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THE CHANGE OF CONSOLIDATION RULES AND ITS IMPACT ON EARNINGS MANAGEMENT

Abstract:

Boundaries of consolidated reporting entities vary between International Financial Reporting Standards (IFRS) and U.S. Generally Accepted Accounting Principles (GAAP). Based on the rules-oriented conceptual framework, U.S. GAAP adopts ownership-based consolidation approach (ARB 51), while IFRS adopts control-based approach that is more principle-oriented (IAS 27). Exploiting a unique setting which took place in Taiwan that switched from U.S. GAAP to IFRS in consolidation rules in 2005, this study finds that parent firms conducting more related party transactions with their subsidiaries are inclined to hide them from consolidation under ownership-based consolidation. This intention to avoid consolidation, however, is substantially restrained when switching to the control-based consolidation approach. In addition, firms employ real earnings management to substitute for earnings management via related party transactions after control-based consolidation approach is adopted, consistent with prior studies (e.g., Zang, 2012) that find relative costliness drives the earnings management decision.

Keywords:

Consolidated rules; Business group; Earnings management; Related party transactions

JEL Classification: M41, M48