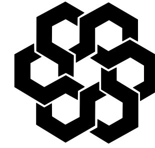

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410   Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org   Website: www.iasb.org

International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**16 May 2007, London**
Project:	**Conceptual Framework**
Subject:	**Phase D: Reporting Entity—Outstanding Issues (Agenda Paper 3)**

Introduction

1. The Boards have discussed a variety of issues in the reporting entity project phase and, in most cases, have reached a common preliminary view. However, there are two issues upon which the boards have not yet reached a common preliminary view:

   Issue 1: Determining the composition of a group entity, including whether the control concept should be used, in much the same way as it is used today, or whether it should be extended, such that a group could comprise entities under common control.

   Issue 2: Parent-only financial statements and consolidated financial statements—determining which set of financial statements (or both) should be included in a general purpose external financial report prepared for a parent entity.

2. When these issues were last discussed in December, it was agreed that staff would work on further improving the articulation of the various viewpoints on these issues, especially the second issue. When that work was completed, the

boards would discuss the issues again, to determine if a common preliminary view had emerged. If so, the Discussion Paper would set out that preliminary view, along with other viewpoints considered by the Boards in reaching that preliminary view. If not, the Discussion Paper would explain the various viewpoints, and perhaps give an indication of the majority and minority positions of each Board, but would not contain a common preliminary view. (However, on other issues discussed during the reporting entity project phase, upon which a common preliminary view has been reached, the Discussion Paper would contain the Boards' preliminary views.)

3. The staff held a small group meeting with some IASB and FASB members in January, to explore the two issues further and gain a better understanding of Board members' views. The staff also discussed these two issues with other accounting standard setters at a meeting of national standard setters held in Hong Kong in March. Furthermore, the staff prepared a revised and restructured draft of the Discussion Paper, and obtained comments from some IASB and FASB members on that revised draft.

4. [Paragraph omitted from Observer Notes.]

Issue 1: Determining the composition of a group reporting entity

5. The Boards have previously discussed three potential approaches to determining the composition of a group entity for financial reporting purposes:

    a. Controlling entity model

    b. Common control model

    c. Risks and rewards model.

6. In previous discussions, neither Board supported the adoption of the risks and rewards model. The boards concluded that it does not seem to provide a conceptually robust basis for determining the composition of a group entity. [Sentence omitted from Observer Notes.]

7. The majority of Board members supported either the controlling entity model or common control model. However, 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.

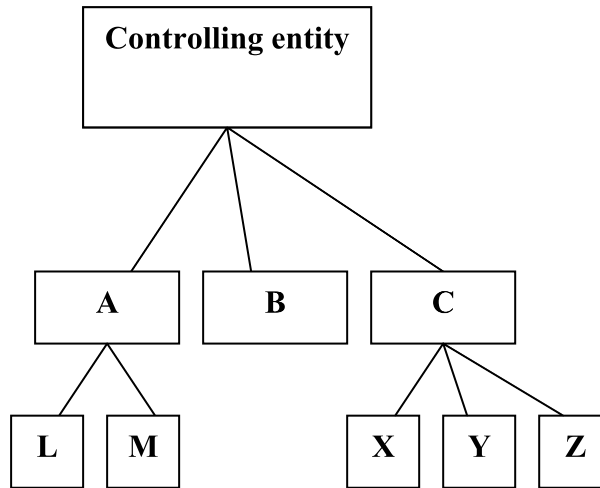
8. This paper outlines both the controlling entity model and the common control model. It also outlines another approach (the synergistically managed assets approach) to determining the composition of a reporting entity, both in the context of a group entity and also in the context of an individual entity. This approach arose out of discussions with some FASB and IASB members in a small group meeting held in January.

Controlling entity model

9. The controlling entity model discussed in this section is broadly similar to the control model currently used today, but with control defined to include both a power element and a benefits element.[1] Under this model, the area of economic interest is circumscribed by the extent of one entity's control over other entities. Hence, a group entity comprises the controlling entity (i.e. the parent) and other entities under its control (i.e. its subsidiaries).

10. For example, consider the following group of entities:

[1] The inclusion of a benefits element in the definition of control is likely to be important when applying the definition of control to special purpose entities (SPEs). For example, SIC-12, *Consolidation—Special Purpose Entities*, lists various circumstances that may indicate a relationship in which an entity controls an SPE, which focus 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*. This Interpretation 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. There seems to be 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.



11. The following combinations of entities would be possible under the controlling entity model:

    a. The group headed by the ultimate controlling entity, i.e. that entity plus all the other entities (A, B, C, L, M, X, Y, Z)

    b. A + L + M

    c. C + X + Y + Z

12. The controlling entity model seems consistent with the objective of financial reporting, which is to provide information that is useful to present and potential investors, creditors and others in making investment, credit and similar resource allocation decisions. To help achieve this objective, financial reporting should provide information to help present and potential investors, creditors and others to assess the amounts, timing and uncertainty of the entity's future cash inflows and outflows.[2] 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. Thus, the cash flows that flow from the controlled entity (i.e. the subsidiary) to the controlling entity (i.e. 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.

[2] Paragraphs OB2 and OB 3 of the Phase A Discussion Paper, *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information*.

13. Therefore, to assist investors and creditors of the parent 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. Hence, 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. Thus, the controlling entity model is consistent with the objective of financial reporting.

14. Based upon the above discussion of user information needs, the controlling entity model seems a reasonable approach to determining what constitutes a group entity for financial reporting purposes.

Common control model

15. There are some examples in accounting practice in which *combined* financial statements are prepared, which combine the results and activities of two or more 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.[3]

16. Thus, one could circumscribe an area of economic interest as being those entities that under the common control of the same controlling entity (or controlling body).[4]

17. The key difference between the common control model and the controlling entity model is that, under the controlling entity model, the parent entity is *always* included in the group reporting entity, whereas the inclusion of the parent entity (or controlling body) is not essential under the common control model. This allows for the possibility of preparing "group" GPEFR, prepared

[3] 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. Also, the IASB's *Exposure Draft of a Proposed IFRS for Small and Medium-sized Entities* proposes that the preparation of combined financial statements be permitted, but not required, for two or more entities controlled by a single investor (IASB Exposure Draft, paragraph 9.21).

[4] In some of the situations discussed in this section, there are entities controlled by an individual person or a group of individual persons, such as a family. Some do not regard an individual person or a family to be an "entity", and therefore would not use that term to describe the controlling individual or family. The alternative term "controlling body" is provided to accommodate that viewpoint, but otherwise has no effect on the analysis in this section.

by combining the assets, liabilities and activities of the entities under common control, even though the parent entity (or controlling body) might not be required to (or might not choose to) prepare GPEFR.

18. For example, suppose there are five companies, none of which controls any of the others, but all are under the control of an individual person. That individual might not be required to (or choose to) prepare GPEFR. However, there might be an entity within the group that is required to (or chooses to) prepare GPEFR. Under a common control model, financial statements of the commonly controlled group of entities could be prepared, by combining the assets, liabilities and activities of the five companies under the control of the individual person.[5]

19. Furthermore, even when there is a controlling entity that is required to (or chooses to) prepare consolidated financial statements for the entire group, there might be circumstances when it would be helpful to prepare combined financial statements for two or more entities under its control. For example, suppose a parent company has a manufacturing subsidiary and a retail subsidiary, which regularly transact with one another. The two entities combined together could be regarded as being a circumscribed area of economic interest.

20. If the common control model were adopted, it would be necessary to determine which combinations of entities are appropriate for the purposes of GPEFR. For example, some might permit specific types of combinations only. In particular, they would permit the combination of all entities under the control of an individual person (or perhaps a group of people, such as a family) whose only business assets comprise their investments in the controlled entities; however, they would rule out the preparation of combined financial statements for entities that are under the common control of an entity that has assets other than its investments in its subsidiaries. This is because, in the former situation, there would be no difference between (a) the combined financial statements for the entities under common control and (b) the consolidated financial statements of the individual investor.[6] In contrast, in the latter situation, the exclusion of the

[5] 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.

[6] If consolidated financial statements were prepared for the individual investor, that individual's investments in the subsidiary entities would be eliminated upon consolidation. If that individual has no

controlling entity from the group reporting entity would result in there being a difference between (a) the consolidated financial statements of the parent entity and (b) the combined financial statements of the entities under common control. That difference would arise because the combined financial statements would exclude other assets, liabilities and activities of the controlling entity.

21. However, others would support a more broadly applicable common control model. For example, consider the group structure in paragraph 10 above. Suppose that X operates as a clothing manufacturer, and all its products are sold to Y, which operates as a clothing retail store, while Z operates as a winery, and has no transactions or other interactions with either X or Y. Some would argue that the preparation of combined financial statements for X and Y would provide decision-useful information to the external investors and creditors of both entities.

22. 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.[7]

23. There remains the question of whether the same conclusion would be reached for the financial statements of a group of entities under common control, such as under the common control of a family or the same shareholder group. In other words, the question to be addressed is: 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?

24. There may be some situations when such combined financial statements would provide decision-useful information, such as the situation described in

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other business assets, liabilities and activities, then there would be no difference between the assets, liabilities, and activities included in (a) the investor's consolidated financial statements and (b) the combined financial statements of the commonly controlled entities.

[7] Some would disagree with this conclusion in some instances, such as when the parent entity is an investment company. However, the above discussion is focused on reaching a general conclusion, not possible exceptions to that general conclusion.

paragraph 21 above. Another 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. In this situation, combined financial statements for the lending group may provide decision-useful information to the lender.

25. However, some argue that, to support the adoption of a common control model in the context of *general purpose* external financial reporting, 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. Rather, limited circumstances such as meeting the needs of a particular lender to a commonly controlled, co-obligated group of entities could be satisfied by special purpose financial reports.

26. Alternatively, others argue 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. In addition, they 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.

Synergistically managed assets approach

27. Another approach to circumscribing the area of economic interest, both for an individual entity and group entity, is to focus on the group of net assets that are managed synergistically together to generate returns to investors, creditors and others.

28. Under this approach, the boundary of the *reporting* entity would not necessarily correspond to the boundary of a legal entity. Rather, the reporting entity's boundary would be determined by considering:

    a. the various groups of external users (such as investors and creditors) who rely upon in the information provided in GPEFR;

    b. the net asset base that is managed synergistically together to generate returns to each group of external users; and

    c. the common information needs of those external users, that is, the net asset base that is managed synergistically together to generate returns to the majority of external users.

29. For example, suppose that one company (X) owns a majority of the shares in a second company (Y), both companies have the same management, and the net assets of the two companies are managed synergistically together to generate returns to the investors and creditors (and other claimants) of the two companies. When assets are managed together synergistically, it is not possible to clearly distinguish between the returns from one legal entity and another. The two companies combined (or consolidated) together would be a single reporting entity, so as to capture the net assets that generate the risks and returns to users of GPEFR. Neither one of the individual companies, on its own, would be regarded as a reporting entity.

30. Conversely, if Y's net assets were not managed synergistically together (for example, it operated in a different industry), then each company would be a reporting entity. Each company would prepare financial reports that presented information about its respective assets, liabilities and activities. Company X's investment in Y would be reported as an investment in another company, not by consolidating the assets, liabilities and activities of Y.

31. Under this approach, control of one legal entity over another legal entity is likely to be necessary, but would not be *sufficient* in determining the boundaries of a reporting entity. That is, in order for the business activities of the two (or more) legal entities to be arranged such that the net assets of those legal entities are managed synergistically together to generate returns to investors and creditors, typically one legal entity would need to have control over the other legal entity. (Although that would not always be the case. For example, joint

control might be sufficient, such as when two venturers enter into a contractual arrangement to manage their net assets synergistically together to generate returns to investors and creditors of each venturer.) However, control alone would not be *sufficient* to establish the boundary of the reporting entity—as in the example in the previous paragraph, X might control Y, but as the two companies' net assets are not managed synergistically together, then each company would be a separate reporting entity.

32. Also, under this approach, although the boundary of the reporting entity is determined by identifying the *common* information needs of the majority of external users, the GPEFR of that reporting entity would include a comprehensive income statement that would provide information about the allocation of returns to particular groups of investors and creditors, such as the minority shareholders of Y.

33. Furthermore, as with other approaches discussed by the Boards, the approach would not rule out the preparation of special purpose financial reports to meet the specific information needs of particular groups of users of a legal entity. For example, company Y might wish to prepare individual financial statements for its creditors or minority shareholders. However, if its net assets are managed synergistically together with the net assets of company X, then the individual financial statements of company Y would be special purpose financial statements, and thus precluded from being described as GAAP-compliant. (Those individual financial statements might comply with GAAP in all other respects, but would not be fully GAAP-compliant because the entity preparing those financial statements would not qualify as a reporting entity for the purposes of GPEFR.)

34. Applying this approach would lead to a different conclusion than the Boards reached in the discussion of an individual reporting entity. [Sentence omitted from Observer Notes.] The Boards concluded that legal existence is a *sufficient* condition for concluding that an entity exists for financial reporting purposes. However, under the approach being discussed here, legal existence may not be sufficient. This is because the reporting entity's boundary is determined by identifying the net assets that are managed synergistically together to generate

returns to investors and creditors, irrespective of the legal entities to which particular assets or returns are allocated.

35. If this approach were pursued, it would be necessary to establish some criteria for determining whether the net assets of particular legal entities were managed together in a sufficiently synergistic manner, such that they should be regarded as a single reporting entity.

36. It would also be necessary to consider how to establish the boundaries of each reporting entity when a legal entity has multiple areas of operation, each of which may be aligned or managed together to a greater or lesser extent with the operations of other legal entities, which themselves may have multiple areas of operation.

37. Additionally, it would be necessary to develop some appropriate criteria to determine when there is sufficient commonality of information needs of particular groups of external users, such that two or more legal entities (or components of legal entities) should be treated as a single reporting entity.

Staff comments

38. The staff does not recommend pursuing the synergistically managed assets approach. The staff thinks the approach would require a great deal of research (including both staff and Board time) to develop, and doubts that such an effort would produce a conceptually robust model that would be workable in practice.

39. Furthermore, the staff does not regard the approach as conceptually superior to the controlling entity model or common control model. In particular, the staff is concerned that the synergistically managed assets model would, in some circumstances, preclude the subsidiary entity from being the subject matter of general purpose external financial reports. In the staff view, there would be many situations in which a subsidiary entity would have external investors and creditors who require, but are unable to demand, information about the subsidiary’s assets, liabilities, revenues and expenses, to make investment or credit decisions—irrespective of whether the subsidiary’s net assets are managed synergistically with the net assets of its parent.

40. Of the two remaining models discussed above, the staff’s first preference is the common control model, followed by the controlling entity model. In saying

that, the staff thinks that there is a stronger case to conclude that group financial statements would provide relevant information (capable of making a difference to users) to help investors, creditors and others in making resource allocation decisions when there is a parent/subsidiary relationship between members of the group. In other words, the staff thinks that the controlling entity model is more consistent with the objective of general purpose external financial reporting. However, the staff also agrees that, even in the absence of a parent/subsidiary relationship, group financial statements of commonly controlled entities would also likely provide decision-useful information. Rather than be limited to the controlling entity model, the staff recommends adopting a broader control model at the concepts level. The Boards could then consider, at the standards level, when that broader model should be applied.

Questions for the boards

41. Do the Boards agree that the synergistically managed assets model should not be pursued? Do the Boards wish to include discussion of this approach in the Discussion Paper? [Sentence omitted from Observer Notes.] If the answer to both questions is yes, do the Boards agree with the staff comments above on why that model should not be pursued, or do the boards have additional or different reasons?

42. If the boards agree that the synergistically managed assets model should not be pursued, do the boards wish to adopt the controlling entity model or the common control model? Why?

Issue 2: Parent-only financial statements and consolidated financial statements

43. In some jurisdictions, where an entity has one or more subsidiaries, it is common for both parent-only financial statements and consolidated financial statements to be prepared.[8] There may be a legal requirement to do so, and both sets may be regarded as being general purpose external financial statements prepared in accordance with GAAP.[9] In some other jurisdictions, typically

[8] In parent-only financial statements, information is presented about the parent's investment in its subsidiaries (and returns on that investment), rather than the underlying assets, liabilities and activities of those subsidiaries.

[9] For an entity preparing financial statements under IFRS, "GAAP" means prepared in accordance with IFRS. For an entity preparing financial statements under national accounting standards and other

consolidated financial statements are prepared, whereas parent-only financial statements are not. And there are also instances where either parent-only financial statements or consolidated financial statements are prepared, but not both. In considering this phenomenon, the Boards have been discussing two related issues:

a. An *entity* issue: determining whether both sets of financial statements relate to the same entity, or two different entities.

b. A *presentation* issue: determining which set of financial statements (or both) meets the objective of general purpose external financial reporting, by providing decision-useful information to present and potential investors, creditors and other external users with a financial interest in the parent entity.

44. Up until now, the Boards have been discussing three views, referred to as View 1 (One Entity – Two Alternative Displays), View 2 (One Entity – One Display) and View 3 (Multiple Entities). The staff has re-grouped these three views into two categories:

a. Parent = Group View

b. Parent ≠ Group View.

45. This re-grouping is intended to help distinguish the *entity* issue (i.e. identifying the entity that is reporting) from the *presentation* issue (i.e. how to present information about that entity). The "Parent = Group View" discussed in this paper encompasses both View 1 and View 2, whereas the "Parent ≠ Group View is the same as View 3.

Outline of the entity issue

46. Under the Parent = Group View, the parent entity and the group entity are regarded as one and the same entity. The subsidiary entity is regarded of being part of the parent entity, for the purposes of the parent entity's financial reporting, akin to an unincorporated branch.[10] In other words, within the

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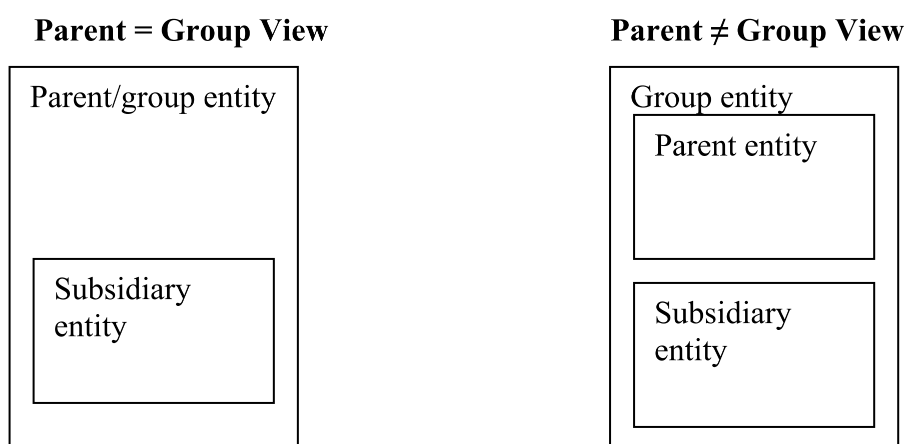
accounting requirements (such as US GAAP), "GAAP" means in accordance with those national standards and other guidance.

[10] The phrase "akin to" is used here because there may be some differences between a subsidiary and a branch. For example, the subsidiary might not be wholly-owned. In this case, there would be other parties (non-controlling interests) with an interest in the net assets of the subsidiary entity—a circumstance that typically would not arise in the case of a branch. However, the presence of non-

boundary of one entity (a "circumscribed area of economic interest") there is another entity (a second "circumscribed area of economic interest").

47. In contrast, under the Parent ≠ Group View, the parent entity is a different entity than the group entity. Under this approach, the subsidiary entity and the parent entity represent two *separate* entities (two separate "circumscribed areas of economic interest"), while the group entity is a third entity (i.e. a third "circumscribed area of economic interest") that encompasses within its boundary both the parent entity and the subsidiary entity.

48. Diagrammatically, the relationship between the entities can be shown as follows:



Outline of the presentation issue

49. The presentation issue is related to the entity issue outlined above. In particular, if one regards the parent entity and group entity as being one and the same entity—as under the Parent = Group View—then could that entity have two different sets of general purpose external financial statements (GPEFS)? There are several different ways of answering this question:

Approach One

The parent entity can have only one set of GPEFS, but it would be a standards-level issue to determine how the parent should present information about the subsidiary's assets, liabilities and activities. That standards-level issue is to determine, in a given set of circumstances,

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controlling interests does not change the basic premise of the Parent = Group View. In other words, the subsidiary entity is regarded as being part of the group entity under this view, irrespective of whether the subsidiary is wholly owned.

whether users' information needs would best be served by presenting, in the parent's GPEFS, information about its net investment in the subsidiary (as is done now in parent-only financial statements) *or* information about the underlying assets and liabilities of the subsidiary (as is done now in consolidated financial statements).

Approach Two

The parent entity can have only one set of GPEFS, which are its consolidated financial statements, because consolidated financial statements present information about *all* the parent's assets, liabilities and other activities, whereas parent-only financial statements do not. Parent-only financial statements present information about the parent's investment in its subsidiaries, not the underlying assets, liabilities and activities. Therefore, assets, liabilities, revenues and expenses are omitted (or offset), which is not a relevant or faithful representation of the parent entity's assets, liabilities, revenues and expenses. This should be explained at the concepts level. Parent-only financial statements should be treated as special purpose financial statements, and should be precluded from being described as GAAP-compliant (i.e., should not be described as prepared in accordance with IFRS or US GAAP).

Approach Three

The parent entity can have only one set of general purpose external financial statements, but it can include other financial information within its single set of general purpose external financial reports. In particular, the parent's GPEFR could include both consolidated and parent-only financial statements. For example, there could be "parent" and "group" columns in each of its primary financial statements, or one set of financial statements presented as its general purpose external financial statements (GPEFS) with another set of financial statements provided as supplementary information, all within a single set of GPEFR.[11]

[11] For example, the parent entity could present consolidated financial statements, with parent-only financial statements also provided as supplementary information, as part of its single set of GPEFR.

Staff discussion

50. In considering the discussion set out below, there are two points that should be borne in mind. First, it should be noted that this discussion focuses on GPEFR in the context of the information needs of external investors and creditors of the parent/group entity, not the *subsidiary* entity. In particular, under either of the Views described above, the subsidiary entity could be the subject matter of its own general purpose external financial reports. For example, if the subsidiary entity has external investors (e.g. non-controlling ordinary shareholders or preference shareholders) or creditors that require information about that subsidiary entity for investment, credit and similar resource allocation decisions, then those information needs could be served by preparation of individual financial statements for the subsidiary entity.[12]

51. Second, the staff notes that some might be concerned about practical implications arising from reaching a conclusion on the issues under discussion. In particular, depending upon which View one supports, including which particular variation of the Parent = Group View, there are the following implications:

    a. Under Approach One of the Parent = Group View, the parent entity would prepare parent-only *or* consolidated financial statements as part of its general purpose external financial report, but not both;

    b. Under Approach Two of the Parent = Group View, parent-only financial statements would be *precluded* from being described as GAAP-compliant financial statements (i.e., prepared in accordance with IFRS or US GAAP).

    c. Under Approach Three of the Parent = Group View, *both* parent-only financial statements and consolidated financial statements could be included *within* the parent entity's single set of general purpose external financial reports.

[12] In the context of the Parent = Group View, some might ask, if the subsidiary entity is part of—rather than separate from—the parent entity, then does this imply that the subsidiary does not exist in its own right? If the subsidiary does not exist in its own right, then how can it be the subject matter of GPEFS/GPEFR? The answer to this question is that there is a distinction between *existence* and *separate existence*. That is, the subsidiary entity *exists*, but does not exist *separately* from the parent entity. Rather, the subsidiary entity exists *within* the parent entity (as shown in the diagram in paragraph 48), akin to an unincorporated branch. Thus, although the *separate* legal existence of the subsidiary has been set aside in arriving at the Parent = Group View, that does not mean that the subsidiary's *existence* has been set aside. Since the subsidiary entity exists, then it may be the subject matter of GPEFS/GPEFR.

d. Under the Parent ≠ Group View, parent-only financial statements could be prepared as the GPEFR of the *parent* entity, and consolidated financial statements could be prepared as the GPEFR of the *group* entity.

52. Some may be concerned about reaching a conclusion that would be inconsistent with legal requirements in particular jurisdictions. However, in the staff view, the Boards' deliberations should not be bound by current legislative requirements that apply in particular countries. (This is particularly relevant in the case of the IASB, as an international standard-setting body, which cannot base its decisions on the legal requirements of particular jurisdictions.) In the staff view, the project objective is to develop an improved conceptual framework that provides a sound foundation for the development of high quality financial reporting standards, irrespective of legislative or regulatory barriers to the implementation of those concepts or standards. Therefore, in the staff view, the focus should be on considering the issue at the conceptual level.

53. To consider the issues at the conceptual level, the objective of general purpose external financial reporting should be considered. The objective of GPEFR is to provide decision-useful information to meet the common information needs of a range of external users, such as present and potential investors and creditors, who lack the ability to prescribe the financial information they need from an entity and, therefore, must rely on the information provided in the financial reports.

54. If financial statements are prepared for a *specific* purpose, then those financial statements may not satisfy the objective of general purpose external financial reporting. This might occur, for example, if parent-only financial statements are prepared for taxation purposes only.

55. However, in some cases, both the parent-only financial statements and the consolidated financial statements might be made available to a wide range of external users, for example, by inclusion in an annual report. In these circumstances, the question is whether one set of financial statements or the other, or both, serve the information needs of present and potential investors and creditors of the parent entity.

<u>Conclusion A: Both sets of financial statements provide decision-useful information to external users</u>

56. Some argue that *both* sets of financial statements provide decision-useful information, and therefore are consistent with the objective of financial reporting. For example, some note that investors and creditors of the parent entity typically do not have a legal claim against the assets of subsidiary entities. Therefore, they argue that the parent-only financial statements provide information about the resources that are available to settle the claims of the parent entity's creditors in the normal course of business, and from which the investors' returns on investments will be paid. In addition, consolidated financial statements would provide decision-useful information, to help users assess the amounts, timing, and uncertainty of the parent's future cash inflows and outflows. This is because the cash flows of the parent entity often depend significantly on the cash flows from the subsidiary entities, which in turn depend upon the subsidiary's activities and the parent's actions in directing those activities.

57. Therefore, *both* types of financial statements are capable of providing decision-useful information in the context of general purpose external financial reporting. Indeed, without both types of statements, the needs of users (especially present and potential creditors, but also present and potential investors) will not be met adequately. If consolidated financial statements only were provided, the parent entity's GPEFR would not meet the objective of financial reporting as fully as would be the case if parent-only financial statements also were included, and vice versa.

58. If one agrees that *both* types of financial statements are capable of providing decision-useful information in the context of general purpose external financial reporting, this conclusion is consistent with either:

    a. Approach Three of the Parent = Group View; or

    b. Parent ≠ Group View, with the proviso that financial statements be prepared for both the parent entity and group entity.

59. Provided that both sets of financial statements are contained in a single general purpose external financial report, then there may be no need to reach a conclusion on the entity issue. That is, irrespective of whether the parent entity and the group entity are the same entity, or two different entities, both views are accommodated by the provision of parent-only financial statements and

consolidated financial statements within a single general purpose external financial report.

60. Some may find such a result unsatisfactory. In particular, some may be concerned that not reaching a conclusion on the entity issue at the conceptual level could have an impact on issues addressed at the standards-level. For example, although supporters of Approach Three of the Parent = Group View might agree that both types of financial statements are capable of providing decision-useful information to investors and creditors of the parent entity, some might regard the entity's consolidated financial statements as being the parent entity's *primary* financial statements, with parent-only financial statements provided as *supplementary* information. If so, when considering issues at the standards-level, issues relating to the preparation of consolidated financial statements may be regarded as much more important than issues relating to the preparation of parent-only financial statements. This would likely impact upon the amount of resources devoted to particular issues and the amount of accounting guidance considered necessary at the standards-level.[13]

61. The staff notes that the key difference between the two Views discussed above is whether, when one entity has control over another legally separate entity, the legal boundary between the two entities is a matter of economic substance or merely legal form. In other words, conceptually the issue is which of the two Views more *faithfully represents* the relationship between the parent entity and the assets, liabilities, and activities of the subsidiary entities.

62. For example, suppose a company transferred the business operations of an unincorporated branch into a newly formed company under its control. Supporters of the Parent = Group View would argue that such a transfer does not substantially change the parent company's relationship with the assets and activities concerned—it controlled those assets and activities before the transfer, and continued to do so after the transfer to the new company, through its control of that new company. Therefore, those assets and activities should be regarded

[13] There also may be other implications at the standards-level. For example, depending on which View is selected, it may affect the way in which the informational objective of consolidated financial statements is described. For example, one could describe consolidated financial statements as providing information about the *parent* entity's assets, liabilities and activities, or as providing information about the wider economic entity—the *group* entity—that is headed by the parent entity.

as being within the boundary of the parent company, both before and after the transfer.

63. However, supporters of the Parent ≠ Group View would argue that the transfer does substantially change the parent company's relationship with the assets and activities concerned—previously, the parent company had direct control of those assets, and therefore those assets are part of the parent company's assets against which the parent company's investors and creditors have claims. After the transfer, the parent company has only a residual interest in those assets and activities (i.e. an interest in the subsidiary's net assets only)—the subsidiary company's creditors have claims that would have to be satisfied first, before any distributions of assets could be made to the parent company (and its investors or creditors). Furthermore, after the transfer, the parent company will not have an obligation to transfer resources to other parties that are now the creditors of the subsidiary rather than the parent (unless the parent company provides a guarantee, in which case it may have a stand-ready obligation under that guarantee, but no longer has primary responsibility to pay those creditors).

64. Depending on which of the above arguments in the proceeding two paragraphs one finds the more convincing, this will help determine whether to support the Parent = Group View or the Parent ≠ Group View.

Conclusion B: Only one set of financial statements would best serve the information needs of external users

65. Some might agree with much of the discussion in Conclusion A, in that they agree that both parent-only financial statements and consolidated financial statements are each *capable* of providing decision-useful information to investors and creditors of a parent entity. However, in a given set of circumstances, it is likely that one set or the other would *best* meet user information needs. Each set of financial statements gives a different perspective or different display of the assets, liabilities and activities of the parent entity. For the purposes of the parent entity's GPEFR, it is necessary to decide which particular perspective or display provides the more decision-useful information to present and potential investors and creditors of the parent entity. It would be a standards level matter to determine, in a given set of circumstances, whether

parent-only financial statements *or* consolidated financial statements would best meet the information needs of external users.

66. This conclusion is consistent with Approach One of the Parent = Group View.

Conclusion C: Consolidated financial statements, not parent-only financial statements, serve the information needs of external users

67. Some argue that parent-only financial statements are not capable of providing decision-useful information to investors and creditors of a parent entity. This is because parent-only financial statements are incomplete and do not faithfully represent the parent entity's assets, liabilities and activities. The parent entity's financial statements should include information about *all* its assets, liabilities and activities, including those assets, liabilities and activities that it controls through its control of its subsidiaries. That information is contained in consolidated financial statements only. Parent-only financial statements present information about the parent's investment in its subsidiaries, not the underlying assets, liabilities and activities. Therefore, assets, liabilities, revenues and expenses are omitted (or offset), which is not a relevant or faithful representation of the parent entity's assets, liabilities, revenues and expenses.

68. This conclusion is consistent with Approach Two of the Parent = Group View.

Questions for the Boards

69. Do you think that both parent-only financial statements and consolidated financial statements are capable of providing decision-useful information to external users in the context of general purpose external financial reporting? Please select one of the following answers:

    a. Conclusion A: Yes, and both should be provided in the GPEFR for a parent entity. This conclusion is consistent with Approach Three of the Parent = Group View or the Parent ≠ Group View.

    b. Conclusion B: Yes, but it would be a standards-level matter to determine whether, in a given set of circumstances, parent-only financial statements *or* consolidated financial statements should be prepared to best meet user information needs. This conclusion is consistent with Approach One of the Parent = Group View.

c. Conclusion C: No, because parent-only financial statements are incomplete and do not faithfully represent the parent-entity's assets, liabilities and activities. This conclusion is consistent with Approach Two of the Parent = Group View.

70. For those Board members that support Conclusion A, do you believe it is necessary to also reach a conclusion on the related entity issue, that is, choose between Approach Three of the Parent = Group View and the Parent ≠ View (as discussed in paragraphs 59 to 64 above)? If so, which View do you support and why?

Next steps

71. At their respective May meetings, the Boards will discuss again the two outstanding issues set out above, to determine if the Boards have a common preliminary view. If so, the Discussion Paper will set out that preliminary view, along with other viewpoints considered by the boards in reaching that preliminary view. If not, the Discussion Paper will explain the various viewpoints, and perhaps give an indication of the majority and minority positions of each Board, but would not contain a common preliminary view.

72. [Paragraph omitted from Observer Notes.]

73. Therefore, at their respective May meetings, the staff will ask the Boards for their approval to proceed with publication of the Discussion Paper.

Question for the Boards

74. Do you agree that the staff should proceed with publication of the Discussion Paper?