The impact of IFRS 10 on consolidated financial reporting

Comments  Tom Scott
Why is this important?

• Starting a Post-Implementation Review (PIR) of
  – IFRS 10 Consolidated Financial Statements
  – IFRS 11 Joint Arrangements
  – IFRS 12 Disclosure of Interests in Other Entities

• PIRs assess how well a standard is working.
  – PIRs should be evidenced based.
  – Research is an important contributor to a complete set of evidence.
Fundamental Question & Authors’ Primary Conclusion

• The fundamental question with respect to IFRS 10 is:

• Does IFRS 10’s principles-based definition of control lead to:
  – more appropriate classification of subsidiaries for consolidated statements? and
  – more informative financial statements?

• Authors Primary Conclusion is:

• The adoption of IFRS 10 is associated with:
  – firms consolidating fewer subsidiaries
  – a decrease in the likelihood of firms consolidating non-majority owned subsidiaries

• There is evidence that something is happening, but we need clearer evidence and causal links to help us make decisions
Interesting results in Table 6
Supports IFRS 10 provides more appropriate accounting

<table>
<thead>
<tr>
<th>PRE period</th>
<th>SUBCOUNT</th>
<th>SUBSNONMAJORITY = 1</th>
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</thead>
<tbody>
<tr>
<td>POST period</td>
<td>Coeff</td>
<td>Sig</td>
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<tr>
<td>Post</td>
<td>0.214</td>
<td>0.01</td>
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<tr>
<td>Leverage</td>
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<td>0.01</td>
</tr>
<tr>
<td>Leverage*Post</td>
<td>-0.049</td>
<td>0.10</td>
</tr>
<tr>
<td>Sum above Lev Lev*Post</td>
<td>0.056</td>
<td>marg sig?</td>
</tr>
<tr>
<td>Big4</td>
<td>0.504</td>
<td>0.01</td>
</tr>
<tr>
<td>Big4*Post</td>
<td>-0.140</td>
<td>0.05</td>
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<tr>
<td>Sum above Big4 Big4*Pos</td>
<td>0.364</td>
<td>sig</td>
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<tr>
<td>CEOown</td>
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<tr>
<td>CEOown*Post</td>
<td>-0.505</td>
<td>0.01</td>
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<tr>
<td>Sum above CEOown CEOown*Post</td>
<td>-0.084</td>
<td>prob ns</td>
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<tr>
<td>Loss</td>
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<tr>
<td>Loss*Post</td>
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<tr>
<td>Sum above Loss Loss*Pos</td>
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<td>prob sig</td>
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Opportunities to increase the contribution – Sample and Design 1

- The number of subsidiaries and the incidence of at least one non-majority subsidiary can be attributed to different causes.
  - Given 1092 /2000 firm-years, then each of the two main dependent variables can change from a firm entering or leaving the sample based on the availability of date.
  - The two variables can change from firms entering or leaving the 500, although this is a smaller risk.
  - Firms may add or dispose of investments for economic reasons that have nothing to do with IFRS 10.
    - Similarly, firms may increase or decrease their ownership share for economic reasons.
- These reasons have little to do with IFRS 10
Opportunities to increase the contribution – Sample and Design 2

• It would be useful to focus on changes that can be attributed to IFRS 10:
  – Firms may use their judgment or the latitude a standard allows to classify non-majority owned investments as subsidiaries or not.
    • The majority owned must be consolidated.
  – Firms could reduce their ownership interest or completely dispose of investments to achieve a non-consolidation outcome. This can apply to majority-owned or non-majority owned investments.

• In contrast to the prior slide, these reasons capture effects that are potentially directly or indirectly important to assessing IFRS 10

• It would be good to try and refine the analysis to capture these effects more clearly.
Opportunities to increase the contribution – Focus and Reader Understanding

• Useful to have a complete set of descriptive statistics and simple parametric and non-parametric correlations for all variables.
  – Enhances a reader’s understanding and confidence

• Useful to know the period to period change in number of subsidiaries and consolidated non-majority subsidiaries for a within firm analysis.
  – Try to attribute these changes to economic and/or accounting decisions
    • Possibly analyse changes as mini cases to supplement statistical analysis
  – How material are these changes? There is no descriptive information.
  – Is there a theory explaining what to expect if an entity reduces its subsidiaries by one or more? Results in Table 7 suggest a radical change in how the market values an entity in the post period. Why?

• Given hand collection did you consider collecting missing data to increase sample size?
Opportunities to increase the contribution – Financial Reporting Choices and Incentives

• There are two main potential financial statement effects, leverage and income effects.
  – Consolidating a subsidiary increases leverage on the balance sheet relative to not consolidating.
  – Consolidating or ceasing to consolidate can affect profit or loss (EBIT) relative to using the equity method. These are:
    1. Positive/negative income subsidiaries increase/decrease profit or loss (or EBIT) relative to not consolidating.
      – Possibly impact bonus plans (test CEO Bonus interactions?)
      – Market valuations can still be based on net profit or loss attributable to the parent, so valuation likely not affected.
    2. Losing control & ceasing consolidation triggers a fair valuation of the remaining interest. Firms can generate a gain in profit or loss by ceasing to consolidate
Conclusion

• Helpful to know that there appears to be an impact to IFRS 10, more likely positive than negative.

• The authors can potentially provide a more refined and focused analysis
  – Distinguish subsidiary changes at a within firm level, and assess the motivation for the change more precisely
  – Use this in the broader empirical tests
  – Consider mini case investigations of specific firm decisions

• Such an analysis should be helpful in IASB’s PIR.

• Thank you
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