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Conceptual Framework
Phase D: Reporting Entity – Draft Discussion Paper

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Note to IASB/FASB members

This paper contains an incomplete staff working draft of the Discussion Paper for the reporting entity phase of the conceptual framework project. Some sections/paragraphs contain draft content, while other sections/paragraphs give an indication of what material would be included in that section/paragraph [set out in square brackets]. Also, this paper contains the main body of the document only. For example, it does not contain an invitation to comment, or introductory material about the conceptual framework project. The format of the document is similar to a traditional Discussion Paper (rather than as a draft of the reporting entity chapter of the framework) and therefore will not have a separate Basis for Conclusions. The document discusses various issues, different viewpoints on those issues, and concludes with the Boards' preliminary views on issues that have been agreed upon. For issues upon which the Boards have not agreed a preliminary view, an indication of various Board members' views is (or will be) given. For an explanation of why this format was adopted, refer to IASB Agenda Paper 8, FASB Memorandum 44.

This staff working draft of the Discussion Paper is provided mainly for information purposes. The staff is not requesting drafting comments at this time since there is more work to be done on the document before that would be a worthwhile effort for Board members. However, the staff would welcome substantive comments on the planned content, such as whether there are any major omissions of issues or viewpoints that require discussion.

CONTENTS

        - Common control model
        - Risks and rewards model
        - Boards' discussions
    - Summary of discussion of determining the composition of a group entity
- Section summary

Summary

PART I: INTRODUCTION

1. [This section would contain some discussion about the following points (the text below gives an *indication* of the points to be discussed—actual text is to be developed):

   a. The two Boards' existing frameworks do not include a reporting entity concept. The IASB framework defines the reporting entity in one sentence with no further explanation.[1] The FASB framework does not contain a definition, although some of its commentary is similar to that in the IASB CF.[2] As a result, neither framework specifically addresses the reporting entity concept. Therefore, this is a gap in both frameworks.

   b. Despite this lack of an explicit reporting entity concept in the two Boards' conceptual frameworks, an implicit reporting entity concept (or concepts) already exists in practice. In particular, there are accounting standards (and accounting practice) relating to the composition of, and financial reporting by, a group entity. Existing accounting standards and practice serve as a starting point—but not as a precedent or constraint—to the development of reporting entity concept for the Boards' common conceptual framework.

   c. The objective of the project phase is to develop a reporting entity concept for inclusion in the Boards' common conceptual framework, that is, establish what is the "thing" that is the subject matter of general purpose external financial reports (GPEFR) prepared in accordance with IFRS/US GAAP—this links back to Phase A document, which establishes the objective of GPEFR. (Discussion of GPEFR to be included here.) In other words, the project phase is not concerned with special purpose financial reports prepared at the request of particular users, or supplementary information that might be prepared in addition to GPEFR.

   d. However, it is not the objective of the project phase to resolve the wide variety of accounting issues that relate to the reporting entity, in particular, issues that arise in standards-level projects about consolidated financial statements. The conceptual framework provides a conceptual framework upon which accounting

[1] IASB *Framework*, paragraph 8, states "A reporting entity is an entity for which there are users who rely on the financial statements as their major source of financial information about an entity."
[2] For example, CON1, paragraph 28.

standards are based—it does not negate the need for those accounting standards. Therefore, even once a reporting entity concept has been developed, there will remain many issues to be addressed at the standards-level. This is true of all parts of the conceptual framework. However, because the Boards are seeking to fill a gap in their existing frameworks, and therefore there is no existing content to given an indication of the extent of guidance that ought to be provided at the conceptual level, some may have unrealistic expectations about the extent to which the conceptual framework will assist in resolving the many, complex issues that currently exist in practice. The objective of the project phase to develop a conceptual foundation, to serve as a starting point for resolving those issues, not to act as a "silver bullet".

e. In developing this discussion paper, various literature sources were considered, in addition to the Boards' existing frameworks, such as:

   i. The Australian framework, which includes a concepts statement on the topic, SAC 1 *Definition of the Reporting Entity*.

   ii. The UK *Statement of Principles for Financial Reporting*, which also includes some discussion of the reporting entity concept.

   iii. Existing and proposed accounting standards, in particular, consolidation standards that define *control*.

   iv. Relevant academic literature

f. Other points?]

2. [The layout of paper would be explained. Current structure is:

   a. individual reporting entity

   b. group reporting entity

   c. summary]

INDIVIDUAL REPORTING ENTITY

3. This section focuses on an individual or single entity, not an entity that has an investment or interest in another entity. In other words, the section focuses on establishing the simplest (or basic) form of entity for financial reporting purposes.

4. For the purposes of the conceptual framework, issues that arise include:

a. Is it necessary to define an *entity*?

b. Should a distinction be drawn between an *entity* and a *reporting entity*, such that not all entities are reporting entities? That is, are there some entities that should be precluded from being the subject matter of GPEFR?

c. Should the conceptual framework specify (or provide guidance on) which entities should be required (or encouraged) to prepare GPEFR?

5. For example, the Australian conceptual framework defines both an entity and a reporting entity, and it requires that reporting entities prepare GPEFR.[3] An entity that is not a reporting entity might prepare special purpose financial reports, but not GPEFR.

Should an entity be defined?

6. It could be argued that the term entity should be defined, particularly given its frequent use throughout the conceptual framework, accounting standards and other accounting literature.

7. Also, some might argue that there should be some limits placed on the "things" that can describe themselves as being entities for the purposes of GPEFR. For example, is it acceptable for a branch or segment of a legal entity to be the subject matter of GPEFR?

8. When considering whether to define an entity, the Boards considered what the characteristics of an entity for financial reporting purposes might be. For example, is it necessary for the entity to be a legal entity?

9. The Boards noted that exactly what constitutes a legal entity might differ across jurisdictions. Therefore, if an entity for financial reporting purposes was limited to legal entities, economically similar types of organisations might or might not be entities for financial reporting purposes, depending on the jurisdiction in which they were established or operate.

10. Also, the term *legal entity* could be defined broadly, to mean something that has some sort of legal standing or recognition in the eyes of the law. Or it could be defined narrowly, to mean something that has a separate legal existence, as distinct from other parties having an interest in it. Factors that might be relevant to establishing whether an entity has a separate legal existence include whether it is able to enter into contracts, incur liabilities, or hold legal title to property in its own name (as distinct from its owners) and/or whether its creditors have recourse to its assets only (as distinct from the assets of its owners).

[3] SAC 1, paragraphs 6, 40 and 41.

11. The Boards concluded that what constitutes an entity for financial reporting purposes should not be limited to legal entities (however defined). For example, a sole proprietorship is not a legal entity, but should not be precluded from being the subject matter of GPEFR. The Boards concluded that legal existence (or some sort of legal standing) is a *sufficient* condition for concluding that an entity exists, but is not *necessary* condition.

12. The Boards also considered whether, for something to be an entity for financial reporting purposes, it should have "the capacity to deploy resources" ,[4] or some similar notion, such as the capacity to engage in transactions with other parties.

13. However, the Boards were concerned that defining an entity in this manner might result in some organisations failing to satisfy that definition, and therefore be precluded from being the subject matter of GPEFR. For example, a special purpose entity, with a narrowly-defined purpose and pre-determined financing and operating policies, might have a very limited capacity to deploy resources or engage in transactions in other parties.

14. The Boards also noted that what constitutes an entity for financial reporting purposes is often defined by others. For example, in order to establish a requirement to prepare general purpose external financial reports, then the person or body responsible for establishing that requirement (e.g., legislator, regulator, lender or investor) will have to define the "thing" that is required to report.

15. The Boards concluded that it was not necessary for their common conceptual framework to define the term *entity*. Rather, the conceptual framework should broadly describe what constitutes an entity for financial reporting purposes, as being a circumscribed area of economic interest. Examples of entities include a natural person, sole proprietorship, company, trust, partnership, association and, in some circumstances, a branch or segment.

Should a distinction be drawn be an entity and a reporting entity?

16. It could be argued that the conceptual framework should specify, or at least indicate, which particular entities should be regarded as reporting entities for the purposes of GPEFR. For example, some argue that this would provide a focus for the Boards when setting accounting standards, by identifying the "entities" to which those standards are intended to apply.

17. Furthermore, given that GPEFR are directed to the needs of external users who lack the ability to prescribe the financial information they need from an entity, it could be argued

[4] SAC 1, paragraph 6.

that reporting entities should be identified as those entities for which there is (or is likely to be) a demand for GPEFR.

18. [For example, the Australian conceptual framework and UK Statement of Principles – insert discussion here]

19. However, by limiting which entities are reporting entities, this might limit which entities are able to prepare financial reports that purport to be GPEFR in accordance with IFRS/US GAAP. The Boards noted that, in many jurisdictions, there are entities that are required to (e.g., by legislation) prepare GPEFR in accordance with GAAP, or that might choose to do so, irrespective of whether there are any external users who are unable to demand the information they require from the entity. In addition, some entities might have external users who *are* able to prescribe the information they want from an entity, but nevertheless those users prefer to receive GPEFR prepared in accordance with GAAP, rather than specify their own reporting requirements.

20. Rather than limit which entities should be reporting entities, the Boards decided that any entity that is required to, or chooses to, prepare GPEFR is a reporting entity. In other words, the adjective *reporting* is used to refer to a particular entity that is preparing GPEFR, not to preclude particular entities from being reporting entities.

Should the conceptual framework specify which entities should be required (or encouraged) to prepare GPEFR?

21. The previous sub-section considered whether the framework should specify which entities *qualify* as reporting entities, for the purposes of GPEFR. The issue addressed in this sub-section is whether the framework should specify which entities should be *required* (or encouraged) to prepare GPEFR. For example, as noted earlier, the Australian conceptual framework requires reporting entities to prepare GPEFR.

22. Also, even if the conceptual framework does not establish a requirement to prepare GPEFR, it could be argued that the conceptual framework should at least provide some guidance on the topic. That guidance could be used by the Boards to decide when an entity (such as a company) should be disaggregated into several reporting entities (such as several branches or segments). It could also by used by individual jurisdictions (such are regulators or legislators) when establishing financial reporting requirements.

23. The Boards noted that it is not within their authority to set requirements for which entities are required to prepare GPEFR. That authority rests with others. For example, in many

jurisdictions, securities regulators and government legislators often specify which entities are required to prepare GPEFR.

24. Furthermore, as a consequence of their decision not to distinguish between entities and reporting entities, the Boards concluded that the conceptual framework need not (and should not) provide any guidance on which entities should be encouraged to prepare GPEFR, such as guidance on when an entity should be disaggregated into several reporting entities. That would be a matter for others to determine (for example, regulators, legislators, investors, creditors or the entity itself).

GROUP REPORTING ENTITY

Introduction

25. In the previous section, the discussion focused on what constitutes an individual entity, for financial reporting purposes.

26. However, in accounting practice, it has long been common for group or consolidated financial statements to be prepared, in which the results and activities of two or more entities (such as two or more companies) are consolidated or combined together, and presented as a single, economic entity.[5]

27. 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.[6]

28. In general, the concept of control is used as the basis for determining which entities should be included in group financial statements. That is, broadly speaking, a group comprises an entity and other entities under its control (or in which the first entity has a controlling financial interest).

29. Even though there has been a long-established practice of preparing consolidated financial statements, questions continue to arise about that practice, including questions that are relevant to the conceptual framework project, such as:

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[5] The term *economic entity* is often used to describe a group entity for financial reporting purposes because, typically, a group entity is not a legal entity.

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

a. Is control, as the basis for consolidation, the most appropriate way of serving user information needs?

b. How does the concept of control, in the context of one entity having control over another, relate to the concept of control, in the context of the asset definition?

c. What is the entity that is the subject matter of "parent-only" financial statements and "consolidated" financial statements? In particular, do the two sets of financial statements relate to the *same* entity (the parent entity) or do they relate to two different entities (the parent entity and the group entity)?

d. [What about the parent company approach? See Agenda Paper 8A, FASB Memorandum 45.]

30. [Explain here that the discussion starts with looking at conceptual issues relating to the existing conceptual frameworks and current accounting practice, to understand more about "where we are now". A clearer picture of the concepts or thinking underlying current accounting practice helps to provide a starting point. For example, it helps to establish what concepts or practices are—and are not—relevant to determining the composition of a group entity. The discussion then moves on to considering what approach should be taken in the Boards' common conceptual framework to determining the boundaries (or composition) of a group entity for the purposes of GPEFR. An outline of the various sub-sections will be included. The current structure is as follows:

a. Conceptual issues relating to current practice

   - control over entity versus control over assets—which determines the boundary (or composition) of the group entity?
   - parent/group entity views
   - parent company approach
   - summary of above, including what is—and isn't—relevant to determining the composition of a group entity.

b. Determining the composition of a group entity

   - User information needs
   - Meaning of control
   - Group entity models (controlling entity model, common control model, risks and rewards model)]

Control over entity versus control over assets—which determines the boundary (or composition) of the group entity?

31. At present, control is used both in the asset definition in existing conceptual frameworks (including the two Boards' frameworks) and in accounting standards for determining the composition of a group entity.

32. At present, assets are defined in terms of "things" the entity controls—those "things" are variously described as resources, economic resources, future economic benefits, or rights to future economic benefits. Control (in some form) is also used to determine the composition of a group entity. That is, a group entity comprises the parent entity and other entities under its control.

33. The fact that the control concept is used in two ways raises questions about the relationship between the two. For example, if control (or some similar notion) is used in the asset definition, does that imply that control also must be used as the basis for consolidation? This question itself raises another question—is the asset definition relevant to determining the composition of a group entity?

34. At present, under some thinking about the group entity and consolidated financial statements, it seems to be the asset definition that is driving the determination of the boundaries (or composition) of the group entity. This line of reasoning can be seen in the UK Statement of Principles' discussion of the boundaries of a group entity:

> An entity indirectly controls an asset if it has control of an entity that has direct control of the asset…Direct plus indirect control is used to determine the boundary of the reporting entity that prepares consolidated financial statements. Those financial statements will deal with the gains, losses, assets and liabilities directly controlled or borne by the entity as well as those that are indirectly controlled or borne by the entity through its control of other entities." [SoP, paragraphs 2.4(b) and 2.6(b), footnote omitted]

35. Under this approach to determining what constitutes a group entity and the current definition of assets, it seems that the control concept must be used to determine the boundary (or composition) of a group entity, otherwise the process of consolidating the subsidiary's assets into the group financial statements would result in the parent/group entity reporting things that were not under its control and therefore did not meet the definition of an asset.

36. Furthermore, under this approach, it seems that any change to the asset definition might also change the composition of the parent/group entity. Thus, under this approach, the

Boards would need to first reach some conclusions about how to define assets. Once the Boards have agreed on the asset definition, it would then be a matter of considering in what circumstances the assets of one entity (the subsidiary) are also the assets of another entity (the parent/group entity).

37. Indeed, under this approach, it *appears* there may be no need for a reporting entity concept as such. In other words, it could be argued that there is no need to consider the question of when two or more *entities* should be consolidated or combined together, to form a group entity. Rather, all that is required is guidance on how to apply the asset definition in particular circumstances.

38. However, the asset definition (in the existing frameworks and in the work to date in Phase B of the conceptual framework project) refers to an "entity", so it seems circular to use the asset definition to determine what constitutes the "entity". (The same comment also applies to the definition of liabilities and other elements.)

39. Also, for something to meet the definition of an asset, it must be associated with a particular entity. Hence, each particular "asset" is an asset of one particular entity. Even if two or more entities have a shared interest in a particular economic resource, such as land, the "asset" of each entity represents that particular entity's rights to (or share of) that economic resource. Given that each particular asset is the asset of one particular entity, it follows that the only way for two entities to report the *same* items as assets is for one entity to be part of the other entity. In other words, one *entity* is subsumed within the other entity.

40. In turn, for it to be reasonable to regard one entity as being part of another entity, when the second entity has its own separate legal existence (e.g., when the second entity is a company), there must be some basis for setting aside the separate legal existence of the second entity.

41. At present, it is control, in the context of one entity having control over another entity, which is being used as the basis for setting aside the separate legal existence of the subsidiary entity. In other words, before being able to conclude that one entity has control over another entity's *assets*, one must first conclude that the first entity has control over the second *entity*. In the absence of such a relationship between the two entities, it would be conceptually inconsistent for two entities to both report the same assets (the parent/group entity and the subsidiary entity).

42. Therefore, although it might appear that, at present, control in the context of the asset definition is driving the determination of the boundary (or composition) of a parent/group entity, in fact it is the control relationship between the two *entities* (parent entity and subsidiary entity) that is the determining factor.

43. Accordingly, to be consistent with the asset definition (and the definitions of other elements), 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.

44. Before considering how we should determine the entity that is reporting (in particular, which entities to include within the group), the next section considers another conceptual issue relating to accounting practice today—the relationship between the parent entity and group entity, and the implications for parent-only and consolidated financial statements.

Parent/group entity view—what is the relationship between the parent entity and group entity?

45. [Introductory comments to be included here. For example, explain that accounting practice varies across different jurisdictions and different types of entities—sometimes consolidated financial statements are prepared while parent-only financial statements are not, sometimes both sets of financial statements are prepared, and sometimes parent-only financial statements are prepared while consolidated financial statements are not. This raises the question of to which entity do the parent-only and consolidated financial statements relate? For example, are the parent-only entity and the group entity one and the same entity? Or two different entities? Similarly, the previous section argued that, for the parent/group entity and the subsidiary entity to both report the same things as assets, then the subsidiary entity must be part of another entity—but is that other entity the parent entity? Or is it the group entity, as distinct from the parent entity?]

46. For the purposes of the discussion below, the control concept is used to determine when the separate legal existence of an entity should be set aside, such that the subsidiary entity is regarded as being part of another entity. Consider two entities, Company X and Company Y. Assume that Company X has control over Company Y.

View 1: One Entity – Two Alternative Displays

47. Under this approach, the parent entity (Company X) and the group entity are regarded as being one and the same entity. Company Y (the subsidiary) is regarded as being *part of* Company X (the parent), for the purposes of the parent entity's financial reporting. (The subsidiary may also prepare its own general purpose external financial reports.)

48. In addition, under this approach, the consolidated financial statements are regarded as being an alternative way of presenting information about the *same set* of assets, liabilities and activities that appear in the parent-only financial statements. In other words, the investment asset (holding in Company Y) reported in the parent-only financial statements is a combined (or summarised) amount, which comprises all the assets and liabilities of Company Y that are presented separately in the consolidated financial statements. Therefore, both the parent-only financial statements and the consolidated financial statements include all of the assets, liabilities, and activities under the control of the parent entity; the difference is whether those assets and liabilities are presented separately as gross amounts, or combined into a single, net amount. We commonly present summarised information about assets and liabilities in the financial statements—so this could be viewed as another example of summarisation.

49. 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. It would be a standards-level issue to determine which presentation approach (i.e., net or gross) should be followed. In other words, it would be a standards-level issue to determine which presentation method would best meet users' information needs.[7]

50. The approach has been described as "One Entity – Two Alternative Displays". It should be noted that some would support the conclusion that the parent and the group are the same entity, and that there are two alternative ways of presenting information about that entity, but might use a somewhat different rationale to arrive at that conclusion.

51. In particular, some would draw a distinction between the parent as a *legal* entity and the parent as an *economic* entity. That is, in legal terms, Company X and Company Y are regarded as two separate entities, while in economic terms, Company Y is regarded as being part of Company X. Thus, the consolidated financial statements relate to the parent

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[7] 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.

as an economic entity, and therefore include information about its assets, liabilities and activities, in economic terms. Conversely, the parent-only financial statements relate to the parent as a legal entity, and therefore present information about its assets, liabilities and activities, in legal terms.

52. However, it should be noted that the rationale in paragraph 51 would require two different reporting entity concepts—one based on legal considerations and another based on economic considerations. It also seems inconsistent with the approach taken to defining elements (in the Boards' existing frameworks, the frameworks of other standard-setters and the work to date in Phase B of the framework project). For example, there is only one definition of assets, not two—an entity's GPEFR will include information about its *assets*, not information about *legal assets* in one set of financial statements and information about *economic assets* in another set of financial statements.

53. Therefore, the discussion of View 1 in the remainder of this paper focuses on the first rationale set out above, in which parent-only and consolidated financial statements are regarded as two alternative presentations about the same entity (both in legal and economic terms).

View 2: One Entity – One Display

54. This view is similar to the one described above, in that the parent entity and the group entity are regarded as being one and the same entity. Company Y (the subsidiary) is regarded as being *part of* Company X (the parent).

55. However, in contrast to View 1, the consolidated financial statements are regarded as presenting information about a *different set* of assets and liabilities than the set of assets and liabilities that appear in the parent-only financial statements. The consolidated financial statements include all the assets and liabilities of the subsidiaries, which do not appear in the parent-only financial statements. The parent-only financial statements therefore omit assets and liabilities of the parent/group entity.

56. In other words, View 2 rejects the view of View 1 that the investment asset reported in the parent-only financial statements is a summarised amount, comprising the assets and liabilities that are presented separately in the consolidated financial statements. Furthermore, even if that view was accepted, presenting those assets and liabilities as a single net amount would not be regarded as a relevant or faithful representation of the parent entity's assets and liabilities. Although assets and liabilities are commonly aggregated and presented as summarised amounts in the financial statements, they are not

offset.[8] For example, the assets and liabilities in a disposal group might be separated from other assets and liabilities, and aggregated, but those highly aggregated amounts of assets and liabilities are not offset and presented as a net amount.[9] To do so would result in the understatement of the parent entity's total assets and total liabilities.

57. Hence, under View 2, the parent-only financial statements are not regarded as being general purpose external financial reports—those financial statements fail to meet the objective of GPEFR and qualitative characteristics of decision-useful information, because they fail to include relevant and complete information about all of the assets, liabilities and activities of the entity. Therefore, under this approach, the consolidated financial statements are, in concept, 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.

View 3: Multiple entities

58. 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, Company Y (the subsidiary) is regarded as being an entity in its own right that is separate from—rather than part of—Company X (the parent). The group entity for financial reporting purposes is formed by combining two separate entities (Company X and Company Y), and presenting the results of that combination as a single, economic entity (Group XY).

59. Thus, the subsidiary is not part of the parent—rather, both the parent and the subsidiary are part of the group. Similarly, the subsidiary's assets are not assets of the parent—rather, the subsidiary's assets and the parent's assets are part of the group's assets.

60. Under this approach, the parent-only financial statements relate to the parent entity (Company X). The consolidated financial statements relate to the group entity (Group XY). Hence, both sets of financial statements are regarded as general purpose external financial reports, which relate to two different entities. If the parent entity chooses to, is required to (e.g., by a regulator), prepare GPEFR, the relevant accounting standard would determine whether that parent entity should prepare:

[8] There is at least one exception in accounting practice, involving monetary assets and monetary liabilities, where the counterparty is the same for both the asset and liability, and there is a right of set-off.
[9] For example, see IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*, paragraph 38; SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, paragraph 46.

a. Financial statements that relate to the parent entity;

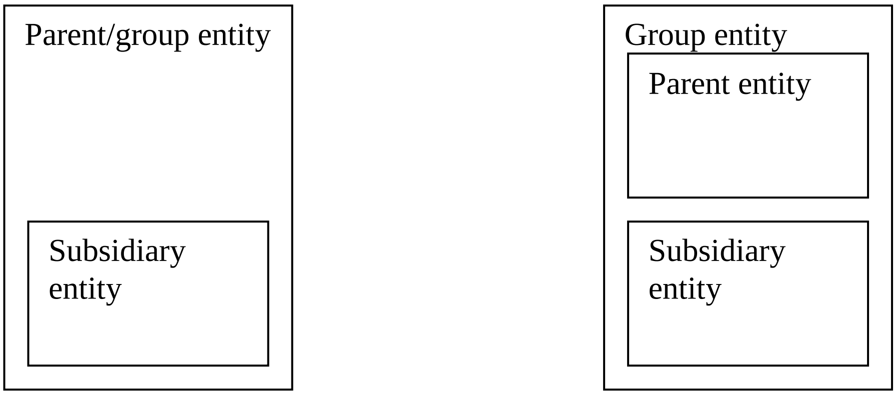
b. Financial statements that relate to the group entity, comprising the parent entity and other entities under its control; or

c. Financial statements for both the parent entity and the group entity.

Discussion of Views 1, 2 and 3

61. The key difference between the various parent/group entity views is that Views 1 and 2 both regard the parent and the group as the same entity, whereas View 3 regards the parent and group as being different entities. The relationship can be viewed diagrammatically, as follows:

Views 1 and 2 **View 3**



62. Hence, under Views 1 and 2, there are potentially two reporting entities that could prepare GPEFR: the parent/group entity and the subsidiary entity. Under View 3, there are potentially three reporting entities that could prepare GPEFR: the parent entity, the subsidiary entity and the group entity.

63. Proponents of Views 1 or 2 argue that, although a parent entity and subsidiary entity might be separate legal entities, the legal boundary between the parent entity and subsidiary entity is a matter of legal form, rather than economic substance. In particular, the parent entity's control over the subsidiary entity enables the parent entity to utilise or deal with the subsidiary entity's assets as if they were the parent's own assets. Therefore, to enable the parent entity's financial reports to present a complete and faithful representation of the parent entity's assets, liabilities and activities, the subsidiary entity's separate legal existence should be set aside. Instead, the subsidiary entity should be regarded as being part of the parent entity, akin to an unincorporated branch (the treatment of unincorporated

branches is considered later). Thus, under View 1 and View 2, the parent entity and the group entity are one and the same entity.

64. In contrast, proponents of View 3 argue that, when the subsidiary entity has a separate legal existence, that separate existence is not merely a matter of legal form, but is a matter of economic reality. For example, even through the parent's control over the subsidiary would give it power over the subsidiary's assets, the parent does not have access to all of the benefits from those assets—the parent usually has only a residual interest, being the amount that remains after the other claimants to the subsidiary's assets have been satisfied. Similarly, the parent entity often has no obligation in respect of the subsidiary entity's creditors. Therefore, it is not representationally faithful to treat the subsidiary entity as being part of the parent entity. Rather, it is more representationally faithful to regard the existence of the control relationship between the two entities as indicating the existence of another, larger entity—a group entity—that encompasses both the parent entity and subsidiary entity.

<u>User information needs</u>

65. In deciding which approach is appropriate, it is helpful to consider user information needs. [Explain here that the discussion focuses on the primary user group, as identified in the Phase A document, i.e., present and potential investors and creditors.]

66. Generally speaking, investors and creditors make decisions about allocating funds to individual entities (such as individual companies). That is, usually investors invest funds in, and creditors advanced funds to, individual entities, not group entities. Even when an investment or credit decision is related to a group of entities (for example, where a lender advances funds to a group of entities, with each entity guaranteeing the loans of the other entities), typically the investors' or creditors' claim relates to each of the entities within the group, not against the group entity per se.

67. In the case of a parent entity with a single subsidiary, which is not wholly-owned, there are potentially four different groups of present and potential investors and creditors:

a. Present and potential investors of the parent entity

b. Present and potential creditors of the parent entity

c. Present and potential investors of the subsidiary entity, other than the parent entity (i.e. non-controlling interests)

d. Present and potential creditors of the subsidiary entity.

68. The latter two groups of users (present and potential investors and creditors of the subsidiary entity) are most likely to be most interested in information about the subsidiary entity. For example, for a highly-leveraged subsidiary entity, and/or one that has many shareholders other than the parent entity, there may be a large number of external users that are interested in information about the subsidiary entity. Thus, they would be interested in the financial statements/reports of the subsidiary entity.

69. The first and second groups of users (present and potential investors and creditors of the parent entity) would likely be interested in information in the consolidated financial statements. The cash flows from the controlled entity (the subsidiary) to the controlling entity (the parent), and eventually to the parent's investors and creditors, depend significantly on the subsidiary's activities and the parent's actions in directing those activities. [Include more discussion here.]

70. In addition, users might also be interested in the information contained in parent-only financial statements. In particular, present and potential creditors of the parent entity might be interested in information about the parent entity's investment in other entities, as distinct from the underlying assets, liabilities and activities of the subsidiaries. For example, for a highly-leveraged parent entity, there may be many external users that are interested in this information. This is because the creditors have a claim against the assets of the parent entity, not the assets of the subsidiary entity. Also, the parent-only financial statements would present information about the parent entity's cash flows, including cash flows from the subsidiary to the parent (such as dividends), which may be useful in assessing the parent entity's ability to settle creditors' claims in the normal course of business.

71. [Some concluding comments here?]

<u>Implications for parent-only and consolidated financial statements</u>

72. The difference between the parent/group entity views discussed above primarily affects which set of financial statements (parent-only financial statements or consolidated financial statements) are regarded as being GPEFR. Each entity that is required to (or chooses to) prepare general purpose external financial reports would prepare a single set of GPEFR. [Include discussion here from Phase A document, where the Boards concluded that the concepts in their common framework (and hence the accounting standards based

upon that framework) should relate to a single set of general purpose external financial reports.[10]]

73. Therefore:

a. Under View 1 (One Entity – Two Alternative Displays), the parent entity's GPEFR would be *either* the parent-only financial statements *or* the consolidated financial statements, but *not both*. If the relevant accounting standard required consolidated financial statements to be prepared, then parent-only financial statements could be prepared as supplementary information, but not as the parent entity's GPEFR. The reverse applies if the relevant accounting standard required parent-only financial statements to be prepared.

b. Under View 2 (One Entity – One Display), in concept, the parent entity's GPEFR always would be the consolidated financial statements, not the parent-only financial statements. The parent-only financial statements could be prepared as supplementary information, in addition to the consolidated financial statements, but not instead of the consolidated financial statements, and could not be described as being the parent entity's GPEFR. In other words, View 2 rules out, at the conceptual level, the possibility that a parent-only entity could be the subject matter of general purpose external financial reports. Therefore, at the standards-level, it would place a heavy burden on the Boards to explain why an exception to consolidation might be permitted in a given set of circumstances.

c. Under View 3 (Multiple Entities), both parent-only financial statements and consolidated financial statements could be prepared. Both sets of financial statements would be GPEFR, as they relate to two different entities.

<u>Implications for unincorporated branches</u>

74. The above discussion took place in the context of subsidiary entities that have a separate legal existence, such as a company. However, not all entities for financial reporting purposes have a separate legal existence. As noted earlier, the Boards have concluded that legal existence is a sufficient condition for concluding that an entity exists, but is a not necessary condition. This raises the issue of how entities that have no separate legal existence would be treated under the various approaches. For example, consider a company with an unincorporated branch.

[10] See paragraphs BC1.18-BC1.22 of the Preliminary Views document, *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Information*.

75. Under View 1 and 2, the branch entity is part of the wider entity, the company. The next issue is how that branch entity's assets, liabilities and activities should be presented in the company's GPEFR.

76. Under View 1, there are two ways of looking at this issue. Some might argue that the presentation approach should be the same as that adopted for incorporated subsidiaries. That is, it would be a standards-level issue to determine whether a net or gross presentation should be followed. More specifically, it would be a standards-level issue to determine whether the company should report its net investment in the branch (and its net return from the branch) or the assets, liabilities, revenues and expenses of the branch entity.

77. However, others might argue that, although an incorporated subsidiary is regarded as being *akin to* a branch under View 1, in that both are regarded as being part of the parent entity, there is an important difference between an incorporated subsidiary and an unincorporated branch, which affects how information about each is presented. In the case of an incorporated subsidiary, the parent entity usually holds equity securities (such as shares) in the subsidiary entity. Thus, when reporting information about the incorporated subsidiary, the presentation issue to be addressed is whether the parent entity should report (a) the investment asset (the equity securities held) and returns on that investment or (b) the underlying assets, liabilities and activities of the subsidiary. However, in the case of an unincorporated branch, the parent does not hold equity securities in the branch, and hence there is no investment asset corresponding to the parent's net investment in the branch. Accordingly, the assets, liabilities and activities of a branch entity should be reported on a gross basis in the parent's financial statements, irrespective of the parent entity prepares parent-only financial statements or consolidated financial statements.

78. Under View 2, in concept, the assets, liabilities and activities of the branch entity would always be reported gross, in the same manner as the assets, liabilities and activities of a subsidiary entity. In other words, under View 2, no distinction is drawn between an unincorporated branch and an incorporated subsidiary.

79. Under View 3, there are two possible ways of addressing this issue, similar to View 1. On the one hand, it could be argued that if a branch is an entity (as distinct from the wider legal entity) for the purposes of preparing GPEFR for the branch entity, then the branch should also be treated as being separate from—rather than part of—the parent entity for the purposes of the parent entity's GPEFR. In other words, the parent entity (in *its* financial statements, as distinct from the group entity's financial statements) should report its net investment in the branch rather than the assets and liabilities of the branch.

80. However, View 3 regards the subsidiary entity as being separate from the parent entity on the grounds that when a subsidiary entity has a separate legal existence, that separate existence is a matter of economic reality, not merely a matter of legal form (see paragraph 64). This argument does not hold true in the case of an unincorporated branch. Therefore, it could be argued that, under View 3, it makes a difference whether the subsidiary has a separate legal existence, because it affects the relationship between the parent and the branch/subsidiary. In particular, it changes whether the assets and liabilities of the branch/subsidiary entity meet the definitions of elements when viewed from the perspective of the parent entity. In effect, a subsidiary entity is *separate from* the parent entity, whereas a branch entity is *part of* the parent entity. Accordingly, the gross amounts for the assets, liabilities of the branch would be reported, in both the parent entity's financial statements and the group entity's financial statements.

<u>Summary and Boards' discussions</u>

81. [Summarise above and insert results of Boards' discussions:

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

b. Majority of FASB members prefer View 2, with a minority supporting View 3.]

Parent company approach

82. [Insert discussion here, if the Boards agree to cover this topic in the Discussion Paper. Refer to IASB Agenda Paper 8A, FASB Memorandum 45.]

Summary of discussion of conceptual issues relating to current practice

83. [Summarise here the above discussion of:

a. Control concept – control over assets versus control over entities

b. Parent/group entity views

c. Parent company approach.]

84. [Include here discussion on what is, and is not, relevant to developing a reporting entity concept for the Boards' common framework:

a. The definition of assets is not relevant to determining the composition or boundary of a group entity – rather, we need to first the "entity" that is reporting, and then apply the asset definition to that entity. This means first determining when the legal boundary between one entity and another should be set aside, for the purposes of determining which entities are part of a group entity.

b. The parent entity versus group entity views are relevant – this determines the status of parent-only financial statements, e.g., whether they can be GPEFR. It also has implications for other standards-level issues, such as describing the informational objective in an accounting standard on consolidations, as discussed in Agenda Paper 8B, FASB Memorandum 46.

c. The parent company approach is not relevant – it focuses on presentation of information in the consolidated financial statements, not the determination of which entities to consolidate.]

85. [Comments here to explain that this concludes the discussion of conceptual issues relating to current practice. Now move on the discuss issues relating to determining the composition of the group for the reporting entity concept to be included in the common conceptual framework.]

Group reporting entity – determining the composition of the group

86. [Introductory comments, including outline of section. Current structure is as follows:

a. User information needs—should the composition of the group entity be left to users to determine?

b. Concept of control—what does control mean?

c. Group entity models—what should be the unifying factor for determining the composition of a group entity?

  i. Controlling entity model

  ii. Common control model

  iii. Risks and rewards model

d. Boards' discussion of group entity models]

User information needs—should the composition of the group entity be left to users to determine?

87. The Boards' tentative decision about the objective of financial reporting is as follows:

> The objective of general purpose external financial reporting is to provide information that is useful to present and potential investors and creditors and others in making investment, credit, and similar resource allocation decisions**.** [OB2]

> To help achieve its objective, financial reporting should provide information to help present and potential investors and creditors and others to assess the amounts, timing, and uncertainty of the entity's future cash inflows and outflows (the entity's future cash flows). That information is essential in assessing an entity's ability to generate net cash inflows and thus to provide returns to investors and creditors. [OB 3]

88. As noted earlier, generally speaking, investors and creditors make decisions about allocating funds to individual entities (such as individual companies). That is, usually investors invest funds in, and creditors advanced funds to, individual entities, not group entities.

89. However, an entity might have a variety of interests in, or relationships with, other entities. Because of this, the financial statements of the entity alone may be insufficient to satisfy user information needs. It is for this reason that the accounting practice of preparing consolidated financial statements evolved.

90. As noted earlier [insert reference], despite the long-established practice of preparing consolidated financial statements, questions continue to arise about that practice, including questions about whether control—or something else—should be used as the basis for determining which entities to include in group financial statements.

91. To be consistent with the objective of financial reporting, the question we are seeking to answer is: "what approach would best suit users' information needs?"

92. Some might argue that, at the conceptual level, there is no need to answer that question. For example, it might be argued that the conceptual framework should simply say that a group reporting entity consists of a combination of entities about which users require information.

93. However, there are problems with leaving this up to users to decide:

    a. Leaving it up to users to decide assumes that all users are in a position to demand what they want. There could be users who would like financial statements to be prepared for a particular group, but are not in a position to demand that information. That is why GPEFR are prepared—to provide general purpose information to users who *cannot* demand information for their specific information needs. So if an entity is required to prepare GPEFR in accordance with GAAP (e.g. because of a legislative requirement) or chooses to do so, then it would be a matter for GAAP to establish reporting requirements for that entity. In particular, GAAP would need to establish (i) whether group financial statements should be prepared and (ii) which entities to include in the group.

b. Even for users who do have the power to demand what they want, some of those users might say that they want GPEFR prepared in accordance with GAAP. If so, the same conclusions as in paragraph (a) apply—GAAP would need to establish whether group financial statements should be prepared and which entities to include in the group.

94. Essentially, we need a basis for determining when two or more entities should be consolidated or combined into a group entity. We need something that binds the group together, i.e., a *unifying factor*.

95. However, once an agreed-upon unifying factor has been established, does that mean all other potential unifying factors are rejected, for the purposes of GPEFR? Some could argue that GAAP should provide guidance on when two or more entities *must be* combined together, to form a group reporting entity, but should not rule other possible combinations. It could be argued that this is consistent with the Boards' earlier conclusion that an individual reporting entity is any entity that is required to, or chooses to, prepare GPEFR. That is, it could be argued that a group reporting entity should comprise any combination of entities that is required to, or chooses to, prepare group GPEFR.

96. However, this would mean applying more than one unifying factor when determining the composition of the group. That is, if the conceptual framework (or accounting standards) determines which entities must be included in the group, then excluding any of those entities would not be in accordance with GAAP. Therefore, another unifying factor could be used only as a supplementary unifying factor, not as a substitute for the unifying factor specified in the conceptual framework (or accounting standards). This would entail including additional entities within the group on the basis of the supplementary unifying factor.

97. However, such an approach likely would be confusing to users of group financial statements/reports. If more than one unifying factor is applied—and different supplementary unifying factors are applied by different entities—then there will be no clear, single notion of what constitutes a group entity.

98. Therefore, the remainder of this paper focuses on determining what the single, unifying factor should be.

99. Given that an entity may have a variety of interests in, or relationships with, other entities, there are likely to be a variety of ways of combining entities together to form a group reporting entity. However, rather than explore every conceivable approach, this paper

focuses on three approaches that seem reasonable candidates, either because they are similar to the approach already in use (such as the controlling entity model) or have been suggested as a replacement for the current approach (such as the risks and rewards model).

100. The following approaches are discussed in this paper:

a. Controlling entity model

b. Common control model

c. Risks and/or rewards model

101. Since two of these approaches involve control, the concept of control is first considered.

Concept of control—what does control mean?

102. This section considers the definition of control and issues relating to determining when one entity has control over another. It also considers various other control issues. [Further introductory comments to be included here. It should be noted that this section includes the various control issues that the Boards have discussed and agreed should be addressed at the concepts level. The section probably needs restructuring, to ensure a logical flow.]

<u>Definition of control</u>

103. In its ordinary sense, control is defined as follows:

> The fact of controlling, or of checking and directing action; the function or power of directing and regulating; domination, command, sway. [Oxford English Dictionary, Second Edition, 1989.]

104. Control therefore may be viewed as a synonym for power, in particular, the power to direct something. Some accounting definitions[11] also define (or proposed to define) control as a synonym for power, for example:

> **Control** of an enterprise is the continuing power to determine its strategic operating, investing and financing policies without the co-operation of others. [CICA Handbook, Section 1590, *Subsidiaries*, paragraph .03]

> Control of an entity is power over its assets—power to use or direct the use of the individual assets of another entity in essentially the same ways as the controlling entity can use its own assets. [1995 FASB Exposure Draft, *Consolidated Financial Statements: Policies and Procedures*, paragraph 10.]

105. However, most accounting definitions of control refer not only to power over another entity, but also to benefits obtained from that entity. For example:

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[11] This paper focuses on the meaning of control for accounting purposes, and therefore draws on definitions of control found in accounting standards and accounting conceptual frameworks. Other sources of definitions of control include companies' legislation, securities' regulations, and legal and economics' literature.

Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. [IAS 27, *Consolidated and Separate Financial Statements*, paragraph 4.]

"Control" by one entity over another entity exists in circumstances where the following parts (a) and (b) are both satisfied:

(a) the first entity has the capacity to determine the financing and operating policies that guide the activities of the second entity…

(b) the first entity has an entitlement to a significant level of current or future ownership benefits, including the reduction of ownership losses, which arise from the activities of the second entity.

[NZ FRS-37, *Consolidating Investments in Subsidiaries*, paragraph 4.13]

The ability of an undertaking to direct the financial and operating policies of another undertaking with a view to gaining economic benefits from its activities. [UK FRS 2, *Accounting for Subsidiary Undertakings*, paragraph 6]

Control—the ability of an entity to direct the policies and management that guide the ongoing activities of another entity so as to increase its benefits and limit its losses from that other entity's activities…. [1999 FASB Exposure Draft, *Consolidated Financial Statements: Purpose and Policy*, paragraph 6(a).]

106. Similarly, even though the Canadian definition shown above does not explicitly refer to benefits, its explanatory material adds:

The right and ability of the parent to obtain future economic benefits from the resources of an enterprise that it controls and the parent's exposure to the related risks are *necessary characteristics* of a parent-subsidiary relationship. [CICA Handbook, Section 1590, *Subsidiaries*, paragraph .04, emphasis added.]

107. The UK Statement of Principles (SoP) explains the meaning of control, both in general and in the context of control of another entity. In both cases, the ability to benefit is a necessary component of control:

Control has two aspects: the ability to deploy the economic resources involved and the ability to benefit (or to suffer) from their deployment. To have control, an entity must have both these abilities.

An entity will have control of a second entity if it has the ability to direct that entity's operating and financial policies with a view to gaining economic benefit from its activities. [SoP, paragraphs 2.8 and 2.11]

108. The reason for including a benefits element, rather than simply defining control as a synonym for power, is to exclude situations in which an entity might have power of another entity as a trustee or agent. For example, the SoP, after defining control as requiring both the ability to deploy economic resources and the ability to benefit from their deployment, then explains:

This can be contrasted with the position in a trusteeship or agency arrangement, where the abilities are held by different parties. For example, in a trusteeship, the

> trustee…has the power to deploy the trust's resources whilst the beneficiaries benefit from their deployment. (SoP, paragraph 2.9)

109. Of course, a trustee or agent might have the ability to obtain some benefits, such as a commission or fee. However, the primary responsibility of a trustee or agent is to use their power over another entity not to benefit the trustee or agent themselves, but to benefit the trust's *beneficiaries* or agent's *principal*. Hence, most definitions of control link the power element with the benefits element, such that control entails an entity using its power for its *own* benefit.

110. In addition, most accounting definitions of control refer to *benefits*[12] or to *economic benefits*[13], rather than to specific types of benefits. Similarly, any accompanying explanatory material does not limit benefits or economic benefits to particular types of benefits. For example, the Canadian definition refers to economic benefits and provides examples comprising dividends, interest, fees, royalties, and profits on inter-company sales.[14]

111. Furthermore, existing definitions of control typically do not specify any minimum level of economic benefits that is required to satisfy the benefits element of the control definition.[15]

112. A possible exception is control in the context of SPEs, as some accounting standards refer to the majority of benefits in such situations. This issue is considered later (paragraphs 143–157).

113. After considering the above, the Boards concluded:

    a. the definition of control should include both a power element and a benefits element, together with a link between the two;

    b. the power element should relate to the ability to direct the financing and operating policies of the entity;

    c. the benefits element should refer broadly to benefits or economic benefits, and no minimum level of benefits should be specified.

114. The following is a working definition of control:

> 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).

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[12] For example, IAS 27, 1999 FASB ED.
[13] For example, the SoP, UK FRS-2, and the Canadian Handbook (Section 1590).
[14] CICA Handbook, Section 1590, paragraph .04.
[15] For example, the SoP, IAS 27, UK FRS-2, and the Canadian Handbook (Section 1590).

Determining when one entity has control over another

115. Both SAC 1 and the SoP note that determining when one entity controls another entity involves an assessment of all the facts and circumstances; there is no single fact or circumstance that demonstrates that one entity has control over another in all cases.[16]

116. Similarly, accounting standards that define control contain discussion of a variety of factors to consider when assessing whether one entity controls another.[17]

117. One exception is ARB No. 51, *Consolidated Financial Statements*, which does not define control or discuss a variety of factors to consider when assessing control. Rather, it states:

> The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one company, directly or indirectly, of over fifty percent of the outstanding voting shares of another company is a condition pointing toward consolidation. [Paragraph 2.]

118. Ownership of a majority of the voting interest is expressed as being the *usual* condition for a controlling financial interest. However, in U.S. practice, it has sometimes been interpreted as being a *necessary* condition.[18] (That is not, however, the view acknowledged by the FASB in 1987 when it said that "ownership of a majority voting interest…is the most common but not the only means of controlling a subsidiary.")[19] U.S. practice contrasts with other accounting standards, in which ownership of a majority of the voting interest is not a necessary condition, as control can exist through other means. For example, IAS 27 lists other situations in which control exists even though the parent owns half or less of the voting power of another entity.[20] Similarly, the SoP notes:

> Although control of another entity has traditionally involved share ownership and voting rights, that need not be the case. (SoP, paragraph 2.12)

119. The Boards concluded that whether one entity has control over another entity involves an assessment of *all* the *present* facts and circumstances. Therefore:

a. there is no single fact or circumstance that evidences that an entity has control over another entity in all cases, nor should one particular fact or circumstance—such as ownership of a majority voting interest—be regarded as a necessary condition for control to exist;[21]

[16] SAC 1, paragraph 17; SoP, paragraphs 2.12 to 2.15.
[17] Examples include accounting standards in Australia, Canada, New Zealand and the UK; IAS 27; and the proposals in the 1995 and 1999 FASB Exposure Drafts.
[18] However, it is not necessarily a *sufficient* condition, because having a majority voting interest does not guarantee control, for example, in bankruptcies or foreign expropriations.
[19] FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, paragraph 20.
[20] IAS 27, paragraph 13.
[21] Although ownership of a majority voting interest is not a *necessary* condition for control to exist, typically it would be a *sufficient* condition.

b. the concept of control does not exclude situations in which control exists but it might be temporary.

Control other than by legal rights

120. The working definition of control discussed earlier (insert cross-reference) refers to *the ability* to direct the financing and operating policies of the other entity. There might be situations in which the entity has that ability, because of particular circumstances, rather than because of (or solely because of) legal rights held by the entity. (This is sometimes referred to as *de facto control* or *effective control*.)

121. The Boards concluded that the control concept in the conceptual framework should not be limited to circumstances in which the entity has sufficient voting rights or other legal rights to direct the financing and operating policies of another entity, but should be a broad concept that encompasses economically similar circumstances.

122. The Boards noted that such a concept may give rise to practical difficulties when applied in practice. However, any such practical difficulties, and what might be done to resolve those practical difficulties, are issues to be addressed at the standards level. In other words, the existence of practical difficulties does not negate the conclusion that, *in concept*, control should be sufficiently broad to encompass economically similar circumstances, regardless of whether the ability to control is through legal rights or other means.

Latent control and the treatment of options

123. The ASB's Statement of Principles notes that if the entity has the ability to control another entity, it is usually presumed that the first entity is exercising control, even if such control is not apparent.[22]

124. Some argue that latent control exists if the unilateral action by one entity will clearly place it in control of another, provided that the economic cost of that action is not so high that it would be irrational to take the action. Similarly, accounting standards typically require that potential voting rights be considered, when assessing whether control exists.[23]

125. For example, suppose Company A holds options over 100 percent of the ordinary shares in Company X, which are currently held by Company B. Does this give the option holder the *present* ability to control the entity?

[22] SoP, paragraph 2.18.
[23] For example, IAS 27, Canadian Handbook (Section 1590), AASB 1024, and NZ FRS-37.

126. The Boards concluded that, in the absence of other facts and circumstances, Company A does not presently control either the shares in Company X or Company X itself—Company A may have the ability to *take* control of those shares/Company X, but does not *at present* control the shares/Company X. Moreover, Company B has *present* control of both the shares and Company X.

127. In essence, the argument that holding an option (in and of itself) gives the option holder control of the underlying resource over which the option is held is to treat the exercise of the option as inconsequential. In other words, it treats the holding of an option and the holding of the underlying resource as substantially the same. However, this misrepresents the relationship between the option holder and the thing over which the option is held. The basic purpose of holding an option is to give the holder choice—whether to acquire the underlying or not. In the absence of other circumstances, until the option is exercised, the option holder does not have present control of the underlying resource. Similarly, an option to acquire voting rights does not give the option holder *present* control over those voting rights.

128. However, the conclusion that holding an option does not, in itself, give the option holder present control of another entity (or the underlying asset, in the case of options over assets), does not rule out the possibility that there might be situations in which the holding of options, *taken in conjunction with other facts and circumstances*, might lead to the conclusion that the option holder has present control over the other entity. This is because an assessment of whether one entity has control over another entity should be based on an assessment of *all* the facts and circumstances.

129. In other words, 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 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. In particular, there might be facts or circumstances that indicate that the "option" does not have all the usual economic characteristics of an option or that have that effect when considered in conjunction with the option.

Power is non-shared

130. Some accounting standards make it clear that to satisfy the power element, power cannot be shared with others. For example, NZ FRS-37 states:[24]

> The decision-making capacity that satisfies the power element of control must be unilateral. The capacity cannot be shared or divided such that it enables power to be exercised jointly by two or more partners or co-owners. The ability to participate with others in making decisions that guide the activities of another entity usually characterises joint venture relationships, which are covered under a separate financial reporting standard. [Paragraph 4.21]

131. The Boards agreed that, to satisfy the power element of the definition of control, power should be non-shared—an entity does not have power over another entity if the first entity must obtain the agreement of others to direct the financing and operating policies of the second entity. This does not imply that power must be *absolute*, that is, an entity is not required to have total, unrestricted power over another entity's financing and operating policies to satisfy the power element.[25] Rather, the point is that, to have the ability to direct another entity's financing and operating policies, the first entity must have that ability itself, rather than in conjunction with others.

Control, joint control and significant influence

132. As noted above, the Boards concluded that control is non-shared. In particular, to satisfy the power element of the definition of control, power must be non-shared—an entity does not have power over another entity if the first entity must obtain the agreement of others to direct the financing and operating policies of the second entity.

133. In contrast, what is referred to as "joint control" seems to include some notion of shared control, for example:

> Joint control is the contractually agreed sharing of control over an economic activity, and exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control (the venturers).[26]

134. In the case of joint ventures, whereby financing and operating policy decisions require unanimous consent of the venturers, it might be said that, *as a group*, the venturers control the joint venture. However, none of the individual venturers has control over that joint

[24] Other examples include AASB 1024 and Canadian Handbook (Section 1590).
[25] There often are limits on power that are imposed by law, regulations, fiduciary responsibilities and contractual rights. Those limits or restrictions are usually protective in nature, and do not usually deprive the controlling entity of the ability to direct the operating and financing policies of the controlled entity (NZ-FRS-37, paragraph 4.22; Canadian Handbook, Section 1590, paragraph .14; EITF Issue No. 96-16, "Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights"; 1995 FASB ED, paragraph 12; and the 1999 FASB ED, paragraph 12).
[26] IAS 31, *Interests in Joint Ventures*, paragraph 3.

venture. Therefore, the Boards concluded that the relationship between an individual venturer and the joint venture is not a control relationship.

135. Similarly, the Boards concluded that the relationship referred to as “significant influence” is not a control relationship. The fact that an entity might have some influence over the financing and operating policy decisions of another entity does not mean it has control over that entity.

Summary

136. [Summary of discussion on control to be included here.]

Group entity models—what should be the unifying factor for determining the composition of a group entity?

137. This section considers the three potential group entity models mentioned earlier:

a. Controlling entity model

b. Common control model

c. Risks and rewards model.

138. It is important to bear in mind that, when discussing control in the remainder of this paper, the working definition of control set out above is used, which contains both a power and a benefits element. That is, *control* is not a synonym for *power*.

Controlling entity model

139. The controlling entity model discussed in this section is broadly similar to the control model currently used today, but with control defined as set out above (i.e., including both a power element and a benefits element). Under this model, a group entity comprises the controlling entity (the parent) and other entities under its control (its subsidiaries). Hence, the group is united by the parent entity’s control over other entities.

140. The controlling entity model seems consistent with the objective of financial reporting. When one entity has control over another, it has the ability to direct the other entity’s financing and operating policies, so as to access benefits flowing from that entity (or to reduce the incidence of losses), and to increase, maintain or protect the amount of those benefits. The cash flows from the controlled entity (the subsidiary) to the controlling entity (the parent), and eventually to the parent’s investors and creditors, depend significantly on the subsidiary’s activities and the parent’s actions in directing those activities.

141. Therefore, to assist users in assessing the amounts, timing, and uncertainty of the parent's future cash inflows and outflows, they are likely to require more information than would be provided by the parent's (separate) financial statements alone, even when those financial statements are considered in conjunction with the financial statements of the subsidiary. In this situation, it seems reasonable to conclude that group financial statements would provide relevant information to assist those users in making investment, credit and similar resource allocation decisions.

142. Therefore, the controlling entity model is consistent with the objective of financial reporting. Hence, at the broadest level, the controlling entity model seems a reasonable approach to determining what constitutes a group entity for financial reporting purposes.

143. However, one issue that frequently arises—at least with the version of the controlling entity model that is used today—is whether it works well in the context of special purpose entities (SPEs).

144. Some would argue that the issue of applying a controlling entity model (no matter what definition of control is used) to SPEs is essentially a standards-level issue. In particular, if difficulties arise because of entity structures that have been established for accounting reasons (that is, to circumvent consolidation standards) rather than for commercial or economic reasons, then that does not imply that controlling entity model is flawed at the conceptual level.

145. Others argue that the problems encountered in practice are significant enough that they might be indicative of problems at the conceptual level. For the latter reason, it is worth giving some thought to SPEs.

146. It should be noted that the discussion below is a brief, high-level discussion of SPEs, which is appropriate for a conceptual framework project. Hence, it leaves unanswered many questions that would need to be addressed in a standards-level project.

147. Some say that, when accounting for SPEs, accounting standards seem more consistent with a risks and rewards model than a control model, because the emphasis seemingly shifts to looking at who benefits and who bears risks, rather than who has power over the entity. It could be argued that this indicates that the controlling entity model is flawed, because it has to be supplemented by another model in order to cope with SPEs.

148. However, there is another way of looking at this issue. As explained above, the working definition of control involves both a power element and a benefits element, together with a link between the two:

> 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).

149. In the case of special purpose entities, the entity may have predetermined financing and operating policies, that is, the SPE is on autopilot. In this situation, it may seem that no-one—including neither the entity that established the SPE nor the SPE's own "management" (or administrators)—has the present ability to direct the financing and operating policies of the entity (except perhaps to a very limited extent).

150. This differs from the situation in which the power element and the benefits element are clearly separated, that is, are held by different parties. For example, the trustees of a trust may have the ability to direct the financing and operating policies of the trust, while the ability to benefit from the activities of the trust lies with the beneficiaries. In contrast, for an SPE on autopilot, the issue is not the separation of power and benefits, but rather determining whether the power element exists and with whom power lies.

151. In this situation, in which there is little observable evidence for determining the existence of the power element, accounting standards may look to (or emphasise) the benefits element to determine whether the SPE is under the control of another entity.

152. For example, SIC-12, *Consolidation—Special Purpose Entities*, lists various circumstances that may indicate a relationship in which an entity controls an SPE:

> (a) in substance, the activities of the SPE are being conducted on behalf of the entity according to its specified business needs so that the entity obtains benefits from the SPE's operation;
>
> (b) in substance, the entity has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an 'autopilot' mechanism, has delegated these decision-making powers;
>
> (c) in substance, the entity has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE; or
>
> (d) in substance, the entity retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its operations. (SIC-12, paragraph 10).

153. In these circumstances, the focus is on benefits rather than power, and on the *majority* of benefits. A similar notion is applied in FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, which requires consolidation of a variable interest entity (VIE) in specified circumstances, including when the parent lacks the ability (through voting rights or similar rights) to make decisions about the VIE's activities that have a significant effect on the success of the VIE, but is the primary beneficiary of the VIE.

154. It could be that accounting standards focus on the *majority* of benefits to place some limits on which entities are consolidated, so that the net is not cast too wide. If so, it seems rather arbitrary—why 51% and not 49%, especially as the control model does not, in other circumstances, include any minimum level of benefits?

155. Another argument is that the predetermination of the financing and operating policies means that the major beneficiary does not need to have the ability to direct those policies in order to obtain or protect benefits flowing from the entity. In other words, if benefits can be obtained or protected without a need for decision-making powers, then the power element is irrelevant. A problem with this argument is that it is hard to know where to draw the line. For example, suppose one of the predetermined policies is that all surplus profits are automatically distributed to shareholders. Even a 1% shareholder would be able to obtain benefits in this situation, without the need for power over the entity.

156. However, there is another explanation for why accounting standards focus on the majority of benefits. It could be argued that there is an underlying assumption that whichever entity is entitled to the majority of benefits is likely to be the one in control. Typically, it is unusual to have a majority stake in another entity without some capacity to protect that stake. Hence, even though it otherwise might not be *apparent* that the major beneficiary has the ability to direct the financing and operating policies of the second entity, the holding of such a stake is, *in itself*, indicative that the major beneficiary does indeed have that ability.

157. On balance, the Boards concluded that the difficulties encountered in practice when applying the controlling entity model to SPEs are not necessarily indicative that the *concept* is flawed. However, before drawing any conclusions on the merits or otherwise of the controlling entity model, some alternative approaches to determining what constitutes a group entity for financial reporting purposes are considered.

<u>Common control model</u>

158. There are some examples in accounting practice in which *combined* financial statements are prepared, which combine the results and activities of commonly controlled entities. In contrast to *consolidated* financial statements, combined financial statements do not include the controlling party (a parent) as part of the group reporting entity. For example, ARB No. 51, *Consolidated Financial Statements*, discusses circumstances in which combined financial statements of commonly controlled companies could be prepared, with examples

being companies that are controlled by an individual or under common management.[27] [Also include IASB example from draft IFRS for SMEs (per paragraph 9.21 and 9.22 of draft ED).]

159. The key difference between the common control model and the controlling entity model is that the common control model does not require the parent entity to be included in the group. This allows for the possibility of preparing group GPEFR, even though the parent entity might not be required to (or might not choose to) prepare GPEFR. In addition, it allows for the possibility of preparing group GPEFR when there is no parent *entity*, as explained further below.

160. Suppose there are five companies, none of which controls any of the others, but all are under the control of a single person. The earlier discussion of what constitutes an entity included the conclusion that a natural person is an entity. Accordingly, in this situation, one could apply the controlling entity model and arrive at the conclusion that there is a group entity, comprising the controlling entity (the person) and the controlled entities (the five companies).[28]

161. Although a group entity under the controlling entity model exists in the above situation, the parent entity may not be required to (or choose to) prepare GPEFR. However, there might be an entity within the group that chooses to, or is required to (e.g., by a regulator), prepare GPEFR. Under a common control model, group financial statements could be prepared, comprising the five companies under the control of the natural person.

162. In another situation similar to that described above, the five companies might be under the control of a group of people. A common situation in which this might arise is a group of companies that are owned by a family, with no single family member holding a controlling interest in the companies.

163. In this situation, one question that arises is whether there is a parent *entity* as such. Some might argue that, even though the common control model does not require the parent entity

[27] ARB 51, paragraph 17.

[28] Some might ask whether, if a natural person is part of a group entity, does that mean all of that person's assets and liabilities are part of the group's assets and liabilities, including their personal (non-business) assets and liabilities? This issue also arises in the context of a sole proprietorship. In the case of a sole proprietorship, the entity's assets and activities comprise the business assets and activities of the proprietor, not his/her personal assets and activities. Although there might be cases when making that distinction is difficult in practice, conceptually the distinction can be drawn, based on the nature of the assets and activities. In other words, a sole proprietorship is a *business* entity—the proprietor's business assets and activities represent a 'circumscribed area of economic interest'. Similarly, if an individual has control of several entities, then the group's assets and activities would include that person's business assets and activities, but not their personal assets and activities. Indeed, another way of looking at this situation is that the controlling entity is not the natural person per se, but rather the sole proprietorship, comprising the individual's business assets and activities. Hence, the group comprises the sole proprietorship entity and other entities under its control.

to be included in the group, the parent entity must nevertheless exist, as the unifying factor for determining that the entities in the group are under common control. In other words, some might argue that, for two or more entities to be under *common control*, they must have the same ultimate controlling *entity*.

164. However, it would be possible to develop a common control model whereby a group entity for financial reporting purposes comprised entities under the common control of the same controlling *body*. The online Oxford concise dictionary defines a body as "an organised group of people with a common function".[29]

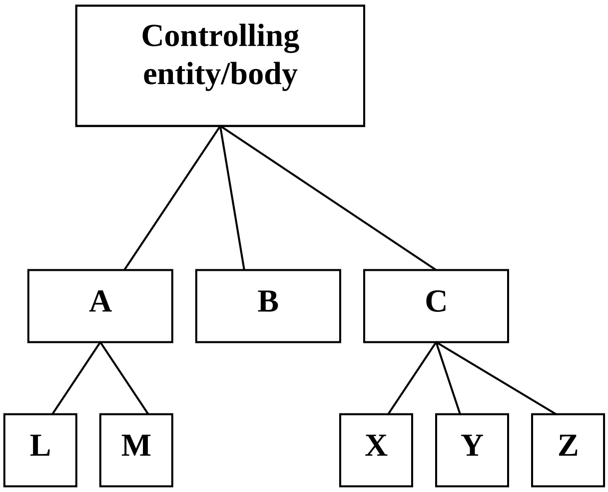
165. Note the use of the term controlling body rather than governing body. The definition of control discussed earlier includes both a power element and a benefits element. A governing body may have power over whatever it governs, but may not benefit from that power, if that governing body is simply acting as agent for others. For example, the trustees of a trust will be the entity's governing body, but if they are not also beneficiaries of the trust, then the trustees are not a controlling body.[30] Similarly, if two or more entities had the same management, those two entities would not be regarded as being under common control, in the absence of other facts and circumstances.

166. In summary, a common control model could be developed whereby the group comprises entities under the control of the same controlling *entity* or the same controlling *body*. (However, it could be argued, given that the Boards have adopted a broad definition of what constitutes an entity, there is no substantive difference between a controlling *entity* and a controlling *body*.)

167. If the common control model were adopted, it would be necessary to determine which combinations of entities are appropriate. For example, consider the following group structure:

[29] www.askoxford.com/concise_oed?view=uk

[30] A trustee might have the ability to obtain some benefits, such as a commission or fee. However, the primary responsibility of a trustee is to use his/her power not the benefit him/herself, but to benefit the trust's beneficiaries.



168. Which combinations of entities are acceptable? For example:

a. Should a group include all entities that are either (a) under the control of another entity included in the group or (b) have the same immediate parent? Under this approach, the following combinations would be possible:

i. A, B, C, L, M, X, Y Z

ii. A, L, M

iii. C, X, Y, Z

iv. L and M

v. X, Y and Z

b. Or could the group include entities that have the same *ultimate* parent, but do not have the same *immediate* parent? For example, in addition to the five possible combinations outlined in (a) above, would it be acceptable for the group to comprise L, M, X, Y and Z?

c. Is it necessary for *all* entities under common control to be included in the group? For example, would it be acceptable to prepare group GPEFR that combined X and Y, but not Z?

169. This paper does not address the questions above. Rather, the questions are raised to give examples of the sorts of issues that would need to be addressed at the standards-level, if a common control model were adopted. For the purposes of the conceptual framework, the key question is the broader issue of whether some form of common control model should be adopted as the basis for determining the composition of a group entity for financial reporting purposes.

170. It was noted earlier that there is a rationale for concluding that a group reporting entity should include a parent entity and its subsidiaries, which is derived from the objective of financial reporting. In particular, the cash flows from the subsidiary to the parent, and eventually to the parent's investors and creditors, depend significantly on the subsidiary's activities and the parent's actions in directing those activities. Therefore, group financial statements would provide relevant information to assist users in making investment, credit and similar resource allocation decisions.

171. But is that so for entities under common control, such as under the common control of a family or the same shareholder group? In other words, in the absence of a parent/subsidiary relationship between the entities within the group, would a combined set of financial statements provide decision-useful information?

172. Certainly, *some* situations might arise when such combined financial statements would provide decision-useful information. (An example might be when a lender has advanced funds to a group of entities, with each entity within the group guaranteeing the loans of the other entities.) However, it could be argued that, to support the adoption of a common control model, one must first reach a *general* conclusion that the combined financial statements of a group comprising entities with the same controlling body would provide decision-useful information. In the absence of such a general conclusion, it seems questionable whether there is much to be gained by pursuing the idea of adopting a common control model.

173. Alternatively, it could be argued that because there are *occasions* when combined financial statements of a group comprising entities with a common controlling body/entity would provide decision-useful information, a broader control concept should be adopted at the conceptual level, with it left to the standards-level to determine when that broader concept should be applied.

174. In addition, some argue that the combined financial statements would provide relevant information to investors and creditors of each entity within the group, even in the absence of a parent/subsidiary relationship between members of the group. Being a part of a commonly controlled group may significantly affect the amount, timing and uncertainty of cash flows to a particular entity's investors and creditors. Combined financial statements may provide additional information to assist these users in making investment, credit and similar resource allocation decisions.

Risks and/or rewards model

175. Another approach sometimes suggested is that entities should be combined into a group entity when the activities of the second entity affect the wealth of the residual shareholders (or claimants) of the first entity.

176. However, without refinement, such a broad and undefined notion is unlikely to be workable. The nature of a residual interest is such that the activities of virtually every other entity with which the first entity conducts business has the potential to affect that entity and the wealth of its residual shareholders. For example, the activities of major customers of the entity could have a significant effect on that entity and hence its residual shareholders, for example, if the customers withdraw their business or go bankrupt. Similarly, a major supplier with pricing power can affect the entity. This notion would seemingly lead to some suppliers including major customers in their financial statements and perhaps the same major customers including those suppliers in their financial statements.

177. Therefore, if this idea were pursued, it would be necessary to narrow down or more precisely define the notion, perhaps by identifying some relevant factors. Since we are looking for a relationship where the activities of one entity affect the amounts, timing and uncertainty of the future cash inflows and outflows of another entity, we could focus on situations in which one entity has provided capital to another entity. It would then be necessary to define capital and perhaps narrow the notion down further, to particular types of capital with specific characteristics. Otherwise, for example, a bank would be required to prepare group financial statements that included every entity to which it had advanced funds (capital).

178. Determining the relevant characteristics would likely involve considering factors such as the following:

    a. The nature of the financial interest, that is, whether it exposes the first entity to risks and/or rewards, such as a "residual", "variable" or an "ownership" interest. One way of doing this would be to link it to the distinction between liabilities and equity. That is, the relevant types of capital are those that give the first entity an equity interest in the second entity. (This is simply a suggestion—distinguishing between liabilities and equity is itself a difficult and complex topic.)

b. The extent of exposure to risks and rewards. For example, does the first entity need to be the "major beneficiary" of the second entity? What if there is no single major beneficiary, but the first entity's interest in the second entity is a significant investment from the perspective of the first entity? Depending on the relative size of the entities involved, owning 5% of the shares in the second entity could be a major investment of the first entity. Should we instead focus on when the first entity is entitled to a "significant" amount of benefits (and/or exposed to a "significant" level of risk) and, if so, should "significance" be assessed from the perspective of the first entity or the second entity, or perhaps both?

179. The Boards did not attempt to answer these questions. Rather, they are simply examples of the sorts of issues that would need to be addressed if the idea of adopting a risks and/or rewards model was pursued. Once some conclusions had been reached about the relevant characteristics, a group reporting entity would be defined on that basis. In other words, the unifying factor (i.e., the thing that binds the group together) would be the provision of capital with specified characteristics by one entity to other entities.

180. In the earlier discussion of SPEs under the controlling entity model, it was noted that the notion of risks and/or rewards has a role under that model. Whenever it is difficult to determine who has power over an entity, accounting standards look to the benefits element instead, to help determine whether the first entity controls the second entity.

181. Hence, there is some cross-over between the controlling entity model, and the risks and/or rewards model described above. However, the risks and/or rewards model described above has the potential to be both broader and narrower than the controlling entity model, for the following reasons:

a. It is broader, because it does not require a power element, hence could result in entities being combined when the first entity does not have power over the second entity—not only in the SPE situations discussed above, but also when someone else has that power.

b. It could be narrower, because it would likely require a focus on particular types of benefits (such as benefits arising from a residual, variable or ownership interest), rather than benefits generally, and also would likely require that a minimum level of benefits be specified (such as when the first entity has an entitlement to a majority or "significant" amount of those benefits).

Boards' discussions

182. Both Boards concluded that the risks and/or rewards model does not seem to provide a conceptually robust basis for determining the composition of a group entity. From a conceptual perspective, it seems arbitrary. The basic idea is so broad that, in order to place what seem like reasonable and necessary limits on which entities should be included in the group, it would be necessary to develop criteria that would involve drawing some bright lines, such as the minimum level of exposure to risks and/or rewards. Although *applying* the controlling entity model might sometimes result in bright lines being drawn at the standards level, the concept itself is much more definitive—a control relationship either exists or it does not. The fact that there can be difficulties in practice determining whether the power element of control exists does not negate this conclusion at the conceptual level. In the Boards' view, this is no different from difficulties in determining whether an asset or liability exists. In contrast, the risks and/or rewards model seems to require bright lines to be drawn at the conceptual level, which the Boards found undesirable.

183. Moreover, the lack of a well-defined concept would make it even more problematic to develop principles-based accounting standards, compared with either the controlling entity model or the common control model.

184. 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.

185. [Include more here about Boards' discussions.]

Summary

186. [Summary of this section to be included here. Issues covered in this section included:

    a. User information needs

    b. Meaning of control

    c. Group entity models (controlling entity model, common control model, risks and rewards model).]

SUMMARY

187. [TO BE WRITTEN. This section would summarise the issues addressed in the paper and the Boards' preliminary views. Also a reminder about points in the introduction, especially about the objective of the project phase.]