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Disclosure of Interests in Other Entities: IFRS vs. US GAAP

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I would really like to thank my Family for having supported me throughout the entire university course, for having sustained me in my personal and professional growth, and for hence having allowed me to achieve such great results.

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INTRODUCTION

On August 15, 2019, an astonishing fact was all over the news: the blue-chip company General Electric was accused to be involved in a big accounting scandal. A private financial investigator, Harry Markopolos, in a 175-pages report alleged GE of concealing $38 billion in potential losses, an amount equalling over 40% of GE's market capitalization. Furthermore, still in accordance with the report, the company's cash situation was much worse than disclosed in the 2018 annual report (Fraud Investigators, 2019). Following the news, GE's share price dropped dramatically, closing down 11% with respect to the previous day closing. The fell was the effect of a general panic selling (Hotten, 2019). Indeed, in accordance with the report under consideration, the risk of bankruptcy for GE following the fraud scandal is high. As the author states, "GE has been running a decades long accounting fraud by only providing top line revenue and bottom line profits for its business units and getting away with leaving out cost of goods sold, SG&A, R&D, and corporate overhead allocations." And again, "To make it impossible to compare GE's numbers across multi-year time periods, GE changes its Financial Statements reporting formats every few years" (Fraud Investigators, 2019, p.10). Thus, the fraud have been accomplished not only by reporting fake revenues and earnings or by employing some accounting tricks, but also by preparing opaque, unreadable financial statements, and by using off-balance sheet entities to hide debt (Fraud Investigators, 2019). Poor disclosure, thus, albeit not the only factor, have played an important role in enabling the company to engage in such fraudulent behaviours. This is a case that, if proved to be true, would be very similar – as the same Mr. Markopolos states – to the famous Enron case (Fraud Investigators, 2019). The Enron case dates back to 2001 and also there off-balance sheet entities were used to hide debt and in general some kinds of transactions were put in place with such entities to conceal large losses and get more favourable financial statements results. False and misleading information was reported about the financial performance of the company and about the relationships with its partnerships. As the scandal was uncovered, the Enron's share price fell dramatically and in few months the company was forced to file for bankruptcy. The hidden losses were not as the same size as

those hypothesized for GE, but investors lost the faith in the company and that fact was determinant in bringing the company down to the collapse.

In the first chapter of this dissertation, I dedicate an entire paragraph to the Enron case as it is one of the most important cases relating to accounting scandals and to disclosure matters from which important lessons can be learnt. The chapter 1 of this dissertation, more generally, is devoted to the importance of the disclosure, stressing first the relevance of disclosure per se and then deepening the importance of disclosure relating to the entities' interests in other entities. It is indeed the disclosure of interests in other entities that is the specific issue at stake of this dissertation, and the Enron case and the 2007-2009 financial crisis are taken as case studies to explain the relevance of such matter. In this dissertation, in particular in the chapters from 2 to 4, I will analyse the state-of-the-art of the US GAAP and IAS/IFRS standards relating to the disclosure of interests in other entities. I will basically compare the corresponding provisions in the two sets of standards trying to come at the end of each chapter to a conclusion on which of the two sets of standards require the most extensive disclosure relating to the specific subtopic addressed in each relevant chapter. The overall topic of the dissertation is split throughout the various chapters into the different types of entities which the disclosure of interests is about. In particular, chapters 2, 3, and 4 will deal with the disclosure of interests in subsidiaries, structured entities/variable interest entities and equity-method investees, respectively. Then, in chapter 5, also a sort of empirical research will be carried out. While in the other chapters the dissertation essentially deals with the accounting standards as issued by the respected Boards and the comparison between them, in chapter 5 I analyse a sample of 15 financial statements prepared in accordance with US GAAP and a sample of again 15 financial statements prepared in accordance with IFRS. The aim is twofold. On the one side, the intention is to look at whether the accounting standards considered in chapters from 2 to 4 are applied as expected in the financial statements. On the other side, in order to perform a complete analysis on the issue at stake it would be desirable to look also at the form other than the substance of the disclosure. This may include for example looking at whether information under consideration is reported in separate notes of the financial statements, whether schedules or just narrative is used to report disclosure, or more in general how clear is the information and how

easy is to quickly find the desired disclosure in the financial statements. In a way, I can refer to the concept of effectiveness of disclosure. Finally, in the conclusions I will recap the main points made in the various chapters, and I will suggest some further issues, that is some research topics relating to the overall one of this dissertation that may allow to further expand the analysis on the matter under consideration. The conclusion, therefore, will be pretty clear-cut as regard the specific issues treated in this dissertation, but it will be also sort of "open" in terms of the further analysis that may be done on the topic.

Thus, this dissertation is mainly supposed to be a conceptual paper, at least as regard the chapters about the comparison of the disclosure requirements as provided in the accounting standards of US GAAP and IAS/IFRS. No data are present in those chapters, but a new view on the disclosure requirements about interests in other entities is proposed starting from the basic rules stated in the relevant accounting standards. Disclosure required by IASB, indeed, is not analysed per se but is put in relationship with that required by FASB, and thus the extension of the disclosure requirements under consideration is not assessed solely on an absolute basis but also and especially in light of the disclosure required by the other authoritative set of standards, the US GAAP. As it will be clearer throughout the next chapter, indeed, disclosure is particularly relevant and the specific type of disclosure of interests in other entities as well. Thus, carrying out throughout this dissertation such kind of analysis will be useful in order to understand which set of standards among IFRS and US GAAP require more transparent and so, from this point of view, better financial statements on the matter at stake. Then, the analysis in chapter 5 is less conceptual and more empirical, but still no statistics will be employed. It will be simply a way to verify directly from the financial statements the substance and the form of the disclosure of interests in other entities.

Some of the readers may wonder why I have chosen to carry out the dissertation on such particular issue. I can provide mainly two reasons. First, I have always been interested both in matters of disclosure and in M&A operations. Thus, this research topic allowed me to combine the two interests by analysing the disclosure required relating to interests in entities over which the reporting one has acquired a controlling interest, or also over which there is simply a significant influence. Second, there is very poor literature on the topic at issue. In my research, indeed, I

found various documents prepared by the Big Four in which a comparison of US GAAP and IFRS is made, but in all the documents the part of analysis relating to the disclosure of interests in other entities is quite broad and superficial. No one of them analyses the matter sufficiently in depth. Thus, all these reasons made me think about the necessity or at least the usefulness of an analysis of this kind.

In carrying out the dissertation, therefore, I read about all the relevant accounting standards in IFRS and US GAAP, I analysed many financial statements, and I made use of many documents prepared by the Big Four. Hence, I did not performed just a broad analysis of the matter, but I made a very complete and in-depth analysis of the issues under consideration. The overall intention has been that of providing a comprehensive guidance on the disclosure requirements relating to interests in other entities.

1. RELEVANCE OF DISCLOSURE AND EVOLUTION OF DISCLOSURE REQUIREMENTS

Over the last two decades, poor corporate disclosure has been one of the major factors contributing to the bankruptcy of companies involved in some scandals and to the financial distress of capital markets. Disclosure, indeed, is important. It allows for a reduction in information asymmetry between counterparties, for an optimal allocation of savings/resources, and for an efficient functioning of markets. Good disclosure is also important for the credibility of a business, it is important to build trust, and ultimately to minimize the risk of accounting/financial scandals. These and other arguments will be the object of the first paragraph of this chapter, in which the benefits of disclosure will be presented. In the second paragraph, the focus will be on the importance of disclosure in other entities, and the analysis that will be carried out will be a case-study one. In particular, the Enron scandal and the subprime mortgage crisis will be used to bring some light to the concrete threats that poor disclosure can pose. Finally, in the third paragraph I will lay out how accounting standards – both US GAAP and IFRS – have evolved, in particular with regard to the disclosure of interests in other entities, in response to the requests for more disclosure that followed the events above-mentioned.

1.1 THE RELEVANCE OF CORPORATE DISCLOSURE (IN GENERAL)

When talking about disclosure, we usually refer to the act of conveying information from one party to another. Corporate disclosure, in particular, is about managers communicating performance and other information about the firm to outside investors and to other various stakeholders (Healy and Palepu, 2001). In fact, the corporate disclosure term is an umbrella term, which covers the addressing of several kinds of informational needs. Information provided by firms can be both financial and non-financial. The financial one has always been important for shareholders and investors to evaluate the relevance, the risks related to, and the profitability of their investments. However, over the last two decades increasingly strong pressure has been put also on the disclosure of information about the corporate governance and about the environmental and social impacts of the business activities of the firms. Corporate governance scandals and concerns for

sustainability have played an important role in the increase of demand for disclosure in this regard (EY, 2016; Fung, 2014). Therefore, not all the disclosure firms provide is mandatory. Also voluntary disclosure is possible, especially in response to demands and expectations of various stakeholders.

As regard the forms of disclosure, firms provide financial information mainly through the financial reports, but communication can occur also by means of announcements on the websites and press conferences among the other ways (Farvaque et al., 2011). Then in response to the demand for ESG information, many firms also prepare sustainability reports, either separately or jointly with the financial reports in the so-called integrated reports (EY, 2016; KPMG, 2017a).

The question that in this section I want to address, however, is why, technically speaking, all this information is demanded by shareholders and other stakeholders. What are the benefits for the shareholders and for the society at large of such a disclosure? The answer revolves around the concept of information asymmetry.

Information asymmetry can be considered as the situation in which the two counterparties to a transaction have different information on it. More precisely, a party has, with respect to the other, not enough information to take correct decisions (Mishkin and Eakins, 2015). To understand what happens in presence of information asymmetry, we can consider the popular study by Akerlof (1970) on the market for "lemons". The author took into consideration the market of used cars and hypothesized a situation where just two types of cars are traded: good cars and "lemons" (i.e., bad cars). The potential buyers in this market thus know that the cars they are going to buy are either good cars or lemons, but they do not know of which specific type each car is. Only the sellers can know, as they used the cars for a certain length of time. Therefore, the price for all the transactions will be the same. Given the proportions of good cars and of lemons in the market, the price will simply be a matter of statistics. It will be equal to the average value of all the cars in the market. In such a situation, the real value of lemons will be lower than the market price, while for the good cars it will be the opposite. As a result, only the owners of lemons will have an incentive to sell their cars. No one will sell good cars, and so the lemons will drive the good cars out of the market. In the end, the average quality of the cars (and so the price) will drop and so the size of the market. Thus, we can say that the

information asymmetry causes a misallocation of resources and, in turn, a drop in the market efficiency.

These results, of course, hold not only for the market of used cars, but also for the financial markets. If investors, indeed, have no information to distinguish between good investments and bad investments, they will value both good and bad investments at an average level. This will lead to the capital market undervaluing some good business ideas and overvaluing some bad ideas with the consequences aforementioned (Healy and Palepu, 2001). Moreover, in the absence of good information on the quality of (and so the risks associated to) stocks, bonds and other forms of financing, investors and lenders may even decide not to provide capital. The fear, of course, is the risk that the counterparty will go bankrupt (Mishkin and Eakins, 2015). Such a system does not allow the providers of capital to efficiently allocate their savings. Capital markets would not work properly and this would represent a problem especially for the good companies needing financing. So far, we have seen one of the two problems caused by the information asymmetry: the adverse selection. The other one is the moral hazard. We have the latter kind of problem when managers make decisions that de facto expropriate the funds savers have invested in the firm, either in the form of equity or in the form of debt (Healy and Palepu, 2001). In other words, the risk here is that, once the investment is made, the managers of the firm take decisions and so undertake initiatives that may threaten the returns the investors expected to get from that investment. In the case of equity investment, the possibility for moral hazard is due, when applicable, to the separation between ownership and management and so to the conflicts of interests between shareholders and managers. Manager may pursue their personal interests at the expense of the maximization of the firm value or of the profits. In this respect, managers may use the equity funds to pay excessive compensation, to get perquisites or to take decisions, e.g. acquisition of other companies, aimed at improving their reputation and that do not necessarily make the profit of the firm to rise. In case of debt investments, instead, moral hazard reflects for example in the decisions of managers to take on new investments which are riskier than what the debt holders would consider as acceptable, in the act of issuing new debt or in the act of paying out the cash received from lenders as dividends. These, of course, are

all actions that are not in the best interests of the debt holders (Healy and Palepu, 2001; Mishkin and Eakins, 2015).

All this to say that providing high-quality information is very important in order to have as little information asymmetry as possible, to minimize the problems of adverse selection and moral hazard, and ultimately to have efficient markets. However, there are several mechanisms other than the direct provision of disclosure by firms by which it is possible to minimize the two problems at issue. The adverse selection can be addressed in several ways (see Mishkin and Eakins, 2015). We can mention some of them.

- Rating agencies, which collect information on companies that issue bonds and stocks in the financial markets and then sell it to investors who have the intention to buy those securities;
- Authorities like CONSOB in Italy or SEC in the US, which require public companies to recur to auditing firms like KPMG or PwC for the auditing of their financial statements;
- Intermediaries such as banks, which are better than individual investors at evaluating the financial position of firms and are thus able to lend money to firms with low risk of bankruptcy.

As regard the problem of moral hazard, some of the solutions are those listed below.

- Monitoring of the activities of the firms;
- Regulation and standards about the preparation of financial statements, and enforcement of such rules;
- Covenants and other restrictive clauses in debt contracts aimed at avoiding undesirable behaviours.

Therefore, to make some corporate disclosure mandatory is not enough, other mechanisms such as the ones mentioned above have to be used in order to achieve the objectives aforementioned.

By the way, the question that I originally wanted to address is about the benefits, in more practical terms, for both shareholders and the society at large of an improvement specifically in corporate disclosure. In this respect, we can refer to the literary review made by Farvaque et al. (2011).

First, corporate disclosure is beneficial for shareholders if it creates value for them. This can occur through an increase in share prices, an increase in the price to book

ratio, a reduction in the cost of capital, or an increase in the ability of the firm to make investments and so to attract investors willing to provide financing for them. The cost of capital, in particular, can decrease through three mechanisms. More and better information leads to an improvement in the information held by market participants and to a reduction in the information asymmetry among investors and between the firm and third parties. Being the investors able to make more informed decisions, price variations in the shares of the firm will depend less on the general market trend and more on specific factors related to the firm. As a result, the systematic risk will fall and the cost of capital will drop. Then, the cost of capital can fall also because of the increase in share liquidity. More informed trading, indeed, leads to an increase in market liquidity, which in turn allows to attract more investors and to cause the cost of capital to go down. Finally, the cost of capital can decrease thanks to an improvement in the corporate governance and so to decisions taken by managers that are better in line with the interests of the shareholders. However, it is worth mentioning that although there is much evidence in the direction just shown, not all the evidence provides the same conclusions. Thus, the concepts just explained should be taken carefully.

As regard the other stakeholders, instead, the greater benefits provided by corporate disclosure come from the avoidance of financial scandals and an improvement in financial stability. Many fraud scandals have occurred over the years, and scandals have the effect of undermining the credibility of the firm and ultimately to cause losses for investors. Thus, the more socially responsible the firm behaves and the more disclosure the firm makes, the more the financial scandals can be avoided. Furthermore, as already said above, corporate disclosure decrease information asymmetry between the firm and third parties. Therefore, if investors are more informed, the estimates about the value of the firm can be more accurate and so closer to its fundamental value. This would allow for a reduction in the information bubbles, with all the benefits that can follow from that. The authors also argue that the benefits for the stakeholders other than the owners, albeit only realizable in the long run, may be more significant than those for the shareholders.

To conclude, although the costs for disclosure can be very high, the benefits may be outstanding. After an overview of the importance of corporate disclosure in theory,

in the next section we will explain the importance of disclosure, in particular of interests in other entities, in more practical terms.

1.2 THE RELEVANCE OF DISCLOSURE OF INTERESTS IN OTHER ENTITIES

As already mentioned, accounting and financial scandals can have a very negative impact on firms and investors. The firms involved in a scandal may be subject to a loss of credibility, to investors running away and so to a drop in the market value of the firm. On the other side, investors may have huge losses due to the drop in the stock price of the firm and so to the impossibility to sell the stocks at an acceptable price.

In this section, I will try to explain the bad consequences a lack of disclosure can have, in particular lack of good disclosure of interests in other entities, and I will do it by making reference to two big scandals, that is the Enron scandal of 2001 and the scandal of the subprime mortgages and all the related matters that brought to the 2007-2009 financial crisis. Of course, many fraud scandals occurred over the last two decades (Enron, WorldCom, Xeron, Parmalat etc.), but I have deliberately chosen to talk just about the Enron one and about the financial crisis for two reasons. First, the intention is not that of making a review of all the scandals. The intention is just to better explain the bad effects of a lack of disclosure and so few examples would be enough to do that. Second, the purpose of this section is that of explaining the specific importance of disclosure of interests of firms in other entities and hence just the most relevant events in this respect would be considered.

1.2.1 The Enron Scandal

The Enron case is very popular. Many books were written about it and also a documentary film was made. Basically, this is the story of a company that in 2001 was the seventh-largest US corporation based on revenues. According to the available public information as of August 2001, Enron was a very profitable company. Then suddenly, in few months, the market value of the company dropped and, by the end of the year, Enron filed for bankruptcy. Just to give an idea of the scale of the dramatic fall, in January and February 2001 the stock was selling for roughly $80. Then, in August the price was already down to $40 and by the end of November it was dropped to $0.26 (Bierman, 2008). Now, the question that arises

is about the reasons of such a dramatic event. However, let us give first an overview of the company.

Enron was a company operating in the sectors of gas and electricity. In particular, it was into the business of energy trading, a newly created and largely unregulated business (Norris, 2001). It is said, indeed, that, "Enron managed the world's largest portfolio of natural gas risk management contracts and pioneered innovative trading." (Frontain, n.d).

Enron made a large use of special purpose entities (SPEs). A SPE is a separate entity, designed to make easier the collection of capital and the management of risk relative to certain assets. However, what makes a SPE very attractive for a company is also the possibility to treat the interests in a SPE, from an accounting point of view, as an investment. Basically, if structured properly, a SPE does not have to be consolidated, that is assets and liabilities of the SPE do not have to be included in the balance sheet of the "parent" company. This kind of treatment is referred to as "off-balance sheet". Among the other things, this would imply no inclusion of SPEs' debt into the Enron's balance sheet and thus more favourable financial ratios (Powers, 2002; Bierman, 2008). The SPEs will be outlined more in detail later on in this dissertation, so I will not go more in depth now. However, this brief introduction on the topic was necessary.

Indeed, the fact is that Enron engaged in faulty accounting and poor disclosure behaviours relative to transactions with SPEs and to some other partnerships, and this was central to the collapse of the company.

It was on October 2001 that all the problems emerged. As already said, as of August 2001 the company seemed to be profitable and in good financial health. However, in October Enron suddenly made a set of surprising announcements: (a) loss of $644 million for the third quarter of 2001, (b) after-tax charge against earnings of past years of $544 million, and (c) reduction in stock equity by $1.2 billion, other than other income statements and balance sheets restatements. That is why, as already seen, the stock price of Enron dropped dramatically in October and November of that year. No one would expect those announcements, and investors were afraid that other surprises might be around the corner. Enron was also downgraded by the rating agencies. Moreover, the SEC started to conduct an investigation on Enron's affairs. In particular, in the end of the October a Special Committee was established

in order to investigate some of the related-party transactions of Enron. Indeed, the reasons for the above-mentioned restatements of the income statement and of the balance sheet have to do with the transactions Enron made with some partnerships and with the accounting treatments of them (Bierman, 2008; Powers, 2002).

Basically, three entities, namely Chewco, Jedi and LJM1, between 1997 and 2001 were not consolidated. However, according to the accounting standards, they should have been: Chewco and Jedi since 1997, and LJM1 since 1999. As regard the latter one, only in 2001 Enron had agreed to consolidate it. Thus, income restatements for the years 1997-2000 were made to eliminate the earnings resulting from transactions realized with the entities that had not been consolidated but that actually should have been. Then, with consolidation the Enron's debt also should have been higher. Thus, this led also to a restatement of the reported debt for 2000, which increased by $628 million. The shareholders' equity then was reduced because of accounting errors made in 2000 and 2001 and that had led to an overstatement of the stock equity. Both the $1.2 billion equity reduction and $544 million charge against earnings related to transactions with another partnership, namely LJM2. And many of the transactions effected by Enron involved SPEs (Bierman, 2008; Powers, 2002).

However, the scenario is even worse than what it could seem by simply considering what mentioned above. Indeed, as regard the related-party transactions, the Special Committee set up to investigate in this regard wrote down in the final report what follows.

> "These partnerships – Chewco, LJM1 and LJM2 – were used by Enron Management to enter into transactions that it could not, or would not, do with unrelated commercial entities. Many of the most significant transactions apparently were designed to accomplish favorable financial statement results, not to achieve bona fede economic objectives or to transfer risk. Some transactions were designed so that, had they followed applicable accounting rules, Enron could have kept assets and liabilities (especially debt) off of its balance sheet; but the transactions did not follow those rules. Other transactions were implemented – improperly, we are informed by our accounting advisors – to offset losses. They allowed Enron to conceal from

> the market very large losses resulting from Enron's merchant investments by creating an appearance that those investments were hedge – that is, that a third party was obligated to pay Enron the amount of those losses – when in fact that third party was simply an entity in which only Enron had a substantial economic stake. We believe these transactions resulted in Enron reporting earnings from the third quarter of 2000 through the third quarter of 2001 that were almost $1 billion than should have been reported." (Powers, 2002, p. 4)

This is to say, how much important regulation and enforcement of rules are with regard to the interests that companies have in other entities. Indeed, by means of this system of partnerships, Enron was very good at hiding the true performance of the company. Anyway, two aspects are very relevant to this case, other than the accounting manipulation of the financial results. First, the corruption of the system in which Enron operated. Paul Krugman (2002) in an article published on the New York Times asserts that the system in which Enron operated failed, and that this failure was due to the corruption of the systems itself. Those institutions which were (and actually are) supposed to limit the corporate abuses, such as independent auditors, were corrupted too. The systems in place to supervise, to check, to control the activities of Enron did not work. In particular, it was in the dock Arthur Andersen, the firm that was responsible for the audit of the financial reports. Thus, according to Krugman only the corruption of the whole system, other than the corruption of Enron itself, allowed the managers of Enron to do all this for years. Otherwise, of course, it would have been difficult.

The second aspect of the case is given by the omission and inadequacy of information that would have been necessary to make the representation of the financial performance of the firm fair and accurate. Bierman (2008) asserts that, "Enron […] could have presented more and better financial information to the public" (p.11). The Special Committee, in its report, argues that disclosure about the existence of LJM partnerships was made. "However, these disclosures were obtuse, did not communicate the essence of the transactions completely or clearly, and failed to convey the substance of what was going on between Enron and the partnerships" (p.17). Then, "The disclosures also did not communicate the nature or

extent of Fastow's financial interest in the LJM partnerships" (p.17). Indeed, Fastow was the Enron's CFO and he was also the general manager and partner of the partnerships at issue. Finally, "The disclosures also asserted that the related-party transactions were reasonable compared to transactions with third parties, apparently without any factual basis" (p.17). Thus, Enron, other than providing false and misleading information about the own financial performance, also provided incomplete, unclear, and misleading information on various aspects of the relationships with the partnerships. The term "accounting scandal" could not be more appropriate. However, it is not the end yet. The ultimate cause of the Enron's collapse is another one, that is the loss of credibility of the company. The loss of trust that investors had in Enron, in particular in the past financial statements of Enron and also, most importantly, on the future ones.

Indeed, it is true that Enron for some years overstated the levels of earnings and stock equity and understated the level of debt. However, the mistakes were not of the magnitude to cause financial distress. The total stock equity as of 31 December 2000 decreased from $11,740 million to $10,306, debt as of the same date increased from $10,229 million to $10,857 million, and finally net income (restated) for the years 1997-2000 was still of almost $3 billion, a quite impressive figure. Thus, restatements per se would have not led to financial insolvency. It is the fear of additional surprises that spread among investors that led to the bankruptcy. Norris (2001) in the New York Times describes the situation referring to something like a "bank run". Investors no longer wanted the Enron's stocks. Also, the newspapers probably contributed to cause this fear. At that time, indeed, many news articles were written about Enron, articles that contained some incomplete and misleading information and that made investors and lenders to form bad expectations about the financial position of Enron. Therefore, the financial distress was mainly caused by the fear for financial distress, rather than by fundamentals really indicating that (Bierman, 2008).

Thus, the Enron's bankruptcy occurred not because of a bad financial performance, but because of the loss by investors of faith in the company. And the loss of trust was caused by Enron reporting false, misleading, incomplete, and unclear information on the financial performance of the firm itself and on its relationships with its partnerships. Thus, as Bierman (2008) argues, one of the lessons to be learned from

this case is that, "A trading firm relying on external capital cannot afford not to be transparent in its financial affairs" (p.60). Good disclosure is essential.

1.2.2 The Subprime Mortgage Crisis

SPEs were heavily used by Enron. However, Enron was not the only company to rely much on them. Indeed, SPEs are of common use by many entities, which employ them for the advantages they allow to exploit. During the last decade, in particular, banks created many special purpose vehicles that allowed them to take advantage of a particular financial process whose development on a large scale was made it possible by the increasingly financial innovation of the time. I am talking of the so-called "securitization process".

Basically, securitization is a process by which assets of a company, such as mortgages, are pooled together, transformed into securities – so-called asset-backed securities (ABSs) - and transferred to a special purpose vehicle (SPV). To fund the purchase of the ABSs, the SPVs issue asset-backed commercial paper (ABCP) (Senanayake, 2010; Acharaya and Richardson, 2009).

By selling assets to other entities, securitization – by means of SPEs – enable companies to benefit from off-balance sheet treatment of the assets themselves. Thus, if the SPE is structured appropriately, the company originating the securities may not need to consolidate the SPE assets – with all the benefits already seen for Enron – and may isolate the financial risk of the assets by basically making them "bankruptcy remote" in the event of default. Moreover, through securitization it is possible to transfer the risk of default of the mortgages from the balance sheet of the mortgage lenders to the capital market, including hedge funds, pension funds, and insurance companies among the others (PwC, 2011; Acharaya and Richardson, 2009).

Securitization played an important role in the expansion of the credit markets in the years 2002-2007, that is at the time of the boom in the housing sector. In that period, the ratio of debt to national income increased from 3.75 to 4.75, and house prices increased at a rate of 11 percent each year (Acharaya and Richardson, 2009). When the bubble burst, severe economic and financial crises aroused. The financial crisis, in particular, manifested in the widespread failures of financial institutions, such as

Lehman Brothers, and the freezing up of capital markets. The question is the following one, how could ABSs and SPEs contribute to all of this?

In the case of Enron, SPEs were used to hide debt and to report higher incomes among the other things. In the case of financial institutions in the period of the housing market boom, SPEs in a way were used again to circumvent some rules – in this case with regard to the regulatory requirements of banks. Indeed, there exist rules for banks, which set out the minimum level of capital that have to be kept as a "buffer" against potential losses. The rationale behind this rests on the intention to avoid banks ending up with being in financial troubles in the case in which sudden huge losses arise, and so - given the important role that banks have in the financial markets - to avoid financial distress in the system. According to the Basel agreements, in particular, the capital buffer that banks were required to maintain was of at least an 8 percent of a risk-adjusted measure of the bank's assets. This, of course, would also imply no opportunity to lend out this capital and so no opportunity to earn an interest on it. However, if the bank's loans were securitized and sold – via SPEs and by means of ABCP – to investors, then these loans may disappear from the bank's balance sheet and the banks would not need to maintain capital against them. Therefore, securitization contributed to the credit boom by allowing banks to grant an increasing number of mortgage loans without caring too much of the capital requirements and of the number of loans already granted. If we consider all the ABSs issued – residential mortgages, commercial mortgages, corporate bonds, and student loans among the others – the size of the securitization market worldwide dramatically increased from the $767 billion at the end of 2001 to $2.7 trillion in December 2006, at its peak. A very big jump. How did this lead to the financial crisis? First, it is fundamental to underline that many of the mortgages granted and securitized were either subprime mortgages – i.e., loans with low probability of being repaid – or mortgages designed in such a way that only their future refinancing – made it possible only by higher future house prices – would make it possible for the borrowers to repay the mortgage. Thus, these loans carried a great deal of risk. Second, while in theory the risk of these assets should be transferred to the SPEs through securitization, in practice this is not what actually happened. Banks exploited the securitization mechanism and the SPEs just for making an end run around the capital regulatory requirements, not for giving away

the risk associated with the subprime mortgages. Pursuing both objectives would be hard. Indeed, to sell ABCP to money-market funds, the securities under consideration had to be characterised by high ratings. And for the securities to be highly rated, banks had to provide guarantees of the underlying credit. This way, the risk was brought back onto the banks. (Acharya and Richardson, 2009).

Guarantees could be either explicit or implicit. Explicit guarantees took the form of "retained interests" – essentially the sponsor-originator banks retaining interests in the most junior ABSs issued by the SPEs. This way, in case of failure of the SPE assets the banks would absorb the first loss. This is a form of guarantee as it allows investors in the securities issued by the SPE not to absorb the entire loss in case of failure of the SPE assets. An implicit guarantee, instead, took the form of a "put option" – essentially making good on some portion of the losses the SPE capital providers might suffer not covered by other mechanism. The point is that when SPE failure is rare, the little losses that arise can be easily covered by the retained interests. However, in case of systemic failure of SPEs retained interests would not be enough anymore and honouring the put options would imply very huge losses. Thus, through securitization the risk of the assets securitized does not appear in the balance sheets of the originator banks, but it is not eliminate either (Amiram et al., 2011).

The originating banks engaged in the business of subprime mortgages for the quite high returns it was possible to get on such risky assets. However, they ignored the risk of a systemic default of the subprime mortgages. Thus, when the housing bubble popped many subprime mortgages borrowers turned out to be insolvent and holders of subprime-backed structured products thus had losses. The credit rating agencies (CRAs) downgraded those products, market investors lost confidence in the soundness of markets and financial institutions, and the ABCP market collapsed. Indeed, the loss of confidence in the financial system led the money-market investors in ABCP to refuse to roll over their investments. All this affected adversely commercial banks, such as Citigroup and Royal Bank of Scotland, but also investment banks, such as UBS, Bear Stearns, and Lehman Brothers, which had invested a lot in subprime mortgages. In particular, Bear Stearns and Lehman Brothers among the others literarily collapsed. The whole financial sector collapsed (Acharya and Richardson, 2009; Financial Stability Forum, 2008).

What does financial disclosure have to do with all of this? Basically, many weaknesses in the system have contributed to the development of the asset securitizations business and thus to the collapse of the financial sector. As in the case of Enron, indeed, it was not just a matter of the banks originating the loans, but it is also about a failure of the whole system. Among the underlying weaknesses, we can find poor underwriting standards, weak government oversight, shortcomings in firms' risk management practises, poor investor due diligence, poor performance by the CRAs in respect of structured credit products, weaknesses in regulatory frameworks, and others. As it is beyond the scope of this thesis to make a detailed description of that, for the full list and for the description of each weakness the readers can make reference to the report of the Financial Stability Forum (2008). However, there is one point made in the report that is central to our discussion, i.e., weaknesses in disclosure.

> "Weaknesses in public disclosures by financial institutions have damaged market confidence during the turmoil. Public disclosures that were required of financial institutions did not always make clear the type and magnitude of risks associated with their on- and off-balance sheet exposures. There were also shortcomings in the other information firms provided about market and credit risk exposures, particularly as these related to structured products. Where information was disclosed, it was often not done in an easily accessible or usable way." (Financial Stability Forum, 2008, p.8)

Therefore, disclosure contributed to damage the market confidence in the financial institutions and financial system, where the loss of confidence, as we know, was central to the financial crisis. Unclear, and not easily accessible and not easily usable information about the financial institutions' risks associated with credit products and off-balance sheet entities played a substantial role in the collapse of some banks and the distress of the financial system.

Schwarcz (2010) points out the concept of disclosure's insufficiency, in particular as a consequence of the high degree of complexity of the asset-backed securities under consideration. Full disclosure is in fact essential to allow investors to adequately evaluate the risks and rewards of the multiple investment opportunities and so to

adequately protect the investors themselves, especially in case of complex products as it was in the case of subprime mortgage-backed securities. However, individual investors did not entirely go through the hundreds-pages disclosure documents and purchased the securities simply on the basis of their ratings, without fully understanding the risks associated with them. On the other side, institutional investors did not employed in many cases the experts required to assess such complex securities – the costs of employing them was considered too high – and so did not similarly fully understand the risks.

Barth and Landsman (2010), instead, stress how poor was the disclosure required by the accounting standards – a point also made by the Financial Stability Forum (2008). Barth and Landsman (2010) assert that the US accounting rules in place before and during the financial crisis did not provide many disclosure requirements about firm's interests in SPEs, such that not only it was difficult for investors to evaluate the quality of asset-backed securities at the time of origination but it was also difficult to evaluate the fair value and the risk of the securitized assets subsequently. In particular, in the case of assets sold to SPEs via securitizations, the required disclosure for the originating bank was about the carrying amount of the retained interest, and the total principal amount of financial assets that the bank managed on behalf of its SPEs among the other things. However, no disclosure was required about the fair value of retained interest, the fair value of assets and liabilities of the bank's SPEs, and information useful to evaluate the risk related to the bank's retained interest. Thus, accounting disclosures did not provide complete transparency of securitizations.

All this to say that again – as in the case of Enron – poor and unclear disclosure, among the other things, played a significant role in the loss of confidence – in this case towards the financial institutions – and caused some of them to collapse. Thus, disclosure is very important, especially as regard interests in other entities such as off-balance sheet one.

1.3 EVOLUTION AND IMPROVEMENT OF FINANCIAL REPORTING AND DISCLOSURE REQUIREMENTS

The Enron scandal and the subprime mortgage crisis described before are case studies that were not picked randomly. On the contrary, they represent significant

events which triggered important initiatives aimed at substantially amending/improving some accounting standards related to the recognition and the disclosure of interests in other entities, especially in special purpose entities. Having an idea of the evolution of accounting standards would be useful in order to understand how we actually got to the current version of accounting principles and to gain a broad view of the macro-topic at issue.

One of the first US GAAP that indirectly set the foundation for the accounting of SPEs was the Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, issued in 1959. In 2003, in response to the Enron scandal, an interpretation of ARB No. 51 was issued – i.e., FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*. This interpretation redefined how SPEs should be reported and also improved disclosure of interests in SPEs, regardless of whether they had to be consolidated or not. Thus, FIN 46(R) aimed at improving the financial reporting of those firms that had interests in SPEs – "variable interests", to be precise – by expanding the definition of control for consolidation of those SPEs and by requiring more information on SPEs, both on- and off-balance sheet ones (Soroosh and Zhu, 2009). Let us have a deeper look about that.

At the time of the Enron bankruptcy, the 3 percent rule was in force. According to that practice, a SPE could be treated for accounting purposes as an independent entity - and thus not be consolidated – if two conditions were met:

1. An independent investor owned equity equal to 3% or more of the SPE's total assets. This equity interest must be maintained during the entire period of non-consolidation.
2. The independent investor exercised control over the SPE (Bierman, 2008, p.72).

It was common practice that the form of control that led to consolidate a SPE was the one exercised through voting interests (FASB, 2008). The 3 percent rule allowed the sponsors of many SPEs to avoid consolidation of such entities – with all the negative consequences in terms of transparency that we already know. Soroosh and Zhu (2009), indeed, argue that companies could escape the consolidation of many of the SPEs of whom they were sponsors because, "There was no direct voting control exercised by the sponsors even though they may have had the majority interest in SPEs" (p.72). Therefore, FIN 46(R) expanded the notion of control for consolidation:

consolidation based on "variable interest" – other than that on voting power – was established. The term "variable interest entities" was introduced to refer to the SPEs. In particular, according to this interpretation a VIE should be consolidated in the financial statements of its primary beneficiaries. And the primary beneficiary of a VIE was defined in FIN 46(R) as follows.

> "The primary beneficiary of a variable interest entity is the party that absorbs a majority of the entity's expected losses, receives a majority of its expected residual returns, or both, as a result of holding variable interests, which are the ownership, contractual, or other pecuniary interests in an entity that change with changes in the fair value of the entity's net assets excluding variable interests" (FASB, 2008, p.3).

Thus, the characteristics of a controlling financial interest according to FIN 46(R) are the followings: (1) direct or indirect ability to make decisions about the entity's activities through voting rights or similar rights, (2) obligation to absorb the expected losses of the entity, (3) right to receive the expected residual returns of the entity (FASB, 2008, p.9). And the primary beneficiary was an entity that met at least one of those conditions. The intention with this new rule was that of reducing the share of off-balance sheet entities and so that of bringing assets and liabilities of SPEs that were until then maintained off-balance sheet onto the primary beneficiaries' financial statements. The ultimate stated aim of that was to hide as little information as possible about the consolidated SPEs (i.e., the VIEs). In particular, "To provide more complete information about the resources, obligations, risks, and opportunities of the consolidated enterprises" (FASB, 2008, 4).

FIN 46(R) also sat the required disclosure for both the primary beneficiary of a VIE and the holder of a significant variable interest in a VIE which was not however a primary beneficiary. In both cases, it was required the disclosure of the nature, purpose, size, and activities of the VIE. Among the other things, the primary beneficiary had also to disclose carrying amount of consolidated assets pledged as collateral for the VIE's obligations, and the holder of a significant variable interests in a VIE which was not the primary beneficiary had also to disclose the nature of its involvement with the VIE and the exposure to loss as a result of the involvement

itself. Particularly important was the latter case, that is the disclosure of interests in a SPE for which no consolidation was required. The ultimate stated aim of that was to help investors to assess the risks of enterprises (FASB, 2008). Of course, it is important to underline that the disclosure required by this Interpretation did not substitute but had to be provided in addition to the disclosure that may also be required for VIEs in other standards, such as SFAS No. 140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* and SFAS No. 141 *Business Combinations*.

To conclude, in response to the Enron bankruptcy and to the increasing use of SPEs (often accounted for as off-balance sheet entities), the FASB tried to improve financial reporting of firms that have interests in SPEs by issuing FIN 46(R). The ultimate aim of this Interpretation was to enhance the transparency of enterprises which were involved in VIEs, both by improving the disclosure requirements about their involvements and by expanding the definition of control for consolidation and thus trying to bring many off-balance sheet debt onto the financial statements.

Another important watershed in the history of accounting standards is represented by the subprime mortgage crisis. The financial crisis that followed the burst of bubble of the housing market, indeed, led both the FASB and the IASB to issue new important accounting standards that amended and improved the previous ones. The rationale behind that was the need for disclosures in particular about the risks associated with structured credit products and off-balance sheet entities, with the ultimate aim again to improve transparency, and thus to foster market confidence and allow for an efficient functioning of the system.

In late 2007, the Financial Stability Forum (FSF) was asked by the G7 Ministers and Central Bank Governors to carry out an analysis of the causes of the financial crisis and to provide recommendations on ways to increase the efficiency and the resilience of the system, that is of market and institutions. As the crisis was the result of the failure of several institutions, that is a failure of the whole system, they were identified many areas in which to take concrete actions, such as "strengthen prudential oversight of capital, liquidity and risk management", and "changes in the role and uses of credit ratings". However, for the purpose of my analysis I will focus just on one area of intervention as identified by the FSF: "enhancing transparency and valuation". The Forum made many points about that. In particular, regarding

off-balance sheet entities a clear position was taken. Indeed, according to the FSF, "Risk exposures and potential losses associated with off-balance sheet entities should be clearly presented in financial disclosures, and the accounting standards affecting these entities should be enhanced and their international convergence accelerated based on the lessons learned" (FSF, 2008, p.25). Thus, not only the disclosure per se is important, but also the convergence of accounting standards issued by FASB and IASB regarding such disclosure. The report also provide leading disclosure practice about that. Then, another important point is, "To achieve better disclosures about valuations, methodologies and the uncertainty associated with valuations" (FSF, 2008, p.27). Indeed, the various valuation techniques carry a high degree of uncertainty, in particular relative to the point estimates of valuation. Sound valuation processes and good information about this uncertainty would be important to avoid giving investors a false sense of security and to allow for a reporting and management of those complex risks in the best ways. Finally, among the other things, the FSF highlighted the relevance of disclosure with regard to the securitised products and their underlying assets. And this of course requires a greater transparency at each stage of the securitization chain, thus involving originators, arrangers, distributors, managers and CRA.

These recommendations were mainly aimed at IASB. And, in fact, the International Accounting Standards Boards took them seriously under consideration in the preparation of the standards issued in 2011. In particular, two projects were carried out: ED 9 Joint Arrangements and ED 10 Consolidated Financial Statements. The aim of ED 9 was to enhance the faithful representation of joint arrangements – through, among the other things, the provision of enhanced disclosures about the interests in joint ventures – while the main aims of ED 10 was to improve the definition of control and related application guidance – such that a single definition of control could be applied to all entities – and to improve the disclosures requirements about consolidated and unconsolidated entities (IASB, 2008a; IASB, 2007a). As a result of this work, in May 2011 new standards – in replacement of previous ones – were issued and some standards were revised. In particular,

- IFRS 10 *Consolidated Financial Statements* was issued to supersede IAS 27 *Consolidated and Separate Financial Statements* and to incorporate the guidance contained in SIC-12 *Consolidated-Special Purpose Entities* and SIC-

33 *Consolidation*. IAS 27 was revised and renamed *Separate Financial Statements*. Indeed, from then on the requirements for the preparation of consolidated financial statements were addressed by IFRS 10, and IAS 27 was left just with the discipline of separate financial statements (IFRS Foundation).

- IFRS 11 *Joint Arrangements* was issued to replace IAS 31 *Interests in Joint Ventures* and to incorporate the guidance contained in SIC-13 *Jointly Controlled Entities-Non-Monetary Contributions by Venturers*; IAS 28 *Investment in Associates* was revised and renamed *Investments in Associates and Joint Ventures* (IFRS Foundation).
- IFRS 12 *Disclosure of Interests in Other Entities* was issued to replace the disclosure requirements contained in IAS 27 *Consolidated and Separate Financial Statements*, IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures* (IFRS Foundation).

Thus, as regard disclosure requirements, a single IFRS was adopted to include all the requirements and with its – IFRS 11 – issuance in 2011 many disclosure improvements were made. In particular, about the basis of control, about the nature of and risks associated with an entity's involvement in unconsolidated structured entities - "Structured entity" is the term used in IFRS to refer to SPEs – and about the nature and extent of an entity's operations conducted through joint arrangements (IASB, 2007b; IASB, 2008b).

In the bullet points above, many kinds of entities have been mentioned: associates, joint ventures, structured entities. I will define each of them and also others and I will talk about the accounting treatments and disclosure requirements required for each of them in the next chapters.

In the US, instead, two new standard were issued in 2009, SFAS No. 166 *Accounting for Transfers of Financial Assets* and SFAS No. 167 *Amendments to FASB Interpretation No. 46R*. The stated aim of the FASB with the issuance of SFAS 166 was, "To improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transferor on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets (FASB, 2010a). The objective of the FASB with

the issuance of SFAS 167, instead, was, "To improve financial reporting by enterprises involved with variable interest entities" (FASB, 2010b). Basically, SFAS 166/167 caused on-balance sheet recognition – instead of off-balance sheets – of more securitization entities. Indeed, before the issuance of these new standards a special type of SPEs – qualifying SPEs – were exempt from consolidation and some mortgage securitizations were exceptionally allowed for sale accounting. With SFAS 166, these exceptions were eliminated. Then, SFAS 167 revised and clarified the definition of the primary beneficiary of a VIE and introduced a regular ongoing assessment of it. All this led to more consolidation as well. Then, SFAS 166/167 improved disclosure about securitization transactions, in particular about assumption in the determination of consolidation, restrictions on assets and liabilities in securitization entities, and the nature of and risks associated with securitization entities among the others things (Oz, 2017).

The FASB and IASB projects aforementioned should also be analysed in light of convergence program of US GAAP and IFRS. Indeed, in 2002 the FASB and the IASB signed a memorandum of understanding to collaborate on the development of common, high-quality global accounting standards. The US GAAP and IFRS issued in 2009 and 2011, respectively, were part of this convergence effort. Thus, it should not come as a surprise to find many similarities between them. However, we will be able to understand the effective degree of this convergence only at the end, after having analysed in detail the differences between US GAAP and IFRS about the disclosure requirements of interests in other entities. This is the aim of this dissertation: to analyse those differences in order to understand which of the two set of standards require the most extensive and effective disclosure. Several kind of entities and arrangements will be considered: subsidiaries, joint arrangements, associates, and variable interest entities/structured entities. In the next chapter, I will start from an analysis of interests in subsidiaries.

2. DISCLOSURE OF INTERESTS IN SUBSIDIARIES

Many types of entities do exist. According to IFRS, we mainly have subsidiaries, structured entities (which can also be consolidated and thus be considered as subsidiaries), joint arrangements and associates. These entities are treated in different ways, with regard to their accounting in the financial statements. And also in respect to the disclosure, specific provisions are made for each of them. In the US, the FASB distinguishes among subsidiaries, variable interest entities (which can also be consolidated and thus be considered as subsidiaries), joint ventures and other equity-method investees. As we can see, there is no perfect matching between IFRS and US GAAP with regard to the categories of entities. In both cases, we have subsidiaries, that is entities controlled by other entities (i.e., parent entities) and thus consolidated in the financial statements of the parents, and joint ventures, typically accounted for using the equity method. Then, we have structured entities, on the one side, and variable interest entities (VIEs), on the other one, that broadly refer to the category of special-purpose entities, of which I already talked about in the previous chapter. However, there is no use of the term "associate" in the US GAAP. Moreover, structure entities are not defined in exactly the same way as VIEs, so that an entity that is considered as a structured one under IFRS may not be a VIE under the US GAAP. Also the notion of control for consolidation and other features present some differences, so that the accounting treatments of subsidiaries by the IASB and the FASB are not exactly the same, and similar reasoning can also be made for joint ventures and associates. It is important to know all of that as to have first the broad picture of the complex puzzle we are going to deal with – and so to have the background for all the issues we will address – and then to understand that to properly compare the disclosure in IFRS and in US GAAP it will be necessary to know the different ways in which the entities are defined and accounted for. I will lay out the ways in which each type of entity is defined, the ways in which they are accounted for and, above all, the disclosure of interests in them in this chapter on.

Then, another important point to make before starting to address the very topic of this dissertation is the one about the different approaches of IASB and FASB with respect to regulation. The IAS/IFRS, indeed, are principle-based standards, while the US GAAP are rule-based. Basically, the IASB issue and update principles that can be

deemed to be universal. They are standards that all applying entities must follow, irrespective of the actual contractual form chosen by those entities for their business operations or transactions. On the other hand, the FASB attempts to rule all the actual situations that applying entities might face. Thus, among the other things, US GAAP are more detailed, imply less discretion and provide greater comparability. However, principle-based standards may be more intelligible and provide indications about the correct accounting treatment also for those transactions that otherwise may not be ruled by less discretionary GAAP (Gallimberti *et al.*, 2013). Hence, there are pros and cons on both sides. However, one point can be made for sure. In lieu of their nature, indeed, I expect the US GAAP to provide disclosure requirements that are more industry-specific and that rule more specifically than the IFRS do a series of situations.

Finally, it is also worth (re)calling the standards in which the disclosure requirements relative to interests in other entities are provided. As already seen in the previous chapter, in 2011 it was issued the IFRS 12 *Disclosure of Interests in Other Entities*, which gathered under a single standard the requirements relative to the disclosure of interests in all types of entities. In the US GAAP, instead, we have no single standard. The disclosure requirements relative to the interests in the various entities are presented in separate standards.

I begin in the current chapter by addressing the disclosure of interests in subsidiaries. The structure is as follows. First, a brief introduction on the accounting treatment of the subsidiaries in IFRS and US GAAP in order to set the ground. Then, a comparison between IFRS and US GAAP in respect to the disclosure requirements relative to interests in subsidiaries. The next two chapters – chapter 3 and 4 – are structured in an analogous way and deal with the remainder entities, that is with structured entities/variable interest entities and equity-method investees, respectively.

2.1 CONSOLIDATION: IFRS VS. US GAAP

The standards providing the guidance for this topic, that is the standards establishing the principles underlying the preparation and presentation of consolidated financial statements in the IFRS and in the US GAAP, are the IFRS 10 *Consolidated Financial Statements* and the ASC 810 *Consolidation*, respectively. As

we know, the ASC 810 also provides the disclosure requirements for the subsidiaries while the IFRS 10 do not. Moreover, in the US GAAP also the ASC 946 *Financial Services – Investment Companies* is important. It provides the accounting requirements for a particular type of entities, that is the investment companies.
In this paragraph, I lay out the main points about consolidation, stressing in particular those topics that are more relevant in light of the subsequent discussion on disclosure requirements.

2.1.1 Consolidation Model(s)

In both IFRS and US GAAP, the concept of control is at the basis of the definition of the perimeter of consolidation. Thus, with the term "subsidiary" we refer to an entity that is controlled by another one – i.e. the parent – and that is thus consolidated in the financial statements of the latter. In line with their nature of being principle-based standards, IFRS provide a single definition of control that applies to all entities under the scope of the reference standard.

> "*An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee*" (IFRS 10, para 6).

Thus, three conditions must be satisfied for an investor to claim control over an investee: (1) power over the investee, (2) exposure, or rights, to variable returns from its involvement with the investee, and (3) the ability to use its power over the investee to affect the amount of the investor's returns. For the condition of power to be satisfied, it is necessary for the investor to have existing rights that give it the current ability to direct the relevant activities of the investee, that is the activities that significantly affect the investee's returns. Typical rights that provide the investor with power over the investee are voting and similar rights, but power can arise also from contractual arrangements. Furthermore, it is important to stress that only substantive rights can be considered in assessing power, while protective rights cannot. Then, as regard the second condition, the investor has to be exposed to variable returns from its involvement with the investee. By "variable returns" the IASB refers to returns, such as dividends, changes in the value of the investor's

investment in that investee, remuneration for servicing an investee's assets or liabilities, and fees and exposure to loss from the provision of credit or liquidity support among the others, that have the potential to vary as a result of the investee's performance. Finally, the investor has to have the ability to use its power over the investee to affect the amount of the investor's returns. This implies that in case of an investor with decision-making rights, it is important for the investor to determine whether it is a principal or an agent since an agent – in the exercise of the decision-making rights delegated to it – does not control an investee (IFRS Foundation).

This concept of control applies to all entities within the scope of the standards, even to structured entities. In this respect, a structured entity is defined as, "*An entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements*" (IFRS 12, p.A577). In determining whether an investor has rights that give it power over a structured entity, it is important to consider in particular the purpose and design of the structured entity and also some additional indications provided by IFRS 10. Anyway, I recall that – albeit some additional indications in the standard – the definition of control used for the assessment of these entities is always the same.

A different approach is adopted by the FASB, which instead provide two primary control models: (1) the Voting Interest Entity Model and (2) the Variable Interest Entity (VIEs) Model.

The former states that an entity other than a limited partnership has a controlling financial interest in another entity if it owns the majority of voting rights, so more than 50 percent of the outstanding voting shares. In case of limited partnerships, similarly, a limited partner has a controlling financial interests if it owns more than 50 percent of the limited partnership's kick-out rights through voting interests. However, this is true only if the noncontrolling shareholders or limited partners do not have substantive participating rights (EY, 2018a).

A variable interest entity (VIE), instead, similarly to a structured entity, is an entity in which control is achieved in a way other than the majority ownership of voting interests. An entity has a controlling financial interest in a VIE – and is called "primary beneficiary" – if the following conditions hold:

a. The power to direct the activities 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 (EY, 2018a).

Then, in respect to the consolidation of VIEs, two particular issues are addressed by ASC 810: the accounting for entities under common control and the consolidation of collateralized financing entity.

According to the amendments contained in the Accounting Standards Update (ASU) No. 2018-17 (effective for entities other than private companies for fiscal years beginning after December 15, 2019, and for private companies for fiscal years beginning after December 15, 2020), a private company evaluating a VIE shall not apply the variable interest entity model and may instead elect an accounting alternative if both the reporting (private) entity and the VIE are under common control (and other conditions are met). In case in which because of the application of this alternative no consolidation occurs, then the reporting entity should provide much disclosure about its involvement with the unconsolidated VIE. We will see it in the next paragraph.

Then, we have the case of collateralized financing entities. A collateralized financing entity is defined as, "*A variable interest entity with no more than nominal equity that holds financial assets and issues beneficial interests in those financial assets*" (FASB, 2014, p.1). The beneficial interests are classified as financial liabilities. A reporting entity that consolidates a collateralized financing entity can apply, under some conditions, an alternative to what stated in ASC 820 *Fair Value Measurement* for the measurement of the financial assets and the financial liabilities of the collateralized financing entity itself. Basically, "*Under the measurement alternative, the reporting entity shall measure both the financial assets and the financial liabilities of the collateralized financing entity using the more observable of the fair value of the financial assets and the fair value of the financial liabilities*" (FASB, 2014, p.6). Moreover, any gain or loss given by the difference between the fair value of the financial assets and the fair value of the financial liabilities shall be reflected in earnings and attributed to the reporting entity in the consolidated statement of income (loss). Of course, disclosure shall also be given about this (EY, 2018a).

By the way, we have seen that in the US two distinct models for consolidation do exist. However, additional guidance on consolidation is also provided for a particular category of entities, that is the entities controlled by contract. ASC 810 contains specific provisions about that. The guidance applies in particular to the so-called "physician practices", that is to entities that operate in the health care industry. And it applies in the case in which the physician practice management entity does not own the majority of the outstanding voting equity instruments of the physician practice. Basically, the standard states that a physician practice management entity has a financial interest in the physician practice if the interest meets a set of requirements – for which the reader can refer to ASC 810-10-15-22 (EY, 2018a).

Finally, it is worth saying that in case of IFRS control is assessed on a continuous basis, that is the reassessment is made any time there are facts and circumstances indicating changes to one or more of the three elements of control. In the US, control of VIEs is assessed on a continuous basis as well, while for the other entities control is reassessed only when there is a change in voting interests (KPMG, 2017b).

2.1.2 Investment Entities

Of course, there are also exemptions from consolidation. The most prominent exemption from consolidation of subsidiaries is the one that involves the investment entities, that is entities that provide investors with investment management services and so that invest the funds provided by investors themselves to get returns solely from capital appreciation, investment income or both. Under IFRS 10, basically, an investment entity shall not consolidate its subsidiaries and should instead measure the investments in the subsidiaries at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments*. However, there is an exception to this tenet. Indeed, if the subsidiary of an investment entity is not an investment entity and its main purpose is to provide services that relate to the investment entity's investment activities, then it must be consolidated (IFRS Foundation). ASC 946 *Financial Services – Investment Companies,* in the section relative to consolidation, provides quite consistent rules for the (non-)consolidation of an investment company's subsidiaries (KPMG, 2017b). Also the approaches adopted by the FASB and IASB for the definition of an investment company and so for the

determination of whether an entity is an investment entity are consistent. There are, perhaps, still few significant differences between IFRS and US GAAP related to certain characteristics of an investment company (FASB, 2013). However, it is beyond the scope of this chapter to make a detailed analysis of that.

An important difference also to mention is about the consolidation of an investment entity and its subsidiaries by a non-investment entity parent. According to IFRS 10, the parent of an investment entity consolidates the investment entity and all its underlying controlled investments. According to the US GAAP, instead, the parent of an investment company does not consolidate entities it controls through the investment company and thus does retain the investment company's fair value accounting. Therefore, US GAAP does not provide different accounting treatments depending on whether the parent is an investment entity or not (EY, 2018b).

2.1.3 Changes in a Parent's Ownership Interest in a Subsidiary

Some other issues, then, may be worth being taken into consideration, including the accounting treatments for changes in a parent's ownership interest in a subsidiary (without losing control of it), and for the parent instead losing control of a subsidiary. According to both IFRS 10 and ASC 810, the former operation is accounted for as an equity transaction. As a consequence of that transaction, the parent shall adjust the carrying amounts of the controlling and non-controlling interests in the subsidiary and shall recognize in equity attributable to itself any difference between the fair value of the consideration received or paid and the amount by which the noncontrolling interest is adjusted. The only difference between the two sets of standards is about the scope, that is the IFRS guidance applies to all types of subsidiaries under the scope of IFRS 10 while in case of US GAAP some exceptions to the scope of ASC 810 hold. However, except for that the two approaches are consistent (IFRS Foundation; EY, 2018b).

Consistency holds also in the case of loss of control of a subsidiary and so in the case of deconsolidation of a subsidiary. According to both IFRS 10 and ASC 810, an entity losing control of a subsidiary should derecognize the assets and liabilities of the subsidiary at their carrying amounts, and shall recognize the fair value of the consideration received, if any, from the transaction resulted in the loss of control, and any investment retained in the former subsidiary at its fair value among some

other items. It is important to stress the re-measurement of the retained interest at the date the control is lost at fair value. Moreover, the entity should recognize any resulting difference as a gain or loss in profit or loss attributable to the parent. Again, there is a difference between IFRS and US GAAP just as regard the scope, that is the IFRS guidance apple to all types of entities under the scope of IFRS 10, while in case of US GAAP some exceptions to the scope of ASC 810 hold (IFRS Foundation; EY, 2018b).

2.1.4 Different Reporting Dates of Parent and Subsidiaries

Finally, a point should be made about the accounting treatment of parent's and the subsidiaries' financial statements with different reporting dates. According to both IFRS and US GAAP, a difference in the fiscal-period-end between the consolidated financial statements and the subsidiaries' financial statements of up to three months is allowed. However, in case of IFRS, unlikely US GAAP, consolidation of subsidiaries whose financial statements have different reporting date than that of consolidated financial statements is allowed only if it is impracticable for the subsidiaries to prepare additional financial information as of the date of the parent's financial statements. Moreover, in case of IFRS, the financial information on the subsidiary should be also adjusted for the effects of significant events occurred between the two reporting dates. In US GAAP, instead, only disclosure is required to be given about those effects (IFRS Foundation; EY, 2018b).

More generally, IFRS 10 requires consolidated entities and the reporting entity to have the same accounting policies, while ASC 810 does not. Thus, it is not just a matter of the reporting dates (IFRS Foundation; EY, 2018b).

2.2 DISCLOSURE OF INTERESTS IN SUBSIDIARIES: IFRS VS. US GAAP

Once set the background, it is now time to address the very topic of this dissertation, that is the disclosure and, in particular in this chapter, the disclosure of interests in subsidiaries. Before proceeding with the analysis, however, I must first say a word about how the comparison has been performed. I basically analysed the standards in IFRS and US GAAP providing requirements on the disclosure of interests in subsidiaries, that is IFRS 12 on the one side and ASC 810 and ASC 946 on the other one, by making a line by line comparison of the provisions included in the above-

mentioned standards. In other words, I checked the provisions that are common in the two sets of standards and the ones for which instead the standards differ. Then, the current section of this chapter reports the explained results of my analysis, stressing the extent to which the two sets of standards either are similar or differ and trying to see whether the IFRS-US GAAP convergence is at a good point or whether instead one of the two sets is characterised by a remarkably higher level of disclosure requirements.

In making the above-described analysis, I drew a clear line between the disclosure required for interests in subsidiaries other than structured entities/VIEs and the disclosure specifically required instead for interests in consolidated structured entities/VIEs. The disclosure required in these two cases, indeed, is quite different. However, the analysis about consolidated structured entities/VIEs is not part of the current chapter. Although they are subsidiaries and should deal with them in this chapter, I decided to include the analysis about them in the next one, that is in the one specifically devoted to SPEs. Therefore, by the term "subsidiaries" in the current chapter I refer to all the subsidiaries other than consolidated structured entities/VIEs.

Then, another point to make is in respect of the investment entities. The interests that investment companies have in other entities represents a particular case to be faced separately. A specific paragraph will be devoted to them and an in-depth analysis will be made.

Anyway, in the analysis below I will proceed in a systematic way. I will basically first list the disclosures required by IFRS 12, I will then see which items are in common with US GAAP, and which additional items are required to be disclosed either by IFRS or by US GAAP. The objective again is to get to the final judgement about which of the two sets require the most extensive disclosure.

A good starting point of my analysis is represented by the objectives of disclosure. Let us have a look at the objectives of IFRS and at the ways to meet those objectives.

2.2.0 Objective of Disclosure

IFRS 12 – 1

The objective of this IFRS is to require an entity to disclose information that enables users of its financial statements to evaluate:

(a) The nature of, and risks associated with, its interests in other entities; and
(b) *The effects of those interests on its financial position, financial performance and cash flows.*

Source: IFRS Foundation

IFRS 12 – 2

To meet the objective in paragraph 1, an entity shall disclose:
(a) The significant judgements and assumptions it has made in determining:
(i) The nature of its interest in another entity or arrangement;
(ii) The type of joint arrangement in which it has an interest […];
(iii) That it meets the definition of an investment entity, if applicable […]; and
(b) Information about its interests in:
(i) Subsidiaries […];
(ii) Joint arrangements and associates […]; and
(iii) *Structured entities that are not controlled by the entity (unconsolidated structured entities) […].*

Source: IFRS Foundation

IFRS 12 – 3

If the disclosures required by this IFRS, together with disclosures required by other IFRSs, do not meet the objective in paragraph 1, an entity shall disclose whatever additional information is necessary to meet that objective.

Source: IFRS Foundation

The objective of disclosure, according to IFRS, is therefore to disclose information about the nature of, the risk associated with, and the effects of interests in other entities. And the ways an entity has to achieve this objective are mainly two:

1. Disclosure of the significant judgments and assumptions it has made in determining the nature of its interests in other entities;
2. Disclosure of information about its interests in those other entities.

In the US GAAP, instead, there is no equivalent standard providing the overall objective of disclosure regarding the interests an entity has in other entities. Indeed, it is worth recalling first of all that while in IFRS there is a single standard dealing with the disclosure requirements for entities having interests in other entities, in US GAAP there is not. In the US GAAP the disclosure relative to each type of investee is reported in the Codification Topic relative to the specific investee under consideration. Therefore, it is quite normal that in the US there is no single standard stating the overall objective of disclosure for entities having interests in other entities. Moreover, in IFRS an "interest in another entity" is an overall concept that

is clearly defined. In accordance with IFRS 12, an "interest in another entity" is a "*contractual and non-contractual involvement that exposes an entity to variability of returns from the performance of the other entity*" (IFRS 12, p.A577). In the US GAAP, instead, there is no overall concept of "interest in another entity" (KPMG, 2017b). Thus, I say again, it is quite reasonable why in US GAAP there cannot be an equivalent standard for the overall objective of disclosure and for the ways by which such objectives can be met.

Anyway, the good way forward now is to analyse in detail the two points made above about the ways by which to achieve the objective of disclosure. Of course, given the topic of the current chapter, the analysis that I am going to make is just about interests in subsidiaries (the interests in the joint ventures, associates and structured entities will be matters of discussion of the next chapters).

2.2.1 Significant Judgement and Assumptions

An entity shall disclose information about significant judgements and assumptions made in determining that it has control over another entity, including those made when the conclusions on whether it has control change during the reporting period (IFRS 12, para 7-8). In accordance with IFRS 12, an entity should for example disclose the significant judgments and assumptions made in determining that:

(a) *"It does not control another entity even though it holds more than half of the voting rights of the other entity.*
(b) *It controls another entity even though it holds less than half of the voting rights of the other entity.*
(c) *It is an agent or a principal [...]".* (IFRS 12, para 9)

These are general statements that apply to all the subsidiaries, regardless of the way they are controlled by. In the US GAAP, instead, there is separation between the provisions relating to entities controlled through voting rights and those relating to VIEs. In US GAAP, no disclosure of significant judgements and assumptions is required with regard to interests in entities controlled through the ownership of the majority of the voting rights. That kind of requirements are present only in respect of interests in VIEs. However, it is worth asserting that in the US GAAP, unlike IFRS, the notion of "de facto" control is not considered (EY, 2018b). This means that disclosure requirements about the significant judgements and assumptions made in

determining control of majority-owned entities are less relevant under US GAAP. Moreover, there is another reason why in the case just mentioned the disclosure requirements about significant judgements and assumptions are not so relevant. Indeed, as reported in Regulation S-X Rule 3A-02, "*In rare situations consolidation of a majority owned subsidiary may not result in a fair presentation because the registrant, in substance, does not have a controlling financial interest (for example, when the subsidiary is in legal reorganization or in bankruptcy)*" (e-CFR website). Therefore, if we consider the case of this chapter, that is of subsidiaries other than structured entities/VIEs, under US GAAP – with regard to the judgements and assumptions made in determining control – no disclosure requirements are present. However, such requirements in US GAAP would be less applicable and in general, in both IFRS and US GAAP, the most important case with regard to this kind of disclosure is the one relating to VIEs.

2.2.2 Disclosure of Information

The second way by which to achieve the disclosure objective is to disclose information about the interests in other entities. In the case of subsidiaries, the list of disclosures required is reported in the paragraph 10 of IFRS 12.

IFRS 12 – 10

An entity shall disclose information that enables users of its consolidated financial statements

(a) to understand:

(i) the composition of the group; and

(ii) the interest that non-controlling interests have in the group's activities and cash flows [...]; and

(b) to evaluate:

(i) the nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the group [...];

(ii) the nature of, and changes in, the risks associated with its interests in consolidated structured entities [...];

(iii) the consequences of changes in its ownership interest in a subsidiary that do not result in a loss of control [...]; and

(iv) *the consequences of losing control of a subsidiary during the reporting period [...].*

Source: IFRS Foundation

The following points can be made:

- Disclosure about non-controlling interest (para 10(a)(ii)) and about the consequences of changes in the ownership interests in a subsidiary (para 10 (b)(iii) and (iv)) is also required by US GAAP. However, we need to see whether the extent of such disclosures in the two sets is the same. Therefore, in the analysis below I will start from a comparison between IFRS and US GAAP on the topics just mentioned.
- Then, disclosure about the nature and extent of significant restrictions on the ability to use assets and settle liabilities of the group (par. 10(b)(i) in US GAAP is required just for interests in VIEs. However, in SEC Regulation some requirements are present.

Furthermore, I will say a few words also about the following topics:

- Disclosure to be made in the case in which the reporting date of the financial statements of a subsidiary is different from the reporting date of the consolidated financial statements.
- Aggregation that is allowed to be made for the disclosures required for interests in similar entities.

2.2.3 Subsidiaries with NCI

In case of a parent with less than fully-owned subsidiaries, the disclosure required by IFRS 12 is quite extensive.

<u>IFRS 12 – 12</u>

An entity shall disclose for each of its subsidiaries that have non-controlling interests that are material to the reporting entity:

(a) the name of the subsidiary.

(b) the principal place of business (and country of incorporation if different from the principal place of business) of the subsidiary.

(c) the proportion of ownership interests held by non-controlling interests.

(d) the proportion of voting rights held by non-controlling interests, if different from the proportion of ownership interests held.

(e) the profit or loss allocated to non-controlling interests of the subsidiary during the reporting period.

(f) accumulated non-controlling interests of the subsidiary at the end of the reporting period.

(g) *summarised financial information about the subsidiary [...]*

Source: IFRS Foundation

Furthermore, some details are provided about summarised financial information.

IFRS 12 – B10

For each subsidiary that has non-controlling interests that are material to the reporting entity, an entity shall disclose:

(a) dividends paid to non-controlling interests.

(b) *summarised financial information about the assets, liabilities, profit or loss and cash flows of the subsidiary that enables users to understand the interest that non-controlling interests have in the group's activities and cash flows. That information might include but is not limited to, for example, current assets, non-current assets, current liabilities, non-current liabilities, revenue, profit or loss and total comprehensive income.*

Source: IFRS Foundation

Thus, IFRS 12 requires extensive disclosure requirements for subsidiaries with NCI. In case of US GAAP, instead, it is quite different. First, Topic 810 provides disclosure requirements that apply to all the less-than-fully-owned subsidiaries and not only to the subsidiaries that have material NCI. Second, such disclosure is not the same as of IFRS 12. In Topic 810, only general disclosure requirements are present. Such requirements in IFRS are provided in IAS 1 *Presentation of Financial Statements*. In Table 1 below, a comparative analysis.

TABLE 1 – ASC 810 vs. IAS 1

ASC 810	IAS 1
Para 10-50-1A(a)	**Para 81B**
A parent with one or more less-than-wholly owned subsidiaries shall disclose all of the following for each reporting period: • *Separately, on the face of the consolidated financial statements, both of the following:* *1. The amounts of consolidated net income and consolidated comprehensive income* *2. The related amounts of each attributable to the*	*An entity shall present the following items, in addition to the profit or loss and other comprehensive income sections, as allocation of profit or loss and other comprehensive income for the period:* *(a) Profit or loss for the period attributable to:* *(i) Non-controlling interests, and* *(ii) Owners of the parent.* *(b) Comprehensive income for the period attributable to:* *(i) Non-controlling interests, and*

parent and the noncontrolling interest.	*(ii) Owners of the parent* *If an entity presents profit or loss in a separate statement it shall present (a) in that statement.*
Para 10-50-1A(b)	**Para 82(ea)**
• *Either in the notes or on the face of the consolidated income statement, amounts attributable to the parent for any of the following, if reported in the consolidated financial statements:* 1. *Income from continuing operations* 2. *Discontinued operations*	*In addition to items required by other IFRSs, the profit or loss section or the statement of profit or loss shall include line items that present the following amounts for the period:* *[…]* *(ea) A single amount for the total of discounted operations […]* *[…]*
Para 10-50-1A(c)	**Para 106(d)**
• *Either in the consolidated statement of changes in equity, if presented, or in the notes to consolidated financial statements, a reconciliation at the beginning and the end of the period of the carrying amount of total equity (net assets), equity (net assets) attributable to the parent, and equity (net assets) attributable to the noncontrolling interest. That reconciliation shall separately disclose all of the following:* 1. *Net Income* 2. *Transactions with owners acting in their capacity as owners, showing separately contributions from and distributions to owners* 3. *Each component of other comprehensive income.*	*An entity shall present a statement of changes in equity […]. The statement of changes in equity includes the following information:* *[…]* *(d) For each component of equity, a reconciliation between the carrying amount at the beginning and at the end of the period, separately (as a minimum) disclosing changes resulting from:* *(i) Profit or loss;* *(ii) Other comprehensive income; and* (iii) *Transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners and changes in ownership interests in subsidiaries that do not result in a loss of control.*

Source: EY (2018a); IFRS Foundation; author's elaboration

The Topic 810 in the paragraph 10-50-1A includes also another point other than the ones reported above, but that additional point will be subject to analysis later on in the dissertation.

By the way, as we can see, the disclosure required by US GAAP for entities with less-than-fully-owned subsidiaries is also required in IFRS. Differences are very small. ASC 810 specifically requires to disclose both the amount of income from continuing operations and the amount of discontinued operations. IAS 1 just requires to report a line item presenting the total of discontinued operations. However, as the discontinued operations have to be disclosed separately, that means that before the line item relative to that an aggregate relative to the total income from continuing operations is usually presented. Thus, also in IFRS both the amount of income from continuing operations and the total of discontinued operations are disclosed. Then, no other particular differences are worth being analysed.

However, there is no record in ASC 810 of all the specific disclosures required in IFRS 12 in para 12 and B10.

To conclude, both ASC 810 and IAS 1 require the same information about the amount of income attributable to the parent, that attributable to NCI, that from continuing operations, and the total of discontinued operations among the other things already seen above. However, IFRS 12 requires a lot of information about each subsidiary in which the parent has material non-controlling interests and these disclosure requirements cannot be found in US GAAP. Thus, IFRS require much more extensive disclosure about the composition of the group.

2.2.4 Changes in a Parent's Ownership Interest

If for any reason there are changes in a parent's ownership interest in a subsidiary (that do not result in a loss of control of the subsidiary), the effects of these changes on the equity attributable to the parent have to be presented in a separate schedule. This is what both IFRS 12 (para 18) and ASC 810 (para 10-50-1A(d)) require (IFRS Foundation; EY, 2018a).

Then, in the case in which the change in a parent's ownership interest in a subsidiary does instead result in a loss of control and so in the deconsolidation of the subsidiary, other disclosure is required. Both IFRS 12 (para 19) and ASC 810 (para 10-50-1B) require to disclose what follows:

- The amount of any gain or loss (recognized in accordance with the respective rules seen in paragraph 1.3);
- The portion of that gain or loss related to the re-measurement of any retained investment in the former subsidiary at its fair value;
- The line item in the income statement in which the gain or loss is recognised (unless separately presented)

ASC 810, finally, require other disclosures as follows.

- A description of the valuation technique(s) used to measure the fair value of any direct or indirect retained investment in the former subsidiary
- Information that enables users of the parent's financial statements to assess the inputs used to develop the fair value in the item above
- The nature of continuing involvement with the subsidiary after it has been deconsolidated
- Whether the transaction that resulted in the deconsolidation was with a related party
- Whether the former subsidiary will be a related party after the deconsolidation (IFRS Foundation; EY, 2018a)

Thus, in the case of deconsolidation of a subsidiary, US GAAP require greater disclosure than IFRS.

2.2.5 Nature and Extent of Significant Restrictions

Disclosure requirements in IFRS about the topic of the current paragraph are given in the para 13 of IFRS 12.

IFRS 12 - 13

An entity shall disclose:

(a) Significant restrictions (e.g. statutory, contractual and regulatory restrictions) on its ability to access or use the assets and settle the liabilities of the group, such as:

(i) Those that restrict the ability of a parent or its subsidiaries to transfer cash or other assets to (or from) other entities within the group.

(ii) Guarantees or other requirements that may restrict dividends and other capital distributions being paid, or loans and advances being made or repaid, to (or from) other entities within the group.

(b) *The nature and extent to which protective rights of non-controlling interests can significantly restrict the entity's ability to access or use the assets and settle the liabilities of the group [...].*

(c) *The carrying amounts in the consolidated financial statements of the assets and liabilities to which those restrictions apply.*

Source: IFRS Foundation

As already said, as regard the subsidiaries, in the US GAAP there is no provision of this kind. Some requirements on this topic can be found however for SEC registrants in Regulation S-X, para (e)(3), in which basically it is stated what follows:

Regulation S-X Rule 4-08 (e)(3)

The disclosures in paragraphs (e)(3)(i) and (ii) of this section shall be provided when material.

(i) *Describe the nature of any restrictions on the ability of consolidated subsidiaries and unconsolidated subsidiaries to transfer funds to the registrant in the form of cash dividends, loans or advances (i.e., borrowing arrangements, regulatory restraints, foreign government, etc.)*

(ii) *Disclose separately the amounts of such restricted net assets for unconsolidated subsidiaries and consolidated subsidiaries as of the end of the most recently completed fiscal year.*

Source: e-CFR website

In SEC Regulation, in particular in Rule 4-08 para (e)(3)(i) we have similar requirements to those contained in IFRS 12 para 13(a) with the main difference that in the SEC case restrictions are about the transfer of funds just to the registrant while in the IFRS case restrictions are about the transfer of funds to any other entity within the group. Moreover, in accordance with IFRS amounts of both restricted assets and liabilities should be given while in SEC Rules amount of restricted net assets should be provided.

2.2.6 Different Reporting Dates

When the reporting date of the financial statements of a subsidiary is different from that of the consolidated financial statements, disclosure should be given about the closing date of the subsidiary and about the reason for using a different date. This is what both IFRS 12 (para 11) and S-X Regulation (Rule 3A-02) require. Moreover, the aforementioned SEC rule requires also disclosure or otherwise to be given about the

material effects of any event on the financial position or results of operations (IFRS Foundation; e-CFR website).

Thus, disclosure in this respect is more or less the same in IFRS and in the US. In US, just additional disclosure about the effects of intervening events.

2.2.7 Aggregation

Information about interests in other entities – under certain conditions – may be aggregated. Of course, information must be presented separately for interests in each kind of entity (subsidiaries, joint ventures, joint operations, associates, and unconsolidated structured entities). However, within each category information for similar entities may be aggregated. The relevant IFRS paragraphs are the paragraphs 4 and B2-B6 of IFRS 12. Below a selection of the most important provisions.

IFRS 12 – B2

An entity shall decide, in the light of its circumstances, how much detail it provides to satisfy the information needs of users, how much emphasis it places on different aspects of the requirements and how it aggregates the information. It is necessary to strike a balance between burdening financial statements with excessive detail that may not assist users of financial statements and obscuring information as a result of too much aggregation.

Source: IFRS Foundation

IFRS 12 – B3

[…] An entity shall disclose how it has aggregated its interests in similar entities.

Source: IFRS Foundation

IFRS 12 – B5

In determining whether to aggregate information, an entity shall consider quantitative and qualitative information about the different risk and return characteristics of each entity it is considering for aggregation and the significance of each such entity to the reporting entity. The entity shall present the disclosures in a manner that clearly explains to users of financial statements the nature and extent of its interests in those other entities.

Source: IFRS Foundation

In IFRS, these rules hold for all the kinds of entities, while in US GAAP aggregation is not considered for subsidiaries. In US GAAP, aggregation of information for similar

entities is considered only for VIEs. From the point of view of the substance, then, the provisions are basically the same, but the scope is different.

2.3 INTERESTS IN SUBSIDIARIES – INVESTMENT ENTITIES: IFRS VS. US GAAP

A separate section is devoted to investment entities. As we know, indeed, the interests that an investment entity has in other entities are treated – from an accounting point of view – in a different way. Except for the case in which the subsidiary is not an investment entity and provides services to the parent entity that relate to the investment activities, investment entities do not consolidate subsidiaries. They instead usually measure an investment in a subsidiary at fair value through profit or loss. Therefore, investment entities need specific disclosure requirements with regard their interests in (unconsolidated) subsidiaries. In this respect, disclosure can be divided in two main overall points:

- Disclosure of significant judgements and assumptions made in determining the investment entity status.
- Disclosure of interests in unconsolidated subsidiaries.

2.3.1 Investment Entity Status

According to IFRS 12 (para 9A and para 9B), an investment entity shall disclose:

- Information about the significant judgements and assumptions made in determining that it is an investment entity.
- When there is a change in status, the fact and the reasons for that change. Moreover, in case of an entity becoming an investment entity, such entity shall disclose the effect of the change in status on the financial statements for the period presented, including:
    - The total fair value, as of the date of change of status, of the subsidiaries that cease to be consolidated;
    - The total gain or loss, if any;
    - The caption in profit or loss in which the gain or loss is recognized, unless separately presented (IFRS Foundation).

According to ASC 946 (para 10-50), instead, disclosure about an investment entity status is required as well but on a lower scale. ASC 946 still requires disclosure of

any change in status and the reason for that change. It also require the disclosure on the effect of the change in status, but instead of making a bullet list of the specific disclosures required as it is in IFRS 12 it simply states that the investment entity shall disclose the effect of the change in status on the "reported amounts of investments". Finally, in ASC 946, no requirements are made about the disclosure of judgements and assumptions made in the determination of the investment entity status (FASB, 2013). Thus, like for all the other companies, also for the particular case of the investment entities no disclosure requirements about assumptions and judgments are present.

2.3.2 Interests in Unconsolidated Subsidiaries

On the unconsolidated subsidiaries, a great deal of disclosure is required, by both IFRS and US GAAP. In the IFRS, there is a specific section of IFRS 12 devoted to interests in unconsolidated subsidiaries. In the US GAAP, instead, in ASC 946, there is not. Anyway, many provisions are given throughout ASC 946 about the disclosure relative to the outstanding investments of an investment company.

2.3.3 Interests in Unconsolidated Subsidiaries – Features/Schedule of Investments

The main features that are required to be disclosed in IFRS 12 about the unconsolidated subsidiaries are the followings.

<u>IFRS 12 – 19B</u>

For each unconsolidated subsidiary, an investment entity shall disclose:

(a) the subsidiary's name;

(b) the principal place of business (and country of incorporation if different from the principal place of business) of the subsidiary; and

(c) *the proportion of ownership interest held by the investment entity and, if different, the proportion of voting rights held*

Source: IFRS Foundation

However, before making any comparison between IFRS 12 and ASC 946, it would be worth noting two things:

- In IFRS 12, it is just required to disclose some items, but no schedule (or condensed schedule) of investments is required. In ASC 946, instead, as we

will see below, a schedule (or condensed schedule) of investments is specifically required.

- In US GAAP a distinction is made between investment companies other than nonregistered investment partnerships and nonregistered investment partnerships. Indeed, in the two cases different disclosure requirements are made and so two separate considerations should be made.

With regard to the investment companies other than investment partnerships, we have to say in principle that disclosure is required only about those investments that meet some criteria of relevance and anyway at least for the 50 largest investments. Items to be disclosed are about the name, number of shares, or principal amount of each investment. Moreover, those investments should be categorized by the type of investment and by the related industry, country or geographic region. For all the other investments just aggregate amounts should be disclosed. More precisely, such other investments should be categorized again by type of investment and by the related industry, country, or geographic region and for each category it should be disclosed the aggregate percentage of net assets and the total value. The relevant standard of reference for what said so far is ASC 946, para 210-50-1.

Then, we have the investment partnerships that are exempt from SEC registration, e.g. hedge funds, limited liability companies, limited liability partnerships, and offshore investment companies among the others. In this case, it is required the same disclosure as the other case plus some additional items. Basically, investments must be categorized in the same way as before, expect for the case of derivative instruments for which the underlying is not a security in which the categorization has to take place by type of investment and by broad category of underlying. Then, again information about the name, number of shares or principal amount of the investments have to be given and also the percent of net assets and the total fair value and cost for each category of investment have to be disclosed. Moreover, in the case of nonregistered investment partnerships also specific information about the features of derivative instruments have to be given, such as the range of expiration dates and the number of open futures contracts among the others. Finally, for each investment in another nonregistered investment partnership whose fair value constitutes more than 5 percent of net assets, disclosure should be provided about

the investment objective and the restrictions on redemption. The relevant standard for what aforementioned is ASC 946, para 210-50-6.

In both cases, thus, even if the kind of disclosure is more or less the same, more items are required to be disclosed in ASC 946 with respect to IFRS 12. However, it is worth mentioning that even if in IFRS 12 no schedule is required, in IFRS 13 *Fair Value Measurement* some disclosure is required by class of financial assets and liabilities measured at fair value, such as the fair value of each class (Deloitte, 2014).

Finally, for completeness purposes, it is worth also reporting that in IFRS 12, in para 19C, is also stated that in case of an investment entity that is the parent of another investment entity, the disclosure required in 19B should be made also for the investments of the investment entity subsidiary (IFRS Foundation).

2.3.4 Interests in Unconsolidated Subsidiaries – Significant Restrictions

Disclosure is also required in IFRS about the restrictions that there may be on the activities of the unconsolidated subsidiaries.

IFRS 12 – 19D(a)

An investment entity shall disclose:

(a) the nature and extent of any significant restrictions (e.g. resulting from borrowing arrangements, regulatory requirements or contractual arrangements) on the ability of an unconsolidated subsidiary to transfer funds to the investment entity in the form of cash dividends or to repay loans or advances made to the unconsolidated subsidiary by the investment entity; […]

Source: IFRS Foundation

I do not find any provision of this kind in ASC 946, so that I can assert that just IFRS requires disclosure about significant restrictions described above.

2.3.5 Interests in Unconsolidated Subsidiaries – Financial (and Other) Support

In accordance with IFRS, an investment entity shall also disclose what follows.

IFRS 12 – 19D(b)

An investment entity shall disclose:

[…]

(b) *any current commitments or intentions to provide financial or other support to an unconsolidated subsidiary, including commitments or intentions to assist the subsidiary in obtaining financial support.*

Source: IFRS Foundation

IFRS 12 – 19E

If, during the reporting period, an investment entity or any of its subsidiaries has, without having a contractual obligation to do so, provided financial or other support to an unconsolidated subsidiary (e.g. purchasing assets of, or instruments issued by, the subsidiary or assisting the subsidiary in obtaining financial support), the entity shall disclose:

(a) the type and amount of support provided to each unconsolidated subsidiary; and

(b) *the reasons for providing the support.*

Source: IFRS Foundation

As regard the provision included in IFRS 12 para 19D(b), we can say that also in ASC 946 para 20-50-16 disclosure is required about commitments to provide financial support. However, two points could be made in this respect:

- While in IFRS it is just stated in general terms to provide disclosure about the commitments of an investment entity to provide financial or other support to an unconsolidated subsidiary, in US GAAP – as regard the financial support that an investment company is contractually required to provide to any of its investees but has not yet provided – it is specifically required to disclose,
    a. The type and amount of financial support to be provided
    b. The primary reasons for the contractual requirement to provide the financial support
- In ASC 946, no disclosure is required with respect to any intention of the investment entity to provide financial support.

Then, in IFRS 12 para 19E, it is reported the disclosure required for investment entities that provided financial support to an unconsolidated subsidiary without having a contractual obligation to do so (IFRS Foundation). In ASC 946 para 20-50-15, we have basically the same disclosure requirements. However, US GAAP also require that disclosure for investment company that provided it and that were contractually required to provide it.

Moreover, IFRS 12 also requires disclosure in the case of unconsolidated subsidiaries that are structured entities. We will see it in the next chapter.

2.3.6 Interests in Unconsolidated Subsidiaries – Other Disclosure

Finally, we come to the last but not least important part. Indeed, ASC 946 is plenty of other disclosure requirements about the investments of investment entities. In the previous paragraphs, basically, I reported the IFRS 12 disclosure and the correspondent US GAAP disclosure, but in ASC 946 there is much more – not just what seen so far. It would be heavy and useless to consider in detail all the provisions of ASC 946 that are left. Therefore, I will just make the some important points.

- The section 205 *Presentation of Financial Statements* of ASC 946 contains important disclosure requirements. They are about financial highlights. Basically, investment companies should present –either within the notes of the financial statements or as a separate schedule – financial highlights for each class of common shares outstanding. The highlights should include per-share information, ratios of expenses and net investment income to average net assets, total return, and capital commitments. Disclosure required in this respect is quite extensive.
- In the section 235 *Notes to Financial Statements* of ASC 946, specific disclosure requirements are presented for management investment companies that have multiple classes of shares, master-feeder structures, or fund of funds structures. Of course, such disclosure has to be presented in the notes to financial statements and basically focuses on the investment structure of the investment company.

However, on the other side, there are also some other areas of IFRS in which we can find disclosure requirements that are not contained in US GAAP. For example with regard to the disclosure of risks of financial instruments, IFRS 7 *Financial Instruments: Disclosures* provides robust disclosure requirements. And, among the other things, it is also required a sensitivity analysis, which is not contained in US GAAP (FASB, 2013).

Thus, to conclude, in IFRS 12 – as regard for example significant restrictions, and significant judgements and assumptions – disclosure is more detailed than it is in ASC 946. However, on the whole, many more provisions are contained in ASC 946 that it is in IFRS, in particular in respect to the investment structure of an investment

company and on the features of the shares and securities in which the investment company has made investments. KPMG (2017b) states that disclosures required in US GAAP for investment companies in respect of the investees is on the whole more extensive than IFRS. This is a reasonable conclusion. However, it is important to bear in mind that the matter is pretty complex and that the shades are several.

2.4 ON THE BALANCE

Many points have been addressed in the current chapter.

- We have seen that, as regard the composition of the group, much more disclosure is required by IFRS especially as regard interests that a reporting entity has with respect to subsidiaries with material NCI.
- In respect of the significant restrictions on the ability of an entity to access or use the assets and to settle the liabilities of the group, and in respect of the significant judgements and assumptions made in determining control of another entity, US GAAP do not provide disclosure requirements at all. However, in the specific case of this chapter, that is in the case of interests in subsidiaries other than VIEs, disclosure requirements on significant judgements and assumptions are not so relevant under US GAAP. Moreover, some disclosure requirements on the restrictions of a subsidiary to transfer funds to the parent are present in SEC Regulation.
- As regard deconsolidation of a subsidiary, instead, more disclosure is required by US GAAP.
- And finally, we have seen the case of the investment entities concluding that the disclosure requirements are more extensive under US GAAP.

Thus, much work has been done in the last decade to converge the two sets of standards, and in fact it is possible to find many common points between IFRS and US GAAP. However, still some differences remain and the complexity of the matter is high so that no overall conclusion can be made on which of the two sets of standards require the most extensive disclosure about interests in subsidiaries. It is necessary to assess separately each single section of disclosure as I personally did in the current chapter.

3. DISCLOSURE OF INTERESTS IN STRUCTURED ENTITIES/VIES

Disclosure of interests in subsidiaries is important. Even more important, perhaps, is the disclosure of interests in unconsolidated structured entities/VIEs. Indeed, in case of non-consolidation of this kind of entities, an appropriate disclosure of the interests in them would be fundamental. It could be otherwise possible for example to quite easily hide debt or doing some other kinds of frauds. I have already given an overview of the special purpose entities in chapter 1, where I wrote about the Enron scandal and the financial crisis in order to stress the importance of disclosure of interests in such kind of entities. Now, it is time to go more in-depth and to better define the special purpose entities or special purpose vehicles. This is what I am going to do in the next paragraph. In particular, I will demonstrate how they can be related to the categories of structured entities and of variable interest entities, respectively in IFRS and in US GAAP, and I will also show how similar structured entities and variable interest entities are. Then, I will approach the standards in IFRS and in US GAAP that address the disclosure of interest in these two kinds of entities, that is in structured entities and in VIEs. Similarly to the analysis done in the previous chapter, a comparison between the two sets of standards on the disclosure requirements with regard to the interests in these two kinds of entities will be done. The analysis will include also the structured entities/VIEs that are consolidated.

3.1 DEFINITION, FEATURES OF, AND MOTIVATIONS FOR SPES

The special purpose entities (SPEs) – that can be referred to also as special purpose vehicles (SPVs), or special purpose corporations (SPCs) – can be described in the following way.

> "*An SPE is a legal entity created at the direction of a sponsoring firm (which may also be referred to as the sponsor, originator, seller, or administrator). The sponsor is typically a major bank, finance company, investment bank or insurance company. An SPE can take the form of a corporation, trust, partnership, corporation or a limited liability company. An SPE is a vehicle whose operations are typically limited to the acquisition and financing of specific assets or liabilities*" (BIS, 2009, p.1)

The main process which come to our mind when referring to SPEs is the securitization process. In securitization, SPEs are used to isolate assets from the selling institutions. Basically, as we have already said, assets are pooled together and transferred to a SPE. Among the assets, we can mention mortgages, credit card receivables, automobile loans and home equity loans. Bonds backed by the cash flows generated by the underlying assets – so-called asset-backed securities – are then issued by the SPE in order to fund the purchase of the underlying assets. Institutions involved in the securitization of assets – the sponsors – are usually banks and finance companies. However, not only assets can be securitized. Insurance companies undertake also the securitization of liabilities, basically issuing bonds which assume the risk of potential insurance liabilities, e.g. a catastrophic natural event (BIS, 2009).

Special purpose entities have many important features. Among the others, we can mention the following ones.

- SPEs are bankrupt-remote entities, that is the bankruptcy of the sponsoring entity will not affect the SPE. In other words, the sponsor's creditors cannot seize the assets of the SPE.
- SPEs are limited purpose entities.
- SPEs are usually thinly capitalized, that is the equity amount is not sufficient to support the activities of the SPE. Quite often, the activities are funded through the issuance of debt securities.
- SPEs are designed in such a way to have a low probability of insolvency.
- The administrative functions of the SPE are performed by a trustee or an outside agent, not by employees.
- SPEs are usually established in offshore jurisdictions, e.g. Cayman Islands, that make it easier for sponsoring entities to achieve the desired objectives.
- SPEs exist just for financial engineering purposes.
- In case of sale of assets to a SPE, risk associated to those assets is transferred to the SPE.
- SPEs, under certain conditions, may not be consolidated, and so may be used to set up off-balance sheet transactions (BIS, 2009; Na'im, 2006).

The last point of the bullet list above, as already seen, represents one of the main reasons why SPEs had been used so widely in the years before the outbreak of the

financial crisis. Of course, it is not the only one. The purposes for which SPEs are set up are several, and many of them can be in fact inferred by just working on the main features of SPEs mentioned above. On the whole, we can consider reasons that involve risk management, funding, liquidity, project financing, accounting, regulatory capital, and tax issues (Na'im, 2006; BIS, 2009).

1. RISK MANAGEMENT: SPEs can be used to transfer risks (of various types) of an underlying pool of exposures from an originator to third parties.
    - By transferring assets to a SPE, the assets get legally isolated, and so the originating institution would not have any obligation to provide additional funds to the SPE in case in which the SPE's assets were not sufficient to fully repay the SPE's creditors. The extent of the credit risk transfer to third parties depends on which tranches of SPE's debt are sold to third parties. If the subordinated tranches are not retained, then almost of the credit risk is transferred.
    - Then, SPEs can be used also to manage interest rate risk. Indeed, in some structures the cash flows of the debt issued by the SPE better match the cash flows of the underlying assets than if the originator had issued its own debt to finance the assets.
    - Finally, by engaging in transactions involving SPEs, also other risks can be mitigated, especially risks which insurance companies may be involved in. There are structured products, indeed, that may be issued and whose payments are linked to some measure of the severity of natural disaster. Basically, structured products which assume the risk of losses that may arise from earthquakes, hurricanes, or droughts.
2. FUNDING & LIQUIDITY
    - Entities with a certain credit rating lower than the highest one, that is lower than AAA, can use SPEs to convert non-rated assets into tranched securities, with the highest tranches being rated AAA and having funding costs lower than the one associated with the stand-alone rating of the company. Even if the remainder tranches would be characterised by funding costs higher than the one associated with the stand-alone rating of the company, the balance may be positive. Thus,

SPEs allow to lower the overall funding cost of the originating company.

- SPEs enable companies also to have a wider investor base or, more generally, to get access to additional sources of funding. Indeed, being the SPE a legally separate entity, the originator can – through the SPE – gets funds from other new lenders and get additional funds from existing ones that may otherwise have some limits in borrowing money to a single entity.
- SPEs may also enable small institutions to more easily access the capital markets. An institution, indeed, may be so small that access to capital markets may be difficult. However, by pooling its exposures with the exposures of other small institutions, capital markets may be more efficiently accessed.
- As we have seen, the conversion of non-rated exposures into structured (rated) securities and the pooling of those exposures allow to lower the funding costs, expand the investor base, and facilitate the access to the capital and financial markets. Thus, all this ultimately allow to increase the liquidity of the originating institution.

3. PROJECT FINANCING: SPEs are also used by companies to finance large infrastructure projects without investing in them directly.
    - The reasons for using SPEs when investing in large projects or ventures are several: to avoid increasing the level of debt of the sponsoring firm and so to maintain a more favourable financial profile, to contribute some of the equity for the investment with other investors, and to mitigate some legal constraints relating to strict financial regulation bound by the project sponsor.
4. FINANCIAL ENGINEERING
    - Under certain conditions, originating entities can avoid consolidating SPEs. Basically, assets can be removed from the balance sheet of the sponsoring entity. This way, the originating entity will be able to show a more favourable financial profile, such a higher return on assets, and will also able to affect some regulatory capital ratios in which capital adequacy requirements are based on the amount of reported balance

sheet assets. However, not only SPEs' assets disappear from the originator's balance sheet but also SPEs' liabilities are removed. As SPEs' debt is just reported in the footnotes, the result is more favourable financial leverage. Thus, SPEs – if structured properly – can be used to hide, or at least make less explicit or less visible, unproductive assets or potential liabilities.

- The issues pointed above are the reasons why so many SPEs were set up in the last decade. Nowadays, however, the conditions for the non-consolidation of the SPEs are stricter than they were till a decade ago and also disclosure of such unconsolidated SPEs is greater (BIS, 2009; Na'Im, 2006, PwC, 2011).

5. TAX AVOIDANCE: it is not one of the main factors explaining the huge use of SPEs, but it would be anyway worth underlining that SPEs can enable companies to achieve significant corporate tax savings.
    - SPEs enable entities to make savings especially from R&D and intangible assets.
    - Through the use of SPEs, corporate tax savings are facilitated in two ways. First, SPEs allow sponsoring firms to increase tax-advantaged activities. Indeed, by separating high-risk assets from the sponsor, it would be possible for example to achieve greater external financing – and therefore in turn more R&D deductions and tax credits – and to get larger debt capacity – leading to more tax deductible interest expense. Second, SPEs allow sponsoring firms to improve tax efficiency. Indeed, through the use of SPEs, it is possible for example to shift profits to jurisdictions with low tax rates (Demerè et al, 2018).

Thus, the motivations that made SPEs so popular in the decade before the last one are several. However, the possibility in particular to account for SPEs off-balance sheet generated significant opportunities for accounting misconducts. Over the last ten years, therefore, many improvements have been made to disclosure requirements, and our analysis will be essentially an analysis of the current state of the art.

3.2 STRUCTURED ENTITIES/VIES

In IFRS and US GAAP, SPEs are broadly referred to as "structured entities" and "variable interest entities", respectively. In the standards relating to the accounting rules for these two kinds of entities, indeed, we find many of the attributes that we listed in the previous pages about SPEs.

As regard structured entities, we can report what follows.

IFRS 12 – B22

A structured entity often has some or all of the following features or attributes:

(a) restricted activities.

(b) a narrow and well-defined objective, such as to effect a tax-efficient lease, carry out research and development activities, provide a source of capital or funding to an entity or provide investment opportunities for investors by passing on risks and rewards associated with the assets of the structured entity to investors.

(c) insufficient equity to permit the structured entity to finance its activities without subordinated financial support.

(d) *financing in the form of multiple contractually linked instruments to investors that create concentrations of credit or other risks (tranches).*

Source: IFRS Foundation

There are many elements in common with the features of SPEs mentioned previously in this paragraph: limited purpose/narrow objective, insufficient amount of equity to finance the activities, financing in the form of tranched securities. Among the purposes, we can underline the funding and the transfer of risks associated with some assets to third parties.

We should precise that the name by which the structured entities were referred to as by IASB till a decade ago was in fact that of special-purpose entities. As said in Chapter 1, IFRS 12 was issued in 2011 and incorporated the provisions of SIC-12 *Consolidation: Special Purpose entities*. In the basis for conclusion of IFRS 12, para BC82, it is the IASB itself which asserts that, "The type of entity the Board envisages being characterised as a structured entity is unlikely to differ significantly from an entity that SIC-12 *Consolidation-Special Purpose Entities* described as a special purpose entity (SPE)" (IFRS Foundation, 2011, p.23). The reason for the claiming of similarity instead of perfect matching between the two entities is mainly due to the fact that – albeit the similar features – the technical definitions in the two cases are different. A SPE, indeed, was simply defined in SIC-12 in a way that reflected the

underlying features of the SPE itself, that is as, "An entity created to accomplish a narrow and well-defined objective" (IFRS Foundation, 2011, pag.23). A structured entity is instead basically defined as, "An entity that has been designed so that voting rights are not the dominant factor in deciding who controls the entity" (IFRS Foundation). In the definition of SPE in SIC-12 there was no reference to voting rights as a determinant factor and this may be a reason for differences between SPEs and structured entities. However, the IASB in the Basis for Conclusion of IFRS 12, para BC84, asserts that in IFRS 12 similar guidance to that in SIC-12 has been included, "To reflect the Board's intention that the term "structured entity" should capture a set of entities similar to SPEs in SIC-12" (IFRS Foundation, 2011, pad.24). And EY (2013), referring to the structured entities, argue that, "The implications from the Basis for Conclusions is that the IASB considers that, where some features and attributes are present in an entity, then it is unlikely that the entity is controlled by voting or similar rights" (pag.4). Thus, I can infer that the difference in the technical definitions of the two entities should imply in practice no significant difference between the two types of entities, and so that structured entities in a broad sense can be considered as SPEs.

In US GAAP, instead, unlikely IFRS, there is no paragraph outlining in a systematic way the attributes of variable interest entities. By the way, I can collect some information spread over ASC 810 section 10-05:

- Equity investment is insufficient to finance the activities of the entity – need for subordinated financial support (para 10-05-6);
- VIEs may be structured in such a way to enable the originating entity to report gains that are illusory, or to avoid reporting assets and liabilities for which the originating entity itself is responsible (para 10-05-9);
- VIEs are often set-up for a single purpose. We can mention securitisation, risk hedging, and R&D purposes among the others (para 10-05-11).

Thus, also for VIEs we have again many of the elements seen in general for SPEs. All this to show that both kinds of entities refer to the broad category of SPEs. Moreover, the technical definition of a VIE takes into consideration the concept of control as in the case of structured entities. Indeed, I recall that also a VIE is defined basically as an entity whose activities are not directed through voting or similar rights, other than being considered as an entity whose equity is not sufficient to finance its

activities without the help of subordinated financing. This should not come as a surprise, since it is the IASB itself that in the Basis for Conclusions of IFRS 12, in para BC83 and BC84, claims that in defining a structured entity it has considered whether to do so in a way similar to a VIE in US GAAP (IFRS Foundation, 2011). Thus, not only both structured entities and VIEs can be considered SPEs with regard to the attributes that characterise them, but also their technical definitions are similar. This way, I can confirm the version of EY (2018b), according to which the definition of structured entity is quite similar to that of variable interest entity. Just to be more precise and to be complete, I will just report below some of the specific elements common to both definitions:

- Power does not arise from voting rights but instead from contractual arrangements
- Power is about directing the activities that significantly impact the structured entity/VIE's performance
- In case of structured entities, exposure to variable returns; in case of VIEs, obligation to absorb losses and right to receive benefit that could be significant to the VIE.

Of course, the aforementioned elements are not all the elements that characterise the definitions of the entities, but it is just a way to show the similarity between the two definitions.

I have spent many lines of the current paragraph in establishing the comparability of the two kinds of entities under consideration for a specific reason. Indeed, the comparison of the disclosure requirements in IFRS and US GAAP for structured entities and variable interest entities, respectively, can make sense only if in principle the two kinds of entities – considered in their attributes and in their definitions – are comparable.

3.3 DISCLOSURE OF INTERESTS IN STRUCTURED ENTITIES/VIES: IFRS VS. US GAAP

The very topic of this chapter is given by the differences and similarities between the disclosure in IFRS and that in US GAAP about interests in structured entities and variable interest entities, respectively. It would be good to start the analysis by introducing the specific standards in the two sets that rule out the topic under

consideration. In IFRS, as we already know, the disclosure requirements about the interests in structured entities are provided in IFRS 12. Recall, indeed, that the entire disclosure of interests in other entities is combined in one single standard under IFRS. In the US GAAP, instead, the disclosure requirements about VIEs are provided in ASC 810. Just for clarity purposes, two points should be made before moving on to the underlying analysis.

- In the first chapter of this dissertation – when talking about the evolution of accounting standards – I mentioned standards such as Statements of Financial Accounting Standards (SFAS) No. 166 and 167. Now instead I talk about Accounting Standard Codification (ASC). Basically, the reason is that in 2009 a reorganisation of accounting standards was undergone by FASB. Before the Codification came into effect, there were various standards issued by various standard setters in different forms. This meant quite dispersed accounting standards literature and so difficulty for all individuals to select/apply the right/relevant accounting standard for each specific case. Thus, the Accounting Standard Codification was implemented in order to better organize and simplify the authoritative GAAP literature. All the GAAP pronouncements have been arranged in a consistent structure made of several topics all having the same level of authority. So, it is just a change in the form, not in the substance. The accounting provisions remained the same. Of course, SEC's rules and interpretative releases have not been included in this Codification – although some link is given to the relevant ones for each relevant topic. However, both the Accounting Standards Codification and the SEC's rules and interpretative releases represent authoritative GAAP for SEC registrants as well. Moreover, it is better to specify that the Codification apply just to nongovernmental entities (FASB, 2009).
- IFRS 12, especially the sections relating to the disclosure of interests in unconsolidated structured entities, was designed and issued to answer to the needs for disclosure requirements about "off-balance sheet entities" identified during the global financial crisis – in particular, need for more disclosure about investment and securitization activities. However, while disclosure requirements about VIEs at the time of the financial crisis had

existed already for some years, the disclosure requirements about structured entities were introduced for the first time with IFRS 12. Of course, as already seen, the Enron case in 2002 put pressure for disclosure requirements about SPEs and that's probably the reason why in US disclosure requirements on such entities had developed earlier. Anyway, the fact is that in IFRS disclosure requirements on SPEs developed later. And the fact that – as we will see in the current section of this chapter – disclosure requirements in US GAAP and in IFRS are pretty similar is also due to the fact that the IASB – at the time of the design of IFRS 12 – was persuaded by the positive feedback of the financial statements' users in the US about the disclosure required by US GAAP on VIEs. The IASB, therefore, noted that, "Addressing disclosures for interests in unconsolidated structured entities would be an opportunity to align the disclosure requirements in IFRSs and US GAAP in this respect" (IFRS Foundation, 2011, pag.21).

The analysis will then be structured as follows:

1. First, disclosure requirements about the significant judgements and assumptions made in determining whether to consolidate a structured entity/variable interest entity will be presented.
2. Then, a comparison of the disclosure requirements for consolidated structured entities/VIEs will be made. Indeed, this is a part of the analysis on subsidiaries that I left for this chapter.
3. Finally, I will move on to the most relevant part, that is the analysis of the disclosure requirements in IFRS and in US GAAP about the unconsolidated structured entities/VIEs. This is the most important part because – as we know – it is the possibility of off-balance sheet accounting that can threaten the most the proper representation of a company's interests in other entities.

3.3.1 Significant Judgements and Assumptions

As we have already seen in the previous chapter, in IFRS 12 there is a general statement about the need for a reporting entity to provide disclosure on the significant judgments and assumptions made in determining that it controls another entity, including those made when conclusions about control change during the reporting period. In ASC 810, albeit specific for VIEs, we have similar requirements.

ASC 810-10-50-5A(a)

Its methodology for determining whether the reporting entity is the primary beneficiary of a VIE, including, but not limited to, significant judgements and assumptions made.

Source: EY, 2018a, pag.383

ASC 810-10-50-5A(b)

If facts and circumstances change such that the conclusion to consolidate a VIE has changed in the most recent financial statements (for example, the VIE was previously consolidated and is not currently consolidated), the primary factors that caused the change and the effect on the reporting entity's financial statements.

Source: EY, 2018a, pag.383

US GAAP still require significant judgements and assumptions made in determining whether an entity controls a VIE. They require then disclosure about the main factors that caused a change in the conclusion about whether to consolidate. In this respect, IFRS 12 simply require disclosure on the significant judgements and assumptions made in determining the change in such kind of conclusion, while ASC 810 refer to the "factors" that caused the change. Moreover, ASC 810 specifically requires the disclosure reported in the paragraphs above for both the primary beneficiary of the VIE and the holders of a variable interest in a VIE that are not the primary beneficiary (EY, 2018a).

3.3.2 Consolidated Structured Entities/VIEs

As already seen in the previous section of the current chapter, one of the fundamental characteristics of a structured entity is the insufficient level of equity of the structured entity itself that does not allow the entity to finance its activities without subordinated financial support. Thus, it should not come as a surprise that the disclosure requirements in IFRS revolves around the financial support that the parent entity did provide, does provide, and that does intent to provide to the consolidated structured entities. Now, we are going to analyse the provisions in this respect reported in IFRS 12. I shall start from the existing arrangements to provide the support.

IFRS 12 – 14

An entity shall disclose the terms of any contractual arrangements that could require the parent or its subsidiaries to provide financial support to a consolidated structured entity, including events or circumstances that could expose the reporting entity to a loss (e.g. liquidity arrangements or credit rating triggers associated with obligations to purchase assets of the structured entity or provide financial support).

Source: IFRS Foundation

Also in ASC 810 (para 10-50-3(d)) we have disclosure requirements about the terms of arrangements to provide financial support to the VIE (including the events or circumstances that could expose the reporting entity to a loss). There are just two differences:

- In ASC 810, there is no reference to the need also for the subsidiaries to give such kind of disclosure;
- Most importantly, in ASC 810, by "arrangements" they refer both to explicit arrangements and to implicit variable interests, while in IFRS 12 there is reference just to contractual arrangements (EY, 2018a; IFRS Foundation).

As regard instead the financial support that the reporting entity did provide, I can make reference to the following paragraphs of IFRS 12.

IFRS 12 – 15

If during the reporting period a parent or any of its subsidiaries has, without having a contractual obligation to do so, provided financial or other support to a consolidated structured entity (e.g. purchasing assets of or instruments issued by the structured entity), the entity shall disclose:

(a) the type and amount of support provided, including situations in which the parent or its subsidiaries assisted the structured entity in obtaining financial support; and

(b) *the reasons for providing the support*

Source: IFRS Foundation

IFRS 12 – 16

If during the reporting period a parent or any of its subsidiaries has, without having a contractual obligation to do so, provided financial or other support to a previously unconsolidated structured entity and that provision of support resulted in the entity controlling the structured entity, the entity shall disclose an explanation of the relevant factors in reaching that decision.

Source: IFRS Foundation

As regard the content of IFRS 12 para 15, in ASC 810 (para 10-50-5A(c)) we have basically the same disclosure requirements with again only the two aforementioned

differences. In respect instead of IFRS 12 para 16, we do not have an equivalent provision in US GAAP. We can only mention the para 10-50-5A(b) of ASC 810 in which it is required to disclose the main reasons that brought to a change in the most recent financial statements in the conclusion about whether to consolidate a VIE (EY, 2018a).

Finally, also the disclosure about any intention to provide financial support is important. Both IFRS 12 and ASC 810 require a reporting entity to disclose any current intentions to provide financial or other support to a consolidated structured entity/variable interest entity, including any intention to assist the structured entity/variable interest entity itself in obtaining the financial support (EY, 2018a; IFRS Foundation).

Thus, we can assert that, even with some differences, there is significant consistency in the disclosure required in the two sets of standards about the provisions relating to the financial support to a structured entity/variable interest entity.

US GAAP, then, specifically require the primary beneficiary of a variable interest entity to provide other disclosure about the interests in the VIE. In this respect, Table 2 shows the main disclosures.

TABLE 2 – Other US GAAP Disclosure Requirements

ASC 810 10-50-3(bb)	The carrying amounts and classifications of the VIE's assets and liabilities in the statement of financial position that are consolidated in accordance with the Variable Interest Entities Subsections, including qualitative information about the relationship(s) between those assets and liabilities. For example, if the VIE's assets can be used only to settle obligations of the VIE, the reporting entity shall disclose qualitative information about the nature of the restrictions on those assets.
ASC 810 10-50-3(c)	Lack of recourse if creditors (or beneficial interest holders) of a consolidated VIE have no recourse to the general credit of the primary beneficiary.
AC 810 10-50-5A(d)	Qualitative and quantitative information about the reporting entity's involvement (giving consideration to both explicit arrangements and implicit variable interests) with the VIE, including, but not limited to, the nature, purpose, size, and activities of the VIE, including how the VIE is financed. […]

Source: EY, 2018a, pages 381,383; author's elaboration

Furthermore, if the VIE is not a business, the primary beneficiary should also provide disclosure about the amount of gain or loss recognized on the initial consolidation of the VIE. And, if the VIE is a business, the primary beneficiary should also provide disclosures required by other guidance (EY, 2018).

To balance, I can conclude that, as regard the disclosure of interests in consolidated structured entities/VIEs, more disclosure is required in US GAAP with respect to IFRS.

3.3.3 Unconsolidated Structured Entities/VIEs

As already seen, the greatest threaten to disclosure comes from the opportunity – in certain situations – to account off-balance sheet for structured entities/VIEs. I will not recall all the reasons underlying that statement. Now, it is time to see how great is the disclosure required in IFRS and US GAAP in this respect. I can anticipate that disclosure required in IFRS for unconsolidated structured entities is much more extensive than that required for consolidated ones. By the way, let us start from the beginning. IFRS 12 basically categorises the disclosure requirements about interests in structured entities into two groups:

- The nature (and extent) of its interests;
- The nature of (and changes in) the risks associated with its interests.

Of course, for the controlled unconsolidated structured entities investment entities must apply the rules seen in the previous chapter and not the rules that I will present in the current section of this chapter.

3.3.4 Unconsolidated Structured Entities/VIEs – Nature (and Extent) of Interests

IFRS 12 – 26

An entity shall disclose qualitative and quantitative information about its interests in unconsolidated structured entities, including, but not limited to, the nature, purpose, size and activities of the structured entity and how the structured entity is financed.

Source: IFRS Foundation

In ASC 810 (para 10-50-5A(d)), we have basically the same disclosure requirements, with the only difference that in IFRS 12 they generally refer to "interests" in unconsolidated structured entities while in ASC 810 they refer to "involvement"

both in the form of explicit arrangements and in the form of implicit variable interests (EY, 2018a). In this respect, however, we have to say that in IFRS 12 "interest in" basically refers to both contractual and non-contractual involvement. And in the Basis for Conclusion of IFRS 12, para BC80, it is basically stated that in US GAAP "involvement" is interpreted in a way similar to how "interest in" is defined in IFRS 12 (IFRS Foundation, 2011).

Moreover, IFRS requires disclosure also for entities that during the reporting period sponsored an unconsolidated structured entity but that at the reporting date have no interests in such unconsolidated entity or anyway that for any reason do not provide disclosure required in para 29 of IFRS about the risks arising from such involvement in the unconsolidated structured entity.

IFRS 12 – 27

If an entity has sponsored an unconsolidated structured entity for which it does not provide information required by paragraph 29 (e.g. because it does not have an interest in the entity at the reporting date), the entity shall disclose:

(a) how it has determined which structured entities it has sponsored;

(b) income from those structured entities during the reporting period, including a description of the types of income presented; and

(c) the carrying amount (at the time of transfer) of all assets transferred to those structured entities during the reporting period.

Source: IFRS Foundation

The information about the carrying amount of the assets transferred and about the income received should be presented in tabular format, unless another format is more appropriate, and the sponsoring activities should be classified into relevant categories (IFRS Foundation). This kind of disclosure is not required in US GAAP. The IASB introduced it because it received comments about the risks that can arise from sponsoring a structured entity without anyway holding an interest in it. The opinion of the Board indeed is that, "If the structured entity encounters difficulties, it is possible that the sponsor could be challenged on its advice or actions, or might choose to act to protect its reputation." (IFRS Foundation, 2011, pag.25)

3.3.5 Unconsolidated Structured Entities/VIEs – Nature of (and Changes in) the Risks Associated with the Interests

IFRS 12 – 29

An entity shall disclose in tabular format, unless another format is more appropriate, a summary of:

(a) the carrying amounts of the assets and liabilities recognised in its financial statements relating to its interests in unconsolidated structured entities.

(b) the line items in the statement of financial position in which those assets and liabilities are recognised.

(c) the amount that best represents the entity's maximum exposure to loss from its interests in unconsolidated structured entities, including how the maximum exposure to loss is determined. If an entity cannot quantify its maximum exposure to loss from its interests in unconsolidated structured entities it shall disclose that fact and the reasons.

(d) *a comparison of the carrying amounts of the assets and liabilities of the entity that relate to its interests in unconsolidated structured entities and the entity's maximum exposure to loss from those entities.*

Source: IFRS Foundation

The disclosure requirements above are present also in the US GAAP. The reference section of the Codification for that kind of disclosure is ASC 810-10-50-4. Few points are worth being made:

- IFRS 12 in paragraph 29(b) requires disclosure of the "line items" of the statement of financial position in which the assets and liabilities relating to interests in unconsolidated structured entities are recognised. ASC 810, instead, requires disclosure of the "classification" of those assets and liabilities (in the reporting entity's statement of financial position). I suppose they broadly refer to the same thing.
- As regard instead the point (c) of the paragraph above, the correspond ASC 810 paragraph requires also disclosure of the significant sources of the reporting entity's exposure to the VIE.
- As regard then the point (d) of the paragraph above, the basic disclosure required in ASC 810 is the same. However, US GAAP are much more detailed about the type of disclosure to be made.
    - ASC 810 requires a "tabular" comparison to be made;
    - Qualitative and quantitative information should be provided in US GAAP to allow the users of the financial statements to understand the differences between the two amounts under consideration.

Then, IFRS 12, in paragraphs 30 and 31, focuses on the topic of the financial or other support provided or intended to be provided to an unconsolidated structured entity.

IFRS 12 – 30

If during the reporting period an entity has, without having a contractual obligation to do so, provided financial or other support to an unconsolidated structured entity in which it previously had or currently has an interest (for example, purchasing assets of or instruments issued by the structured entity), the entity shall disclose:

(a) the type and amount of support provided, including situations in which the entity assisted the structured entity in obtaining financial support; and

(b) the reasons for providing the support.

Source: IFRS Foundation

IFRS 12 – 31

An entity shall disclose any current intentions to provide financial or other support to an unconsolidated structured entity, including intentions to assist the structured entity in obtaining financial support.

Source: IFRS Foundation

Here the disclosure requirements, expect for some non-significant differences, are the same as for the case of consolidated structured entities. And also in US GAAP, the disclosure requirements in this respect are the same as for the case of consolidated variable interest entities. Thus, no relevant differences between IFRS and US GAAP hold on the disclosure about financial support provided to unconsolidated structured entities/VIEs.

3.3.6 Unconsolidated Structured Entities/VIEs – Additional Disclosure Requirements

There is some other disclosure – in particular, in IFRS – that is not mandatory but that in certain circumstances may be relevant in order to still assess the risk associated with interests in unconsolidated structured entities. In Table 3, I report such additional statements for either IFRS and US GAAP, writing down in the first lines the statements that are common to both set of standards.

TABLE 3 – Unconsolidated Structured Entities/VIES – Additional Disclosure

IFRS 12	ASC 810
Para B26(a)	**Para 10-50-4(c)**
The terms of an arrangement that could require the entity to provide financial support to an unconsolidated structured entity (e.g. liquidity arrangements or	*[…] The terms of arrangements, giving consideration to both explicit arrangements and implicit variable interests, that could require the*

credit rating triggers associated with obligations to purchase assets of the structured entity or provide financial support), including: *(i) a description of events or circumstances that could expose the reporting entity to a loss.* *(ii) whether there are any terms that would limit the obligation.* *(iii) whether there are any other parties that provide financial support and, if so, how the reporting entity's obligation ranks with those of other parties.*	*reporting entity to provide financial support (for example, liquidity arrangements and obligations to purchase assets) to the VIE, including events or circumstances that could expose the reporting entity to a loss*
Para B26(e)	**Para 10-50-4(d)**
Information about any liquidity arrangements, guarantees or other commitments with third parties that may affect the fair value or risk of the entity's interests in unconsolidated structured entities.	*Information about any liquidity arrangements, guarantees, and/or other commitments by third parties that may affect the fair value or risk of the reporting entity's variable interest in the VIE is encouraged.*
Para B26(b)	
Losses incurred by the entity during the reporting period relating to its interests in unconsolidated structured entities	
Para B26(c)	
The types of income the entity received during the reporting period from its interests in unconsolidated structured entities	
Para B26(d)	
Whether the entity is required to absorb losses of an unconsolidated structured entity before other parties, the maximum limit of such losses for the entity, and (if relevant) the ranking and amounts of potential losses borne by parties whose interests rank lower than the entity's interest in the unconsolidated structured entity.	
Para B26(f)	

Any difficulties an unconsolidated structured entity has experienced in financing its activities during the reporting period.	
Para B26(g)	
In relation to the funding of an unconsolidated structured entity, the forms of funding (e.g. commercial paper or medium-term notes) and their weighted-average life. That information might include maturity analyses of the assets and funding of an unconsolidated structured entity is the structured entity has longer-term assets funded by shorter-term funding.	

Source: IFRS Foundation, EY (2018a) pag.382-383, author's elaboration

As we can see from Table 3, IFRS 12 requires disclosures about the arrangements that allow to provide financial support to an unconsolidated interest entities and some of such disclosures is also required by ASC 810. Then, we have disclosure requirements about any arrangements or commitments with third parties as stated in IFRS 12 para B26(e) and exactly the same statement is also made by US GAAP. Finally, there is much more disclosure required by IFRS about losses incurred or income received as a result of the involvement with the structured entities, forms of funding of the unconsolidated structured entities and difficulties those entities have incurred in financing their activities among the others. On the balance, therefore, it is reasonable to conclude that in the case of unconsolidated structured entities/SPEs, the disclosure requirements in IFRS are more extensive than in US GAAP. By the way, there are still other issues to take into consideration. Above all, the fact that in US GAAP there are some exceptions to the general rules for consolidation of VIEs, and for each of this exception specific disclosure requirements apply. We can mention the case of entities under common control and that of collateralised financing entities. Finally, in US GAAP, there is also some scope-related disclosure.

3.4 US GAAP: SPECIAL CASES

3.4.1 Entities under Common Control

I recall that an entity that is under common control with another entity is an entity that neither consolidates nor applies the VIEs' requirements. For this kind of entities, the Codification devotes separate and substantial paragraphs for the disclosure requirements relating to the interests in the other entities under common control. It is important to make clear that the disclosure requirements in this respect have been recently updated. The updates will be effective for entities other than private ones for fiscal years beginning after December 15, 2019, and for private entities for fiscal years beginning a year later. Thus, at the time of writing of this dissertation these updates are not effective yet. However, in presenting this topic, I have chosen to keep a forward looking and so to show the updated disclosure requirements.

ASC 810-10-50-2AG

A reporting entity that neither consolidates nor applies the requirements of the Variable Interest Entities Subsections to a legal entity under common control because it meets the criteria in paragraph 810-10-15-17AD shall disclose the following:

a. *The nature and risks associated with a reporting entity's involvement with the legal entity under common control.*
b. *How a reporting entity's involvement with the legal entity under common control affects the reporting entity's financial position, financial performance, and cash flows.*
c. *The carrying amounts and classification of the assets and liabilities in the reporting entity's statement of financial position resulting from its involvement with the legal entity under common control.*
d. *The reporting entity's maximum exposure to loss resulting from its involvement with the legal entity under common control. If the reporting entity's maximum exposure to loss resulting from its involvement with the legal entity under common control cannot be quantified, that fact shall be disclosed.*
e. *If the reporting entity's maximum exposure to loss (as required by (d)) exceeds the carrying amount of the assets and liabilities as described in (c), qualitative and quantitative information to allow users of financial statements to understand the excess exposure. That information shall include, but is not limited to, the terms of the arrangements, considering both explicit and implicit arrangements, that could require the reporting entity to*

provide financial support (for example, implicit guarantee to fund losses) to the legal entity under common control, including events or circumstances that could expose the reporting entity to a loss.

Source: FASB (2018), pag.9-10

As we can see, since no consolidation is possible in this case, no disclosure requirements are presented with regard to the significant judgements and assumptions made in determining whether the reporting entity is the primary beneficiary. However, except for that, in the ASC paragraph above we find many of the provisions seen in the previous section of the current chapter of this dissertation. We can see many disclosure requirements in particular about the risks associated with the reporting entity's involvement with the other entities under common control. However, also disclosure about the nature of the involvement is considered, and also the consequences of this involvement on the reporting entity's financial performance should be. Thus, we can say that a company that is eligible to apply the accounting alternative in accordance with paragraph 810-10-15-17AD should provide detailed disclosures about its involvement with and exposure to legal entities under common control.

In the paragraphs of the Codification currently in force the accounting alternative regards just common control leasing arrangements, that is arrangements in which the reporting entity (the private company lessee) and the other entity (the lessor legal entity) are under common control. In the Update under consideration (No. 2018-17), entities eligible for the accounting alternative are the entities belonging to the broader overall category of entities under common control. Of course, some conditions have to met in order to apply the accounting alternative, conditions that I have listed in the previous chapter. And with this Update the disclosure requirements have increased and been improved.

3.4.2 Collateralised Financing Entities

We have then the case of collateralized financing entities, which - as we can remember - are a particular type of VIEs that can apply for an accounting alternative for the measurement of the own financial assets and financial liabilities. In this case, the following disclosure should be given:

- "*Information required by Topic 820 on fair value measurement and Topic 825 on financial instruments for the financial assets and the financial liabilities of the consolidated collateralized financing entity*"
- "*For the less observable of the fair value of the financial assets and the fair value of the financial liabilities of the collateralized financing entity that is measured in accordance with the measurement alternative [...], a reporting entity shall disclose that the amount was measured on the basis of the more observable of the fair value of the financial liabilities and the fair value of the financial assets*"
- The disclosure in the points above, "*Do not apply to the financial assets and the financial liabilities that are incidental to the operations of the collateralized financing entity and have carrying values that approximate fair value*" (EY, 2018a, pag.386-387).

3.4.3 US GAAP: Scope-related Disclosure

Finally, there is an exception to the application of the VIEs Subsections that is very particular and that the FASB expects to be infrequent. Basically, if a reporting entity has an interest or a potential interest in a VIE created before December 31, 2003, such reporting entity is exempt from the application of the guidance in the VIEs Subsections to the VIE under consideration if certain conditions are met, such as the impossibility to collect the information necessary to determine whether the legal entity is a VIE or whether the reporting entity is the VIE's primary beneficiary. In this case, the reporting entity shall disclose what follows.

<u>ASC 810-10-50-6</u>

[...]

(a) The number of legal entities to which the guidance in the Variable Interest Entities Subsections is not being applied and the reason why the information required to apply this guidance is not available

(b) The nature, purpose, size (if available), and activities of the legal entities and the nature of the reporting entity's involvement with the legal entities

(c) The reporting entity's maximum exposure to loss because of its involvement with the legal entities

(d) The amount of income, expense, purchases, sales, or other measure of activity between the reporting entity and the legal entities for all periods presented.

[...]

Source: EY, 2018a, pag.384

3.5 ON THE BALANCE

The disclosure of interests in structured entities/VIEs is the most important one, so the conclusions of this part of the dissertation are of extreme relevance. As regard the consolidated structured entities/VIEs, we can say that in US GAAP more disclosure requirements are made. In respect of the disclosure about the financial or other support to a consolidated structured entity/VIE we have similar disclosure requirements, but then the FASB specifically requires also the following disclosure:

- The nature of restrictions on a consolidated VIE's assets and on the settlement of its liabilities reported by a reporting entity, including the carrying amounts of such assets and liabilities.
- Information about the involvement with the VIEs, including nature, purpose, size and activities of the VIEs and how the VIEs are financed.

As regard instead the unconsolidated structured entities/VIEs, disclosure requirements are in a way more extensive under IFRS. In particular, in IFRS 12 we have the following disclosure requirements that cannot be found in ASC 810:

- The risk from sponsoring an unconsolidated structured entity for which the reporting entity does not provide other risk disclosures.
- Extensive additional (not mandatory) disclosure about the risks associated with a reporting entity's involvement with an unconsolidated structured entity, including losses incurred in or income received as a result of the involvement, forms of funding of the unconsolidated structured entity, and difficulties the unconsolidated structured entity has experienced in financing its activities.

On the other side, we should also made the following points about the US GAAP:

- Disclosure requirements about the significant judgements and assumptions made, and more generally about the methodology used for determining whether the reporting entity is the primary beneficiary of a VIE, apply also to non-primary beneficiaries.
- In respect of the basic (mandatory) disclosure requirements about the risks associated with the involvement with a VIE, in US GAAP the disclosure requirements are a bit more detailed.

- In the US GAAP, there are some consolidation exceptions to the guidance in the VIEs Subsections of ASC 810. In each case of exception, specific disclosure requirements are presented.

Thus, as a result of my analysis, I can conclude that most of the disclosure requirements for structured entities are similar to those for VIEs, both in the case of consolidation and non-consolidation, and that in general the disclosure requirements are quite extensive. As we know, the IASB, in developing IFRS 12, worked in conjunction with the FASB in order to achieve converge of the standards in the area of disclosure requirements for interests in other entities. It has followed the suggestions of the Financial Stability Forum. However, still some differences remain. And in particular we have such differences that I conclude that disclosure requirements about consolidated structured entities/VIEs are more extensive under US GAAP, while those about unconsolidated structured entities/VIEs are in a way more extensive under IFRS. However, with regard to the latter case, there are also some points in favour of US GAAP. In particular, as the US GAAP are rules-based standards and so tend to rule out more specifically various specific cases, the disclosure requirements are also impacted by that factor and so there is specific disclosure required for each specific particular case. Thus, the general disclosure requirements for unconsolidated structured entities/VIEs are more extensive in IFRS, but then US GAAP present much more specific case-by-case disclosure.

4. DISCLOSURE OF INTERESTS IN EQUITY METHOD INVESTEES

Once addressed the disclosure of interests in subsidiaries and in structured entities/VIEs there is just one major issue left, that is the disclosure of interests in associates and joint arrangements. Indeed, it is important not only to write about entities in which a reporting entity has stand-alone control, but also about entities in which a reporting entity has a so-called "significant influence" and entities in which a reporting entity has "joint control". The definition and so the description of such kind of entities will be outlined in the first paragraph of this chapter. Associates and joint arrangements are quite common, and a detailed analysis of the disclosure of interests in them is thus worth as much as that in subsidiaries and structured entities/VIEs. Joint arrangements, say, are useful for many purposes, e.g. to share risks and rewards, to provide parties with access to new market, product or technology, or to pool resources in developing various facilities. That is why a detailed analysis about them would be important as well. The underlying method used to account for associates and joint arrangements (except, as we will see later on, joint operations) is the equity one. That is why I decided to refer to such entities in the title of this chapter as "equity method investees".

This chapter is structured as follows. First, the definitions of associates and joint arrangements in IFRS and US GAAP will be compared. Similarly to the structured entities/VIEs, to establish the comparability of associates and joint arrangements in IFRS and US GAAP would be important in order to make sure that the subsequent comparison of the disclosure of interests in them makes sense. The comparison will include a brief overview of the way in which they are accounted for in the financial statements. Then, I will move on to the heart of this chapter, that is the comparison of the disclosure of interests in them. The analysis, of course, will be done in a way similar to that applied for the other entities in the previous chapter.

The reference standards and codification topics for the issue of this chapter are the followings:

- In respect of the definitions and of the accounting methods for associates and joint arrangements, IAS 28 *Investments in Associates and Joint Ventures* and

IFRS 11 *Joint Arrangements*, on the one side, and the Topic ASC 323 *Investments – Equity Method and Joint Ventures*, on the other one.

- In respect of the disclosure requirements for the interests of a reporting entity in an associate or joint arrangement, IFRS 12 *Disclosure of Interests in Other Entities*, on the one side, and ASC 323 *Investments – Equity Method and Joint Ventures* and Regulation S-X, on the other one.

Now, a good way to carry out my introductory analysis would be to start from the definition of associate and joint arrangement in accordance with IAS 28 and IFRS 11 and then to compare them with the definitions of the equity-method investees under the scope of ASC 323.

4.1 ASSOCIATES AND JOINT ARRANGEMENTS: IFRS VS. US GAAP

As we already know, an associate is an entity over which an investor has significant influence, where significant influence is defined in the following way:

> "*If an entity holds, directly or indirectly (e.g. through subsidiaries), 20 percent or more of the voting power of the investee, it is presumed that the entity has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the entity holds, directly or indirectly (e.g. through subsidiaries), less than 20 percent of the voting power of the investee, it is presumed that the entity does not have significant influence, unless such influence can be clearly demonstrated* […]" (IAS 28, para 5, IFRS Foundation)

Basically, as a general rule, significant influence exists when a reporting entity holds between 20 and 50 percent of the voting power of the investee, unless such presumption can be overcome on the basis of facts and circumstances. In determining significant influence, also potential voting rights are considered (but only if currently exercisable). Such kind of entities are accounted for using the equity method (IFRS Foundation).

In US GAAP, instead, the term "associate" does not exist. However, under the scope of ASC 323 *Investments – Equity Method and Joint Ventures* there are still entities over which an investor has significant influence, and significant influence in Subtopic 323-10 is defined in the following way:

> "*An investment (direct or indirect) of 20 percent or more of the voting stock of an investee shall lead to a presumption that in the absence of predominant evidence to the contrary an investor has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20 percent of the voting stock of an investee shall lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated* […]" (ASC 323-10-15-8, EY (2019), pag.20)

The definition of significant influence in accordance with US GAAP is exactly the same as that in accordance with IAS/IFRS, and also under US GAAP the entities over which an entity has significant influence are accounted for using the equity method. The only difference is that, in the case of US GAAP, potential voting rights are generally not considered in determining significant influence (EY, 2018b).

The case of joint arrangements then is a bit more complex. In accordance with IFRS 11, as already anticipated, a joint arrangement is basically an arrangement of which two or more parties have - by contract – joint control. Joint control is set to exist only when, "*Decisions about the relevant activities require the unanimous consent of the parties sharing control*" (IFRS 11, para 7, IFRS Foundation). Thus, an entity with joint control cannot control on its own the arrangement, but at the same time can prevent the other parties sharing control from taking decisions which it does not agree upon (IFRS Foundation).

Then, in accordance with IFRS 11, there are two types of joint arrangements: joint ventures and joint operations. The difference between the two lies in the types of rights and obligations of the parties to the arrangement. In a joint venture, the parties sharing control have rights to the net assets of the arrangement. In a joint operation, instead, the parties sharing control have rights to the assets, and obligations for the liabilities - of course again relating to the arrangement. A joint venture, then, is always structured through a separate vehicle, while a joint operation may be structured either through a separate vehicle or not. A joint venturer shall account for its investment in a joint venture using the equity method in accordance with IAS 28. In case of joint operations, instead, the underlying rule is not that of the equity method. A joint operator, indeed, shall recognise the assets,

liabilities, revenues and expenses relating to its interests in a joint operation and shall account for them in accordance with the IFRSs applicable to the particular assets, liabilities, revenues and expenses (IFRS Foundation).

In the US GAAP, instead, the category of joint operations does not exist. Under the scope of ASC 323, just entities over which significant influence is exercised and joint ventures are considered. In accordance with ASC 323, joint ventures are generally accounted for using the equity method as in the case of IAS/IFRS. Also the definition is similar as that in IAS/IFRS, though not exactly the same.

> "*A corporation owned and operated by a small group of entities (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a corporate joint venture frequently is to share risks and rewards in developing a new market, product or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A corporate joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An entity that is a subsidiary of one of the joint venturers is not a corporate joint venture*. […]" (ASC 323-10-20, EY(2019), pag.40)

Three main elements emerge from the definition outlined above:

- The joint venture has to be arranged within a separate legal entity;
- The joint venture must be under the joint control of the venturers;
- The joint venture is set up for specific purposes.

All these three elements are in line with the concept of joint venture under IFRS. Then, there are some points to be made. We can mention the followings:

- The parties sharing control under US GAAP can be just equity investors, while joint control under IFRS may be exercised also by means of decision-making rights held through a contract;
- Under US GAAP, joint control is not defined, but it is commonly interpreted in the same way as IFRS;

- In US GAAP, by joint control they generally refer to the control of operations and activities of the venture, while in IFRS those parties sharing the control of the venture are said to have rights to the net assets of the venture (EY, 2018b).

The last point made in the bullet list above in particular have relevant implications. In fact, under US GAAP an entity can be a joint venture irrespective of the rights and obligations the parties sharing control have with respect to the entity's underlying assets and liabilities. In IFRS, instead, a party sharing control of a joint venture cannot have direct rights and obligations with respect to the underlying assets and liabilities of the entity. A party sharing control of a joint operation can. Thus, even if in Codification Topic 323 there is no reference to the term "joint operation", we can say that in a way the definition of corporate joint venture in accordance with the Topic 323, Subsection 10-20, includes both the definition of joint venture and that of joint operation structured through a separate vehicle in accordance with IFRS 11. However, as we know joint ventures under US GAAP are accounted for by using the equity method, while joint operations under IFRS are not. The implication is that an investor having an interest in a separate entity accounted for as a joint operation under IFRS would recognise line-by-line its share of the joint operation's assets, liabilities, revenues, and expenses, whereas under US GAAP the investor would recognise the same kind of entity using the equity method (and so through a singe line-item presentation of the interest in the balance sheet and income statement) (Deloitte, 2013).

As regard, instead, the entities accounted under IFRS as joint operations not structured through a separate legal entity, no equivalent guidance can be found in US GAAP. However, as Deloitte (2013) stresses, "*US GAAP guidance on collaborative arrangements does contain specific requirements affecting income statement classification for collaborative arrangements that are not primarily conducted through a legal entity*". And again, "*The guidance requires, in part, that participants to a collaborative arrangement consider the revenue recognition principal-agent criteria when evaluating the reporting for costs incurred and revenue generated from transactions with third parties*" (p.7).

Thus, we can say that a so-called "associate" in accordance with IAS/IFRS and a so-called "equity-method investee" in accordance with US GAAP are basically defined

in the same way and accounted for the same way. Joint ventures in accordance with IAS/IFRS are defined in a similar way also in US GAAP. The definition of corporate joint ventures in accordance with US GAAP comprises also the definition of joint operation structured through a separate legal entity in accordance with IAS/IFRS. However, such kind of entities are treated from an accounting point of view in different ways in the two sets of standards. Finally joint operations that in accordance with IFRS are not set up through a separate vehicle does not find equivalent provisions in US GAAP, though some similar arrangements can be found. The final point that we have to make is about the exceptions to the application to the equity method. Indeed, we have said so far that the general method for the accounting of associates and joint arrangements (with the exceptions of joint operations in accordance with IFRS) is the equity method. However, of course, each rule has some exceptions. The main points are made below.

- Exemptions from applying the equity method. In accordance with IFRS, the limitations under which a subsidiary shall not be consolidated – IFRS 10, para 4(a) – should be applied also as limitations for the use of the equity method in case of investments in associates and joint ventures. Moreover, an entity should be exempt from the application of the equity method if the entity itself is a parent that is exempt from preparing consolidated financial statements again by the scope exception in paragraph 4(a) of IFRS 10. In US GAAP, similarly, the limitation under which a majority-owned subsidiary shall not be consolidated – ASC 810, para 10-15-8 through 15-10 – shall also be applied as limitations to the use of the equity method, and moreover the equity method shall not be applied to an investment in common stock within the scope of Topic 810 (IFRS Foundation; EY, 2019). Furthermore, the guidance in Topic 323 on the equity method investments should not be applied to investments accounted for in accordance with Subtopic 815-10, to investments in common stock held by a non-business entity, and to investments held by an investment company.
- Investments measured at fair value. In accordance with IAS 28, para 18, "*When an investment in an associate or a joint venture is held by, or is held indirectly through, an entity that is a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance*

funds, the entity may elect to measure that investment at fair value through profit or loss in accordance with IFRS 9" (IFRS Foundation, IAS 28-18). Also in US GAAP there is the option to account for certain equity method investments at fair value, in accordance with ASC 825 *Financial Instruments* (EY, 2019)

- Other relevant exceptions. When the investee is a limited partnership, a limited liability company, a trust or a similar entity with specific ownership account, specific rules apply instead of the general one on equity method investments. Indeed, in accordance with US GAAP, an investor in like entities should normally accounts for its interests using the equity method if the interests are greater than 3% to 5%. In IFRS, instead, for like entities the general rules on equity method investments still hold (EY, 2018b).

One more point can be made about the uniformity of the accounting policies between investor and investee. In accordance with IFRS, uniform accounting policies are required. In accordance with US GAAP, instead, conforming accounting policies is generally not permitted (EY, 2018b).

Thus, we have seen that associates under IFRS and equity-method investees under US GAAP are defined in a similar way, and the same reasoning can be made also for joint ventures. A comparison of the disclosure of interests between IFRS and US GAAP in like types of entities hence does make sense. Though for joint operations a comparison with US GAAP is not possible, some considerations will be nonetheless made.

Although there are cases in which the kinds of investments under consideration in this chapter may be accounted alternatively at fair value, I will not analyse the disclosure required in that case. When dealing with fair value measurement, indeed, many things can be written down. Then, since the topic of fair value measurement is very wide and in case of associates and joint ventures it represents just an exception to the main rule of equity method accounting, I have decided not to consider for the purposes of this dissertation the disclosure of interests in entities over which another entity has significant influence and in joint ventures. This is the reason why in the title of the chapter I refer specifically to "equity method investees".

The analysis will be structured as follows.

1. First, I will compare the disclosure of interests in associates under IFRS and that of equity-method investees under US GAAP.
2. Then, I will move on to the joint ventures. In IFRS, as the majority of disclosure requirements for joint ventures are the same as those for associates, I will just deal with the further requirements not requested for associates. In US GAAP, instead, joint ventures are comprised in the broader category of the equity-method investees and thus disclosure requirements in their respect are the same as those in the general category of equity-method investees.
3. Finally, I will dedicate just few words to joint operations under IFRS.

As in the case of subsidiaries, also for equity-method investments there are some industry-specific requirements, such as those for the oil and gas industry for which the reader can made reference to paragraphs 235-50-28 of Topic 932.

4.2 DISCLOSURE OF INTERESTS IN ASSOCIATES/EQUITY METHOD INVESTEES: IFRS VS. US GAAP

A note to make for the reader before going through the analysis of disclosure of interests in associates/equity-method investees is a technical one. In the analysis below I make reference to various provisions relating to the issue under consideration. The provisions may hold for both associates and joint ventures. However, since the purpose of this section is to analyse specifically the disclosure of interests in associates, I may refer for simplicity to like provisions just considering the scope of associates. This does not necessarily mean that such provisions hold just for associates.

The section about disclosure of interests in associates/equity-method investees is divided in paragraphs by type of disclosure. A good starting point is about significant judgements and assumptions made in determining significant influence.

4.2.1 Significant Judgements and Assumptions

In accordance with IFRS 12, a reporting entity should disclose information about the significant judgements and assumptions made (and changes to those judgements and assumptions) in determining that it has significant influence over another entity. Typical information to be provided within this scope, when applicable, are

about the significant judgements and assumptions made by a reporting entity in determining that:

- "*It does not have significant influence even though it holds 20 per cent or more of the voting rights of another entity*";
- "*It has significant influence even though it holds less than 20 per cent of the voting rights of another entity*" (IFRS Foundation).

In US GAAP, instead, we have the following disclosure requirements:

> "*The accounting policies of the investor with respect to investments in common stock. Disclosure shall include the name of any significant investee entities in which the investor holds 20 percent or more of the voting stock, but the common stock is not accounted for on the equity method, together with the reasons why the equity method is not considered appropriate, and the names of any significant investee corporations in which the investor holds less than 20 percent of the voting stock and the common stock is accounted for on the equity method, together with the reasons why the equity method is considered appropriate*" (ASC 323-10-50-3(a)(2), in EY, 2019, pag.167).

As we can see, the approach is different in the sense that while in IFRS 12 the matter revolves around the concept of "significant influence", in ASC 323 they talk about "equity method". Moreover, in IFRS they talk about "judgements and assumptions" while in US GAAP they simply talk about "reasons". Of course, an entity over which a reporting one has significant influence is generally accounted for by using the equity method, so in this sense we could consider the provisions in the two standards similar. However, the reasoning cannot be so straightforward. Indeed, we know first that associates under IFRS can be accounted in some cases by using the fair value method, and second we cannot exclude cases in US GAAP in which a reporting entity has significant influence over another entity but still does not consider appropriate to use the equity method to account for it. Thus, even if I do not agree with KPMG (2017b) - according to which in US GAAP, unlike IFRS, there are no similar disclosures for equity-method investees – I have nevertheless to state that in terms of significant judgements and assumptions in US GAAP we do not find the same disclosure requirements as of IFRS.

However, it is fair to note that in the two sets of standards the differences in terms of the issue under consideration follow a logic. Indeed, the scope of IFRS 12 is represented by associates and joint arrangements, despite of the way they are accounted for and the disclosure requirements for associates in fact are about the significant judgements and assumptions made in determining significant influence. US GAAP, in Topic 323, instead, take into consideration not all the entities over which there is significant influence or joint control but just those that are accounted for using the equity method. Thus, requiring disclosures about whether the equity method is considered appropriate as a way of accounting for a certain investment is something logical given the scope of the Subtopic.

4.2.2 Nature of an Entity's Interests in Associates/Equity-Method Investees

In IFRS 12, para 21, 22, B12, B14-17, it is plenty of disclosure requirements in respect of the nature, extent and financial effects of an entity's interests in associates. In para 21(a), general information is required.

IFRS 12 – 21(a)

An entity shall disclose:

(a) For each joint arrangement and associate that is material to the reporting entity:

(i) The name of the joint arrangement or associate.

(ii) The nature of the entity's relationship with the joint arrangement or associate (by, for example, describing the nature of the activities of the joint arrangement or associate and whether they are strategic to the entity's activities).

(iii) The principal place of business (and country of incorporation, if applicable and different from the principal place of business) of the joint arrangement or associate.

(iv) *The proportion of ownership interest or participating share held by the entity and, if different, the proportion of voting rights held (if applicable).*

Source: IFRS Foundation

The US GAAP, instead, in Topic 323, para 50-3(a)(1), requires just two out of the four points made above: the name of each equity method investee, and the percentage of ownership of common stock (EY, 2019). However, the IASB just requires disclosure

of the associates that are material to the reporting entity, while the FASB does it for all the investees.

Then, for material associates also other information, such as summarised financial information, are required by the IASB.

IFRS 12 – 21(b)

> *(b) For each joint venture and associate that is material to the reporting entity:*
> *(i) Whether the investment in the joint venture or associate is measured using the equity method or at fair value.*
> *(ii) Summarised financial information about the joint venture or associate as specified in paragraphs B12 and B13.*
> (iii) *If the joint venture or associate is accounted for using the equity method, the fair value of its investment in the joint venture or associate, if there is a quoted market price for the investment.*

Source: IFRS Foundation

Of course, the first point of the para above cannot find an equivalent provision in Topic 323 of US GAAP as that Topic is just about equity method investments. However, summarised financial information about associates and the fair value of the equity method investments based on the quoted market prices of the investments themselves are required also by the FASB, in Topic 323.

Summarised financial information, in accordance with IFRS, should be provided both for each material associate and for immaterial ones (cfr. IFRS 12-21(c)) However, disclosure requirements for material associates are much more extensive than for immaterial ones. In accordance with US GAAP, instead, summarised financial information about equity method investments should be provided only when such investments are material in aggregate, and shall be provided either individually or on an aggregated basis by any combination of such equity method investees (EY, 2019). Thus, in this respect, some differences hold. As regard then the types of summarised financial information to be provided, we need to recall IFRS 12, on the one side, and the SEC regulation – Regulation S-X, on the other one. Below, in Table 4, the reader can find the comparison of the summarised financial information required in the two sets of standards for material associates and for equity-method investees which are material in aggregate, with the common or similar information reported in the same lines.

TABLE 4 – Summarised Financial Information about Material Associates/Equity Method Investees: IFRS vs. SEC RULES

IFRS 12	Regulation S-X Rule 1-02
Current assets	Current assets
Non-current assets	Non-current assets
Current liabilities	Current liabilities
Non-current liabilities	Non-current liabilities
#	Redeemable preferred stocks (when applicable)
#	Noncontrolling interests (when applicable)
Revenue	Net sales or gross revenues
#	Gross profit (or, alternatively, costs and expenses applicable to net sales or gross revenues)
Profit or loss from continuing operations	Income or loss from continuing operations before extraordinary items and cumulative effect of a change in accounting principle
Post-tax profit or loss from discontinued operations	#
#	Net income or loss
#	Net income or loss attributable to the entity
Other comprehensive income	#
Total comprehensive income	#

Source: IFRS Foundation; EY (2019); author's elaboration

On the one hand, therefore, we have information such as OCI and total comprehensive income that is not required to be provided in the right case, and on the other hand, information such as gross profit, net income and NCI that are not required to be provided in the left case. Then, there are many information requirements which are common to both cases. Moreover, IFRS 12, para B14, requires an entity accounting for its interests in an associate using the equity

method to provide a reconciliation of the summarised financial information presented to the carrying amount of its interests in the associates. For further minor information about the disclosure of summarised financial information about material associates, the reader can make reference to para B14 and B15 of IFRS 12 (IFRS Foundation).

As regard, instead, the information about immaterial associates, IFRS 12 require such information for associates which are individually immaterial and require it in aggregate for all individually immaterial associates. Information to be provided by a reporting entity are the followings:

- The carrying amount of its interests in the immaterial associates accounted for by using the equity method;
- Profit of loss from continuing operations;
- Post-tax profit or loss from discontinued operations;
- Other comprehensive income;
- Total comprehensive income (IFRS Foundation).

When an entity's interest in an associate (or a portion of its interests in an associate) is classified (or included in a disposal group that is classified) as held for sale in accordance with IFRS 5, the entity does not have to disclose summarised financial information for that associate (IFRS Foundation).

Finally, still in respect of the financial information to be provided, IFRS 12 require a reporting entity to disclose for each material associate the dividends received from the associate itself (IFRS Foundation). SEC rules require similar disclosure. Indeed, in accordance with Regulation S-X Rule 12-04, a registrant shall disclose condensed financial information, and among the other things disclosure to be made should be about the amounts of cash dividends paid by an equity method investee to the registrant for each of the last three fiscal years. Such condensed financial information should be provided when the restricted net assets of consolidated subsidiaries exceed 25 percent of consolidated net assets as of the end of the most completed fiscal year. Furthermore, still in accordance with Regulation S-X, a registrant should disclose also the amount of consolidated retained earnings which represents undistributed earnings of the equity method investees (EY, 2019).

Then, disclosure should be given, both in case of IFRS and in case of US GAAP, about the quoted market price – if available – of the investments in associates/in common stock of entities accounted for using the equity method (IFRS Foundation; EY, 2019). Finally, we have still some information required by IASB and FASB about the nature of interests in associates/equity method investees.

IFRS 12 – 22

An entity shall also disclose:

(a) The nature and extent of any significant restrictions (e.g. resulting from borrowing arrangements, regulatory requirements or contractual arrangements between investors with joint control of or significant influence over a joint venture or an associate) on the ability of joint ventures or associates to transfer funds to the entity in the form of cash dividends, or to repay loans or advances made by the entity.

(b) When the financial statements of a joint venture or associate used in applying the equity method are as of a date or for a period that is different from that of the entity:

(i) The date of the end of the reporting period of the financial statements of that joint venture or associate; and

(ii) The reason for using a different date or period.

(c) *The unrecognised share of losses of a joint venture or associate, both for the reporting period and cumulatively, if the entity has stopped recognising its share of losses of the joint venture or associate when applying the equity method.*

Source: IFRS Foundation

The point (a) of the para above of IFRS 12 deals with the disclosure of significant restrictions on the ability of associates to transfer dividends or any other funds to the registrant, or to repay loans or advances. The same provision is also made in Regulation S-X Rule 4-08 para (e)(3)(i). In accordance to the SEC, however, such kind of disclosure is required just for consolidated and unconsolidated subsidiaries and not for 50% percent or less owned persons accounted for by the equity method (EY, 2019). Then, as regard the point (b) above we know from the theory that under IFRS if the financial statements of the investor and those of the equity method associate are of different dates, then the associate should prepare the financial statements as of the same date as the financial statements of the investor unless it is impracticable to do so. In case it is impracticable to do that, a difference of up to three months is allowed. However, adjustments for significant events and

transactions occurred between the reporting dates should be made, and disclosure mentioned above in IFRS 12, para 22(b), should be given. In US GAAP, instead, still a difference of up to three months is allowed but also if it would be practicable to prepare the financial statements of the equity method investee as of the same date of the investor. Moreover, no adjustment is required for the effects of events of significant events occurring between the reporting dates of investor and investee. However, it is required disclosure about the effects of such events (EY, 2018). Then, we have the point (c) of IFRS 12 para 22, about the unrecognised share of losses. Finally, in US GAAP, there is one additional element of disclosure. In the Codification Topic 323, para 10-50-3(a)(3), indeed, it is stated that disclosure should be given about, "*The difference, if any, between the amount at which an investment is carried and the amount of underlying equity in net assets and the accounting treatment of the difference*" (EY, 2019, pag.167).

4.2.3 Risks Associated with an Entity's Interests in Associates/Equity Method Investees

Finally, we have very few disclosure requirements about the risks associated with an entity's interests in associates/equity method investees, both in IFRS and in US GAAP.

IFRS 12 – 23(b)

An entity shall disclose:

(a) [...]

(b) *In accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets, unless the probability of loss is remote, contingent liabilities incurred relating to its interests in joint ventures or associates (including its share of contingent liabilities incurred jointly with other investors with joint control of, or significant influence over, the joint venture or associates), separately from the amount of other contingent liabilities.*

Source: IFRS Foundation

ASC 323-10-50-3(d)

All of the following disclosures generally shall apply to the equity method of accounting for investments in common stock:

a. [...]
b. [...]

c. *[…]*
d. *Conversion of outstanding convertible securities, exercise of outstanding options and warrants, and other contingent issuances of an investee may have a significant effect on an investor's share of reported earnings or losses. Accordingly, material effects of possible conversions, exercises, or contingent issuances shall be disclosed in notes to financial statements of an investor.*

Source: EY, 2019, pag.167

4.2.4 Aggregation of Disclosures

As regard the aggregation of disclosures, for IFRS I can simply make reference to paragraph 2.2.7 *Aggregation* of Chapter 2 of this dissertation. Those principles set for subsidiaries hold also for associates, joint ventures and joint operations. In US GAAP, instead, there are not so numerous and articulated rules as for IFRS in respect of the aggregation for disclosure. In Topic 323, para 10-50-2, it is simply stated that, "*If the investor has more than one investment in common stock, disclosures wholly or partly on a combined basis may be appropriate*" (EY, 2019, pag.167). And, unlike IFRS, no examples of aggregation are provided (EY, 2019). At the basis of these principles on aggregation there is the presumption common to both IFRS and US GAAP that the reporting entity should consider the level of detail/extent of disclosure to apply for each investment. In both IFRS and US GAAP, such decision should be taken in light of the significance of each investment to the reporting entity. IFRS also consider the different risk and return characteristics of each entity as basis for evaluation (IFRS Foundation; EY, 2019).

4.3 DISCLOSURE OF INTERESTS IN JOINT VENTURES/EQUITY METHOD INVESTMENTS: IFRS VS. US GAAP

As we already know, in US GAAP corporate joint ventures and entities over which a reporting one has significant influence are under the common category of equity method investments for which common disclosure is required. Thus, basically, the disclosure requirements required for joint ventures under US GAAP are the same already seen in the previous section of this chapter. On the other hand, in IFRS, as we know, there is a clear-cut distinction between associates and joint ventures. However, all the disclosure requirements seen above for equity method associates under IFRS apply also to joint ventures. Moreover, in IFRS there are some additional disclosure requirements that apply specifically to joint ventures. Thus, in this

section I will simply present the additional disclosure requirements for interests in joint ventures.

4.3.1 Significant Judgements and Assumptions

Similarly to associates, a reporting entity shall disclose information about significant judgements and assumptions (and changes to those judgements and assumptions) made in determining that it has joint control of an arrangement. Should also disclose, in case of an arrangement structured through a separate entity, the type of joint arrangement – joint venture or joint operation (IFRS Foundation).

4.3.2 Nature of an Entity's Interests in Joint Ventures/Equity-Method Investees

As already said, all the things written down above about associates hold also for joint ventures. There is just one additional point to make about summarised financial information. Indeed, in case of joint ventures more information is required. Other than the information required in accordance with paragraph B12 of IFRS 12, for each material joint venture also the paragraph B13 should be taken into account.

IFRS 12 – B13

In addition to the summarised financial information required by paragraph B12, an entity shall disclose for each joint venture that is material to the reporting entity the amount of:

(a) Cash and cash equivalents included in paragraph B12(b)(i).
(b) Current financial liabilities (excluding trade and other payables and provisions) included in paragraph B12(b)(iii).
(c) Non-current financial liabilities (excluding trade and other payables and provisions) included in paragraph B12(b)(iv).
(d) Depreciation and amortisation.
(e) Interest income.
(f) Interest expense.
(g) *Income tax expense or income.*

Source: IFRS Foundation

Thus, in case of joint ventures disclosure requirements under IFRS are much more detailed and extensive than in case of associates.

4.3.3 Risks Associated with an Entity's Interests in Joint Ventures/Equity-Method Investees

In IFRS, other than the risk disclosures already seen, a reporting entity should also disclose commitments that it has relating to its joint ventures separately from the amount of other commitments. In particular, IFRS 12, para B18, requires what follows.

IFRS 12 – B18

> *An entity shall disclose total commitments it has made but not recognised at the reporting date (including its share of commitments made jointly with other investors with joint control of a joint venture) relating to its interests in joint ventures. Commitments are those that may give rise to a future outflow of cash or other resources.*

Source: IFRS Foundation

Para B19, then, provides some cases of commitments included in the definition of para B18. We can mention unrecognised commitments to contribute funding or resources as a result of for example the constitution or acquisition agreements of a joint venture and capital-intensive projects undertaken by a joint venture, and unrecognised commitments to acquire another party's ownership interest (or a portion of that ownership interest) in a joint venture if a particular event occurs or does not occur in the future (IFRS Foundation).

4.4 DISCLOSURE OF INTERESTS IN JOINT OPERATIONS

As already seen, the case of joint operations is quite complex within the context of a IFRS-US GAAP comparison. However, in terms of disclosure of interests in like arrangements, very few words can be said as just little general information is required by IFRS 12 on the issue. Out of all the provisions seen in the previous sections, just para 21 of IFRS on general information applies also to joint operations (IFRS Foundation). Thus, I believe it is not worth putting a great effort in comparing disclosure of interests in joint operations between IFRS and US GAAP. As in US GAAP no exact correspondence of joint operations in accordance with IFRS does exist and in IFRS anyway very little disclosure is required on the matter, I would not further deepen the matter.

4.5 ON THE BALANCE

In order to make a balance between the disclosure requirements in IFRS and in US GAAP, I believe it would be useful to summarise the main points seen throughout this chapter in Table 5 below.

TABLE 5 – Disclosure of Interests in Equity-Method Investments: The Main Points

Issues	Comments
Significant Judgements and Assumptions	The provisions in the two sets do not require the same things. However, the substance of such provisions is the logical consequence of the different scopes of the standards in the two sets.
General Information	In IFRS, more information is required
Summarised Financial Information	The provisions are not exactly the same. Anyway, much information is required both in IFRS and SEC Rules and much information is in common. In case of joint ventures, the IFRS disclosure requirements are more detailed and extensive than both the IFRS ones for associates and the US ones for equity-method investees. Moreover, IFRS clearly distinguishes between information required for material associates and joint ventures and that required for immaterial ones, whereas in US GAAP/SEC Regulation there is no like distinction. In the latter case, summarised financial information shall be provided when equity-method investments are material in aggregate and may be provided either individually or in aggregate by any combination of the equity-method investees.
Significant Restrictions	Disclosure on the nature and extent of any significant restrictions on the ability of an associate or joint venture to transfer funds to the reporting entity, or to repay loans or advances is required only in IFRS.
Risks	In both IFRS and US GAAP there are disclosure requirements on the risks associated with an entity's interests in the types of entities under consideration. However, the provisions are different. In case of joint ventures, in particular, in accordance with IFRS,

	unlike US GAAP, total commitments it has made but not recognised at the reporting entity relating to interests in joint ventures should be disclosed.
Aggregation	In both IFRS and US GAAP, aggregation of disclosures is permitted. However, in US GAAP no guidelines are provided but just a general statement.

Source: author's elaboration

Thus, I can conclude by making the following points:

- On the whole, in IFRS more disclosure requirements are provided about entities accounted for by using the equity method.
- In IFRS, all the information are combined in a single standards and, in terms of the form, are better organised.
- In the two sets of standards the approaches are different. In IFRS, "associates" and "joint arrangements" are defined and disclosure requirements about them are given. In US GAAP, instead, it is referred to "equity-method investees". In such kinds of entities were approached in the same way in both IFRS and US GAAP, it would easier to compare the relating parts in the IFRS and US GAAP financial statements.

5. AN ANALYSIS OF FINANCIAL STATEMENTS

So far, we have compared IFRS and US GAAP by mainly making an analysis of the disclosure requirements provided in the relevant IAS/IFRS standards and in the Accounting Standard Codification (ASC), respectively. To make a complete analysis, however, it would be good to evaluate the disclosure requirements relating to the interests of a parent company in other entities not only in theoretical terms, but also in practical terms. It is good indeed not to take the correct application of the standards for granted. And then, also an assessment of the form in which the disclosure items are presented in the financial statements would be valuable for the ultimate purpose of this dissertation. In this thesis, indeed, I do not want just to look at which framework presents the most extensive disclosure on the issues at stake, but also at the effectiveness of such disclosure. In other words, it is not only important that the disclosure is presented, but such disclosure has also to reach the reader of the financial statement in an as much immediate manner as possible. In this chapter, therefore, I will proceed with an evaluation of a sample of financial statements for the purposes just mentioned. I chose 15 companies preparing the annual report in accordance with IFRS and 15 companies preparing the annual report in accordance with US GAAP. Of course, I checked the information reported on the financial statements of those companies. However, I did not verified the presence of every single disclosure item provided in the previous chapters. It would have been time-consuming and above all useless. What I instead did is more reasonable. The following points should be considered:

- In verifying the information reported in the financial statements on the issues at stake, I decided to check just those information regarding the nature of interests of a reporting entity in other entities and the relative judgements and assumptions made in determining that nature. No evaluation has been made with regard to the disclosure of risks associated with those interests. The reason is straightforward. It is indeed very difficult to verify the latter information. Disclosure about the risks associated with the interests of a reporting entity in other entities in some cases may not be presented for two reasons – either because of a lack of disclosure or simply because no

particular risks are in place. And for me it is not possible to understand in which of the two cases each single company falls.

- I concentrated my analysis on four macro-areas:
    1. Subsidiaries, including significant judgements and assumptions made in determining the nature of interests, and information on subsidiaries with non-controlling interests.
    2. Equity-method investees, including significant judgements and assumptions made in determining the nature of interests, general and summarised financial information.
    3. Structured entities/VIEs, including significant judgements and assumptions made in determining the nature of interests, and all the various disclosures required in the relevant standards.
- I did not check in every single case whether all the disclosure items required in IFRS and US GAAP are present or not. I will just give an evaluation of whether the majority of information required for each area and sub-area above mentioned are present.
- In analysing the financial statements of the selected companies, I just looked at the parts of the annual report relating to the consolidated financial statements, the notes to the consolidated financial statements, and table and annexes in the end of the report relating to the consolidated financial statements.
- As regard the selection of companies, I have chosen randomly public companies that are components of some of the main US and European equity indexes. For the US GAAP case, I have chosen 15 companies that are components of the S&P 500 index. For the IFRS case, I have chosen 15 companies that are members of the FTSE MIB, DAX, FTSE 100 and Euronext 100 indexes. I analysed their 2018 annual reports. However, it is fair to say that in many cases the reporting year was not ending at December 31. In any case, for the purpose of our analysis differences in the reporting dates do not matter. In Table 6 below the list of the selected companies.

TABLE 6 – Selected Companies

EUROPEAN COMPANIES	US COMPANIES
Bayerische Motoren Werke Aktiengesellschaft	Amazon.com Inc
Deutsche Lufthansa AG	American Airlines Group
Deutsche Telekom AG	Apple Inc
Infineon Technologies AG	Boeing Company
Ferrari N.V.	Coca-Cola Company
Pirelli & C. S.p.A.	General Motors
Telecom Italia SpA	Home Depot
Atlantia S.p.A.	Johnson & Johnson
Rolls-Royce Holdings plc	JP Morgan Chase & Co.
Tesco PLC	McDonald's Corp.
Vodafone Group Plc	Microsoft Corp.
Danone S.A.	Procter & Gamble
BNP Paribas SA	Visa Inc.
Peugeot S.A.	The Walt Disney Company
Randstad N.V.	Walmart

Source: author's elaboration

The empirical analysis that I make in this chapter is more about a case studies analysis than a statistical analysis. It means that I will use mainly the narrative rather than numbers. The reason is that while analysing the first financial statements I realised that, given the complexity and the extension of the matter, only an analysis in the form of case studies and of narrative would have allowed me to fully explain to the readers the complex issues that came up during the reading of the financial statements themselves. Moreover, I will not describe the situation of disclosure for each company in detail. I believe it would be heavy, given the high number of companies analysed. What I will do, it will be just directly presenting the main issues that came up from my analysis of the financial statements of the selected companies and to associate each issue to the companies directly interested.

5.1 THE MAIN ISSUES ARISING FROM THE ANALYSIS

The main issues that aroused from my analysis of the financial statements of the aforementioned companies are about the followings micro-topics:

- List of subsidiaries, including structured entities/VIEs, and equity-method investments and provision of relating information;
- Line-item presentation – on the face of the balance sheet – of the equity-method investments and of non-controlling interests;
- Structure and form of the presentation in the notes to the consolidated financial statements of all the information regarding interests in other entities;
- Completeness/Extension of Disclosure.
- Relevance of the concept of materiality.

The last point is perhaps the most important one and can be considered as the one that synthetize almost all the prior issues.

5.1.1 List of Subsidiaries and Equity-Method Investments and Relating Information

The sample chosen for my analysis is a sample of big public companies. And in big companies, usually, under the scope of consolidation there are many entities. As we know since the first chapter of this dissertation, disclosure of information about interests in other entities is important, especially in such a case where the number and size of interests are pretty relevant. Thus, a list of all the subsidiaries, equity-method investees, and unconsolidated entities would be appropriate.

In my analysis, I found that a table with a list of the entities in which the parent one has interests usually is presented. However, such table is not presented in accordance with the IFRS or US GAAP principles. The table is presented in accordance with each country relevant local codes. Therefore, the information disclosed about such entities varies according to the specific country. And in this respect, I found a huge difference between the SEC rules and the rules applied instead in the main European countries. The Regulation S-K - Item 601(b)(21) - indeed, requires any registrant to disclose the list of just the significant subsidiaries and in particular to disclose only information about the name and the jurisdiction of incorporation of each single subsidiary. The list may be incorporated in the annual report just by reference (e-CFR website). That means that in some of the annual report analysed the table with the list of subsidiaries is attached at the end of the report, while in many others the table can be found just in the SEC website. In the

other countries, instead, disclosure is different. In the companies listed in the DAX, FTSE MIB, and FTSE 100, a table with a list of all the subsidiaries and equity-method investees is provided and a lot of information is provided about them, not just the name and the jurisdiction of incorporation. Typical info provided are about the name, the registered office, the type of business, the share capital, the percentage of ownership and the name of the specific company holding the capital under consideration. In some cases also info about the percentage of voting interests may be reported, if different from the percentage of ownership. Then, usually there are notes to each entity in which some other information may be given, such as reasons for consolidating a company despite minority interests in it. In companies listed in the EURONEXT 100, less information is available. In the annual reports of Peugeot, BNP Paribas and Danone, info provided are about name, registered office, and voting interests (or ownership interests). In that of Randstad even just info on the name and on the registered office. Moreover, in case of Danone (and also in case of Deutsche Telekom), the list of all the subsidiaries and equity-method investees is not provided in the annual report but on the website of the company, but reference to that is made in the relevant notes of the consolidated financial statements.

Thus, we can say that the amount of information provided about each subsidiary or equity-method investee of a public company varies according to the relevant local codes applied, to the type of company, and to the will of the reporting entity to disclose more or less information. In any case, for US listed companies very few disclosure is required in this respect. In Italy, Germany and UK much more disclosure is provided. This may be considered as a good thing, of course. However, recall that in IFRS 12 about aggregation of disclosures it is stated that it would be good to strike a balance between burdening financial statements with excessive detail that may not assist users of financial statements and obscuring information as a result of too much aggregation. Of course, in this paragraph we are not talking of aggregation of disclosures and we are not talking of information required by IFRS either. However, I believe the reasoning can be the same. In my opinion in US listed companies, too little disclosure in the list of subsidiaries is required by SEC. For example, it would be good to provide at least also the percentage of ownership that the parent company has in each subsidiary. However, to provide in European companies pages and pages of list of all the entities in which the parent one has an

interest, including also all the insignificant ones, may be insane as well. Personally, I think that a balance should be found. Here a first issue of materiality arises, that is whether also all the insignificant/immaterial subsidiaries should be reported in the relating table.

5.1.2 Line-Item Presentation of Equity-Method Investments and Non-Controlling Interests

Another element which may be used as an indicator of the importance given to disclosure of interests in other entities is the reporting or not of the amounts of non-controlling interests and of equity-method investments in separate line items of the consolidated balance sheet. In case of IFRS, all the 15 companies analysed reports the aforementioned items in separate line items, with just the exception of Infineon for which the non-controlling interests are not separately reported. However, even if no explanation is given for that, from the list of all the subsidiaries under the scope of consolidation reported in the annual report it is possible to suppose that the non-controlling interests of that company for the fiscal year 2018 are insignificant. In case of US GAAP, instead, the situation is a bit more complex. Starting from the analysis of non-controlling interests, we can say that just 7 out 15 of the companies analysed present the non-controlling interests in separate line items. However, in case of Home Depot, Apple, Visa, and Amazon the scope of consolidation includes just wholly-owned subsidiaries. In case of JP Morgan, Mc Donald's, and American Airlines, it is not specified whether the scope of consolidation includes also less-than-wholly-owned subsidiaries. Finally, the group of Johnson and Johnson includes also less-than-wholly-owned subsidiaries but they seem to be insignificant. Of course, in case in which no reference is made to non controlling interests it is straightforward to presume that they are either null or insignificant. However, given that a list of all the subsidiaries with the percentage of ownership of each one is not compulsory according to the SEC and that no info about subsidiaries with non-controlling interests is required by the FASB, it would be appropriate in my opinion to report whether the reporting company has non-controlling interests or not.

Then, there is the issue of equity-method investees. In case of US GAAP, only 5 out of the 15 companies analysed report separately in the balance sheet an item for the equity-method investments or more generally for "investments", which include also

the equity ones. In all the other cases, similarly to the non-controlling interests, either equity-method investments are claimed to be immaterial and so typically included in other assets, or they are simply not reported separately without specifying whether they are considered immaterial or not. In our sample, Walmart declares equity-method investments to be immaterial, then we have 6 companies – American Airlines, Procter & Gamble, Mc Donald's, Amazon, Visa, and JP Morgan – in which reference is made to equity method investments but also in which either it is not specified if they are material or not or it is not clear at all whether they really exist. Finally, there are 3 companies – Apple, J&J, and Home Depot – in which no reference at all is made to equity-method investments. Of course, again, when it is not specified whether they are material and when no reference is made to them, the presumption is that their amount is either null or insignificant. However, in my opinion, more clarity should be made about that.

Thus, we can say that, even if there may seem to be quite relevant differences between IFRS and US GAAP on the topic at stake in this paragraph, the reality is that in many of the US listed companies analysed the reporting in a separate line item of the balance sheet of the non-controlling interests and of the equity-method investments would not be applicable. However, a second issue on materiality here arises: is the huge number of non-applicable cases in the US sample simply a matter of accident or are there differences between IFRS financial statements and US GAAP financial statements in the concept of materiality applied?

5.1.3 Structure and Form of the Presentation in the Notes

The issue now is about the way information on subsidiaries, including structured entities/VIEs, and equity-method investments is reported in the notes to the consolidated financial statements. As in the first paragraph of this analysis, here we have again a relevant difference between US companies and European companies. Let us say first of all that when the interests in other entities are relevant usually information on them are reported in separate notes. In the IFRS case, indeed, in all the 15 companies analysed there is a separate note for the description of the interests in associates and joint ventures. This is pretty normal, given that in all the 15 companies analysed a separate line is made in the balance sheet for the amount of equity-method investments and so that such interests are quite relevant

throughout the entire sample. Similarly in the US GAAP case, out of 5 companies for which a separate line item was made for equity method investments, 4 of them provide a separate note for the information on them. Just Microsoft out of the 5 does not do that.

However, things get more interesting in the case of subsidiaries or more generally in the case of the scope of consolidation. Indeed, while in case of European companies, 13 out 15 companies present a generic description of the scope of consolidation/composition of the group in a separate note, in case of US no company analysed present a separate note for the scope of consolidation. Of course, the list of entities with all the relating information is reported in the specific table mentioned in the first paragraph of this section. And of course in the first note to the consolidated financial statements in which usually are summarised the main accounting policies applied, a paragraph titled "Principles of Consolidation" gives always a very brief overview of the entities under the scope of consolidation. However, that paragraph usually does not provide so large information on the issue. A separate note on the scope of consolidation typically provides more information. A separate note is useful in order to have an idea of the types of entities that make up the group, of the changes in the scope of consolidation between the previous year and the current one, and in some cases of information about the main subsidiaries.

As regard finally the structured entities/VIEs, we can say that in case of IFRS out of the 6 companies that have interests in structured entities 4 of them report information about those entities in a separate note. In US GAAP case, out of the 10 companies that have interests in VIEs only 2 of them report the interests in a separate note. And just 2 companies out of the 8 that do not report information about VIEs in a separate note claim that their interests in them are immaterial. The other do not say anything, but of course the presumption is that they are immaterial as well.

Thus, in light of what seen in this paragraph, we can say that European companies gives a clearer overview of the composition of the group, especially with reference to the scope of consolidation.

5.1.4 Completeness/Extension of Disclosure and the Concept of Materiality

Now, we get to the final point, the one about the verification of correct application of the accounting standards. In this paragraph, the issue of materiality will arise again soon. By the way, let us first look at whether the standards are correctly applied. I divided the assessment into four points: material non-controlling interests, structured entities/VIEs, equity-method investments, and immaterial equity-method investments. For each of them I assessed whether the disclosure provided is (almost) complete, whether there is little (or no) disclosure, or whether disclosure is non-applicable. In Table 7 below the results of my analysis. For each category of disclosure I show the number of companies of the sample for which the disclosure provided is, respectively, (almost) complete, little (or null), or non-applicable.

TABLE 7 – Completeness/Extension of Disclosure Provided

IFRS	(Almost) Complete	Little (or No)	N/A
Material NCI	6	6	3
Structured Entities/VIEs	3	3	9
EMIs	10	5	0
Immaterial EMIs	3	12	0
US GAAP	**(Almost) Complete**	**Little (or Nothing)**	**N/A**
Material NCI	0	0	15
Structured Entities/VIEs	2	8	5
EMIs	3	6	6
Immaterial EMIs	0	12	3

Source: author's elaboration

Some consideration to understand the table above would be appropriate:

- In case of material NCI, in the category of "little (or no) I included also the companies whose NCI may be immaterial but that no specification is made about that. In the category "N/A" I included instead only the companies for which in annual report is specifically stated that the NCI are not material.
- In case of EMIs, I included in that category all the companies that provide info about specifically material equity-method investees but also the cases in

which the companies provide information on equity-method investments without specifying whether they are material or not.

Now, I can provide just few insights that can be inferred from Table 7. What follows is a list of the most relevant:

- In case of IFRS, as a consequence of the obligation to provide information on material NCI in accordance with IFRS 12, companies provide info on them. 6 companies do not provide disclosure but their NCI may be immaterial as already said. In case of US GAAP, instead, as a consequence of the fact that no disclosure requirements are stated for subsidiaries with material non-controlling interests, no disclosure at all about that is given.
- In case of Structured Entities/VIEs, the two banks analysed – BNP Paribas and JP Morgan – provide a very large amount of information on such kinds of entities and this is quite normal since the great importance that such entities have for the business of banks and all the risks relating to them. For the other companies, instead, in few cases disclosure is given about structured entities/VIEs. Just a mention to them is usually found.
- In case of equity-method investments, we have huge differences between European companies and US companies, but the difference is mainly due to the fact that in the US sample there are many companies for which either the equity-method investments are (supposedly) immaterial or they do not exist at all. Anyway, also in the case in which disclosure requirements are applicable, disclosure is provided but just in very few cases it is possibly to find in the notes to the consolidated financial statements all the items required by the relevant authorities.
- As specific disclosure is required also for the immaterial equity-method investments, it is very interesting to look also at this part of disclosure. The results for European companies are quite surprising. In case of US, indeed, no disclosure is required for immaterial equity-method investments, so the results shown are quite logical. However, IFRS 12 specifically requires summarised financial information about immaterial associates and joint ventures. The fact that only 3 companies meet such requirement, it means that the provision under consideration in many cases is not applied.

Thus, here again the issue of materiality is central. As we have said, even if disclosure in many cases is provided, it is difficult that it is really complete and extensive. And in case of immaterial equity-method investments the disclosure requirements are not met very well either. Moreover, there are many cases in which few disclosure is provided without explicitly justifying whether the fact is due to a lack of materiality or not.

To conclude this paragraph, we can make the following two points:

- Companies tend to report information only about material interests. And also among the material ones, disclosure is pretty complete only if interests are pretty material as well – as in the case of structured entities/VIEs for the banks;
- In case of financial statements prepared in accordance with IFRS, more disclosure is on average provided than in the case of US GAAP.

Moreover, to conclude the chapter, we can say also:

- In the financial statements prepared in accordance with IFRS, the composition of the group tend to be presented in a clearer and more detailed way. Moreover, in the financial statements just mentioned, it is generally easier to find the desired information. Indeed, more separate and specific notes on the underlying topics are present.
- There are local rules that force the groups listed in the main European countries to provide a table of a full list of the subsidiaries and equity-method investments and a lot of relating information, while the US SEC rules just requires few disclosures on the matter.

CONCLUSION

Finally, we have come to the conclusions of this work. My dissertation has dealt in great detail with the disclosure required by IASB and FASB about the interests of a parent company into other entities, especially subsidiaries, unconsolidated structured entities/VIEs, and equity-method investees. Such research topic has required an accurate and demanding reading of all the IFRS and US GAAP principles relating to the underlying matter. Given the complexity and the extension of the topic, the results come up at the end of each chapter were quite articulated. Easy answers and simple reasonings have not been possible in this dissertation. In my opinion, however, it is the complexity of such matter that makes the matter itself attractive. Also, the topic of this thesis is interesting because – as already said – there is no literature on the issues addressed in this dissertation. Just the Big Four deal in some papers with the comparison of disclosure requirements about interests in other entities. The analysis made by them, however, is quite broad and superficial. Thus, the topic has been pretty attractive also because I tried to shed light on some, say, "untouched" issues. I tried to do my best. By the way, I have to say that while writing down the dissertation I understood that there are many topics related to the underlying one whose analysis would be quite interesting as well in order to further deepen the topic of this dissertation.

However, before going through further considerations, it would be good to make first a synthesis of all the issues addressed insofar in order to get to final overall conclusions. We have seen that good disclosure is a major player in financial and capital markets in reducing the information asymmetry, in allowing for optimal allocation of savings/resources, and in making the markets to function efficiently. It is also important to avoid accounting/financial scandals and so for the credibility of a business. Indeed, the major accounting scandals occurred over the last two decades made some firms or financial institutions either to fail or to suffer because of the loss of trust by the investors caused by the scandals themselves. And among the things that allowed the underlying companies and institutions to hold fraudulent behaviours, we can mention the provision of poor, unclear, uncomplete and misleading information on the relationships of the underlying entities with third parties. The financial profile of some companies, including the risks that their

business involved, was not that good as it seemed. In case of Enron, the debt of the company was higher than that represented, and in the case of the subprime mortgage crisis the business risks of some banks and financial institutions were not properly disclosed. And some related parties were used to pursue those fraudulent intentions. The Financial Stability Forum, thus, in 2008 stated that risk exposures and potential losses associated with off-balance sheet entities should be clearly presented in financial disclosures, and the accounting standards affecting these entities should be enhanced. It also stated that convergence of accounting standards should be pursued on an accelerated basis. That is why near the end of the decade, both IASB and FASB improved or anyway modified the accounting standards relating to the interests of a parent company into other entities, trying also to achieve a greater convergence in the provisions of the standards themselves. Of course, there are various types of "other entities" in which the parent one could have interests. I have analysed subsidiaries, unconsolidated structured entities/VIEs, and equity-method investees.

In case of subsidiaries other than structured entities/VIEs, more disclosure requirements are provided by the IASB in terms of the composition of the group – especially of subsidiaries with non-controlling interests – and in terms of restrictions on the ability of an entity to access or use the assets and to settle the liabilities of the group. Then, in case of investment entities and in case of deconsolidation of a subsidiary more disclosure is required instead by the FASB.

In case of consolidated and unconsolidated structured entities/VIEs, most of the disclosure requirements in IFRS and US GAAP are similar and both quite extensive. Then, if we want to look at that in greater detail we can say that in case of consolidated entities US GAAP provide a little bit larger disclosure, while instead in case of unconsolidated ones IFRS do provide greater disclosure requirements. However, we should always keep in mind that the matter is quite more complex than this synthesis.

In case of equity-method investees, more disclosure on the whole is required by IFRS and in IFRS disclosure provisions are also better structured.

Thus, even if in general both IFRS and US GAAP required extensive disclosure about the interests of an entity in other entities, there are many relevant cases – namely the composition of the group, unconsolidated structured entities, and equity-

method investees – in which IFRS seem to provide more extensive disclosure. In favour of US GAAP, we can mention in particular disclosure requirements for investment entities. In IFRS, then, all the disclosure requirements on the interests of an entity in other entities are combined in a single standard, while in case of US GAAP the requirements are spread throughout the entire Accounting Standard Codification (ASC).The larger requirements in IFRS for the composition of the group is reflected also in the case study analysis made in chapter 5. In that analysis, it emerged that in case of financial statements provided in accordance with IFRS, more disclosure is on average provided than it is in the case of US GAAP. Hence, there are many theoretical aspects for which IFRS require more detailed and clearer disclosure and we find confirmation of this also in practice in the financial statements . However, the matter is very complex. We need to keep in mind that also US GAAP require extensive disclosure requirements and that there aspects also in US GAAP for which more disclosure is required by the FASB. Thus, much effort has been done over the last two decades to converge IFRS and US GAAP. There is still much road ahead but in many areas of disclosure of interests in other entities, the provisions provided by the two authorities are quite similar.

Finally, as already anticipated, we need to say there are many topics related to the underlying one whose analysis would be quite interesting in order to further deepen the topic of this dissertation. Two topics in particular come to my mind: definition of the concept of materiality and related application, and disclosure requirements overload. As regard the first one, I want just to underline that throughout all the dissertation I compared the disclosure requirements in IFRS and US GAAP where in both cases much disclosure is required just for material interests. Of course, as no reasoning I made on the notion of materiality in the two sets of standards I implicitly assumed that the definitions of materiality in the two cases are the same. However, this should not taken for granted. Moreover, there are many aspects of disclosure in both sets for which disclosure is required for all the interests, not just the material ones. One thing that would be interesting to see in this case is how much out of the disclosure required for all entities is actually provided for all entities. In chapter 5, we have seen that, despite the provisions in the standards, disclosure tend to be provided just for material interests. Thus, to see whether there are differences in this respect could represent another important aspect of the overall analysis of the

disclosure of interests in other entities. Finally, I would like to mention also the concept of disclosure overload. As we have seen in chapter 5, usually not all the disclosure requirements are met. One may wonder whether the fact that not all the requirements are satisfied is simply wrong or whether instead disclosure requirements are too burdensome and so should be reduced.

These are just few of several issues that may be addressed relative to the disclosure of interests in other entities. The matter is really complex. I deliberatively chose to deal with the aspects of the extension and effectiveness of disclosure in the financial statements prepared in accordance with IFRS and US GAAP. However, the analysis may be further deepened. I hope to have given a great analysis of the topic chosen and I hope someone else will be pleased to keep working on this project.

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