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Topic **Effect Analyses**

Introduction

1. Before the IASB issues a new or revised IFRS, the Board is required to consider the *costs and benefits* of the proposal. This includes assessing the costs that would be incurred by preparers of financial statements, and the costs that are currently incurred by users of financial statements because the information that would be required by the proposed IFRS is not available.[1] In making this assessment, the Board considers the comparative advantage that a preparer has in preparing information, when compared with the costs that a user would incur to develop surrogate information. The Basis for Conclusions to each IFRS includes a section analysing the Board's assessment of the likely costs and benefits of the Standard.

2. Some jurisdictions that incorporate IFRSs within their legal framework require, or elect to prepare, some form of regulatory impact assessment before a new IFRS, or an amendment to an existing IFRS, is brought into law. The

[1] In this paper the term *preparer* is intended to mean a reporting entity and all of the parties that are involved in preparing the financial statements of that entity (including the employees, auditors, advisers etc). I assume that the costs (and cost savings) of all of these parties are borne by the reporting entity (as reflected by auditor fees, employee remuneration etc). The term *user* is intended to mean those who use the financial statements of a reporting entity (such as investors and analysts). The definition of a user is important. The IASB's cost-benefit analysis has tended to focus on investors as being the primary users, reflecting the IASB *Framework* (see *Framework* Paragraph 10).

This paper has been prepared for discussion at a public meeting of the Standards Advisory Council of the IASB.

The views expressed in this paper are those of the authors.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

requirements vary from jurisdiction to jurisdiction, and in some cases have broader policy factors in mind than are considered by the IASB analysis.

Effect analyses

3. In April 2007 the Trustees announced that 'it would be beneficial to develop a more explicit framework for evaluating the relative costs and benefits of its proposals and that this framework should become part of the IASB's due process'.

4. In 2008 the IASB published, for the first time, a *Project summary and Feedback Statement* and a *Project summary, feedback and effect analysis* to accompany its replacement of IFRS 3 *Business Combinations* and the revised IAS 27 *Consolidated and Separate Financial Statements*.

5. The *Project summary and Feedback Statement* explains the history of the project, including the motivation for changing the accounting requirements. It also identifies the issues on which respondents were most divided in their comments to the Board.[2]

6. The *Project summary, feedback and effect analysis* is an expanded version of the *Project summary and Feedback Statement*. It has additional analysis of the likely effects of the new requirements. We used the term *effect analysis*, rather than *impact assessment*, because we did not want to give the impression that we were undertaking a comprehensive regulatory impact assessment. Also, we wanted to show that the Board understood the likely effect of the changes on the financial statements and in the context in which the information is used.

[2] The Bases for Conclusions to IFRS 3 and IAS 27 provide a comprehensive analysis of all of the decisions made by the Board. The *Project Summary and Feedback Statement* is, essentially, a highlights document.

Are our processes meeting the needs of regulators?

7. It is difficult to conclude that there is agreement about what is an appropriate way to assess the implications of an IFRS. Our interactions with national standard-setters and regulators have revealed that some people are satisfied with our cost-benefit assessments, and with the type of effect analysis that we undertook for IFRS 3 and IAS 27. Others think we should be required to undertake a wider and deeper analysis. This topic has been discussed at two meetings of the national standard-setters, and is on the agenda again at their meeting in Seoul in April 2010. The discussions at the first two meetings illustrated the contentious nature of this topic.

8. It is unlikely that we could prepare an assessment that meets the needs of regulators in every jurisdiction. The main difficulty is that some regulators appear to be seeking an analysis that includes macro-economic factors. It is in this context that financial stability, for example, is sometimes mentioned.

9. Contrast this with the report of the Financial Crisis Advisory Group (FCAG) dated July 28, 2009, which states:

> Financial reporting is of great importance to investors and other financial market participants in their resource allocation decisions and to regulators and other users. The confidence of all these users in the transparency and integrity of financial reporting is critically important to global financial stability and sound economic growth.
>
> Where regulatory standards differ from accounting standards in ways that could have significant effects on financial reporting, the effects of those differences should be disclosed in a manner that does not compromise the transparency and integrity of financial reporting.

10. The report also states:

> Although effective financial reporting provides indispensable rigor and transparency to the market, investors, analysts, regulators and others cannot rely exclusively on the information it provides. All users should recognize the limitations of financial reporting: it provides only a snapshot in time of economic performance, and cannot provide perfect insight into the effects of macro-economic developments.

11. Giving primacy to the transparency and integrity of financial reporting does not mean that the Board is not aware of the context in which financial reports are used. For example, the Board maintains an active dialogue with banking supervisors to ensure that the supervisors are aware of potential changes to financial reporting.

12. The first IASB *Effect Analysis* was designed to provide jurisdictions with input to their processes. We documented what we learned during the development of the new IFRS 3 and IAS 27 about the likely costs, first of implementing the new requirements, and then when continuing to use it. We also gained insights into the costs and benefits through our canvassing of opinions, both via consultative publications (discussion papers, exposure drafts etc) and communications with interested parties (liaison activities, public round tables and private meetings, etc).

13. One of the main objectives of developing a single set of high-quality global accounting standards is to improve the allocation of capital. We therefore also considered the benefit of better economic decision-making as a result of improved financial reporting. We expect our standards to have economic effects, and we expect those effects to be beneficial for some entities and detrimental to others. A change in financial reporting requirements might affect the cost of capital for individual entities if, for example, the financial reporting requirements change the absolute or relative level of information asymmetry associated with those entities.

IASB Feedback Statement and Effect Analysis

Effects

14. The IFRS 3 / IAS 27 *Effect Analysis* provided the Board's assessment of how the new requirements are likely to affect the financial statements, in terms of how the elements are measured and the information that will be made available to users.

15. Sometimes disclosure requirements will place into the public domain information prepared by the entity that users have not been able to observe directly. Users might previously have been estimating this information from data collected from other sources. The disclosure could, therefore, reduce information uncertainty. This can have the effect of changing the way users view the business, perhaps affecting the cost of capital. Changes to the disclosure or measurement requirements that reveal new information to users are appropriate, because they should lead to a more efficient allocation of resources within a capital market.

16. A disclosure requirement might require entities to disclose information that is helpful to their competitors. In such cases, the competitive advantage that an entity enjoys could be reduced. This is a cost to the entity, which is sometimes referred to as a proprietary cost.

17. It is not possible for us to assess how a change in the disclosure or measurement requirements in a particular IFRS will affect individual entities. Consequently, our assessment of the effect on the financial statements is descriptive rather than judgemental.

18. In the case of IAS 27, the Board was told, through comment letters, round tables and discussions at liaison meetings, that the proposal to require the acquisition of non-controlling interests as a transaction within equity would lead to distorted statements of financial position over a wide range of entities. To assess these claims, we collected data about listed companies and performed some basic analysis of the potential effect of entities acquiring all of their non-controlling interests. That analysis suggested that the claims were not sustainable. A summary of that analysis is reproduced in the Appendix to this paper.

Costs and Benefits

19. Our evaluation of costs and benefits in the IFRS 3 / IAS 27 effect analysis was qualitative, rather than quantitative. This is because quantifying costs and, particularly, benefits is inherently difficult. Although other standard-setters

undertake similar types of analysis, there is a lack of sufficiently well-established and reliable techniques for quantifying this analysis.

20. In assessing the effect of IFRS 8 *Operating Segments*, the Australian Accounting Standards Board stated:

> There is no universally accepted methodology for quantitatively measuring costs and benefits of information presented in financial reports. The costs of providing financial information are incurred, in the main, by reporting entities, but extend in various direct and indirect ways to the users of general purpose financial reports. There is no guarantee that the costs are borne ultimately by those who derive the benefits. (Australian Accounting Standards Board, Regulation Impact Statement, AASB 8 *Operating Segments).*

Who bears the costs?

21. Who bears the costs is important, but not because of concerns about the distribution of costs, or establishing whether there has been a redistribution of costs. Rather, knowing where the costs fall can help in an assessment of the probable total costs related to processing particular information, including the costs associated with information uncertainty.[3]

22. Suppose that information about sales back-orders is useful in helping an investor to predict the future cash flows of an entity, but that there is no requirement to disclose such information. Also assume that entities generally have this data in their internal systems, and that the cost of compiling and auditing this summary information would be low. If sales back-order information is not a required disclosure, and entities are not disclosing it voluntarily, each analyst will bear the cost of estimating that number for each entity that the analyst monitors. Requiring the entity to disclose that number relieves many analysts from making many estimates, thus removing costs from the system. Additionally, the analyst's estimate will be an approximation of the actual number; ie it will be measured with error. Requiring entities to disclose that information eliminates this informational asymmetry.

[3] All costs borne by the reporting entity are costs to the investors, because they are cash outflows of the entity.

23. Not all incremental tasks will cause an analyst or investor to incur incremental costs, ie cash outflows. A person may simply be forced to spend more time on a task that is less productive. Analysts might have limited time to incorporate data from an earnings announcement in their valuation models, and consequently spend more time collecting data than analysing them than they would prefer.[4]

Costs

Preparation

24. Preparation costs include the costs of collecting and processing information, seeking independent expertise and professional advice and auditing. Changes in the recognition or measurement requirements in an IFRS could increase or decrease preparation costs. For example, it is likely to be more costly to measure PP&E at fair value each reporting period than it would be to measure PP&E at a depreciated cost.

25. Sometimes a change in the requirements of an IFRS will cause entities to change their accounting systems. In other cases, the requirements have continuing cost implications. For example, changing an IFRS in a way that aligns its requirements more closely with how management accounts for a transaction is likely to reduce the entity's costs in the future.

26. If the requirements in an IFRS are not clear, or if there is no guidance, the preparer will often have to seek independent advice and consult its auditors to resolve the uncertainty about how to account for a particular type of transaction. These costs should decrease if the requirements in the revised IFRS are clearer.

[4] In private correspondence, an analyst described having 60 or 70 minutes from the time they received an earnings release to making a recommendation related to the share price. The analyst spent a considerable amount of that time finding the data and hand-coding it into a spreadsheet. The analyst said that he would have preferred to have to have used that time to assess the data and to undertake sensitivity analysis. He also said that he sometimes made mistakes when he coded the data, which he identified when he had more time to check the initial analysis (which was after the recommendation had been made). The correspondence was in relation to XBRL.

Analysis

27. Analysis costs include the costs of extracting data, identifying how the data has been measured and adjusting data for the purpose of including them in, for example, a valuation model. The more work a user has to do to put the data into a form suitable for a particular purpose, the higher the analysis costs.

Benefits

Comparability

28. Users prefer to have information that is comparable. By comparable, we mean the ability of a user to compare information from reporting period to reporting period for an individual entity, and between different entities in a particular reporting period.

29. Comparability is, generally, achieved by having clear principles that lead to similar transactions or events being accounted for in a similar way.

Usefulness

30. In making our decisions, we have tried to identify the information requirements of those who use the information. We have assumed that users consider information to be useful if it helps them to assess the future cash flows of the entity. Comment letters, and our interactions with our user advisory groups have confirmed that this is appropriate.

Relative costs and benefits

31. In assessing new requirements, our focus in the IFRS 3 / IAS 27 effect analysis was on the likely costs and benefits of the new requirements, by comparison with the requirements that they were replacing. It is inherently difficult to measure costs and benefits in absolute terms.

32. Take the case of business combinations (the subject of the revised IFRS 3). Business combinations can vary significantly in size and complexity. The ways in which the changes we have made to the accounting will affect a particular entity or user can also vary to the same extent. It would not be meaningful to try

to assess the average effect. Also, that project revised an existing IFRS. Because we had requirements in place, we thought it appropriate to focus on the likely effect of a change, rather than trying to establish what the definite effect would be.

Example

33. In developing the revised IAS 27, we proposed that any investment that the parent retains in a former subsidiary after control is lost should be measured initially at fair value, regardless of whether the retained investment is classified as an associate, as a jointly controlled entity or as a financial asset. At the date when control is lost, the difference between the fair value and carrying amount of the retained interest should be recognised in profit or loss.

34. The Cost and Benefit Assessment included in the Feedback Statement was:

Cost and benefit assessment

Preparers

Assessment	Effect	Analysis
Preparation costs	Neutral	The parent will need to make one new fair value measurement. However, in many cases that measurement is being made at the same time that the parent has sold some of the shares in the former subsidiary. Therefore, we think that these costs will be relatively low. The new guidance on how to measure a gain or loss on disposal should reduce audit costs and the costs of seeking professional advice. On this basis we have assessed the likely effect on preparation costs as marginally negative.

Users

Assessment	Effect	Analysis
Analysis costs	Neutral	Most analysts are already adjusting out of earnings any gain or loss related to the loss of control of a subsidiary. Changing the amount of that adjustment does not affect the costs of analysis.
Comparability	Positive	Comparability should improve because entities will be measuring the gain or loss on a consistent basis. The initial measurement of the shares in the former subsidiary will also be on a consistent basis.
Usefulness	Positive	We assess the increased comparability and the more relevant basis for establishing the deemed cost of the investment as combining to improve the usefulness of the information.

Assertions

35. Our assessment is on the *likely* effect of the new requirements. The actual effects will not be known until after the new requirements have been applied.

36. Our assertions of likely effects are based on the information that we collect during the development of the Standard. For example, we discuss implementation costs with entities, auditors and software vendors. We have made a commitment to undertake post implementation reviews of our major projects. These reviews will provide an opportunity to assess how accurate our assertions have been.

37. We encourage academic researchers to perform empirical research into the way information mandated by our standards is incorporated into economic decisions. These studies, which focus on the role of accounting information in the capital markets, provide us with insights into how accounting information is incorporated into share prices. Other studies focus on how changes to IFRSs affect the behaviour of parties, such as management.

38. We expect to consider relevant research as part of our post-implementation review.

Summary

39. The development of IASB effect analyses is evolving. An effect analysis is not simply a document; it is a process. We have already begun to embed more of the issues reflected in the first effect analysis at earlier stages in our due process steps. There has been extensive analysis of costs to preparers in the *Financial statement presentation* project, particularly in relation to the presentation of cash flows. The forthcoming exposure draft will include questions about preparation costs, because some of the decisions that the Board has reached have been on the basis of its understanding of the likely cost to the reporting entities.

40. The purpose of this paper and of the public session in February is both to inform you about how we have been developing effect analyses, and to seek your input on the developments to date.

Questions for the SAC
Is the approach we have been taking sufficient?
Should we do more or are we already doing enough?
How do you think we can improve our processes and communication?

Appendix – Example

Business Combinations II

Respondents' comments—equity might be destroyed by these requirements

Some respondents disagreed with the proposed accounting because they were concerned about the effect on reported equity of the subsequent acquisition of non-controlling interests by the parent. Those respondents seemed to be particularly concerned about the effect on the reported leverage of an entity that acquires non-controlling interests and whether this might, for example, cause those entities to have to renegotiate loan agreements.

Our response

We analysed the reported equity of the 600 largest listed entities in Europe at 31 March 2007. Our analysis suggests that the concerns expressed by respondents about the possible widespread, and substantial, erosion of equity as a consequence of buying the non-controlling interest are not supported by the data we observed.

We stress, however, that even if we had concluded that there was a high probability that the accounting we were proposing was likely to cause equity to be reduced significantly we would not have made a different decision about the accounting. We know that the proposed accounting for subsequent acquisitions of non-controlling interests results in a reduction in equity. All acquisitions of an entity's own equity result in a reduction of that entity's reported equity. Even a simple cash dividend increases the leverage of an entity. Therefore, it should not have been surprising to respondents that acquiring non-controlling interests would also affect the leverage of an entity. Such an outcome is a fair representation of the fact that resources have been transferred outside the group and the equity has been reduced.

If acquiring non-controlling interests causes the equity of a group to decrease to a very low level, or even become negative, the underlying reason for that outcome will have been a difference between the carrying amount of the equity being acquired and the amount paid.

Financial statement effect

Because many different methods are being used by entities presently applying IFRSs, it is difficult to assess the effect on the financial statements. The most likely effect will be that goodwill and equity will be lower in the case of an acquisition. For a disposal, some entities will no longer be able to recognise a gain.

The new disclosure requirements are likely to increase the amount of information revealed about transactions between controlling and non-controlling interests.

Many respondents were concerned about the effect on reported equity of the accounting for acquisitions of non-controlling interests. Although we remain confident that the accounting is robust, we did some empirical analysis to assess the concerns of these respondents.

We assessed the 600 companies in the Dow Jones STOXX 600.[5]

As a first step we assessed the relative level of non-controlling interests to total equity (which includes the non-controlling interests). The basic statistics are reported in the table below. The data reveal that 26 per cent of the STOXX companies do not have non-controlling interests. A further 25 per cent of the STOXX companies have non-controlling interests equivalent to less than 1 per cent of equity. Hence, approximately 50 per cent of the IFRS entities examined have non-controlling interests of less than 1 per cent of equity. We analysed the financial statements of the 22 companies with the largest percentage of non-controlling interests relative to total equity, to get a better understanding of the reasons why their non-

[5] The Dow Jones STOXX 600 Index represents large, mid and small capitalisation companies across 18 European countries: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom.

controlling interests were a relatively higher portion of total equity than other entities. The two main reasons for non-controlling interests constituting a high proportion of total equity appear to be:

- underperformance of those parts of the group in which there are no non-controlling interests; and
- the investment strategy of the parent entity—entities that fund a lot of their operations using non-controlling equity providers.

The observed proportion of non-controlling interests as a percentage of equity is lower than the comment letters suggested. That said, the data we used are for the largest Europe-based IFRS entities. It is possible that smaller entities have relatively more, or less, non-controlling interests. We are also told that many countries that have reduced the degree of public ownership in their economies to become more reliant on private capital tend to have companies with high proportions of non-controlling interests. We do not have data to be able to assess these factors.

We also performed further simulations based on the data of those 22 companies as if the non-controlling interests were acquired. These are the companies for which acquiring non-controlling interests should have the largest effect on equity. For each of the 22 companies we collected market capitalisation data and calculated the market-to-book ratio. The reported non-controlling interests was then multiplied by this ratio to give a proxy for the fair value of the non-controlling interests. Using the ratio in this way assumes that the market-to-book ratio is the same for all segments of the group, including those segments in which there are non-controlling interests. The actual multiple is unlikely to be the same, and the resulting measure is not likely to be the same as the fair value of the non-controlling interests. Nevertheless we think that using the market to book ratio for the controlling interest as the ratio of non-controlling interests market to book is sufficient for the purposes of our analysis. We then assumed that the parent acquired all of the non-controlling interests, paying out an amount equal to our fair value proxy. The result is a hypothetical measure of what the reported equity might be if all of the non-controlling interests were acquired by the parent.

As would be expected, equity was reduced in all cases. This is neither a surprise nor a concern. Acquiring non-controlling interests **should** reduce the reported equity of a group—because assets are transferred out of the entity to the non-controlling interests holders (for example, cash paid to acquire the shares). This is the outcome we expect for any transaction with owners. A cash dividend has the same effect on leverage as acquiring non-controlling interests.

Our analysis also tells us that concerns about the possible widespread, and significant, erosion of equity as a consequence of buying out the non-controlling interests are not supported by the data. We do know that some companies would report significantly lower, or negative, equity if they bought out all of their non-controlling interests. However, those entities will have chosen to change the way they are financed. The parent is acquiring the right to receive the share of the returns from the assets and liabilities previously allocated to the non-controlling interests. The parent already controls the net assets but does not have rights to all of the returns of those assets. The parent is not investing in more assets, it is securing the rights to the returns from the assets it already controls and it is presently sharing with the non-controlling interests.

Many entities choose to buy out the other shareholders even if doing so reduces reported equity. One of the entities we looked at reported non-controlling interests equal to 75 per cent of total equity. It also reported total equity (including non-controlling interests) as a proportion of total assets of 7 per cent, compared with an industry average of 45 per cent. The main reason for the relatively low level of total equity appears to be that the entity held treasury shares at the year-end equal to 22.6 times the carrying amount of reported equity. The ability to acquire such a large portion of its own shares is a sign of financial strength of the company, yet the effect is that reported equity is reduced.