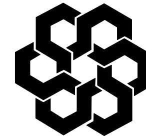

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **12 December 2006, London**

Project: **Conceptual Framework**

Subject: **Phase D: Reporting Entity—Parent Company Approach (Agenda Paper 8A)**

Introduction

1. The Boards have not yet discussed whether (and how) the parent company approach to the preparation of consolidated financial statements fits in with the Boards' discussions about the reporting entity concept.

2. The Boards will recall that there was some brief discussion of the parent company approach during the Boards' initial deliberations on the objectives of financial reporting, in Phase A of the conceptual framework project. In particular, the issue arose during the Boards' discussions of the entity perspective, and whether the objective of financial reporting should be to provide information to a wide range of users or to existing ordinary shareholders only. Relevant extracts from the Preliminary Views document[1] are set out in the appendix.

3. Although this issue was not raised as a cross-cutting issue, it seems likely that the Boards' constituents would be interested in how the Boards' discussions of

[1] *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information.*

the reporting entity concept fits in with the parent company approach to the preparation of consolidated financial statements.

Overview of the parent company approach

4. During the Boards' discussions in Phase A of the conceptual framework project, it was noted that there are different views about the objective of financial reporting, which may arise from two competing accounting theories—the proprietary theory and the entity theory. As noted by Baxter and Spinney, the parent company approach falls somewhere between the proprietary theory and the entity theory; it evolved from accounting practice, as a means of explaining and codifying existing consolidated practices.[2] Baxter and Spinney prepared a table, comparing the two variations of the parent company approach that existed in practice with the proprietary theory and the entity theory. Their table is reproduced below.

Summary of Basic Consolidation Techniques under the Four Concepts

	Problem areas	*Proprietary*	*Parent company*	*Parent company extension*	*Entity*
1	Investee tangible assets, identifiable intangibles and liabilities	Report investor proportionate share of fair value	Report book value plus investor proportionate shares of difference between book value and fair value	Report 100% of fair value allocated proportionately between interests	Report 100% of fair value allocated proportionately between interests
	Investee goodwill	Report investor proportionate share (equals amount purchased)	Report investor proportionate share (equals amount purchased)	Report investor proportionate share (equals amount purchased)	Report 100% of fair value allocated proportionately between interests
2	Unrealized inter-company gains or losses - investee sells	Eliminate investor proportionate share	Eliminate investor proportionate share	Total elimination allocated proportionately between interests	Total elimination allocated proportionately between interests
	- investor sells	Eliminate investor proportionate share	Eliminate investor proportionate share	Eliminate 100% against investor	Eliminate 100% against investor
3	Minority interest in investee at acquisition	N/A	Report proportionate share of investee book	Report proportionate share of fair value of investee net	Report proportionate share of fair value of

[2] Baxter, G. C. and Spinney, J. C., *A Closer Look at Consolidated Financial Statement Theory*, CA Magazine (Canada), January 1975, page 32.

			value	identifiable assets	investee net assets
	Minority interest subsequent to acquisition	N/A	As above + share of unadjusted investee net income (equals proportionate share of investee current book value)	As above + share of investee net income adjusted for effects of fair value of net identifiable assets, and unrealized gains or losses	As above + share of investee net income adjusted for effects of fair valuation of net assets, and unrealized gains or losses
4	Disclosure of minority interest in investee income	N/A	Deduction in consolidated income statement	Deduction in consolidated income statement	Deduction in consolidated statement of retained earnings
5	Disclosure of minority interest in investee assets and liabilities	N/A	A creditor claim	Between liabilities and equity	A part of shareholders' equity

5. Two issues are discussed below:

   a. Are these various consolidation theories, including the parent company and parent company extension, relevant to the development of a reporting entity concept?

   b. How does the parent company approach relate to the various parent/group entity views discussed previously by the Boards?

Relevance to reporting entity concept

6. In looking at the table above, the staff notes that, irrespective of which consolidation theory is applied, it does not change which entities are included in the group. Or, to put it another way, none of the four consolidation theories provide any guidance on which entities should be consolidated. Rather, all four assume that the composition of the group entity has already been determined. Instead, these consolidation theories provide guidance on the presentation of information about the assets, liabilities, equity, revenue and expenses of the consolidated group, such as how to measure goodwill and other assets and liabilities, and how to present information about minority interests.

7. Therefore, none of the four consolidation theories described above, including the parent company and parent company extension, are relevant to issues such as whether control (or something else) should be used as the basis for determining which entities should be included in the group.

8. However, there remains the question of whether the parent company approach is relevant to the issue of the relationship between the parent entity and the group entity.

Relationship with the various parent/group entity views

9. The Boards have previously discussed three parent/group entity views:

   a. View 1 (One Entity – Two Alternative Displays). Under this approach, the parent entity and the group entity are regarded as being one and the same entity, with the subsidiary regarded as being part of the parent entity, for the purposes of the parent entity's financial reporting. In addition, under this approach, the investment asset reported in the parent-only financial is a combined (or summarised) amount, which comprises all the assets and liabilities of the subsidiary that are presented separately in the consolidated financial statements. It would be a standards-level issue to determine which presentation approach (i.e., net or gross) should be followed when preparing the parent/group entity's GPEFR. That is, it would be a standards-level issue to determine whether the parent entity should prepare *either* parent-only financial statements *or* consolidated financial statements.[3]

   b. View 2 (One Entity – One Display). This approach is similar to View 1, in that the parent entity and the group entity are regarded as being one and the same entity, with the subsidiary regarded as being part of the parent entity, for the purposes of the parent entity's financial reporting. However, under View 2, presenting the assets and liabilities of the subsidiary as a single, net amount would not be regarded as a relevant or faithful representation of the parent entity's assets and liabilities. Therefore, in concept, the consolidated financial statements are the only set of financial statements that are regarded as GPEFR.

   c. View 3 (Multiple Entities). This approach contrasts with both View 1 and View 2, in that it regards the parent entity and the group entity as being two different entities, both in legal and economic terms. Under this approach, the subsidiary is regarded as being an entity in its own right that

[3] Presumably that would be based on an assessment of which presentation results in the most useful, relevant and faithful representation of the information for the users of the entity's financial reporting in the given set of circumstances.

is separate from—not part of—the parent. Rather, both the parent entity and subsidiary entity are part of the group entity. The financial statements of the group entity are prepared by combining two (or more) separate entities, and presenting the results of that combination as a single, economic entity. Thus, for a parent entity with one subsidiary, there are potentially three reporting entities that could each prepare GPEFR—the parent entity, the subsidiary entity and the group entity.

10. As can be seen from the summary above, the key difference between Views 1 and 2, on the one hand, and View 3, on the other hand, is whether the parent entity and group entity are regarded as being one and the same entity, or two different entities.

11. The parent company approach is not consistent with View 3. The financial statements of the group entity are prepared by combining together the assets, liabilities and activities of all the entities within the group, and presenting them as a single, economic entity. No distinction is drawn between the parent entity and other entities within the group.

12. At first sight, it might *appear* that View 1 and View 2 are somewhat closer to the thinking behind the parent company approach, because of the greater emphasis placed on the parent entity under these views—the relationship between the parent entity and the group entity is such that the parent is central (and essential) to the composition of the group. However, a closer look reveals that the parent company perspective is not consistent with View 1 or View 2. Under both views, the parent and the group are regarded as being one and the same entity, which means there is no difference between the parent's perspective and the group's perspective.

13. The parent company approach is not consistent with any of these views because all three views involve a *complete* setting aside of the boundary between the parent entity and the subsidiary entities, such that the subsidiary entities are regarded as being part of—rather than separate from—another entity (either the parent entity, under Views 1 and 2, or the group entity, under View 3). In contrast, the parent company approach seems to involve a *partial* setting aside of the boundary between the parent and the subsidiary.

14. For example, both the parent company and parent company extension involve recognising (in some fashion) the assets, liabilities, revenues and expenses of the subsidiaries, which suggests that the boundary between the parent and subsidiaries has been set aside. However, some of the reporting of those assets, liabilities, revenues and expenses is more consistent with the boundary having been only partially set aside. For example, only the investor's portion of goodwill is included, not the full amount.

15. Also, the presentation of minority interests, and the accounting treatment of transactions between the parent and minority interest holders, is more consistent with the notion that the subsidiary entity is separate from, not part of, the parent entity. For example, minority interests are not regarded as being part of equity. However, the Boards' conceptual frameworks define equity as a residual interest in the assets of the entity after the deduction of liabilities. Minority interests do not meet the definition of a liability in the conceptual frameworks, no matter whether considered from the perspective of the parent entity or the parent entity's shareholders—neither has an obligation to transfer cash or other assets to the minority interest holders. The reason often given by supporters of the parent company approach as to why minority interests are not part of equity is that the minority interests do not have an equity interest in the parent company. This rationale involves drawing a distinction between the parent entity and the subsidiary entities, which is more consistent with the notion that those subsidiary entities are separate from, not part of, the parent entity. The same applies to the recognition of gains or losses arising from transactions between the parent entity and the minority interests holders.

16. In effect, the consolidated financial statements prepared under the parent company approach are akin to an expanded form of parent-only financial statements. In other words, the consolidated financial statements are an alternative way of reporting information about the parent's investment in its subsidiaries. The investment asset is replaced by the assets and liabilities of the subsidiary, but the consolidation process does not result in treating the entire subsidiary *entity* as being part of the parent entity, because in some instances (e.g., when reporting equity), the separation between the parent entity and the subsidiary entity is still preserved.

17. To understand more about the parent company approach, it is helpful to consider its history. As noted earlier, the parent company approach evolved from accounting practice, as a means of explaining and codifying existing consolidated practices. In particular, when an entity owns (or has control over or a controlling financial interest in) another entity, it has been generally (if not unanimously) accepted that the financial statements of the individual entities are not sufficient to satisfy user information needs. It is for this reason that the accounting practice of preparing consolidated financial statements evolved. For example, consolidated financial statements have been used in the U.S. from the early 1900s, as substitutes for parent-only financial statements. In the UK, consolidated financial statements were introduced in the 1920s, as a supplement to parent-only financial statements. By the 1940s, consolidated financial statements were regarded as the customary way of communicating information to the securities markets.[4]

18. Therefore, the parent company approach existed before the conceptual frameworks (of any standard-setter) were developed. Therefore, it is perhaps not surprising that it conflicts with the conceptual frameworks. Conceptually, the partial setting aside of the boundary between the parent entity and the subsidiary entities results in the parent company approach being internally inconsistent. On the one hand, it treats the subsidiary's assets and liabilities as if they were the parent's assets and liabilities. That makes sense only if the subsidiary entity is part of the parent entity. (If the subsidiary entity is not part of the parent entity, then it would mean the parent entity would be reporting *another entity's* assets and liabilities in its financial statements.) However, on the other hand, it sometimes treats the subsidiary entity as being separate from the parent entity, such as the presentation of minority interests as something other than equity and the recognition of gains and losses from transactions between the parent company and the minority interest holders.

19. Nevertheless, despite its conceptual flaws, some might argue that the parent company approach should not be cast aside entirely. [Sentences omitted from Observer Notes]. In particular, it has relevance to Phase B, when considering

[4] R.G. Walker, *An Evaluation of the Information Conveyed by Consolidated Statements*, Abacus, December 1976, page 77.

liabilities and equity (or claims), and Phase E, when considering presentation and disclosure.

20. In conclusion, the key issue to address is whether a discussion of the parent company approach should be included in the Discussion Paper for the reporting entity phase of the project. On the one hand, as noted in paragraphs 6 and 7, the Discussion Paper could simply point out that the parent company approach is not relevant to determining the boundaries (or composition) of the group entity. On the other hand, as noted in paragraph 19, the Discussion Paper could include a more expansive discussion for the purposes of inviting comments on matters relevant to Phases B and E.

Questions for the Boards

21. The Boards are asked to give feedback to the staff about:

    a. whether a discussion of the parent company approach should be included in the Discussion Paper for Phase D, and

    b. if so, which of the approaches outlined in paragraph 20 should be followed?

Appendix

Extracts from IASB/FASB Preliminary Views document

Extract from Chapter 1

OB10 The information provided by general purpose external financial reporting is directed to the needs of a wide range of users rather than only to the needs of a single group. (Throughout the [draft] framework, the terms *financial reports* or *financial reporting* refer to *general purpose external financial reports* or *reporting*.) Accordingly, financial reports reflect the perspective of the entity rather than only the perspective of the entity's owners (existing ordinary shareholders or ordinary shareholders of the parent entity in consolidated financial statements) or any other single group of users. However, adopting the entity perspective as the basic perspective underlying financial reporting does not preclude also including in financial reports information that is primarily directed to the entity's owners or to another group of users. For example, financial reports include *earnings per (ordinary) share*, which may be of interest largely to holders and potential purchasers of those shares. Financial statements generally also report separately the amount of *earnings*, which may be termed *comprehensive income, profit or loss*, or the like, attributable to holders of ordinary shares in the parent entity and the amount attributable to holders of non-controlling interests in subsidiaries. That information, however, is in addition to—not a replacement for—information prepared in accordance with the entity perspective. [Paragraph OB10]

Extract from the Basis for Conclusions to Chapter 1

BC1.8 Both the FASB's and the IASB's existing frameworks discuss the objective of financial reporting in terms of information that is useful to a wide range of users in making economic decisions. Both frameworks list a variety of present and potential users including, among others, investors, creditors, employees, suppliers, customers, and governmental agencies.

BC1.9 Questions continue to be raised in standards-level projects about whether financial reporting should be directed to, or reflect the perspective of, existing ordinary shareholders only. Many, though not all, of those questions involve the effects of adopting the *proprietary perspective* or the *entity perspective*. (See paragraphs BC1.14–BC1.17 for a discussion of designating a primary user group.) The two perspectives are important primarily for consolidated financial statements and for determining the distinction between liabilities and equity. They affect whether the effects of transactions and other events are viewed from the perspective of the entire consolidated group or solely from the perspective of the parent entity.

BC1.10 The boards decided to retain the focus on a wide range of users because it is more consistent with the objective of providing information that is useful for resource allocation decisions by investors, creditors, and other

users than a narrower focus on existing ordinary shareholders would be. Although existing ordinary shareholders are important users of financial reports, many other groups need financial information about the entity that they cannot require management to provide and therefore must rely on the information in financial reports. Examples of those groups are potential ordinary shareholders as well as present and potential holders of other types of equity shares, bonds, or options. An example of a situation in which an entity's financial report is directed primarily to potential shareholders and other users, such as present and potential creditors, is in an initial public offering. Moreover, the boards expect that information needed by existing shareholders generally would also be pertinent to decisions by potential shareholders and vice versa. Furthermore, many who are not investors or creditors, such as suppliers, customers, employees, their advisers, and the general public, frequently use financial reports.

BC1.11 The boards also concluded that the entity perspective is consistent with the focus on a wide range of users because it views the effects of transactions and other events from the perspective of the entire entity rather than only a part of it (in consolidated financial statements, that part would be the parent entity). The proprietary perspective, in contrast, would reflect in financial statements the effects of transactions and other events from only the parent entity's perspective. However, adopting the entity perspective as the main perspective underlying financial reports does not mean that the information needs of existing ordinary shareholders (such as existing ordinary shareholders of the parent entity in consolidated financial statements) should be neglected. On the contrary, adopting that perspective is intended to help ensure that financial reports meet the needs of existing shareholders and other user groups.

BC1.12 Although the boards adopted the entity perspective as the basic perspective underlying financial reports, including in financial reports some information that is primarily directed to ordinary shareholders, existing or potential (that is, information consistent with the proprietary perspective), is appropriate. The boards observed that adopting the entity perspective does not preclude also deciding in future standards projects to include in financial statements more information that might be viewed as consistent with a proprietary perspective.

BC1.13 The boards observed that a broader focus on the needs of a range of users is appropriate both in jurisdictions with a corporate governance model defined in the context of shareholders and in those with a corporate governance model that focuses on stakeholders, which is a broader group than shareholders.