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**Current developments in International
Financial Reporting Standards:
IFRS 10, *Consolidated Financial Statements*, and IFRS 12,
*Disclosure of Interests in Other Entities*²**

Sustainable financial reporting aims at high quality accounting standards designed to protect stakeholders in providing a basis for a transparent and “true and fair” financial reporting on the economic situation of companies.

Current development of IFRS responds to significant weaknesses uncovered in the financial crisis, such as the accounting for “off-balance-sheet structures”. IFRS 10, Consolidated Financial Statements, published by the IASB in May 2011, introduces a new single definition of control to be used to determine which companies form part of the group for which the IFRS consolidated financial statements are prepared. The single definition of control, its complexity of application as well as its possible impact on true and fair financial reporting is discussed. In relation to that the importance of disclosure requirements for entities’ involvement in other entities introduced by the IFRS 12, Disclosure of Interests in Other Entities, is stressed.

Sustainability & Financial Accounting

Sustainability – the concept of “sustainability” or “sustainable development” as presented in the 1987 UN conference: “is development that meets the needs of the present without compromising the ability of future generations to meet their own needs”³. Sustainability is most often associated with the use of natural resources, water, land, energy, but also in relation to social behaviour, whereas accounting seems being quite far away from this topic.

Accounting is the language of business.⁴ It is the language used by companies to report to investors and other stakeholders on their financial situation and on economic events that affected the company throughout the reporting period or those that will have an impact on its future development.

“Sustainable” financial reporting can be related to the aim of accounting standards to protect investors and other stakeholders in providing a basis for transparent and

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“true and fair” financial reporting on the economic situation of a company. Understandability of and trust in the information provided by companies is necessary for active and functioning markets.⁵ The financial crisis⁶ has uncovered some significant weaknesses in the current accounting rules, especially with regard to the so called “off-balance-sheet structures”.⁷ This led to a speed up of the improvement of the existing and of the development of new financial reporting standards by the International Accounting Standards Board (IASB).⁸

Almost every country of the world has its own language – local accounting rules – that provide e. g. the basis for the measurement of tax payments and of the amount of gain that is allowed to be distributed to equity shareholders. To understand the financial situation of a company preparing its financial statements on the basis of local accounting rules, one needs to know these rules in detail. This makes it difficult for investors to compare companies that prepare financial statements using different local accounting standards and highlights the importance of one set of globally accepted accounting rules.

Importance of International Financial Reporting Standards

International Financial Reporting Standards are developed and published by the International Accounting Standards Board (IASB). The principal objective is to develop a single set of high quality, understandable, enforceable and globally

³ WECD (1987).

⁴ The description of accounting as the language of business can be found in students’ textbooks, such as Schoenebeck, Karen P., and Mark P. Holtzman (2010), page 1. The picture drawn with this description especially highlights the need to speak one language within the international environment to communicate about the economic situations of companies and is widely used, for instance by the IASB chairman in his speech on the IFRS Foundation/AICPA conference, see Hoogervorst, Hans (2011b), page 2. A more “formal” definition would be that of the American Accounting Association: “Accounting is the process of identifying, measuring and communicating financial information about an entity to permit informed judgements and decisions by users of the information”. See Weetman, Pauline (2011), page 6.

⁵ Hoogervorst, Hans (2011), page I.

⁶ For a discussion of the subprime crisis and the respective role of the weaknesses in accounting rules be referred to Dobler, Michael, and Christoph Kuhner (2009), pages 24-33. For the IASB chairman’s view on the relationship between accounting standards and the financial crisis, see Hoogervorst, Hans (2011a), pages 5-8.

⁷ The weaknesses led to divergence in consolidating entities practice and a lack of transparency. Deficiencies were found in financial statements published for the years 2007, 2008 and 2009 especially with regard to information about risks resulting from the involvement with special purpose entities, Erchinger, Holger, and Winfried Melcher (2011), page 1229; Alvarez, Manuel, and Manuel Büttner (2009), page 201. It was observed, that, for example, entities varied in their application of the control concept: (a) in circumstances in which an investor controls an investee but the investor has less than a majority of the voting rights of the investee, (b) in circumstances involving special purpose entities, agency relationships and/or protective rights. Be referred to Erchinger, Holger, and Winfried Melcher (2011), page 1229 and the there mentioned reports of the European Securities Regulators (CESR), the Financial Stability Board, the Basel Committee on Banking Supervision or the European Banking Supervisors and IFRS 10.BC2. For a more detailed view on the context of the financial crisis, be referred to Schön, Stephan, and Benjamin Cortez (2009).

⁸ Kirsch, Hans-Jürgen, and Corinna Ewelt (2009), page 1574, Küting, Karlheinz, and Mana Mojadadr (2011), page 273 and Pütz, Timo, and Jürgen Ramsauer (2009), page 867.

accepted financial reporting standards based upon clearly articulated principles.⁹ The European Parliament decided in 2005 to adopt IFRS¹⁰ and at the time called for IFRS to become the globally accepted language of financial reporting.¹¹ The majority of the G20 members are IFRS adopters, in total almost 120 countries require or permit the use of IFRS and all remaining major economies have established time lines to converge with.¹² After many years of convergence work of the IASB and the FASB, the US Financial Accounting Standard Setting Board, the US Securities and Exchange Commission (SEC) is expected to decide shortly whether to incorporate IFRS into its own financial reporting regime.¹³ As the US share in the capital market capitalisation in 2011 made up for over 30%,¹⁴ this would be an important step towards the objective of the IFRS Foundation and the IASB. Having decided on one language spoken worldwide all forces could be concentrated on improving existing and developing new high quality standards.¹⁵

High quality standards could be described as those that significantly contribute to enhance transparency. Risks and economic volatility seem to be quite normal in the current business environment.¹⁶ Transparency contributes to long-term financial stability and to hold up trust in market economies as it makes these risks visible to investors¹⁷ and therewith prepare the basis necessary to avoid situations where risks grow unnoticed to an unmanageable level.

The following overview on two of the new International Financial Reporting Standards published by the IASB this year: IFRS 10, *Consolidated Financial Statements*, and IFRS 12, *Disclosure of Interests in Other Entities* shall outline how the development of new standards contributes to transparency.¹⁸ The new standards will have to be applied by entities starting from 2013 on.¹⁹

⁹ IFRS Foundation, and IASB (2011), page 1.

¹⁰ EU (2002).

¹¹ Hoogervorst, Hans (2011a), page 2, and Hoogervorst, Hans (2011c).

¹² IFRS Foundation, and IASB (2011), page 4.

¹³ Hoogervorst, Hans, (2011a), page 3. Until the date of writing this article (Jan. 12, 2012), no decision has been published by the SEC.

¹⁴ Hoogervorst, Hans (2011b), page 2.

¹⁵ See also Hoogervorst, Hans (2011a), page 2.

¹⁶ Hans Hoogervorst cites in his speech to European Parliament ECON Committee the CEO of Deutsche Bank having said „volatility is the new normality” and states that the days of ’risk-free assets are long gone, if ever they existed. Hoogervorst, Hans (2011a), pages 6-7.

¹⁷ Hoogervorst, Hans, (2011a), page 6.

¹⁸ Both standards have been published by the IASB in May 2011. Endorsement by the European Commission is expected to take place in Q3/2012, EFRAG (2011). It has to be noted, that EFRAG requested the IASB to defer the effective dates of IFRS 10, IFRS 11 and IFRS 12 to allow companies to plan and implement these Standards, and the expected standard on investment entities, in a manner that would contribute to the quality of the information reported, EFRAG (2011a).

¹⁹ IFRS 10 is to be applied retrospectively for annual periods beginning on or after January 2013. Earlier application is permitted, if IFRS 11, IFRS 12, IAS 27 and IAS 28 (as amended in 2011) are applied at the same time. IFRS 10.C1-C3. IFRS 12 shall be applied for annual periods beginning on or after 1 January 2012. Earlier application is permitted. Due to the perceived needs for additional information, the IASB explicitly encourages reporting entities to disclose the information required by IFRS 12 already at earlier dates. The IASB stresses the point, that providing some of the disclosures required by this IFRS would

IFRS 10, Consolidated Financial Statements

A consolidation standard provides for the rules to determine which entity belongs to a group – whose assets and liabilities as well as revenues and expenses are included in the Consolidated Financial Statements of the parent entity – and which entity doesn't belong to a group. The application of consolidation rules therewith determines which of the risks an entity is exposed to appear “on-“ or “off-balance sheet”.

IFRS 10 will replace the existing International Accounting Standard, IAS 27, *Consolidated and Separate Financial Statements*, and the related Interpretation, SIC-12, *Consolidation—Special Purpose Entities*.

The existing IAS 27 uses control as the basis for consolidation. Control is defined as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.²⁰ Whereas SIC-12 acknowledges that for some entities, those that are created to accomplish a narrow and well-defined objective, the decision-making powers of the governing bodies may be legally arranged to be limited or the operations may be predetermined.²¹ These are the so called “Special Purpose Entities”, in short: SPE. Examples of activities of an SPE are research and development of pharmaceutical products, leasing operations or the securitization of receivables.²² SIC-12 describes circumstances that indicate a relationship in which an entity controls an SPE.²³ One of the most crucial elements of determining, whether consolidation of a SPE is necessary, is the evaluation of who assumes the majority of risks associated with this entity and obtains the majority of benefits from this entity.²⁴ SIC-12 improved accounting as it focuses more on the substance and economic reality of the relation to a SPE, rather than only on the legal form.²⁵

Since the introduction of SIC-12 the two concepts of control – the model of power of IAS 27 and the model of risks and rewards of SIC-12 – coexisted. Diversity in practice resulted from perceived inconsistencies between these two concepts. Already in June 2003 the IASB added the project on consolidation requirements to its agenda.²⁶ The global financial crisis that started in 2007 highlighted the lack of transparency about the risks to which investors were exposed from their involvement with “off balance

not compel the entity to comply with all the requirements of IFRS 12 or to apply IFRS 10, IFRS 11, IAS 27 (as amended in 2011) and IAS 28 (as amended in 2011) early. IFRS 12.C1-C2.

²⁰ IAS 27.4.

²¹ SIC 12.1.

²² For more details and further examples, be referred to PwC (2010), pages 24035-24040, and KPMG (2011), pages 79-84.

²³ SIC 12.10

²⁴ KPMG (2011), page 81.

²⁵ SIC 12.12.

²⁶ IASB (May 2011), page 4.

sheet vehicles”²⁷ and illustrated that the guidance on consolidation needed improvement.²⁸

Part of the result of the IASB’s project on consolidation is the IFRS 10. This standard introduces a single definition of control that applies to all types of entities.²⁹ The definition comprises three elements: power over an investee; exposure, or rights, to variable returns from an investee; and ability to use power to affect the investor’s entity’s returns.³⁰

According to IFRS 10, an investor has power over an investee when the investor has existing rights that give it the current ability to direct the relevant activities, i.e. the activities that significantly affect the investee’s returns.³¹ Power arises from rights; such rights may – in the most straightforward situation – be voting rights granted by equity instruments, but may exist also in more complex situations, where power arises from other contractual arrangements.³²

An investor is exposed, or has rights, to variable returns from its involvement with the investee when the investor’s returns from its involvement have the potential to vary as a result of the investee’s performance.³³ While in IAS 27 the term “benefits” is used to define control³⁴, the IASB decided to introduce the term “returns” for the single control definition. The IASB has observed that “benefits” are often interpreted as implying only positive returns,³⁵ whereas the investor’s returns can be positive and/or negative.³⁶ Therewith the aspect of “risks and rewards” analysed in assessing the existence of power according to SIC-12 has been considered in the single control definition of IFRS 10.

This single definition of control combines the control model of the existing IAS 27 with the “risks and rewards” approach of SIC-12 by introducing as a link between “power” and “variable returns” the above mentioned third element,³⁷ that is, the requirement that the investor is able to use its his power over the investee to affect the investor’s returns from its involvement with the investee.³⁸

²⁷ IFRS 10.IN5.

²⁸ A further reason for adding the consolidation project on its Agenda was the aim of US GAAP convergence, see IASB (May 2011), page 4. It has to be noted, that in developing and issuing IFRS 10 some but no full convergence to US GAAP has been achieved, IASB (May 2011), page 24. Erchinger, Holger, and Winfried Melcher (2011), page 1238, and Küting, Karlheinz, and Mana Mojadadr (2011), page 285.

²⁹ IASB (May 2011), page 5.

³⁰ IFRS 10.7 and IFRS 10.B2.

³¹ IFRS 10.10.

³² IFRS 10.11.

³³ IFRS 10.15.

³⁴ IAS 27.4.

³⁵ IFRS 10.BC62.

³⁶ IFRS 10.15.

³⁷ PwC (2011), page 4.

³⁸ IFRS 10.17. The importance of the link between “power” and “risks and rewards” is outlined by the IASB in the Basis of Conclusion to IFRS 10. IFRS 10.BC32 describes that under IFRS 10 the exposure to risks

In addition to the outline of these three elements of control, the application guidance to the standard sets out factors to consider in situations when control is difficult to assess,³⁹ such as cases involving power without the majority of voting rights⁴⁰, potential voting rights for instance arising from call options⁴¹, power delegated to agents⁴², control of specified assets⁴³-and circumstances in which voting rights are not the dominant factor in determining control.⁴⁴

IFRS 12, Disclosure of Interests in Other Entities

Another result of the consolidation project is the new Disclosure Standard, IFRS 12. The global financial crisis highlighted the need for new disclosure requirements to provide users with better information, especially information about the risks to which a reporting entity is exposed from its involvement with structured entities.⁴⁵

IFRS 12 requires a reporting entity to disclose information that helps users of financial statements to evaluate the nature of, and risks associated with, its interests in other entities; and the effects of those interests on its financial position, financial performance and cash flows.⁴⁶ To meet this objective a reporting entity has to disclose information that helps users understand the significant judgements and assumptions made by a reporting entity in determining the nature of its interest in another entity or arrangement.⁴⁷ Additional information has to be disclosed not only with regard to interests in consolidated subsidiaries, joint arrangements and associates, but also to unconsolidated structured entities.⁴⁸

A structured entity is described in IFRS 12 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

and rewards alone would not lead to the conclusion that the investor has control over an investee, as this has been the case under SIC-12. Due to the fact that the incentive for an investor to obtain decision-making rights that give it power over an investee is the greater the more the investor is exposed to risks and rewards from its involvement with that investee, the exposure to risks and rewards is seen by the IASB as an indicator of control and an important factor to consider when assessing control.

³⁹ IFRS 10.B3.

⁴⁰ The so called “de facto” power describes situations, where an investor with less than a majority of the voting rights has rights that are sufficient to give it power when the investor has the practical ability to direct the relevant activities unilaterally. IFRS 10.B41-B46.

⁴¹ Potential voting rights are rights to obtain voting rights of an investee, such as those arising from convertible instruments or options, including forward contracts. IFRS 10.B47-B50.

⁴² An agent is a party primarily engaged to act on behalf and for the benefit of another party or parties (the principal(s)). IFRS 10.B58-B61.

⁴³ IFRS 10.B76-B79.

⁴⁴ IFRS 10.B8.

⁴⁵ IASB (May 2011) page 4 and IFRS 12.IN5.

⁴⁶ IFRS 12.1 and IASB (May 2011), page 5. Another aspect is to help users understand the interest that non-controlling interest have in consolidated entities and the nature and extend of significant restrictions on the reporting entities ability to access or use the assets and settle the liabilities of the group. IFRS 12.12-13.

⁴⁷ IFRS 12.2(a).

⁴⁸ IFRS 12. 2(b).

relevant activities are directed by means of contractual arrangements.⁴⁹ The description of features or attributes that are associated with structured entities given in IFRS 12 Appendix B⁵⁰ suggests that the disclosure requirements have been formulated by the IASB in view of the – under SIC-12 called “special purpose entities” – even though this or a similar term is neither used in IFRS 12 nor in IFRS 10.⁵¹

With regard to interests in unconsolidated structured entities an entity shall inform about the nature and extent of its interest in this entity, i.e. in giving qualitative and quantitative information about nature, purpose, size and activities of the structured entity and how the structured entity is financed.⁵² Information about the nature of risks associated with the interests in unconsolidated structured entities shall be given as a summary of carrying amounts of the assets and liabilities relating to the interests in unconsolidated structured entities and the amount of the reporting entity’s maximum exposure to loss from its interests, including how the maximum exposure to loss is determined.⁵³ In case that financial support has been provided or is intended to be provided to the unconsolidated structured entity, this would lead to further disclosures.⁵⁴

Conclusion

The effect of the application of the single control model of IFRS 10 will be twofold: Some entities that have not been consolidated before will be consolidated and others that have been consolidated will not form part of the group anymore after application of IFRS 10.⁵⁵ The single control definition seems very comprehensible and straightforward,⁵⁶ but in the view of the detailed application guidance that describes the manifold circumstances under which the assessment of control may be difficult,

⁴⁹ IFRS 12, Appendix A.

⁵⁰ IFRS 12.B22-B23.

⁵¹ Böckem, Hanne, Bernd Stibi, and Oliver Zoeger (2011), page 399. The distinction made by the IASB in IFRS 12 between unconsolidated structured entities and entities that are controlled by voting rights shows that although IFRS 10 introduces a single control definition applicable to all entities, this single definition does not result in an equal treatment of all entities with regard to additional notes disclosures that have to be provided only for unconsolidated structured entities and not for unconsolidated other entities. This could equally lead to inconsistencies in determining, if an entity is, or is not, a structured entity for which the additional notes disclosure requirements apply, see Zülch, Henning, Mark-Ken Erdmann, and Marco Popp (2011), page 512.

⁵² IFRS 12.24(a) and IFRS 12.26.

⁵³ IFRS 12.24(b) and IFRS 12.29.

⁵⁴ See IFRS 12.30-31.

⁵⁵ IASB (May 2011), page 7.

⁵⁶ The introduction of a single control definition applicable to all entities has been generally appreciated within the accounting literature, see for example Beyhs, Oliver, Michael Buschhüter, and Anne Schurbohm (2011), page 668, Böckem, Hanne, Bernd Stibi and Oliver Zoeger (2011), page 409, Kirsch, Hans-Jürgen, and Corinna Ewelt-Knauer (2011), page 1645.

the rules might be too complicated, highly judgemental, and difficult to apply in practice, leading to diversity in practice.⁵⁷

The complexity of this accounting guidance is due to the complexity of the structure of relationships between entities in reality.⁵⁸ Current accounting literature often concludes that the application of IFRS 10 is unclear in many respects.⁵⁹ The accounting practice will have to overcome this in determining whether control exists in some cases, or not. Even though the IASB expects less diversity in practice and less structuring opportunities for entities wishing to achieve particular accounting outcomes after having introduced a single principle based control model,⁶⁰ this needs to be shown in the future.⁶¹

On the other hand, diversity in practice may arise mainly for relationships between parent and a (potential) subsidiary, that have been structured, or that due to other reasons are around the margins to control.⁶² Information on such cases will be given to investors in the notes to the financial statements. A reporting entity will be required by IFRS 12 to disclose information that helps users understand the judgements and assumptions made by a reporting entity when deciding how to classify its involvement with another entity. The information that is to be provided according to IFRS 12 in the notes to the financial statements shall enable an investor to make his own judgement with regard to the appropriateness of the underlying assumption and the classification of an entity and therewith will enhance transparency about “on-“ and “off-balance sheet” risks significantly.⁶³ The

⁵⁷ More critical views have been expressed by Erchinger, Holger, and Winfried Melcher (2011), page 1236, Kütting, Karlheiz, and Mana Mojadadr (2011), page 285, Wollmert, Peter (2011), page I, Reiland, Michael (2011), page 2736, and Zülch, Henning, and Marco Popp, (2011), page 1538.

⁵⁸ See also Beyhs, Oliver, Michael Buschhüter, and Anne Schurbohm (2011), page 670, and Böckem, Hanne, Bernd Stibi and Oliver Zoeger (2011), page 406.

⁵⁹ Be referred to the more critical views mentioned in Footnote 55.

⁶⁰ The expectation of the IASB is founded on the fact that the single control model is built on principles and shall better reflect the economic substance of the relationship between entities. Bright lines such like those included in SIC-12, leading to the assessment of control based on the majority of risks rewards, that is more than 50 % of the risks and rewards, have been removed. IASB (May 2011), page 6 and IASB (September 2011), page 10.

⁶¹ Due to the unclear and complex accounting guidance, some expect even more structuring possibilities, be referred to the more critical views mentioned in Footnote 55.

⁶² IASB (September 2011), page 17. The disclosure standard could be criticized because it requires only additional information for unconsolidated structured entities and not for unconsolidated other entities, that due to other reasons are around the margins to control, see for instance Reiland, Michael (2011), page 2735-2736. On the other hand, mostly structured entities require judgement about the existence of control. Also, companies may face difficulties in acquiring information from an entity that it does not control. Therefore, it is comprehensible that information requirements could not be set too high, see also Beyhs, Oliver, Michael Buschhüter, and Anne Schurbohm (2011), page 671, and Kirsch, Hans-Jürgen, and Corinna Ewelt-Knauer (2011), page 1645. For unconsolidated entities, that are not structured and for whom judgement has to be applied in deciding about the existence of control, information could be expected to be given on the face of the income statement and in the notes, when these entities have been classified being joint arrangements or associates. The respective risks will then not be totally “off-balance sheet”. IFRS 12.2ff., IFRS 12.7ff., and IFRS 12.20ff..

⁶³ More critical views about the usefulness of the notes disclosures are expressed by Wollmert (2011), page I, and Zülch, Henning, Mark-Ken Erdmann, and Marco Popp (2011), page 511, who recognise, that the

information that has to be provided with regard to the nature and extent of an investor's interest in unconsolidated structured entities as well as the nature of risks associated with the interests could be considered being a certain "surrogate" for the consolidation.⁶⁴

As a closing remark, it has to be admitted that the "common sense" sustainability mainly relates to operating activities of a business. Accounting relates to sustainability in a very broad sense. Nevertheless, the importance is not to be neglected. It focuses on the financial reporting of the activities of a company to external stakeholders. If profitability and financial stability is seen in most cases as a precondition for sustainable behaviour of a company, then the contribution of accounting is to ensure "true and fair" financial reporting about the business activities and associated risks. The aim is to protect investors and other stakeholders by giving them faithful information. Still a lot of work is to be done.

extensive and burdensome information requirement could possibly serve as an incentive for companies to consolidate its structured entities, see also Bieker, Marcus (2011), page 306. Reiland, Michael (2011), page 2736, accurately remarks, that notes disclosures should not serve to compensate deficiencies in the control concept. Information given in notes is not as strongly perceived as information given on the face of financial statements

⁶⁴ Böckem, Hanne, Bernd Stibi and Oliver Zoeger (2011), page 407 and 409, stressing on the interest in information about judgements made in deciding about consolidating or not consolidating structured entities. Wollmert, Peter (2011), page I, calls into question the use of additional information in view of the already existing extensive information provided in the notes to the user of financial statements.

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