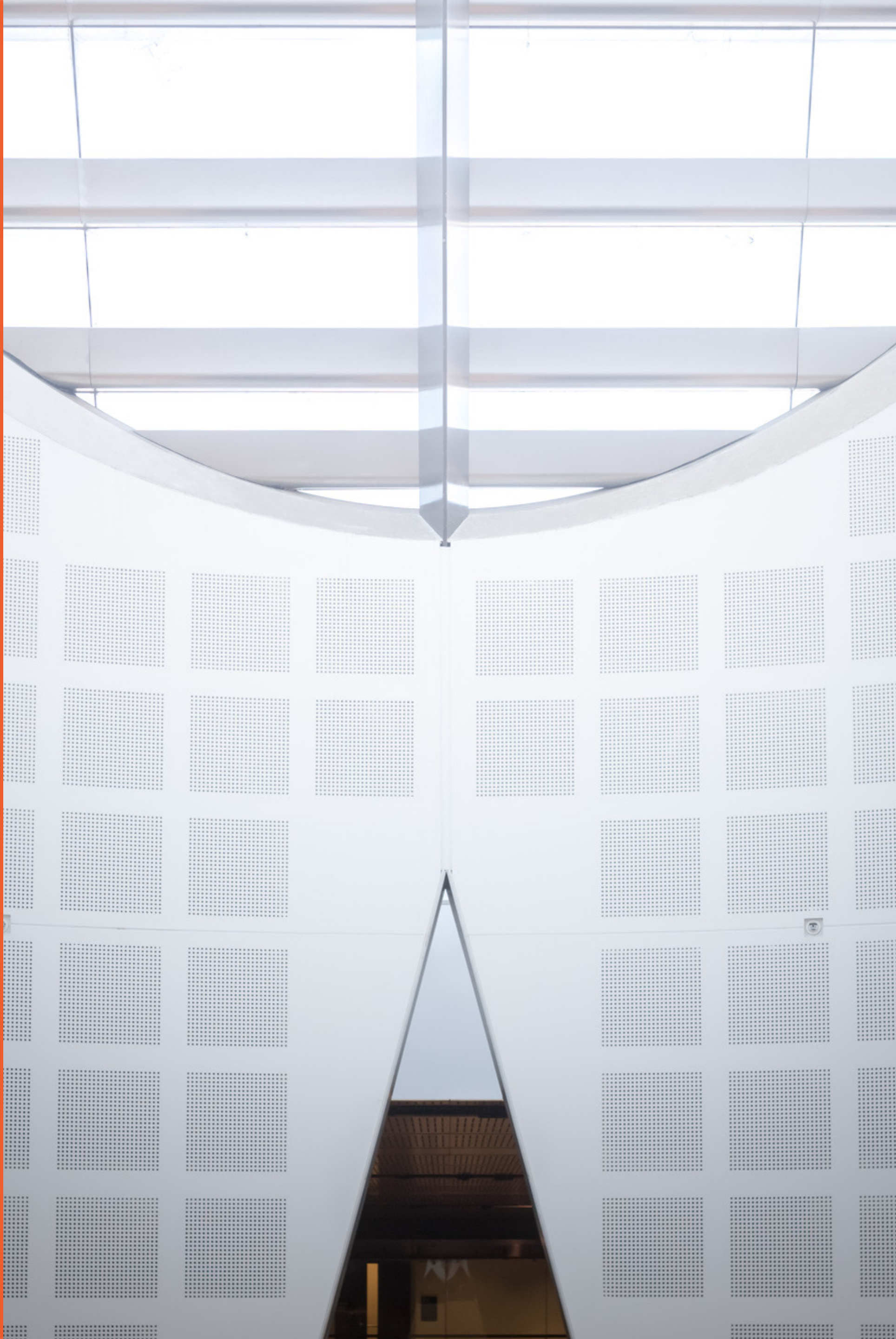
ACCT 6002

The International Development of Group Accounting



THE UNIVERSITY OF SYDNEY

International Development of Group Accounting

- **Text readings:**
- *Comparative International Accounting*: Chapter 8

- **Academic paper, on Canvas:** Nobes, C. W. (2014) 'The development of national and transnational regulation on the scope of consolidation', *Accounting, Auditing & Accountability Journal*, Vol. 27, No. 6

- **Self-Study Questions:** See Canvas for instructions

Learning objectives

After this week's studies, you should be able to:

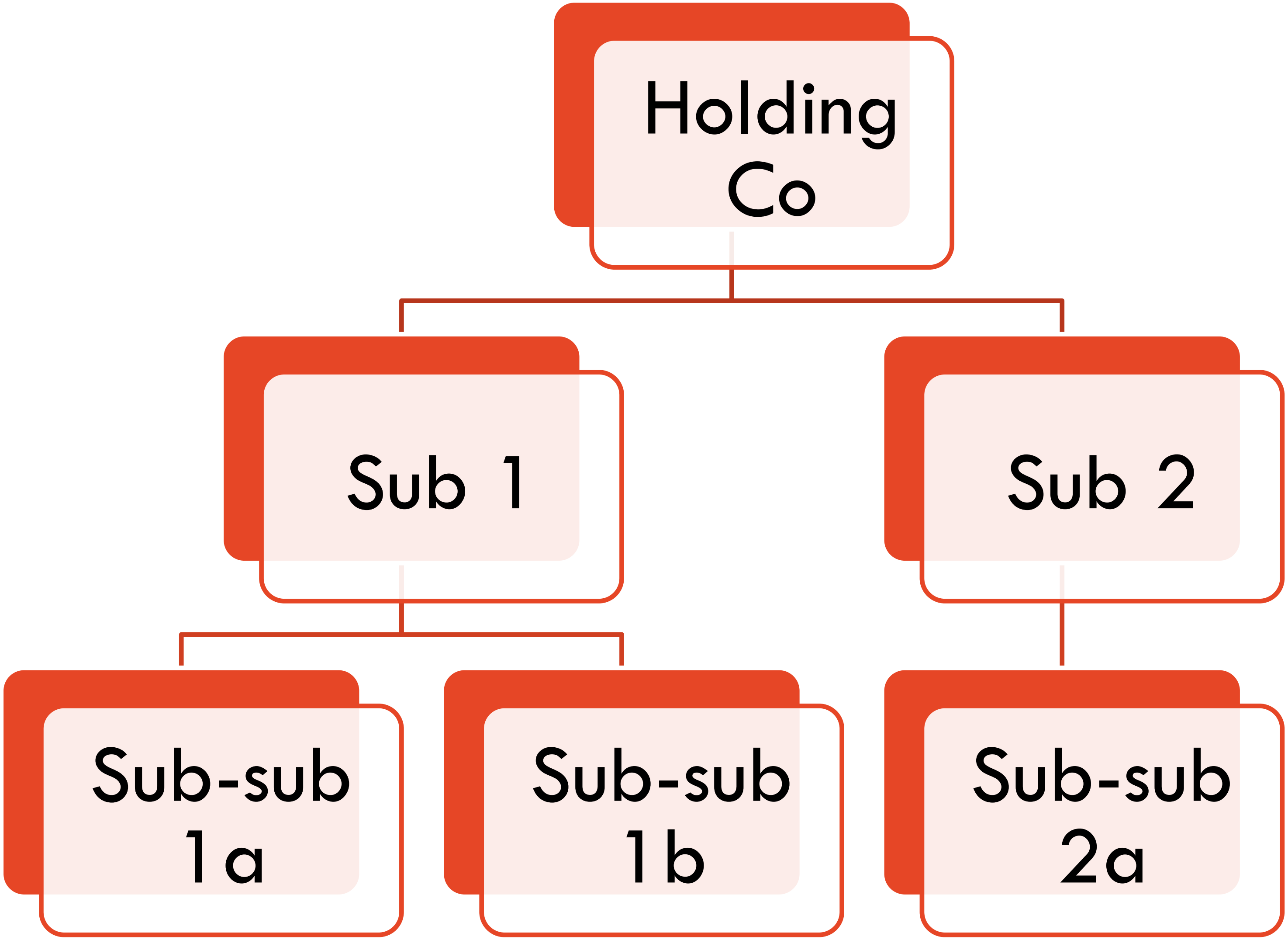
- explain why the United States and the United Kingdom adopted consolidated financial statements before China, Japan and the countries of continental Europe
- Note the different concepts of a 'group' and how they are reflected in IFRS and US GAAP
- explain how the number of exclusions from the group have gradually fallen
- outline the effects on group accounting of the harmonisation programs of the European Union and the International Accounting Standards Board

Introduction

- Both theory and practice of group accounting has differed substantially from country to country:
  - Rate of adoption of consolidated statements
  - **Differences in the concept of the group and the scope of the group**
  - Differences in the techniques of consolidation
  - Differences in what is published by companies
- Harmonisation efforts of the IASB and the EU have narrowed these differences, but they are unlikely to be removed entirely

- Consolidated financial statements: financial statements of the group as if it is a single entity

Simple Group Company Structure



Development of group accounting

- In some countries, group structures preceded consolidation by many decades
- Consolidated statements were first introduced in the US
- Some US companies published consolidated statements in late 19th century
- But the pattern for these statements was set by US Steel in its first annual report (1901/2)
  - US Steel had been created in 1901 from multiple steel companies that operated in different states

Groups and consolidated financial statements

"the spread of consolidation is connected to the spread of group structures. However, such structures do not by themselves lead to consolidated statements: they are a necessary but not a sufficient condition. Indeed, in some countries, group structures existed decades before consolidation became common"

Nobes, 2014, p. 997

US

- US adopted consolidated reporting before everyone else because:
  - The US developed the idea of the “holding company” earlier than other countries
    - Holding company: typically holds shares in other companies, but does not itself produce goods or services
  - Because each state had different laws, it was easier to keep companies as separate legal entities within these states
  - A wave of mergers in the early 20th century meant that groups of companies, rather than individual companies, conducted commercial activities
  - At the time, there was no legal or regulatory control of accounting, so accounting practices were being innovated, including consolidation

UK

- The UK developed consolidated reporting later:
  - earliest consolidation in 1910
  - holding companies became important with a wave of merger activity (1916-22), and consolidated reporting became more common
  - From 1939, London Stock Exchange required consolidated statements for new issues
  - 1947, UK company law required “group accounts”

Other countries

- Consolidated statements developed even later in continental Europe
  - Netherlands: earliest example, 1926
  - Sweden: law of 1944 required consolidation
  - Germany: some practice from 1930s, required by law 1965
  - France: rare until 1970s, required from 1986
  - Not compulsory in some EU countries until 7th Directive
- Japan: consolidated statements regarded as supplementary from 1944 to 1992
- China: consolidation developed during 1990s
- India: consolidated statements required from 2001; Turkey, 2003

Attempts to harmonise group accounting

- From the 1970s, the IASC/B and EU tried in different ways to harmonise group accounting. For the EU, this involved the Seventh directive which attempted to define a group and make rules for consolidation.
- Those efforts merged in 2005 when the EU required IFRS to be used for the consolidated statements of all listed companies.

Table 8.1
Implementation of the Seventh EU Directive by pre-2004 EU members

	National laws	In force (year ends)
France	1985	1986 (Listed); 1990 (Others)
Germany	1985	1990
Greece	1987	1990
Luxembourg	1988	1990
Netherlands	1988	1990
Spain	1989	1991
United Kingdom	1989	1990
Belgium	1990	1991
Denmark	1990	1992
Austria	1990*	1994
Italy	1991	1994
Portugal	1991	1991
Ireland	1992	1993
Finland	1992*	1993
Sweden	1995	1997
Norway‡	1998	1998

Notes: *Less than complete implementation.
‡Member of the European Economic Area, not the EU.

Importance of the 'scope' of the group

- The production of consolidated financial statements assumes that a group of entities can be regarded as a single reporting entity
- But how do we define the boundaries of that entity? Requires thinking about:

1. Who the information is for.
2. The purpose of that financial information?
    - Recall that consolidation emerged from practice.
    - Answering the question how to identify the boundaries brought attempt to retro-fit conceptual ideas to the practices that had evolved.

Users and purpose

- Purpose of consolidation (what it is used for) will affect the scope of the group
- See next slide from Nobes (2014)
  - Are we trying to pretend the group is a single economic entity for investors?
  - Or are we trying to assess the managers of the group as those who look after the resources?
- Depending on what we imagine the purpose is, we may get different results
- If we work backwards, and see in practice what consolidations are used for:
  - in the English speaking world, we have decided we are reporting to the shareholders of the parent company

Table 1 Uses and scopes of consolidation

	Use	*Criterion for consolidation*
1.	Assess resources and results of concentrations of economic power	Control
2.	Assess management	Control
3.	Depict or amplify financial position and performance of entity with investments in other entities	Participation
4.	Assess ability of entity to meet its debts	Control or existence of inter-entity guarantees

Definitions of asset and subsidiary

- Nobes (2014, p.1003) draws a connection between the definitions of asset and subsidiary. For both, ownership and control are the “two contenders for the role of key criterion”
- Asset:
  - US (1970s) and UK/IASC (1980s): control + benefit
  - Control alone is not enough - example of trustees, who have control but not benefit
- Subsidiary:
  - US, definition subsidiary (1971 to 2007) via <u>ownership</u> of majority of voting stock)
  - German rules contributed to EU’s 7th Directive’s definition of a group as: ”Any company (parent company) that <u>legally controls</u> another company (subsidiary company) is under a duty to prepare consolidated accounts”
  - UK, definition of subsidiary in 1929 (but not for consolidation)

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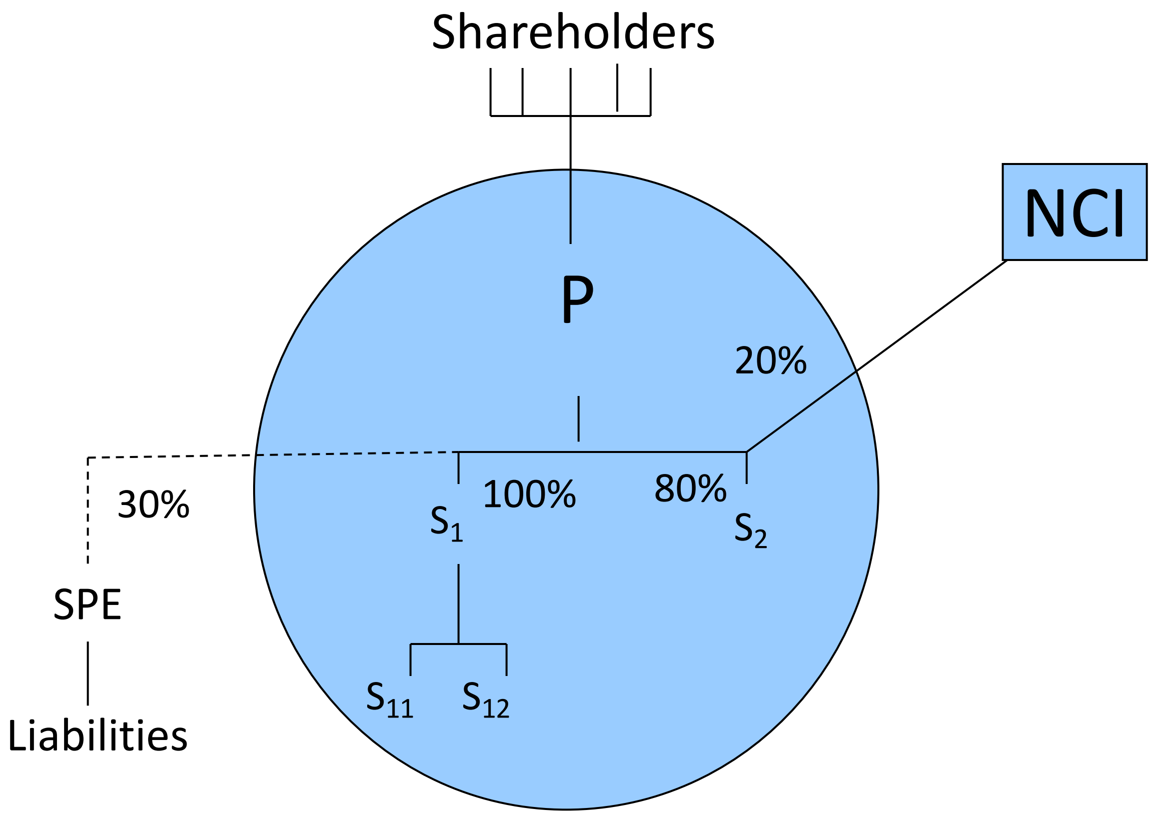
Definitions of control have changed

- “Control is ownership…” (IAS 3)
- “Control is power to govern…to obtain benefits” (IAS 27)
- Control is power to affect variable returns from an investee - a subsidiary in an entity controlled by an investor (IFRS 10)
  - Power arises from rights such as voting rights or the right to elect directors
- So, ‘control’ $\neq$ control
  - Following control definition in new framework (2018), IASB has been revising relevant standards
- US defines a subsidiary based on control
  - But this has to do with number of voting rights, not influence/power

Special-purpose entities



Enron, special purpose entities: off balance sheet finance

https://www.youtube.com/watch?v=hwollZoVmUc

Consolidation/group accounting scandals (Enron)

Defining the subsidiary now

- IFRS 10: *Consolidated Financial Statements* (of 2011) clarifies the definition of the subsidiary and the scope of consolidation
  - requires an entity (the parent) that controls one or more other entities (subsidiaries) to present consolidated financial statements;
  - defines the **principle of control**, and establishes control as the basis for consolidation;
  - sets out how to apply the principle of control to identify whether an investor controls an investee and therefore must consolidate the investee's financial statements.

IFRS 10 Consolidated Financial Statements

- “Control”
  - 5. An investor, regardless of the nature of its involvement with an entity (the investee), shall determine whether it is a parent by assessing **whether it controls** the investee.
  - 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).

Questions on scope of consolidation

1. Company P1 owns 48% of the voting shares of Company W. The remaining shares are widely spread. Is W a subsidiary?
2. Company P2 owns 40% of the shares in Company X and has a fixed-price option to buy 20% more. Is X a subsidiary?
3. Company P3 owns no shares in entity Y, which runs on auto-pilot, i.e. it is a trust with detailed instructions on its purposes (which are largely to help Company P3). Is Y a subsidiary?
4. Company P4 owns 15% of the shares in Company Z but would suffer 70% of the problems if Z went bankrupt. Should Z be consolidated?

Should entity be consolidated?

	IFRS 10	US GAAP
W		
X		
Y		
Z		

Old exclusions from consolidation

- Less than substantially owned (US,1910s; UK,1920s)
- Ownership of equity (SEC, UK) or of voting rights (ARB 43)?
- Control but no majority ownership (US still; UK originally); not Germany
- Severe restrictions (UK)
- Unincorporated entities (US, UK, not Germany)
- Foreign entities (US, UK?, Germany?)
- Dissimilar entities (US, UK, IAS, not Germany)
- Temporary control (UK)
- Immateriality (law not standards)

The scope of the group has widened over time

- In the US and UK, there was a long list of reasons for exclusion of entities from the scope of consolidation
- Germany set out the clearest way to determine scope with its concept of control (1965)
- Since then the move to the concept of control has meant the scope of the group has become wider
  - It has taken many years for IFRS to achieve similar clarity.
  - US GAAP remains less clear

Three possible explanations for developments

1. Increasing complexity and internationality of groups
2. Differences (internationally and over time) in owners/managers of companies (agency theory)
3. International spread of ideas and regulations

Let's look at each of these individually

1. Increasingly complex and international

- This explanation doesn't seem to work because:
  - Complex groups existed in many countries (e.g. France) well before consolidation.
  - The arrival of foreign subsidiaries also had little effect on the techniques in countries where foreign subsidiaries could be excluded.
    - Foreign subsidiaries were omitted in most GAAPs, so this complication was not relevant

2. Insider vs outsider owners/financing

- The separation of ownership and control may have affected developments in consolidation accounting:
    - Berle & Means (1932): separation of control from ownership
    - Mueller (1967), Nobes (1988): insider v. outsider investors
    - Ding *et al*. (2008): insider/outsider ratio changes over time
    - Tarca *et al*. (2013): in Germany, firms with more outsiders move to IFRS
    - Nobes (1998): whole countries can move to outsider basis
  - Link between changes from insider to outsiders financing entities, and changes in the scope of the group

Table 2 Synoptic hypothesis

	System A	*System B*
Owners	Insiders	Outsiders
Key issues	Dividends, Tax	Accountability, Future cash flows
Reporting entity	Legal entity	Group
Boundary of asset, group entity	Legal ownership	Control with benefit

Summary of puzzle

- US
  - first with investor purpose of consolidation financial reporting
- Germany
  - dominated by insider finance and tax
  - One would expect it to stress ownership and legal arrangements
  - BUT Germany had the clearest and earliest “control” concept of the group, whereas US stressed ownership
- Explanation:
  - US/UK had “accounting as an independent discipline”: practicality, auditability (management and auditors prefer restricted scope)
  - Germany saw consolidated statements as an extra set of accounting, with a different purpose (not tax or dividends)

3. International spread of ideas

- Parker (1989); Carnegie and Parker (1996)
- Spread:
  - International capital movement, and involvement of transnational audit firms
  - regulator draws on other countries
  - company or regulator abandons national GAAP

Examples of spread of ideas

– US → UK: (via auditors?)	consolidation; expansion from 100% to majority, from equity to voting equity; exclusion of dissimilar, then inclusion of dissimilar
– UK before US: (via IASB?)	inclusion of foreign subsidiaries, non-companies, non-majority owned
– France:	PW assisted with first consolidation
– China:	PwC leads creation and consolidation of VIEs
– Many countries:	effects of 7th Directive and then IFRS

Nobes (2014)

‘The development of national and transnational regulation on the scope of consolidation’, *Accounting, Auditing & Accountability Journal*, Vol. 27, No. 6.

- Explores the changes in the scope of consolidation (boundary of the group)
- Focus on USA, UK, Germany and France as many drivers of change
- Considers the last 100 years
- US concentration on ownership
- German concentration on control
- So what is a group is ‘constructed’, decided by us and it has changed over time.

Summary on scope

- US began by limiting consolidation to: substantially owned domestic companies similar to the rest of the group
- All this has changed and US scope now also includes VIEs (variable interest entity – investor does not control but would suffer most of the loss)
- Key issue has been ownership v control
  - Is a group a set of things owned or a set of things controlled?
  - battle seen in the development of 7th Directive
- France had clearest ownership view
- Germany clearest control
- IFRS has slowly moved to German position

Summary of topic

- **What is meant by a reporting entity and how do we define its boundaries?**
  - What is included within and what is excluded from the reporting entity's boundary can make a major difference to a reporting entity's financial reports
    - The case of Enron (and others) highlights the effects that may be achieved
  - And yet, this crucial question was not addressed in conceptual frameworks until 2018 (Australia was the exception)
- The reporting entity is now included in the IASB's framework,
  - The IASB attempted to use conceptual ideas for its reporting entity concept and abandoned that attempt. The revised conceptual framework describes practice.
  - While "control" widens the boundary of the reporting entity, group reporting has emerged in practice, and there remains no consistent conceptual thinking to underpin group accounting practices