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Issues of Control in Accounting: A Comparative Analysis of IAS 27 and IFRS 10

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ABSTRACT: *Subsidiaries identification has always been a contentious issue in consolidation of financial statements and till date is one of the most challenging issues accounting standard setting bodies such as the International Accounting Standards Board (IASB) have to contend with. The global financial crisis of 2007 and some prominent accounting scandals in recent history e.g., the Enron saga, have remarkably demonstrated the consequences of wrong application of consolidation rules on entities, investors, and other stakeholders. International Accounting Standard (IAS) 3 – Consolidated financial statements and IAS 27 – Consolidated and separate financial statements were respectively issued in 1976 and 1989 by the International Accounting Standards Committee (IASC) to address these controversies. Additionally, In May 2011, the IASB which replaces the IASC in 2001, published International Financial Reporting Standards (IFRS) 10 which came-up with a revised consolidation model replacing the provisions of IAS-27 and SIC-12. However, the consolidation criteria in IFRS 10 were adjudged as difficult to understand, even amongst experts and even more challenging to apply in practice. IFRS-10 is principled-based and is not only broader and more complex than IAS-27 and Standards Interpretation Committee (SIC) 12, but the structure remains questionable. In addition, the provisions of IFRS 10 contained several terms that were undefined and unspecified which are capable of subjective interpretation and application. In-depth understanding of the new provisions of IFRS 10 and its basic concepts are necessary to achieve the objective of the revised standard. Lack of adequate understanding of the new rules and its basic concepts will practically make it impossible to properly apply the new consolidation criteria. The research methodology adopted is therefore to review relevant literatures, practical and professional assertions by contrasting and comparing the provisions of the two standards.*

KEYWORDS*:* Consolidated financial statements, control, parent, subsidiary

INTRODUCTION

Consolidated financial statements are fundamental to decision makers as they are the most essential source of information used by stakeholders to make informed decisions regarding the parent entity. Accounting Standards provides guidance on what, how, where, when and why accounts of related entities should be consolidated. Different standards at different times provided guidance on consolidation of entities financial statements.

However, the core of all the guidance was to consolidate when control is established. Control is often used casually to describe power of influence over something. Control is central to identify a subsidiary for purpose of consolidation. To ascertain which related entity qualified as a subsidiary for purpose of consolidation has always been and continue to be key issue for discussion amongst managers and subject matter experts. It is also arguably that one of the big issues affecting corporate reporting, particularly, for entities that has investments in other entities has been identification of subsidiary for purpose of control.

To provide guidance and reduce instances of free for all interpretation of the word "Control", standards setters around the globe have in the past made several standards and interpretations. The International Accounting Standard Board (IASB) first issued IAS 3 – Consolidated Financial Statements focusing mainly on majority shareholding (greater than 51%) in 1976 to address the issues concerning Control. In order to address the problems of free-for all attitude and creative accounting associated with IAS 3, IAS 27 – Consolidated and Separate Financial Statements was issued in 1989. IAS 27 recognizes control once an entity has the "power to govern". IAS 27 governed the preparation and presentation of consolidated financial statements for entities using IFRS prior to 2013. Although IAS 27 was seen as an improvement towards addressing the challenges of the previous accounting standard (Hsu et al., 2012), it was however, been criticized for adopting a definition of control which, debatably, allows entities with the option to exclude non-majority-owned and loss-making entities from consolidation (IASB, 2011). In addition, IAS 27 and SIC-12 placed emphasis on different elements which had led to varying application of the concept of control.

IAS 27 provisions required consolidation of firms provided control has been established the reporting firm, and defined control - as the "power to govern" the financial and operating policies of an entity so as to "obtain benefits" from its activities'. SIC-12, which aim was to interpret the provisions of IAS 27, however, places higher emphasis to "Risks and Rewards". In view of these conflict in emphasis between IAS 27 and SIC-12, and to practically address the controversies in application of IAS 27 and SIC-12, the IASB included a project on consolidation to its agenda and later in 2013, IFRS 10 was issued with a revised definition of control which was aimed at addressing the issues raised regarding the IAS 27 control definition.

Statement Problem

The underlying reason for review of definition of control in IFRS 10 was the incorrect use of control definition by entities to the extent that some do not include all controlled off-balance sheet activities in consolidation (Ernest and Young, 2011; Ben-Shahar et al., 2016). Supposing the IFRS 10 definition of control resolved the problems associated with the IAS 27 definition, there exist chances for greater number of entities being consolidated. However, the IASB conducted an effect analysis on the revised standard, and it expresses uncertainty as to whether IFRS 10 adoption will lead to higher or fewer number of entities to be "consolidated", as the new definition requires investors to re-evaluate if truly, they control the investee (IASB, 2011, p. 17). Despite the primary objective of IFRS 10 in minimizing differences in practical application of control definition and improve comparability of financial information (IASB, 2011), there exit however, few empirical evidences to validate its effectiveness.

Given the uncertainty regarding the effect of IFRS 10, it is difficult to conclude, without empirical evidence, whether or not the adoption of the new standard will lead to fewer or higher number of subsidiaries to be consolidated and increases or reduces the value relevance of financial information. This paper, therefore discusses the conceptual issues of control in Accounting as regards IAS 27 and IFRS 10.

Conceptualisation

IAS 27 defined control - *as the "power to govern" the financial and operating policies of an entity so as to "obtain benefits" from its activities" (para. 4).* This definition was however, criticized because of two main issues. Firstly, the term "power to govern" give rooms to argue that more than 50 percent beneficial ownership was necessary by firms to have power to govern another entity. The second criticism was the requirement for firms to 'benefit from the activities' (para. 8) of other entity to be viewed as having control. This also provide an opportunity for firms to claim that only entities that firms benefit from are eligible to be consolidated thereby technically omitting loss-making subsidiaries from consolidation.

In view of these criticisms highlighted as regards to IAS 27 and the presumed divergence in practical usage of the definition of control, the IASB exposed an Exposure draft (ED) - 10 titled "Consolidated Financial Statements" in December 2008 to solicits for public comments (IASB, 2011, p. 9). At the end of the exposure, the IASB reveals that 148 comment letters were received in response to the exposure draft. The feedback from the comment letters indicates that although many users are comfortable with the control concept being the pillar for consolidation of financial statement, however it shows substantial level of divergence on how the control concept was put together by the IASB. This divergence has further led to stakeholders' engagements, consultations, meetings and outreach activities. In May 2011, the IASB released IFRS 10, IFRS 11 and IFRS 12 on Consolidated Financial Statements, Joint Arrangements and Disclosure of Interests in Other Entities respectively, which were to commence implementation for financial years beginning on or after January, 1, 2013. Even though IFRS 10 has revised the meaning of control under IAS 27

and provided more guidance on its implementation, that did not largely change the accounting procedures for consolidation of financial statements.

In an attempt to address the first criticism identified with regards IAS 27 which allows entities with lesser than 50 percent ownership to be excluded from consolidation, IFRS 10, (para. B41) states that, an investor with lesser than 50% voting right will have "sufficient power" over an investee provided he has the ability to unilaterally direct its relevant activities. Paragraph B42 also provided a comprehensive list of instances for consideration by entities with non-majority ownership to assess if they have "sufficient power" over an investee. Such instances include the quantity of shares owned by an investor compare to the number and spread of shares of the remaining investors.

On the second criticism with regards IAS 27, which was on non-inclusion of loss-making entities on consolidation, IFRS 10 however, address the issue on the strength that, an investor returns from investment need not to be positive, but either, positive, negative or both. This revised provision will ultimately enhance transparency with regards to off-balance-sheet transactions and reduce risks to investors (European Commission, 2012, p.).

LITERATURE REVIEW

Researchers such as Walker, (1990, 1991); and Psaros, (2007) focused their attention on how the usage of control definition on principles-based or rules-based affects consolidated financial statements. Precisely, the studies were meant to assess the impact of using more than 50 percent ownership threshold as a basis of identifying subsidiaries. The findings reveal that Prior to 1991, subsidiaries were mostly identified if an entity owns greater than 50 percent ownership in other entity and therefore, firms purposefully fine-tune their ownership structure below the threshold of 50 percent to circumvent consolidation requirements particularly for loss-making entities.

However, post 1991, accounting standards-setters shifted focus towards principles-based standards instead of the rules-based. This shift was to prevent entities from creative accounting from inappropriate consolidation.Although this shift in focus has been generally supported by stakeholders, Maines et. al. (2003), Schipper, (2003) and Nobes, (2005) were concerned that the success of principles-based standards is only depends on greater professional judgement from both the auditors and the preparers of the consolidated financial statement. Nelson, (2003); Ewert and Wagenhofer, (2005) and Folsom, et. al., (2017) added that principles-based standards will lead to high level of discretion thereby resulting to very aggressive financial reporting.

McEnroe and Sullivan, (2013) concluded that both the preparers and the auditors of financial statements prefer rules-based standards than the principles-based because of its simplicity in application. In the studies of Donelson et. al., (2012) and Gimbar, et. al., (2016), it was found that principles-based application of control definition increases risk of litigations for both auditors and preparers.

Ernst and Young (2011) postulated that the revised control definition will certainly addresses the problem of excluding loss-making entities from consolidation, which according to them was a major factor that triggered the 2008-2009 global financial crisis. *"IFRS 10 may change which entities are within a group. These changes were made by the IASB, in part, in response to the financial crisis, when there was heavy criticism of accounting rules that permitted certain entities to remain off-balance sheet (Ernst and Young, 2011, p. 1)."*

Beck et. al., (2017) in their study raised some concerns about the continued application of principles-based control definition which allows for more subjectivity and unnecessarily increased complication with regards to consolidation of non-majority owned investees. Bedford et al (2021) studied the impact of IFRS 10 adoption on consolidated financial reports. Their findings suggest that, IFRS 10 adoption has led to entities consolidating fewer subsidiaries with non-majority ownership. In addition, consolidation of fewer subsidiaries was also linked to financial reporting incentives. They also found that the value relevance of equity increases and that of profit decreases after adoption IFRS 10 for entities reporting fewer subsidiaries.

DISCUSSIONS

Stakeholders will make informed decision about an entity if all genuinely controlled entities are consolidated by the parent, thus, making consolidated financial accounts relevant and useful. to stakeholders when all 'truly' controlled entities are included. Supposing the perceived objective for which IFRS 10 was released is achieved, issues of divergence in application of control definition will greatly reduce and will unify the consolidation practices amongst different groups. In addition, will results in producing statements that correctly reflects all the economic activities of an undertaking and further provide benefits for investors and other stakeholders in terms of comparability and usefulness of financial information (IASB, 2011).

Barth et al., (2001), opined that, if the consolidated financial statements prepared under IFRS 10 is more useful for decision making by investors', the value relevance of financial information will surely increase. This expression is in agreement with previous research, which shows that with the implementation of principled-based definition of control and the disclosure of non-controlling interest separately in Statement of Financial Position and Statement of Profit or Loss Accounts and Other Comprehensive Income (So and Smith, 2009), the value relevance of financial statements will improve (Hsu et al., 2012).

Ewert and Wagenhofer, (2005), however, asserted that, the IFRS 10 control definition may be applied more subjectively than the IAS 27 control definition, thereby resulting in more diversity in application, thus, reduces value relevance of financial information. Based on prior studies, it is still not crystal clear to conclusively assert if IFRS 10 has addressed all the observed weaknesses of IAS 27 and brought in consistency and appropriate consolidation of subsidiaries, thereby improving the usefulness of the consolidated accounts.

Whittred, (1987); Mian and Smith, (1990b); Beck et al., (2017), are of the opinion that, the decisions to consolidated are mainly based on the firm-specific incentives from the consolidation. They argued that firms with high outstanding debt or have been in persistent dwindling financial situations are tactically taken off-balance sheet by adjusting the ownership structure thresholds to omit such firms from consolidations. They added that, managerial incentives determine whether or not to improve financial performance. Whittred (1987), also added that, where a Chief Executive Officer possess large ownership in an entity, he/she will be motivated by the consequences of market valuation to conceal poor performance of his/her firm.

Becker et al., (1998), DeFond and Zhang, (2014), and Beck et al., (2017) are of the opinion that, the statutorily requirements for audit of financial statements by an appointed external auditor will results in appropriate consolidation of subsidiaries. Based on the foregoing studies, it can be concluded that factors such as debt profile, Chief Executive Officer's ownership level, profitability level and the type of auditor appointed influence the possibility that entities accurately report investees as subsidiaries prior to IFRS 10 adoption, and thus such firms are predicted to be differentially impacted by the new control definition.

CONCLUSION

The control definition under IAS 27 requires the parent entity to (i) have the 'power to govern' over, and (ii) the receipt of 'benefits' from, the subsidiary, suggesting that majority shareholder ownership and positive returns are necessary conditions, respectively, for consolidation. However, IFRS 10 is built on a principles-based control definition which requires firms to consolidate entities (i) from which investor receive 'variable returns', be it positive or negative returns, and (ii) from which investor have the 'power' to affect these returns. This definition of control under IFRS 10 has limit the ability of investors to deliberately omit loss-making (i.e., no 'benefits') and non-majority-owned (i.e., inability to 'govern') entities from consolidated financial reports. With the issuance of IFRS 10, the IASB was optimistic that the revised control definition would address the diversity in practical application of control definition under IAS 27 and reduce the inconsistencies of interpretation about which entity is to be included or excluded for the purpose of consolidation (IASB, 2011, p. 5).

In addition, IFRS 10 clearly mention that a firm can have control over another firm without necessarily having majority of shares and that the returns could be positive, negative or both as against positive returns under IAS 27. The revised provision provided further guidance on control definition to reduce inappropriate consolidation practices. With these new provisions, stakeholders were optimistic that the problem of exclusion of non-majority owned and loss-making subsidiaries will drastically be eliminated.

However, Agoglia et.al, (2011) argued that the revised control definition in IFRS 10, will lead to increased subjectivity, wider dispersion in implementation and aggressive reporting of financial information.

From the perspective of users, the emphasis was on how the control definition under IFRS 10 has impacted on area of interest to them. For investors, their focus is mainly on how the revised control definition has address the diversity in implementation of IAS 27 provisions and improves the quality of financial reports. This is necessary for them to assess whether they should place high reliance on its contents or not, thus, will help them reduce the extra effort of seeking further information for decision making.

For debtholders and creditors, if all controlled entities are appropriately consolidated; including loss-making entities, it will place more confidence on them to lend additional funds to such entities.

Recommendations

The IASB should continuously carry out effect analysis on the adoption of IFRS 10 and provide further guidance on its application, while auditors must ensure that proper assessment have been carried-out on all investments by the auditee, this is to identify and correctly reflect which entity need to be included or excluded for consolidation purpose.

Preparers of financial statements and their auditors should scale up their professional judgement in identifying which entities qualifies as subsidiary for consolidation.

Finally, Regulators should call for more disclosures in terms of investments in other entities by the reporting entity. This is to enable them to review whether the accounts were prepared in accordance with the provisions of the standard.

Shareholders should call for more accountability to ensure that all entities needed for consolidation are consolidated.

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