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Consolidated Financial Statements. The identification of group's boundaries for control purposes: a comparison between IAS/IFRSs versus US GAAPs

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LIST OF ABBREVIATIONS / ACRONYMS

AASB	Australian Accounting Standards Board
ABS	Asset-Backed Security
ACCA	Association of Chartered Certified Accountants
APES	Accounting Professional and Ethical Standard
ARB	Accounting Research Bulletin
ASAF	Accounting Standards Advisory Forum
ASC	Accounting Standards Codification
ASU	Accounting Standards Update
BC	Basis for Conclusion
BM	Business Model
BOD	Board of Directors
BS	Balance Sheet
BU	Business Unit
CCCTB	Common Consolidated Corporate Tax Base
CFS	Cash Flow Statement
DP	Discussion Paper
DSE	Deemed Separate Entity
EC	European Community
ECM	Equity Capital Market
ED	Exposure Draft
EEC	European Economic Community
EITF	Emerging Issue Task Force
EU	European Union
FAF	Financial Accounting Foundation
FASB	Financial Accounting Standards Board
FIN	FASB Interpretation Number
FTSE MIB	Financial Times Stock Exchange “Milano Indice di Borsa”
GAAP	Generally Accepted Accounting Principles (US)
GASB	Governmental Accounting Standards Board
GP	General Partner
GPFR	General Purpose Financial Report
IAASB	International Auditing and Assurance Standards Board
IAS	International Accounting Standards

IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
ICS	Internal Control System
IFRS	International Accounting Financial Reporting Standards
IS	Income Statement
ITCY	Intercompany
LLC	Limited Liability Company
LP	Limited Partner
LSE	London Stock Exchange
MD&A	Management Discussion and Analysis
MNE	Multinational Enterprise
MOU	Memorandum of Understanding
NASDAQ	National Association of Securities Dealers Automated Quotations
NCI	Non-Controlling Interest
NYSE	New York Stock Exchange
OCI	Other Comprehensive Income
OTC	Over The Counter
PIR	Post-Implementation Review
P&L	Profit and Loss (Statement)
PCAOB	Public Company Accounting Oversight Board
QSPE	Qualifying Special Purpose Entity
RFI	Request of Information
R&D	Research and Development
SAC	Statements of Accounting Concepts
SEC	Security Exchange Commission
SFAS	Statement of Financial Accounting Standards
SFP	Statement of Financial Position
SIC	Standard Interpretations Committee
SPE	Special Purpose Entity
SPFR	Special Purpose Financial Report
SPV	Special Purpose Vehicle
VIE	Variable Interest Entity
VOE	Voting Interest Model

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ABSTRACT

This thesis moves from the awareness that financial information is key for investors in order to make valuable decisions in global capital markets where companies nowadays operate. And this is even more accentuated when it comes to multinational enterprises, organized in complex structures (usually as a group), with the aim to look beyond stand-alone financial statements of single entities. Heretofore, data did not play such a critical role: with globalization and state-of-the-art technologies, corporate disclosure evolved significantly. The work is intended to fill the gap present in the literature by offering to the reader the tools for reaching a comprehensive knowledge of how control is assessed for recognizing group's boundaries, by looking both at IFRS Standards and US GAAP Principles. Across the chapters, we will discover what control is and, at the end of the reading, we should have a strong understanding about how different consolidation models work and when they apply. We will go through their limits, differences and peculiarities, thereby adopting a transverse approach. Furthermore, we will see also how companies behave when they no longer control another entity or a pool of assets. In the last stage, fundamental to the entire analysis will be the auditors' standpoints that will ease the overall apprehension. Eventually, we will try to sketch humble conclusive considerations regarding the relevance in assessing control to properly define the consolidation perimeter, thus conveying to investors purposeful, meaningful and worthy information about the group's performance and helping increasingly complex businesses to improve consolidation practices aimed at facing upcoming challenges in a long-term horizon.

Keywords: IFRSs, US GAAPs, Consolidated Financial Statements, Regulatory changes, Global Accounting Convergence, Conceptual Framework for Financial Reporting, Concepts Statements, Consolidation Frameworks, Post-Implementation Reviews, Unconsolidated Financial Reporting, Control, Consolidation Perimeter, IFRS 10 Control Model, Variable Interest Entity Model, Voting Interest Entity Model, Special Purpose Entities, Silos, Loss of Control

INTRODUCTION

Nowadays, data is the biggest asset companies have to manage after people: particularly, financial information produced by corporations and other organizations is essential to investors for decision-making purposes. Capital markets are chaotic, so that investors have to disentangle this very complex world by assessing properly risks and returns of alternative investment opportunities in order to end up with a rationale expectation oriented to the optimal allocation of their financial resources.

That is why firms have to face several challenges that are posed in the broader fast-paced and technological-driven today's capitalism era. They are responsible to provide a good-quality financial information to any company's stakeholder with the aim to minimize information asymmetries.

Corporate disclosure has evolved significantly over time and now, more than ever, companies must take particular care of how financial and non-financial information is provided to stakeholders. As a result, annual reports and the financial statements embedded in are fundamental data source through which investors rely on.

Globalization, state-of-the-art technologies and the competitive mechanism of financial markets have contributed to create large-scale organizations, Multinational Enterprises (MNEs) and structured businesses that, most of the times, operate in different countries besides the domestic one, in multiple sectors (whether their business model is diversified) and with different legal structures, thus requiring a comprehensive knowledge of the whole firm before making any relevant investment decision.

Within this context, groups of companies need to consolidate their accounts in order to draft the so-called "Consolidated Financial Statements", since single financial statements issued by the economic entities that belong to a certain group is not enough to satisfy the information requirements of investors. As a matter of fact, they do not provide a holistic picture of the overall performance of the group.

To go beyond the separate financial statements, hence, we need to shed light on the consolidated accounts of the parent company and its subsidiaries:

this need stems from the fact that the operations and activities of the subsidiaries are not fully represented in the parent company's financial statements where, instead, they just appear among its financial investments.
The parent company, which often conducts activities independently from those carried out by the single subsidiaries, is separated from them by legal boundaries, so that it might not be clear at all which are the entities that need to be consolidated: this academic thesis aims primarily to define the perimeter of consolidation, trying to give as well an exhaustive representation about how group of companies define the legal entities that must be included in their consolidation process, which are exempted to this process (*scope exceptions*) and which are the concerned implications.

That said will be contextualized in the global accounting arena by focusing on two accounting standard sets: the IAS/IFRS Standards and the US GAAP Principles. We take as a reference these two sets of principles because are those issued by the two majors standard-setters worldwide: the *International Accounting Standards Board (IASB),* which is in charge to issue the *International Financial Reporting Standards (IFRS),* and the *Financial Accounting Standards Board (FASB)* which instead is responsible for issuing the *US Generally Accepted Accounting Principles (US GAAP)*. In this regard, we will analyze in-depth updates and amendments of the rules governing Consolidated Financial Statements according to the above-mentioned accounting standards.
In addition, different models of consolidation are taken into account, even if it is worth mentioning that there have been various attempts of convergence over the years into a single consolidation technique. Indeed, consolidation is not a challenging research topic just for standard-setters, but also for practitioners, audit firms, chartered accountants and the like.

The work, in essence, is divided and presented in different chapters as follows: *Chapter 1* aims to provide readers with an overview on regulatory changes that, time to time, interested the consolidation topic. *Chapter 2* offers pillars to understand the control concept and how the consolidation process is carried forward, while in *Chapter 3* we will go through the consolidation models available under IAS/IFRSs and US GAAPs. After having considered silos in *Chapter 4*, we will have a look in *Chapter 5* at how companies behave when they are affected by a loss of control. Ultimately, C*hapter 6* will try to conclude the dissertation by contributing auditors' standpoints about consolidation issues.

CHAPTER 1. REGULATORY CHANGES SHAPING THE CONSOLIDATION ARENA

1.1 The Conceptual Framework for Financial Reporting

1.1.1 The key historical milestones of the IFRS Framework's evolution

The most suitable starting point to address thoroughly the complex world of consolidation is departing from the so-called "Conceptual Framework for Financial Reporting". The latter, hereafter also "Conceptual Framework", is part of the work carried out by the IASB and it «*sets out the fundamental concepts for financial reporting that guide the Board in developing IFRS Standards*» (IFRS Foundation, 2018)[1].

Before depicting the Consolidation Framework, which can be identified as a restricted set of standards strictly related to the consolidation topic part of the broader Conceptual Framework, it is worth mentioning briefly the history of the latter. It dates back to April 1989 (Deloitte, 2018; IFRS Box, 2012)[2] when, at the very beginning, it was approved by the *International Accounting Standard Committee (IASC)*; afterwards, it changed name becoming «Framework for the Preparation and Presentation of Financial Statements» (Deloitte, 2018). In 2001, also the IASC became IASB. Published on July of the same year, in the early 2000s it was adopted by the IASB. Subsequently, on September 2010, the prior "Framework" changed its name into the current one «Conceptual Framework for

[1] IFRS Foundation. *Conceptual Framework for Financial Reporting*. (2018). www.ifrs.org; IFRS Foundation. *IASB completes revisions to its conceptual framework*. (2018). www.ifrs.org
[2] Deloitte. *Effective dates of IFRSs and amendments*. (2018). www.iasplus.com; IFRS Box. *The Conceptual Framework for Financial Reporting*. (2012). www.ifrsbox.com

Financial Reporting» (Deloitte, 2018), being ultimately approved by the IASB. Finally, on March 2018, the IASB published the revised version of the 2010 Conceptual Framework (Deloitte, 2018)[3], without upsetting its fundamental aspect, but barely introducing fewer clarifications and updates.

The IASB, in order to ease and speed the realization and the conclusion of the 2018 project, involved a consultative group, the *Accounting Standards Advisory Forum (ASAF)*, which is still operational, and it is composed by several national accounting standard-setters and regional organizations active in the field of financial reporting.

For the sake of clarity, the Conceptual Framework is not a stand-alone IFRS, but as Gallimberti, C. et al. point out, it «*[…] provides only guidance to enhance the proper application of the accounting standard itself*» (Gallimberti et al., 2013, p. 44)[4]. Furthermore, should there be any conflict between the Conceptual Framework and a specific IFRS Standard, then the latter will prevail in any case.

Another important aspect that we should recall is that IFRSs are *principles-based standards*, contrarily to US GAAPs, which are *rules-based* (Benston, G. J. et al., 2006, p. 171)[5]. The main difference between these two sets of accounting standards lies on their conceptual approach, meaning that they basically differ in the methodology to gauge an accounting treatment. While IFRSs leave more room for uncertainty and professional judgment, rules-based accounting does not leave any space for second-guessing, since rules must be followed without any degree of discretion or personal interpretation.

As the IASB reports, the Conceptual Framework revised in 2018 was fine-tuned by setting out three main uses:

«

I. *to assist the Board to develop IFRS Standards based on consistent concepts, resulting in financial information that is useful to investors, lenders and other creditors;*

[3] Deloitte. *Conceptual Framework for Financial Reporting 2018.* (2018). www.iasplus.com
[4] Gallimberti et al. *Consolidation. Preparing and understanding consolidated financial statements under IFRS.* Mc Graw Hill Education. P. 44. (2013)
[5] Benston, G. J. et al. *Principles- Versus Rules-Based Accounting Standards. The FASB's Standard Setting Strategy*. Abacus, Vol. 42, No. 2. Pp. 165-188. P. 171. (2006). www.cpb-us-w2.wpmucdn.com

II. *to assist preparers of financial reports to develop consistent accounting policies for transactions or other events when no standard applies, or a standard allows a choice of accounting policies;*

III. *to assist all parties to understand and interpret standards*» (IFRS Foundation, 2018, p. 69)[6].

Furthermore, the 2018 revised *Conceptual Framework* sets out:

«

- *the objective of financial reporting;*
- *the qualitative characteristics of useful financial information;*
- *a description of the reporting entity and its boundary;*
- *definitions of an asset, a liability, equity, income and expenses and guidance supporting these definitions;*
- *criteria for including assets and liabilities in financial statements (recognition) and guidance on when to remove them (derecognition);*
- *measurement bases and guidance on when to use them;*
- *concepts and guidance on presentation and disclosure;*
- *concepts relating to capital and capital maintenance*» (Deloitte, 2018; Ernst & Young, 2018, p. 2; IFRS Foundation, 2018, p. 69; Mazars, 2018)[7].

Since our purpose is not that one to describe in full detail any IFRS composing the Conceptual Framework, in *paragraph 1.2* on we will introduce and focus exclusively on the *Consolidation Framework* with the aim to build up the fundamentals in order to ease its comprehension and, in general, the entire discussion that this academic work is intended to pursue.

[6] IFRS Foundation. *Conceptual Framework for Financial Reporting*. P. 69. (2018). www.ifrs.org

[7] Deloitte. *IASB publishes revised Conceptual Framework*. (2018). www.iasplus.com; Ernst & Young. *Applying IFRS. IASB issues revised Conceptual Framework for Financial Reporting*. P. 2. (2018). www.ey.com; IFRS Foundation. *Conceptual Framework for Financial Reporting*. P. 69. (2018). www.ifrs.org; Mazars. *Key Features of the New IFRS Conceptual Framework*. (2018). www. mazarsledger.com

1.1.2 The ongoing FASB project to set its own Conceptual Framework

FASB Conceptual Framework, also called "Concepts Statements" (Financial Accounting Standards Board, 2018)[8], is the equivalent of the IFRS one that is applicable in US jurisdictions.

It can be defined as «*[…] a body of interrelated objectives and fundamentals. The objectives identify the goals and purposes of financial reporting and the fundamentals are the underlying concepts that help achieve those objectives […]*» (Financial Accounting Foundation, 2018)[9]. Thus, similarly to IFRS, the main aim is to provide guidance to the Board in its standard-setting function and give the proper tools to users to comprehend issued standards, as well as having the possibility to contribute significantly to their development.

Differently from the IFRS one, FASB project related to the issuance of its own Conceptual Framework has not been completed so far: for instance, several topics of *financial presentation*, *derecognition*, *disclosure*, and the *definition of a reporting entity* are not covered yet. In addition, further aspects (like *recognition* and *measurement*) have remained incomplete.

Since the project started approximately in the 90s, it cannot be valued still modern nowadays, since businesses and the complexity of the world have evolved remarkably over time, thus requiring clearly continuous updates.

Current FASB Concepts Statements address the following:

«

- *Objectives of financial reporting by business enterprises and non-business organizations;*
- *Qualitative characteristics of useful accounting information;*
- *Elements of financial statements;*
- *Criteria for recognizing and measuring financial statement elements;*
- *Use of cash flow and present value information in accounting measurements*» (Financial Accounting Foundation, 2018).

[8] Financial Accounting Standards Board. *Concepts Statements*. (2018). www.fasb.org
[9] Financial Accounting Standards Board. The *Conceptual Framework*. (2018). www.fasb.org

What matters most is that «*unlike IFRS, the Conceptual Framework is non-authoritative guidance and is not referred to routinely by preparers of financial statements*» (KPMG, 2013, p. 7)[10].

As IFRS Conceptual Framework, the US one is not a single standard and if there is a contrast between an US GAAP Standard and the Framework, the former prevails.

1.1.3 The 2004-2010 joint project of IASB and FASB to issue a common Framework

In 2004, the IASB started to cooperate with FASB in order to brush-up their own already existing frameworks, thus starting a new joint project by developing a common conceptual framework. This project was intended to pursue the convergence between the two major accounting bodies' agendas and to augment efficiency when developing new standards. The most controversial issue was linked to the measurement sphere, as pointed out by Whittington (Whittington, G., 2008, p. 140)[11], which did not reach a discussion paper stage during the development of the project. While IASB prefers fair value as prevalent measurement method, FASB's view is generally different, since it moves from the assertions that markets are not perfect and complete, thereby preferring historical-cost accounting. That is why the search of an alternative view became the research focus of Whittington, concluding that «*[…] it is not possible to deduce a general, 'theoretically' correct accounting measure in a world of imperfect and incomplete markets […]*» (Whittington, G., 2008, p. 165). The joint project was split in eight phases (Table 1.1, *Phases and status of the 2004-2010 joint project for issuing a common Conceptual Framework for Financial Reporting*)[12]:

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[10] KPMG. *IFRS compared to US GAAP: An overview*. KPMG's Global IFRS Institute. P. 7. (2017). https://assets.kpmg.com

[11] Whittington, G. *Fair Value and the IASB/FASB Conceptual Framework Project – An Alternative View.* Abacus, Vol. 44, No. 2. Pp. 139-168. Pp. 140; 165. (2008). www.onlinelibrary.wiley.com

[12] Table 1.1: *Phases and status of the 2004-2010 joint project for issuing a common Conceptual Framework for Financial Reporting*. Re-elaborated by the Author.
Source: Axelsson, C. *The joint IASB/FASB Conceptual Framework project*. Karlstads Universitet. P. 4. (2009). www3.kau.se; Deloitte. *Conceptual Framework – IASB-FASB Joint Project.* (2010). www.iasplus.com; Karlssson, M. *IASB'S & FASB'S joint conceptual framework project. International financial accounting*. Karlstads Universitet. (2009). www3.kau.se

Phase	Title	Status
A	Objectives and qualitative characteristics	Completed, *Conceptual Framework for Financial Reporting* 2010
B	Elements and recognition	Completed, Revised version of *Conceptual Framework for Financial Reporting* 2018
C	Measurement	Completed, Revised version of *Conceptual Framework for Financial Reporting* 2018
D	Reporting entity	ED/2010/02 *Conceptual Framework for Financial Reporting: The Reporting Entity*
E	Presentation and disclosure	Completed, Revised version of *Conceptual Framework for Financial Reporting* 2018
F	Purpose and status	Discontinued, being carried forward by the IASB stand-alone
G	Application to not-for-profit entities	Discontinued as the current focus of the IASB is on business entities in the private sector

As we may notice in the table are reported only seven steps; the eighth step "H", namely *Remaining issue*, was initially included in the project plan, but subsequently abandoned due to the fact that remaining topics have been considered in a stand-alone way by the IASB, being excluded from the joint project itself.

Important for the development of any of the project issued by the IASB and/or FASB are *Discussion Papers (DPs)* and *Exposure Drafts (EDs)*. The former are documents issued in order to gather contributions and acceptance from stakeholders on specific matters or ad-hoc projects regarding financial and accounting topics, while the latter are final drafts that are going to be finalized with the observation of the bodies once comments from stakeholders are received. Notice that such exposure drafts are mostly used by FASB. In the particular case of the 2004-2010 joint project of IASB and FASB were relevant the DP/06 and the ED/08 concerning «*the objective of general-purpose financial reporting and the qualitative characteristics of useful financial information*» (IFRS Foundation, 2018, pp. 67; Sutton, D., 2009, p. 87)[13].

As a consequence, both bodies issued the first two chapters regarding the topic of the above-mentioned Exposure Draft, becoming part full-fledged of the "Conceptual Framework for Financial Reporting (2010)". The remainder of the

[13] IFRS Foundation. *Conceptual Framework for Financial Reporting*. Pp. 67-68. (2018). www.ifrs.org; Sutton, D. *The foundations for a general theory of general purpose financial reporting for business*. Victoria University of Wellington. P. 87. (2009). pdfs.semanticscholar.org

“1989 Conceptual Framework for Financial Reporting” was included in the 2010 version without making any changes.

Afterwards, the IASB and the FASB published the ED/10 about the *concept of reporting entity* and the *elements of financial statements*, discussing as well public round-table meetings about measurement topics. However, both Boards left apart their joint project to leave spaces to other upcoming projects with higher priority. The public showed to be interested to carry forward such project about the realization of a common framework to be implemented worldwide as a way to use a unique set of standards and make comparable most of financial statements; hence, in 2012 the IASB decided to continue its initial endeavour, even if without the presence of the US standard-setter.

When both Boards were working together on the project, only the first phase came to an end. For this reason, the IASB decided to «*develop a complete set of proposals for a revised Conceptual Framework instead of continuing the phased approach*» (IFRS Foundation, 2018, pp. 68). Given that the IASB made some changes (of limited significance, though) to the parts developed jointly (i.e., the objective of general-purpose financial reporting and the qualitative characteristics of useful financial information), the FASB rejected the option to change the *Statement of Financial Accounting Concepts* accordingly.

1.2 The current Consolidation Frameworks: IAS/IFRSs versus US GAAPs

This section tries to give a clear understanding of the *Consolidation Framework* that will be useful throughout the work. Particularly, we are able to make a quite evident distinction, but not for this irrelevant, between the IFRS regulation and the US GAAP one. Considering them jointly would not be properly right: indeed, according to the set of accounting standards adopted, the models of consolidation, as well as their effects and implications produced vary substantially. For instance, an entity that is required to be consolidated under US GAAP Principles might not be included in the group’s perimeter according to IFRS Standards.

At a glance, it might seem very complex to disentangle the IFRS regulation for determining the group’s perimeter, but if we look at IFRS Standards closer, we can easily realize that the main accounting standard dealing with the consolidation issue is *IFRS 10 – Consolidated Financial Statements*, which

establishes the rules for determining the perimeter of consolidation (i.e., when an economic entity has to consolidate the accounts of one (or more) subordinated companies). Then, other IFRS Standards that are worth mentioning are *IFRS 3 – Business Combinations,* that points out more operating aspects with respect to the preparation and presentation of consolidated financial statements, *IFRS 12 – Disclosure of Interests in Other Entities,* which is «*a consolidated disclosure standard requiring a wide range of disclosures about an entity's interests in subsidiaries, joint arrangements, associates and unconsolidated structured entities*» (Deloitte, 2018)[14].

Besides the above-cited IFRSs, there are other two IFRSs relevant for consolidation purposes that give representation about how to account for investments in associates and joint ventures: these are *IAS 28 – Investment in Associates* and *IFRS 11 – Joint Arrangements* (Deloitte, 2017)[15].

As for the US regulation, the major accounting principle relevant to the discipline of consolidation, that is the *ASC 810 – Consolidation*, is essentially organized into three different parts: *810-10 Overall*, *810-20 Control of Partnerships and Similar Entities*, and *810-30 Research and Development Arrangements*. The first section «*provides guidance on general consolidation issues, as well as guidance related to variable interest entities and consolidation of entities controlled by contract*», the second one «*provides guidance related to the potential consolidation of partnerships and similar interests*» and, finally, the last one «*provides guidance on whether and how a sponsor should consolidate a Research & Development arrangement*» (Deloitte, 2018)[16].

1.3 Relevant amendments to the Consolidation Frameworks

1.3.1 The primary role played by the Seventh Directive in establishing pillars for future regulation about consolidation

Besides the IFRS Foundation, the European Union (EU) aims to enhance comparability of accounting practices and it is committed to «*[…] ensure*

[14] Deloitte. *IFRS 12 – Disclosure of Interests in Other Entities*. (2018). www.iasplus.com
[15] Deloitte. *IFRS 11 – Joint Arrangements*. (2017). www.iasplus.com
[16] Deloitte. *ASC 810 - Consolidation.* (2018). www.iasplus.com

consistent and comparable financial reporting across the EU» (European Commission, 2019)[17].

In this regard, the EU is in charge to both issue directives and regulations: the former must be incorporated in each of the Member States' legislation systems, while the latter are directly applicable with immediate effect.

Among directives, in the early 80s, no rule was established about consolidation, so that it was not straightforward to identify which set of standards or directives businesses had to apply when drafting their (consolidated) financial statements. That is why the most important one that is in line with our purpose and marked the history of consolidation evolution process over time is certainly the *Seventh Directive 83/349/EEC* issued on 13 June 1983 by the European Council and applicable from 26 June of the same year on.

Member countries had time to adopt the *Seventh Directive* until the end of the year 1987, as established by the deadline set by the European Union at that time.

Prior to that, the *Fourth Directive 78/660/EEC* issued on 25 March 1978 belonged to the accounting directives that regulated stand-alone financial statements. As noticed by some Authors: «*Both directives are to be read jointly, being strictly inter-connected owing to their internal connections, joint conception and global aim*» (Gray, S. J., Coenenberg, A., 1988, p. 106)[18].

The text of the Seventh Directive was composed by twenty-seven articles, organized in seven sections: two of them specifically addressed the perimeter of consolidation. The reason why such directive was issued in the early 80s stems from the growing necessity of companies to make business in the form of group, challenging the status quo due to the effects of globalization, thus provoking in stakeholders (especially investors) the need for having a complete depiction of the group performance and results that stand-alone financial statements were not able to provide.

According to Article 4, the Directive applied to different legal forms of enterprise according to the Member States that implemented it in their legislation systems. For instance, in Italy was introduced in 1991 (but became effective from 1994 Fiscal Year) and it applied to all public companies and companies with

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[17] European Commission. *Financial Reporting. EU rules on financial information disclosed by companies*. (2019). www.ec.europa.eu

[18] Gray, S. J., Coenenberg, A. *International group accounting: international harmonisation and the seventh EEC directive*. London, Croom-Helm. P. 106. (1988)

limited liabilities ("Società per azioni", "Società in accomandita per azioni", "Società a responsabilità limitata"), excluding partnerships ("Società semplice", "Società in accomandita semplice" and "Società in nome collettivo"). In accounting jargon, the holding company was identified as "parent", which had to consolidate all its subsidiaries on which control was held. The same is valid, in turn, when one (or more) of the latter had to consolidate their subsidiaries, ending with a sub-consolidated financial statement.

Table 1.2 provides evidence of the years related to the adoption by Member States in their national legislation systems of both the Fourth and Seventh Directives (as mentioned above, for Italy it became effective from 1991 on) (Table 1.2, *Transformation of the Fourth and Seventh Directives into national laws*)[19]:

Member State	Fourth Directive	Seventh Directive
Austria	1996	1996
Belgium	1984	1990
Denmark	1981	1990
Finland	1992	1992
France	1983	1985
Germany	1985	1985
Greece	1986	1886
Ireland	1986	1892
Italy	1991	1991
Luxembourg	1984	1988
Netherlands	1983	1989
Portugal	1989	1991
Spain	1989	1991
Sweden	1995	1995
UK	1981	1989

Furthermore, the European legislator abandoned the idea of "set of companies" to replace it with the expression "group" considered as a whole. This change was very important for recognizing the perimeter of consolidation

[19] Table 1.2: *Transformation of the Fourth and Seventh Directives into national laws*. Re-elaborated by the Author.
Source: Haller, A. Fin*ancial accounting developments in the European Union: past events and future prospects*. Johannes Kepler Universität Linz. European Accounting Review, Vol. 11, No. 1. Pp. 153-190. P. 156. (2002). www.tandfonline.com

because it led to identify control substantially, even without the legal power over the subsidiaries. In particular, Article 1 reported:

«

1. A Member State shall require any undertaking governed by its national law to draw up consolidated accounts and a consolidated annual report if that undertaking (a parent undertaking):

(a) has a majority of the shareholders' or members' voting rights in another undertaking (a subsidiary undertaking); or

(b) has the right to appoint or remove a majority of the members of the administrative, management or supervisory body of another undertaking (a subsidiary undertaking) and is at the same time a shareholder in or member of that undertaking; or

(c) has the right to exercise a dominant influence over an undertaking (a subsidiary undertaking) of which it is a shareholder or member, pursuant to a contract entered into with that undertaking or to a provision in its memorandum or articles of association, where the law governing that subsidiary undertaking permits its being subject to such contracts or provisions. A Member State needs not prescribe that a parent undertaking must be a shareholder in or member of its subsidiary undertaking. Those Member States the laws of which do not provide for such contracts or clauses shall not be required to apply this provision; or

(d) is a shareholder in or member of an undertaking, and:

(aa) a majority of the members of the administrative, management or supervisory bodies of that undertaking (a subsidiary undertaking) who have held office during the financial year, during the preceding financial year and up to the time when the consolidated accounts are drawn up, have been appointed solely as a result of the exercise of its voting rights; or

(bb) controls alone, pursuant to an agreement with other shareholders in or members of that undertaking (a subsidiary undertaking), a majority of shareholders' or members' voting rights in that undertaking. The Member States may introduce more detailed provisions concerning the form and contents of such agreements» (Council of European Union, 1983, p. 2)[20].

[20] Council of the European Union. *Seventh Council Directive 83/349/EEC of 13 June 1983*. Official Journal of the European Communities, No. L. 193. Pp. 1-17. P. 2. (1983). https://eur-lex.europa.eu

The duty to prepare consolidated financial statements regarded only traditional "vertical groups", i.e. those groups where the parent company is linked to its subsidiaries by a subordination relationship, and not "horizontal groups", where more companies control the subsidiaries, being them in a mutual equality relationship, as evidenced by Article 12 of the *Seventh Directive*. Even if the obligation was extended mandatorily also to horizontal groups in the directive proposal, subsequently was turned just as an optional choice when the directive was officially released. No mention is given to "mixed groups" and so-called "cross-holdings", the latter term used for identifying publicly traded companies owning securities in other listed corporations, as pointed out by Taylor, P. A. (Taylor, P. A., 1987, p. 203)[21].

As far as regulations are concerned, the regulation *EC/1606/2002* introduced the obligation, from 1 January 2005 on, for all public companies (i.e., listed in one or more Stock Exchanges) to prepare their consolidated financial statements according to a single set of international standards (i.e., the IFRS Standards, previously known as *IAS – International Accounting Standards*). On the contrary, non-listed companies, independently from their size, must prepare annual financial reports in respect to the more recent *Directive 2013/34/EU*, as known as the "accounting directive". Such directive abrogated the former *Seventh Directive*, thus being a relevant turning point in the history of the consolidation evolution.

1.3.2. More recent changes to the regulation over time regarding IAS/IFRS Standards

The majority of the IFRS discipline that refer to consolidation has been revised significantly in the last decade, making notable updates and amendments that partially superseded older dispositions. Indeed, before 2011, there were four main accounting standards regulating consolidation:

«

1) *IAS 27 – Consolidated and Separate Financial Statements*
2) *IAS 28 – Investments in Associates*
3) *IAS 31 – Interests in Joint Ventures*

[21] Taylor, P. A. *Consolidated financial statements: concepts, issues and techniques*. London, Harper & Row. P. 203. (1987)

4) *IFRS 3 – Business Combinations*» (ACCA, 2010; Corporate Finance Institute, 2019; Deloitte, 2018; Deloitte, 2019; IFRS Box, 2014; IFRS Foundation, 2017, pp. 11-13; IFRS Foundation, 2019)[22].

In addition to above-mentioned IFRSs, a relevant role was played by two interpretation standards, that were *SIC 12 – Consolidation – Special Purpose Entities* and *SIC 33 – Consolidation and Equity Method – Potential Voting Rights and Allocation of Ownership Interests* (Deloitte, 2011)[23].

IAS 27, originally issued in April 1989 by the IASC as "Consolidated Financial Statements and Accounting for Investments in Subsidiaries", changed its name as "Consolidated and Separate Financial Statements" in December 2003 (IFRS Foundation, 2018, p. 1)[24]. IAS 27 was adopted by IASB in April 2001 and replaced the majority of the content of its predecessor *IAS 3 – Consolidated Financial Statements*, officially released by IASC in June 1976.
In December 2003, the IASB amended the IAS 27 by integrating the dispositions already included in the above-mentioned interpretation standards (i.e., SIC 12 and SIC 33).

However, in May 2011 the IAS 27 left space to the newest *IFRS 10 – Consolidated Financial Statements*, which is the main accounting principle resulting from the consolidation project carried out by the IASB since June 2003, that basically had the scope to «*[…] address perceived inconsistencies between IAS 27 and SIC 12, and also to enhance convergence with US GAAP […]*» (PwC, 2011, p. 3)[25].

As a result of the new rules, current version of IAS 27 contains requirements only relating to separate financial statements: this change is

[22] ACCA. *Preparing simple consolidated financial statements*. (2010). www.accaglobal.com; Corporate Finance Institute. *IFRS Standards*. CFI Education. (2019). www.corporatefinanceinsitute.com; Deloitte. *IFRS standards effective in 2018 and beyond | Deloitte CFR*. (2018) www.iasplus.com; Deloitte. *Standards*. (2019). www.iasplus.com; IFRS Box. *Intro to Consolidation and Group Accounts – Which Method for Your Investment?* (2014). www.ifrsbox.com; IFRS Foundation. *Pocket guide to IFRS® Standards: the global financial reporting language*. Paul Pacter. Pp. 11-13. (2017). www.ifrs.org; IFRS Foundation. *List of IFRS Standards*. (2019). www.ifrs.org
[23] Deloitte. *SIC Interpretations*. (2001). www.iasplus.com
[24] IFRS Foundation. *IAS 27 – Separate Financial Statements*. P. 1. (2011). www.ifrs.org
[25] PwC. *Practical guide to IFRS. Consolidated financial statements: redefining control*. P.3. (2011). www.pwc.com.au

reflected also in its updated title, i.e. *IAS 27 – Separate Financial Statements* (Deloitte, 2011; PKF, 2017)[26].

Only after five years later, the consolidation project was published as Exposure Draft in December 2008, in response to the need to speed up the process and get the final accounting standard as soon as possible. As Gallimberti, C. et al. confirm (Gallimberti et al., 2013, p. 34)[27], one year after that, the IASB and the FASB reached an agreement to carry on their respective consolidation projects jointly, despite the differences in the timeline.

In January 2011, while the FASB decided to maintain unchanged the consolidation requirements relating to Voting Interest Entities, the IASB a few months later was publishing the final consolidation standard (by issuing IFRS 10) and disclosure requirements (by issuing IFRS 12).

A series of amendments followed (Deloitte, 2018; Grant Thornton, 2017, p. 10; IFRS Foundation, 2018, p. 1)[28]:

- In June 2012, IFRS 10 was amended by "Consolidated Financial Statements, Joint Arrangements and Disclosure of Interests in Other Entities: Transition Guidance". Such update also involved IFRS 11 and 12;
- In October 2012, IFRS 10 was amended by "Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27)". This amendment introduced the definition of investment entity, highlighting an exception as well to consolidating particular subsidiaries for investment entities. It was also up to date by proposing new disclosure requirements for investment entities thereafter incorporated in IFRS 12;
- In September 2014, it was integrated with some dispositions of "Sale or Contribution of Assets between an Investor and its Associate or Joint Venture (Amendments to IFRS 10 and IAS 28)";
- In December 2014, it was amended by "Investment Entities: Applying the Consolidation Exception (Amendments to IFRS 10, IFRS 12 and IAS 28)". These improvements brought to light which subsidiaries of an investment

[26] Deloitte. *IAS 27 – Separate Financial Statements*. (2011). www.iasplus.com; PKF. *IAS 27 Separate Financial Statements*. Accounting Summary 2017-07. (2017). www.pkf.com

[27] Gallimberti et al. *Consolidation. Preparing and understanding consolidated financial statements under IFRS.* Mc Graw Hill Education. P. 34. (2013)

[28] Deloitte. *IFRS 10 – Consolidated Financial Statements*. (2018). www.iasplus.com; Grant Thornton. *Under control? A practical guide to applying IFRS 10 Consolidated Financial Statements*. (2017). www.grantthornton.global; IFRS Foundation. *IFRS 10 – Consolidated Financial Statements*. P. 1. (2018). www.ifrs.org.

entity should be consolidated instead of being measured at fair value through profit or loss;

- In December 2015, it was finally updated by "Effective Date of Amendments to IFRS 10 and IAS 28".

With respect to IAS 28 (IFRS Foundation, 2018, p. 1)[29], in April 2011 the IASB decided to adopt I*AS 28 – Accounting for Investments in Associates*, previously issued by the IASC in 1989. Such Standard superseded dispositions about accounting for investment in associates that were embedded in the older *IAS 3 – Consolidated Financial Statements*.
Here, follows some pivotal revisions and amendments that interested the development of IAS 28 (Deloitte, 2003; Deloitte, 2011; Deloitte, 2013)[30]:

- In December 2003, IAS 28 changed its name into *IAS 28 – Investments in Associates*. The revised version of IAS 28 included the guidance incorporated in three related interpretations ("SIC-3 Elimination of Unrealised Profits and Losses on Transactions with Associates", "SIC-20 Equity Accounting Method — Recognition of Losses" and "SIC-33 Consolidation and Equity Method — Potential Voting Rights and Allocation of Ownership Interests");
- In May 2011, the Board updated the Standard and changed its name again in "Investments in Associates and Joint Ventures";
- In December 2014, IAS 28 was modified for further improvements by "Investment Entities: Applying the Consolidation Exception (Amendments to IFRS 10, IFRS 12 and IAS 28)". These improvements led to significant changes, such as a non-investment entity investor that can, when applying the equity method, choose to retain the fair value through profit or loss measurement applied by its investment-entity associates and joint ventures to their subsidiaries;

[29] IFRS Foundation. *IAS 28 – Accounting for Investments in Associates*. P. 1. (2018). www.ifrs.org.
[30] Deloitte. *IAS 28 – Investments in Associates.* (2003). www.iasplus.com; Deloitte. *IAS 28 – Investments in Associates and Joint Ventures.* (2011). www.iasplus.com; Deloitte. *IFRS 10 and IAS 28 – Sale or contribution of assets between and investor and its associate or joint venture*. (2013). www.iasplus.com

To conclude the evolution process of such Standard, we can acknowledge that minor changes were made through the "Annual Improvements to IFRS Standards 2014 – 2016 Cycle" (as for IFRS 10), as well as by *IFRS 9 – Financial Instruments* (Deloitte, 2017)[31] and by amendments to IAS 27 (i.e., "Equity Method in Separate Financial Statements").

Next up, last standards we introduced at the beginning of the *paragraph 1.3.2* are *IAS 31 – Interests in Joint Ventures* and *IFRS 3 – Business Combinations*, which both play a marginal role in determining the consolidation area since are more focused on other topics they cover.

As for IAS 31 (Deloitte, 2018)[32], it was released in December 1990, with effective date departing from 1 January 1992. Revised several times across the years, in May 2011 was no longer effective since it was replaced by *IFRS 11 – Joint Arrangements* and *IFRS 12 – Disclosure of Interests in Other Entities*, becoming effective from 1 January 2013.

As far as IFRS 3 is concerned (ACCA, 2008; Deloitte, 2018)[33], the project to issue such Standard was added to the IASB agenda only in July 2001 with the aim to supersede IAS 22 once issued. In March 2004, IFRS 3 and amendments to *IAS 36 – Impairment of Assets* and *IAS 38 – Intangible Assets* were issued. Subsequently, four years later, *IFRS 3 – Business Combinations (2008)* was also issued, followed by annual updates and improvements that led to the October 2018 revised version, becoming effective for business combinations and asset acquisitions for which the acquisition date coincides (or is after) the beginning of the first annual reporting period starting on 1 January 2020.

1.3.3 Changes to the regulation over time regarding US GAAP Principles

Debates on consolidation topic and financial reporting developments have been many also overseas, where US private companies have faced for a long time the threat of giant competitors used to build an extensive network of separate entities in order to manage diverse business interests. That is why, now more than ever, it is fundamental to properly set the boundaries of the reporting entity by following dispositions contained in FASB's consolidation guidance. As

[31] Deloitte. *IFRS 9 – Financial Instruments*. (2017). www.iasplus.com
[32] Deloitte. *IAS 31 – Interests in Joint Ventures.* (2018). www.iasplus.com
[33] ACCA. *Business Combinations – IFRS 3 (Revised)*. (2008). www.accaglobal.com; Deloitte. *IFRS 3 – Business Combinations.* (2018). www.iasplus.com

anticipated in *paragraph 1.2*, the main accounting Standard belonging to US regulation is *ASC 810 – Consolidation*. It is not far behind IFRS Standards for many aspects and like IFRSs has been amended and modified several times.

As a matter of fact, the dawning of ASC 810 dates back to 1959 when "Accounting Research Bulletin (ARB) 51 – Consolidated Financial Statements" was issued (The CPA Journal, 2018)[34]. ARB 51 stated that a company had to consolidate any affiliate towards which it had a direct or indirect controlling financial interest, meaning a 50% or more of the voting equity of an affiliate (or related group of entities).

Under ARB 51, the "Voting Interest Model (VOE)" was created, according to which the consolidating entity exercised a significant influence on the investee included in the consolidation area, thus becoming part of the consolidated financial statements. Voting powers of the investor allowed the reporting entity to veto against those measures of the consolidated entities which were going to act contrary to its interests. Afterwards, the VOE was renamed as *Voting Interest Entity* model.

In 2003, FASB issued "FIN 46(R) – Consolidation of Variable Interest Entities (VIEs)", subsequently revised in December. Whether to apply the VIE, or the Voting Interest Entity model, the investee had to be evaluated under different aspects, such as «*funding structure arranged for the legal entity and the related rights, risks and rewards of the equity investors relative to one another and relative to other subordinated financing received by the legal entity*» (The CPA Journal, 2018)[35].

Additionally, the CPA Journal stated the following:

«*In general, under FIN 46(R), an equity investor consolidates the VIE when that investor retains a majority interest in the VIE's expected losses or a majority interest in the VIE's residual returns. If the equity investor retaining a majority interest in VIE's residual returns differs from who retain a majority interest in its expected losses, FIN 46(R) requires the latter to consolidate the VIE*» (The CPA Journal, 2018).

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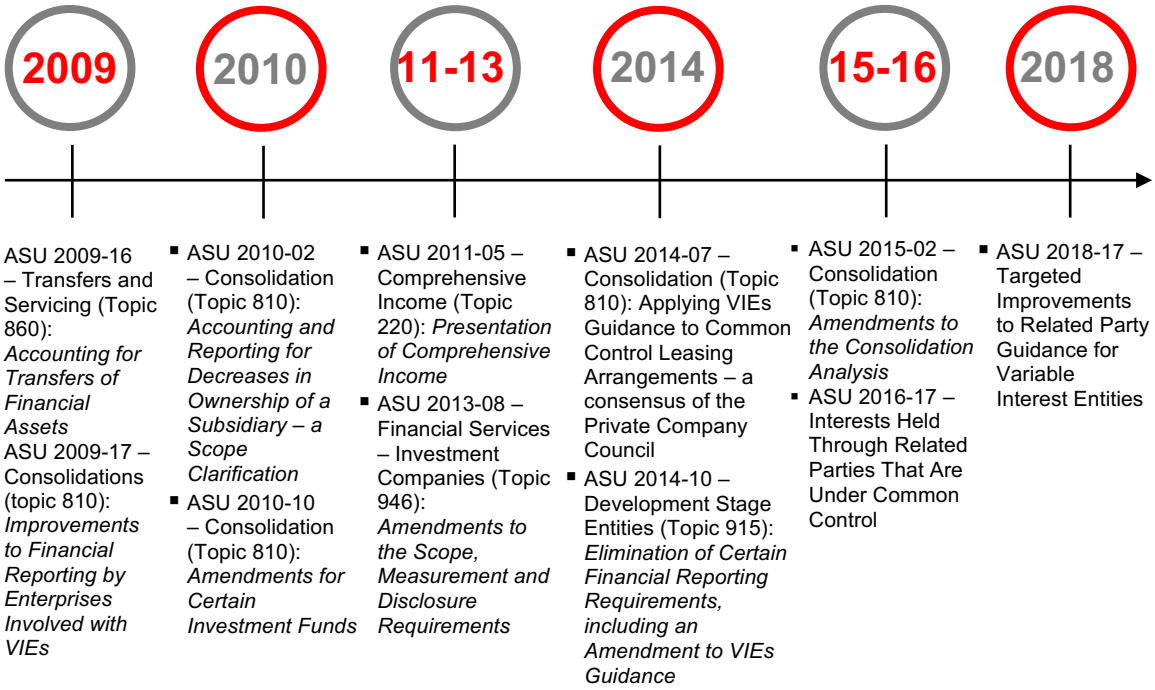
[34] The CPA Journal. *Common Control Entities and Consolidation of Variable Interest Entities*. Jones, R. C. (2018). www.cpajournal.com

[35] The CPA Journal. *Common Control Entities and Consolidation of Variable Interest Entities*. Jones, R. C. (2018). www.cpajournal.com

In 2009, FASB officially released "Statement of Financial Accounting Standards (SFAS) 167" and "Amendments to FIN 46(R)". SFAS 167 looked at things from a different perspective by abolishing the "risk-reward"-based consolidation model, «*[…] where the party that participated in the majority of the entity's economic impact consolidates such operations […]*» (The CPA Journal, 2006)[36] and adopting instead consolidation requirements more focused on the qualitative aspects for assessing the reporting entity's control over the significant activities of the VIEs. A milestone in the history of consolidation rules in the US environment was the codification of SFAS 167 into *US GAAP ASC 810 – Consolidation*. Moreover, the following timeline aims to address key amendments and improvements that interested ASC 810 in the last decade, following a deep "reorganization" of the consolidation topic (Figure 1.1, *FASB Accounting Standards Updates (ASUs) regarding Consolidation - Topic 810*)[37]:



[36] The CPA Journal. *Consolidation of Variable-Interest Entities. Applying the Provisions of FIN 46 (R)*. Reinsten, A. et al. New York State Society of CPAs. (2006). archives.cpajournal.com

[37] Figure 1.1: *FASB Accounting Standards Updates (ASUs) regarding Consolidation - Topic 810*. Created by the Author.
Source: Deloitte. *ASC 810 – Consolidation*. www.iasplus.com; Deloitte. *FASB Proposes Targeted Amendments to the Related-Party Guidance for Variable Interest Entities*. Heads Up, Vol. 24, No. 19. Pp. 1-15. (2017). www.iasplus.com; Financial Accounting Foundation. *Accounting Standards Updates Issued*. (2019). www.asc.fasb.org; Financial Accounting Standards Board. *Consolidation (Topic 810) – ASU No. 2014-07 – Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements.* (2015). www.asc.fasb.org; Financial Accounting Foundation. *Accounting Standards Update No. 2018-17. Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities*. (2019). www.fasb.org; Grant Thornton. *Proposed Accounting Standards Update – Consolidation (Topic 812) – Reorganization*. Financial Accounting Standards Board. (2017). gtw3.grantthorton.in; www.ey.com

1.3.4 Post-implementation Reviews (PIRs): Are we there yet?

First and foremost, in order to comprehend the following considerations, it should be noted that, after standards (and even major amendments) are issued, a subsequent phase (usually, individual for each principle) is carried out by the Board (being either the IASB or the FASB, respectively for IFRSs and US GAAPs). This stage is called "Post-Implementation Review (PIR)" and it is useful for Boards to obtain thorough information about standards' outcome and to test whether they are effectively working as intended once they are officially issued (usually after two years, the PIR process is commenced). Also, they serve as reference to make due updates necessary to maintain standards performing in time, to verify if pre-fixed objectives have been met in practice (since the number of companies actively participating during the standard-setting process is insignificant with the countless subjects applying IFRSs after their issuance worldwide), to ensure that organizations did not encounter any relevant issue when complying with them and to make sure that guidance conveyed was enough understandable and exhaustive. Sometimes, Post-Implementation Reviews are carried forward «*in response to changes in the financial reporting environment and regulatory requirements, or in response to concerns about the quality [of standards]*» (IFRS Foundation, p. 34, 2016; The CPA Journal, 2017)[38].

Each PIR consists of two stages (IFRS Foundation, 2017)[39]: the first one is based on a preventive determination and evaluation of the topics to be considered in order to submit the latter to the public for getting a consultative feedback through a formal document, commonly called as "Request of Information (RFI)", while the second phase involves chiefly taking into account the information collected and the analysis of the answers gathered. The two phases are more or less the same both for IASB and FASB, although the PIR's process of the latter is conducted much more in a confidential way, as confirmed by Moldovan, R. (Moldovan R., p. 116, 2014)[40]. Hence, the Boards present their findings (with a "Feedback Statement") thereby planning future actions to take (if

[38] IFRS Foundation. *Due Process Handbook*. P. 34. (2016). www.ifrs.org; The CPA Journal. *Reflections on Changes in the Financial Reporting Environment*. Larry Smith. (2017). www.cpajournal.com

[39] IFRS Foundation. *A holistic look at IFRS Standards: the role of Post-implementation Reviews*. (2017). www.ifrs.org

[40] Moldovan, R. *Post-Implementation Reviews for IASB and FASB Standards: A Comparison of the Process and Findings for the Operating Segments Standards*. Accounting in Europe, Vol. 11, No. 1. Pp. 113-137. P. 116. (2014). www.tandfonline.com

any, since minor changes might not pass a cost-benefit analysis), such as «*perform additional research, proceed to standard-setting or develop educational material*» (IFRS Foundation, 2017)[41].

The reader would know, at this point, which are the developments tied to the PIRs of IFRS 10 and US GAAP ASC 810, i.e. the two major consolidation standards of IASB and FASB, respectively. As far as PIRs conducted by the IASB are concerned, at the present time of writing, IASB completed just three PIRs: that ones on *IFRS 3 – Business Combinations*, *IFRS 8 – Operating Segments* and *IFRS 13 – Fair Value Measurement* out of 17 IFRS principles (PIRs on IAS principles have never been considered by the IASB, since IFRSs are more modern and, somehow, they replace older standards). The PIR on *IFRS 10 – Consolidated Financial Statements* was expected to start in 2019, but in April the IASB announced that it will be postponed. Indeed, PIR on IFRS 10 (together with that ones on *IFRS 11 – Joint Arrangements* and *IFRS 12 – Disclosure of Interests in Other Entities*) are forthcoming, although currently no PIR is carried out. The just cited PIRs are intended to be developed as a common project, since they all relate to consolidation, commencing in late 2019.
With respect to Post-Implementation Reviews in the US regulatory environment, the *Financial Accounting Foundation (FAF)* is responsible for issuing PIRs for the FASB and the *Governmental Accounting Standards Board (GASB)*. Currently, like IASB, no PIR is carried forward, and neither for *US GAAP ASC 810 – Consolidation* the FAF issued a Post-Implementation Review. So far, there is just a PIR issued by the FAF that relates to consolidation topic, that is *FASB Statement 160 – Non-controlling Interests in Consolidated Financial Statements (an amendment of ARB No. 51)*.

Eventually, as pointed out by Ewert, R., Wagenhofer, A, academics, researchers and practitioners should actively take part in the PIR process with the aim to augment the level of reliability of reviews produced. Indeed, standard-setters should be aware of potentialities that only a scientific methodology can contribute, although considering their inertia that makes them often «*[…] [staying]*

[41] IFRS Foundation. *A holistic look at IFRS Standards: the role of Post-Implementation Reviews*. (2017). www.ifrs.org

away from normative conclusions» (Ewert, R., Wagenhofer, A., p. 282-283, 2012)[42].

1.3.5 Convergence of global accounting regulation regarding Consolidated Financial Statements

The first attempts to reach convergence of global accounting regulation concerning consolidation were initiated by the two major accounting standard-setters, i.e. IASB and FASB, dating back to September 2002. Indeed, the convergence process between IFRSs and US GAAPs was officially started with the signature of the "Norwalk Agreement" by the two bodies (so-called since it was formalized in Norwalk, Connecticut, US), as confirms Cîrstea, A., Baltariu, A. C. (Cîrstea, A., Baltariu, A. C., 2004, p. 1)[43]. Such agreement can be defined as a "Memorandum of Understanding (MoU)" through which the two international Boards committed themselves to strive towards high-quality financial reporting standards worldwide, as affirmed at that time by the FASB Chairman R. H. Herz. [current FASB Chairman is R. G. Golden, appointed in July 2013 and in charge until June 2020, ed.]. Main goals of the above-mentioned agreement are: the elimination of all the differences and relevant gaps between IFRSs and US GAAP Standards and the alignment of the Board's future initiatives with the aim to develop as much as possible joint projects, both at the domestic and cross-border levels, by capturing the needs of investors who are used to allocate financial resources in different capital markets on a global scale.

In this respect, for the sake of clarity, we need to distinguish between "harmonization" and "standardization": the former indicates the process through which redundant or conflicting accounting practices standards are simplified by eliminating differences; in doing so, compliance costs are minimized, and it will be easier meeting accounting requirements. Instead, standardization means to apply the same accounting rules by two (or more) countries.

In February 2006, the Boards issued a new MoU entitled "The Roadmap for Convergence", setting both short-term and long-term priorities and projects to

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[42] Ewert, R., Wagenhofer, A. *Using Academic Research for the Post-Implementation Review of Accounting Standards: A Note*. Abacus, Vol. 48, No. 2. Pp. 278-291. P. 289. (2012). www.onlinelibrary.wiley.com

[43] Cîrstea, A., Baltariu, A. C. *Convergence of consolidated financial statements regulations: are we there yet?* Procedia Economics and Finance 15 (2014). Elsevier B. V. Pp. 1297-1303. P. 1. (2014). www.sciencedirect.com

be added to the agenda of both IASB and FASB (Financial Stability Board, 2012, p. 1)[44].

Among short-term goals, we can find major topics that were addressed by the two Boards separately (Deloitte, 2006, p. 2)[45]: while the FASB was in charge to examine "Fair Value option" (on agenda from 1 July 2005), "Investment properties", "Research and Development" and "Subsequent events", the IASB was charged to analyze and work on "Borrowing costs", "Government grants", "Joint Ventures" and "Segment Reporting". Anyway, there were also short-term objectives developed jointly, such as "Impairment" and "Income Tax". Some of the long-term goals that the two bodies set together breathed life to two joint projects that they decided to carry forward, "Business Combinations" and "Consolidation", ending in the issuance of IFRS 3 (in 2008) as for the first project and in a set of principles as for the "Consolidation" one (IAS 27, IFRS 10, IFRS 11 and IFRS 12 in 2011).

However, convergence is constructive as long as does not cause chaos in the application of the global accounting standards once it has been completed, but it can turn to be a very demanding process, as pointed out by Schipper, K., who stated that:

«*[…] one key convergence issue to be resolved between the FASB and the IASB involves both the amount of implementation guidance to be provided when US GAAP and IFRS have been converged at the standards level and the mechanisms for providing that guidance*» (Schipper, K., 2005, p. 105)[46].

Results below coming from the study of *Cîrstea, A., Baltariu, A. C. (2004)* suggested that the level of convergence of accounting standard in the private sector regarding Consolidated Financial Statements is not that high, since some

[44] Financial Stability Board. *Joint Update Note from the IASB and FASB on Accounting Convergence. Note from IASB on Governance Enhancements*. P. 1. (2012). www.fsb.org

[45] Deloitte. *A Roadmap for Convergence between IFRSs and US GAAP – 2006-2008 Memorandum of Understanding between the FASB and the IASB*. P. 2. (2006). www.ifrs.org

[46] Schipper, K. *The introduction of International Accounting Standards in Europe: Implications for international convergence*. European Accounting Review, Vol. 14, No. 1. Pp. 101-126. (2005). papers.ssrn.com

differences persist between the two set of principles (Lam, H., 2015, pp. 37-39)[47] (Table 1.3, *List of sub-elements* included in the comparative analysis)[48]:

Analysis Element	US GAAP	IFRS
The existence of the concept of direct control	X	X
The existence of the concept of indirect control	X	X
The existence of control with less than 50% ownership	X	X
The requirement of contractual support for the existence of control with less than 50% ownership	X	X
The requirement of legal support for the existence of control with less than 50% ownership		X
The existence of the concept of *de-facto* control		X
The existence of specific guidance to *de-facto* control concept		X
Consideration of economic dependency in assessing control over an investee		X
Consideration of the size of shareholding in comparison to other holdings in assessing control over an investee		X
Consideration of the voting patterns at shareholding meetings in assessing control over an investee		X
Consideration of the potential voting rights in assessing control over an investee		X
The existence of the concept of shared power	X	

That is why there is still margin of improvement hopefully. In point of fact, they considered a set of elements, taking as reference IFRS Standards, to be analyzed comparatively with US GAAP Principles, being these factors the following: “requirements to prepare consolidated financial statements”; “control”; “consolidation methodology”; “accounting policies”; “reporting dates”; “disclosure”.

[47] Lam, H. *Why does the U.S. Continue to Use GAAP and Will it Ever Converge to IFRS?* Claremont McKenna College. Paper 1066. Pp. 37-39. (2015) scholarship.claremont.edu

[48] Table 1.3: *List of sub-elements* included in the comparative analysis. Re-elaborated by the Author.
Source: Cîrstea, A., Baltariu, A. C. *Convergence of consolidated financial statements regulations: are we there yet?* Procedia Economics and Finance 15 (2014). Elsevier B. V. Pp. 1297-1303. Pp. 1299-1300. (2014). www.sciencedirect.com

CHAPTER 2. CONSOLIDATED FINANCIAL STATEMENTS: FIRST STEPS TOWARDS THE IDENTIFICATION OF THE GROUP'S PERIMETER

2.1 Consolidated Financial Statements

Consolidated financial statements represent the primary tool through which investors get to know about the overall group performance. They comprehend the group accounts derived from all the entities within the consolidation perimeter and are presented as if they were a single economic entity. The holding company generally has the unified management of the entire group and it is in charge for the preparation of the aggregate accounts. The purpose of such tool is to allow stakeholders to gather economic-financial information of the group as a whole that is more valuable and meaningful rather than extracting partial and fragmentary data from the individual financial statements of the entities belonging to the group.

The latter is commonly composed by a parent company and all its subsidiaries, i.e. the entities being controlled by the holding. It might be possible, as we will see later on, that barely a portion of entities will enter in the consolidation area, meaning that only some assets and/or liabilities will be consolidated.

In general, companies have to disclose economic-financial information of the group in their annual reports, in which consolidated financial statements are only a part of the broader yearly disclosure made to stakeholders (in general, shareholders are more interested in such restricted information, since it is where is possible to know, among others, the bottom line of the Profit & Loss (P&L)).

Then, if the group is listed in one (or more) of the stock exchanges worldwide (e.g., NYSE, NASDAQ, FTSE MIB, LSE, merely by way of example), it will be

required, and this happens in most jurisdictions, to present consolidated accounts at more frequent intervals (so-called "interim consolidated financial statements", which cover a period shorter than one year), depending on the rules governing the stock exchange on which the group of companies is listed on.

2.1.1 Structure and definitions in the international normative context

Consolidated financial statements, as described above, are the main toolkit that gives stakeholders economic-financial (and also non-financial) figures that depict the overall group performance.

As a rule of thumb, consolidated statements are complex documents that are composed by (PwC, 2018, pp. 6-28)[49]: the group "Balance Sheet (BS)" or also known as "Statement of Financial Position (SFP)", the group "Income Statement (IS)" or also known as "Profit & Loss (P&L)" and "Statement of Comprehensive Income", the group "Statement of Changes in Equity" or also known as "Equity Statement and Statement of Retained Earnings", the group "Cash Flow Statement (CFS)", the "Footnotes" or also known as "Notes to the Accounts" (including the so-called "accounting policy", i.e. principles, bases, conventions, rules and common practices), and finally the "Management Discussion and Analysis (MD&A)" document. The BS includes the group assets, liabilities, shareholders' equity at a given point in time, whilst the P&L reports the group revenues, expenses and profits during a certain time frame and the CFS gives information regarding the group's activities that generated or absorbed, respectively, cash inflows and outflows (such activities are generally divided as "operating", "investing" and "financing activities"). Ultimately, the MD&A document contains commentaries on the company's management over the past year, compliance issues with law, but also future goals and related actions that the company has planned to take; sometimes, it includes also expectations about future projects development and, if the company is facing a crisis, how it planes raising to lead again the sector in which operates (Investopedia, 2019)[50]. As

[49] PwC. *Value IFRS Plc. Illustrative IFRS Consolidated Financial Statements*. Pp. 6-28. (2018). www.pwc.com
[50] Investopedia. *Management Discussion & Analysis - MD&A*. Corporate Finance & Accounting. (2019). www. investopedia.com

confirms Leoci, P., the just cited elements «*[…] are all aspects that are easily hidden or difficult to find […] [elsewhere]*» (Leoci, P., 2016, p. 76)[51].
Moreover, the degree of complexity of consolidated financial statements varies according to the group structure and might be different under some aspects from country to country, even if those statements described above are the most widespread in practice on the global scale.

Considering the global accounting regulatory environment, *IFRS 10 – Consolidated Financial Statements* in its Appendix A (Defined terms) defines consolidated financial statements as: «*The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity*» (IFRS Foundation, 2018, p. 8)[52]. As one would easily notice, the part of the sentence "as those of a single economic entity" wants to emphasize that group accounts have to be presented by the parent company operating as an economic unit which is representative of many related undertakings without losing sight on the legal separateness and independence that characterize all the subsidiaries that are circumscribed to the group boundaries.
US GAAP *ASC 810 – Consolidation* defines consolidated financial statements in a similar manner compared to the definition provided by IFRS rules by highlighting the relevance of the group beyond the separate existence of individual entities. ASC 810-10-1 recites:

«*The purpose of consolidated financial statements is to present, primarily for the benefit of the owners and creditors of the parent, the results of operations and the financial position of a parent and all its subsidiaries as if the consolidated group were a single economic entity […]*» (Financial Accounting Foundation, 2019, p. 35)[53].

Both set of principles agree on the fact that the consolidation area is determined by defining control (which will be deepened in *paragraph 2.3*) and consolidated financial statements must be prepared on a going concern basis, meaning that the holding will consolidate group accounts until liquidation of the entities is

[51] Leoci, P. *Some aspects of the auditing of the consolidated and separate financial statements in the EU, Italy and other countries: a critical analysis*. Rirea. P. 76. (2016)
[52] IFRS Foundation. *IFRS 10 – Consolidated Financial Statements*. P. 8. (2018). www.ifrs.org
[53] Financial Accounting Foundation. *ASC 810 - Consolidation.* P. 35. (2019). www.asc.fasb.org

imminent (e.g., due to bankruptcy) (KPMG, 2017, p. 14)[54]. In the latter case, no principles regarding "measurement", "recognition" and "disclosure" apply.

Another common trait that is present in both US GAAPs and IFRS Standards is that, although minimum disclosure requirements are imposed, there is not a pre-defined format to follow during consolidation. Nonetheless, for SEC registrants (i.e., those companies listed in a US Stock Exchange that are subjected to specific rules under the market authority, the US *Security and Exchange Commission*) some specific format may be required, such as the 10K form (which includes, besides financial figures, the company history, the organizational structure, the executive compensation, etc.). The *Regulation S-X* (i.e., a set of rules covering annual reports of SEC registrants) has summarized in ten inflexible rules (Rules 4-02 to 4-13) what companies must comply with for consolidation purposes, such as the separate indication in the consolidated BS of capital and surplus allocable to minority interests, a specific criterion for consolidating insurance companies (i.e., subsidiaries that are insurance companies must be consolidated only if their role is that one of insuring the risks of the affiliated group when the parent is not an insurance company), etc.

As Childs, W. H. suggests in the construction and presentation of consolidated financial statements, it is important for the Security and Exchange Commission «*to obtain accurate information from companies which have publicly held securities and to make such data available to stockholders […]*» on an ongoing basis (Childs, W. H., 1949, p. 254)[55].

Whilst IFRS prescribes comparative information for the preceding period (to which may be added prior periods, according to company's needs), US GAAP rules do not say anything in this respect, leaving a legislative vacuum. Only for SEC registrants, the SFP is required for the current and prior reporting periods.

2.1.2 Accounting requirements and consolidation procedure

The "consolidation procedure" (also known as "consolidation process" or "consolidation accounting") is the technique of combining all the accounting items that appear in the stand-alone financial statements of the investees by

[54] KPMG. *IFRS compared to US GAAP: An overview*. KPMG's Global IFRS Institute. P. 14. (2017). https://assets.kpmg.com

[55] Childs, W. H. *Consolidated Financial Statements Principles and Procedures*. Cornell University Press. P. 254. (1949)

assembling them with those that are included in the holding's financial statements (Ministry of Corporate Affairs, 2010, p. 339)[56]. Indeed, the final aim is to show the overall situation of the group as if the parent had acquired the assets and recorded liabilities of the subsidiaries, thus eliminating the investment in shares included in the shareholder's equity of the parent company that it has until accounts will not be consolidated (generally, if the investment has been financed with strategic purposes, it will be included in the long-term investments, among financial assets). This is possible because shares held in a company represent a part (or all) the assets and liabilities of the investee, although they are not always proportionated with respect to the equity's segment that the investor has in its portfolio (for instance, a 20-percent ownership interest might not translate exactly into a 20-percent ownership of investee's assets and liabilities, as it is instead for dividend payments).

In order to include all subsidiaries that must be consolidated, it is important to assess upstream whether new entities have recently joined the group, but also the opposite scenario is possible, as confirmed by Büdy-Rózsa, I. «*[…] it may happen [that] an entity qualified to be a subsidiary earlier is no longer qualified as a subsidiary by the business organization […]*» (Büdy-Rózsa, I., 2012, p. 19)[57]. And this might have serious repercussions on the consolidation process to be carried forward, since it can require a great deal of effort and at the same time becoming a highly time-consuming activity.

Before assembling the different items composing the individual financial statements of the parent company and its subsidiaries, we need to take care of those accounting requirements that must be accomplished in order to make as much uniform as possible such financial statements. Uniformity involves the accounting period, the accounting policies, the reporting currency (through a translation process in order to align foreign currencies) and, lastly, the layout that is used to present consolidated financial statements. Shortly hereafter we will focus just on the first two accounting requirements, since they are the most relevant under their regulatory aspect. According to *IFRS 10 – Consolidated Financial Statements*, paragraph B92 affirms, with respect to the accounting period, that «*The financial statements of the parent and its subsidiaries used in*

[56] Ministry of Corporate Affairs. *AS 21 – Consolidated Financial Statements*. P. 339. (2010)
[57] Büdy-Rózsa, I. *New trends in consolidation - challenging the changes of new IFRS rules*. Periodica Polytechnica Social and Management Sciences, Vol. 20, No. 1. Pp. 11-22. P. 19. (2012). www.pp.bme.hu

the preparation of the consolidated financial statements shall have the same reporting date» (IFRS Foundation, 2018, p. 34)[58]. When reporting dates are different (and the difference cannot be longer than 3 months, in any case), then the subsidiary is required to prepare additional financial information to integrate the consolidated information as of at the date of the parent company. When this is not possible, the holding has alternatively to proceed to consolidate the most recent subsidiary's financial statements as they are presented, but «*adjusted for the effects of significant transactions or events that might have occurred between those financial statements and the consolidated financial statements*» (IFRS Foundation, 2018, p. 34). As Ellmer, R. E. points out, discordant reporting dates «*[…] may result in the effect of […] [unfaithful] trends in stocks, debtors, and bank balances being obscured under conditions where the accounts of the holding company [do not reflect those ones of its subsidiaries] […]*» (Ellmer, R. E., 1974, p. 108)[59]. As for the US regulation, like IFRS one, the difference between reporting dates cannot be longer than 3 months (ASC 810-10-45-12 "Different Fiscal Year- Ends between Parent and Subsidiary") and just cited adjustments are made only in case of necessity; thus, both IASB and FASB agree under the accounting period aspect. Moreover, paragraph B87 states that further adjustments have to be done regarding accounting policies (i.e., when they are different from those adopted for the drafting of the consolidated financial statements for similar transactions and/or events in similar circumstances), whereas *ASC 810 – Consolidation* does not require any uniform accounting policy. After having made the financial statements of the parent and its subsidiaries uniform, we would have to «*combine [all] assets, liabilities, equity, revenues, expenses and cash flows of the parent with those of the subsidiaries*» (Gallimberti, C. et al., 2013, p. 115)[60] (this is what we commonly refer as "account aggregation"). Then, the following step, as prescribed by *IFRS 10 – Consolidated Financial Statements*, is to:

«*offset (eliminate) the carrying amount of the parent's investment in each subsidiary against the parent's portion of equity of each subsidiary (IFRS 3 explains how to account for any related goodwill), [recognizing also any potential*

[58] IFRS Foundation. *IFRS 10 – Consolidated Financial Statements*. P. 33-34. (2018). www.ifrs.org
[59] Ellmer, R. E. *The mechanism of consolidated accounts*. London, Heinemann. P. 108. (1974)
[60] Gallimberti, C. et al. *Consolidation. Preparing and understanding consolidated financial statements under IFRS.* Mc Graw Hill Education. P. 115. (2013)

surplus in subsidiaries' assets and liabilities that might be generated by such offsetting]» (IFRS Foundation, 2018, p. 33).

After all, we should proceed to recognize and measure the share of equity that represent the so-called *Non-Controlling Interests (NCIs)* in non-wholly owned subsidiaries (i.e., when shares of an entity are held by multiple parties, see *paragraph 2.3.1* for further explanations). Subsequent phase consists in eliminating fully intra-group assets, liabilities, equity, income, expenses and cash flows related to intercompany transactions, such that intercompany effects are cancelled in order to make the parent operating as if it was a single economic entity and avoiding potential double counting (IFRS Box, 2014)[61]. Last but not least, calculation of group's result (profit/loss) is requested by allocating to Non-Controlling Interests the part of economic result that they are entitled to receive, so that the preparation of consolidated financial statements is finally ready to be advanced.

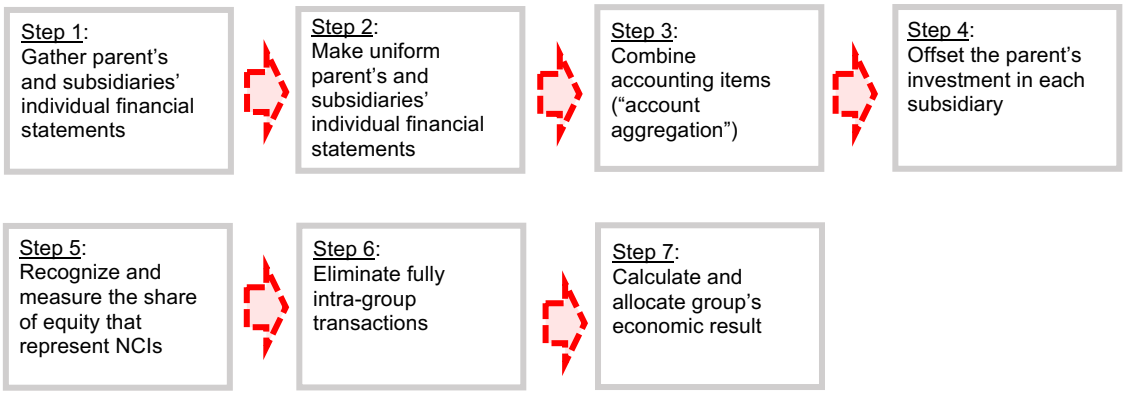
One would spend a few words about when consolidation is impracticable (the reader should not be confused with "troublesome" or "inconvenient"): the parent company's directors must apply a "reasonable business discretion" (Robson, T. B., 1956, p. 19)[62] when deciding whether the consolidation process cannot be carried forward, or even be started, for a variety of reasons: foreign currency translation is impossible, accounting policies cannot be made uniform due to unobtainable information, for reasons of force majeure (for instance, let us think to a state of war or civil strife) and the like.

Concluding, to recap all the stages that form the seven-step consolidation process, we report an explanatory figure illustrating main phases (Figure 2.1, *The seven-step consolidation process*)[63]:

[61] IFRS Box. *Example: How to Consolidate*. (2014). www.ifrsbox.com

[62] Robson, T. B. *Consolidated and other Group Accounts: Principles and Procedure*. Third Edition. London, Gee and Company Publishers Limited. P. 19. (1956)

[63] Figure 2.1: *The seven-step consolidation process*. Figure created by the Author.
Source: Gallimberti, C. et al. *Consolidation. Preparing and understanding consolidated financial statements under IFRS.* Mc Graw Hill Education. P. 117. (2013)



2.1.3 Is it convenient presenting Consolidated Financial Statements? Evidence of incentives for unconsolidated financial reporting

Consolidated financial statements are generally presented, as stated earlier, in order to give a comprehensive economic and financial depiction of the company and its subsidiaries to group's stakeholders, since they are deemed to be more meaningful than single financial statements. However, some entities might not be included in the consolidation area, even if owned by the parent company (meaning that the investor exerts a significant influence over the investee, but it does not have a Controlling Interest), thus representing their assets, liabilities, revenues, costs and cash flows solely in their individual financial statements. The most intuitive indicator detecting a "significant influence" is an ownership interest held in the investee's equity ranging from 20 to 50 percent (Deloitte, 2018, p. 31)[64].

Investments are recorded either *at cost* or according to the "equity method of accounting" (PKF, 2017, p. 2)[65]. As a matter of fact, the common trait between these two accounting techniques is that these legally separated entities appear in the parent company's financial statements among assets, recording the initial investment at cost in the SFP. However, according to the equity method, the investor also recognizes proportionally the income/loss (and dividend payments) coming from the investment in its P&L, adjusting consequently the initial investment at cost to reflect such variations. Indeed, it will be increased proportionally for the share in profits coming from the investee and likewise

[64] Deloitte. *A Roadmap to Accounting for Equity Method Investments and Joint Ventures*. P. 31. (2018). www2.deloitte.com
[65] PKF. *IAS 28 Investments in Associates and Joint Ventures*. Accounting Summary 2017-07. (2017). www.pkf.com

decreased for the share in investee's losses and dividends received, thereby accounting for its carrying value.

However, taking one step back, as Nobes, C. pointed out in one of his research papers:

«[…] *standard-setters should not perpetuate operationally difficult concepts and arbitrary thresholds […] [or terms, like the above-mentioned "significant influence"] which seem inconsistent with their frameworks […]. One way forward would be to require all investments to be shown at fair value [rather than at their carrying value], taking gains and losses [exclusively] to comprehensive income. This would replace the equity method with a more honest valuation approach and would remove arbitrary thresholds*» (Nobes, C., 2002, p. 41)[66].

Now assume that, during year t, a firm acquires 30 percent of another company's equity with a net result of € 0.5 mln. The price agreed is € 300.000 (which represents the initial cost of the investment). Consequently, the investee's equity will be equal to: € 300.000/0,30 = € 1 mln. Further, suppose that the book value of the investee's underlying assets is € 800.000, so that a € 200.000 goodwill is recorded (i.e., investee's total equity net of the carrying value of its assets). Presume that in year t there is no impairment loss on goodwill, pursuant to *IAS 36 – Impairment of Assets* (Deloitte, 2013)[67]. Hence, the share of the investor in the investee's goodwill will be: € 200.000*0,30 = € 60.000; this amount is already included in the price agreed for acquire a portion of the investee's equity.

Therefore, considering the share in profit of € 150.000 (€ 0.5 mln *0,30) and assuming that no dividend is paid by the investee during year t, then the investment cost reported in the SFP will be: € 300.000 (which, once again, includes already goodwill) + € 150.000 = 450.000. The € 150.000 profit will be reported as well in the P&L of the investor in the proper account, namely "Profit (loss) from investment in equity-accounted companies", reported as a single-line item. In the next page, we report the investor's SFP and P&L Statement templates

[66] Nobes, C. *An analysis of the international Development of the Equity Method*. Abacus, Vol. 38, No. 1. Pp. 16-45. (2002). www.onlinelibrary.wiley.com
[67] Deloitte. *IAS 36 – Impairment of Assets*. (2013). www.iasplus.com

illustrating the aforementioned accounting method (Table 2.2, *Equity method of accounting: an illustrative example*)[68]:

Investor's Statement of Financial Position

ASSETS *(in thousand EUR)*	**31/12** **Year$_t$**	**31/12** **Year$_{t+1}$**
Goodwill		
Other Intangible Assets		
Property, Plant & Equipment (PPE)		
Non-current financial assets		
Investment in equity-accounted companies	450	
Non-current derivatives (positive fair value)		
Deferred tax assets		
Non-current assets		
Current financial assets		
Current derivatives (positive fair value)		
Inventories & Work-In-Progress (WIP)		
Trade & Other Receivables		
Tax Assets		
Cash & Cash Equivalents (C&CE)		
Current assets		
Assets related to discontinued operations		
Total Assets		

EQUITY AND LIABILITIES *(in thousand EUR)*	**31/12** **Year$_t$**	**31/12** **Year$_{t+1}$**
Share capital		
Retained earnings		
Net unrealized gains on available-for-sale financial assets		
Profit (loss) for the period		
Total Equity		
Provisions		
Borrowings subject to specific conditions		
Non-current interest-bearing financial liabilities		
Non-current derivatives (negative fair value)		
Deferred tax liabilities		

[68] Figure 2.2: *Equity method of accounting: an illustrative example*. Figure created by the Author. Source: Corporate Finance Institute. *Balance Sheet Template.* CFI Education. (2019). www.corporatefinanceinstitute.com; Corporate Finance Institute. *Income Statement Template*. CFI Education. (2019). www.corporatefinanceinstitute.com

Other non-current financial liabilities		
Non-current liabilities		
Provisions		
Current interest-bearing financial liabilities		
Trade & Other payables		
Tax liabilities		
Current derivatives (negative fair value)		
Other current financial liabilities		
Current liabilities		
Liabilities related to discontinued operations		
Total Equity and Liabilities		

Investor's Profit & Loss Statement

(in thousand EUR)	**31/12 Year$_t$**	**31/12 Year$_{t+1}$**
Revenues		
Other income		
A) Operating revenues		
Change in Inventories of Finished goods and Work-In-Progress (WIP)		
Raw materials and consumables used		
Personnel costs		
Depreciation & Amortization (D&A)		
Asset impairment		
Other recurring operating income and expenses		
B) Operating expenses		
A) - B) Operating profit		
Cost of net debt		
Foreign exchange gain (loss)		
Profit (loss) from investment in equity-accounted companies	150	
Other financial income and expense		
C) Financial Income (loss)		
A) – B) ± C) Profit before Tax (PBT)		
Income tax benefit (expense)		
Profit from continuing operations		
Profit from discontinued operations and disposal gain		
Profit for the period		

Why the parent can have an incentive to not include one (or more) of its subsidiaries in its consolidated financial statements? (Bank for International Settlements, 2009, pp. 11-19)[69]

First of all, to streamline time and costs associated to the financial reporting function, since usually the latter is poorly seen just as a cost constraint.

Secondly, there might be a shady reason behind: indeed, unconsolidated financial reporting can be used even with misleading purposes if, for instance, the parent company wants to take-off unfavorable assets and/or liabilities from the consolidated BS, as well as show increased revenues and/or reduced costs in the group profit and loss (P&L). As a consequence, off-balance sheet and off-profit and loss accounting lead inevitably to incomplete information, which is a very explicit red flag, given that there might be hidden costs or fake revenues as well as some resources/claims that might be kept out of sight in *Special Purpose Entities (SPEs)*, even when these items may belong to the parent company, as confirms Ewelt-Knauer, C. (Ewelt-Knauer, C., 2014, p. 832)[70]. On the contrary, assets that are not owned or economically not refer to the holding shall not be included in the group accounts, as liabilities cannot be recorded if claims have not to be paid off by the same parent. By the way, Special Purpose Entities (SPEs) will be object of a separate detailed study carried out in *paragraph 3.1.5*.

Thirdly, there is also the possibility that unconsolidated financial statements are presented fraudulently for tax purposes: this can be achieved through profit-shifting activity in order to avoid or pay less taxes as a group, transferring part (or all, but in very rare cases) of group's income to off-shore unconsolidated subsidiaries operating in tax heavens, as an handy solution to increase group's profitability and appear to stakeholders' eyes as a healthy company that behave consistent with pre-fixed strategic and long-term goals.

Fourthly, it is very frequent that, when the operations of the parent are not homogeneous with those of the subsidiaries, the choice to opt for unconsolidated financial reporting is quite forced and common in practice (e.g., the holding is an industrial corporation and the subsidiary is a bank/insurance company), as

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[69] Bank for International Settlements. *Report on Special Purpose Entities*. Pp. 11-19. (2009). www.bis.org; www.iosco.org

[70] Ewelt-Knauer, C. *Determining reporting entity boundaries in the light of neo-institutional theories beyond the conceptual framework of IFRS*. Journal of Business Economics, Vol. 84, No. 6. Pp. 827-864. Springer-Verlag. P. 832. (2014). link.springer.com; www.springerprofessional.de

confirmed by a study conducted by the Accountants International Study Group (AISG, 1973, Par. §31)[71].

Finally, unconsolidated financial reporting usually is convenient when the parent owns less than 50% of voting shares in a certain subsidiary, thus considering its shareholding as irrelevant to be included within its consolidation perimeter. But it might be convenient to do so even if it owns more than a half: for instance, when it has temporary control on the subsidiary, when the latter exercises a totally different business activity completely detached from the parent's operations/core business or when there is a political (or of different nature) hostility in the country in which operate, so that such situation might damage the parent's reputation.

A valid alternative to reduce incentives related to the presentation of unconsolidated financial statements is to perform the consolidation process in outsourcing, but this shall be done evaluating if the presence of strategic, operating and financial interdependences between the parent company and its subsidiaries allow for subcontracting. Moreover, Mian, S.L., Smith, C. W. Jr found that «*[…] the more interdependent the parent and subsidiary activities, the more likely is the subsidiary's performance to be reported on a consolidated basis [and, thus, greater is the willingness for subcontracting]*» (Mian, S.L., Smith, C. W. Jr, 1990, p. 143)[72].

Besides interdependencies, we believe that a cost-benefit analysis (Solomon, D., 2017, p. 748)[73] of providing unconsolidated financial statements should be made on a case-by-case basis (in circumstances when this is allowed, i.e. when consolidation is not required by law), such that there is no room for a general rule that might incentivize subsidiaries to present their stand-alone financial statements separately.

[71] Accountants International Study Group (AISG). *Consolidated Financial Statements. Current recommended practices in Canada, the United Kingdom and the United States*. Canada. Par. §31. (1973)

[72] Mian, S.L., Smith, C. W. Jr. *Incentives for Unconsolidated Financial Reporting*. Journal of Accounting & Economics, Vol. 12. Pp. 141-171. P. 143. (1990). www.sciencedirect.com

[73] Solomon, D. *The Voice: Minority Shareholder's Perspective*. Nevada Law Journal, Vol. 17, No. 739. P. 748. (2017)

2.2 Definitions of reporting entity and legal entity

Reporting and legal entities are two extremely important concepts when considering the boundaries of the group, since the former is normally considered as that one that is supposed to consolidate group accounts, while the latter plays the role of the "investee", i.e. the entity being controlled that operates within the consolidation perimeter.

To avoid the regrettable situation in which stakeholders are asked to analyze assets and liabilities of the reporting and legal entities individually, thus being not able to assess the accountability of management (and perhaps obfuscated about the overall group performance), consolidated financial statements are required with the aim to analyze these items as a whole.

Should we make a global accounting regulation comparison, we would start by considering that IASB published in May 2008 a Discussion Paper (DP) entitled "Preliminary Views on an improved Conceptual Framework for Financial Reporting – The Reporting Entity", as part of the IASB-FASB joint project to develop a Conceptual Framework in which including a common reporting entity concept (Kabalski, P., 2009, p. 96)[74]. Such DP described the reporting entity as «*a circumscribed area of business activities of interest to present and potential equity investors, lenders and other capital providers*» (Deloitte, 2008, p. 1)[75], rather than a simple bundle of legal structures. Additionally, both Boards specified that it is up to the reporting entity to present consolidated financial statements, that can prepare consolidated accounts either from the perspective of the group reporting entity (i.e., "entity approach") or from the standpoint of its shareholders (i.e., "proprietary approach"). As Saccon, C. confirms:

«*Various regulations governing group accounts are moving towards an entity view of the group structure. […] [This is also supported by] the progressive [and growing] inclusion of subsidiaries in the consolidated accounts […]. As a result, the perimeter of consolidation, that is subsidiaries fully consolidated in group accounts, becomes greater*» (Saccon, C., 2008, p. 75)[76].

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[74] Kabalski, P. *Comments on the Objective of Financial Reporting in the Proposed New Conceptual Framework*. Eurasian Journal of Business and Economics, Vol. 2, No. 4. Pp. 95-111. P. 96. (2009). www.ejbe.org

[75] Deloitte. *IASB considers 'what is a reporting entity'?* IAS Plus. P. 1. (2008). www.iasplus.com

[76] Saccon, C. *Perimeter of Consolidation: Converging regulations and national effects*. Revista Economicâ. No. (3)40. Pp. 75-88. P. 75. (2008). www.economice.ulbsibiu.ro

Moreover, the results of a study conducted by some authors show that *«[…] Consolidated Financial Statements based on a broader definition of control [i.e., control that embraces the entity approach] provide more useful accounting information than those based only on majority-ownership control*» (Hsu, A. W. et al., 2012, p. 198)[77].

According to US GAAP Principles, *US GAAP ASC 810 – Consolidation* does not specifically provide explicit definitions of both reporting entity and legal entity in its Glossary section (ASC 810-10-20), although throughout the Codification «*[…] a reporting entity is [intended as] the entity performing the consolidation analysis (i.e., the party potentially consolidating a legal entity)*» (Deloitte, 2015, p. 20; Deloitte, 2019, p. 9)[78] and the legal entity is «*[…] almost any legal structure that is used to own assets, issue debt or otherwise conduct activities […], regardless of its legal form (e.g. a corporation, a partnership, a limited liability company, a trust, etc.)*» (Deloitte, 2015, p. 7; Deloitte, 2019, p. 21).

There are several factors (some aspects more operating, while others more judgmental) that must be taken into consideration when establishing whether a legal entity exists: e.g., whether the structure invoices its customers under its own name, whether vendors invoice the structure under its own name, whether the structure has its own separate financial statements, whether the structure can be sued or, in turn, is in the position to sue other subjects, the appearance as legal structure by third parties, the ability of the structure to enter into contracts and agreements and so on and so forth.

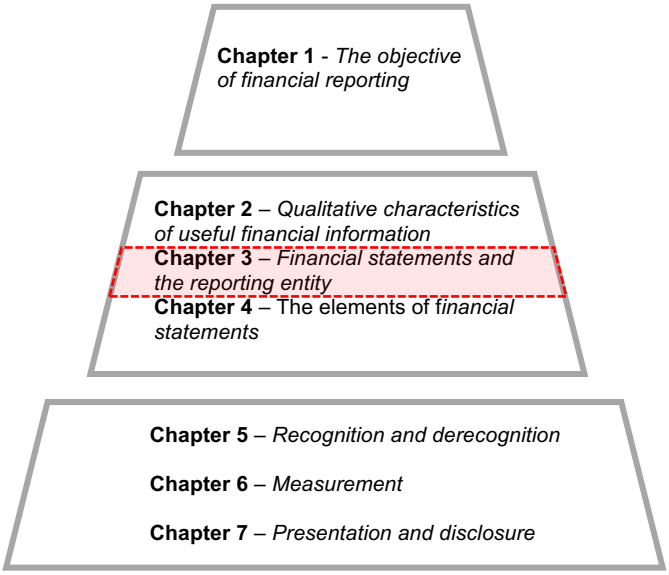
According to the IFRS regulation, *IFRS 10 – Consolidated Financial Statements* mirrors its correspondent US GAAP Standard by linking the reporting entity concept to the parent and the concept of the legal entity to the subsidiary (as it was logically predictable). Such rule of thumb is in line with what is prescribed by the Conceptual Framework for Financial Reporting. But things are slightly different compared to US principles, since the Conceptual Framework consider Consolidated Financial Statements those drafted when a reporting entity comprises both the parent and its subsidiaries, thus identifying the stand-alone

[77] Hsu, A. W. et al. *Does the Control-based Approach to Consolidated Statements Better Reflect Market Value than the Ownership-based Approach?* The International Journal of Accounting, Vol. 47, No. 2. Pp. 198-225. P. 198. (2012). www.sciencedirect.com

[78] Deloitte. *Consolidation. A Roadmap to Identifying a Controlling Financial Interest*. Pp. 7; 20. (2015). www2.deloitte.com; Deloitte. *A Roadmap to Consolidation. Identifying a Controlling Financial Interest*. Financial Accounting Foundation. Pp. 9; 21. (2019). www2.deloitte.com

reporting entity preparing the "unconsolidated financial statements" (Annualreporting.info, 2019; Investopedia, 2019)[79].

Below is contextualized the reporting entity concept (included in Chapter 3) within the Conceptual Framework for Financial Reporting (Figure 2.2, T*he Reporting Entity Concept within the Conceptual Framework for Financial Reporting*)[80]:



Moreover, should be present within a reporting entity two (or more) entities that are not linked each other by a parent-subsidiary relationship (e.g., in case of subcontracting, franchising, alliances), then the reporting entity's financial statements are referred to as "combined financial statements" (IFRS Box, 2019)[81].

Even if at first glance they seem synonyms and can be used them interchangeably, they cannot. Indeed, the main difference between consolidated financial statements and combined financial statements is that in the latter presentation the parent company's financial statements are not included. But, what is the ratio to draft combined financial statements rather than consolidated ones?

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[79] Annualreporting.info. *Reporting Entity*. (2019). www.annualreporting.info; Investopedia. *Consolidated Financial Statements*. Corporate Finance & Accounting. (2019). www.investopedia.com

[80] Figure 2.2: *The Reporting Entity Concept within the Conceptual Framework for Financial Reporting*. Figure created by the Author.
Source: IFRS Foundation. *Conceptual Framework for Financial Reporting – Project Summary*. Pp. 5-14. (2018). www.ifrs.org

[81] IFRS Box. *Conceptual Framework for the Financial Reporting Function 2018*. (2019)

ASC 810-10-55-1b gives some examples about:

«*For example, combined financial statements would be useful if one individual owns a controlling financial interest in several entities that are related in their operations. Combined financial statements might also be used to present the financial position and results of operations of entities under common management*» (Financial Accounting Foundation, 2019, p. 2)[82].

Eventually, the identification of the entity's boundaries might require particular effort when the reporting entity does not comprise only entities linked by a parent-subsidiary relationship.

In this circumstance, the determination of the consolidation perimeter is driven by the information needs revealed by the primary users of the reporting entity's financial statements, who want to obtain a faithful representation of group accounts, such as the complete and neutral information regarding the set of economic activities carried on at the group level and a description of how the entity's boundaries have been determined, as well as which are the entities being consolidated.

2.2.1 Focus on the reporting entity concept in Australia

As we may wonder, the choice to dedicate an entire paragraph to the peculiarities of the reporting entity concept to the specific case of the Australian regulation (while comparing so far just IFRS and US regulations) is not arbitrary, but it has been taken due to the richness of the Australian literature related to such topic.

In particular, the reporting entity concept has a relevant impact on financial reporting because, depending on the classification of an entity as "reporting entity" or "non-reporting entity", financial reporting requirements vary significantly (Stuchbery, T., 2017, p. 1)[83]. Entities are asked themselves to self-classify as belonging to the first or second category. This distinction, as a Deloitte flowchart

[82] Financial Accounting Foundation. *ASC 810 - Consolidation.* P. 2. (2019). www.asc.fasb.org.
[83] Stuchbery, T. *The Reporting Entity Concept in Australia: An Exploration of the Impact and Comparison to International Standards*. Ca' Foscari University of Venice. P. 1. (2017). www.dspace.unive.it

confirms (Deloitte, 2016, p. 30)[84], implies that reporting entities comply with full GAAP-based or commonly known as "General Purpose Financial Reports (GPFRs)", while non-reporting entities are asked to operate according to "Special Purpose Financial Reports (SPFRs)", which are simplified and less complex financial reporting requirements (e.g., due to lower disclosure thresholds to comply with).

This stems from the objective fact that financial reporting is a costly and time-consuming activity that must be performed (besides the potential benefits it involves), so that simpler and shorter requirements are asked to small and medium-sized enterprises. Whit this in mind, it would be reasonable perform a cost-benefit analysis related to financial reporting in order to establish its profitability, although most of the times financial disclosure requirements are imposed by law and it is not a matter of corporate decision-making.

As in Europe and in the United States we find, respectively, the IASB and FASB standard-setters (which are in charge to issue, for the sake of clarity once again, IFRSs and US GAAP Standards), alike the major governing body responsible for issuing Australian GAAP (i.e., "Statement of Accounting Concepts") is the *Australian Accounting Standard Board (AASB)*.

The reporting entity concept has been the foundation of differential reporting (Deloitte, 2009, p. 1)[85] since its introduction in Australia in 1991 (Carey, P. et al., 2014, p. 465)[86] (i.e., financial reporting needs and requirements vary according to the category of entities, such as listed companies, private companies, not-for-profit entities, the public sector). Originally introduced in *SAC 1 – Definition of the Reporting Entity*, soon became a widely debated and even criticized several times, since differential reporting strived towards comparable financial reporting. Companies wanted to find, no matter how, an efficient loophole to be classified as non-reporting entities, thus lightening the waste of resources and time dedicated to financial reporting activities. In this way their businesses could became more profitable just saving; nonetheless, future research should be focused on how to augment the economic performance of those entities that spontaneously decide to adopt GPFRs. The reasons that lye

[84] Deloitte. *Australian financial reporting guide*. P. 30. (2016; 2018). www2.deloitte.com
[85] Deloitte. *Section D. Reporting Obligations*. P. 1. (2009)
[86] Carey, P. et al. *Application of the Reporting Entity Concept in Australia*. Abacus, Vol. 50, No. 4. Accounting Foundation, The University of Sydney. Pp. 463; 465. (2014). www.onlinelibrary.wiley.com

on this highly debated topic, above of all, is the subjectivity at the bottom of the self-classification as reporting entity or not, besides the two-fold motives that reporting entities are asked to produce higher-quality financial reports and entity's stakeholders are those users most at risk that could be influenced by misleading financial reporting.

The degree of discretion in determining if an entity is a reporting entity or not is quite high, since Australian GAAPs are very similar to IFRS Standards considering that they are both principles-based standards (as opposed to US GAAP Principles, which are rules-based; see *paragraph 1.1.1* for further explanations). Moving from this presumption, many are the factors that are taken into account, such as: «*[…] the separation of management from economic interest, the economic and political importance of the entities and their financial characteristics (like the value of sales, of assets, the level of indebtedness, the number of employees/customers, etc.)*» (Carey, P. et al., 2014, p. 463). The more such aspects are prominent, the more users will rely on financial statements as primary information source, leading to classify the entity as a reporting entity. Therefore, regardless of the strictly quantitative sphere, professional judgement is required combined with a discrete knowledge of informational risks that a potential wrong entity classification might involve.

In general, companies that are typically considered to be reporting entities are identified by "AASB 1053 – Application of Tiers of Australian Accounting Standards", which makes a bullet point by listing publicly accountable companies, trusts, government-controlled entities and government departments.

Moreover, as pointed out by Challen, D., Jaffery, C. (Challen, D., Jaffery, C., 2005, pp. 71-73)[87], current Australian GAAPs do not make the public sector accountable as the private one, thus resulting in a poor comparability of financial performance information.

This difference is mainly due to the different needs that stakeholders have towards for-profit businesses with respect to public enterprises, since the former are typically investors that are interested in trading in Equity Capital Markets (ECMs), while the latter are mostly citizens that want to make government accountable for the allocation of public resources and the achievement of pre-defined policy outcomes.

[87] Challen, D., Jaffery, C. *Definition of the Reporting Entity*. Australian Accounting Review, Vol. 15, No. 1. Pp. 71-73. (2005). http://onlinelibrary.wiley.com

Anyway, the application of the reporting entity concept is not mandatorily prescribed by any Australian GAAP, but it is encouraged by the Accounting Professional and Ethical Standard "APES 205 – Conformity with Accounting Standards", as confirms Carey, P. et al.

Ultimately, an interesting topic for practitioners, academics, researchers and the like would be how to increase "comparability", "transparency", "usability" and "understandability" of information between those reporting entities that comply with GPFRs and those which instead are required to disclose financial performance information according to SPFRs.

In a similar fashion, it would be compelling as well to test whether a standardized disclosure and accountability requirements applied to both for-profit businesses and the public sector will enhance the above-mentioned characteristics of financial performance information, as pointed out by Walker, R. G. (Walker, R. G., 2007, p. 71)[88], though considering the limits that could not be overcame in any way regarding the different interests that the two groups of stakeholders have.

2.3 The control principle

2.3.1 Accounting of (Non)-Controlling Financial Interests

The determination of the subsidiaries to be included in the consolidation process is not so straightforward as it might seem at first sight. In fact, it is crucial to identify a so-called "Controlling Financial Interest" because it represents the initial step when establishing whether one (or more) economic entity should consolidate another one (Deloitte, 2015, p. 1; Deloitte, 2019, p. 2; Ernst & Young, 2016, pp. 18-19)[89].

In particular, stakeholders (and, among them, especially investors) are interested in knowing the overall performance of the group: therefore, the latter

[88] Walker, R. G. *Reporting Entity Concept: A Case Study of the Failure of Principles-Based Regulation*. Accounting Foundation, The University of Sydney. Abacus, Vol. 43, No. 1. Pp. 49-75. P. 71. (2007). www.onlinelibrary.wiley.com

[89] Deloitte. *Consolidation. A Roadmap to Identifying a Controlling Financial Interest*. P. 1. (2015). www2.deloitte.com; Deloitte. *A Roadmap to Consolidation. Identifying a Controlling Financial Interest*. Financial Accounting Foundation. P. 2. (2019). www2.deloitte.com; Ernst & Young. *Consolidation and the Variable Interest Model. Determination of a controlling financial interest (following the adoption of ASU 2015-02, Amendments to the Consolidation Analysis)*. Pp. 18-19. (2016). www.ey.com

must account for the other entity's assets and liabilities, as well as revenues and expenses, as if they were a single economic unit.

If we exclude the financial statements of certain entities that should belong to a group, as a consequence possible misrepresentation of group accounts may be generated, thus creating a fertile ground for frauds and financial scandals coming to light (for instance, the Enron scandal in 2001 is a valid example, which led the energy giant to its bankruptcy due to the discovery of an impenetrable network of hidden companies created in tax heavens ad-hoc to find a way to avoid taxes).

It is worth recalling that "reporting entity" does not constitute a synonym of "legal entity". Instead, they are legally independent. In a nutshell, to better identify them, let define the reporting entity as the "parent company" (or commonly called "holding") and the legal entity as the "subsidiary".

The principle that underlies the relationship between the reporting entity and the legal entity is "control", that is the fulcrum based on which a consolidation model can be built upon.

When the parent company has a controlling interest in the subsidiary, attributable in the measure of 100%, the latter is said to be a "wholly-owned subsidiary". But "troubles" begin when a company owns less than 100% of another entity, being doubtful whether it is entitled to exercise the control over it, thus including it in the consolidation area.

Nonetheless, we can try to grasp the matter by giving firstly the definitions of "Controlling Financial Interest" and "Control" under both IFRS and US regulations.

Departing from US GAAPs, a Controlling Financial Interest definition can be met by taking as reference the "Summary of Statement no. 160" which for the first time introduced the opposite concept (i.e., Non-Controlling Interests) as amendment of ARB no. 51. Literally it was defined as: «*A non-controlling interest, sometimes called a minority interest, is the portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent*» (IFRS Box, 2014; Financial Accounting Foundation, 2019)[90].

[90] IFRS Box. *IFRS 3 Business Combinations*. (2014). www.ifrsbox.com; Financial Accounting Foundation. *Summary of Statement no. 160 – Non-Controlling Interests in Consolidated Financial Statements – An amendment of ARB no. 51*. (2019). www.fasb.org

It goes without saying that a Controlling Financial Interest is defined diametrically as the portion of equity (net assets) in a subsidiary ascribable, directly or indirectly, to a parent (Ignatowski, R., Zaton, W., 2015, p. 75)[91].

This Statement is effective for fiscal years (and interim periods within those fiscal years) beginning on or after 15 December 2008 (1 January 2009, for entities with calendar year-ends), while earlier adoption is prohibited.

However, when *US GAAP ASC 810 – Consolidation* became effective, Statement no. 160 was replaced accordingly. According to ASC 810, the representation of a Controlling Financial Interest can be spotted in the excerpt from "Scope and Scope Exceptions" provision embedded in 810-10 Overall: in particular, 810-10-15-8 stated that (prior to ASU 2015-02):

«*The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one reporting entity, directly or indirectly, of more than 50 percent of the outstanding voting shares of another entity is a condition pointing toward consolidation. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree*» (Financial Accounting Standards Board, 2015, p. 17) [92].

ASU 2015-02 made some changes to this provision as follows:

«Under the voting interest entity model, for legal entities other than limited partnerships, the usual condition for a controlling financial interest is ownership by one reporting entity, directly or indirectly, of more than 50 percent of the outstanding voting shares of another entity (see paragraph 810-10-15-8). For limited partnerships, the usual condition for a controlling financial interest is ownership by one limited partner, directly or indirectly, of more than 50 percent of the limited partnership's kick-out rights through voting interests (see paragraph 810-10-15-8A). If non-controlling shareholders or limited partners have substantive participating rights, then the majority shareholder or limited partner

[91] Ignatowski, R., Zaton, W. *Non-controlling interests, financial performance and the equity of groups. An empirical study of groups listed on the Warsaw Stock Exchange*. Zeszyty Teoretyczne Rachunkowości, Vol. 84, No. 140. Pp. 67-93. P. 75. (2015). www.7292.indexcopernicus.com

[92] Financial Accounting Standards Board. *Consolidation (Topic 810) – ASU No. 2015-02 – Amendments to the Consolidation Analysis.* Pp. 9-10; 17. (2015). www.fasb.org; www.asc.fasb.org

with a majority of kick-out rights through voting interests does not have a controlling financial interest» (Financial Accounting Standards Board, 2015, p. 9-10).

As we may notice, with respect to the previous one, such statement stresses the difference between companies and limited partnerships and also it highlights the potential existence of substantive participating rights (as opposed to protective rights). Such kind of rights will be analyzed more in-depth along *Chapter 3*, when the Voting Interest Entity Model will be taken into consideration as well.

Comparing IFRSs to US GAAP Standards, Statement no. 160 contributed to the alignment of recording Non-Controlling Interests in subsidiaries with requirements contained in IAS 27, thus eliminating a source of non-comparable financial reporting. Previously, entities applying IFRS Standards detected Non-Controlling Interests as equity, while US companies reported those interests as liabilities (or, at most, in the mezzanine section between liabilities and equity).

Now, if we take into account the IAS/IFRS regulation, we can observe how the latter is not so detached from the US one: indeed, also according to IFRSs there is no a clear statement of what a Controlling Interest is, but instead it can be easily defined diametrically opposite of the Non-Controlling Interests definition provided initially from IAS 27 and, subsequently, included in IFRS 10.
Non-Controlling Interests were, at the very beginning (i.e., prior to the amendments to IAS 27 in 2008), called "Minority Interests" (IFRS Foundation, 2011)[93], referring to those who did not hold a controlling interest in an entity. We are often used to think wrongly that Controlling Interests are solely those that control an entity and NCIs are those who do not have any control. However, in certain situations (e.g., due to a formal agreement between shareholders), it might be possible that the owners of a majority interest do not have any control on the entity, while Non-Controlling Interests might control such entity.

The definition of Non-Controlling Interests provided by IAS 27 is very similar to that one proposed by the US "Summary of Statement no. 160" (described previously), which corresponds to the current version included in IFRS 10: «*Non-Controlling Interests are the equity in a subsidiary not attributable, directly or indirectly, to a parent*» (IFRS Foundation, 2018, p. 8)[94].

[93] IFRS Foundation. *IAS 27 – Separate Financial Statements*. (2011). www.ifrs.org
[94] IFRS Foundation. *IFRS 10 – Consolidated Financial Statements*. P. 8. (2018). www.ifrs.org

Furthermore, IAS 27 was revised in 2000 (paragraph 26) by imposing Minority Interests to be presented in the consolidated balance sheet separately from liabilities and equity of the parent's shareholders. In 2003, with the change of terminology, Non-Controlling Interests had to be disclosed in the consolidated statement of financial position within equity, but separately from the portion related to parent's shareholders. The logic behind this different presentation requirement is that Non-Controlling Interests could not be classified as liability simply because it cannot, by nature, give rise to a present obligation, otherwise being in contrast with the Framework for the Preparation and Presentation of Financial Statements (replaced in 2010 by the current Conceptual Framework for Financial Reporting, as argued in *Chapter 1, paragraph 1.1*). In addition, in support of that said, there is no outflow of economic benefits from the group justifying the fact that Non-Controlling Interests should be presented among liabilities.

Finally, being Non-Controlling Interests included in the equity, the latter is defined in the Conceptual Framework in paragraph 4.4 (c) as «*the residual interest in the net assets of the entity after deducting all its liabilities*» (IFRS Foundation, 2018)[95], representing consequently a further confirmation that also such Non-Controlling Interests are nothing less than the residual interest in the net assets of a group's subsidiaries.

2.3.2 The notion of control

The notion of control is a fundamental concept since it represents the basis for determining the boundaries of the group, from which, in turn, depends the decision about the entities that should be included within the group's perimeter.

From an historical point of view, the principle that firstly introduced the control definition was *IAS 3 – Consolidated Financial Statements*, replaced in 1989 by IAS 27 and IAS 28 as per request by the Seventh Directive. It was issued in 1976 and became effective from the following year, when the Consolidated Financial Statements preparation was still not mandatory for all countries.

[95] IFRS Foundation. *Conceptual Framework for Financial Reporting*. (2018). www.ifrs.org

IAS 27, paragraph 4, defines control as: «*power to govern the financial and operating policies of that entity, so as to obtain benefits from its activities*» (Deloitte, 2008)[96].

This statement has also been included in *paragraph 6-8* embedded in *IFRS 10 – Consolidated Financial Statements*. Hence, control depends on the degree of influence of business decisions of an entity over another one, such as the budget approval, financial and industrial plans approval, issuance of debt, investment decisions and management strategies (like mergers and acquisitions of assets, transfers of business branches, participations, etc.).

Several are the ways in which control can be exercised: e.g., by owning a majority of shares, by contractual agreements, by other legitimate claims, etc. (Gallimberti, C. et al., 2013, p. 83)[97].

As time passed by, IFRS 10 became the main character for defining rules governing Consolidated Financial Statements. According to such Standard, regardless of the nature of the investor's involvement with an entity*, control of an investee* is pronounced as: «*An investor controls an investee when the investor 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*» (BDO, 2016, p. 1; IFRS Foundation, 2018, p. 4)[98].

The control can still persist even if the subsidiary being controlled reports a negative performance, thus conducting in this way the parent to record a negative result: that is why the obtainment of a gain out from the subsidiary is merely potential and it is not a necessary nor sufficient condition for control to exist.

To make control effective, a set of conditions must be verified simultaneously as prescribed by IFRS 10:

«*[…] an investor controls an investee if and only if the investor has all the following:*

(a) Power over the investee;

[96] Deloitte. *IAS 27 – Consolidated and Separate Financial Statements (2008)*. www.iasplus.com

[97] Gallimberti, C. et al. *Consolidation. Preparing and understanding consolidated financial statements under IFRS.* Mc Graw Hill Education. P. 83. (2013)

[98] BDO. *IFRS AT A GLANCE – IFRS 10 Consolidated Financial Statements*. P. 1. (2016). www.bdo.global; IFRS Foundation. *IFRS 10 – Consolidated Financial Statements*. Pp. 4-5. (2018). www.ifrs.org

(b) *Exposure, or rights, to variable returns from its involvement with the investee;*

(c) *The ability to use its power over the investee to affect the amount of the investor's returns*» (BDO, 2016, p. 1; IFRS Foundation, 2018, p. 4-5).

Each of the above-mentioned elements will be discussed in-deep in *Chapter 3*. The Standard proceeds delineating control by stating:

«*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*» (IFRS Foundation, 2018, p. 5).

Therefore, considering the fact that IFRSs are principles-based (as described in *paragraph 1.1.1*), there are no thresholds regarding the percentage or the number of shares needed to control the investee: on the contrary, the investor is encouraged to consider all facts and circumstances when assessing whether it controls an investee.

It two (or more) investors jointly control the investee, nobody can prevail on the others by imposing its own control over the entity to be consolidated. As a matter of fact, each investor will recognize its interest in the investee according to *IFRS 11 – Joint Arrangements*, *IAS 28 – Investments in Associates and Joint Ventures* or *IFRS 9 – Financial Instruments*.

A relevant empirical study conducted by Vašek, L., Gluzová, T. pointed out whether a new concept of control under IFRS might have an impact on the "Common Consolidated Corporate Tax Base (CCCTB)", which is «*a single set of rules that companies operating within the European Union (EU) could use to calculate their taxable profits*» (Vašek, L., Gluzová, T., 2014, p. 110)[99]. In this way, corporate practices to compute taxes would be ease strongly (Fuest, C., 2008, p. 721)[100], since a group *«[…] would have to comply with just one EU*

[99]Vašek, L., Gluzová, T. *Can a New Concept of Control under IFRS Have an Impact on a CCCTB?* European Financial and Accounting Journal, Vol. 9, No. 4. Pp. 110-127. P. 110. (2014). www.econstor.eu

[100] Fuest, C. *The European Commision's proposal for a common consolidated corporate tax base*. Oxford Review of Economic Policy, Vol. 24, No. 4. Pp. 720-739. P. 721. (2008). www.academic.oup.com

system for computing its taxable income, rather than different rules in each Member State in which they operate» (Vašek, L., Gluzová, T., 2014, p. 110). However, in 2011, the European Commission (that was in charge to evaluate such project) decided to issue a *Proposal for a Council Directive*, which has not been concluded yet.

Vašek, L., Gluzová, T. found that no IFRS Standard, national rule nor any accounting system is able to influence the tax group, meaning that a change of the control concept as it is defined by IFRS would not affect the tax to be paid by a certain group.

Afterwards, in October 2016, the Commission decided to re-take into consideration the CCCTB project by starting a two step-process making it mandatory for the largest groups in the European Union (European Commission, 2016)[101], with the aim to foster transparency, reduce tax avoidance through profit shifting and incentivize investments within the EU.

Looking instead at the US perspective, it has never been introduced a unique notion of control, but subsidiaries are generally consolidated by applying alternatively two different consolidation techniques which will be both faced in *Chapter 3* (i.e., the "Variable Interest Entity (VIE)" and the "Voting Interest Entity" models). «*All entities are first evaluated as potential VIEs*» (Ernst & Young, 2018, p. 8)[102]. Hence, we can easily distinguish:

«

- *for non-VIEs, 'control' [requires the ownership of the majority voting rights and] is the continuing power to govern the financial and operating policies of an entity;*
- *for VIEs, control is [based on determining which party has power and benefits]. The power to direct the activities that most significantly impact the VIE's economic performance and either the obligation to absorb losses of the VIE, or rights to receive benefits from the VIE, that could potentially be significant to the VIE*» (Financial Accounting Foundation, 2019, p. 12)[103].

[101] European Commission. *Common Consolidated Corporate Tax Base (CCCTB)*. (2016). www.ec.europa.eu
[102] Ernst & Young. *US GAAP versus IFRS. The Basics*. P. 8. (2018; 2019). www.ey.com
[103] Financial Accounting Foundation. *ASC 810 - Consolidation.* P. 12. (2019). www.asc.fasb.org

Like IFRS regulation, control [of a VIE] is gauged periodically, while differently from IFRS Standards, control [of non-VIEs] is assessed any time that there is a change in voting interests in the investee.
Contrarily to IFRSs, US GAAP Principles do not link investor's return from its ability to use the power over the investee, but instead, under the VIE model, give the investor the right to receive benefits (and, symmetrically, the obligation to absorb losses) from the VIE.

2.3.3 De jure control versus de-facto control

The notion of control described in *paragraph 2.3.2*, under both IFRS and US GAAP perspectives, highlights its fundamental role when determining the entities to be included in the group for consolidation purposes.

In general, control can be imposed in two different ways: through "de jure or formal control" and "de-facto or substantive control". While the former is exercised through the ownership of the majority of the voting rights (required by law), the latter consists in the ability of the parent company to handle the strategic/operating policies of another entity, independently from the number of the shares held, which can be even zero (circumstance that happens in very rare cases, though). However, de jure control requires, besides the majority of the voting rights, that the control is exercised effectively, since otherwise minority shareholders could conduct the entity according to their own interests. Such occasion, i.e. when the majority of the voting rights does not constitute control, has to be proved by conveying evidence regarding the management of the controlled entity by minority shareholders. The common trait between these two different typologies of control is that both forms are exercised through voting rights during the shareholder's meeting.

At last, with a view to the global accounting regulation comparison (Ernst & Young, 2018, p. 25)[104], IFRS rules differ from US GAAP Principles since *IFRS 10 – Consolidated Financial Statements* supports de-facto control, while *US GAAP ASC 810 – Consolidation* «*[…] effectively considers control as a Controlling Financial Interest represented by the direct or indirect ownership of*

[104] Ernst & Young. *US GAAP/IFRS accounting differences identifier tool*. P. 25. (2018). www.ey.com

the majority voting rights» (Alexander, D., Archer, S., 2008, p. 32)[105], which is a full-fledged form of de jure control.

2.3.4 Looking at control from different perspectives: internal versus external organizational boundaries

Hitherto, we looked at control chiefly as the means through which firm's boundaries delimited the external environment. However, organizational boundaries are commonly set also internally in order to keep separated different business functions in divisions and make possible the exercise of unitary control by the top management over the underlying "Business Units (BUs)", as pointed out by Cainelli, G., Iacobucci, D. (Cainelli, G., Iacobucci, D., 2009, p. 1)[106].

Many BUs are just the operative translation of something broader called "Business Model (BM)". The definitions of a firm's business model are several in the literature, but it can be briefly introduced as a valid plan for value creation, its retention (by making profit) and deliverance through the insertion of goods and services in the economic, social and cultural environment where companies operate. This definition can be extended also to a group of enterprises that share bureaucratic links and economic synergies for the realization of a common goal. Digging this concept, rather than focusing on the legal units that compose a group of firms, the business model notion represents a useful way to comprehend control from an internal standpoint and study the organizational behavior of groups, strictly from a management perspective. A conglomerate of firms is typically the output of a series of convenience-based decisions through which multiple businesses decide to cooperate or of legal-driven reasons when an entity controls (at least) another one, and thus is required to form a business group. In other words, Dumez, H., Jeunemaître, A. (2010) confirm that: «*There are no such things as natural boundaries. Organizational boundaries are the result of decisions about capability units that are always debated*» (Dumez, H., Jeunemaître, A., 2010, p. 152)[107]. Often the decision-making power is centralized to the parent company and this «*[…] depends, among other things, on parent*

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[105] Alexander, D., Archer, S. *International Accounting/Financial Reporting Standards Guide*. Wolters Kluwer Business. Chicago, IL, US. 10.04. P. 32. (2008)
[106] Cainelli, G., Iacobucci, D. *Business groups and the boundaries of the firm*. c.MET Working Paper 5/2009. Università Politecnica delle Marche. P. 1. (2009). www.leibniz.diiga.univpm.it
[107] Dumez, H., Jeunemaître, A. *The management of organizational boundaries: a case study*. AIMS. M@na@gement, Vol. 13, No. 3. Pp. 151-171. P. 152. (2010). www.cairn.info

company factors (e.g., culture and management style, mission and objectives, planning and control mechanisms), subsidiary evolution […] and MNEs' strategies of global or regional integration» (Di Carlo, E. et al., 2016, p. 325)[108]. This is even more accentuated in multinational groups where subsidiaries are not only geographically far from the parent, but also from cultural and socio-political standpoints.

In the 90s, some academics started wondering whether the notion of control (that we described in *paragraph 2.3.2*) *per se* overlapped and included the definition of "Internal Control System (ICS)", the latter being the set of rules, processes and organizational structures governing the corporate strategy and ensuring reliability and integrity of company's data. However, later on some authors expressed their contrariety and gave their contribution to the literature by stating that:

«*The definition of internal control systems reveals that it is […] different from [control intended as element for delineating groups' boundaries, since it is closer to the notion of] management control, which […] [can be better identified] as planning, organizing, staffing and directing*» (Chambers et al., 1987, p. 846)[109].

The theoretical line that separates the external perimeter from the internal boundaries sometimes is so thin that it makes difficult to delineate which are those that have been brought into play. Eventually, we can imagine external boundaries as static, since once they have been defined, they persist until a new change is adopted and, generally, such change requires formal recognition (think, for instance when a new entity is acquired and enters into the group). Differently, internal boundaries are closer to the idea of a flow of information, resources, spaces that fluctuates within the organizational sphere, shaping the business model with the unfolding of the business activities. A misalignment between external and internal boundaries might be possible when a new strategy is adopted at the group level that is not consistent with the business model of the parent, thus leading the holding (and the group consequently) out of way.

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[108] Di Carlo, E. et al. *Boundaries of the Business Model within Business Groups*. Journal of Management and Governance, Vol. 20. Pp. 321-362. P. 325. (2016). www.ebsco.com
[109] Chambers, A. D. et al. International Auditing. ELBS. P. 846. (1987)

CHAPTER 3. DIFFERENT CONSOLIDATION MODELS UNDER THE TWO MAJOR GLOBAL ACCOUNTING STANDARD SETS: COMPARING IAS/IFRS STANDARDS VERSUS US GAAP PRINCIPLES

3.1 The consolidation model based on de-facto control under IFRS 10

The notion of control, as anticipated earlier in *paragraph 2.3.2*, constitutes the premise for recognizing the group's boundaries in order to apply the proper consolidation model, being the latter the main tool to formally identify the entity's perimeter. On one side, there is the model regulated by *IFRS 10 – Consolidated Financial Statements* and, on the other side, the models governed by *ASC 810 – Consolidation*. In the first part of the chapter, we will dedicate to discover the IFRS consolidation model based on de-facto control (opposed to de jure control, as already introduced in *paragraph 2.3.3*), while the two US models will be deepened subsequently in order to obtain an overall understanding about how group of companies define their consolidation perimeter depending on whether they are subjected to US regulation; otherwise, IFRS rules will apply.

It is worth recalling, since we are going to see each of them in detail later on, the three main elements that form the notion of control provided by IFRS 10; together they contribute to give birth to the consolidation model supported by the IASB:

«*[…] an investor controls an investee if and only if the investor has all the following:*

(a) Power over the investee;

(b) *Exposure, or rights, to variable returns from its involvement with the investee;*

(c) *The ability to use its power over the investee to affect the amount of the investor's returns*» (IFRS Foundation, 2018, p. 4-5)[110].

Even if we do not want to stress same concepts multiple times, it is useful to remember that the above-mentioned consolidation model, to be valid, requires all these three elements be present simultaneously. Hence, let us focus on the power criterion in the next paragraph.

3.1.1 Power criterion and the relevance of underlying rights

The attribution of power to the "investor" over another entity (the "investee") is made possible through the existence of rights (even still not exercised) that give it the ability to direct relevant operating and financing activities (detailed in Appendix B (Application guidance), in paragraph B11-B13), such as (merely by way of example):

«

(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» (IFRS Foundation, 2018, p. 10).

These activities are only some of those that are able to «*[…] significantly affect the investee's returns*» (IFRS Foundation, 2018, p. 5). Within this context, "decisions about relevant activities" are also important, like (as an example): «*(a) establishing operating and capital decisions of the investee, including budgets; and (b) appointing and remunerating an investee's key management personnel or service providers and terminating their services or employment*» (IFRS Foundation, 2018, p. 11).

[110] IFRS Foundation. *IFRS 10 – Consolidated Financial Statements*. Pp. 4-5; 10. (2018). www.ifrs.org

It is extremely important, since it might be frequent in practice, considering the case in which two (or more) investors have both the ability to direct relevant activities: in this situation, they have to establish which of them is effectively able to direct the activities that «*most significantly affect […] returns consistently with the treatment of concurrent decision-making rights […]. The investors shall reconsider this assessment over time if relevant facts or circumstances change*» (IFRS Foundation, 2018, p. 11).

Since the ability to direct relevant activities stems from rights, there are no problems to assess power when the investor has exclusively voting rights that it has obtained, for instance, because it acquired some shares or other comparable equity instruments. Even when it has only potential voting rights (i.e., «*such as those arising from convertible instruments or options, including forward contracts*» (Dieter, C., Norbert, L., 2013, p. 230)[111]), power can be also easily detected; however, being voting rights just "potential", they are not currently exercisable (RSM US LLP, 2014, p. 2)[112]. But things turn complicated when power is ascribed not with voting rights, but, for example, with contractual arrangements.

Therefore, as we got to see above, power is not a synonym of control, but just a partial element for its exercise: to be attributed, power needs to be substantive. In this regard, it might be handy distinguish between "protective rights" and "substantive rights". While the former rights are defined in *IFRS 10 – Consolidated Financial Statements* in its Appendix A (Defined terms), the latter ones are defined by Dieter, C., Norbert, L. as follows:

- **Protective rights**: «*rights designed to protect the interest of the party holding those rights without giving the party power over the entity to which those rights relate*» (IFRS Foundation, 2018, pp. 8-9)[113];
- **Substantive rights**: «*For a right to be substantive, the holder must have the practical ability to exercise the right. The determination whether a right is substantive requires judgment, taking into account all facts and circumstances. […]*» (Dieter, C., Norbert, L., 2013, p. 230).

[111] Dieter C., Norbert, L. *IFRS Essentials*. West Sussex, United Kingdom. P. 230. (2013). http://onlinelibrary.wiley.com
[112] RSM US LLP. *U.S. GAAP vs. IFRS: Consolidations at-a-glance*. P. 2. (2014). www.rsmus.com
[113] IFRS Foundation. *IFRS 10 – Consolidated Financial Statements*. Pp. 8-9; 11. (2018). www.ifrs.org

Whether rights are classified as substantive depends upon the evaluation of a variety of "facts and circumstances" that might be limited by one or multiple barriers that we can spot in IF*RS 10 – Consolidated Financial Statements* in its Appendix B (Application guidance, paragraph B23). Moreover, «*when the holder of these rights would benefit from their exercise by realizing synergies with the investee, then these rights are likely to be substantive*» (Deloitte, 2013, p. 2)[114]. We report hereafter some of them only by a way of example, but this list is not exhaustive, and the presence of such barriers shall be assessed following a case-by-case approach:

«

- *financial penalties and incentives that would prevent (or deter) the holder from exercising its rights;*
- *terms and conditions that make it unlikely that the rights would be exercised (for example, conditions that narrowly limit the timing of their exercise);*
- *the inability of the holder of the rights to obtain the information necessary to exercise its rights;*
- *operational barriers or incentives (e.g., the absence of other managers willing or able to provide specialized services that would prevent (or deter) the holder from exercising its rights […]);*
- *legal or regulatory requirements (e.g., where a foreign investor is prohibited from exercising its rights)*» (IFRS Foundation, 2018, p. 14)[115].

For completeness, we cite some examples of protective rights that must not be confused with substantive ones, and they are, by way of example (listed in Appendix B (Application Guidance), paragraph B28):

«

- *a lender's right to restrict a borrower from undertaking activities that could significantly change the credit risk of the borrower to the detriment of the lender;*

[114] Deloitte. *The control concept in IFRS 10. TEN things investment managers need to know*. P. 2. (2013). www2.deloitte.com

[115] IFRS Foundation. *IFRS 10 – Consolidated Financial Statements*. Pp. 14; 16. (2018). www.ifrs.org

- *the right of a party holding a non-controlling interest in an investee to approve capital expenditure greater than that required in the ordinary course of business, or to approve the issue of equity or debt instruments;*
- *the right of a lender to seize the assets of a borrower if the borrower fails to meet specified loan repayment conditions*» (IFRS Foundation, 2018, p. 16).

3.1.2 Exposure to Variable Returns

The second fundamental prerequisite for control to exist is the «*exposure, or rights, to variable returns from the involvement with the investee*» (IFRS Foundation, 2018, p. 5)[116]. IFRS 10 strongly emphasizes the variability of returns coming from the investment, since the latter depends on the performance of the investee (which can be either positive or negative). Thus, in this way the investor cannot decide ex-ante the investment yield, thus being the investor's return strictly related to the economic results of the controlled entity. By the way, the investor will try to maximize its exposure to variability of returns, hoping that the investee's performance will be positive, such that the higher the latter, the greater the incentives to obtain rights that, in turn, will give power needed for control purposes, as confirmed by PwC's study on consolidation topic (PwC, 2018 p. 12-7)[117].

The terminology used by IFRS 10 is sometimes different from that one used by its predecessor *IAS 27 – Consolidated and Separate Financial Statements (2008),* as it is the case of "returns" instead of "benefits", thereby including negative performances as well.

Returns also depend from the "substance of the [participating] arrangement", but they do not depend whatsoever from their legal form, as highlighted by IF*RS 10 – Consolidated Financial Statements* in its Appendix B (Application guidance, paragraph B56).

While control over an investee is held exclusively by one party, nothing bans the possibility of Non-Controlling Interests of the investee to participate in its economic results (again, profits and losses are both possible forms of returns).

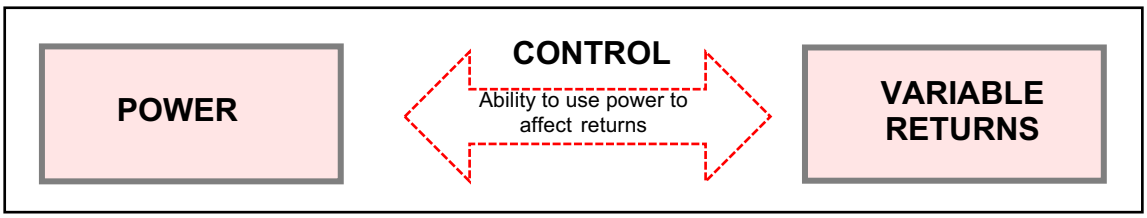
[116] IFRS Foundation. *IFRS 10 – Consolidated Financial Statements*. Pp. 5; 22. (2018). www.ifrs.org

[117] PwC. *IFRS and US GAAP: similarities and differences*. Financial Accounting Foundation. P. 12-7. (2016; 2018). www.pwc.com

The most frequent examples of returns are dividend and interest payments (Annualreporting.info, 2019)[118] (even if the payment is periodically fixed over time, e.g. with a quarterly frequency; what is variable is the amount to be paid out, being, in case of bonds, the bond holder subjected to credit risk), but tax benefits and more operating functions are possible too, as illustrated by IF*RS 10 – Consolidated Financial Statements* in its Appendix B (Application guidance, paragraph B57), such as «*economies of scale, cost savings, […], gaining access to proprietary knowledge […]*» (IFRS Foundation, 2018, p. 22).

3.1.3 How power is tied to investor's returns

The third and last aspect that is needed for control to become effective is the correlation relationship between the two elements described in the prior paragraphs, i.e. the "link between power and returns", meaning the «*[…] ability to use power over the investee to affect the amount of the investor's returns*» (IFRS Foundation, 2018, p. 4-5)[119]. It can be represented graphically as follows (Figure 3.1, *The correlation relationship between power and returns*)[120]:



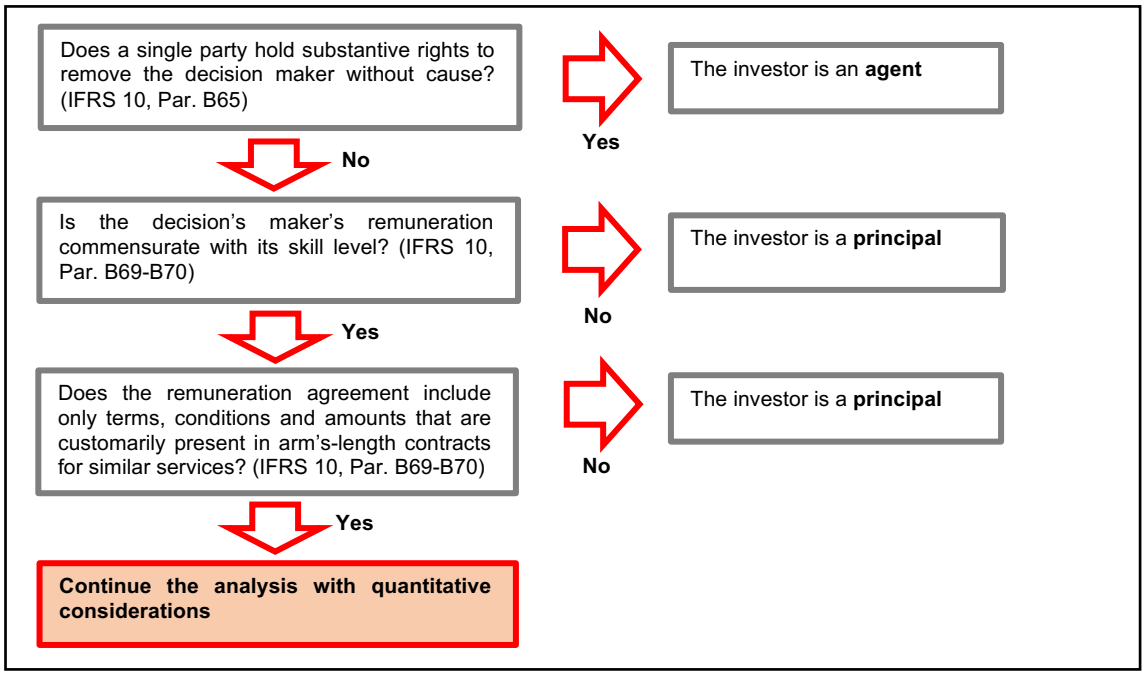
Indeed, having simply the "power over the investee" and the "exposure, or rights, to variable returns" is not enough to control the investee, but the investor has to possess the ability to use the power to affect those returns.

At the bottom of these interrelated elements there is the principal-agent relationship, since IFRS 10 requires establishing whether the investor acts as a

[118] Annualreporting.info. *The investor's exposure or right to variable returns*. (2019). www.annualreporting.info
[119] IFRS Foundation. *IFRS 10 – Consolidated Financial Statements*. Pp. 4-5; 23. (2018). www.ifrs.org
[120] Figure 3.1: *The correlation relationship between power and returns*. Figure re-elaborated by the Author.
Source: PwC. *Practical guide to IFRS. Consolidated financial statements: redefining control*. P.4. (2011). www.pwc.com.au; Deloitte. *Clearly IFRS. Moving ahead in an IFRS world. A practical guide to implementing IFRS 10 Consolidated Financial Statements*. P. 4. (2013). www2.deloitte.com

"principal" (i.e., on its own behalf) or as an "agent" (i.e., «*on behalf and for the benefit of another party or parties*», as expressed by IF*RS 10 – Consolidated Financial Statements* in its Appendix B (Application guidance, paragraph B58)). The investor, alternatively identified as the "decision-maker", is entitled to control the investee if and only if it makes decisions directly, and not through mandate of third parties. Indeed, the investor acting as an agent (being the subject delegated to make decisions upon the existence of rights) will not be given at all the control of the investee, thus not being able to benefit from the decisions made by its principal. IF*RS 10 – Consolidated Financial Statements* in its Appendix B (Application guidance, paragraph B59) further states that «*in situations where there is more than one principal, each of the principals shall assess whether it has power over the investee […]*» (IFRS Foundation, 2018, p. 23).

In determining whether the investor is a principal, quantitative and qualitative analyses might be necessary (PwC, 2012, p. 9)[121]. The next flowchart gives representation about how should be conducted a first qualitative analysis (Figure 3.2, *Qualitative analysis about the principal-agent relationship*)[122]:



[121] PwC. *A practical guide to IFRSs 10 and 12. Questions and answers*. P. 9. (2012). www.pwc.fi

[122] Figure 3.2: *Qualitative analysis about the principal-agent relationship.* Figure re-elaborated by the Author.
Source: Gornik-Tomaszewski, S., Larson, R. K. *New Consolidation Requirements Under IFRS*. St. John's University. Review of Business, Vol. 35, No. 1. Pp 47-58. P. 53. (2014). www.questia.com

Generally, after having considered firstly qualitative factors, we then should move towards the consideration of more quantitative aspects. Hence, the following factors must be taken into account if any conclusion has not been reached yet, considering always related "facts and circumstances":

«

(a) the scope of its decision-making authority over the investee;

(b) the rights held by other parties;

(c) the remuneration to which it is entitled in accordance with the remuneration agreement(s);

(d) the decision maker's exposure to variability of returns from other interests that it holds in the investee» (IFRS Foundation, 2018, p. 23)[123].

The first point regards the object of the decisions that the investor, in quality of principal, has to make according to the underlying arrangement with the investee (e.g., operating and financial choices related to the management of the controlled entity that are comprised within the relevant activities list mentioned by IFRS 10). The rights held by other parties might influence the relevant activities of the controlled entity and hinder the investor's decision-making power: when this happens, the investor would operate as an agent, thus losing the control over the investee. Third point is merely worth it from an economic point of view: indeed, the possibilities that the role played by the investor is that one covered by a principal increase significantly the greater is the remuneration given to the investor for its decision-making power. Lastly, other factors contributing to the identification of the investor as a principal are the ownership of further interests in the investee (besides controlling interests) and the associated exposure to variability of returns coming from such interests.

3.1.4 The relationship with other parties

The relationship between two entities can be much broader than just involving two subjects respectively playing the role of investor and investee. Indeed, other parties might be brought into play: in this respect, IF*RS 10 – Consolidated Financial Statements* in its Appendix B (Application guidance,

[123] IFRS Foundation. *IFRS 10 – Consolidated Financial Statements*. Pp. 23; 28. (2018). www.ifrs.org

paragraph B73) looks at the underlying arrangement (whether contractual or not) by stating that «*an investor shall consider the nature of its relationship with other parties and whether those other parties are acting on the investor's behalf (i.e., they are "de-facto agents")*» (IFRS Foundation, 2018, p. 28). The lack of an eventual contractual arrangement between the investor and investee implies a certain degree of discretion and judgmental expression by the investor to spot other parties, such that the substance prevails over the form in this case (and this does nothing less than reinforcing the concept of de-facto control of IFRS 10).

Hence, when there is not a statutory agreement regulating the investor-investee relationship, other parties «*might act as de-facto agents for the investor*» (IFRS Foundation, 2018, p. 28)[124], being for instance:

«

(a) the investor's related parties;

(b) a party that received its interest in the investee as a contribution or loan from the investor;

(c) a party that has agreed not to sell, transfer or encumber its interests in the investee without the investor's prior approval (except for situations in which the investor and the other parties have the right of prior approval and the rights are based on mutually agreed terms by willing independent parties);

(d) a party that cannot finance its operations without subordinated financial support from the investor;

(e) an investee for which the majority of the members of its governing body or for which its key management personnel are the same as those of the investor;

(f) a party that has a close business relationship with the investor, such as the relationship between a professional service provider and one of its significant clients» (IFRS Foundation, 2018, p. 28).

3.1.5 The case of Special Purpose Entities (SPEs) under IFRS 10

A particular case of consolidation is that one involving "Special Purpose Entities (SPEs)" or also called "Special Purpose Vehicles (SPVs)", regulated, at the time that were introduced, by *SIC 12 – Consolidation – Special Purpose*

[124] IFRS Foundation. *IFRS 10 – Consolidated Financial Statements*. P. 28. (2018). www.ifrs.org

Entities under the principles embedded in *IAS 27 – Separate Financial Statements*, as a PwC report confirms (PwC, 2004, p. 4)[125]. This peculiar legal device implies issues that are now subsumed in *IFRS 10 – Consolidated Financial Statements*, for periods beginning on or after 1 January 2013.

As its name suggests, a SPE is a company that is created for the achievement of a particular and well-defined scope, which is often set for a limited time period, such as «*[…] a lease [contract], a securitization of financial assets [e.g., loans or other receivables], or Research and Development (R&D) activities*» (Bank for International Settlements, 2009, pp. 11-19; Deloitte, 2012; Gorton, G., Souleles, N., 2005, p. 1)[126].

As we saw in *paragraph 2.1.3*, similarly to unconsolidated financial reporting habits, companies use SPEs in order to avoid taxes by creating ad-hoc legal stratagems in tax heavens, where tax policy is more favorable compared to the jurisdictions in which they currently operate. In a similar fashion, SPEs are created, for instance, to avoid an unfavorable regulatory regime to which they would be subject to.

Another particular circumstance in which companies create SPEs is for risk-sharing purposes, thus isolating very high-risk projects from the parent company; investors will participate in the risk by acquiring a certain number of shares of the SPE's equity.

SIC 12 – Consolidation – Special Purpose Entities in its paragraph 8 identified when a reporting entity must consolidate a SPE, thus entering in the consolidation area, by stating: «*Under SIC-12, an entity must consolidate a special purpose entity ("SPE") when, in substance, the entity controls the SPE*» (Deloitte, 2012).

The founder of a SPE is called "sponsor" and it is the subject that usually controls it, thus being in charge to handle SPE's operating and financing policies, whereas other legal parties (contractually linked or by form of other arrangements to the SPE) are not allowed to its management. Indeed, other parties cannot actively conduct the SPE, but they can, at most, participate in the funding of SPE's ordinary activities.

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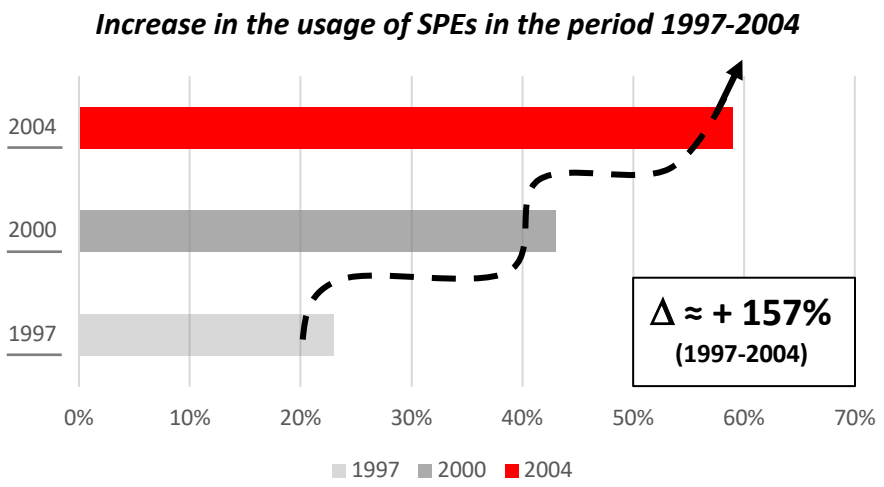
[125] PwC. *SIC-12 and FIN 46R. The substance of control*. P. 5. (2004). www.pwc.com

[126] Bank for International Settlements. *Report on Special Purpose Entities*. Pp. 11-19. (2009). www.bis.org; Deloitte. *SIC 12 – Consolidation – Special Purpose Entities.* (2012). www.iasplus.com; Gorton, G., Souleles, N. *Special Purpose Vehicles and Securitization*. The National Bureau of Economic Research. WP No. 11190. Pp. 1-63. P. 1 (2005). www.pdfs.semanticscholar.org

Since the company having the majority voting rights in the SPE will benefit from the SPE's earnings, likewise it will be exposed to business risks faced by such Special Purpose Entity. And this calls to mind what similarly IFRS 10 stated in defining control, since the latter is exercised when there is, *inter alia*, "exposure to variable returns", thus including both positive and negative results.

The use of SPEs increased significantly in the last two decades, and especially in the early 2000s, as showed by an empirical study carried out by Feng, M. et al., who analyzed a sample of 6.473 companies in the period 1997-2004. Results of this study highlighted an exponential boost in the diffusion of SPEs on a global basis, finding «*[…] a two-and-a-half-fold increase in the percent of observations reporting at least one SPV (from 23 percent in 1997 to 59 percent in 2004)*» (Feng, M. et al., 2009, p. 1835)[127]. Moreover, the highest concentration of SPVs was found in companies operating in «*[…] trading, real estate, and construction […]*» (Feng, M. et al., 2009, p. 1835).

Below, the reader would find useful to consider the illustrative chart representing the outstanding increase in SPE use (Figure 3.3, *Increase in the usage of SPEs in the period 1997-2004)*[128]:



[127] Feng, M. et al. *Special Purpose Vehicles – Empirical Evidence on Determinants and Earnings Management*. The Accounting Review, Vol. 84, No. 6. Pp. 1833-1876. P. 1835. (2009). www.jstor.org

[128] Figure 3.3: *Increase in the usage of SPEs in the period 1997-2004*. Figure created by the Author.
Source: Feng, M. et al. *Special Purpose Vehicles – Empirical Evidence on Determinants and Earnings Management*. The Accounting Review, Vol. 84, No. 6. Pp. 1833-1876. P. 1835. (2009). www.jstor.org

However, they figured out that, even if financial reporting and economic incentives to use SPVs can be sometimes really attractive and convenient, the stronger the corporate governance and the more structured organizations are, the lesser should be the use of SPEs.

A frequent phenomenon is the transfer to a SPE of assets that have been derecognized, as a valid alternative of asset sale. In particular, derecognition of assets is common when companies want to dismiss a particular financial asset (or even financial liability) from their Statement of Financial Position. In such a case, the SPE must be consolidated. «*Even if the transfer qualifies as a sale, the provisions of IAS 27 and SIC-12 may mean that the enterprise should consolidate the SPE*» (Deloitte, 2012)[129].

The assets transferred to the SPE can be utilized exclusively by the sponsor in order to accomplish the pre-defined SPE's objectives, independently from the equity's share held by the same founder (which can be, *ad absurdum*, even zero), benefiting and being exposed to the SPE's positive and negative performances (like the founder activated an "autopilot"). Again, this recalls what IFRS 10's basic principal affirms: de-facto control prevails on de jure control, since are not equity's shares determining the power of the SPE's management, but the effective, real and concrete ability to cope with its operating and financing policies.

IFRS 10 – Consolidated Financial Statements in its "Basis for Conclusions (BC76)", in defining the purpose and design of an investee, basically confirms what we have just explained, since it states:

«*SPEs […] frequently operate in a predetermined way so that no entity has explicit decision-making authority over the SPE's ongoing activities after its formation (i.e., they operate on 'autopilot'). […]. In these circumstances, control may exist for the sponsoring party or others with a beneficial interest, even though it may be particularly difficult to assess, because virtually all activities are predetermined. However, the predetermination of the activities of the SPE through an 'autopilot' mechanism often provides evidence that the ability to control has been exercised by the party making the predetermination for its own benefit at the formation of the SPE and is being perpetuated*» (IFRS Foundation, 2018, p. 63)[130].

[129] Deloitte. *SIC 12 – Consolidation – Special Purpose Entities.* (2012). www.iasplus.com
[130] IFRS Foundation. *IFRS 10 – Consolidated Financial Statements*. P. 63. (2018). www.ifrs.org

Ultimately, compared to *IFRS 10 – Consolidated Financial Statements* where the "exposure to variable returns" is an essential element to assess control, SIC-12, once again, gauged as indispensable the decision-making power, as a PwC report confirms by expressing: «*Whilst IFRS 10 states that having a large exposure to variability of returns is a relevant indicator, more weight is given to the question of whether a party has a practical ability to direct the relevant activities of the SPE*» (PwC, 2011, p. 2) [131].

3.1.6 The case of Investment Entities and other scope exceptions

As a general rule, *IFRS 10 – Consolidated Financial Statements* in its Scope section (paragraph 4) calls upon all parent companies to present consolidated financial statements: no entity that is supposed to present group accounts is excluded. But, at the same time, it identifies which are those entities that do not enter in the scope of IFRS 10. Hence, scope exceptions involve the following:

«

(i) it is a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;

(ii) its debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an Over-The-Counter (OTC) market, including local and regional markets);

(iii) it did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market; and

(iv) its ultimate or any intermediate parent produces financial statements that are available for public use and comply with IFRSs, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with this IFRS […]» (Deloitte, 2013; Deloitte, 2014; IFRS Foundation, 2018, p. 4)[132].

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[131] PwC. *Structured finance – accounting developments: Special purpose entities – Consolidation and Disclosure*. P. 2. (2011). www.pwc.com

[132] Deloitte. *IFRS 10 – The Exemption from preparing consolidated financial statements requirements in IFRS 10*. (2013). www.iasplus.com; Deloitte. *IFRS 10 – Exemption from*

We should not be confused with "scope of the firm" when discussing the "scope of consolidation", the former being just the answer to a merely economic questions ("What is the ideal size of the firm?"), while the latter identifying the group's boundaries (it answers the question: "*W*hat proportion of the firm should be included in its reporting entity?"), as clarified by Nobes, C. (Nobes, C., 2014, p. 999)[133]. And this consideration is valid both under IFRSs and US GAAPs, i.e. regardless of the accounting standard set taken as reference.

Moreover, among IFRS 10 scope exceptions enter "Investment Entities", whose particular mention is given in the following paragraph 4B*,* thereby exempting from the duty to prepare consolidated financial statements those parent companies that «*[…] in accordance with paragraph 31 of this IFRS, [are required] to measure all of its subsidiaries at fair value through profit or loss [in accordance with IFRS 9 – Financial Instruments, as confirmed by Ernst & Young]*» (Ernst & Young, 2019, p. 6; IFRS Foundation, 2018, p. 4)[134]. This means that should there be a difference between the fair value of an investment and the transaction price (i.e., the price agreed between the parties) related to such investment, this discrepancy will be accounted as profit or loss (Ernst & Young, 2012, p. 3)[135]. The choice to use fair value accounting made by the IASB is to reflect as much as possible current market conditions, which are those which investors rely much more on.

Only if the parent and the subsidiary are both investment entities (and the subsidiary provides services related to the investment activity), then the parent will have to consolidate it, otherwise not (BDO, 2015, p. 2; Deloitte, 2014)[136].

Investment entities are therefore those companies that usually possess manifold ownership interests in other firms: thus, they are intended to pursue merely investing objectives, having as a chief aim that one of increasing the investment

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preparing consolidated financial statements. (2014). www.iasplus.com; IFRS Foundation. *IFRS 10 – Consolidated Financial Statements*. P. 4. (2018). www.ifrs.org

[133] Nobes, C. *The Development of National and Transnational Regulation on the Scope of Consolidation*. Accounting, Auditing & Accountability Journal, Vol. 27, No. 6. Pp. 995-1025. P. 999. (2014). www.emeraldinsight.com

[134] Ernst & Young. *IFRS Core Tools. IFRS Update of standards and interpretations in issue at 31 December 2018*. P. 6. (2019). www.ey.com; IFRS Foundation. *IFRS 10 – Consolidated Financial Statements*. P. 4. (2018). www.ifrs.org

[135] Ernst & Young. *Investment entities final amendment. Exception to consolidation*. No. 44. P. 3. (2012). www.ey.com

[136] BDO. *Investment Entities: Applying the Consolidation Exception (Amendments to IFRS 10, IFRS 12 and IAS 28)*. International Financial Reporting Bulletin 2015/01. P. 2. (2015). www.bdo.global; Deloitte. *IASB finalises amendments regarding the application of the investment entities exception*. (2014). www.iasplus.com

income (e.g. dividends), and sometimes even with speculative purposes by taking advantage of small changes in the fair value of investments. In other words, their main goal is not to take care of managing the group's operating and financial policies.

As we saw when discussing the reporting entity concept in Australia (where entities are required to self-classify as reporting entity or not), likewise here entities are required to self-determine whether they are investment entities (considering as well facts and circumstances that, at a certain point in time, might change their status, likely losing benefits associated with such appointment: in this case, investment entity-related dispositions do not apply retrospectively).
At this stage, a question arises: How can an entity be identified as an "Investment Entity"? *IFRS 10 – Consolidated Financial Statements* in paragraph 27 states:

«[…] An investment entity is an entity that:
(a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services;
(b) commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and
(c) measures and evaluates the performance of substantially all of its investments on a fair value basis» (IFRS Foundation, 2018, p. 7)[137].

These conditions must be verified simultaneously. Moreover, in paragraph 28, further requirements are explicated:

«an entity shall consider whether it has the following typical characteristics of an investment entity:
(a) it has more than one investment […];
(b) it has more than one investor […];
(c) it has investors that are not related parties of the entity […]; and
(d) it has ownership interests in the form of equity or similar interests […]» (IFRS Foundation, 2018, p. 7).

[137] IFRS Foundation. *IFRS 10 – Consolidated Financial Statements*. P. 7. (2018). www.ifrs.org

Nevertheless, it is relevant to notice that the latter criteria are not mandatory to classify a parent company as an investment entity: if one (or more) of them are not respected, additional disclosure shall be given according to *IFRS 12 – Disclosure of Interests in Other Entities*.

Examples of entities that might be classified as investment entities are: pension funds, hedge funds, mutual funds, venture capital organizations, private equity funds and the like.

Investment entities are considered as such regardless of the subsidiaries' nature, which can be in turn either investment entities or not.

According to paragraph 32 of *IFRS 10 – Consolidated Financial Statements*, a parent company that would have all the requirements to be classified as an investment entity (thus being exempted to present consolidated financial statements), but whose subsidiaries are only constituted to provide services related to the parent's investment activities (actually taking the role of investment entities themselves), can still be classified as such, but no scope exceptions will apply, thus having to consolidate its subsidiaries as usual, in accordance with the IFRS 10 Standard rules.

Eventually, investment entities constitute a quite recent legal device for not presenting consolidated financial statements, since in the past just limited scope exceptions were allowed according to IAS 27 (Deloitte, 2014)[138]. Indeed, in agreement with Gluzová, T., «*[…] consolidation exception for investment entities has been in practice for a limited period of time, [therefore] its impact on financial statements of companies is yet to be analyzed further in the future*» (Gluzová, T., 2015, p. 35)[139], thus leaving room for future research studies.

3.2 The Variable Interest Entity (VIE) model under US GAAP ASC 810

In this second part of the chapter, we shift our attention to the US regulation by investigating the models through which control is established, allowing companies (that comply with US rules) to define which are the entity's boundaries to be considered for consolidation purposes. As we discussed in *paragraph 2.3.3*, de jure control in US jurisdictions requires "direct or indirect

[138] Deloitte. *IFRS 10/IAS 28 – Investment entity amendments*. (2014). www.iasplus.com
[139] Gluzová, T. *Consolidation Exemptions under IFRS*. Elsevier B. V. Procedia Economics and Finance 25 (2015). Pp. 32-40. P. 35. (2015). www.sciencedirect.com

ownership of the majority voting rights" (i.e., more than 50 percent of the outstanding voting shares, as prescribed by ASC 810-10-05) for a Controlling Financial Interest to exist.

Therefore, FASB identified two main models for consolidating group accounts: "Variable Interest Entity (VIE)" and "Voting Interest Entity" models. We will focus firstly on the former just because the Voting Interest Entity is a residual model, meaning that it applies only when the VIE model is not applicable.

3.2.1 The identification of a Variable Interest

Before identifying the reporting entity in charge of the preparation of consolidated financial statements, it is essential to determine «*which consolidation model to apply*» (Deloitte, 2010, p. 6)[140] and to «*identify a Variable Interest Entity*» (Harvard Law School Forum on Corporate Governance and Financial Regulation, 2018)[141]. Indeed, the question is not trivial at it might seem: here, we are not dealing anymore with just a single control model (as we did for IFRSs), but we have to shed light on the conditions that are needed to distinguish whether the VIE model is required.

When the VIE model applies, the consolidating entity is called "Primary Beneficiary", whilst the investee being consolidated is also known as "Variable Interest Entity (VIE)". The criterion to discern if an investor that is going to present group accounts has to apply one model (i.e., the VIE model) over another one (i.e., the Voting Interest Entity model) exclusively lies on the classification of the legal entity as a potential VIE. This means that should the investee be a VIE, then the VIE model apply, otherwise the reporting entity will comply with the Voting Interest Entity model or other applicable GAAP, as suggested by Deloitte (Deloitte, 2015, p. 6; Deloitte, 2019, p. 9)[142].

As we may recall from *paragraph 2.3.2*, the VIE model attributes control based on the determination on which party has power and benefits over the investee. The recognition of control based on the existence of a Controlling Financial

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[140] Deloitte. *Consolidation of Variable Interest Entities. A roadmap to applying the Variable Interest Entities Consolidation Model*. P. 6. (2010). www.iasplus.com

[141] Harvard Law School Forum on Corporate Governance and Financial Regulation. *Reporting Obligations of Variable Interest Entities*. (2018). www.corpgov.law.harvard.edu

[142] Deloitte. *Consolidation. A Roadmap to Identifying a Controlling Financial Interest*. P. 6. (2015). www2.deloitte.com; Deloitte. *A Roadmap to Consolidation. Identifying a Controlling Financial Interest*. Financial Accounting Foundation. P. 9. (2019). www2.deloitte.com

Interest pursuant to ASC 810-10-55-16, instead, relates to the Voting Interest Entity model. Moreover, ASC 810-10-55-17 further specifies:

«The identification of variable interests requires an economic analysis of the rights and obligations of a legal entity's assets, liabilities, equity, and other contracts. Variable interests are contractual, ownership, or other pecuniary interests in a legal entity that change with changes in the fair value of the legal entity's net assets exclusive of variable interests […]» (Financial Accounting Foundation, 2019, p. 12) [143].

In general, as a PwC report confirms (PwC, 2011, p. 2)[144], all entities that are controlled by the reporting entity must be consolidated (although, there are some exemptions that will be faced more in-depth afterwards in *paragraph 3.2.6*). Further, ASC 810-10-05-10 states:

«*Some relationships between reporting entities and VIEs are similar to relationships established by majority voting interests, but VIEs often are arranged without a governing board or with a governing board that has limited ability to make decisions that affect the VIE's activities. A VIE's activities may be limited by the articles of incorporation, bylaws, partnership agreements, trust, […] or contractual agreements between the parties involved with the VIE*» (Financial Accounting Foundation, 2019, p. 33).

ASC 810-10-05-6 includes a "consolidation decision tree" that gives overall guidance on several topics, such as which accounting model to apply, how to identify a VIE, which are scope exceptions of the VIE model (i.e., whether a primary beneficiary should consolidate a VIE) and when the reporting entity consolidates group accounts according to the Voting Interest Entity model.
The next flowchart can be intended as a smaller part of the broader above-mentioned consolidation decision tree (Figure 3.4, *Consolidation decision tree – The choice of the consolidation model to apply)*[145]:

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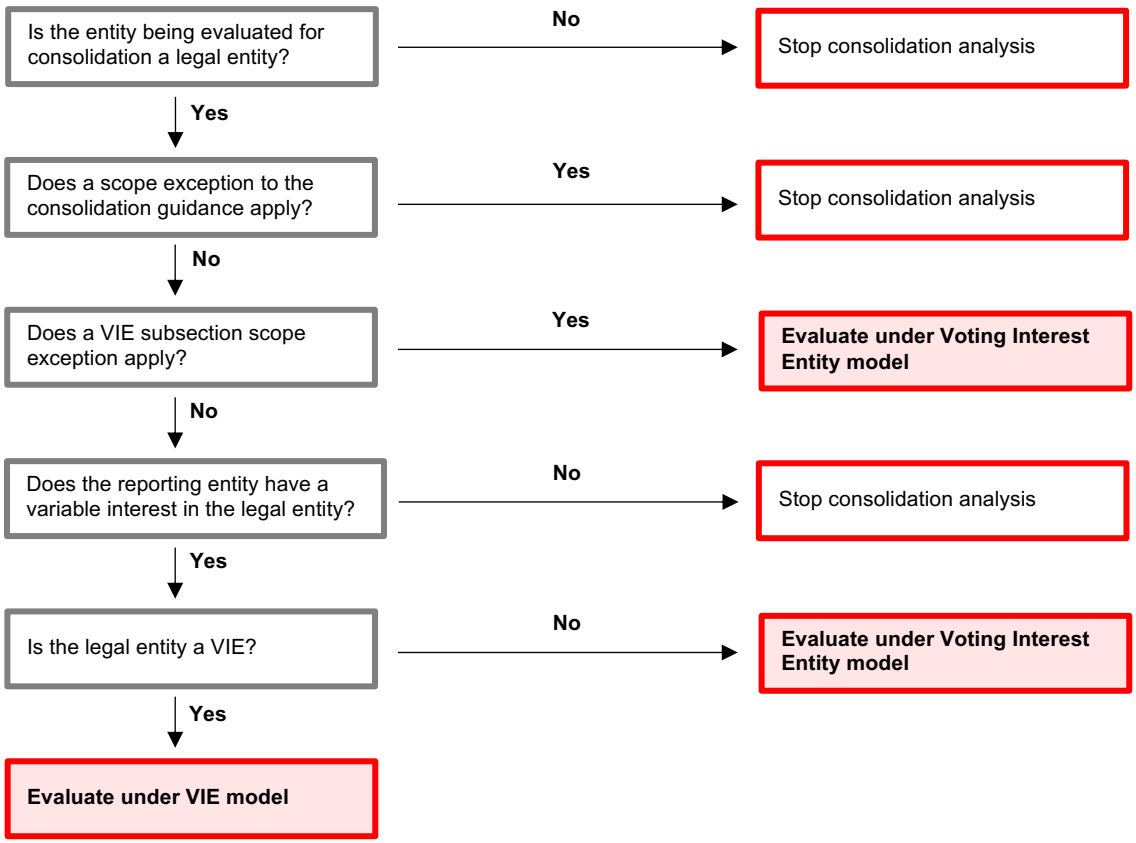
[143] Financial Accounting Foundation. *ASC 810 – Consolidation.* P. 12; 33. (2019)
[144] PwC. *Consolidation standard (IFRS 10) revises definition of control*. IFRS bulletin from PwC. P. 2. (2011). www.pwc.in
[145] Figure 3.4: *Consolidation decision tree – The choice of the consolidation model to apply*. Figures re-elaborated by the Author.
Source: Financial Accounting Foundation. *ASC 810 – Consolidation.* P. 31-32. (2019)



Once the consolidation model has been chosen, to classify as such, the VIE must present one of the criteria identified by ASC 810-10-15-14:

«

- *the legal entity does not have sufficient equity investment at risk;*
- *the equity investors at risk, as a group, lack the characteristics of a controlling financial interest;*
- *the entity is structured with disproportionate voting rights, and substantially all of the activities are conducted on behalf of an investor with disproportionately few voting rights*» (Financial Accounting Foundation, 2019, pp. 38-40)[146].

Therefore, likewise IFRS rules, also US GAAP Standards requires a certain level of discretion when accounting for VIEs, though always keeping in mind that US GAAP Principles are rules-based (hence, no too much room for judgment should

[146] Financial Accounting Foundation. *ASC 810 – Consolidation.* Pp. 38-40. (2019)

be left when assessing control), in consonance with Reinsten, A., Churyk, N. T. (Reinsten, A., Churyk, N. T., 2013, p. 57)[147].

3.2.2 The primary beneficiary using the VIE model

In the previous paragraph we have familiarized with the VIE model by introducing the primary beneficiary. The latter is nothing more than the consolidating entity when a variable interest is recognized in the legal entity being consolidated (i.e., the VIE).

As an in-depth analysis is required for determining when an entity is a VIE, likewise it is not that automatic that every reporting entity is a primary beneficiary. Indeed, ASC 810-10-25-38A imposed to the reporting entity to perform a qualitative self-assessment of whether it possesses both the two elements that determines control under the VIE model, i.e.:

«

a) The power to direct the activities of a VIE that most significantly impact the VIE's economic performance;

b) The obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE» (Financial Accounting Foundation, 2019, p. 66)[148].

Considering point b) for a while, the quantitative expressions (such as "expected losses", "expected residual returns" and "expected variability") that can be implicitly spotted are not sufficient to determine whether a reporting entity has obligations or rights, but the presence of the latter must be verified.

Moreover, for any VIE, there is only one primary beneficiary (and it is not sure at 100% that it exists if control is not detected because, for instance, one or more requisites are lacking, meaning the power criterion, the economic criterion or both). However, this does not mean that a reporting entity should not be classified as primary beneficiary only because another entity is entitled to: as a matter of fact, «*each reporting entity must independently analyze its involvement*

[147] Reinsten, A., Churyk, N. T. *Auditing and Accounting for the Consolidation of Variable Interest Entities*. Journal of Corporate Accounting & Finance, Vol. 24, No. 6. Pp. 55-57. P. 57. (2013). www.onlinelibrary.wiley.com

[148] Financial Accounting Foundation. *ASC 810 – Consolidation.* P. 66. (2019)

with a legal entity, including whether the entity is a VIE and whether it should consolidate the VIE» (Deloitte, 2015, p. 152; Deloitte, 2019, p. 190)[149].

3.2.3 May the power criterion be affected by some rights?

The primary beneficiary's power to direct relevant activities may be affected by the existence of two kinds of rights: "**kick-out rights**" and "**participating rights**". *US GAAP ASC 810 – Consolidation* in its Glossary section (810-10-20) defines the former as: «*the ability to remove the entity with the power to direct the activities of a VIE that most significantly impact the VIE's economic performance or to dissolve (liquidate) the VIE without cause*» (Financial Accounting Foundation, 2019, p. 50)[150], while participating rights are defined as: «*the ability to block or participate in the actions through which an entity exercises the power to direct the activities of a VIE that most significantly impact the VIE's economic performance […]*» (Financial Accounting Foundation, 2019, p. 54).

These two typologies of rights basically impact negatively the power criterion leading to the loss of control on the VIE (Deloitte, 2019)[151]. As a consequence, the primary beneficiary will lose its qualification (even if the economic criterion may still persist), thus entailing the fact that it will not be anymore in charge of the preparation of consolidated financial statements.

Kick-out rights, to be effective, must be held exclusively by a single party that it is not the primary beneficiary (and, at most, by its related parties and de-facto agents, which will be both considered in *paragraph 3.2.4*); moreover, they have to be exercised without cause.

With regard to the possession of such rights by a single party, Deloitte investigated whether the primary beneficiary's Board of Directors (BoD) might have been considered in the position to exercise kick-out rights (Deloitte, 2015, p. 167; Deloitte, 2019, p. 210): however, since the BoD is composed usually by several members who are very often the reporting entity's shareholders, this

[149] Deloitte. *Consolidation. A Roadmap to Identifying a Controlling Financial Interest*. Pp. 152; 167. (2015). www2.deloitte.com; Deloitte. *A Roadmap to Consolidation. Identifying a Controlling Financial Interest*. Financial Accounting Foundation. Pp. 190; 210. (2019). www2.deloitte.com

[150] Financial Accounting Foundation. *ASC 810 - Consolidation.* Pp. 50; 54. (2019). www.asc.fasb.org

[151] Deloitte. *Life Sciences. Accounting and Financial Reporting Update – Including Interpretative Guidance on Consolidation*. P. 144. (2019). www2.deloitte.com

implies that the BoD cannot be considered as a single party. One particular case of exception is allowed when there is the ownership of more than 50% of voting rights held by a shareholder representing the BoD.
Secondly, kick-out rights must be substantive, meaning that there should not be any barrier that limits or prevents their exercise.

Hitherto, we have just seen how kick-out rights operate, but likewise participating rights must be exercised by a single party and be substantive. Participating rights are exactly the opposite of protective rights (that we discussed in *paragraph 3.1.1* when looking at the power criterion under IFRS regulation), forasmuch as they do not protect a party's interests.
Therefore, as reported by Reinsten, A. et al. (Reinsten, A. et. al., 2012, p. 58)[152], the exercise of kick-out rights and/or participating rights will entail the deconsolidation of the VIE departing from the date when the control is lost, resulting in unexpected gains or losses that might deface significantly the ex-ante economic-financial situation of the primary beneficiary.

3.2.4 Related parties and de-facto agents

The existence of other parties besides the usual two entities (i.e., the investor and the investee) must be carefully considered (as we did with IFRS rules in *paragraph 3.1.4*), since interests in related parties might be held intentionally with goals that can be outside of consolidation purposes, e.g. in the day-to-day transactions (Deloitte, 2018)[153].
The relationship with related parties varies whether such parties are under common control. In this respect, as a Deloitte report confirms, an explicit definition of what "common control" is not provided by *ASC 810 – Consolidation* (Deloitte, 2016, p. 3)[154]: though, it can be derived from ASU 2015-02, where *paragraph BC69* states that, under the VIE model, the following entities are examples of companies under common control: «*subsidiaries controlled (directly or indirectly) by a common parent, or a subsidiary and its parent*» (Financial Accounting

[152] Reinsten, A. et al. *Changes in Accounting and Auditing for consolidation of Variable Interest Entities*. Journal of Corporate Accounting & Finance, Vol. 23, No. 4. Pp. 55-60. P. 58. (2012). www.onlinelibrary.wiley.com
[153] Deloitte. *ASC 805 – Related Party Disclosures*. (2018). www.iasplus.com
[154] Deloitte. *A Roadmap to Common-Control Transactions*. P. 3. (2016). www2.deloitte.com

Standards Board, 2015, p. 140)[155]. In addition, the VIE model acknowledges also the existence of "de-facto agents", who are mandated to exercise rights and assume duties on investor's behalf.

US GAAP ASC 810 – Consolidation in its Glossary Section provides a set of subjects who can configure as related parties. In particular:

«*Related parties include:*

a) Affiliates of the entity;
b) Entities for which investments in their equity securities would be required, absent the election of the fair value option, to be accounted for by the equity method by the investing entity;
c) Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management;
d) Principal owners of the entity and members of their immediate families;
e) Management of the entity and members of their immediate families;
f) Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests […]» (Financial Accounting Foundation, 2019, p. 55)[156].

Therefore, all these subjects potentially might be consolidated within the reporting entity's boundaries, always keeping in mind that all relevant facts and circumstances must be taken into consideration, as well as a certain degree of judgment is required, especially in complex structures. The relationship with other parties is arranged in a measure that is directly proportional with the interest held in the related entity. For instance, let us imagine the following very simple case: the primary beneficiary (that we call subject "A") holds a 30 percent-interest in a related party (subject "B"), which in turn owns a 50 percent-interest in the VIE (subject "C"). The indirect interest held by A in C through the related party B will correspond to a 15-percent direct interest of A in the VIE.

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[155] Financial Accounting Standards Board. *Consolidation (Topic 810) – ASU No. 2015-02 – Amendments to the Consolidation Analysis.* P. 140. (2015). www.fasb.org; www.asc.fasb.org
[156] Financial Accounting Foundation. *ASC 810 - Consolidation.* Pp. 55; 69. (2019). www.asc.fasb.org

Moreover, ASC 810-10-25-43 deals with de-facto agents, such as:

«

a) A party that cannot finance its operations without subordinated financial support from the reporting entity (for example, another VIE of which the reporting entity is the primary beneficiary);

b) A party that received its interests as a contribution or a loan from the reporting entity;

c) An officer, employee, or member of the governing board of the reporting entity;

d) A party that has an agreement that it cannot sell, transfer, or encumber its interests in the VIE without the prior approval of the reporting entity.

The right of prior approval creates a de-facto agency relationship only if that right could constrain the other party's ability to manage the economic risks or realize the economic rewards from its interests in a VIE through the sale, transfer, or encumbrance of those interests.

However, a de-facto agency relationship does not exist if both the reporting entity and the party have right of prior approval and the rights are based on mutually agreed terms by willing, independent parties.

e) A party that has a close business relationship like the relationship between a professional service provider and one of its significant clients» (Financial Accounting Foundation, 2019, p. 69).

As we may notice, both above-mentioned related parties and de-facto agents' lists do not mention those entities that provide "employee benefit plans". The latter ones are basically further benefits granted to employees, besides and complementary to the basic salary, such as medical insurance policies, pensions, wellness programs and the like to improve the work-life and provide economic support in their post-employment period. They are subjected to the rules contained in *ASC 712 – Compensation – Non-retirement Post-employment Benefits* and in *ASC 715 – Compensation – Retirement Benefits,* thus being excluded from the consolidation area (they represent a scope exception, as we will see in *paragraph 3.2.6*) and, for this reason, not eligible for being a related party or be involved in a de-facto agency relationship (Ernst & Young, 2017, p. 43; Ernst & Young, 2019, p. 42)[157].

[157] Ernst & Young. *Consolidation. Determination of a controlling financial interest and accounting for changes in ownership interests (after the adoption of ASU 2015-02)*. P. 43. (2017)

Eventually, Grant Thornton recalls the situation when the «*power to direct the most significant activities of a VIE*» are exercised by multiple parties, such that there is not any primary beneficiary at all (Grant Thornton, 2017, p. 42)[158].

3.2.5 The case of Special Purpose Entities (SPEs) in the dynamic US regulatory environment

Special Purpose Entities are very common also in the US environment and the reasons behind the choice to create a SPE/FVC are basically the same we discussed in *paragraph 3.1.5* (e.g., leasing, tax purposes, separation of the financial risk of the group, transfer or securitization of assets, risk-sharing related to a specific project, barely to mention some of them).

As a rule of thumb, a SPV works as follows: a SPE is created by the sponsor (usually, under the legal form of a limited liability company or a trust to actually limit the exposure to third parties that might promote excessive credit claims). Once the SPE is formed, unrelated parties can invest in it, thus obtaining a residual equity interest.

Then, not necessarily in chronological order, the sponsor contributes fixed assets in exchange of cash proceeds from forthcoming credit financing or a contractual arrangement giving the sponsor a right to use the SPV's assets.

As a last stage, through a securitization of SPV's assets, the latter should be able to obtain credit financing from a third-party thereby using the proceeds to give to the sponsor a compensation for its asset contribution. Below we give illustration of a possible SPV structure (Figure 3.5, *A typical structure for creating a Special Purpose Entity*)[159]:

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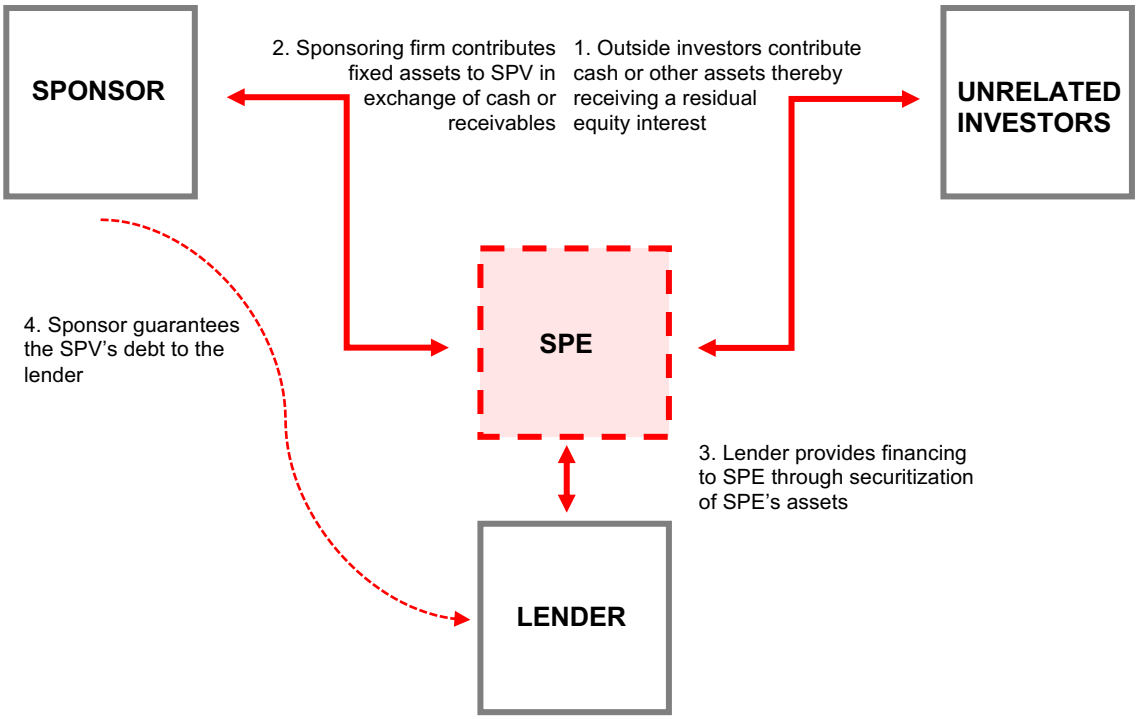
www.ejjapan.jp; Ernst & Young. *Consolidation. Determination of a controlling financial interest and accounting for changes in ownership interests*. P. 42. (2019). www.ey.com;

[158] Grant Thornton. *New Developments Summary. Step-by-step approach to applying the VIE consolidation model. Updated for ASU 2015-02, Amendments to the Consolidation Analysis*. P. 42. (2017). www.grantthornton.com

[159] Figure 3.5: *A typical structure for creating a Special Purpose Entity*. Figure re-elaborated by the Author.

Source: Feng, M. et al. *Special Purpose Vehicles – Empirical Evidence on Determinants and Earnings Management*. The Accounting Review, Vol. 84, No. 6. Pp. 1833-1876. P. 1837. (2009). www.jstor.org.



The most important aspect regarding SPEs, that is in line with the central goal of the present work, is to try to investigate when they collocate within or outside the consolidation perimeter. On one hand, until proven otherwise, a Special Purpose Entity that is not a Variable Interest Entity must not be consolidated. On the other hand, as some authors revealed:

«*[…] consolidating assets and liabilities of SPEs may also enhance perceived informativeness by promoting the reclassification of items before bottom-line earnings. […]. The reclassification gives more faithful information about how earnings have been achieved and enhances the accuracy of evaluations of profitability, which is likely to increase the judged quality of earnings (Hirst et al., 2007)*» (Luo, T., Warfield, T., 2014, p. 540)[160].

Until late 90s, as confirmed by Hartgraves, Al L., Benston, G. J. (Hartgraves, Al L., Benston, G. J., 2002, pp. 247-248)[161], no FASB accounting guidance was governing SPEs. Only the *Emerging Issue Task Force (EITF)*,

[160] Luo, T., Warfield, T. *The implementation effects of expanded consolidation: the case of consolidating special purpose entities*. Accounting and Finance, Vol. 54. Pp. 539-566. P. 540. (2014). papers.ssrn.com
[161] Hartgraves, Al L., Benston, G. J. *The Evolving Accounting Standards for Special Purpose Entities and Consolidations*. The American Accounting Association. Accounting Horizons, Vol. 16, No. 3. Pp. 245-258. Pp. 247-248. (2002). www.researchgate.net

created ad-hoc to address those topics not directly covered by the FASB, started looking at this emerging phenomenon appearing in the business scenario.

Afterwards, FASB decided to take charge of the situation directly: it did it by issuing before "Statement of Financial Accounting Standards (SFAS) 125 – Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities", then replaced by SFAS 140, finally changing name into "Accounting for Transfers of Financial Assets" with Statement of Financial Accounting Standards (SFAS) 166. Especially in the aftermath of the global financial crisis, though, new, more modern regulatory changes regarding SPEs were coming to light in order to align US GAAP Principles to the changed market and economic conditions. Indeed, regulators and policymakers worldwide became aware of the potentialities that SPEs might have, often conceived in practice to firm's earnings management, as the most exemplary and famous bankruptcy case showed belonging to the US history in the last century: Enron did a large use of SPEs to conceal profits, resulting in a firm's poor management and leading to its failure very early.

That is why FASB issued *ASC 860 – Transfers and Servicing*, effective from 15 November 2009 on: indeed, *US GAAP ASC – 810 Consolidation* did not provide specific guidance related to Special Purpose Entities. ASC 860 is divided in main five sections: "860-10 Overall", "860-20 Sales of Financial Assets", "860-30 Secured Borrowing and Collateral", "860-40 Transfers to Qualifying Special Purpose Entities (QSPEs)", "860-50 Servicing Assets and Liabilities". However, ASC 860-40 was replaced by "ASU 2009-16 – Transfers and Servicing (Topic 860)", where the QSPE concept no longer existed (Financial Accounting Standards Board, 2009, p. 4)[162]. QSPEs were entities that, besides being independent and legally separated from the sponsor, held exclusively financial assets, as well being required to have complete control on them. Having these minimum requirements, an asset transfer could have been treated as a sale.

Ultimately, we believe that there is still margin of improvement for years to come by fine-tuning the SPE regulatory environment in the United States, since rules governing SPVs have been object several times of amendments and replacements so far. At the same time, Special Purpose Entities should not be

[162] Financial Accounting Standards Board. *Transfers and Servicing (Topic 860) – ASU No. 2009-16 – Accounting for Transfers of Financial Assets*. (2009). www.asc.fasb.org

seen by firms solely with fraudulent purposes, but as an opportunity to strengthen corporate disclosure and better satisfy stakeholders' needs.

3.2.6 Scope exemptions

As we observed when facing IFRS scope exceptions in *paragraph 3.1.6*, *US GAAP ASC 810 – Consolidation* in its Scope section (810-10-15) requires likewise all parent companies to present consolidated financial statements. Nevertheless, some entities do not enter in the scope of ASC 810. Scope exceptions involve, besides legal entities, also transactions and events that are not subjected to the consolidation rules treated throughout the Codification. Indeed, pursuant to ASC 810-10-15-12, exceptions to consolidation are generally subjected to other GAAPs or guidance: in other words, they are not compliant to ASC 810. There are basically four different categories of subjects: 1) "employee benefit plans" (whose investment will be account by the reporting entity at fair value); 2) "investment entities", conforming to *ASC 946 – Financial Services – Investment Companies*; 3) "governmental organizations"; 4) "money market funds", comprehending those «*included in Rule 2a-7 of the Investment Company Act of 1940 […] [regulating] registered money market funds*» (Financial Accounting Foundation, 2019, p. 37)[163]. In the second case, investment entities can only be consolidated by other investment companies, unless the investee that is not an investment entity provides anyway investing services to the investor. The fourth case had been introduced to incentivize such funds to hold investment with less aggressive maturities and higher credit ratings (i.e., less profitable). Therefore, in all the four cases, the reporting entity should not proceed to consolidate the legal entity's accounts.

Companies representing scope exceptions will certainly avoid from being analyzed by the reporting entity about whether the VIE model shall apply. In the same fashion, it is likely that a legal entity that might be exempted from consolidation under the VIE model is eligible for being consolidated under the Voting Interest Entity model.

As a matter of fact, once it has been determined that an entity does not represent a scope exception for consolidation purposes, a further evaluation should be

[163] Financial Accounting Foundation. *ASC 810 - Consolidation.* Pp. 37; 41. (2019). www.asc.fasb.org

done with respect to whether the same entity qualifies for a scope exception to the VIE model. Notably, in this regard, 810-10-15-17 set four scope exceptions: 1) "Not-for Profit (NFP) entities", for which the Voting Interest Entity model applies; 2) "Separate accounts of life insurance entities", that are regulated by *ASC 944 – Financial Services – Insurance*; 3) "Exhaustive efforts" made by the reporting entity in collecting information about the legal entity where there is the «*inability to obtain the necessary information*» (Financial Accounting Foundation, 2019, p. 41); 4) "Business entities". To determine the last scope exception, the reporting entity must go through a two-step process that, according to Deloitte, consists in:

«*1) the decision about the legal entity's characteristics (i.e., whether it is a business, and its activities); and*
(2) the reporting entity's relationship with the legal entity (i.e., the extent of involvement by the reporting entity in the design or redesign of the legal entity, whether the legal entity is designed so that substantially all of its activities either involve or are conducted on behalf of the reporting entity and its related parties, and whether the reporting entity and its related parties provided more than half of the subordinated financial support)» (Deloitte, 2019, p. 35; Deloitte, 2019, p. 45)[164].

Concluding, it is important that companies qualify for scope exceptions (from consolidation in general or from the VIE model) if and only if above-mentioned conditions apply. Otherwise, trying to not consolidate the legal entity's accounts without having pre-requisites has to be considered just for the sake of convenience or for feeding bad intentions, such as through off-balance sheet accounting, firm's earning management, as confirmed by the literature (Holzmann, O., Robinson, T., 2004, p. 89)[165].

[164] Deloitte. *Consolidation. A Roadmap to Identifying a Controlling Financial Interest*. P. 35. (2015). www2.deloitte.com; Deloitte. *A Roadmap to Consolidation. Identifying a Controlling Financial Interest*. Financial Accounting Foundation. P. 45. (2019). www2.deloitte.com
[165] Holzmann, O., Robinson, T. *FASB revisits variable interest entities*. Journal of Corporate Accounting & Finance, Vol. 15, No. 4. Pp. 89-91. P. 89. (2004). www.ebsco.com

3.3 The Voting Interest Entity model under US GAAP ASC 810

The Voting Interest Entity is the second accounting model (after the VIE model) that *US GAAP ASC 810 – Consolidation* recognizes for consolidating group accounts. The rules for accounting of a Controlling Financial Interest are those that we already discussed in *paragraph 2.3.1*, i.e. control based on existing voting rights. Sometimes a Controlling Financial Interest is identified, besides through the ownership of shares, when the bylaws or other contractual arrangements envisage it (e.g., two-thirds of the outstanding voting shares).

Under the Voting Interest Entity model, ASC 810 distinguishes two categories (i.e., a) "Corporations" in ASC 810-10; and b) "Limited partnerships (and similar entities, like Research and Development arrangements)" in ASC 810-20). If it is not possible to distinguish whether an entity belongs to one category or to the other one (e.g., Limited Liability Companies, trusts, etc.), then their governing documents should be complete enough to let understand if the entity is likely closer to a corporation or to a limited partnership (or similar entity), in order to be able to decide which model to apply. So, in order to understand main differences between these two legal forms, let us focus on them separately from now on in the remainder of the paragraph.

Throughout the chapter, the reader should consider, when referring to limited partnerships, also similar legal entities (even when it is not specified). The latter ones are companies (like, for instance, a Limited Liability Company (LLC)) that basically works as a limited partnership, having a similar (if not identical) legal arrangement and perhaps the akin operating structure.

As for limited partnerships (and similar entities), a Controlling Financial Interest is detected by considering:

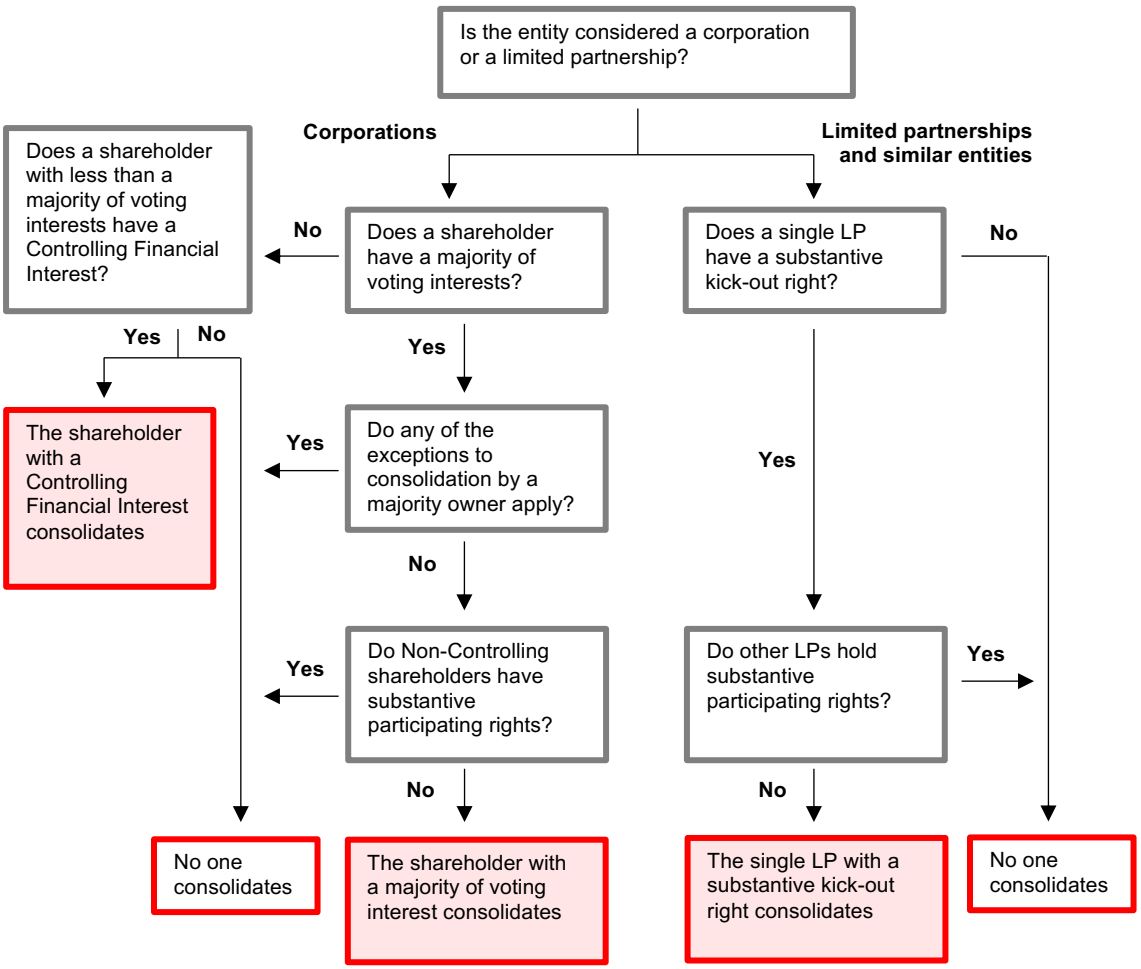
«

(1) whether any limited partner owns substantive kick-out rights that give it the unilateral right to remove the general partner or dissolve the partnership without cause; and

(2) whether the non-controlling limited partners do not have substantive participating rights» (Deloitte, 2015, p. 9; Deloitte, 2019, p. 11)[166].

[166] Deloitte. *Consolidation. A Roadmap to Identifying a Controlling Financial Interest*. P. 9. (2015). www2.deloitte.com; Deloitte. *A Roadmap to Consolidation. Identifying a Controlling Financial Interest*. Financial Accounting Foundation. Pp. 11-12. (2019). www2.deloitte.com

After ASU 2015-02, the "General Partner (GP)" cannot consolidate a limited partnership anymore, but instead the consolidation role has to be exercised by a "Limited Partner (LP)" that has the unilateral right to remove the GP or dissolve the partnership arrangement (for fiscal years beginning on or after 1 January 2016). Prior, the consolidation role was left to the GP because it prevailed the presumption that its decision-making power was far above the passive role played by LPs. As for corporations, meaning those subjects that are not limited partnerships (and similar entities) or VIEs, a Controlling Financial Interest exists if there is «*the continuing power to govern the financial and operating policies of an entity*» (Financial Accounting Foundation, 2019, p. 12)[167]. Below the flowchart summarizes major steps for determining whether to consolidate and who is in charge of consolidating group accounts (Figure 3.6, *The Voting Interest Entity model – Summary Framework)*[168]:



[167] Financial Accounting Foundation. *ASC 810 - Consolidation.* P. 12. (2019). www.asc.fasb.org
[168] Figure 3.6: *The Voting Interest Entity model – Summary Framework*. Figure re-elaborated by the Author.
Source: PwC. *Consolidation and equity method of accounting*. Financial Accounting Foundation. P. 3-3. (2019). www.pwc.com

Eventually, besides the Voting Interest Entity and VIE models, there is another form of control contemplated by ASC 810-10, but the latter plays a marginal role nowadays since the VIE model prevails: we are talking of "control by contract" (also commonly known as "consolidation by contract"). Examples of control by contract include: a) a minority voting interest that, by virtue of contractual arrangements, has the ability to direct the legal entity's activities; b) a majority voting interest obtained by the reporting entity by virtue of a contractual arrangement through which the minority shareholders will always vote in favor of the reporting entity's decisions, so that no veto by them is allowed.
The rarely adoption in practice of this control model is due to the fact that a contract-controlled legal entity is very likely considered to be a VIE since it possesses one of the conditions that are needed to be recognized as such, i.e. «*equity investors at risk must control the most significant activities of the legal entity*», as confirmed by Deloitte (Deloitte, 2015, p. 9; Deloitte, 2019, p. 12).

3.4 Comparing the VIE and the Voting Interest Entity models: Which one is better?

This second to last paragraph is intended to provide a valid summary comparison between the two models that we have discussed so far under US rules. However, the objective is not that one to find a magic formula that works always and will give us guidance in order to determine which model is better in any occasion: indeed, according to facts and circumstances and to the business that we are considering, there is not a model better than the other one. Instead, only one model is applicable considering how control is exercised, as well as group's accounting requirements and organization's needs, in such a way that no other model is permitted.

On one hand, the VIE model recognizes control to the primary beneficiary only if there is the «*power to direct the activities […]*» and the «*obligation to absorb losses […] or the right to receive benefits […]*» (refer to *paragraph 3.2.2* for full description). In order to determine which reporting entity will consolidate the legal entity (thus playing the role of the primary beneficiary), unlike the Voting Interest Entity model, a list of activities must be taken into consideration. On the other hand, the Voting Interest Entity model distinguishes between corporations (other than limited partnerships) and limited partnerships (and similar entities). In

both cases, the ownership of the majority voting rights is needed. In addition, as for limited partnerships (and similar entities), the ownership of the kick-out rights belonging to the limited partner is mandatory. We have also seen that, for both categories of enterprises, there might be control without the majority voting rights (i.e., “control by contract”).

Continuing the comparative analysis, if we look attentively at the presence of related parties, under the Voting Interest Entity model they are not considered whatsoever, whereas, according to the VIE, related parties and de-facto agents must be contemplated, since it can happen that even one related party has to consolidate mandatorily the legal entity when the reporting entity is unable to do so.

Coming to participating rights, the VIE model requires them to be substantive and that they must be held only by one reporting entity that unilaterally exercise them. Moreover, substantive participating rights allow the reporting entity to determine whether a legal entity is a VIE. To be considered as such, substantive participating rights require the legal entity participating in significant financial and operating decisions during the entity’s life. Differently from the VIE model, substantive participating rights in the Voting Interest Entity model held by LPs or NCIs, exercised in some significant financial and operating decisions, entail the preclusion or the interruption of the consolidation process at the expense of the GP.

Last element of the comparative analysis that we face is the subsistence of potential voting rights. The Voting Interest Entity model only recognizes existing voting rights for assessing a Controlling Financial Interest, but nothing bans the fact that potential voting rights might be held until they will become exercisable, for instance when significant financial and operating decisions will be made such that they will deem to be substantive. Instead, the VIE model acknowledges also potential voting rights, that are also called “forward-starting rights” and they are exercised in determining whether the reporting entity is the primary beneficiary.

Regardless relevant differences between the two models, as Reinsten, A. et al. noted, sometimes we should «*focus on the substance, rather than the form, thus allowing one to derive more meaningful and useful financial statements*»

(Reinsten, A. et al., 2006, p. 34)[169], thereby keeping in mind that group's primary users are stakeholders, who will always prefer obtaining a useful information rather than caring about how that information was presented (i.e., according to the Voting Interest Entity or VIE models). Ultimately, the following table recaps all the criteria we used to conduct such comparative analysis (Table 3.1, *A comparative analysis regarding the Voting Interest Entity and VIE models)*[170]:

Concept	Voting Interest Entity model	VIE model
Controlling Financial Interest	Under the Voting Interest Entity model, there is a distinction between corporations (other than limited partnerships) and limited partnerships (and similar entities). In both cases, the ownership of the majority voting rights is needed. In addition, as for limited partnerships (and similar entities), the ownership of the kick-out rights belonging to the limited partner is mandatory. For both categories of enterprises, there might be control without the majority voting rights (i.e., control by contract).	The VIE model recognizes control to the primary beneficiary only if there is the "power to direct the activities […]" and the "obligation to absorb losses […] or the right to receive benefits […]" (refer to *paragraph 3.2.2* for full description). In order to determine which reporting entity will consolidate the legal entity (thus playing the role of the primary beneficiary), unlike the Voting Interest Entity model, a list of activities must be taken into consideration.
Related Parties	Related parties, under the Voting Interest Entity model, are not considered at all.	Related parties and de-facto agents must be contemplated, since it can happen that even one related party has to consolidate mandatorily the legal entity when the reporting entity is unable to do so.
Participating rights	Differently from the VIE model, substantive participating rights in the Voting Interest Entity model held by LPs or NCIs, exercised in some significant financial and operating decisions, entail the preclusion or the interruption of the consolidation process at the expense of the GP.	The VIE model requires them to be substantive and that they must be held only by one reporting entity that unilaterally exercise them in significant financial and operating decisions during the entity's life. Moreover, substantive participating rights allow the reporting entity to determine whether a legal entity is a VIE.
Potential voting rights	Only existing voting rights are recognized for assessing a Controlling Financial Interest, but potential voting rights might be held until they will become exercisable.	The VIE model acknowledges also potential voting rights, that are also called "forward-starting rights" and they are exercised in determining whether the reporting entity is the primary beneficiary.

[169] Reinsten, A. et al. *Consolidation of Variable-Interest Entities*. CPA Journal, Vol. 76, No. 8. Pp. 28-34. P. 34. (2006). www.ebsco.com

[170] Table 3.1: *A comparative analysis regarding the Voting Interest Entity and VIE models*. Re-elaborated by the Author.
Source: Deloitte. *Consolidation. A Roadmap to Identifying a Controlling Financial Interest*. P. 10. (2015). www2.deloitte.com; Deloitte. *A Roadmap to Consolidation. Identifying a Controlling Financial Interest*. Financial Accounting Foundation. Pp. 12-13. (2019). www2.deloitte.com

3.5 Considerations about the three consolidation models applied to a practical case

This last section concluding the chapter is addressed to translate theory we have seen so far into practice: indeed, we are going to deal with an illustrative example to be analyzed under the three consolidation models that we explained throughout Chapter 3, both under IFRS and US regulations, in order to spot similarities and differences in a simplified real-world scenario.

Thus, let us consider the following case: on 1 January 2018 company X acquires 70% of company Y's equity, paying it € 8.000. Company Y's equity, on the date of acquisition, is € 6.500. During the year 2018, among others, some facts and circumstances happened, as described here:

- A plant of company Y has been revalued for € 1.500 (meaning that its fair value has increased with respect to the book value), whereas all other assets and liabilities' figures have remained unchanged;
- The expected residual life of plants is 10 years (consequently, the yearly depreciation rate is 10%);
- No impairment test has been carried out about the goodwill, for the sake of simplicity.

Moreover, we would take into account the following intra-group transactions carried forward during the FY 2018:

- Company X sold to company Y services totaling € 500 (settlement will be in the next accounting period);
- Company X lent € 10.000 to company Y, agreeing to be paid back in 10 years. Both companies recorded interests (as an interest income for X, while as an interest expense for Y) for an amount of € 1.000 (already settled within the accounting period);
- Company Y sold to company X goods totaling € 800 (already settled within the accounting period). Company X stored these goods in its inventory, without processing or re-selling them. Since the cost of goods sold for Y is € 450, then the ITCY profit is € 350;

- Company X sold to company Y a machinery worth € 1.500 (selling price). Consider a historical cost of € 1.700 and a carrying amount of € 900. While company X applied a depreciation rate on a yearly basis of 10%, company Y started to apply a yearly depreciation rate of 15%.

Lastly, assume that the tax rate for both companies is equal to 40%, since they operate in the same jurisdiction, being subjected to the same corporate tax regime.

Following are the Individual Statement of Financial Position and Profit and Loss Statement of the two companies on 31 December 2017 (Table 3.2, *Individual SFP and P&L Statement of companies X and Y*)[171]:

Individual Statement of Financial Position on 31 Dec 2017

ASSETS *(in EUR)*	**Co. X**	**Co. Y**
Goodwill	-	-
Property, Plant & Equipment (PPE)	40.000	10.000
Non-current financial assets	12.000	4.500
Investments	15.000	2.000
Deferred tax assets	-	-
Non-current assets	67.000	16.500
Current financial assets	-	-
Inventories & Work-In-Progress (WIP)	4.500	6.000
Trade Receivables	5.000	3.000
Cash & Cash Equivalents (C&CE)	7.500	2.500
Current assets	17.000	11.500
Assets related to discontinued operations	-	-
Total Assets	84.000	28.000

EQUITY AND LIABILITIES *(in EUR)*	**Co. X**	**Co. Y**
Share capital	20.000	5.000
Retained earnings	11.800	1.500
Profit (loss) for the period	30.600	13.700
Total Equity	62.400	20.200
Provisions	-	-

[171] Table 3.2: *Individual SFP and P&L Statement of companies X and Y*. Figure created by the Author.

Non-current interest-bearing financial liabilities	-	-
Deferred tax liabilities	7.600	3.300
Non-current liabilities	7.600	3.300
Provisions	10.000	-
Current interest-bearing financial liabilities	-	3.200
Trade & Other payables	4.000	1.300
Current liabilities	14.000	4.500
Liabilities related to discontinued operations	-	-
Total Equity and Liabilities	84.000	28.000

Individual Profit & Loss Statement on 31 Dec 2017

(in EUR)	**Co. X**	**Co. Y**
Revenues	240.000	190.000
Other income	200	-
A) Operating revenues	240.200	190.000
B) Operating expenses	200.000	170.000
A) - B) Operating profit	40.200	20.000
C) Financial Income (loss)	-	(2.000)
A) – B) ± C) Profit before Tax (PBT)	40.200	18.000
Income tax benefit (expense)	(9.600)	(4.300)
Profit from continuing operations	30.600	13.700
Profit from discontin. operations and disposal gain	-	-
Profit for the period	30.600	13.700

As we may recall from *paragraph 2.1.2*, the first step of the consolidation procedure, i.e. the collection of the individual financial statements of the companies to consolidate, has been accomplished. The consolidation process we are dealing with now has been simplified to make it applicable to two small companies taken as a reference (instead, in reality, companies are much more structured and complex). Now, suppose also that they have already been made uniform, so that we should move to the next step. The aggregation phase entails the combination of similar accounting items by simply summing them, line by line. For the sake of good order, we would postpone this phase for a while, since it will be more useful move forward to more relevant steps preparatory for the accounting aggregation.

Hence, let us make a series of adjustments and some computations to build up the consolidated financial statements by adding three further columns to

the prior individual SFP and P&L Statement of the two companies to be filled in, respectively, with aggregate, adjusted and consolidated data.
First of all, we need to break down the price paid by company X to acquire a portion of the equity of company Y:

a) Ownership interest 70% x (company Y's common stock € 5.000 + company Y's retained earnings € 1.500) = € 4.550;
b) Ownership interest 70% x revaluation of plants € 1.500 = € 1.050;
c) Marginal tax rate 40% x net surplus at point b) € 1.050 = € 420 (tax effect on surplus);
d) Price paid € 8.000 – 70% x [company Y's equity € 6.500 + (revaluation of plants € 1.500 x (1- tax rate 40%))] = € 2.820 (goodwill).

Moreover, since company X did not acquire the 100% of company Y, Non-Controlling Interests have to be recognized: (1 – 70%) x [company Y's equity € 6.500 + (revaluation of plants € 1.500 x (1 - tax rate 40%))] = € 2.220 (NCIs).
Then, the surplus on plant must be depreciated: yearly depreciation rate 10% x € 1.500 = € 150. This implies to recognize also the deferred tax effect: depreciation € 150 x tax rate 40% = (€ 60).
Subsequently, we make some intercompany eliminations as follows:

- Elimination of company's X revenues of € 500 against company's X expenses for the same amount about the services rendered, meanwhile eliminating the related company's X receivable against company's Y payable;
- Elimination of intercompany loan € 10.000 and related company's X interest income € 200 against company's Y interest expense;
- Elimination of company's Y revenues of € 800 against company's X expenses € 450 about the sale of goods, meanwhile recognizing the ITCY profit € 350 (it will decrease the group's Profit Before Tax). The deferred tax effect impacting on the group SFP computed on the ITCY profit will be equal to: ITCY profit € 350 x 40% = (€ 140). But it is not over yet: since goods are still in the acquirer's inventories, the group's inventory will be reduced by the same amount of ITCY profit;

- Elimination of company's X profit for the sale of machinery: selling price € 1.500 – carrying value € 900 = € 600 (capital gain or surplus). Before selling the machinery, company X was depreciating it for € 170 (yearly depreciation rate applied by company X 10% x historical cost € 1.700). After the machinery was sold, company Y has depreciated it for € 225 (yearly depreciation rate applied by company Y 15% x selling price € 1.500). Hence, group's depreciation will augment by € 225 and decreased by € 170 to reflect the net increase, equal to € 55. Considering the tax aspect, the difference between the company's X profit for the sale of machinery and the net increase in depreciation will decrease the group's Profit Before Tax by: € 600 - € 55 = € 545. The deferred tax effect impacting on the group SFP computed on such amount will be: € 545 x 40% = € 218.

Finally, we need to attribute the share of the yearly profit to NCIs by departing from the Net Income of the subsidiary and adding back all the adjustments that we made that have a direct impact on company's Y profit: (Profit of company's Y € 13.700 - deferred tax on the plant's surplus € 60 - deferred tax on the sale of goods € 140) x (1 – 70%) = € 4.050.

Following are the year-end Consolidated Statement of Financial Position and Profit and Loss Statement on 31 December 2018. Consolidated data have been derived by aggregating similar accounting items and making adjustments described so far (Table 3.3, *Consolidated Financial Statements* of companies X and Y)[172]:

Consolidated Statement of Financial Position on 31 Dec 2018

ASSETS *(in EUR)*	**Co. X**	**Co. Y**	**Aggreg.**	**Adjustments**	**Consolidated**
Goodwill	-	-	-	2.820	2.820
Property, Plant & Equipment (PPE)	40.000	10.000	50.000	805	50.805
Non-current financial assets	12.000	4.500	16.500	(10.000)	6.500
Investments	15.000	2.000	17.000	(8.000)	9.000
Deferred tax assets	-	-	-	358	358

[172] Table 3.3: *Consolidated Financial Statements* of companies X and Y. Table created by the Author.

Non-current assets	67.000	16.500	83.500	(14.017)	69.483
Current financial assets	-	-	-	-	-
Inventories & Work-In-Progress (WIP)	4.500	6.000	10.500	(350)	10.150
Trade Receivables	5.000	3.000	8.000	(500)	7.500
Cash & Cash Equivalents (C&CE)	7.500	2.500	10.000	-	10.000
Current assets	17.000	11.500	28.500	(850)	27.650
Assets related to discontinued operations	-	-	-	-	-
Total Assets	84.000	28.000	112.000	(14.867)	97.133

EQUITY AND LIABILITIES *(in EUR)*	**Co. X**	**Co. Y**	**Aggreg.**	**Adjustments**	**Consolidated**
Share capital	20.000	5.000	25.000	(5.000)	20.000
Retained earnings	11.800	1.500	13.300	(1.500)	11.800
Profit (loss) for the period	30.600	13.700	44.300	(5.005)	39.295
NC Interests	-	-	-	2.220	2.220
NC Common stock and reserves	-	-	-	-	-
NC Net Income	-	-	-	4.050	4.050
Total Equity	62.400	20.200	82.600	(5.235)	77.365
Provisions	-	-	-	-	-
Non-curr. interest-bearing financial liabilities	-	-	-	(10.000)	(10.000)
Deferred tax liabilities	7.600	3.300	10.900	868	11.768
Non-current liabilities	7.600	3.300	10.900	(9.132)	1.768
Provisions	10.000	-	10.000	-	10.000
Current interest-bearing financial liabilities	-	3.200	3.200	-	3.200
Trade & Other payables	4.000	1.300	5.300	(500)	4.800
Current liabilities	14.000	4.500	18.500	(500)	18.000
Liabilities related to discontinued operations	-	-	-	-	-
Total Equity & Liabilities	84.000	28.000	112.000	(14.867)	97.133

Consolidated Profit & Loss Statement on 31 Dec 2018

(in EUR)	Co. X	Co. Y	Aggreg.	Adjustments	Consolidated
Revenues	240.000	190.000	430.000	(1.900)	428.100
Other income	200	-	200	-	200
A) Operating revenues	240.200	190.000	430.200	(1.900)	428.300
B) Operating expenses	200.000	170.000	370.000	(855)	369.145
A) - B) Operating profit	40.200	20.000	60.200	(1.045)	59.155
C) Financial Income (loss)	-	(2.000)	(2.000)	-	(2.000)
A) – B) ± C) Profit before Tax (PBT)	40.200	18.000	58.200	(1.045)	57.155
Income tax benefit (expense)	(9.600)	(4.300)	(13.900)	(418)	(14.318)
Profit from cont. oper.	30.600	13.700	44.300	(5.005)	39.295
Profit from discontinued operations and disposal gain	-	-	-	-	-
Profit for the period	30.600	13.700	44.300	(5.005)	39.295
NC share of profit	-	-	-	4.050	4.050

The consolidation process we have gone through can be deemed to be applicable regardless of the set of rules considered (IAS/IFRSs or US GAAP Standards), since the steps to consolidate group accounts are (more or less) the same under both regulations, but again, in the real world, firms are much more complex than those considered in the practical case and some legal technicalities might make the difference in certain cases. More than the consolidation procedure, significant differences between the three consolidation models exist in how control is detected and exercised.

According to the control model pursuant to *IFRS 10 – Consolidated Financial Statements*, company X (reporting entity) has consolidated Y (legal entity) by acquiring a majority ownership interest, that is besides what required: indeed, to consolidate, the reporting entity may have just been able to show that had de-facto control over the investee, meaning that it had the ability to use the power to affect the investee's returns, even without owning an equity interest worth more than 50% of company Y's stocks.

Company X can be deemed to have power since, among others, it sold services for € 500, purchased goods for € 800, sold a machinery for € 1.500: these are all activities that we mentioned in *paragraph 3.1.1* when discussing the power criterion. Moreover, it is exposed to variable returns of company Y, which was able to generate a profit equal to € 13.700 during the FY2018. Even if it was a

loss, the second element of the IFRS 10 control model could be still deemed valid since both positive and negative performances are considered as well. Third consideration we make is the qualification of company X as “principal”, such that it is able to make decisions over company Y, like operating and financial choices related to the management of the controlled entity. In this illustrative example, we did not include other related parties and SPEs for the sake of simplification, but considerations made in *paragraph 3.1.4* and following shall apply in the case they were present. Additionally, since company Y has not the requirements described in *paragraph 3.1.6*, it does not represent neither an investment entity nor other scope exceptions compliant with the IFRS 10 control model.

Looking instead at the US regulation, compliant to the Voting Interest Entity model regulated by *ASC 810 – Consolidation*, company Y enters in the consolidation perimeter since company X has direct ownership of the majority voting rights. Indeed, this consolidation model is considered by company X due to the lack of the requirements needed for the VIE model to be applicable. Let us try to understand why the VIE model must not be applied in this case. Basically, the investee has sufficient equity investment at risk (i.e., the share capital or common stock plus retained earnings), meaning that it has sufficient equity to finance its activities stand-alone: hence, one of the criteria identified by ASC 810-10-15-14 is not verified. As a matter of fact, regardless of a qualitative analysis that may reveal the contrary (and that the reporting entity may qualify as primary beneficiary), company Y cannot be considered a legal entity merely from a quantitative standpoint: indeed, its equity (€ 6.500) is more than 10% (which is a presumption contained in the ASC guidance to determine whether the equity investment at risk is sufficient) of company Y’s total assets (28.000), such that company Y is able to finance its activities when operating independently and without being necessary to be part of a group. This evaluation should be made considering fair values (both for equity and total assets), but for the sake of the example, we just used book values reported in the company Y’s individual Statement of Financial Position.

We came to this conclusion since it is not so straightforward to conduct a qualitative analysis although the very basic structure of the companies considered. One could point out that, given the loan granted by company X to company Y, the latter used additional subordinated financial support, thus not having sufficient equity investment at risk (consequently, the VIE model shall

apply). However, in the real world, one should qualitatively gauge the legal entity by comparing it to another entity operating in the same industry, with almost the same dimension and having similar assets.

Moreover, we are pretty comfortable to affirm that company X is likely to have «*the continuing power to govern the financial and operating policies of an entity*» (Financial Accounting Foundation, 2019, p. 12)[173], thus being the latter a non-Variable Interest Entity.

For all the above considerations made and since no scope exceptions apply, the legal entity Y is not a VIE and company X (i.e., the reporting entity) must consolidate group accounts according to the Voting Interest Entity model.

[173] Financial Accounting Foundation. *ASC 810 - Consolidation.* P. 12. (2019). www.asc.fasb.org

CHAPTER 4. OWNERSHIP INTERESTS IN SUBSIDIARIES' SPECIFIED ASSETS & SILO PROVISIONS

SUMMARY: 4.1 Silo definitions according to IAS/IFRSs versus US GAAP Standards; 4.2 Determining an interest in subsidiary's assets under IFRSs; 4.3 Silos identification under the VIE model; 4.3.1 The primary beneficiary entities of the host and silo: What is the difference?

4.1 Silo definitions according to IAS/IFRSs versus US GAAPs

The term "silo", derived from the ancient Greek *σιρός – siros*, was invented to identify a cylindrical container to store bulk materials (e.g., grain, carbon and the like) separately from the rest of other production inputs. Similarly, we can think to it in consolidation terms by isolating some company's assets and/or cash flows for creating a silo. These assets and/or cash flows will be the sole items used for paying back the silo's liabilities: this means that credit claims coming from other parties will not be taken into consideration. Indeed, a silo must be thought as a sort of independent company whose boundaries are delimitated by virtual barriers: the latter ones separate it from the overall legal entity, thus working autonomously and feeding by itself.

In a nutshell, the logical ratio behind this structure is to eliminate (or, at most, limit) the attempt of reporting entities to:

«*[…] avoid consolidation by combining separate pools of assets or activities into a single legal entity while effectively segregating the right to govern the activities, the right to receive the benefits, and the obligation to absorb the losses of each separate pool of assets or activities […]*» (Deloitte, 2015, p. 144; Deloitte, 2019, p. 181)[174].

This would lead to the creation of a portion of assets, within the legal entity, that would potentially be exempted from consolidation effects. Silos are very popular in the financial services sector and real estate industry. Sometimes, the creation of silos is devised with fraudulent purposes (as we noticed when talking about

[174] Deloitte. *Consolidation. A Roadmap to Identifying a Controlling Financial Interest*. P. 144. (2015). www2.deloitte.com; Deloitte. *A Roadmap to Consolidation. Identifying a Controlling Financial Interest*. Financial Accounting Foundation. P. 181. (2019). www2.deloitte.com

SPVs), in order to deconsolidate certain assets/liabilities that would otherwise be included in the consolidation area, thus wrecking the image of the group that the holding wants to transmit to the general public/stakeholders.
A silo is not a totally different concept from the Special Purpose Entity one, except for this distinction: the former implies control only on a pool of assets (or group of liabilities and even equity, though rarely) by some other entity, while a SPE is a full-fledged separate legal firm that is controlled involving the overall entity.

A common example of silo used in practice might be that one whose pool of assets is the collateral related to a security's income payments and also to its value that takes the name of "Asset-Backed Security (ABS)" (Deloitte, 2014, p. 6)[175]. An ABS is frequently created when the underlying assets are illiquid (and, hence, very difficult to be sold in the market individually for lack of demand) and investors ask for their portfolio diversification. However, securitization (as the process to combine different pool of assets into one asset-backed security) is used more often in the formation of SPEs that we faced along Chapter 3 in *paragraph 3.1.5* (when discussing IFRS implications) and *paragraph 3.2.5* (when discussing US GAAP regulatory terms), rather than for creating a silo.

Referring to the regulatory environment, neither *IFRS 10 – Consolidated Financial Statements* nor its predecessor *IAS 27 – Consolidated and Separate Financial Statements (2008)* did not provide any definition of silo in their Glossary section; nevertheless, IFRS 10 in paragraph B76 invite investors to determine when they are dealing with a segregate entity and thus to assess if they control such separate investee's portion. Generally, control is detected over another entity, regardless of whether it is a silo or just an "ordinary" subsidiary. When control is assessed over a limited portion of specified assets and liabilities, all the three elements delineating control must be present simultaneously. Nothing changes. In the case that one of them is not subsisting at the time that the consolidation process is carried forward, the silo must be excluded from the reporting entity's boundaries.

US GAAP regulation, instead, ties the creation of a silo to a specific quantitative criterion related to the interest held in the separated entity. As a matter of fact, *ASC 810* – Consolidation in paragraph 810-25-55 states that:

[175] Deloitte. *Securitization Accounting*. P. 6. (2014). www2.deloitte.com

«*A variable interest in specified assets of a VIE (such as a guarantee or subordinated residual interest) shall be deemed to be a variable interest in the VIE only if the fair value of the specified assets is more than half of the total fair value of the VIE's assets or if the holder has another variable interest in the VIE as a whole (except interests that are insignificant or have little or no variability) […]*» (Financial Accounting Foundation, 2019, pp. 71-72)[176].

Hence, it is really important for an investor, when identifying if a legal entity is a VIE, investigating also whether some assets might form a silo in that VIE, thus allowing an ownership interest in that silo to come to light. According to the VIE model, this translates into the formation of a new VIE, that is in turn part of the "original" VIE, the latter representing the entity to be consolidated. The remainder of the legal entity, deprived from all identified silos, is referred to as "host". As for the right timing for spotting a silo, *ASC 810 – Consolidation* suggests that a silo should be identified at the time of the potential involvement of the interest in a VIE and whenever facts and circumstances have inducted changes in control.

Ultimately, the situation in which multiple silos exist is contemplated by both regulations: by the way, should two (or more) reporting entities have all the requirements to control the silos, then they have to determine which of them is effectively exercising predominantly control (here, de-facto control prevails on de jure control). As noticed by Lee, P. J., «*in some instances, US GAAPs may disregard certain assets and liabilities that IFRSs would otherwise consolidate and vice versa [creating the premise for a misalignment in accounting for silos]*» (Lee, P. J., 2015, p. 66)[177]. This is due to the differences that still we have in assessing control under the two accounting standard sets, so that convergence of global accounting regulation sometimes is not so closer as it might seem.

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[176] Financial Accounting Foundation. *ASC 810 - Consolidation.* Pp. 71-72. (2019). www.asc.fasb.org

[177] Lee, P. J. *Assessment of Business Subsidiary Operations and Consolidated Financial Statements through a Common Global Accounting Language, IFRS vs. GAAP*. International Journal of Business and Social Research, Vol. 5, No. 7. Pp. 61-70. P.66. (2015). pdfs.semanticscholar.org

4.2 Determining an interest in subsidiary's assets under IFRSs

In the former paragraph, we have seen what a silo is by making a comparison between the two set of accounting standards. When the investor assesses, besides control over the legal entity, whether it possesses control over a separate portion of assets within it, different rules should be considered as many as are the legislation systems of the specific jurisdictions in which the legal entity operates.

Now, focusing just on IFRS Principles, *IFRS 10 – Consolidated Financial Statements* in its Appendix B (Application guidance), paragraphs B77-B79, prescribes the conditions that need to be met in order for a silo to exist. Indeed, the reader would appreciate to know which are the requirements that must be verified in order to make the creation of a separate pool of assets possible.

Control over specified assets is a quite recently "phenomenon" faced for the first time by IFRS 10, since *IAS 27 – Separate Financial Statements* (and its prior 2008 version) never dealt with this topic, although it started to be very diffused in practice in the last few decades.

IFRS 10 in paragraph B77 expresses the most important condition that must be satisfied to create a silo: «*[…] all the assets, liabilities and equity of that deemed separate entity [DSE] are ring-fenced from the overall investee*» (IFRS Foundation, 2018, p. 29)[178].

As we already noticed in brief previously, the silo's liabilities (or other ownership interests in the silo) can only be paid off against its assets and credit claims, thus banning other parties (except those that hold a liability in the silo) to assume obligations or enforce their rights to obtain any credit or cash flow coming from the assets of the silo itself. Instead, they can only hold a share in the silo's equity and perhaps receive yearly dividends (if any).

Moreover, returns from the specified assets cannot be used by the host (i.e., the remaining part of the investee); likewise, residual liabilities cannot be paid off against the host's assets.

Once that above-mentioned conditions are met, paragraph B78 limits to recall and explicit the usual three main requirements that characterize control under IFRS 10: firstly, it will be necessary to identify which are the relevant

[178] IFRS Foundation. *IFRS 10 – Consolidated Financial Statements*. P. 29. (2018). www.ifrs.org

activities that affect the investee's returns and that entail the exercise of power over the portion of the investee; secondly, the investor should have the exposure or rights to variable returns coming from the silo's involvement and, lastly (but not in order of importance) the ability to use the power over the DSE to affect the amount of investor's returns.

As a consequence, if the investor controls the silo, it must be included in the consolidation area (no discretion is allowed); otherwise it will not be considered when drafting Consolidated Financial Statements (IFRS 10, paragraph B79). Even if a DSE satisfies all above conditions, it is excluded from consolidation when another investor controls and consolidates (control is not a sufficient, but necessary condition) the entity in which the silo is contained.

4.3 Silos identification under the VIE model

Silos accounting in the US regulatory environment is governed by the rules contained in *ASC 810 – Consolidation* principle. No specific guidance is given about the creation of silos under the Voting Interest Entity model, since a silo cannot exist if the host entity is not a VIE. That is why the FASB decided not to take care of it. Thus, first of all, a question mark needs to be posed: Are we really dealing with the VIE model? If not, stop consolidation analysis related to silos. It goes without saying that all following considerations we make solely refer to the VIE model.

Unlike IFRSs, in *paragraph 4.1* we went through a quantitative criterion that US GAAP Standards require to be complied with, otherwise a variable interest over specified assets cannot be deemed to be an interest in the VIE. If, and only if, this occurs, expected losses and expected residual returns related to an interest in the silo can be considered the same of the VIE.

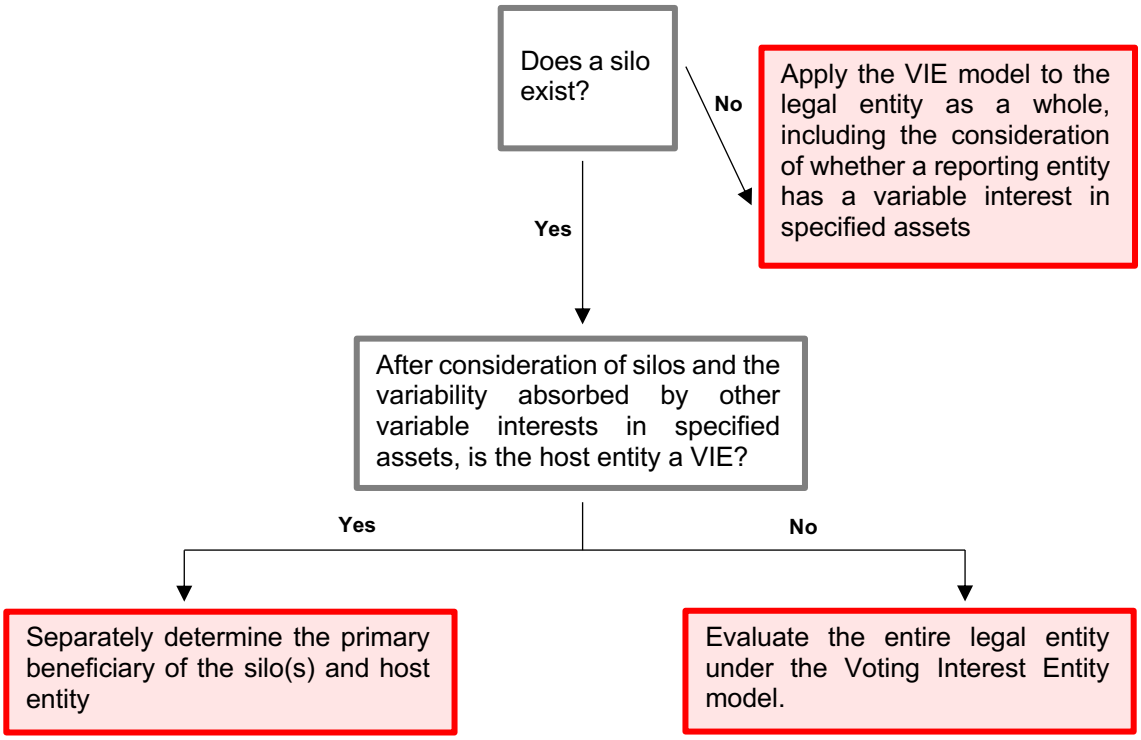
The crux of the matter, according to the VIE model, is to determine whether the silo must be consolidated separately from the broader legal entity or if it is more appropriate to treat it as an integrating part of the VIE, thus forcing the primary beneficiary to consolidate the latter.

Besides the fair value considerations pursuant to paragraph ASC 810-10-25-55, a further forethought must be done regarding the presence of three conditions that allow the creation of a silo:

- All the assets, liabilities and equity of the silo must be separated, and they have to be clearly distinguishable from those of the host;
- No silo's returns can be used by the remaining VIE and no silo's liability can be paid off against the host's assets;
- The host entity must possess the requirements to be classified as a VIE (see *paragraph 3.2.1* for full description).

A silo does not exist «*[…] if other parties have rights or obligations related to the specified asset or to residual cash flows [deriving from it] […]*» (Financial Accounting Foundation, 2019, p. 72)[179].

Below the flowchart is intended to facilitate the reader in comprehending whether a silo exists and whether the primary beneficiary should consolidate it: indeed, it is not automatic that a specified asset or pool of assets, once configured, will enter the consolidation perimeter (Figure 4.1, *The pattern for identifying a silo: Must it be consolidated?)*[180]:

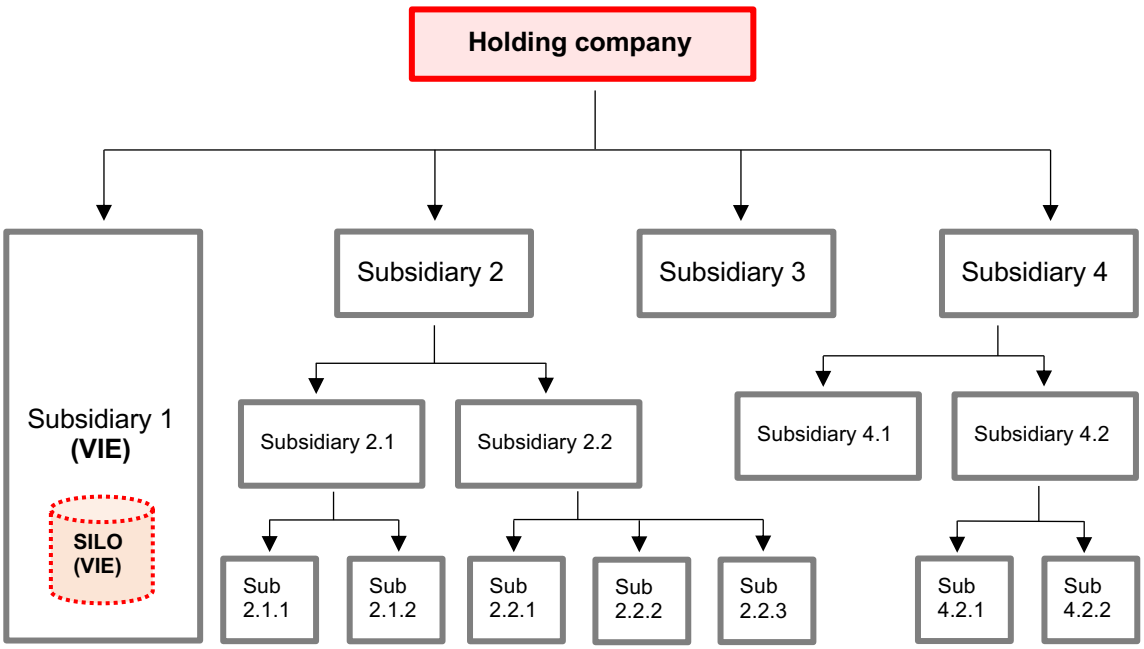


[179] Financial Accounting Foundation. *ASC 810 - Consolidation.* P. 72. (2019). www.asc.fasb.org
[180] Figure 4.1: *The pattern for identifying a silo: Must it be consolidated?* Figure re-elaborated by the Author.
Source: Deloitte. *Consolidation. A Roadmap to Identifying a Controlling Financial Interest*. P. 145. (2015). www2.deloitte.com; Deloitte. *A Roadmap to Consolidation. Identifying a Controlling Financial Interest*. Financial Accounting Foundation. P. 182. (2019). www2.deloitte.com

Therefore, the Voting Interest Entity model is brought into play only when the silo does not exist because the host entity is not a VIE, being so the alternative consolidation model to be used. Hence, it would be appreciable for the reader to sum up the all possible scenarios:

1) *A silo exists, and the host entity is a VIE* – the VIE model applies and the primary beneficiary entities consolidate the silo separately from the host entity;
2) *A silo does not exist, and the legal entity is a VIE* – the VIE model applies to the legal entity as a whole;
3) *A silo does not exist, since the legal entity is not a VIE* – the Voting Interest Entity model applies.

Finally, in the third case, the silo does not exist because the legal entity, being deprived of the pool of assets, would be considered as a shall company, thus loosing also the requirements that characterize it as a Variable Interest Entity. This scenario typically provokes a sort of chain reaction, given that a silo is a "VIE within a VIE": if the host entity is not a VIE, the silo consequently cannot be a VIE. The following figure is a typical structure (that has been simplified for the sake of understanding) for representing a silo under the VIE model (Figure 4.2, *The structure for representing a silo under the VIE model)*[181]:



[181] Figure 4.2: *The structure for representing a silo under the VIE model.* Figure created by the Author.

In the above illustration, the *Holding company* has a Variable Interest in *Subsidiary 1* (that plays the role of the host entity), which is a VIE; in turn, it contains another VIE, representing the pool of assets (i.e., the *Silo*). On the same level of *Subsidiary 1* there are other subsidiaries belonging to the group structure that can be either consolidated through the VIE model (likewise *Subsidiary 1*) or according to the Voting Interest Entity one. The same applies to the subsidiaries on lower levels.

4.3.1 The primary beneficiary entities of the host and silo: What is the difference?

As the title of the paragraph intuitively suggests, the primary beneficiary (that, once again for the sake of clarity, is the consolidating entity under the VIE model) of the legal entity may be different from that one of the silo. Hence, multiple parties can be involved in the consolidation process, contrarily to what usually people think (that, applying the VIE model, there is always only a primary beneficiary). In fact, this translates in the potential presence of two primary beneficiary entities that have to coordinate in order to properly consolidate group accounts, paying attention to not overlap their functions and roles, otherwise incurring in wrongly consolidating items that they do not belong to their responsibility spheres or that have already been consolidated.
Prior to proceed to the analyses necessary to determine whether one party is the primary beneficiary of both (the legal entity and the silo) or there are two primary beneficiary entities, the reporting entity must ensure itself that both the legal entity and the silo are VIEs, otherwise the VIE model cannot be applied *ab initio*.

Indeed, in general, the decision related to the identification of the primary beneficiary entities can be imagined as a two-step process involving two separate analyses:

1) The identification of the *primary beneficiary of the host* – the reporting entity is supposed to cut-off from the consolidation perimeter the expected losses and residual returns of the silo from the remainder of the VIE (i.e., the host) in order to determine if control is applicable. Should a relationship with related parties exist, then careful considerations must be made according to the rules described in *paragraph 3.2.4*;

2) The identification of the *primary beneficiary of the silo* – the reporting entity should remove from the consolidation area the expected losses and residual returns of the host in order to determine if control applies.

When two primary beneficiary entities are present, one is called to consolidate the host and just one the silo: the case in which they both consolidate the silo is not allowed pursuant to ASC 810-10-25-57.

Eventually, hitherto we have not taken into consideration the instance in which no primary beneficiary of the silo is determined: in this peculiar occurrence, the primary beneficiary of the host cannot add back the silo's assets, liabilities and equity to the host itself, trying so to consolidate the entire VIE as it was at the very beginning, i.e. before a silo had been recognized.

CHAPTER 5. LOSS OF CONTROL AFFECTING A SUBSIDIARY OR AN ASSET GROUP

5.1 When a loss of control takes place: change in ownership interests

This chapter is structured for conveying guidance to the reader about the situation in which a loss of control may take place, so that Controlling Interests are transferred or sold to other parties. Both sale and transfer arrangements are taken into consideration: while a share transfer can happen even free of charge, the sale is just the usual contractual agreement for publicly traded shares in the market (i.e., anyone that is willing to pay the price is the potential acquirer). However, we should bear in mind that the selling company, for instance, can decide to set barely small transfer fees to be paid by the acquirer, without obtaining a “real” profit. Therefore, selling shares involves mandatorily the transfer of shares, whereas it is not always true the contrary, i.e. a share transfer may not configure as a sale if another [contractual] arrangement applies (e.g., donation, inheritance, etc.).

Indeed, it might happen, sometimes, that a solid group of companies becomes weaker due to the loss of control over one (or more) subsidiaries and/or a pool of assets (i.e., a silo), even more if the latter ones covered a key or strategic role for the organization as a whole. Intuitively and logically reasonable is that one may think that the subsidiary must be deconsolidated, or the silo derecognized *ipso facto*.

However, what is undoubtfully true is that ownership interests will vary (both in absolute and relative terms): as a consequence, this will not lead inevitably to the loss of control, but it could entail just a variation of the portion held in the group shareholders’ equity. Consequently, Controlling Interest and Non-Controlling Interest stakes will be modified. As a matter of fact, the loss of ownership interests held over another entity or a group of assets depends upon the decision of the parent company to retain control.

Hence, two alternative scenarios are possible (IFRS Box, 2018)[182]:

1) *the parent transfers/sells the shares held in a legal entity or a silo, but keeping control over it* (for instance, shares are transferred/sold to NCIs) – this will entail just a variation to be made to the group shareholders' equity, without impacting on the consolidated P&L statement;
2) *the parent transfers/sells the shares held in a legal entity or a silo, loosing at the same time control* – this will imply the parent to remove the subsidiary or the silo from the consolidation area, meaning that the latter must be eliminated from the parent company's Consolidated Financial Statements.

The first hypothesis is typical of deals settled among company's shareholders, i.e. without involving external third parties, so that it can be considered encompassed within company's ordinary activities. Both *IFRS 10 – Consolidated financial statements* and *US GAAP ASC 810 – Consolidation* agree in the accounting treatment when there are no losses of control by considering them simply as "equity transactions". «*Any gain/loss generated implies solely equity changes*» (Deloitte, 2008, p. 143)[183]. No separate indication is prescribed by both regulations, thus being acceptable either presenting gains/losses indistinguishable from equity or disclosing them in a specific segregate category within equity.

The second one is contemplated by IFRS 10 in its paragraph 25, dedicated to the loss of control. Operative aspects will be faced in the next paragraph. ASC 810 regulates the matter in its sub-section named "Deconsolidation of a subsidiary or derecognition of a group of assets", substantially agreeing with IFRS 10 also for the accounting of a loss of control.

Eventually, besides the transfer/sale of shares, a loss of control can be provoked also in other different ways, such as: the ending of a contractual arrangement by which the parent exercised control over the subsidiary, a capital increase disposed by the subsidiary by issuing new shares (thereby turning the parent's ownership interests into NCIs, being diluted up to the point that the

[182] IFRS Box. *Example: IFRS 10 Disposal of Subsidiary*. (2018). www.ifrsbox.com
[183] Deloitte. *Business Combinations and changes in ownership interests – A guide to the revised IFRS 3 and IAS 27*. P. 143. (2008). www.iasplus.com

investor no longer controls the investee), a contractual agreement between minority interests obtaining control over pre-existing Controlling Interests, the taking of control over the subsidiary «*by a governmental body, court, administrator or regulator*» (Bakker, E et al., 2017, p. 278; Grant Thornton, 2017, p. 73; Flood, J. M., 2018, p. 972)[184].

5.2 Accounting treatment of a loss of control pursuant to IFRS 10

The accounting treatment regarding the loss of control was, for the first time, contemplated by the predecessor of *IFRS 10 – Consolidated Financial Statements*, i.e. *IAS 27 – Consolidated and Separate Financial Statements (2008)* in paragraphs 32-37. However, after IAS 27 was amended and renovated, becoming *IAS 27 – Separate Financial Statements (2011)*, the matter was entirely segregated into the newest IFRS 10.

A loss of control can be induced by the shortage of one (or more) out of the three requirements that must be present simultaneously for control to exist. That is why: «*an investor [should continuously] also considers changes affecting its exposure, or rights, to variable returns from its involvement with an investee*» *(IFRS Foundation, 2018, p. 29)*[185].

IFRS 10 takes care of this topic in paragraphs B97-B99 detailed in Appendix B (Application guidance), setting out the practical steps that need to be accomplished when control is missing.

Sometimes, it is possible that the parent company loses control in simultaneous or subsequent phases, like two (or more) arrangements. If this is the case, IFRS 10 establishes that such arrangements «*should be accounted for as a single transaction*» *(IFRS Foundation, 2018, p. 35)*, if one (or more) of the following apply:

«

(a) They are entered into at the same time or in contemplation of each other.

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[184] Bakker, E. et al. *Application and Interpretation of IFRS Standards*. United States of America, John Wiley & Sons. P. 278. (2017). www.wiley.com; Grant Thornton. *Under control? A practical guide to applying IFRS 10 Consolidated Financial Statements*. P. 73. (2017). www.grantthornton.global; Flood, J. M. *Wiley GAAP 2018: Interpretation and Application of Generally Accepted Accounting Principles*. United States of America, John Wiley & Sons. P. 972. (2018). www.wiley.com

[185] IFRS Foundation. *IFRS 10 – Consolidated Financial Statements*. Pp. 29; 35. (2018). www.ifrs.org

(b) They form a single transaction designed to achieve an overall commercial effect.
(c) The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.
(d) One arrangement considered on its own is not economically justified, but it is when considered together with other arrangements. An example is when a disposal of shares is priced below market and is compensated for by a subsequent disposal priced above market» *(IFRS Foundation, 2018, p. 35)*.

Since the former ones are not quantitative criteria, careful considerations and a quite level of professional judgment are required, so that economic substance might prevail on legal form.
Paragraph B98 of IFRS 10 operatively translates paragraph 25 showing how a loss of control must be recorded, from an accounting standpoint, to fully deconsolidate a subsidiary or a silo:

«*If a parent loses control of a subsidiary, it shall:*

(a) derecognise:

(i) the assets (including any goodwill) and liabilities of the subsidiary at their carrying amounts at the date when control is lost; and

(ii) the carrying amount of any non-controlling interests in the former subsidiary at the date when control is lost […].

(b) recognise [as a counterpart]:

(i) the fair value of the consideration received, if any, from the transaction, event or circumstances that resulted in the loss of control;

(ii) if the transaction, event or circumstances that resulted in the loss of control involves a distribution of shares of the subsidiary to owners in their capacity as owners, that distribution; and

(iii) any investment retained in the former subsidiary at its fair value [pursuant to IFRS 9 – Financial Instruments] at the date when control is lost.

(c) reclassify to profit or loss, or transfer directly to retained earnings if required by other IFRSs, […] [potential surplus or minus] recognised in OCI in relation to the subsidiary […].
(d) recognise any resulting difference as a gain or loss in profit or loss attributable to the parent» (IFRS Foundation, 2018, pp. 6; 35)[186].

The reader would better understand the above-mentioned accounting transactions by analysing the following formula, thereby determining the gain/loss resulting from deconsolidation/derecognition (Bakker, E et al., 2017, p. 279; Flood, J. M., 2018, p. 975)[187]. Let us define:

CVAL = carrying value of the former subsidiary's assets (including goodwill) and liabilities on the derecognition date (i.e., the date when control is lost)
CVNI = carrying value of the NCI in the former subsidiary on the derecognition date
FVCR = fair value of the consideration received
DISTRoS = any distribution of shares of the subsidiary to owners
FVNIR = fair value of any non-controlling investment retained by the former parent on the derecognition date

$$\text{Gain (Loss)} = (\text{CVNI} + \text{FVCR} + \text{DISTRoS} + \text{FVNIR}) - \text{CVAL}$$

Now consider an illustrative example in order to further strengthen and complete the knowledge about the loss of control over a subsidiary/silo. Hence, let us consider the next case: ABC Corporation owns a 70-percent interest in XYZ Corporation. On 1 January 2018, ABC Corporation sells a 50-percent interest in XYZ to a third party (thus, retaining the remainder 20-percent, which turns into an NCI) in exchange for cash amounting to € 350.000 (FVCR). On the disposal date (i.e., when control is lost), for the sake of simplicity, the total fair value of the subsidiary XYZ equals the carrying value of its net assets (reported in ABC's

[186] IFRS Foundation. *IFRS 10 – Consolidated Financial Statements*. Pp. 6; 35. (2018). www.ifrs.org
[187] Bakker, E. et al. *Application and Interpretation of IFRS Standards*. United States of America, John Wiley & Sons. P. 279. (2017). www.wiley.com; Flood, J. M. *Wiley GAAP 2018: Interpretation and Application of Generally Accepted Accounting Principles*. United States of America, John Wiley & Sons. P. 975. (2018). www.wiley.com

Consolidated Financial Statements), totalling to € 500.000 (CVAL). Moreover, consider that the carrying value of the NCI in XYZ is € 150.000 (CVNI). The 20-percent interest retained in the former subsidiary is valued, on the disposal date, € 500.000 x 20% = € 100.000 (FVNIR). As a consequence, the gain resulting from the deal is the following: [€ 350.000 (FVCR) + € 100.000 (FVNIR) + € 150.000 (CVNI)] - € 500.000 (CVAL) = € 100.000.

As we have seen, disposing of a majority voting interest rights makes the parent company losing control held in the subsidiary, though being compensated by the net gain that earns upon such selling transaction.

5.3 Types of deconsolidation/derecognition arrangements: loss of control compliant with US GAAP ASC 810

As we anticipated earlier in *paragraph 5.1*, when the parent transfers/sells the shares held in a legal entity or a silo, but keeps control over it, these are just accounted as equity transactions.

Moreover, we argued that the accounting treatment of a loss of control, in accordance with US GAAP ASC 810, is consistent with material aspects of IFRS 10 standard (hence, same considerations made in *paragraph 5.2* shall apply). However, two exceptions apply to the guidance contained in the Codification (810-10-40-3A): indeed, deconsolidation/derecognition rules regard only companies that are businesses or not-for-profit activities, excluding transfer/sale of shares of subsidiaries and pool of assets relating either to real estate sector or businesses operating in the Oil & Gas industry, for which apply, respectively, *ASC 360 – Property, Plant & Equipment* or *ASC 976 – Real Estate* and *ASC 932 – Extractive Activities – Oil and Gas*.

Furthermore, ASC 810 exactly overlaps IFRS 10 for what concerns multiple arrangements, so that is possible that an US GAAP-compliant parent company loses control, not just for the verification of a stand-alone transaction, but for effect of two (or more) transactions linked together.

Besides these situations, a loss of control may take place through a bankruptcy proceeding affecting one (or more) legal entities belonging to the group, such that the entity went bankrupt is likely to be excluded from the Consolidated Financial Statements according to ASC 810-10-15-10a, once considered all facts and circumstances that might have contributed to conduct the entity to assume this legal status (Ernst & Young, 2012, p. 72; Ernst & Young,

2015, p. 65)[188]. Likewise, in the opposite case, emerging from bankruptcy leads usually the legal entity to sign new equity and similar comparable contractual arrangements that make the parent company losing control due to the sub-entrance of new Controlling Interests.

5.3.1 Re-consideration events related to VIEs that might cause a loss of control

Besides the transfer/sale of shares, losses of control can be provoked in several other different ways, as we argued previously (e.g., the ending of a contractual arrangement by which the parent exercised control over the subsidiary, a capital increase disposed by the subsidiary by issuing new shares, etc.). Additionally, in the specific case of US GAAP-compliant companies, a loss of control may be the consequence of the deprivation of the VIE status affecting the legal entity due to the occurrence of a certain event. That is why the parent company shall periodically dispose a re-consideration of the interests held in its Variable Interest Entities. Not being considered a VIE means that the VIE model cannot be applied, by definition; this, in turns, leads to the loss of control, when neither the Voting Interest Entity nor other US GAAP apply.

As a matter of fact, there are several "triggering events" (KPMG, 2019, p. 300)[189] that may induce the parent company to re-consider whether the legal entity to be consolidated is a VIE. Seemingly, a VIE may not be considered as such if this legal entity tackles an unexpected event that, once occurred, makes the company to lose its VIE qualification attributed at the time of its design or afterwards. It is likewise possible that, weirdly, a legal entity not identified as VIE, after having faced a particular event, becomes a Variable Interest Entity, assuming control (this configures as the exact opposite scenario).

It is not that intuitive that, once an event occurs, the VIE status is lost immediately, but professional judgment shall be expressed by the primary beneficiary whether to reconsider the interest held in the legal entity.

[188] Ernst & Young. *Consolidated and other financial statements. Noncontrolling interests, combined financial statements, and parent company financial statements*. P. 72. (2012). www.eyjapan.jp; Ernst & Young. *Consolidated and other financial statements. Presentation and accounting for changes in ownership interests*. P. 65. (2015). www.ey.com

[189] KPMG. *Consolidation of VIEs*. KPMG LLP. P. 300. (2019). https://frv.kpmg.us

At this point, the reader may wonder about which events (called commonly as "re-consideration events") we are referring to. In particular, ASC 810-10-35-4 comes to our aid:

«*[…] The initial determination of whether a legal entity is a VIE shall be reconsidered if any of the following occur:*

1. *The legal entity's governing documents or contractual arrangements are changed in a manner that changes the characteristics or adequacy of the legal entity's equity investment at risk.*
2. *The equity investment or some part thereof is returned to the equity investors, and other interests become exposed to expected losses of the legal entity.*
3. *The legal entity undertakes additional activities or acquires additional assets, beyond those that were anticipated at the later of the inception of the entity or the latest re-consideration event, that increase the entity's expected losses.*
4. *The legal entity receives an additional equity investment that is at risk, or the legal entity curtails or modifies its activities in a way that decreases its expected losses.*
5. *Changes in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity's economic performance*» (Financial Accounting Foundation, 2019, p. 81) [190].

In general, an event to qualify for this purpose must be significant, meaning that it should have the ability to affect somehow the "characteristics or adequacy of the legal entity's equity investment at risk", as the first point cites.
Furthermore, as a Deloitte report confirms, «*such an event could also cause a reporting entity to no longer qualify or begin to qualify for one of the scope exceptions in ASC 810-10-15-12 and ASC 810-10-15-17*» (Deloitte, 2015, p. 198;

[190] Financial Accounting Foundation. *ASC 810 – Consolidation.* P. 81. (2019)

Deloitte, 2019, p. 248)[191]. For full description of ASC 810 scope exceptions, the reader should refer to *paragraph 3.2.6*.

Withal, «*[…] decisions [whether] to consolidate or deconsolidate an entity should be reflected in the financial statements on the date circumstances change, and prior periods are not recast to conform to the current presentation*» (BDO, 2019, p. 28)[192].

Ultimately, it is important to bear in mind that the primary beneficiary shall not assess whether the legal entity is a VIE on a continuous basis (i.e., periodically in each reporting period), but just at the verification of one of the above-mentioned re-consideration events.

[191] Deloitte. *Consolidation. A Roadmap to Identifying a Controlling Financial Interest*. P. 198. (2015). www2.deloitte.com; Deloitte. *A Roadmap to Consolidation. Identifying a Controlling Financial Interest*. Financial Accounting Foundation. P. 248. (2019). www2.deloitte.com

[192] BDO. *BDO Knows: Variable Interest Entities*. P. 28. (2019). www.bdo.com

CHAPTER 6. DIFFERENT PERSPECTIVES ON THE CONSOLIDATION PERIMETER-RELATED ISSUES: Q&A SESSION WITH KPMG AUDITORS

SUMMARY: 6.1 Interview methodology: questionnaire design; 6.2 Presentation of results and related considerations coming from the audit practice under IAS/IFRSs versus US GAAPs; 6.3 Conclusions on auditors' opinions regarding control boundaries

6.1 Interview methodology: questionnaire design

After several theoretical considerations and some practical cases presented in the previous chapters, this section has the core objective to infer the auditors' opinions about some issues related to the group's perimeter with insights coming directly from the audit practice, especially with reference to *IFRS 10 – Consolidated Financial Statements* and *US GAAP ASC 810 – Consolidation*, i.e. the two main accounting standards dealing with consolidation topic. In order to carry out interviews, we firstly describe how the questionnaire was built. The questionnaire has been thought to be addressed only to KPMG auditors, who gave me their availability and precious contribution to enrich this academic thesis and with whom I completed an internship experience that was fundamental, first and foremost, to enhance and shape my career path and also oriented to conclude this Master's Degree Programme.

The questionnaire, handed out through "Google Modules®" platform, has been filled-in anonymously by auditors in order to avoid any possible bias in the subsequent analysis of the answers received. The entire questionnaire is herein enclosed in the dedicated section below. Examples of questions posed to auditors contributed to delineate and accomplish the main objective of the present work, i.e. to investigate the auditors' opinions regarding IFRS 10 and US GAAP ASC 810, whether they agree in relation to specific topics treated within the individual accounting principles, as well as their clue about some of the IASB's and FASB's choices.

The use of the questionnaire as means to interview auditors was not random; indeed, it has been chosen according to many convenience factors, i.e. because accurate, unbiased, fast and trustworthy, alternatively to carry out interviews in person.

The questionnaire has been structured in two parts, with a first generic part common to all (i.e., everyone undertaking the questionnaire was supposed to fill-in this part) composed by eight questions. In this first part, concepts stressed were addressed to obtain their perceptions regarding the following topics: the relevance of the IASB Conceptual Framework for Financial Reporting (and its equivalent FASB Concepts Statements) with respect to stand-alone standards, the difference between principles-based standards compared to rules-based principles, the meaningfulness of Consolidated Financial Statements, the absence of a standardized format available worldwide to present Consolidated Financial Statements, the role played by unconsolidated financial reporting, the differences among the most widespread accounting standard sets (IFRSs, US GAAPs and SACs Standards) about the reporting entity and legal entity concepts, the possibility to introduce a new concept of control within the EU strictly based on taxable profits and, finally, the difference between group's perimeter and internal control boundaries.

Instead, a second section (formed by ten questions) was built differently depending upon the subject undertaking the questionnaire, being addressed to auditors who have either IAS/IFRSs or US GAAPs knowledge. Eventually, for the sake of simplification, an auditor with both knowledge of IFRS 10 and US GAAP ASC 810 had to choose the second part based on its confidence with one accounting standard or the other one.

6.2 Presentation of results and related considerations coming from the audit practice under IAS/IFRSs versus US GAAPs

We now present the auditors' standpoint with respect to the issues discussed above. The answers received stem from two different auditors, i.e. one who has IAS/IFRSs knowledge and one experienced with US GAAPs. In order to keep information collected confidential, we will sum up the most important concepts emerged and their opinions, in lieu of reporting answers as they are. Also, with the aim to ensure privacy, we will call "Auditor 1" that one who has IAS/IFRSs knowledge, while "Auditor 2" who is experienced with US GAAPs.

We can argue that, although the restricted number of answers obtained, the latter ones are deemed to be representative of a most extended sample of auditors that unfortunately was not possible to interview.

Departing from the first common part, about the relevance of the IASB Conceptual Framework for Financial Reporting (and its equivalent FASB Concepts Statements) with respect to stand-alone standards both auditors agree that, although the Framework provide rationale and objectives in case of lack of a specific standard, single principles are more useful in practice, thanks to examples and practical applications contained in the standards themselves. However, Auditor 2 recognizes that individual standards cannot be considered properly as "stand-alone", since most of the time, to solve an issue, multiple standards come into play (e.g., think to Investment Entities that represent a scope exception according to *US GAAP ASC 810 – Consolidation* and, at the same time, are regulated by *ASC 946 – Financial Services – Investment Companies*).

Regarding the difference between principles-based standards compared to rules-based principles, it has emerged a different opinion: Auditor 1 affirms that US GAAPs should be more principles-based in order to converge to the International Financial Reporting Standards, while Auditor 2 sustains that, above all in some practical cases, a rules-based accounting system may leave less room to interpretation and, therefore, permit higher comparability of different financial statements. Auditor 2 even hazards the remote possibility that IFRS Standards should get closer to US GAAPs, thus favoring the adoption of rules-based principles also in Europe.

Among the eight questions, one investigated the meaningfulness of Consolidated Financial Statements compared to Separate ones: both auditors reply that stakeholders usually perceive more useful the Consolidated Financial Statements because, according to Auditor 1, they eliminate intercompany transactions and allow them to evaluate the group as a whole. In particular, Consolidated Financial Statements permit a better understanding of the controlled entities and representation of ownership interests, which in Separate ones would otherwise be simply accounted as "Investments" among Financial Assets. Auditor 2 affirms that Consolidated Financial Statements are far above Separate ones (meaningfully speaking) due to cash stability, negotiating power and other factors that individual companies bring to the rest of the group, provided that they enter it in a stable way (so, they are not temporary part of the group).

Moreover, the absence of a standardized format available worldwide to present Consolidated Financial Statements has been valued by both auditors highly impacted by different local requirements that may pose significant

obstacles in adopting a unique structure to draft financial statements. In addition, Auditor 1 points out that the application of a neutral and homogeneous format at the global level would require extra funds that actually are far behind the current costs that firms have to support when comparing different financial statements; and this is valid above all for unlisted companies, which are most of the times smaller than public corporations and endowed with limited resources. Also, Auditor 2 notices how companies' industry, size and organizational structure are crucial when it comes to consolidate group accounts according to their own format: nonetheless, Consolidated Financial Statements must be drafted intelligibly, so that all stakeholders can comprehend them (even those who do not have a finance background).

Then, it was the turn to infer the auditors' opinions about the role played by unconsolidated financial reporting: specifically, at the question whether outsourcing is a valid alternative to reduce incentives related to the presentation of unconsolidated financial statements, auditors respond positively, but making some considerations. Auditor 1, indeed, recognizes that, even it may be a possible solution to lower the incentives by the management and Auditor 2 pointing out that the group may benefit from the expertise of the outsourcee (i.e., the provider of the service), this choice does not come without risks. Indeed, outsourcing may provoke a lack of data due to the loss or a highway robbery of internal information that should have kept confidential, rather than published on those same financial statements. Furthermore, the choice itself of the service provider is not trivial, since quality and professional experience are key, besides the service fee (to be minimized in order to not increase or maintain steady group's expenditure). However, each case should be analyzed one at a time in order to nullify (or, at least, mitigate) those risks.

If we look at the differences among the most widespread accounting standard sets (IFRSs, US GAAPs and SACs Standards) about the reporting entity and legal entity concepts, the two auditors agree that SACs Standards should align to IFRSs and US GAAPs in order to reach common definitions worldwide oriented to properly define who is in charge to present Consolidated Financial Statements and who instead must be consolidated, thereby increasing comparability of financial statements; indeed, this difference between accounting principles implies a material effect on financial reporting practices that cannot be ignored.

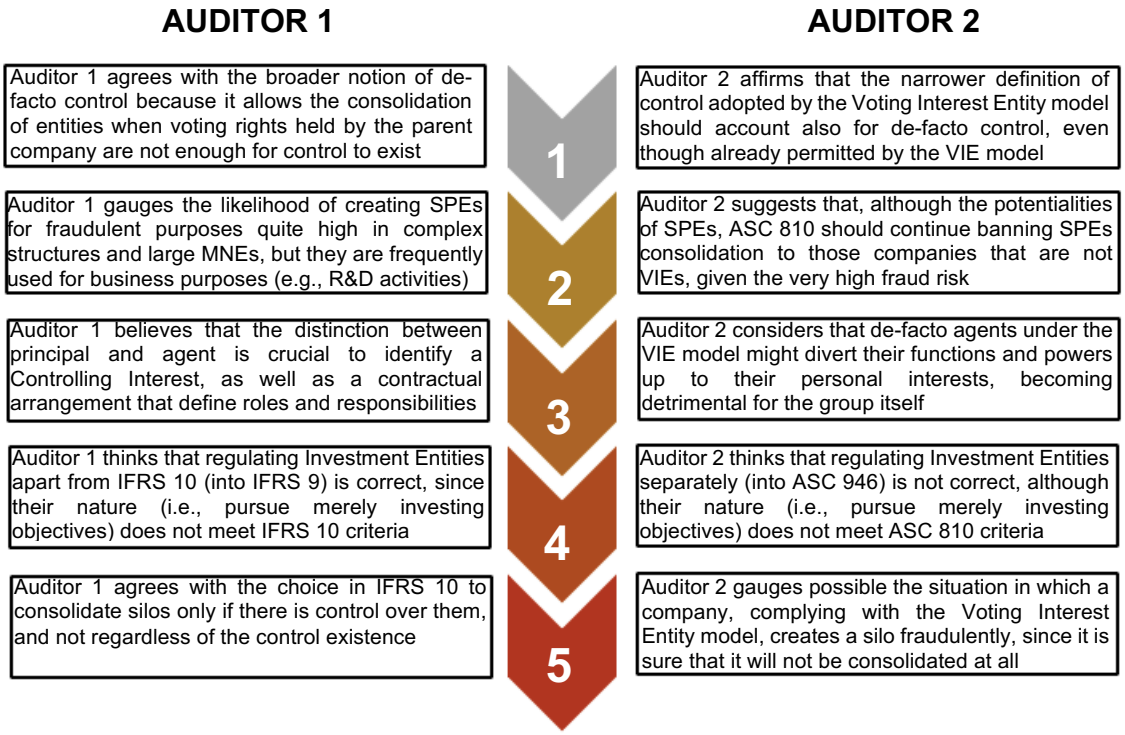
Then, a new concept of control within the EU strictly based on taxable profits is contemplated by both auditors. Both auditors disagree with this innovative control possibility, judging it highly risky. Auditor 1 affirms that this kind of simplification may entail the exclusion of some entities from the consolidation perimeter, so that the group might have no control over them; as a matter of fact, these entities, if not consolidated, would operate independently (e.g., they would likely be controlled by virtue of a shareholders' agreement). In its opinion, the risk of not consolidating those entities is higher than the benefits that such simplification would bring, and this is even more accentuated for large international groups. Auditor 2, instead, underlines the recklessness to merely link control to taxable profits without considering any other factor.

Lastly, with respect to the difference that there could be between the group's perimeter and internal control boundaries, both auditors agree that a potential misalignment between them could lead to a general chaos about the roles/functions within the group organization. Auditor 1 reports that a similar situation can also be reconducted when consolidating sub-groups that use different accounting standards, such that the holding may have limited access to the reporting system of companies hierarchically lower, ending up with sub-Consolidated Financial Statement that do not represent truly the economic-financial situation of the overall group. Auditor 2, preferably, proposes to adopt rules-based accounting (for IFRS-compliant companies) which hopefully might help in clearly determining the external group's boundaries, so that the risk of a potential misalignment would be minimized.

The second part of the questionnaire has been structured, as we argued previously, differently according to the subject undertaking it (i.e., Auditor 1 and Auditor 2 had to answer to ten questions each, respectively on IFRS 10 and US GAAP ASC 810 topics). Therefore, we proceed as follows: we start by dealing with common issues involving both IFRS 10 and ASC 810, i.e.: 1) de-facto control versus de jure control; 2) Special Purpose Entities; 3) de-facto agency relationship; 4) scope exceptions (with a focus on Investment Entities); 5) silos. Finally, we will cope with auditors' thoughts about those matters that will be treated individually related to the two accounting standards.

The infographic below summarizes auditors' opinions regarding the above-mentioned five topics (Figure 6.1, *A comparison between auditors' opinions*

regarding common issues contemplated by both IFRS 10 and US GAAP ASC 810)[193]:



Now, paying attention to topics addressed to both auditors separately, Auditor 1 states that the choice of the IASB to replace the term “benefits” (inserted in IAS 27) with “returns” (cited by IFRS 10) was appropriate, given that control must be exercised not only when group’s performance is positive, but also when losses are coming to surface. Moreover, Auditor 1 judges the simultaneity of the three elements that characterize control indispensable, as long as they are possessed only by one subject (who consolidate group accounts) and not severally (e.g., this might be the case of jointly-controlled entities). Furthermore, Auditor 1 considers the separation between substantive and protective rights useful because the latter ones, by nature, cannot give the power over the entity to which those rights relate. Finally, Auditor 1 evaluates as positive the newest IFRS 10 (compared to its predecessor IAS 27, now the latter dealing only with Separate Financial Statements) because, besides to improve the representation of the group's performance and provide more detailed, adequate and useful

[193] Figure 6.1: *A comparison between auditors’ opinions regarding common issues contemplated by both IFRS 10 and US GAAP ASC 810*. Figure created by the Author.
Source: Questionnaire on accounting standards “IFRS 10 – Consolidated Financial Statements” versus “US GAAP ASC 810 – Consolidation”

information to the preparers and stakeholders of the Consolidated Financial Statements, it has fine-tuned the definition of control by enlarging the consolidation of certain entities excluded by the former IAS 27.

Coming to specific questions regarding US GAAP ASC 810 addressed to Auditor 2, the latter states that the fact that criteria to attribute the VIE legal status to an entity leave somehow room for judgement is in line with the VIE control model, which is closer to the idea of de-facto control, rather than de jure control embraced by the residual Voting Interest Entity model. However, the more rules are fixed, the less inconsistencies there will be. As a further matter, Auditor 2 gauges as more appropriate appointing an external third party to determine whether an entity possesses the two requirements necessary for being recognized as primary beneficiary (thus, for exercising control); this in order to avoid clearly any possible conflict of interest, instead of leaving up to the entity itself the capability to self-assess its legal status also whenever should not be entitled to.

Moreover, Auditor 2 points out that the existence of the two categories of rights (i.e., participating and kick-out rights) could be considered useless provided that both can be used with the scope to impact negatively the power criterion leading to the loss of control on the VIE, but actually this distinction is necessary as long as participating rights offer also the possibility to participate in the actions through which the primary beneficiary exercises power. In addition, Auditor 2 is in agreement with the intention of the FASB to attribute more power to LPs, entitling them to consolidate group accounts (and even remove the GP or dissolve the partnership arrangement through the exercise of kick-out rights), since the older disposition (prior to ASU 2015-02) made prevailing the authority of the GP, since ever seen as the only one capable to play a critical role within the partnership.

Eventually, Auditor 2 respects the choice made by the FASB relatively to ASC 810, which refreshed the previous principle regulating consolidation topic (i.e., SFAS 167) that, in turn, renovated FIN 46 (R) by introducing more qualitative aspects to delineate control over the significant activities of the VIEs, removing prior quantitative thresholds (GAAP Logic, 2019)[194]. This can be interpreted as a further attempt towards the broadening of the entity's boundaries of US GAAP-compliant companies that consolidate group accounts according to the VIE model

[194] GAAP Logic. *ASC 810: A Consolidation Overview*. (2019)

and, perhaps, a struggle oriented to converge definitely to de-facto control also in the US environment.

6.3 Conclusions on auditors' opinions regarding control boundaries

Auditors' opinions have been treated as much neutrally as possible in order to not influence the thoughts of the reader in any way. However, often the audit approach depends from a variety of factors that cannot prescind from the real world, depending upon clients' needs, engagements' peculiarities, the adequacy of clients' internal control systems, so that we can discuss theoretically dispositions, regulations and laws only up to a certain point. Beyond that point, only practical applications and real-case scenarios are able to explains limits, differences between IAS/IFRSs and US GAAPs and choices of regulators.

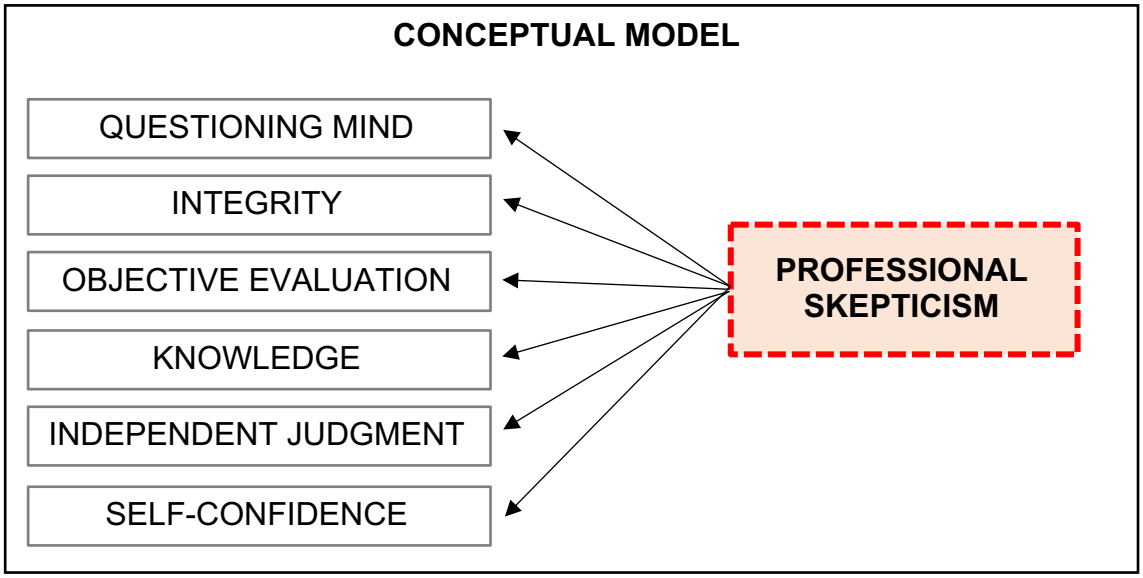
Nonetheless, we should bear in mind that the answers collected could be affected somehow by a discrete dose of what audit experts call "professional skepticism". As clearly stated by Nelson, M. W., professional skepticism can be defined as:

«*an attitude that includes a questioning mind, […] and a critical assessment of audit evidence. The auditor uses the knowledge, skill, and ability called for by the profession of public accounting to diligently perform, in good faith and with integrity, the gathering and objective evaluation of evidence. […]. The auditor neither assumes that management is dishonest nor assumes unquestioned honesty'*» (AICPA, 2018, p. 84; IAASB, 2009, p. 77; Glover, S. M., Prawitt, D. F., 2013, p. 2; Nelson, M. W., 2009, p. 3; PCAOB, 2010)[195].

If we would display graphically the statement barely presented, we shall follow the "Conceptual Model" figured out by Siew, C. et al. showing "The Six Characteristics of Professional Skepticism Affecting Auditors' Fraud Detection".

[195] AICPA. *AU-C Section 200 - Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*. Pp. 79-104. P. 84. (2018); IAASB. I*SA 200 – Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*. New York. P. 77. (2009). www.ifac.org; Glover, S. M., Prawitt, D. F. *Enhancing Auditor Professional Skepticism*. Brigham Young University. P. 2. (2013). www.iaasb.org; Nelson, M. W. *A Model and Literature Review of Professional Skepticism in Auditing*. Auditing: A Journal of Practice & Theory, Vol. 28, No. 2. Pp. 1-34. P. 3. (2009). papers.ssrn.com; PCAOB. *AU 230: Due Professional Care in the Performance of Work*. (2010). www.pcaobus.org

The figure below gives a visual representation of it (Figure 6.2, *A visual representation of Professional Skepticism components)*[196]:



That is why auditors must be always alert on potential frauds, audit misstatements and regulators' and standard-setters' concerns, not just when working with clients, but also when discussing topics like those that we have taken into considerations until now.

Eventually, the interviews conducted with the invaluable auditors' help have been pivotal for easing the apprehension of the reader on the topics discussed along the entire Thesis and hopefully will give some hints that shall light some sparks for future research.

[196] Figure 6.2: *A visual representation of Professional Skepticism components*. Figure re-elaborated by the Author.
Source: Siew, C. et al. *A study on the relationship between professional scepticism characteristics and auditors' fraud detection in Malaysian context*. Faculty of Business & Finance, Universiti Tunku Abdul Rahman, Malaysia. P. 7. (2018). www.researchgate.net

CONCLUSIONS

This academic project has had the main objective to shed light on Consolidated Financial Statements and, in particular, to help the reader in obtaining a good knowledge and a deep understanding about how groups of companies (adopting either IAS/IFRS Standards or US GAAP Principles) define their consolidation perimeter, offering several perspectives to technical issues and related feasible solutions. Needless to say, it would be foolhardy to pretend to have been exhaustive covering any possible topic related to group's corporate disclosure; nonetheless, we have gone through major topics regarding control and also exemplifications made their part in improving the quality of the overall work and easing the comprehension of whomever this study is addressed to.

At the beginning, we dealt with most relevant regulatory changes involving the consolidation arena, by focusing first of all on the Conceptual Framework for Financial Reporting and simultaneously on the effort put by the FASB in the construction process of its Concepts Statements. Moreover, we can recall that both the Seventh and Fourth Directives played a key role when establishing pillars for future regulation about consolidation. And that is why European developments led to birth of *IFRS 10 – Consolidated Financial Statements* whilst its companion *US GAAP ASC 810 – Consolidation* was being developed overseas. However, we should expect that both IASB and FASB shall accelerate their process related to Post-Implementation Reviews of IFRS 10 and ASC 810, in order to ensure that organizations did not encounter any relevant issue when complying with them and to make sure that guidance conveyed was enough understandable and exhaustive. Moreover, there is certainly room for advancing at a faster rate the convergence process about IASB and FASB regulations at the global level, with the aim to strengthen already existing standards, allocate more resources to future research and obtain a greater worldwide recognition when enforcing laws and related amendments to companies complying with these sets of rules. As a result, compliance costs would be minimized strongly. In more practical terms, US GAAPs could get closer to IAS/IFRSs, for instance, by orienting US GAAP Principles following "principles-based" accounting, which leaves more room for professional judgment and constructive interpretations or also allowing for "de-facto control", rather than ownership interests strictly

recognized based on the majority of voting rights (and this are the fundamentals of the Voting Interest Entity model, that we faced along *Chapter 3*). In the latter case, this would mean that “substance” shall prevail over “form”, that in US terms would translates into control recognized going beyond the current narrow legal form.

Furthermore, we went through the structure and the regulatory aspects of Consolidated Financial Statements before illustrating the consolidation process and explaining possible reasons tied to unconsolidated financial reporting. Getting closer to the core of the entire work, we defined what control is, how is detected and the subtle difference that exists between internal organizational boundaries and group external perimeter.

The crucial part of this Master Thesis is embedded in Chapter 3, which covers the three majors consolidation models for aggregating group accounts, i.e. the IFRS 10 control model, the VIE model and the Voting Interest Entity model. Since not all entities fall within the consolidation area, we have determined which are the scope exceptions contemplated by each model. By looking at financial figures and by making some related considerations on the practical case, we can deduce that there is not the “best model” among the others to be used *a priori*, but they differ according to the set of standards considered and, thus, to the way in which control is detected.

Despite the fact that control can be exercised even just on a restricted portion of assets called “silo”, some companies are used to consolidate their accounts without accounting for it, for instance, by considering the VIE as a compact entity incorporating the silo upon which control should be exerted separately from the host entity.

In addition, we took into account the cases in which companies might lose control over a specified pool of assets or even on the entire consolidated enterprise. This happens when the parent transfers/sells the shares held in a legal entity or a silo, thus accounting for the gain/loss resulting from the deconsolidation/derecognition. Also, some occurrences can represent the cause of an entity for not being able anymore to consolidate its subsidiaries, and we are especially referring to the so-called “re-consideration events” that can impact negatively US GAAP-compliant companies, leading to the loss of control. It seems that there is a groundswell of opinion that agree on the fact that some events should be removed from the list included in ASC 810-10-35-4 in order to

reduce the possibilities for a loss of control to happen, when this is not fairly attributed (e.g., assets acquired by the entity that, although may alter the characteristics or adequacy of the legal entity's equity investment at risk, they are gauged totally detached from the core business of the group, such that they would not increase the entity's expected losses). In such a case, we would retain that *segment reporting* could be a profitable solution, since the latter allows to organize company's data by divisions, subsidiaries or segments (thus, presenting apart the figures regarding those categories of assets/liabilities that are not concerned with the core business of the group). Since segment reporting disaggregates consolidated data over economic units, this automatically involves the potential risk of uselessness of information of disclosing separate and fragmentary data offered to users of Consolidated financial statements, who should instead gauge the entire business as a whole, looking at the bigger picture.

Eventually, the interviews carried out in the present work contributed the different auditors' standpoints relating both to *IFRS 10 – Consolidated Financial Statements* and *US GAAP ASC 810 – Consolidation*.

There is a growing body of opinion that sustains that the corporate scene has totally changed, becoming far too complex than ever, particularly looking at the degree of sophistication of capital markets and the resources to be allocated for the preparation and use of group accounts. Anyway, practitioners and academics are confident that financial reporting practices (including consolidation) should be sharpened for strengthening comparability, and thence allowing diverse internal reporting systems that reflect companies' size, industry and characteristics (in consonance with the "contingency management theory").

Concluding, a final aspect that it would be interesting to highlight and that, above all, should always drive the preparation and presentation of Consolidated Financial Statements is the *true and fair view* of the group's situation, meaning that the parent company must ensure to its stakeholders that figures embedded in the Annual Report are free from material misstatements and faithfully represent the financial performance and position of the entity and the overall group. This must not be taken-for-granted, since the holding company has always to be accountable in the use of the resources collected with the aim to further strengthen and forge its relationship network in a medium to long-term horizon.

ANNEX

Questionnaire on accounting standards "IFRS 10 – Consolidated Financial Statements" versus "US GAAP ASC 810 – Consolidation"

The following questionnaire is exclusively addressed to KPMG auditors intended to gather information to be used solely for educational purposes. Evidence collected will be processed and included in the Master Thesis of the student Alberto Strazzacappa enrolled at Ca' Foscari University of Venice.

Data conveyed will be treated confidentially pursuant to GDPR (EU regulation no. 2016/679).

Instructions to fill-in the questionnaire

PLEASE READ CAREFULLY THE FOLLOWING INSTRUCTIONS BEFORE CONTINUE.

The questionnaire is structured as follows: the first part is generic and common to all (i.e., everyone that is undertaking the questionnaire is supposed to fill-in this part), while the second part varies according to the subject that is undertaking the questionnaire, being addressed to auditors who have either IFRS or US GAAP knowledge.

Hence, identify yourself alternatively as:

1) An experienced auditor with IFRS Principles knowledge – you shall fill-in the first generic part plus the second one regarding "IFRS 10 – Consolidated Financial Statements".
2) An experienced auditor with US GAAP Principles knowledge – you shall fill-in the first generic part plus the second one regarding "ASC 810 – Consolidation".

If you have both knowledge of IFRS 10 and US GAAP ASC 810, please choose that one that you are more confident with (after having completed the first part, of course).

Estimated time for filling-in the whole questionnaire: 15-20 minutes.

Thank for your precious time and collaboration!

First part

PLEASE CHOOSE AN OPTION (Yes/No) AND WRITE A BRIEF COMMENT EXPLAINING YOUR CHOICE.

QUESTION 1: The IFRS "Conceptual Framework for Financial Reporting" (and its equivalent FASB "Concepts Statements") are intended to fill-in the gaps that either IFRSs or US GAAP Standards might have, thus providing the lacking guidance. However, should there be any inconsistence between the Frameworks and one standard, the latter one prevails. Do you agree that the Conceptual Framework for Financial Reporting/Concepts Statements are not perceived as useful in practice as stand-alone IFRS/US GAAP dispositions instead are?

a) Yes
b) No
Why? _____

QUESTION 2: IFRSs are “principles-based” standards, contrarily to US GAAPs, which are “rules-based”. While IFRSs leave more room for uncertainty and professional judgment, rules-based accounting does not leave any space for second-guessing, since rules must be followed without any degree of personal interpretation. Do you agree that also US GAAP Standards should be principles-based (as IFRSs) in order to allow more discretion (case-by-case approach) and foster global accounting regulation convergence?

a) Yes
b) No
Why? _____

QUESTION 3: There is a widespread presumption by the general public that Consolidated Financial Statements are more meaningful to stakeholders than Separate ones. Do you agree with that?

a) Yes
b) No
Why? _____

QUESTION 4: A common trait that is present in both US GAAPs and IFRS Standards is that, although minimum disclosure requirements are imposed, there is not a pre-defined format to follow during consolidation, even if for SEC registrants (i.e., those companies listed in a US Stock Exchange) some specific format may be required, such as the “10K form” (which includes, besides financial figures, the company history, the organizational structure, the executive compensation, etc.). Do you agree that Consolidated Financial Statements cannot be presented in a one, unique and homogenous way worldwide in order to better adapt and reflect companies' size, industry and characteristics?

a) Yes
b) No
Why? _____

QUESTION 5: When preparing Consolidated Financial Statements, some entities might not be included in the consolidation area. This may happen for a variety of reason, such as: streamline time and costs associated to the financial reporting function, off-balance sheet and/or off-profit and loss accounting, tax purposes and the like. A valid alternative to reduce incentives related to the presentation of unconsolidated financial statements is to perform the consolidation process in outsourcing. Do you agree with that?

a) Yes
b) No
Why? _____

QUESTION 6: Both IFRS 10 and US GAAP ASC 810 substantially agree when linking the reporting entity concept to the parent company and the concept of the legal entity to the subsidiary. Instead, Australian GAAP Principles (i.e., "Statement of Accounting Concepts, SACs") have a totally different concept of reporting entity: depending on the classification of an entity as "reporting entity" or "non-reporting entity", such entity will be subjected to different financial reporting requirements. This distinction implies that reporting entities comply with full GAAP-based or commonly known as "General Purpose Financial Reports (GPFRs)", while non-reporting entities are asked to operate according to "Special Purpose Financial Reports (SPFRs)", which are simplified and less complex financial reporting requirements. Do you agree that SACs Standards should align to IFRSs and US GAAPs in order to reach common definitions of reporting entity and legal entity worldwide?

a) Yes
b) No
Why? _____

QUESTION 7: Both IFRS 10 and US GAAP ASC 810 provide their own definitions of control (which is the basis for defining the consolidation perimeter, thus making the difference when deciding to include/exclude a certain legal entity from the group). A relevant empirical study conducted by Vašek and Gluzová (Vašek, L., Gluzová, T., 2014) pointed out whether a new concept of control might replace the older one applicable to companies operating within the European Union (EU) to calculate their taxable profits. In this way, a group would have to comply with just one EU system for computing its taxable income, rather than different rules in each Member State in which it operates. Is, in your opinion, this one a feasible solution (i.e., control strictly based on taxable profits, without considering any other factor)?

a) Yes
b) No
Why? _____

QUESTION 8: The theoretical line that separates the group's external perimeter (which allows to determine the legal entities to consolidate) from its internal boundaries (which, instead, are limits to the flow of information, resources, spaces that fluctuate within the organizational sphere, shaping the business model with the unfolding of the business activities) sometimes is so thin that it makes difficult to delineate which are the boundaries that have been brought into play. A misalignment between external and internal boundaries can lead the holding (and the group consequently) out of way. Do you agree with that?

a) Yes
b) No
Why? _____

Instructions for the second part

PLEASE READ CAREFULLY THE FOLLOWING QUESTION BEFORE CONTINUE.

Now, please choose the option that better represent your personal situation. Remember that if you have both knowledge of IFRS 10 and US GAAP ASC 810, please choose that one that you are more confident with. I am...

a) An experienced auditor with IFRS Principles knowledge
b) An experienced auditor with US GAAP Principles knowledge

Second part – "IFRS 10 – Consolidated Financial Statements"

PLEASE CHOOSE AN OPTION (Yes/No) AND WRITE A BRIEF COMMENT EXPLAINING YOUR CHOICE.

QUESTION 1: The predecessor of IFRS 10, i.e. "IAS 27 – Consolidated and Separate Financial Statements (2008)", defined control as: " the power to govern the financial and operating policies of an entity, so as to obtain benefits from its activities", meaning that control could be exercised only over those investees generating positive results. IFRS 10 replaced the term "benefits" with "returns", thus allowing also a negative performance of the investee. Do you agree with this change?

a) Yes
b) No
Why? _____

QUESTION 2: According to IFRS 10, the investor must meet 3 requirements simultaneously for exercising control (i.e., 1) "power over the investee"; 2) "exposure, or rights, to variable returns"; 3) "the ability to use power over the investee to affect the amount of the investor's returns"). Differently from IAS 27, this new definition of control is not strictly based on voting rights held by the parent company, but it accounts also for "de-facto control". Do you believe that this broader way to define control is better than only "de jure control"?

a) Yes
b) No
Why? _____

QUESTION 3: The three elements cited in the previous question defining control, pursuant to IFRS 10, must occur simultaneously. Do you consider this simultaneity indispensable for control to be exercised?

a) Yes
b) No
Why? _____

QUESTION 4: Under IFRS 10, the exercise of power derives from rights. Only substantive rights are valid (i.e., those that give the investor the practical ability to exercise the rights), while ignoring protective rights (designed only to protect the interest of the party holding those rights, without giving it the power over the entity to which those rights relate). Do you consider this separation useful and, therefore, the consideration of only those rights that enjoy the attribute of substantiality?

a) Yes
b) No
Why? _____

QUESTION 5: The use of "Special Purpose Entities" (i.e., legally independent companies that are created for the achievement of a particular and well-defined scope, such as a lease contract, securitization of financial assets, or R&D activities) increased significantly in the last two decades, and especially in the early 2000s, as showed by an empirical study carried out by Feng, M. et al. Do you think that SPEs are created, most of the times, for the above-mentioned scopes or just for fraudulent purposes (e.g., hide some assets, evade taxes, etc.)?

a) Yes
b) No
Why? _____

QUESTION 6: IFRS 10 intervenes on the question of delegated power. It requires establishing whether the investor acts as a "principal" (i.e., on its own behalf) or as an "agent" (i.e., on behalf and for the benefit of another party or parties). The investor, alternatively identified as the "decision-maker", is entitled to control the investee if and only if it makes decisions directly, and not through mandate of third parties. Do you consider this distinction necessary?

a) Yes
b) No
Why? _____

QUESTION 7: The relationship between two entities can be much broader than just involving two subjects respectively playing the role of the “investor” and “investee”. Indeed, other parties might be brought into play. IFRS 10 states that: “an investor shall consider the nature of its relationship with other parties and whether those other parties are acting on the investor's behalf (i.e., they are 'de-facto agents')”. Do you agree that the lack of an eventual contractual arrangement between the investor and investee implies a certain degree of discretion and judgmental expression that can be used by the investor to spot other parties to its own and exclusive advantage?

a) Yes
b) No
Why? _____

QUESTION 8: Among IFRS 10 scope exceptions enter Investment Entities (i.e., companies that are intended to pursue merely investing objectives, having as a chief aim that one of increasing the investment income, like dividends, instead of managing the group’s operating and financial policies). These companies do not have to prepare Consolidated Financial Statements, but just measure all of its subsidiaries at fair value through profit or loss, in accordance with “IFRS 9 – Financial Instruments”. Do you think that is correct the choice of the IASB to exclude such entities?

a) Yes
b) No
Why? _____

QUESTION 9: IFRS 10 considers the particular case of control over a part of the investee, deemed as a separate entity, called "silo". Do you consider the consolidation of the silo adequate only if the parent company has control over it, as defined by IFRS 10? Or should the investee be consolidated in its entirety, including silos, regardless of the existence of control over them?

a) The silo must be consolidated only if there is control over it, as defined by IFRS 10

b) The investee must be consolidated in its entirety, including silos, regardless of the existence of control over them

QUESTION 10: Concluding, do you consider that the issuance of the "new" accounting standard (i.e., IFRS 10 with respect to the predecessor IAS 27, now the latter regulating only “Separate Financial Statements”) improves the representation of the group's performance and provides more detailed, adequate and useful information to the preparers and stakeholders of the Consolidated Financial Statements?

a) Yes
b) No
Why? _____

Second part – “US GAAP ASC 810 – Consolidation”

PLEASE CHOOSE AN OPTION (Yes/No) AND WRITE A BRIEF COMMENT EXPLAINING YOUR CHOICE.

QUESTION 1: Pursuant to US GAAP ASC 810, two are the consolidation models contemplated: the “Variable Interest Entity (VIE)” and the “Voting Interest Entity” models. The latter is a residual model, since it applies only when a variable interest has not been detected (meaning that the VIE model cannot be applied). To be applicable, the VIE must present one of the following criteria: 1) “the legal entity does not have sufficient equity investment at risk”; 2) “the equity investors at risk, as a group, lack the characteristics of a Controlling Financial Interest”; 3) “the entity is structured with disproportionate voting rights, and substantially all of the activities are conducted on behalf of an investor with disproportionately few voting rights”. Do you agree that no too much room for judgment should be left when assessing control?

a) Yes
b) No
Why? _____

QUESTION 2: Under the VIE model, the “primary beneficiary” is nothing more than the consolidating entity when a variable interest is recognized in the legal entity being consolidated. US GAAP ASC 810 imposed to the reporting entity to perform a qualitative self-assessment of whether it possesses both the two elements that delineate control, i.e.: a) “The power to direct the activities of a VIE that most significantly impact the VIE’s economic performance”; b) “The obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE”. Do you think that should be more appropriate leaving the decision to an external third party whether the reporting entity has the requirements for being recognized as primary beneficiary in order to avoid any conflict of interest?

a) Yes
b) No
Why? _____

QUESTION 3: Under the VIE model, the exercise of power may be affected from rights (“kick-out rights” or “participating rights”). Kick-out rights confer the ability to remove the primary beneficiary or to dissolve (i.e., liquidate) the VIE without cause. Participating rights, instead, give the ability to block or participate in the actions through which the primary beneficiary exercises power. Both rights, to be effective, must be held exclusively by a single party and must be substantive, meaning that there should not be any barrier that limits or prevents their exercise. Do you agree that the existence of these two categories of rights is useless since both might be used with the scope to impact negatively the power criterion leading to the loss of control on the VIE?

a) Yes
b) No
Why? _____

QUESTION 4: Under the Voting Interest Entity model, the identification of a "Controlling Financial Interest" is based on the notion of de jure control, thus requiring mandatorily 50% (at least) of ownership of voting rights. Do you believe

that this narrower way to define control is better than also allowing "de-facto control" (i.e., control exercised with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree)?

a) Yes
b) No
Why? _____

QUESTION 5: Under the Voting Interest Entity model, the requirements to spot a Controlling Financial Interest vary depending whether we are considering corporations or limited partnerships (and similar entities). While for corporations a Controlling Financial Interest translates into "the continuing power to govern the financial and operating policies of an entity" (thus, attributing the company the duty to prepare Consolidated Financial Statements), for limited partnerships (and similar entities) the consolidation role must be exercised by a Limited Partner (LP) that has also the unilateral right to remove the General Partner (GP) or even dissolve the partnership arrangement. Prior to ASU 2015-02, instead, the consolidation role was left to the GP because it prevailed the presumption that its decision-making power was far above the passive role played by LPs. Do you agree with the intention of the FASB to attribute more importance to LPs?

a) Yes
b) No
Why? _____

QUESTION 6: Under the VIE model, “Special Purpose Entities (SPEs)” are legally independent companies that are created for the achievement of a particular and well-defined scope, such as a lease contract, securitization of financial assets, or R&D activities. The most important aspect regarding SPEs is to try to investigate when they collocate within or outside the consolidation perimeter. So, a SPE that is not a VIE must not be consolidated, thus representing one of the scope exceptions contemplated by US GAAP ASC 810. Do you think that SPEs are created, most of the times, for the above-mentioned

scopes or just for fraudulent purposes (e.g., hide some assets, evade taxes, etc.)?

a) Yes
b) No
Why? _____

QUESTION 7: Under the VIE model, the relationship between two entities can be much broader than barely involving two subjects respectively playing the role of the "investor" and "investee". Indeed, other parties might be brought into play. The VIE model acknowledges the existence of "de-facto agents", who are mandated to exercise rights and assume duties on investor's behalf. Do you agree that other parties involved in a de-facto agency relationship might be incentivized to pursue their own interests in order to assume the control directly of the VIE, thus taking the position of their principal?

a) Yes
b) No
Why? _____

QUESTION 8: Under the VIE model, pursuant to US GAAP ASC 810, scope exemptions include four categories of subjects: 1) "employee benefit plans"; 2) "investment entities"; 3) "governmental organizations"; 4) "money market funds". In particular, investment entities (i.e., companies that are intended to pursue merely investing objectives, having as a chief aim that one of increasing the investment income, like dividends, instead of managing the group's operating and financial policies) do not prepare Consolidated Financial Statements, since they must comply with "ASC 946 – Financial Services – Investment Companies". Do you think that is correct the choice of the FASB to exclude such entities?

a) Yes
b) No
Why? _____

QUESTION 9: US GAAP ASC 810 considers the particular case of control over a part of the investee (e.g., a pool of assets), constituting a separate entity, called "silo". A silo can exist only if the VIE model applies. The Voting Interest Entity model is brought into play only when the silo does not exist because the host entity is not a VIE, being so the alternative consolidation model to be used. Do you agree that a group, compliant to the Voting Interest Entity model, might create a separate entity (being like a silo) only for accomplish fraudulent purposes (e.g., dismiss a certain asset or pool of assets deemed detrimental for the group itself), given that such entity, for sure, will not be consolidated?

a) Yes
b) No
Why? _____

QUESTION 10: Concluding, before the issuance of US GAAP ASC 810 there was SFAS 167 regulating consolidation. In particular, SFAS 167 abolished the “risk-reward-based” consolidation model, introduced previously by FIN 46 (R), thereby adopting instead consolidation requirements more focused on qualitative aspects for assessing the reporting entity’s control over the significant activities of VIEs. Do you agree with this choice made by the FASB?

a) Yes
b) No
Why? _____

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