Project	**Conceptual Framework – Reporting Entity**
Topic	**Comments on the Pre-ballot Draft of the Exposure Draft**

Purpose of this paper

1. The objective of this paper is to discuss the comments raised by IASB and FASB Board members on the pre-ballot draft of the Exposure Draft of the *Reporting Entity* chapter of the conceptual framework.

General comments

2. Many of the Board members' comments on the *Reporting Entity* chapter were also concerned with the forthcoming *Objective* chapter of the conceptual framework.

   Staff comments: The staff will not discuss these comments in this paper but will ensure that the language in the Exposure Draft for the Reporting Entity *chapter is made consistent with the final* Objective *chapter.*

3. IASB Board members raised concerns about proceeding with this project when the IASB had a standards-level project related to consolidations on its agenda.

   Staff comments: Standards-level projects should be conducted based on the concepts in the framework, not the other way around. Moreover, the board would never be able to work on the conceptual framework if the board were to stop working whenever there is a standards-level project in progress. The staff recommends that the boards continue to work on the conceptual framework project.

General comments

1. Do you agree with the staff's response that the concerns raised with regard to the Objectives chapter will not be discussed on the Reporting Entity chapter?

2. Do you agree with the staff on proceeding with the conceptual framework project with no regard on whether there are conflicts with current standards-level projects?

The Reporting Entity

4. Paragraphs RE2-RE4 stated:

> A reporting entity is a circumscribed area of economic activity whose financial information has the potential to be useful to existing and potential equity investors, lenders, and other creditors in making decisions about providing resources to the entity and in determining whether the directors and management have made efficient and profitable use of the resources provided.
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> The phrase *circumscribed area* means that a reporting entity has an observable boundary that distinguishes the resources and claims, and changes in those resources and claims, from those of its capital providers and other entities. That boundary may be determined by the existence of a legal entity, but the existence of a legal entity is neither necessary nor sufficient to create a reporting entity.
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> A legal entity could, but would not necessarily, meet the description of a reporting entity. For example, the boundaries between two entities with common ownership may not be observable if the activities and records of the two are not separated.

5. Paragraphs BC2.4-BC2.5 stated:

> A reporting entity is essentially a collection of economic resources under the control of single management in which capital providers have investments. Resources are central to a reporting entity and its economic activities. By providing the needed resources to an entity, capital providers obtain investments in the entity's resources, and management's control of the entity's resources gives economic coherence and unity to the reporting entity.
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> The success or failure of a reporting entity depends largely on the ability of its management to obtain and use resources in a way that, over the long run, results in an amount of cash received for its outputs that exceeds the cash expended for inputs. The cash flows of a reporting entity are determined to a large extent by the ways in which the resources available to it (for example, cash, plant, labour, and technical knowledge) are used and by the means by which they are obtained and financed.

6. Board members' comments on the description of a reporting entity included the following:

a. The ability to observe separate activities and records is not a defining characteristic of a reporting entity, and is unrelated to control. Please delete and replace with characteristics of control.

Staff comments: The staff thinks there are three defining characteristics of a reporting entity:

a. economic activities are being conducted, have been conducted, or will be conducted;

b. there is a boundary that distinguishes the entity from other entities and from the rest of the economic environment in which it exists; and

c. there are primary users who need financial information about that entity in order to make decisions about investments, loans, or other credit arrangement that already exist or that are under consideration.

The staff thinks that the ability to observe separate activities and records is necessary to distinguish the boundary of a reporting entity. Moreover, it would be difficult to use the control notion to identify a portion of a single legal entity (or a portion of a group of entities) as a reporting entity.

The staff agrees that the conceptual framework should further elaborate on how the reporting entity description applies to various situations (such as a single legal entity, a portion of a single legal entity, a group of entities, and a portion of a group of entities). A preliminary draft is provided in Appendix A.

b. The description of a reporting entity should clarify that something less than an entire legal entity could be a reporting entity.

Staff comments: The staff agrees. Please see Appendix A.

c. Paragraph BC2.4 provides a second description of a reporting entity. The first sentence in paragraph BC2.4 should read: "A reporting entity is <u>a circumscribed area of economic activity</u> ~~essentially a collection of~~

~~economic resources under the control of single management~~ in which capital providers have investments." Control by "single management" is untrue because, if a subsidiary is not fully owned, the management of the subsidiary has direct control and the parent only has indirect control of the subsidiary.

Staff comments: The staff agrees that paragraph BC2.4 may cause confusion and, therefore, recommends accepting the suggested change. The staff agrees with the comment regarding 'single management' and will consider revising the language if the boards decide to retain this description.

d. The example in paragraph RE4 was confusing and should be eliminated or replaced.

Staff comments: The confusion seems to have arisen because its was discussed in the context of entities under common control. The revised draft (please see paragraph 5 of Appendix A) includes an example that is easier to understand.

e. The first sentence in paragraph BC2.5 should read: "The success or failure of a reporting entity depends largely on the ability of its management to obtain and use resources in a way that <u>allows them to meet their obligations as they come due and,</u> over the long run, results in an amount of cash received for its outputs that exceeds the cash expended for its inputs."

Staff comments: The staff agrees and, therefore, recommends accepting the suggested change.

Reporting entity
3. Do you agree that something less than a legal entity could be a reporting entity? 4. Do you agree that a portion a group of entities could be a reporting entity? 5. Do you agree with the staff's response to Board members' comments listed in paragraph 6 (other than those addressed in questions 3 and 4)? If not, what should the staff do?

Control of an Entity

7. Paragraphs RE5-RE6 stated:

   A group reporting entity refers to a reporting entity that comprises two or more parties that are presented as a single unit. The composition of a group reporting entity is determined on the basis of *control of an entity*. *Control of an entity* refers to one party having the power currently to direct the activities of another party to generate benefits (or limit losses) for itself. The controlling party is often referred to as the *parent* and the party controlled is often referred to as the *subsidiary*.

   The relationship referred to as significant influence is not a control relationship. The fact that a party is able to influence the financing and operating policy decisions of another party does not necessarily indicate that it has control of that other party.

8. Paragraph BC2.23 stated:

   Some respondents to the discussion paper urged the boards to base the determination of a group reporting entity on risks and rewards. The discussion paper presented the boards' view that the notion of risks and rewards is not a conceptually robust basis for determining the composition of a group reporting entity. The basic idea was so broad that, in order to place what seem like reasonable and necessary limits on which parties 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 or entitlement to rewards. Most respondents agreed.

9. Board members' comments on control of an entity included the following:

   a. Do not use the term party (or *parties*) and instead use the term *entity* (or *entities*) consistently throughout the document. If the term *party* were to be used, define what it means.

      Staff comments: The term 'party' was used because the staff was concerned that a portion of an entity might not be viewed by all as an entity. However, this attempt seemed to have created more confusion. The staff recommends that the boards revert to using the term 'entity,' with the clarification that a portion of an entity is also considered to be an entity.

   b. It is unnecessary to define the terms *parent* and *subsidiary* in the conceptual framework. If those terms were to be defined in the conceptual framework, the description "often referred to as" is inappropriate.

Staff comments: The staff agrees that the terms 'parent' and 'subsidiary' are not necessarily necessary in the conceptual framework. The staff recommends that the boards use the terms 'controlling entity' and 'controlled entity' (or 'entity controlled by the controlling entity') instead.

c. The definition of *control of an entity* in the conceptual framework should be exactly the same as that in IASB's ED10, *Consolidated Financial Statements.*

Staff comments: Given that the conceptual framework project is a joint project between the FASB and the IASB, the staff is reluctant to use the same wording as in ED10 unless the FASB agrees with that wording. The staff notes that U.S. GAAP also does not include the same wording as that of the proposed definition.

d. Benefits in the definition of *control of an entity* include risks and rewards, but control is not limited to risks and rewards only. This point should be clarified.

Staff comments: The boards' decision was that risks and rewards cannot be the sole criterion for consolidation. Aspects of risks and rewards may meet the benefits criterion, but in order to have control, the power criterion also needs to be met. The staff recommends clarifying this point in the Basis for Conclusions.

e. The IASB is currently undertaking a project on joint ventures and the Board should consider whether the *Reporting Entity* chapter of the conceptual framework should discuss *joint control.*

Staff comments: Control (for the purpose of identifying a group reporting entity) cannot be shared, but in the case of joint arrangements that constitute joint control, control is *shared. Accordingly, the staff thinks the accounting for joint control is not an issue of defining the reporting entity. The staff recommends clarifying this point in the conceptual framework.*

Control of an entity
6. Do you agree with the staff's plan to replace "party" with "entity," "parent" with "controlling entity" and "subsidiary" with "controlled entity"? 7. Do you agree with the staff's plan not to use the same wording as in ED10 for the definition of "control of an entity"?

> 8. Do you agree with the staff's plan to explain that control of an entity includes a notion of risks and rewards but that risks and rewards by itself is not a workable criterion for identifying a group entity?
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> 9. Do you agree with the staff's plan to add an explanation that joint control is an issue related to accounting for certain types of investments and not an issue of defining the reporting entity?

Group Reporting Entity

10. Paragraphs BC2.15-BC2.17 stated:

> The following example illustrates this point. Entity A conducts two different businesses within the same entity. The prospects for future cash flows from Entity A to its capital providers depend on the success of both businesses and on the resources and claims of both. Because the degree of risk, expected profitability, opportunities for expansion, and other important factors, may be different for the two businesses, the cash flow prospects of the capital providers are affected by how directors and management allocate resources between the two businesses. An investor cannot commit capital to one business without simultaneously obtaining an interest in the other and vice versa. Thus, both businesses are part of the circumscribed area of economic activity in which Entity A's capital providers have (or may have investments).
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> Entity B conducts the same two businesses as Entity A, but it uses two companies. One company conducts the first business and holds all of the voting equity of the second company, which conducts the second business. The first company's directors and management control both companies, one directly and one through its ability to appoint the directors and management of the second company. The capital providers of the first company have investments in both businesses. Their returns depend on the success or failure of the two companies viewed together as a single unit.
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> Although Entity A and Entity B are structured differently, the area of economic activity whose financial information has the potential to be useful to each Entity's capital providers includes both businesses. An investor in either Entity A or Entity B cannot commit capital to the first business without simultaneously obtaining an interest in the second business. Therefore, the boards concluded that the boundaries of a reporting entity should not be determined based on legal form.

11. Board members noted that the second sentence in paragraph BC2.17, which states that an investor in two entities cannot commit capital to one business without simultaneously obtaining an interest in another, is not true. These Board members noted that this may be true for the equity holder of the parent but not for the equity holders of the subsidiary or creditors.

Staff comments: The staff agrees with the comments and, therefore, recommends that the example be clarified to say that the 'equity' investors in the parent of the two entities cannot invest in one business without simultaneously obtaining an interest in the other.

Group reporting entity
10. Do you agree with the staff's plan to clarify the discussion in paragraphs BC2.15-BC2.17as described in paragraph 11 of this paper? If not, what should the staff do?

Parent-only Financial Statements

12. Paragraph RE8 stated:

> Parent-only financial statements present information about the parent's investment in its subsidiaries, and return on that investment, rather than the underlying sources and claims, and changes in those resources and claims, of those subsidiaries. Parent-only financial statements may provide useful information if they are presented together with consolidated financial statements.

13. Paragraph BC2.26 stated:

> In some jurisdictions, it is common for both parent-only financial statements and consolidated financial statements to be presented when a party has one or more subsidiaries. As discussed in paragraph BC2.25, the boards concluded that consolidated financial statements should be presented when the controlling party prepares a general purpose financial report. However, the boards also concluded that parent-only financial statements may provide useful information if they are presented together with consolidated financial statements. For example, parent-only financial statements may be helpful to those who are interested in assessing the level of dividends the parent is legally able to pay without depending on moving funds from its subsidiaries.

14. Board members' comments on parent-only financial statements included the following:

    a. The conceptual framework should explain more why parent-only financial statements could provide useful information. An investment company showing its investments at value gives a different perspective of the parent company's performance.

       Staff comments: The staff recommends adding the point discussed in paragraph 14 of this paper to paragraph BC2.26 of the Reporting Entity chapter.

A related question is whether parent-only financial statements could ever provide information that is more useful than consolidated financial statements.

b. In some cases, it is useful to present consolidated or parent-only financial statements of a subsidiary together with the consolidated financial statements of the parent, and suggested that this point be noted in the conceptual framework.

Staff comments: The staff agrees and recommends that the draft be amended as proposed.

c. The Exposure Draft should include a proposal to universally replace the term *separate financial statements*[1] with *parent-only financial statements* as a consequential amendment to IFRSs. The term *parent-only financial statements* is descriptive and clear.

Staff comments: The staff thinks it is preferable to align the conceptual framework and IFRSs. However, the staff does not think the forthcoming Exposure Draft is the appropriate document to address this issue. The staff recommends that, if the IASB Board decides to make this universal change, such a change should be addressed in the annual improvements process.

Parent-only financial statements
11. Should the conceptual framework discuss whether there are cases where parent-only financial statements could provide information that is *more* useful than consolidated financial statements? 12. Should a universal change to replace *separate financial statements* with *parent-only financial statements* be made to IFRSs? If so, in which document should that proposal be exposed for public comment?

[1] IAS 27 *Consolidated and Separate Financial Statements* defines *separate financial statements* as follows:

> *Separate financial statements* are those presented by a parent, an investor in an associate or venture in a jointly controlled entity, in which the investments are accounted for on the basis of the direct equity interest rather than on the basis of the reported results and net assets of the investees.

> 13. Do you agree with the staff's response (other than those addressed in questions 11 and 12) to Board members' comments listed in paragraph 14? If not, what should the staff do?

Combined Financial Statements

15. Paragraph RE9 stated:

    Combined financial statements include information about the resources and claims, changes in those resources and claims, of two or more commonly controlled parties. In contrast to consolidated financial statements, combined financial statements do not include the controlling party (ie the parent) as part of the group reporting entity. If the controlling party does not prepare a general purpose financial report, it may be useful to present combined financial statements of parties under common control. If the parties that are combined represent a circumscribed area of economic activity whose financial information has the potential to be useful to capital providers, combined financial statements of those parties are considered general purpose financial statements.

16. Board members' comments on combined financial statements included the following:

    a. The Boards have not made a decision as to whether combined financial statements were general purpose financial statements, although the Boards did agree that combined financial statements could provide useful information under certain circumstances.

       Staff comments: The staff would like to ask the boards to clarify whether combined financial statements could qualify as genera- purpose financial statements. The staff thinks combined financial statements are financial statements of a portion of a group of entities. Because the staff thinks a portion of a group of entities could qualify as a reporting entity, combined financial statements could qualify as general-purpose financial statements.

    b. The distinction between consolidated financial statements and combined financial statements should be clarified.

       Staff comments: The staff thinks the description of combined financial statements is sufficient for inclusion in the conceptual framework. Any further discussion should be provided at the standards level.

c. If a reporting entity could be a portion of another entity (or a group of entities), this paragraph may not be needed.

Staff comments: The staff's thinking is in line with this comment. Please see Appendix A.

Combined financial statements
14. Do you agree that combined financial statements can qualify as general purpose financial statements? If not, what should the staff do? 15. Do you agree that there is no need to provide more explanation of the difference between combined and consolidated financial statements? If not, what additional explanation is needed? 16. Do you agree that a discussion similar to that in Appendix A should be added to the Reporting Entity chapter?

Proportionate Consolidation

17. Paragraph BC2.27 stated:

> Both boards permit proportionate consolidation under certain circumstances. However, they decide not to address proportionate consolidation in this chapter of the conceptual framework. If proportionate consolidation is appropriate from a conceptual perspective, it would be only for investments in entities that are not under the control of the parent, ie for investees that are not part of the group reporting entity. Therefore, proportionate consolidation is no more pertinent to a discussion of the reporting entity than are other potential methods of accounting for an investment in another party, such as cost or fair value.

18. Board members' comments on parent-only financial statements included the following:

a. This paragraph should be deleted in its entirety.

Staff comments: The staff thinks that it is useful to clarify that the notion of 'proportionate consolidation,' which appears to be similar to (full) consolidation, is irrelevant in determining the composition of a group reporting entity. The staff recommends that this paragraph be retained.

b. The Boards should clarify whether not discussing proportionate consolidation "in this chapter" implied that it would be discussed in other chapters.

Staff comments: The staff does not think proportionate consolidation would be discussed in other chapters and, therefore, recommends that the phrase 'in this chapter' be replaced with 'in this conceptual framework'. If the boards subsequently decide to discuss proportionate consolidation in other chapters, they can always make consequential amendments to previously- issued chapters.

Proportionate consolidation
17. Do you agree paragraph BC2.27 should be retained because it clarifies the notion of 'proportionate consolidation?' If not, what should the staff do? 18. Do you agree with the staff's response that the phrase "in this chapter" be replaced with "in this conceptual framework?" If not, what should the staff do?

Appendix A

A1. This Appendix presents a preliminary draft regarding the application of the ‘reporting entity’ concept to various situations.

General

1. Based on the description of a reporting entity, the existence of a reporting entity presupposes three things:

   a. economic activities that are being conducted, have been conducted, or will be conducted;

   b. a boundary that distinguishes the entity from other entities and from the rest of the economic environment in which exists; and

   c. the existence of primary users who need financial information about that entity in order to make decisions about investments, loans, or other credit arrangements that already exist or that are under consideration.

2. Identifying a reporting entity in a specific situation requires consideration of the boundary of the economic activities conducted (or, for inactive entities or start-up entities, activities that have been or will be conducted).

3. A boundary that consists of less than a single legal entity (or less than a group of entities) may be defined by the information needs of users. A boundary of a group of entities may be defined by control.

A single legal entity

4. A single legal entity that conducts economic activities and that does not control other entities could qualify as a reporting entity if there are primary users of its financial information. Most, if not all, legal entities have existing investors, lenders, or other creditors, or some combination of the three.

5. A single legal entity, by itself, would not qualify as a reporting entity if its activities and records are commingled with the activities and records of another legal entity. In fact, in some jurisdictions, there may be

questions about whether those entities are actually separate entities under the law.

6. A single legal entity, by itself, would not qualify as a reporting entity if it controls one or more other entities that conduct, have conducted, or will conduct economic activities. Whether the single legal entity and all other entities under its control, as a group, qualify as a reporting entity should be considered.

A portion of a single legal entity

7. A portion of a single legal entity could qualify as a reporting entity if that portion is or can be separated from the rest of the entity and there are primary users of the financial information about that portion of the entity. For example, a potential investor could be considering a purchase of that portion of the legal entity's business.

A group of entities

8. A group of entities, which consists of an entity and all other entities that entity controls, could qualify as a reporting entity if there are primary users of its financial information.

A portion of a group of entities

9. A portion of a group of entities could qualify as a reporting entity if that portion is separate from the rest of the group, or can be separated from it, and there are primary users of the financial information about that portion of the group. For example, a potential investor may be interested in a set of assets owned and used in economic activities by an individual (or a group of individuals) and the related claims to those assets.