered under consolidated financial statement.

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<sup>2</sup> Section 129(3) of the Companies Act, 2013 has been since amended by the Companies (Amendment) Act, 2017. The amendment is effective from 7<sup>th</sup> May, 2018.

<sup>3</sup> Rule 6 of the Companies (Accounts) Rules, 2014 has been since amended by the Companies (Accounts) Amendment Rules, 2014, the Companies (Accounts) Amendment Rules, 2015 and the Companies (Accounts) Amendment Rules, 2016, effective from 14<sup>th</sup> October 2014, 16<sup>th</sup> January 2015 and 27<sup>th</sup> July 2016 respectively.

4. An entity shall disclose the list of subsidiaries or associates or joint ventures which have not been consolidated in the consolidated financial statements along with the reasons of not consolidating.”

8. As per paragraph 1 of Indian Accounting Standard (Ind AS) 110, ‘Consolidated Financial Statements’, the objective of the Standard is to establish the principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities. To meet the above objective, Ind AS 110 requires an entity (the parent) that controls one or more entities (subsidiaries) to present consolidated financial statements. The litmus test for an investor to prove that it can exercise control over the investee is set out in paragraphs 7, 8 and 9 of Ind AS 110, which are reproduced as below:

“ **7 Thus, an investor controls an investee if and only if the investor has *all* the following:**

**(a) power over the investee (see paragraphs 10-14);**

**(b) exposure, or rights, to variable returns from its involvement with the investee (see paragraphs 15 and 16); and**

**(c) the ability to use its power over the investee to affect the amount of the investor’s return (see paragraphs 17 and 18).**

8 An investor shall consider *all facts and circumstances when assessing whether it controls an investee*. The investor shall reassess whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control listed in paragraph 7 (see paragraphs B80-B85).”

9 Two or more investors collectively control an investee when they must act together to direct the *relevant activities*. In such cases, because no investor can direct the activities without the co-operation of the others, no investor individually controls the investee. Each investor would account for its interest in the investee in accordance with the relevant Ind ASs, such as Ind AS 111, *Joint Arrangements*, Ind AS 28, *Investments in Associates and Joint Ventures*, or Ind AS 109, *Financial Instruments*.”

Also, paragraph 10 of Ind AS 110 specifies about exercising the power by an investor. It states that “An investor has power over an investee when the investor has existing rights that give it the current ability to direct the *relevant activities*, ie the activities that significantly affect the investee’s returns”. Further, as per the querist, in accordance with paragraph 11 of Ind AS 110, existing cases/factors also have to be reckoned where the assessment of power will be more complex, one example being power resulting from one or more contractual arrangements.

(Emphasis supplied by the querist.)

9. As per the agreement between the investors of ABC Ltd. i.e., the company and M/s XYZ, the very purpose of establishing the joint venture is to organise and operate a limited liability company under the laws of India to manufacture, assemble, test, market, sell and service the ‘products’, i.e., single and multi-energy X-ray baggage inspection systems, explosive detectors, walk-through metal detectors and related security products. As per the querist, the aforesaid activity constitutes the *only economic activity* and the *relevant activity* that is the subject of the joint venture and it is the sole business purpose or the sole economic activity of the joint venture. However, for the past five years, the envisaged *economic activity or the relevant activity* of the joint venture has ceased to exist due to obsolescence of the

technology, and a proposal for dissolution of the joint venture has been proposed by the venture partner, M/s. XYZ. According to the querist, the company has no control on the current operations of ABC Ltd. for the past five years. The Board of Directors has decided to appoint a financial institution for conducting financial due diligence of the joint venture. ABC Ltd. has appointed a valuer of joint venture. Based on the valuation report, M/s XYZ has proposed an offer to take over 49% company's share in the joint venture. The Board of the company is yet to take a decision in this regard. Further, presently no products are being manufactured and sold by the company to the joint venture company as a part of joint venture agreement. (Emphasis supplied by the querist.)

10. As per the querist, from the above paragraphs, it can be demonstrated that there is no power over investee (ABC Ltd.) and hence, no control can be exercised. By virtue of above facts and circumstances, the very objective of Ind AS 110 cannot be met/sustained and, hence, presentation of consolidated financial statements may not be warranted. Further, section 129 (1) of the Companies Act reads as below:

“(1) The financial statements shall give a true and fair view of the *state of affairs of the company or companies*, comply with the accounting standards notified under section 133 and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III:

Provided that the items contained in such financial statements shall be in accordance with the accounting standards:

...”

(Emphasis supplied by the querist.)

Further, paragraph 35 of the Framework for the Preparation and Presentation of Financial Statements in accordance with Indian Accounting Standards (hereinafter referred to as the 'Framework'), issued by the Institute of Chartered Accountants of India, speaks about 'Substance over Form', as per which, if the information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. Also, paragraph 4 of 'Part III- General Instructions for the Preparation of Consolidated Financial Statements' contained in Division II of Schedule III to the Act states that “An entity shall disclose the list of subsidiaries or associates or joint ventures which have not been consolidated in the consolidated financial statements along with the reasons of not consolidating.”

11. Applying the ratio of above provisions of the Ind ASs, the Act (including Schedule III to the Act), 'Framework' and above all, the existing facts and circumstances at the end of reporting period, it was felt by the company that the consolidation of accounts of ABC Ltd. with that of the company would not present a true and fair view.

## **B. Query**

12. In the above background, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

- (i) Whether the financial statements of the joint venture company (JVC), wherein the relevant economic activity and the purpose of formation of JVC has ceased, be consolidated with those of the company under section 129(3) of the Companies Act, 2013;

(OR)

- (ii) Whether it is sufficient to disclose in its Notes to Accounts (in the financial statements of the company) that the company is not consolidating its financial statements with that of its JVC stating the reasons for not consolidating in line with paragraph 4 of Part III of Division II of Schedule III to the Companies Act, 2013.

### **C. Points considered by the Committee**

13. The Committee notes from the Facts of the Case that the querist has mentioned that there is no control over the joint venture company (hereinafter referred to as ‘the JVC’) due to cessation of envisaged economic activity due to obsolescence of the technology related to single and multi-energy X-ray baggage inspection systems and other security products. In this context, the issue that has been raised by the querist in the extant case is whether the company should consolidate the financial statements of the JVC viz. M/s ABC Ltd., with those of the company under section 129(3) of the Companies Act, 2013 (hereinafter referred to as ‘the Act’). The Committee has therefore, considered only this issue and has not considered any other issue that may arise from the Facts of the Case, such as, assessment of control/joint control on JVC, treatment of joint venture in the separate financial statements of the company, accounting for transactions between the company and the JVC, legal interpretation of the joint venture agreement, accounting in the books of JVC or M/s XYZ, accounting implications of transition to Ind ASs, accounting for impairment (if any) to be provided on investment in JVC, etc. The Committee wishes to mention that Accounting Standards and Indian Accounting Standards cited hereinafter refer to Standards notified under the Companies (Accounting Standards) Rules, 2006 and the Companies (Indian Accounting Standards) Rules, 2015 respectively. Further, since the querist has referred to financial years 2015-16 and 2016-17, the Committee has expressed its views for these two years only, after considering annual reports for these two years available in the company’s website. The Committee notes from the annual reports of the company for the financial years 2015-16 and 2016-17 that the investment in M/s ABC is classified as ‘Investment in Joint Venture’. Further, the querist has referred to M/s ABC as joint venture company (JVC). Accordingly, in the absence of any information to the contrary, the Committee has proceeded on the premise that M/s ABC is neither a subsidiary of the company nor its associate but is a joint arrangement of the nature of joint venture (and not joint operation) as per Indian Accounting Standard (Ind AS) 111, ‘Joint Arrangements’ for the financial year 2016-17 and was a jointly controlled entity under Accounting Standard (AS) 27, ‘Financial Reporting of Interests in Joint Ventures’, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as ‘Rules, 2006’) for the financial year 2015-16. It is also presumed that the company is not acting as an agent of the JVC.

The Committee also wishes to point out that in the extant case, the situation of classification of the investment in JVC as ‘held for sale’ is not considered by the Committee, since, the criteria for such classification are not met in the extant case having regard to paragraph 8 of Ind AS 105, ‘Non-current Assets Held for Sale and Discontinued Operations’. This is because as per the Facts of the Case, the Board of Directors of the company is not yet committed to plan of sale of the investment in the JVC.

14. The Committee notes that section 129(3) of the Act<sup>4</sup> provides as follows:

“(3) Where a company has one or more subsidiaries, it shall, in addition to financial statements provided under sub-section (2), prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own

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<sup>4</sup> Refer footnote 2.

which shall also be laid before the annual general meeting of the company along with the laying of its financial statement under sub-section (2):

Provided that the company shall also attach along with its financial statement, a separate statement containing the salient features of the financial statement of its subsidiary or subsidiaries in such form as may be prescribed:

Provided further that the Central Government may provide for the consolidation of accounts of companies in such manner as may be prescribed.

*Explanation.*—For the purposes of this sub-section, the word “subsidiary” shall include associate company and joint venture.”

Further, the manner of consolidation has been laid down in Rule 6 of the Companies (Accounts) Rules, 2014<sup>5</sup>, which states as under:

**“6. Manner of consolidation of accounts.**

The consolidation of financial statements of the company shall be made in accordance with the provisions of Schedule III of the Act and the applicable accounting standards:

Provided that in case of a company covered under sub-section (3) of section 129 which is not required to prepare consolidated financial statements under the Accounting Standards, it shall be sufficient if the company complies with provisions on consolidated financial statements provided in Schedule III of the Act.

...”

Further, the Committee notes paragraphs 3 and 4 of Part III of Division II of Schedule III to the Act, quoted by the querist in paragraph 7 above and notes that similar requirements are contained in Division I of Schedule III to the Act applicable for financial statements for F.Y. 2015-16.

From the above, the Committee notes that as per the provisions of the Act, a company is required to prepare consolidated financial statements for its associates and joint ventures, even if does not have subsidiaries, unless it is exempt from that requirement in accordance with law and applicable Accounting Standards. In this regard, the Committee wishes to clarify that ‘consolidation’ in the case of associates/joint ventures should not be understood as similar to consolidation of subsidiaries. Rather, it means ‘equity method’ accounting in accordance with Ind AS 28, ‘Investments in Associates and Joint Ventures’. This is also evident from paragraph 7 of Ind AS 27, ‘Separate Financial Statements’, which states, “Financial statements in which the equity method is applied are not separate financial statements. These may be termed as ‘*consolidated financial statements*’. ...” (Emphasis supplied by the Committee). Further, the Committee relies on ‘Frequently Asked Questions (FAQs) regarding requirements to prepare Consolidated Financial Statements’<sup>6</sup>, issued by the Accounting Standards Board of the Institute of Chartered Accountants of India in the context of the Companies (Accounting Standards) Rules, 2006, which, inter alia, states that a company not having subsidiaries is required to prepare consolidated financial statements for its associate and joint venture in accordance with the applicable Accounting Standards, viz,

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<sup>5</sup> Refer footnote 3.

<sup>6</sup> Subsequent to the issuance of these FAQs, paragraph 9 of AS 21, Consolidated Financial Statements’ has been revised vide MCA Notification dated 30.03.2016, which states that “ Where an enterprise does not have a subsidiary but has an associate and/or a joint venture such an enterprise should also prepare consolidated financial statements in accordance with Accounting Standard (AS) 23, Accounting for Associates in Consolidated Financial Statements and Accounting Standard (AS) 27, Financial Reporting of Interests in Joint Ventures respectively”. Further, as per subsequent Announcement by ICAI, “amended Accounting Standards should be followed for accounting periods commencing on or after the date of publication of the notification in the Official Gazette”.

AS 23, 'Accounting for Investments in Associates in Consolidated Financial Statements' and AS 27 respectively. The Committee notes that having regard to the fact that the company itself is not a subsidiary and having regard to the nature of its operations, optional exemption from 'consolidation' in accordance with Ind AS 28 (i.e., equity method) given in paragraphs 17 to 19 thereof is not available to it. Further, for the financial year 2015-16, the two exceptions to consolidation in accordance with AS 27 (i.e., 'proportionate consolidation') given in paragraph 28 thereof (relating to an interest in a jointly controlled entity (a) which is acquired and held exclusively with a view to its subsequent disposal in the near future; and (b) which operates under severe long-term restrictions that significantly impair its ability to transfer funds to the venturer) are not relevant for the extant case. Further, since the company itself is not an intermediate parent, the exemption from preparation of consolidated financial statements given in the second proviso to Rule 6 of the Companies (Accounts) Rules, 2014 is not available to the company.

15. The Committee notes from the Facts of the Case that the only reason cited by the querist for losing 'control' over JVC and resultantly not consolidating the financial statements of JVC is the cessation of, or decline in, the activities of the JVC for the past 5 years. Therefore, the Committee has considered hereinafter only this issue as to whether the cessation of, or decline in, the activities of the JVC can be considered to result in the loss of 'control'/'joint control' over the JVC. The Committee also notes that the concept of 'joint control' involves concept of 'control' dealt with in detail in Ind AS 110, 'Consolidated Financial Statements'. Accordingly, the Committee examines the requirements of Ind AS 110 on the concept of control in the paragraph 16 below. (For F.Y. 2015-16, concepts of control and joint control were dealt with in AS 27, notified under Rules, 2006.)

16. The Committee notes the following paragraphs of Ind AS 110:

**“6 An investor controls an investee when it 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.**

**7 Thus, an investor controls an investee if and only if the investor has all the following:**

**(a) power over the investee (see paragraphs 10–14);**

**(b) exposure, or rights, to variable returns from its involvement with the investee (see paragraphs 15 and 16); and**

**(c) the ability to use its power over the investee to affect the amount of the investor's returns (see paragraphs 17 and 18).**

8 An investor shall consider all facts and circumstances when assessing whether it controls an investee. The investor shall reassess whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control listed in paragraph 7 (see paragraphs B80–B85).

9 Two or more investors collectively control an investee when they must act together to direct the relevant activities. In such cases, because no investor can direct the activities without the co-operation of the others, no investor individually controls the investee. Each investor would account for its interest in the investee in accordance with the relevant Ind ASs, such as Ind AS 111, *Joint Arrangements*, Ind AS 28, *Investments in Associates and Joint Ventures*, or Ind AS 109, *Financial Instruments*.

- 10 An investor has power over an investee when the investor has existing rights that give it the current ability to direct the *relevant activities*, ie the activities that significantly affect the investee’s returns.”

Further, the Committee notes paragraph B11 of Ind AS 110, reproduced below, which provides examples of relevant activities:

“B11 For many investees, a range of operating and financing activities significantly affect their returns. Examples of activities that, depending on the circumstances, can be relevant activities include, but are not limited to:

- (a) selling and purchasing of goods or services;
- (b) managing financial assets during their life (including upon default);
- (c) selecting, acquiring or disposing of assets;
- (d) researching and developing new products or processes; and
- (e) determining a funding structure or obtaining funding.”

From the above, the Committee is of the view that the *ability* to direct relevant activities (and not mere presence of relevant activities *during the current reporting period*) is important for determining control of an investee. Therefore, the querist’s contention that consolidation of the JVC is not appropriate because there are no relevant activities in recent years is not tenable. This is because disposal of the JVC may also be a relevant activity which may arise in future. In this regard, the Committee notes the example of ‘disposing of assets’ as a possible relevant activity cited in paragraph B11 of Ind AS 110 (reproduced above). Incidentally, the Committee notes from annual reports for the financial years 2015-16 and 2016-17 that the JVC has turnover from (i) sale of X-Ray Baggage Inspection Systems and Spares and (ii) servicing and other income. Selling goods and services could be relevant activities as per the example cited in paragraph B11 of Ind AS 110 (reproduced above). The Committee is of the view that size of operations/activities is not a determining factor for deciding presence of ‘relevant activities’. Further, it is also noted from the annual reports of the company for the financial years 2015-16 and 2016-17 that the company has received dividend from JVC. The Committee is of the view that to take decisions regarding dividend itself can also be a relevant activity as per paragraph B11 above. Accordingly, the Committee is of the view that in the extant case, cessation/decline of activities in itself, does not result into loss of ‘control’/‘joint control’. Accordingly, the Committee is of the view that the company should ‘consolidate’ the JVC in its ‘consolidated financial statements’ in accordance with Ind AS 28 (i.e., by applying the ‘equity method’) for the financial year 2016-17.

17. Further, for the financial year 2015-16, the Committee notes the following definition given in AS 27:

***“Joint control is the contractually agreed sharing of control over an economic activity.***

***Control is the power to govern the financial and operating policies of an economic activity so as to obtain benefits from it.”***

From the above provisions of AS 27, the Committee notes that it is the power or ability to govern the financial and operating policies of the economic activities being undertaken by the joint venture and not the presence/quantum of economic activities as such, which is relevant for determining ‘control’ and, consequently, joint control. Therefore, for the financial year 2015-16 also, the Committee is of the view that the company should ‘consolidate’ the JVC in

its 'consolidated financial statements' in accordance with AS 27 (i.e., by applying the 'proportionate consolidation' method).

18. The Committee notes the requirement of paragraph 35 of the 'Framework for the Preparation and Presentation of Financial Statements in accordance with Indian Accounting Standards' (hereinafter referred to as 'the Framework') cited by the querist in paragraph 10 above. The Committee wishes to point out that 'Framework' does not override any specific Ind AS (see paragraph 2 of the Framework). Further, the Committee notes that paragraphs 19-23 of Ind AS 1, 'Presentation of Financial Statements' deal with the course of action in extremely rare circumstances in which the management concludes that compliance with a requirement in an Ind AS would be so misleading that it would conflict with the objective of financial statements set out in the Framework and paragraph 24 of Ind AS 1 gives guidance on making assessment in this regard. The course of action depends on whether the relevant regulatory framework requires, or otherwise does not prohibit, departure from that requirement or whether the relevant regulatory framework prohibits such departure. For the reasons given in paragraphs 16 and 17 above, the Committee is of the view that the extant case does not fall within the purview of paragraphs 19-24 of Ind AS 1. Consequently, the Committee does not further examine whether the departure from consolidation requirements in the extant case is permitted by the first proviso to Rule 6 of the Companies (Accounts) Rules, 2014. However, the Committee wishes to point out that it is for the Auditors to express their view on the management's conclusion in this regard considering the requirements of applicable Standards and submissions of the management and after ascertaining the legal position. Incidentally, the Committee notes that Notes to Accounts for the financial year 2016-17 contains minimum disclosure of the departure from consolidation of the JVC and not full disclosure requirements of Ind AS 1 in this regard. Further, Committee wishes to point out that the accounting requirements applicable for F.Y. 2015-16 does not provide for departure from a requirement of an Accounting Standard, unless such departure is in accordance with law.

#### **D. Opinion**

19. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 12 above:

- (i) (a) For financial year 2016-17, the company should consolidate the financial statements of the JVC with those of the company in accordance with the requirements of Ind AS 110.
  - (b) For financial year 2015-16, the company should consolidate the financial statements of JVC with those of the company in accordance with the requirements of AS 27.
- (ii) This issue does not arise in view of (i) above.