IASB/FASB Joint Meeting
1 June 2010

Staff Paper

IASB Agenda reference	**3A**
FASB Memo reference	**28**

Project **Consolidation**

Topic **Disclosures Principles**

Introduction

1. The staff presented draft disclosure objectives to the boards at their joint meeting on 4 May 2010. At that meeting, the boards instructed the staff to conduct further research on how the general disclosure objectives could be expressed.

2. This agenda paper:

    (a) provides background on how analysts use the information provided in the financial statements; and

    (b) presents a list of specific disclosure objectives.

3. The appendix to the paper provides a summary of how the proposed disclosure objectives would apply to consolidated and unconsolidated entities. Agenda paper 3B discusses specific disclosure requirements.

What information do analysts need to analyse consolidated financial statements?

4. Based on our discussions with analysts, it is apparent that they use different techniques to analyse financial statements depending on their objectives. In addition, based on their different objectives, they require different information to perform their analysis. Equity analysts typically seek to value the interest that the ordinary shareholders of the parent hold in the group. They usually use a

valuation multiple based on a price to earnings (P/E)-ratio, an enterprise value (EV) to EBITDA-ratio, or variations of those metrics. However, some equity analysts may also use a discounted cash flow model. Credit analysts assessing the credit quality of the parent typically use the cash flows available to the parent in their assessment. In order to perform these valuations, the analyst needs to identify the cash flows or earnings attributable to the ordinary shareholders of the parent.

5. The consolidated financial statements present the financial position, the comprehensive income and cash flows of the group as a single entity. The consolidated financial statements ignore the legal boundaries of the parent and its subsidiaries. However, those legal boundaries could affect the parent's access and use of assets and resources of its subsidiaries and, therefore, affect the cash flows that can be distributed to the parent entity. For example, if the parent does not own all of the equity of a subsidiary, it has to consider the rights of other shareholders of that subsidiary (non-controlling interests). Similarly, the existence of creditors at the subsidiary level may limit a parent's ability to access cash generated by a subsidiary's assets and, in the absence of guarantee arrangements, a parent would typically not be legally responsible for a subsidiary's debts.

6. Therefore, to identify the cash flows and income available to the parent, the analyst must understand the composition of the group, the non-controlling interests' share in the profits or losses, cash flows and net assets of group entities, how protective rights in the group that are held by parties other than the parent affect the parent's ability to access and use the assets and resources of its subsidiary and the leverage in subsidiaries. An understanding beyond just the amount of consolidated profit attributed to non-controlling interests on an aggregated basis is needed.

7. Most valuation models are based on forward-looking earnings or cash flow information. As a consequence, the analyst must have a thorough understanding of the reporting entity's risk exposure, including its risk exposure relating to the

reporting entity's involvement with bothconsolidated and unconsolidated entities, especially structured entities.

Disclosure objectives

8. We believe that to meet the information needs of users of financial statements as outlined above a reporting entity should provide information that helps users to understand:

   (a) the significant judgements and assumptions (and changes to those judgements and assumptions) made by the reporting entity in determining whether it controls (or does not control) another entity and/or about the reporting entity's involvement with structured entities

   In order to identify the cash flows and income attributable to the parent, users of financial statements need to understand the composition of the group and how the reporting entity has assessed, whether it should (or should not) consolidate another entity.

   In addition, the reporting entity required to consolidate a structured entity may change as a result of a change in the activities that significantly affect the entity's returns. This may occur if a contingent event occurs during the life of the structured entity. Providing information about an entity's involvement with a structured entity enables users of financial statements to determine whether the entity may be required to be consolidated in the future. For entities that are not considered structured entities, the activities that significantly affect the returns are less likely to change.

   Therefore, we recommend that the boards affirm this disclosure objective.

(b) The interest that the non-controlling interests have in the group's activities

Consistent with this objective, the reporting entity should disclose information about the interest that the non-controlling interests have in the performance, cash flows and net assets of the group. The disclosure and presentation requirements for non-controlling interests were recently updated by the Statement 160 amendments to Subtopic 810-10 *Consolidation* and the amendments to IAS 27 *Consolidated and Separate Financial Statements* in phase II of the joint project on business combinations. Some staff believe that those presentation and disclosure requirements and the segment disclosure requirements should appropriately address the informational needs of users of financial statements. Therefore, these staff do not believe that there is a need for a specific disclosure objective in the consolidation standard relating to the interest that the non-controlling interests have in the group's activities.

Other staff believe that, although some of the disclosure requirements proposed in ED 10 are already required, the proposed disclosure objective goes further. For example, in their view, the proposed disclosure objective implies that a reporting entity should provide summarised financial information about those subsidiaries in which non-controlling interests hold an interest that is individually material to the reporting entity. In addition, the staff supporting this disclosure objective believe that a reporting entity should be required to disclose the non-controlling interests' proportionate interest in dividends paid for each individual subsidiary.

Those staff recommend that the boards affirm the disclosure objective because, in order to identify the cash flows and income attributable to the parent, users of financial statements need to understand the non-controlling interests' share in the profits or losses, cash flows and net assets of group entities. Agenda paper 3B discusses in more detail, which specific disclosures the final standard should require with respect to this disclosure objective.

(c) The effect of restrictions on the reporting entity's ability to access and use assets or settle liabilities of consolidated entities, as a result of where the assets or liabilities are held in the group

Consistent with this objective, a reporting entity would disclose the extent to which (a) legal, regulatory or contractual requirements or (b) rights of other interest holders could restrict the reporting entity's access and use of assets or obligation to settle liabilities of group entities.

In order to identify the cash flows and income available to the parent, users of financial statements must understand how rights of other parties affect the reporting entity's ability to access and use assets and settle liabilities of group entities. Therefore, we recommend that the boards affirm this disclosure objective.

(d) The nature of, and changes in, the risks associated with the reporting entity's control of consolidated structured entities or involvement with unconsolidated structured entities

A reporting entity is exposed to many different types of risks from its involvement with structured entities. Although Topic 275, *Risks and Uncertainties* and IFRS 7 *Financial Instruments: Disclosures* provide general risk disclosures, we believe that additional risk disclosures are required for structured entities. The proposed disclosures in ED10, which are similar to the requirements in the Statement 167 amendments to Subtopic 810-10, were a direct response to concerns related to investment and securitisation activities and the lack of disclosures in the wake of the credit crisis. These disclosures reflect the observation that the risks *associated with some activities* are more systemic than others and that information about a reporting entity's risk exposure from its involvement with structured entities is of particular interest for users of financial statements.

In order to predict future cash flows and income attributable to the parent, users of financial statements must have a thorough understanding of the group's risk exposure. Therefore, we recommend that the boards affirm this disclosure objective. Agenda paper 3B discusses in more detail, which specific disclosures the final standard should require with respect to such a disclosure objective.

9. A reporting entity would not need to duplicate specific disclosures if the disclosure requirements of other IFRS's or Topics require information that meets these disclosure objectives.

10. The boards have already agreed in their joint project on business combinations that a reporting entity should disclose:

    (a) the accounting consequences of changes in the reporting entity's ownership interest in a subsidiary that do not result in a loss of control; and

    (b) the accounting consequences when the reporting entity loses control of a subsidiary during the reporting period

    The IASB disclosure standard will include these disclosure objectives and an additional disclosure objective relating to a reporting entity's involvement with joint arrangements and associates.

Question for the boards
(1) Do the boards agree that a reporting entity should provide information that helps users to understand: (a) the significant judgements and assumptions (and changes to those judgements and assumptions) made by the reporting entity in determining whether it controls (or does not control) another entity and/or the reporting entity's involvement with structured entities; (b) the interest that the non-controlling interests have in the group's activities; (c) the effect of restrictions on the reporting entity's ability to access and use assets or settle liabilities of consolidated entities, as a result of where the assets or liabilities are held in the group; (d) the nature of, and changes in, the risks associated with the reporting entity's control of consolidated structured entities or involvement with unconsolidated structured entities?

Appendix

1. A reporting entity would be required to disclose the significant judgements and assumptions made by the reporting entity in determining whether it controls (or does not control) another entity. This disclosure requirement applies to all entities regardless of whether those entities are consolidated or whether they are considered structured entities.

2. The following matrix shows how the other disclosure objectives would apply to consolidated and unconsolidated entities and to structured and other entities:

	Consolidated	Unconsolidated
Entities other than structured entities	• The interest that non-controlling interests have in the group's activities • Restrictions on consolidated assets and liabilities	• N/A
Structured entities	• The reporting entity's involvement with structured entities • The interests that non-controlling interests have in the groups activities • Restrictions on consolidated assets and liabilities • The nature of, and changes in, the risks associated with the reporting entity's control of consolidated structured entities	• The reporting entity's involvement with structured entities • The nature of, and changes in, the risks associated with the reporting entity's involvement with unconsolidated structured entities