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International Accounting Standards Board

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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—Consistency with the Consolidations Project (Agenda Paper 8B)**

Introduction

1. This paper considers the consistency between the decisions reached by the IASB and FASB in the reporting entity phase (Phase D) of the conceptual framework project and decisions reached by the IASB in its consolidations project.

2. The IASB is planning to publish a discussion paper in mid 2007 as part of its project to replace IAS 27, *Consolidated and Separate Financial Statements,* and SIC-12, *Consolidation – Special Purpose Entities.* The consolidations project is part of the *Memorandum of Understanding.* Under that agreement, the progress expected to be achieved by 2008 is the implementation of work aimed at the completed development of converged standards as a matter of high priority. Although this topic is on the FASB agenda, the FASB is not currently actively working on the project. IASB staff conducted an education session for the FASB in September and are continuing to liaise with FASB staff.

3. In many respects, the decisions reached in the reporting entity phase of the conceptual framework project are consistent with the decisions reached in the

IASB's consolidations project. However, there are a few areas where divergence has occurred or might occur. This paper considers these areas:

a. Parent/group entity view

b. Group entity model

c. Definition of control

d. Other control issues

Parent/group entity view

4. In the conceptual framework project, 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 statements 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. Hence, under this approach, *either* parent-only financial statements *or* consolidated financial statements could be prepared as the parent entity's general purpose external financial reports (GPEFR). It would be a standards-level issue to determine which presentation approach (i.e., net or gross) should be followed in a given set of circumstances.

    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. If parent-only financial statements were prepared, as supplementary information, they could not be described as GPEFR nor could they be presented instead of consolidated financial statements.

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 is separate from—rather than part of—the parent. The group entity for financial reporting purposes is formed by combining two (or more) separate entities, and presenting the results of that combination as a single, economic entity. It would be a standards-level issue to determine when financial statements for the parent entity and/or the group entity should be prepared. Both sets of financial statements are regarded as GPEFR, as they relate to two different entities.

5. [Paragraph omitted from Observer Notes].

6. At present, the IASB and FASB have not reached a common preliminary view on which of the above parent/group entity views should be adopted. In September, the results of the Boards' respective discussions were as follows:

   a. The majority of IASB members prefer View 3, with a minority supporting View 2.

   b. The majority of FASB members prefer View 2, with a minority supporting View 3.

7. The parent/group entity views discussed above have two potential interactions with issues being considered in the IASB's consolidations project:

   a. The status of parent-only (separate) financial statements.

   b. The description of the informational objective.

The status of parent-only financial statements

8. As noted above, one of the objectives of the IASB's consolidations project is to develop an IFRS to replace IAS 27. At present, IAS 27 neither requires nor prohibits the preparation of parent-only (separate) financial statements. However, if such financial statements are prepared, IAS 27 specifies various requirements that must be applied.

9. At present, if a parent entity chooses to (or is required to, for example, by local legislation) prepare parent-only (separate) financial statements, in addition to preparing consolidated financial statements, both sets of financial statements could include an assertion of compliance with IFRS. For parent-only financial statements to comply with IFRSs, those financial statements must identify the consolidated financial statements to which they relate (IAS 27, paragraph 42). In contrast, there is no requirement for consolidated financial statements to identify the separate financial statements of the parent entity (or the individual financial statements of any of the subsidiaries of the group). This requirement suggests that parent-only (separate) financial statements are not sufficient on their own to meet the needs of users whereas consolidated financial statements are sufficient.

10. The consolidations project staff thinks that parent-only financial statements reflect the legal rights and 'form' of a business organisation. The group financial statements (following Views 1 and 2) reflect the economic rights and responsibilities (notwithstanding the legal form) of the parent entity. The consolidations staff thinks that the different financial statements meet different needs and that they are likely to be incrementally informative. These staff think that the appropriate questions to ask are:

- what is the objective of each of the financial statements; and
- do they meet their stated objective?

11. The consolidations project staff thinks that whether either, both or neither should be labelled as GPEFR depends on what the objectives of GPEFR are. Under the current plan, the IASB does not intend to discuss separate financial statements as part of the project to replace IAS 27. The intention is to carry forward those requirements. In the short term, therefore, parent-only financial statements will need to identify the related consolidated financial statements and the question of whether they are general purpose external financial statements will not be discussed.

12. However, in the conceptual framework project, the IASB and FASB discussions in Phase A concluded that the conceptual framework (and hence the accounting standards based on that framework) should relate to a single set of GPEFR. That is, each entity would prepare a single set of GPEFR (although that would

not rule out including supplementary information *as part of* that single set of GPEFR). Therefore, depending on which of Views 1, 2 or 3 is adopted, this would have implications for any requirements relating to parent-only financial statements. At present, the IASB's preliminary conclusion in the conceptual framework project (to support View 3) is consistent with the present contents of IAS 27, in that both parent-only financial statements and consolidated financial statements are regarded as GPEFR. However, if the IASB were to decide to instead adopt View 1 or View 2 in the conceptual framework project, and retain its conclusion that each entity should have only one set of GPEFR, this suggests it should reconsider its decision to carry forward the present requirements in IAS 27.

The description of the informational objective

13. In the consolidations project, the IASB has discussed the informational objective to include in the IFRS to replace IAS 27. That is, the replacement IFRS would state the objective of consolidated financial statements. The staff has described the informational objective as follows:

> That objective should be for the entity reporting to present information about the assets and liabilities, and the activities related to those assets and liabilities, for which it holds sufficient rights to be able to consume or settle as if they were legally theirs. That is to say, combining the results of the operations and the financial position of the investor and its investee as a single economic entity notwithstanding its legal form. Users of the financial statements of an entity are assumed to want information about those assets, liabilities and activities. [IASB Agenda Paper 7A, paragraph 8, September 2006]

14. Although it is not made explicit in the extract shown above, the "entity" being discussed above is the parent entity. Current staff thinking in the consolidations project is that consolidated financial statements are one way that the parent entity can present financial information about its position and activities. These staff characterise this as considering which rights to reflect in a particular set of financial statements rather than thinking about these as different entities or boundaries. In other words, the distinction made between the parent entity and the group entity is based on rights rather than boundaries. As such, the wording of the informational objective is more consistent with View 1 or View 2, rather than View 3.

15. The consolidations project staff also thinks about the parent-only and the group financial statements as reflecting different dimensions of an investment. To

illustrate this idea, consider a simple parent-subsidiary relationship where the parent holds all of the equity (including voting rights) of the subsidiary. The parent-only financial statements would report an asset, being the shares in the subsidiary. Of course, underneath that investment are all of the assets and liabilities that are inside the subsidiary. The consolidated financial statements ‘lift the lid’ off the investment and look inside at the subsidiary’s assets and liabilities.

16. The analogy these staff use is to think of an investment in a legal entity as a box of assets and liabilities. The parent-only financial statements report that investment as the box. The consolidated financial statements report what is inside the box. That is why these staff think about digging deeper into an entity rather than extending the boundaries. That is to say, it is a matter of depth rather than breadth—and the key to opening those dimensions is the rights held by the parent.

17. In summary, staff thinking—and the present drafting of the informational objective—in the consolidations project is more consistent with View 1 (or possibly View 2), rather than View 3. Hence, this represents an area of divergence between the IASB’s consolidations project and its preliminary views in the conceptual framework project.

Group entity model

18. In the conceptual framework project, the IASB and FASB have discussed three group entity models:

    a. Controlling entity model

    b. Common control model

    c. Risks and/or rewards model

19. Both the controlling entity model and the common control model are based on a concept of *control*. The definition of control is discussed in the next section. For now, it should be noted that, in both the conceptual framework project and in the consolidations project, the IASB has concluded that control is not a synonym for power. In particular, the IASB has concluded in both projects that the definition of control should include both a power element and a benefits element, together with a link between the two. Although the FASB has not

recently discussed the definition of control in its consolidations project, the FASB reached the same conclusions as the IASB in the conceptual framework project.

20. As noted above, the IASB and FASB recently considered the three group entity models set out above in the conceptual framework project. Neither Board supported the adoption of a risks and rewards model. Of the two remaining models discussed above, the IASB and FASB reached differing views:

    a. The majority of IASB members prefer the common control model (which they described as an extended controlling entity model), with a minority preferring the controlling entity model.

    b. The majority of FASB members prefer the controlling entity model, with a minority preferring the common control model.

21. To date, the IASB discussions in the consolidations project are consistent with a controlling entity model. However, as yet, there has been no discussion of common control (or combined financial statements) in the consolidations project.

22. The current phase of the business combinations project (phase II) states that common control will be considered in a future phase of the project. The IASB consolidations project staff expect to develop a formal agenda proposal for considering common control as part of the wrap-up of Business Combinations II. It is unlikely, therefore, that common control will be discussed by the Boards until that proposal has been considered.

23. In addition to the consolidations and business combinations projects, the common control model is relevant to the IASB's project on small and medium-sized entities (SMEs). In that project, the IASB has decided to include some discussion of combined financial statements in the draft IFRS for SMEs. The current staff draft of the Exposure Draft describes combined financial statements as a single set of financial statements of two or more entities controlled by a single investor.[1]

[1] Paragraphs 9.21 and 9.22 of the November 2006 staff draft of an Exposure Draft, *International Financial Reporting Standard for Small and Medium-Sized Entities (IFRS for SMEs)*

24. In summary, at present, there is no inconsistency between the IASB's preliminary views on common control in the conceptual framework project and the decisions reached in its related standards-level projects.

Definition of control

25. As noted above, in both the conceptual framework project and in the consolidations project, the IASB has concluded that the definition of control should include both a power element and a benefits element, together with a link between the two.

26. In the conceptual framework project, the working definition of control was originally based on the definition developed by the IASB in its consolidation project. Some modifications were made to that definition in the conceptual framework project to reflect comments from Board members that benefits can be positive or negative:

> Control of an entity is the ability to direct the financing and operating policies of an entity, so as to access benefits flowing from that entity (and/or to reduce the incidence of losses) and increase, maintain or protect the amount of those benefits (and/or reduce the amount of those losses).

27. However, recent thinking in the consolidations project has led staff to propose a definition of control that focuses more on the *assets and liabilities* of the other entity rather than on the other *entity* per se:

> An entity has a controlling interest in another entity when it has exclusive rights over that entity's assets and liabilities which give it access to the benefits of those assets and liabilities and the ability to increase, maintain or protect the amount of those benefits.

28. In the conceptual framework project, the staff has argued that, irrespective of whether View 1, 2 or 3 is adopted, the reporting entity concept should first determine what constitutes the "entity" that is reporting, and only then should the asset definition be applied to *that* entity (together with the other element definitions). This includes determining when the legal boundary between two entities should be set aside, for the purposes of determining which entities are part of a group entity. [Sentence omitted from Observer Notes].

29. Hence, staff working on the reporting entity phase of the conceptual framework project argue that the control definition should focus on the control over another *entity*, rather than control over another entity's *assets*.

30. In contrast, staff working on the consolidations project argue that the objective of the consolidations project is to identify the assets that the group has rights to and responsibility for. This is a change in focus, away from control of the strategic policies of an entity. The consolidations project staff believes that the change is appropriate because use of the assets and liabilities of the entity are, ultimately, what power over the strategic financing and operating policies is intended to capture. In other words, the change in definition simply reflects the objective underlying 'control of an entity'.

31. The holder of strategic power has the ability to determine how assets are used, including using them in conjunction with other assets it controls. That is to say, the holder of strategic power can consume the assets directly within its business or indirectly by having the ability to direct that they be sold. In a similar manner, strategic power gives the holder the ability to commit that entity to borrow additional funds, incur debts and settle existing debts. As described above, the consolidations project staff think that when an entity holds an instrument (such as shares in another legal entity) that gives it rights to that entity's assets and responsibility for its liabilities, then the first entity can and should report all of the assets and liabilities and non-controlling equity interests of the second entity.

32. This characterisation of control also provides a stronger link with benefits. It also avoids implying that control over assets and liabilities can *only* be achieved by directing the strategic financing and operating policies of an entity—control might be achieved other than through strategic power. This last point has so-called SPEs in mind. Our analysis suggests that there are entities that do not have the characteristics that 'control of an entity' generally focuses on.

33. In the conceptual framework project, the Boards have agreed upon a definition of control that includes both a power element and a benefits element, together with a link between the two. Moreover, as noted in the Boards' discussions of SPEs in the conceptual framework project, when it is not apparent whether the power element exists or with whom power lies, focusing on the benefits element may assist in determining whether one entity has control over another entity. Therefore, in the view of the staff working on the reporting entity phase of the

conceptual framework project, it is not necessary (nor appropriate) to focus the definition of control on the other entity's assets and liabilities.

34. However, the consolidations project staff are concerned that requiring that the definition of control focus on an entity, as the conceptual framework project suggests it should, is limiting. Controlling an entity necessarily means that the controller has 'control' over all of that entity's assets and liabilities.[2] But, it is not necessary that one entity control another entity to have 'control' over one or more of the assets or liabilities that are legally held by another entity. An obvious example is an asset that is legally held by one entity and leased by another entity. The consolidations project staff has suggested that some SPEs are entities that hold legal title to assets to which investors have economic rights.

35. However, the conceptual framework project staff think that focusing the control definition on control over another entity, rather than control over the other entity's assets (and liabilities), should not result in a different outcome. If the first entity does not control the second entity, but nevertheless has control over one or more assets that are legally held by that second entity, then application of the definition of assets should lead to the conclusion that those items in question are assets the first entity, rather than the second entity. Therefore, the conceptual framework project staff does not regard a control definition that focuses on control over another entity, rather than the assets or liabilities of that other entity, as limiting.

36. In summary, there is a difference between the current definition of control in the consolidations project and in the conceptual framework project. The consolidations project staff and conceptual framework project staff have different views about which approach to the definition should be retained. That is, although the wording of the definition in a consolidations standard need not be *identical* to the definition in the conceptual framework (for example, the definition at the standards-level might be more specific), the definitions should be *consistent*. Hence, at some point during the course of the two projects, it will be necessary to decide whether to focus on control over an entity (the current

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[2] That control is often constrained, of course, by protective rights such as legislative restrictions on how assets can be managed.

position in the conceptual framework project) or control over that other entity's assets and liabilities (the current position in the consolidations project).

Other control issues

37. The staff think that the decisions reached by the IASB and FASB on other control issues in the conceptual framework project are consistent with the IASB's decisions on similar issues in the consolidations project.

38. In reaching that conclusion, the staff considered the IASB's decisions in both projects about the treatment of options. In the conceptual framework project, the two Boards have concluded that, in concept, when options are considered in isolation, the fact that an entity holds enough options that, if and when exercised, would place it in control over another entity is not sufficient, in itself, to establish that the entity has *present* control of that other entity. However, there could be other facts and circumstances that, taken together, indicate that the entity has present control over the other entity.

39. The Boards reached similar decisions when discussing options in the context of options over assets, in Phase B of the conceptual framework project. In other words, in concept, the Boards reached consistent conclusions on the treatment of options over an entity and options over assets.

40. In the IASB consolidations project, the IASB has concluded that it is important to identify the circumstances in which the rights conveyed by an option are sufficient to require that an entity prepare consolidated financial statements but are not sufficient to allow the recognition of the asset underlying that option in the individual or separate financial statements of that entity.

41. In the consolidations project, the staff intends to develop, at the standards level, indicators that would lead to the conclusion that an option gives the holder power over an entity as a whole. The type of indicator the staff has in mind is the holder of the option also holding a dominant (but less than majority) voting interest.

42. The consolidations project staff think that the decisions made in the two projects are consistent. They also think that providing indicators in that project is consistent with the decisions made in the conceptual framework project. The

staff think that there are unlikely to be any differences between the treatment of options over an entity and options over assets.

43. If that is indeed the outcome, there will be no divergence between the consolidations project and the conceptual framework project on the treatment of options.

Other issues

44. The consolidations project staff thinks that a definition of 'control of an entity' should not be included in the proposed conceptual framework. These staff agree that the conceptual framework should state that control over an entity requires both a power and a benefit element but should not go so far as to define the power element to be power over the financial and operating policies of the entity. That level of detail is best addressed at the standards level. The staff sees no harm in developing this thinking in the conceptual framework Discussion Papers but those papers should also identify how much detail is expected to be included in the conceptual framework and how much is expected to be included in the standards.

45. However, the IASB and FASB have already considered this issue in the conceptual framework project. Both Boards agreed that, if the control concept is retained in the context of determining when two or more entities should be consolidated or combined as a group reporting entity, then control should be defined at the concepts level. Therefore, unless the Boards wish to reverse that decision, then at some point it will be necessary to have consistent definitions of control in the conceptual framework and in the consolidations' standards.

Summary

46. This paper has discussed various areas where divergence between the decisions reached in the IASB consolidations project and decisions reached in the conceptual framework project has occurred or might occur:

   a. Parent/group entity view:

      i. Status of parent-only financial statements: there is no inconsistency between the two projects if the IASB retains its decision to support View 3 in the conceptual framework project. However, if the

IASB were to adopt View 1 or View 2 in the conceptual framework project, and retain its conclusion that each entity should have only one set of GPEFR, then it may need to reconsider the decision to carry over the current requirements of IAS 27 in the consolidations project.

ii. Description of the informational objective: the current description in the consolidations project is more consistent with View 1 or 2, whereas the IASB's preliminary view in the conceptual framework project is to support View 3.

b. Group entity model: at present, there is no inconsistency between the conceptual framework project and the various related standards-level projects.

c. Definition of control: there is some inconsistency between the definition in the consolidations project and the definition in the conceptual framework project; that difference being whether to focus on control of another entity (as in the conceptual framework project) or control over that other entity's assets and liabilities (as in the consolidations project).

d. Control issues: there is no inconsistency between the decisions to date in the consolidations and conceptual framework projects.

Next steps

47. At present, the IASB plans to issue a Discussion Paper for both the consolidations project and the reporting entity phase of the conceptual framework project at around the same time in 2007.

48. The IASB is asked to consider what actions it wishes to take on the inconsistencies identified in this paper. The staff of the two projects will continue to share ideas and will seek to eliminate inconsistencies whenever possible. However, unless the IASB wishes to revisit its decisions in one or both projects, the staff thinks that it is unlikely that all the inconsistencies will be removed before the Discussion Paper for either project is published for comment. Both discussion documents would explain the inconsistencies and seek constituents' input before deciding how to proceed in the projects. The

staff think that developing the two projects together is helpful, because the projects will inform each other.

49. Although the consolidations project is primarily an IASB project, it is still influenced by the Memorandum of Understanding. That is to say, the objective is to develop a converged standard on consolidations. The consolidations project team expects to continue to seek FASB feedback on the consolidations project and to reflect FASB views, where possible, in the Discussion Paper. Therefore, even though the consolidations project is not a joint project, the IASB staff are proceeding on the assumption that it will become a joint project and that both Boards want the conceptual framework and consolidations projects to be consistent.

50. Do the Boards agree with this approach?