Conceptual Framework
Reporting Entity

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INTRODUCTION

1. The Boards began their deliberations on the reporting entity phase (Phase D) of the conceptual framework project in December 2005.

2. The cross-cutting issues identified for the reporting entity project phase (Issues RE1–RE8) are set out in the Appendix. This section outlines the issues considered and the Boards' decisions to date, issues to be addressed at the March/April meetings, and issues to be considered at future meetings. It also outlines links with Phase B of the project, in particular, the work in progress on the definition of assets.

3. In December 2005, the Boards discussed the preliminary staff research for the reporting entity phase. That research included an analysis of key literature resources, including the Australian conceptual framework (SAC 1, *Definition of the Reporting Entity*), the U.K. conceptual framework (*Statement of Principles for Financial Reporting* (SoP), Chapter 2, *The Reporting Entity*), and the 1986 FASB partial draft document (*Reporting Entity—Tentative Conclusions*). The December 2005 paper also included some discussion of Issues RE1–RE4.

4. With respect to the second part of Issue RE1 (which asks whether there are two questions—what is an entity and what is a reporting entity?), the Boards decided that the reporting entity concept should be a broad concept that encompasses all types of entities, not only those entities that have external users who are unable to demand the information they require and, therefore, must rely on information provided by the entity. Hence, a *reporting entity* includes anything that is an *entity*. (Although it could be argued that this makes the adjective *reporting* redundant, it can be helpful to use that adjective to distinguish the entity, to which a particular set of financial reports relates, from other entities.)

5. The first part of Issue RE1 (which asks when a legal entity, or an economic unit, is a reporting entity) and the disaggregation part of Issue RE2 (which asks when a legal entity should be divided into several reporting entities) were discussed to some extent in the December staff paper, but no definitive conclusions were drawn. Essentially, these questions relate to determining what constitutes an individual or single entity (as opposed to a group entity) for financial reporting purposes. This issue is addressed below (see paragraphs 17–59).

6. The aggregation part of Issue RE2 (which asks about when consolidation should occur) cannot be answered until later in the project phase, when more progress has been made on the other cross-cutting issues, in particular, issues relating to the control concept.

7. The first part of Issue RE3 asks about the purpose of consolidated accounts. The December staff paper noted that consolidated financial statements are a type of financial reporting, and therefore the purpose of consolidated accounts should be consistent with the objective of financial reporting. Accordingly, based on the Boards' conclusions about the objective of financial reporting, the purpose of consolidated financial statements is to provide information about the group that is useful to present and potential investors and creditors and other capital market participants of the group, in making rational investment, credit and similar resource allocation decisions. Although this answers the question, the answer is not particularly illuminating in itself, because the issue of determining when two or more entities should be consolidated (or combined) to form a group reporting entity is still under discussion.

8. The preliminary staff research also included some discussion of the second part of Issue RE3, about parent-only financial statements. That prompted the Boards to ask the staff to conduct further research into whether a parent-only entity is (or should be) a reporting entity. This issue is addressed below (see paragraphs 60–97).

9. On Issue RE4 (which asks whether control is the right basis for consolidation), the staff reached a preliminary conclusion that determining which entities should be combined to form a group entity should be based upon the concept of control, as a minimum. However, the staff noted that further work is needed on the control concept before reaching final conclusions. Furthermore, the staff suggested exploring the issue of whether the control concept should be supplemented in some way, or be a component of a higher level concept. The December staff paper noted the following:

> For example, suppose there are two entities that are related (e.g., under common management or with common shareholding), but neither entity controls the other. The

control concept alone would not require these two entities to be combined into a single reporting entity. Nevertheless, there might be external users who would find it useful to have financial reports that combine the two entities into one reporting entity.

> Similarly, in accounting practice, difficulties are sometimes encountered when applying the control concept in particular situations, for example, in the context of special purpose entities. If a reporting entity concept could be developed in which the control concept is supplemented in some way, or is a component of a higher level concept, this approach might prove helpful in the context of special purpose entities. [IASB Agenda Paper 2B, FASB Memorandum 20, paragraphs 125 and 126.]

10. The Boards agreed that the staff should conduct further research into the idea of whether the boundaries of a group reporting entity should be based on a broader concept of control, for example, a concept that might encompass entities under common control. To do that, the staff begins by considering Issue RE5 on the meaning of control, in the context of one entity having control over another entity, together with the related issues about control in Issue RE8 (see paragraphs 98–156).

11. The staff plans to address the remaining cross-cutting issues (Issues RE6 and RE7) at a later date. In particular, the staff plans to address Issue RE6 (which relates to the relationship between control over an entity and control over assets) after the Boards have considered related issues in Phase B, concerning options over assets.

12. This is not the only link between Phase B and Phase D. The preliminary staff research noted that, in both SAC 1 and the SoP, the concept of one entity controlling another is used to look through the legal or organisational structure that separates the controlling entity and the controlled entity:

> …information about all resources able to be deployed by a reporting entity is relevant, whatever the legal or administrative structure established to manage those resources. Thus, where an entity controls other entities, there should be disclosed information regarding the resources of controlled entities as well as the resources of the controlling entity because all of these resources may be deployed by the controlling entity to its advantage. [SAC 1, paragraph 16]
>
> 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, paragraph 2.6(b), footnote reference omitted]

13. Therefore, in these frameworks, the control concept is central to the reporting entity concept. It also is central to the definition of assets, as both frameworks, in common with the Boards' existing frameworks, define assets in terms of control over resources (or future economic benefits). Furthermore, both the reporting entity concept and the asset definition link back to the objective of financial reporting. That is, to satisfy the objective of

financial reporting, the entity should report information about its assets. Hence, at present, the control concept is used to determine both (a) the entity that is reporting and (b) the assets of that entity.

14. The work to date on the asset definition, in Phase B of the conceptual framework project, has proposed that assets be defined in terms of rights rather than control. The replacement of *control* with *rights* is intended to be a clarification of existing definitions rather than a fundamental change. Nevertheless, given the link between the asset definition and the reporting entity concept, the implications of the revisions to the asset definition for the reporting entity phase will need to be considered.

15. In addition to considering the implications of the revised asset definition for the way in which the control concept is used today in the context of determining when two or more entities should be combined into a group reporting entity, it will be necessary to consider how the revised asset definition fits in with the idea of a broader reporting entity concept mentioned above (paragraphs 9 and 10), which might take the form of a broader control concept, or a higher-level concept, of which control is a component.

16. The asset definition being developed in Phase B is still a work in progress, and the staff working on that project phase have yet to fully explore the implications of removing control from the asset definition. Therefore, the implications for Phase D will be considered at a later date.

WHAT IS AN ENTITY

Introduction

17. As noted earlier (paragraph 4), in December 2005, the Boards decided that the reporting entity concept should be a broad concept that encompasses all types of entities, not only those entities that have external users who are unable to demand the information they require and, therefore, must rely on information provided by the entity. Hence, a *reporting entity* includes anything that is an *entity*. The December staff paper included some discussion of what constitutes an entity, but no definitive conclusions were drawn.

18. In its general sense, an entity can be defined as follows:

> a thing with distinct and independent existence. [Compact Oxford English Dictionary, www.askoxford.com]

19. In the context of financial reporting, many of the things that we commonly think of as being entities have a distinct existence. (The above definition also uses the word

independent. The staff analysis below focuses on whether the thing in question has a distinct existence rather than an independent existence. The word *independent* is defined in the Compact Oxford English Dictionary (www.askoxford.com) as "free from outside control or influence". Many of the things that we commonly regard as entities for financial reporting purposes might not be free from outside control or influence, for example, an entity that is controlled by another entity. Hence, to require freedom from outside control or influence would result in a reporting entity definition that seems too narrow for financial reporting purposes).

20. The most straightforward example of something that has a distinct existence is a company, which legally exists in its own right, as distinct from other parties that have an interest in that company, such as directors, shareholders, employees and creditors.

21. Similarly, many other types of organisations have a distinct existence—that is, it is possible to determine that the organisation itself exists, as distinct from other parties who have an interest in that organisation. For example, although the legal status of trusts, partnerships and associations might vary (across organisations and across jurisdictions), typically they have some form of legal structure or legal standing that establishes the existence of the organisation, as distinct from other parties with an interest in that organisation, such as trustees, beneficiaries, partners, employees and creditors.

22. All of the types of organisations discussed above could be described as being entities in legal terms. For example, Miriam-Webster's Dictionary of Law (1996) defines an entity as "an organization (as a business or governmental unit) that has a legal identity which is separate from those of its members."

23. However, as noted in the December staff paper, for financial reporting purposes, the use of the term *entity* is not limited to legal entities. For example, FASB Concepts Statement No. 6, *Elements of Financial Statements*, paragraph 24, states:

> All elements are defined in relation to a particular entity, which may be a business enterprise, an educational or charitable organization, a natural person, or the like….An entity may comprise two or more affiliated entities and does not necessarily correspond to what is often described as a "legal entity."…

24. Similarly, the SAC 1, paragraph 6, definition of an entity is broader than a legal entity:

> …any legal, administrative or fiduciary arrangement, organisational structure or other party (including a person) having the capacity to deploy scarce resources in order to achieve objectives….

25. Likewise, the SoP adopts a broader concept of an entity, which is described as a cohesive economic unit.[1] The 1986 FASB partial draft document, *Reporting Entity—Tentative Conclusions,* adopts a similar notion. It refers to a reporting entity as being an economic unit. It describes this as being a circumscribed area of economic interest, consisting of a group of resources and the claims to or interests in them, that is a discrete source of future cash flows to an identifiable group of investors, creditors or others. It notes that a reporting entity could be a sole proprietor, a single legal entity, a collection of assets and liabilities that is not a legal entity for most purposes, a consolidated group of two or more legal entities, and perhaps a combined group of legal entities (paragraphs 202 and 203).

26. To test what constitutes an entity, the staff discusses below some things that might be described as a "cohesive economic unit" or "circumscribed area of economic interest", but are not legal entities:

    a. A sole proprietorship

    b. A branch or segment of a legal entity

    c. A collection of assets and liabilities that is part of a legal entity.

27. During that discussion, the staff refers to the objective of financial reporting, as determined during Phase A of the conceptual framework project. The Boards concluded that the objective of financial reporting is to provide information that is useful to present and potential investors and creditors and other capital market participants in making rational investment, credit, and similar resource allocation decisions. In the staff view, what constitutes an entity for financial reporting purposes should be consistent with that objective, as explained below.

Sole Proprietorship

28. A business might be owned and operated by a natural person, which is often referred to as a sole proprietorship or sole trader. In considering whether a sole proprietorship is an entity, there are two related questions to address:

    a. Is a natural person an entity?

    b. Is the business enterprise of a natural person an entity?

29. In the ordinary meaning of the word, a natural person is an entity; that is, a natural person exists in his/her own right, as distinct from other persons or organisations.

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[1] SoP, paragraph 2.3.

30. In legal terms, the term *entity* typically refers to an *organisation* that has a legal existence or identity (see paragraph 22 above), rather than a natural person. However, the staff notes that a natural person also has a legal existence or identity. Therefore, in the staff view, a natural person is a legal entity.

31. In accounting literature, including existing conceptual frameworks, the term *entity* commonly includes a natural person. For example, AICPA SOP 82-1, *Accounting and Financial Reporting for Personal Financial Statements*, provides guidance on the preparation of financial reports for natural persons, including an individual, a husband and wife, or a family. Also, many existing definitions of liabilities are expressed in terms of obligations to other *entities*. If an entity did not include a natural person, then an obligation to a natural person would not meet the definition of a liability.

32. Although it is clear that a natural person is an entity, this still leaves the related question of whether the business enterprise of a natural person (a sole proprietorship) is an entity. In legal terms, a sole proprietorship does not have any legal standing by itself. In other words, although a trading name might be used, the business enterprise does not legally exist in its own right, as distinct from the proprietor.

33. For financial reporting purposes, if we were to treat the natural person (the proprietor) as the entity, rather than the business enterprise of the proprietor, then *all* of that person's assets, liabilities, revenues and expenses would be included in his/her financial reports, including those related to his/her personal activities. However, in accounting practice, financial reports for a sole proprietorship relate to the proprietor's business activities only, not his/her personal activities. In essence, these financial reports relate to a *component* of a legal entity.

34. Thus, if what constitutes an entity for financial reporting purposes is confined to something that is a legal entity or has some form of legal existence, then a sole proprietorship would not be a reporting entity.

35. In contrast, the discussion of the reporting entity at the concepts level in SAC 1, the SoP and the 1986 FASB partial draft document (see paragraphs 23–25 above) supports the conclusion that the reporting entity concept *should* encompass a sole proprietorship. In the staff view, that conclusion is appropriate, for the reasons explained below.

36. As noted earlier, the Boards have concluded that the objective of financial reporting is to provide information that is useful to present and potential investors and creditors and other capital market participants in making rational investment, credit, and similar resource

allocation decisions. In the case of a sole proprietorship, typically there will be lenders, suppliers, and other creditors who will make decisions about allocating resources to that sole proprietorship. Those parties would also have a claim against the personal assets of the proprietor, but typically they would make their resource allocation decisions based upon the expectation that their claims would be settled in the normal course of business, from the assets of the sole proprietorship, without having to resort to claiming against the personal assets of the proprietor. This is a similar situation as occurs with a partnership—the lenders, suppliers, and other creditors of the partnership might have a claim against the personal assets of the partners, but would make their resource allocation decisions based upon the expectation that their claims would be settled in the normal course of business from the assets of the partnership.

37. Consequently, in the staff view, information about the sole proprietorship would be useful to lenders, suppliers, and other creditors in making rational investment, credit and similar resource allocation decisions. That is, in the staff view, it is appropriate for a sole proprietorship to be the *entity* that is the subject of the general purpose financial reports. Those financial reports would provide information about the business assets, liabilities, revenues and expenses of the sole proprietor, as distinct from the personal assets, liabilities, revenues and expenses of the proprietor. (The staff acknowledges that *some* capital market participants (e.g., a bank that is loaning funds to the business enterprise) might *also* want information about the personal assets and liabilities of the proprietor, but that does not negate the *general* conclusion that information about the sole proprietorship would be useful to capital market participants.)

A Branch or Segment of a Legal Entity

38. As with the above discussion of a sole proprietorship, the definition or discussion of an entity at the concepts level is sufficiently broad so as to encompass a branch or segment of a legal entity, at least in some circumstances. As was noted in the December staff paper, for a branch or segment to be an entity for financial reporting purposes, it would need to be organised or structured in such a way that it is possible to distinguish it from the rest of the legal entity. In other words, the branch or segment needs to have observable boundaries so that it is possible to determine which assets, liabilities, revenues and expenses relate to the branch or segment, as opposed to the wider entity. Without observable boundaries, it would not be possible to prepare general purpose financial reports for that branch or segment.

39. Some would argue that, even if it has observable boundaries, a branch or segment is not an entity, or should not be regarded as such for financial reporting purposes, because the branch or segment does not legally exist in its own right. In other words, in the eyes of the law, the branch or segment is merely *part* of a legal entity—it does not have a legal identity of its own.

40. However, the same arguments made above in the context of a sole proprietorship would also apply to a branch or segment, in some circumstances. For example, suppose a company has a branch that operates in another country. If the branch is not regarded as an entity for financial reporting purposes on the grounds that it is not a legal entity, then general purpose financial reports could not be prepared for the branch. Yet those financial reports would likely provide useful information to lenders, suppliers, and other creditors in the country in which the branch operates, to help them make decisions about allocating resources to the branch. Although they might have a claim against the assets of the overseas company, typically they would make their resource allocation decisions based upon the expectation that their claims would be settled in the normal course of business, from the assets of the branch. This implies that, to be consistent with the objective of financial reporting, the branch should be regarded as an entity for financial reporting purposes. (For example, if an overseas company has a business operation in New Zealand, then financial statements are required not only for the overseas company, but also for its New Zealand business, prepared as if that business were conducted by a company formed and registered in New Zealand).[2]

A Collection of Assets and Liabilities That Is Part of a Legal Entity

41. Consider a collection of assets and liabilities that is clearly distinguishable from the rest of the legal entity. In other words, for the purposes of this discussion, assume the collection has observable boundaries, such that we know which assets and liabilities are included in the collection, and which are not. That collection could be described as a "circumscribed area of economic interest, consisting of a group of resources and the claims to or interests in them" (see paragraph 25 above).

42. As with the discussion above about a sole proprietorship and a branch, essentially the collection of assets and liabilities is a component of a legal entity. The collection is not, in itself, a legal entity. In other words, in the eyes of the law, the collection has no legal existence in its own right; it is merely part of a legal entity.

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[2] Financial Reporting Act 1993, paragraph 8.

43. Therefore, those who argue that an entity should be confined to legal entities (or things that have some form of legal standing) would argue that a collection of assets and liabilities should not be regarded as an entity for financial reporting purposes.

44. In the staff discussion above about a sole proprietorship and a branch, it was argued that what constitutes an entity for financial reporting purposes should be broader than legal entities, on the grounds of user information needs. That is, information about the sole proprietorship or branch would be useful to lenders, suppliers, and other creditors, when making decisions about allocating resources to that sole proprietorship or branch. In some circumstances, a similar argument might be made in respect of a collection of assets and liabilities.

45. However, intuitively, even if one accepts the arguments made earlier in support of treating a sole proprietorship or a branch as an entity for financial reporting purposes, treating a collection of assets and liabilities as an entity seems more of a stretch. That could be because when we think about an *entity*, we are envisaging something that is capable of engaging in business activities, such as acquiring and disposing of assets, incurring and settling liabilities, purchasing or selling goods or services, and, more generally, engaging in transactions with other parties. Something that is merely a collection of assets and liabilities does not seem capable of undertaking any of these activities by itself.

46. In the December staff paper, it was suggested that for something to be an entity, it must have the "capacity to act". This was based on an analysis of literature that indicated for something to be an entity, it must be capable of operating or functioning in some manner. For example, it was noted that the SAC 1 (paragraph 6) definition of an entity refers not only to "any legal, administrative, or fiduciary arrangement, [or] organisational structure", but also to an arrangement or structure that has "the capacity to deploy scarce resources". Similarly, the SoP (paragraph 2.3) discussion of a reporting entity notes that the boundaries of the entity are determined by the extent of its control over assets and activities. Thus, for something to be an entity, it must be capable of controlling assets and activities. The staff also noted that the definition of a business, as set out in the Boards' Exposure Drafts on business combinations, refers to "an integrated set of activities and assets that is capable of being conducted or managed…" but does not refer to who or what does the conducting or managing.[3] The staff suggested that for something to be an entity, rather than being

[3] IASB Exposure Draft, *Proposed Amendments to IFRS 3—Business Combinations*, paragraph 3; FASB Exposure Draft, *Business Combinations,* paragraph 3(d).

simply a business or a collection of assets, it must have some sort of operating capability or capacity to act.

47. During the Boards' discussions in December, there was some negative reaction to this idea, because of the concern that it might unnecessarily limit what constitutes an entity, for example, it might exclude a special purpose entity (SPE) with predetermined operating and financing policies (that is, an SPE on 'autopilot'). However, the 'capacity to act' could be interpreted broadly, as including any such capacity, no matter how limited in scope. Even an SPE on autopilot will have some capacity to act, for example, the capacity to hold assets and engage in activities with other parties, such as collecting receivables and disbursing the resulting funds.

48. In essence, the idea is that for something to be an entity for financial reporting purposes, it requires some sort of management function, to conduct or manage its resources and activities.

49. For example, in the case of a sole proprietorship, the proprietor has two roles, one as the manager of the business and another as the owner of the business. The *entity* comprises the business itself and the proprietor in his/her capacity as manager, as distinct from others with an interest in that sole proprietorship, such as lenders, suppliers and other creditors, including the proprietor in his/her capacity as owner. The same could be said for a branch that has its own management function.

50. Conversely, something that is merely a collection of assets and liabilities, without any management function to manage that collection, would not have a capacity to act or, to use the SAC 1 terminology, would not have the capacity to deploy resources.

Summary

51. The above discussion began with a general definition of an entity as being something with a distinct existence. It was noted that this definition would encompass anything that is a legal entity, that is, something that has a legal existence or identity. Typically, this would include companies, partnerships, trusts, associations and natural persons.

52. The staff also argued that what constitutes an entity for financial reporting purposes should not be limited to legal entities, but should be defined more broadly, to encompass a sole proprietorship or branch. The staff argued that a broader definition is necessary to be consistent with the objective of financial reporting. That is, investors, creditors, or other capital market participants commonly make decisions about whether to allocate resources to organisations that are not legal entities, such as a sole proprietorship or branch.

Therefore, limiting an *entity* for financial reporting purposes to something that is a legal entity would result in those organisations being unable to provide general purpose financial reports to help capital market participants make resource allocation decisions.

53. The staff also observes that a group reporting entity typically comprises two or more legal entities, but does not legally exist in its own right. If what constitutes an entity for financial reporting purposes is limited to something that is a legal entity, that would preclude a group entity from being a reporting entity. Conversely, if it is acceptable for an entity for financial reporting purposes to include something that is an *aggregation* of two or more legal entities, there seems to be no reason why an entity for financial reporting purposes should preclude one that is a *disaggregation* of a legal entity.

54. In summary, the staff proposes that an *entity* for financial reporting purposes should not be limited to legal entities. Based on the discussion above, the staff proposes that an entity be defined as follows:

An entity is an economic unit that has the capacity to deploy resources.

55. The exact wording will be refined as necessary during the course of the project phase. However, what these words are intended to convey is that an entity for financial reporting purposes:

    a. Is broader than legal entities, hence the use of the word *economic*;

    b. Has a cohesive or *unified* organisational structure, such that it has observable boundaries and therefore can be distinguished from other parties that have an interest in it, such as investors and creditors.

    c. Has a management function included within that organisational structure, to enable it to engage in business activities, such as acquiring and disposing of assets, incurring and settling liabilities, purchasing or selling goods or services, and, more generally, engaging in transactions with other parties.

Questions for the Boards

56. Do the Boards agree with the proposed definition of an entity set out above (paragraphs 54 and 55)?

57. Do the Boards agree that what constitutes an entity should not be limited to legal entities, but should also other types of organisations or structures?

58. More specifically, do the Boards agree that what constitutes an entity for financial reporting purposes includes:

a. A natural person?

b. A sole proprietorship?

c. A branch or segment of a legal entity in the circumstances described in paragraph 56 above?

59. Do the Boards agree that what constitutes an entity for financial reporting purposes does not include something that is merely a collection of assets and liabilities?

PARENT-ONLY ENTITY

Introduction

60. At present, we use the control concept to determine when a group reporting entity exists, comprising the controlling entity (the parent) and all other entities under its control (its subsidiaries). In general, accounting standards require the controlling entity to produce consolidated financial statements, which include the resources and activities of the controlling entity and those of the controlled entities.

61. However, sometimes a parent entity might prepare parent-only (separate) financial statements, in addition to (or instead of) consolidated financial statements. In these separate financial statements, the parent-only entity reports its investment in its subsidiaries, not the underlying assets and liabilities of those subsidiaries.

62. During the December discussion of the preliminary staff research for the reporting entity project phase,[4] some Board members asked whether a parent-only entity can be a reporting entity. That is, assuming that we retain the control concept (in some manner), is the current accounting practice of preparing separate financial statements consistent with the objective of financial reporting? Is it appropriate for a parent-only entity to be the entity that is the subject matter of general purpose financial reports?

63. It should be noted that this section makes frequent references to control, both in the context of one entity having control over another and in the context of an entity's control over assets. This is because existing accounting literature uses control in both contexts, and therefore any discussion of that literature necessarily contains references to control. The meaning of control, in the context of one entity having control over another, is discussed the following section (paragraphs 98–156). Whether there is a difference between the control concept in the context of (a) one entity having control over another and (b) an

[4] IASB Agenda Paper 2B, FASB Memorandum 20.

entity's control over assets, is an issue to be addressed later in the project, as noted above (paragraph 11). Moreover, as noted earlier (paragraph 14), in Phase B of the conceptual framework project, the working definition of an asset does not explicitly refer to control. Hence, the implications for the reporting entity phase of the revised asset definition need to be considered. In the meantime, the staff continues to refer to control in the reporting entity phase. Therefore, any decisions reached in the reporting entity phase might need to be reassessed at a later date, to ensure that there is consistency between the two project phases.

Possible Approaches

64. The staff discussion below first sets out three approaches:

    a. The SAC 1 view (paragraphs 67 and 68)

    b. The SoP view (paragraphs 69 and 70)

    c. A 'legal versus economic boundaries' approach (paragraphs 71–73)

65. The staff then discusses these approaches, during which two other possible approaches are suggested:

    a. An 'aggregation' approach (paragraph 81)

    b. An approach that distinguishes between the parent entity and the group entity (paragraphs 85–91).

66. Staff conclusions and questions for the Boards are set out in paragraphs 92–97.

SAC 1 View

67. SAC 1 uses the control concept to *look through* the legal or administrative structure that separates one entity from another. It states that the entity should disclose information about all its resources, whatever the legal or administrative structure established to manage those resources. If an entity controls other entities, the controlling entity should disclose information about the resources of the controlled entities as well as the resources of the controlling entity.

68. Under this view, it seems that a parent-only entity would not be a reporting entity, because the separate financial statements of a parent-only entity would omit resources under the control of the parent. This conclusion is discussed further below.

SoP View

69. The SoP divides control into direct control and indirect control. It states that the boundary of the reporting entity can be determined by direct control alone, and both direct control and indirect control. Thus, under this approach, a parent entity could prepare separate financial statements, which present information about resources under the direct control of the parent, and/or consolidated financial statements, which present information about resources under the direct and indirect control of the parent.

70. Hence, under this view, a parent-only entity can be a reporting entity. This conclusion is discussed further below.

Legal versus Economic Boundaries

71. Another approach is that a reporting entity could be defined by either its legal boundaries or its economic boundaries, or both.

72. Consider two companies and assume that one is controlled by the other (no matter how we define control). The two companies are separate legal entities. In other words, in legal terms, the subsidiary company is separate from, not part of, the parent company. If we defined the reporting entity in such a way that it was confined to legal boundaries, then a company that holds shares in another company would report a single asset, that is, the shares in that other company, but would not report the assets or liabilities of that other company. Conversely, if we define the reporting entity in such a way that goes beyond the legal boundaries of an entity to encompass other entities under its control, then the resulting economic entity would include in its financial reports all of the assets and liabilities of those other entities.

73. In other words, the information in the parent company's separate financial statements corresponds to its legal boundaries, while the consolidated financial statements corresponds to the company's economic boundaries. Thus, if the reporting entity concept allowed for a reporting entity to be defined by its legal boundaries (either in addition to, or instead of, its economic boundaries), then a parent-only entity could be a reporting entity.

Discussion of Above Approaches

74. The 'legal versus economic boundaries' approach arrives at the same answer as the SoP in the case of a company that has control over other companies, but it is not clear whether that would always be the case. That is, the staff has not researched whether the division between direct and indirect control would always correspond to the division between an

entity's legal and economic boundaries. This issue will be addressed later, if there is a need to do so.

75. The discussion below considers the issue of whether a parent-only entity could be a reporting entity by considering whether that would be consistent with the objective of financial reporting.

Objective of Financial Reporting

76. The Boards' draft document for Phase A of the project describes the overriding objective of financial reporting, elaborates on that objective, and discusses the kinds of information currently provided to help achieve the objective, as follows:

    a. Information that is useful to present and potential investors and creditors and other capital market participants in making rational investment, credit, and similar resource allocation decisions

    b. Information to help present and potential investors and creditors and other users assess the amounts, timing, and uncertainty of the entity's future cash flows

    c. Information about economic resources of the entity (its assets), the claims to those resources (its liabilities and owners' equity), and the effects of transactions, other events, and circumstances that change resources and claims to them.

77. Therefore, to satisfy the objective of financial reporting, an entity should report information about its assets (and claims to those assets). Depending on how we define what constitutes a reporting entity, that will determine its boundaries, which in turn will determine which assets (and claims to those assets) are assets (and claims) of the reporting entity, and which are not.

Do Parent-only (Separate) Financial Statements Satisfy the Objective of Providing Information about the Economic Resources of the Entity?

78. It was noted above that under SAC 1 a parent-only entity would not be a reporting entity, because the separate financial statements of a parent would omit resources under the control of the parent.

79. Also as noted above, the SoP divides control into direct and indirect control, and states that the boundaries of the reporting entity can be drawn by direct control alone, or direct control plus indirect control. In parent-only financial statements, the financial statements provide information about the resources under the *direct* control of the parent, but omit

resources under the *indirect* control of the parent (the resources under the direct control of other entities that are under the control of the parent).

80. Some would argue that drawing the boundary of the reporting entity using direct control alone does not satisfy the objective of financial reporting because it results in the omission of resources under the control of the parent. In other words, irrespective of whether an entity *directly* controls resources or *indirectly* controls resources (through its control of other entities), *all* of those resources are under its control. Hence, the entity's financial statements should include all resources under its control to satisfy the objective of financial reporting.

81. However, others might argue that even when the boundary is drawn by direct control alone, as in parent-only (separate) financial statements, those financial statements *do* include all resources under the control of the parent, because the financial statements include the parent's investment in its subsidiaries. In the consolidation process, that investment is replaced by the assets and liabilities of the subsidiaries. Thus, it could be argued that the consolidated financial statements are an alternative way of presenting information about the same resources that appear in the parent-only financial statements. In other words, the investment asset reported in the parent-only financial statements is an aggregate amount, comprising the assets and liabilities that are presented separately in the consolidated financial statements. We commonly aggregate assets and liabilities in financial reporting—so it could be argued that this is simply another example of aggregation. If one accepts this argument, then the parent-only financial statements *do* satisfy the objective of financial reporting—all resources are included, but are aggregated (and perhaps measured) in a different manner than in the consolidated financial statements.

82. The counterargument is that the difference between parent-only financial statements and consolidated financial statements is much more fundamental than a difference in aggregation (or measurement). The two sets of financial statements do not present the *same* set of assets and liabilities. Rather, each presents a *different* set of assets and liabilities. The parent-only financial statements include an investment asset, which is not included in the consolidated financial statements. The consolidated financial statements include a variety of additional assets and liabilities that are not included in the parent-only financial statements. This is because the boundaries of the reporting entity are drawn in a different place. The SoP explains this as follows:

    (a) Direct control is used to determine the boundary of the reporting entity that prepares single entity financial statements. Those financial statements will

therefore deal with the gains, losses, assets and liabilities directly controlled or borne by the entity, but no other gains, losses, assets or liabilities.

(b) 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 that entity* through its control of other entities. [SoP, paragraph 2.6, emphasis added.]

83. It appears that the SoP regards the entity that is the subject matter of the parent-only financial statements as the *same* entity that is the subject matter of the consolidated financial statements, with its boundary drawn in two different places. Thus, under the SoP, a parent entity can have two different boundaries, and hence two different sets of assets and liabilities.

84. The staff finds this troublesome. In the staff's view, once we have identified the entity for financial reporting purposes, then it ought to have only one boundary and hence one set of assets and liabilities.

85. Another approach would be to view the parent entity and the group entity as being two different entities. For example, consider a parent entity, Company A, which owns all of the common shares of its subsidiary, Company B. For financial reporting purposes, it could be argued that there are three different entities that could be the subject matter of general purpose financial reports:

a. Single entity Company A

b. Single entity Company B

c. Group entity AB, which is a combination of the two single entities Company A and Company B.

86. Under this approach, the parent-only (separate) financial statements would be regarded as presenting information about the parent entity, Company A, while the consolidated financial statements would be regarded as presenting information about a group entity AB, comprising Company A and Company B.

87. This approach seems consistent with the manner in which the purpose of consolidated financial statements is sometimes described, as being the financial statements of the parent and its subsidiaries, prepared *as if they were a single economic entity*.[5] This description acknowledges that a parent entity and a subsidiary entity are, in fact, two separate entities.

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[5] For example, ARB. No. 51, *Consolidated Financial Statements*, paragraph 1.

Thus, the group entity might be described as a hypothetical entity, which is created for financial reporting purposes.

88. The approach also might assist with what some regard as a problem with consolidated financial statements. If the parent entity and the group entity are regarded as being the same entity, then effectively the consolidation process involves taking all of the assets and liabilities of the subsidiaries, and treating them as if they were assets and liabilities of the parent. Some argue that this process results in the parent entity including in its financial reports assets and liabilities that do not meet the definition of assets and liabilities of the parent. For example, the liabilities of Company B are not the liabilities of Company A. Likewise, the assets of Company B are not, in total, the assets of Company A—all that Company A is entitled to is the net assets of Company B, once all other claim to the assets of Company B have been satisfied.

89. Others would argue that the 'problem' outlined above is not necessarily a problem. The group reporting entity to which consolidated financial statements relate is an entity that includes the assets and liabilities of the parent and subsidiary *as if* the boundary between the parent and the subsidiary does not exist. Once that boundary is set aside, the subsidiary is regarded as being part of the parent, rather than being separate from it. Hence, anything that is an asset or liability of the subsidiary also will be an asset or liability of the parent.

90. The issue outlined in paragraph 88 does not arise under the approach outlined in paragraph 85, because the parent entity and the group entity are not regarded as being the same entity. Rather, the group entity is an entity that is created for financial reporting purposes, by combining two or more separate entities and treating them as if they were a single entity. Hence, anything that is an asset or liability of any member of the group also would be an asset or liability of the group. Some might find this approach more understandable than one that treats the assets and liabilities of the subsidiary as if they were the assets and liabilities of the parent.

91. The approach in paragraph 85 also would be more amenable to the idea that the Boards have asked the staff to explore—about whether we should adopt a broader control concept for determining when a group reporting entity exists, which encompasses entities under common control. If the group entity is regarded a combination of two or more entities, one could envisage other types of combinations, in addition to a parent-subsidiary combination.

Concluding Comments

92. Most would probably agree that, even if one entity has control over another, this circumstance does not change the fact that two separate entities exist. However, the question is whether that fact is important or relevant for financial reporting purposes. In other words, the question is whether, for a parent entity, the distinction between the individual entities should be preserved (as in parent-only or separate financial statements) or should be disregarded (as in consolidated financial statements).

93. Various approaches have been discussed above. Some support the conclusion that the separate financial statements of a parent-only entity do not satisfy the objective of financial reporting, and hence a parent-only entity should not be regarded a reporting entity, while other approaches conclude otherwise.

94. In the staff's view, the approach outlined in paragraph 85 seems to be a reasonable balance between the various views. It acknowledges that a parent entity and a subsidiary entity are, in fact, two separate entities. But, in effect, it also acknowledges that the separate financial statements of the parent entity may not be sufficient to satisfy user information needs. For example, 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. Even if the parent's separate financial statements are considered in conjunction with the financial statements of the subsidiary, they do not provide an overall, complete picture of the activities of the group. Hence, for financial reporting purposes, when one entity controls a second entity, there also is a third entity (commonly referred to as an economic entity because it is not a legal entity), being a group entity that combines all of the individual entities together, as if they were a single entity.

95. If this approach is adopted, then the reporting entity concept in the Boards' common conceptual framework would permit a parent-only entity to be a reporting entity. The circumstances in which separate financial statements of a parent entity should be prepared, either in addition to, or instead of, consolidated financial statements of the group, is an issue to be addressed at the standards level, in the staff's view.

Questions for the Boards

96. Do the Boards agree that it is appropriate for a parent-only entity to be an entity that is the subject of general purpose financial reports? If so, is that conclusion based on:

    a. The approach outlined in paragraph 85 above?

    b. The SoP approach (see paragraphs 69 and 70)?

c. The 'legal versus economic boundaries' approach (see paragraphs 71 to 73)?

d. The 'aggregation' approach (see paragraph 81)?

e. Something else?

97. If the Boards conclude that it is not appropriate for a parent-only entity to be an entity that is the subject of general purpose financial reports, is that conclusion based on the SAC 1 approach (see paragraphs 67 and 68), or on something else?

THE MEANING OF CONTROL

Introduction

98. This section addresses the following cross-cutting issues:

RE5: What does control of another entity mean? Should this be defined at the concepts level or at the standards level?

RE8: Does it matter if an entity has control of another entity today but might lose control later (e.g., control today only because of dispersion of other shareholdings)? What if an entity does not have control today, but could gain control of another entity tomorrow (e.g., by exercise of an option)?

99. How these issues fit in with other issues already considered or yet to be considered in the reporting entity project phase is explained above (paragraphs 1 to 16).

Should Control of Another Entity Be Defined at the Concepts Level or at the Standards Level?

100. As noted in earlier staff papers,[6] the U.K. SoP and Australian SAC 1 are the only conceptual frameworks that discuss the reporting entity concept. Both SAC 1 and the SoP define the meaning of control. Hence, both standard setters thought it necessary to define control at the concepts level.

101. In the staff's view, assuming that the control concept is retained in the context of determining when two or more entities should be combined to form a group reporting entity, the conceptual framework should define—or at least contain *some* discussion of—the meaning of the control. To do otherwise would result in the conceptual framework being so vague that it would likely be of little use at the standards level.

[6] For example, December 2005, IASB Agenda Paper 2B, FASB Memorandum 20.

102. If control is defined at the concepts level, one difficulty might be drawing the line between issues to be addressed at the concepts level, and those to be dealt with at the standards level. At one end of the spectrum, in the staff's view, it seems inappropriate for the conceptual framework to contain a detailed, lengthy discussion of the meaning of control that covers all known application issues. Application issues generally are best dealt with at the standards level. Also, new application issues will continue to arise; the framework would quickly become out of date if it sought to provide such detailed guidance. But at the other end of the spectrum, if the discussion is too brief, the conceptual framework may be of little help in addressing issues at the standards level. The staff expects that the Boards' discussion of the issues addressed this paper will provide direction for drawing that line.

What Does Control of an Entity Mean?

103. The meaning of control, in the context of one entity having control over another, is discussed below. The selection of issues included in that discussion is based on various factors:

a. The cross-cutting issues identified for the reporting entity project phase

b. Similarities and differences between existing definitions of control

c. Issues discussed in SAC 1 and the SoP.

104. The staff has attempted to keep the discussion relatively high level, and therefore some issues may require further analysis, if the Boards so wish. Similarly, if there are issues not included in the discussion below that the Boards believe should be addressed at the concepts level, those issues will be addressed at a later date.

Overview

105. 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 Dictonary, Second Edition, 1989.]

106. Control therefore may be viewed as a synonym for power, in particular, the power to direct something. Some accounting definitions[7] also define (or proposed to define) control as a synonym for power, for example:

[7] 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** 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.]

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

> *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).]

108. 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.]

109. The 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]

110. The definition in SAC 1 is not as explicit in referring to benefits, but the staff interprets the last part of the definition as relating to benefits obtained from the other entity:

> **"control"** means the capacity of an entity to dominate decision-making, directly or indirectly, in relation to the financial and operating policies of another entity so as to enable that other entity to operate with it in achieving the objective of the controlling entity. [SAC 1, paragraph 6]

111. 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)

112. In the staff's view, this approach is appropriate. As discussed in the preliminary staff research for the reporting entity project phase,[8] to satisfy the objective of financial reporting, the entity should report information about its assets. For something to be an asset of the entity (under existing definitions of an asset and the working definition being developed in Phase B of the conceptual framework project), it must be capable of generating economic benefits to the entity. Therefore, consistent with the asset definition, the definition of control should exclude situations in which the entity might have power over another entity but without the ability to benefit from that power.

113. 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. The most explicit example of the linkage of the power element with the benefits element is found in the IASB's consolidations project.

> …control of an entity is the ability to direct the strategic financing and operating policies of an entity so as to access benefits flowing from the entity and increase, maintain or protect the amount of those benefits. Therefore, to control an entity the potential controller must satisfy three tests:
>
> - it must have the ability to direct the strategic financing and operating policies of the entity (the 'Power Criterion');

[8] December 2005, IASB Agenda Paper 2B, FASB Memorandum 20.

- it must have the ability to access the benefits flowing from the entity (the 'Benefits Criterion'); and
- *it must be able to use its Power so as to increase, maintain or protect the amount of those benefits*.

[IASB web site, Project Update, *Consolidations (including special purpose entities)*, 5 December 2005, paragraph 23, emphasis added.]

114. For the purposes of discussing further the meaning of control in the remainder of this paper, the staff proposes to use that definition of control:

Control of an entity is the ability to direct the strategic financing and operating policies of an entity so as to access benefits flowing from the entity and increase, maintain or protect the amount of those benefits.

Determining When One Entity Has Control of 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.[9]

116. Similarly, accounting standards that define control contain discussion of a variety of factors to consider when assessing whether one entity controls another.[10]

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, but the staff understands that, in U.S. practice, this is generally interpreted as being a *necessary* condition.[11] (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.")[12] 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

[9] SAC 1, paragraph 17; SoP, paragraphs 2.12 to 2.15.

[10] 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.

[11] 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.

[12] FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries,* paragraph 20.

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.[13] 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. In the staff's view, the approach taken in the SoP, SAC 1, and the majority of accounting standards is appropriate and should be made clear in the conceptual framework. That is, determining whether one entity has control over another entity involves an assessment of all the facts and circumstances; 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, as control can exist through other means. For example, an entity might own less than half of the voting rights, but have the ability to control the other entity by means of a contract, statute, or an agreement with other shareholders.

The Power Element

Power Over Financing and Operating Policies

120. The power element in the working definition of control (in paragraph 114) is expressed as "the ability to direct the strategic financing and operating policies of an entity". This is consistent with other definitions of control, that is, power relates to the other entity's financing and operating policies. This is based on the view that, if an entity has the ability to direct the financing and operating policies of another entity, then it has the power to decide how that other entity's resources are obtained, used and financed, in essentially the same way as it could if it had directly engaged in those activities itself.[14] (The 1995 FASB ED, as shown in the definition set out in paragraph 106, applies the power element at a lower level—it refers to power over the other entity's assets rather than power over that entity's operating and financial policies. The staff understands that respondents to the ED were concerned that this definition could be misread as precluding control where a restriction was placed on a particular asset or class of assets of an entity, which limited the ability to use that asset, but did not deprive the parent of the overall ability to direct use of that entity's assets. The staff observes that the definition of control in the 1999 FASB ED did not refer to power over assets, but referred instead to the ability to direct the policies and management that guide the on-going activities of the other entity, as shown in the definition set out in paragraph 107).

[13] IAS 27, paragraph 13.
[14] 1986 FASB partial draft document, *Reporting Entity—Tentative Conclusions,* paragraph 241.

121. The working definition also includes the adjective *strategic*, that is, it refers to the ability to direct the other entity's *strategic* financing and operating policies, whereas most other definitions of control do not include this adjective. Including it might help to clarify that an entity need not have power over the entity's day-to-day financing and operating decisions. For example, the controlling entity might have delegated the day-to-day decision making to directors or management of the controlled entity.[15] However, that clarification could be given in explanatory material. Furthermore, including the word 'strategic' might raise more questions than it answers. At this stage, the staff does not recommend its inclusion in the definition of control. That can be considered further at a later date, if necessary.

Power Is Non-Shared

122. Some accounting standards (and other sources, such the 1986 FASB partial draft document) make it clear that to satisfy the power element, power cannot be shared with others. For example, NZ FRS-37 states:[16]

> 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]

123. The staff agrees 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.

124. 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.[17] 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. Thus, control is distinguished from joint control. Joint control will be considered at a later date, when cross-cutting issue RE7 is addressed:

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[15] For example, refer to NZ FRS-37, paragraphs 4.24–4.26; 1986 FASB partial draft document, paragraphs 250–252.

[16] Other examples include AASB 1024 and Canadian Handbook (Section 1590).

[17] There could be limitations on power imposed by law, regulations, fiduciary responsibilities and contractual rights. Those 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).

Joint ventures—concept of joint control; joint control over entity or assets? What about 'significant influence'—how does that fit in with the control concept?

Legal Right to Exercise Power versus Ability to Do So

125. The working definition of control (in paragraph 114) refers to *the ability* to direct the strategic financing and operating policies of the other entity. There might be situations in which the entity has that ability, but does not have the *legal right* to do so. For example, an entity might be able to direct the financing and operating policies of another entity when it owns a minority of voting rights and the holdings of other voting rights are widely dispersed and disorganised. This is sometimes referred to as *de facto control* or *effective control*.

126. In the staff's view, the control concept should not be limited to circumstances in which the entity has the legal right to direct the financing and operating policies of another entity, but should be a broad concept that encompasses economically similar circumstances. This would be consistent with the approach taken in other parts of the conceptual framework. For example, under the existing and working definition of assets, assets are not limited to *legal rights* to resources. Similarly, in the staff's view, the control concept should encompass situations in which the entity has the *ability* to direct the operating and financial policies of another entity, including when it does not have the legal right to do so.

127. The staff acknowledges that a control concept that encompasses de facto or effective control, rather than a narrower concept that is limited to legal control, may give rise to practical difficulties when applied in practice. However, in the staff's view, 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 or other means.

128. Of course, if the entity has the present ability to control another entity in the situation described above (paragraph 125), but not the legal right to do so, then control may be temporary, as the controlling entity might lose control if the other shareholders organise themselves to vote against what was the controlling entity. This issue is discussed below.

Temporary Control and Other Timing Issues

129. Cross-cutting issue RE8 asks the following questions:

> Does it matter if one has control today but might lose control later (e.g., control today only because of dispersion of other shareholdings)? What if one does not have control today, but could gain control tomorrow (e.g., by exercise of an option)?

130. Both of these questions relate to the timing of control. On a general level, in the staff's view, whether one entity has control over another should be based upon an assessment of the *present* facts and circumstances.

131. Therefore, in the staff's view, at the concepts level the answer to the first question in paragraph 129 is "no". That is, in the staff's view, the control concept should not exclude situations in which control might be temporary. (That does not preclude the possibility of providing exemptions from consolidation at the standards-level if thought appropriate in specific circumstances, such as when the controlling entity is obliged to relinquish control within a relatively short time after acquisition.)18

132. The example in the first question in Issue RE8 might be questioning whether the control concept should encompass effective or de facto control, which has already been discussed above (paragraphs 125–128). The second question in Issue RE8 relates to potential voting rights, or other means of taking control by unilateral action by the entity. This is sometimes referred to as latent control.

Latent Control and Potential Voting Rights

133. Another form of control that is sometimes discussed is *latent control*. The SoP notes that if an 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.[19] The 1986 FASB draft states that latent control exists if a 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.[20] It gives an example of an entity that holds debt securities that are convertible at any time at the entity's option into 90 percent of a second entity's voting common stock. Similarly, accounting standards typically require that potential voting rights be considered, when assessing whether control exists.[21] The issue of potential voting rights will be considered later in the project, in the context of cross-cutting issue RE6:

> Is there a difference between control over an entity and control over assets? Which should provide the basis for consolidation?

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[18] For example, NZ FRS-37, paragraph 5.5(a).
[19] SoP, paragraph 2.18.
[20] 1986 FASB draft, paragraph 217.
[21] For example, IAS 27, Canadian Handbook (Section 1590), AASB 1024, and NZ FRS-37.

134. This issue raises questions about the treatment of options and is related to other issues to be addressed in Phase B, concerning options over assets. The staff plans to address issue RE6 once the Boards have considered the related issues in Phase B.

Summary

135. The above discussion of the power element can be summarised as follows:

  a. Power relates to the entity's *financing and operating policies*

  b. Power is *non-shared*

  c. *The ability* to direct the financing and operating policies of the other entity is sufficient; hence, in concept, control is broader than legal control, in particular, it includes de facto or effective control.

  d. Whether one entity has control over another should be based upon an assessment of the present facts and circumstances.

136. The issue of latent control, in particular, potential voting rights, is to be discussed later in the project.

137. Another key issue not yet addressed is the application of the power element of the definition of control to special purpose entities (SPEs), in particular, situations in the financing and operating policies of the SPE are predetermined (that is, the SPE is on 'autopilot'). In this situation, it may be unclear whether the power element is satisfied. This issue will be addressed later in the project, when other related issues have been considered.

138. Other than the issues identified above, the staff does not plan to discuss the power element further. For example, the staff does not plan to consider the various power indicators or rebuttable presumptions that are contained in accounting standards. In the staff's view, such issues should be addressed at the standards-level, because they relate to applying the power element in practice. If the Boards disagree and believe that further discussion of the power element at the concepts level is necessary, the staff asks for the Boards' direction on which particular issues the Boards wish the staff to address.

The Benefits Element

139. In the working definition of control (paragraph 114), the power element is linked to a benefits element, whereby the controlling entity has power over the other entity "…so as to *access benefits* flowing from the entity and *increase, maintain or protect the amount of those benefits*" (emphasis added).

140. Even though most definitions of control include a benefits element, this element usually receives less attention than the power element. For example, the discussion of control in IAS 27 focuses on the power element. It is only in the context of SPEs, in SIC-12, *Consolidation—Special Purpose Entities*, that benefits become the focus.

141. There are two key questions relating to the benefits element:

a. Are all types of benefits relevant, or only particular types of benefits?

b. Is there a minimum level of benefits required before control exists?

Types of Benefits

142. Most accounting definitions of control refer to *benefits*[22] or to *economic benefits*[23], 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.[24]

143. There is an exception—the New Zealand definition of control refers more specifically to *ownership benefits*, which are stated to be "benefits equivalent to returns to an investor on or of an investment".[25] However, the term is used more broadly than might first be supposed, because ownership benefits encompasses not only distributions of earnings or net assets, but also other benefits from control over net assets (such as synergistic benefits), and benefits from complementary activities (such as the supply of goods or services to a third party that meets an operating objective of the parent).[26]

144. The term "ownership benefits" is used because the New Zealand standard adopts an "ownership form of control". Again, *ownership* is used more broadly than it might first be supposed, as it is not limited to relationships that arise through the legal ownership of equity instruments.[27] Usually, *ownership* and *control* are regarded as two different bases upon which consolidated financial statements could be prepared. The notion of an "ownership form of control" sounds like a combination of the two. However, it seems that the objective was to avoid the control definition being interpreted too broadly—in particular, to exclude situations in which an entity might have power over another entity

[22] For example, IAS 27, 1999 FASB ED.
[23] For example, the SoP, UK FRS-2, and the Canadian Handbook (Section 1590).
[24] CICA Handbook, Section 1590, paragraph .04.
[25] NZ FRS-37, paragraph 4.29.
[26] NZ FRS-37, paragraphs 4.32–4.35.
[27] NZ FRS-37, paragraph 4.16.

because of a regulatory, purchaser/supplier or lending relationship. The standard distinguishes an "ownership form of control" from:

a. Regulatory control, when a regulatory body has the authority to impose a specified form of compliance on the regulated entity's operation.

b. Control of a purchase form, when there is a power, held as a consequence of a relationship involving the purchase of goods or services, to compel a supplier entity into a certain course of action.

c. Control of a lending form, when there is a power, held as a consequence of a lending relationship, to compel a borrower into a certain course of action.[28]

145. Although the staff understands the rationale, the staff does not recommend using the term *ownership*, either in the context of the benefits element or to describe the definition of control itself. Using such a term might imply that, for one entity to have control over another, the first entity must have an ownership interest in that other entity. That would unnecessarily narrow the control concept, in the staff view.

Level of Benefits

146. In most cases, existing definitions of control do not specify any minimum level of economic benefits that is required to satisfy the benefits element of the control definition.[29] There is one key exception, which is discussed below.[30] Before looking at that exception, that staff notes that including a minimum level of benefits would necessarily result in a narrower concept of control.

147. For example, some might argue that, for control to exist, the 'parent' must have an equity interest of 50 percent or more in the 'subsidiary'. This would result in a much narrower control concept than that used today. For example, suppose Entity A has a 60 percent equity interest in Entity B, and Entity B has a 60 percent equity interest in Equity C. In this situation, Entity A has a 36 percent equity interest in Equity C (60 percent of 60 percent). Therefore, under a minimum benefit approach with a 50 percent threshold, Entity C would not be regarded as being controlled by Entity A, irrespective of whether the power element of the control definition is satisfied.

148. As noted above, most definitions of control do not refer to any minimum level of benefits, and therefore adopt a broader concept of control than the approach suggested in paragraph

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[28] NZ FRS-37, paragraph 4.15.

[29] For example, the SoP, IAS 27, UK FRS-2, and the Canadian Handbook (Section 1590).

[30] There also is another exception: the definition of control in NZ FRS-37 refers a *significant* level of ownership benefits. However, the staff understands that this word was included on the grounds of materiality.

147. The key exception is control in the context of SPEs. Often, SPEs have predetermined financing and operating policies, which cannot be modified (i.e., the SPE operates on 'auto-pilot'). In this situation, it might be doubtful whether the power element of the control definition is satisfied. Nevertheless, some accounting standards require consolidation of SPEs on grounds that focus on the benefits element rather than the power element. For example, as noted above, IAS 27 defines control as requiring both a power element and a benefits element, and its commentary focuses on the power element, while its related interpretation, SIC-12, focuses on benefits rather than power. In particular, the guidance in SIC-12 about when an entity controls an SPE refers to 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.

149. Issues relating to applying the control concept in the context of SPEs will be addressed later in the project phase, as explained earlier (paragraph.

150. In the meantime, leaving aside the issue of SPEs, the staff finds no reason for requiring that the control definition include reference to a minimum level of benefits. In the staff's view, to do so would result in an unnecessarily narrow definition of control. For example, it would not be consistent with the definition of assets. The asset definition (existing definitions and the working definition in Phase B) does not require that the entity have access to a minimum level of economic benefits before something meets the definition of an asset. Moreover, to introduce a minimum level, the Boards would need to draw an arbitrary line, which would be inappropriate in a conceptual framework

Questions for the Boards

151. Do the Boards agree that control, in the context of control of another entity, should be defined at the concepts level?

152. Do the Boards agree that the definition of control should contain both a power element and a benefits element, together with a link between the two, along the lines set out in the working definition in paragraph 114?

153. Do the Boards agree that the conceptual framework should explain that determining whether one entity has control over another entity involves an assessment of all the facts and circumstances; 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?

154. With regard to the power element, do the Boards agree that:

a. Power relates to the entity's *financing and operating policies?*

b. Power is *non-shared?*

c. *The ability* to direct the financing and operating policies of the other entity is sufficient; hence, in concept, control is broader than legal control, in particular, it includes de facto or effective control?

d. Whether one entity has control over another should be based upon an assessment of the present facts and circumstances, and therefore the control concept should not exclude situations in which control might be temporary?

155. With regard to the benefits element, do the Boards agree that:

a. The control definition should refer broadly to benefits or economic benefits, rather than specific types of benefits?

b. Leaving aside the issue of SPEs, the control definition should not specify a minimum level of benefits?

156. Other than the issues identified to be addressed later in the project (for example, potential voting rights and application of the control definition to SPEs), are there any other issues that the Boards wish to consider for the purposes of defining control at the concepts level?

APPENDIX

CROSS-CUTTING ISSUES FOR THE REPORTING ENTITY PROJECT PHASE

RE1: When is a legal entity, or an economic unit, a reporting entity? (e.g., branch versus entity, business versus entity) Are there two questions—what is an entity and what is a reporting entity?

RE2: Aggregation versus disaggregation—which is the most useful information? For example, when should a legal entity be divided into several reporting entities? When should consolidation occur?

RE3: What is the purpose of consolidated accounts? Why do some jurisdictions require parent-only financial statements, others require consolidations, and yet others may want combinations?

RE4: Is control the right basis for consolidation?

RE5: What does control over an entity mean? Should this be defined at the concepts level or at the standards level?

RE6: Is there a difference between control over an entity and control over assets? Which should provide the basis for consolidation?

RE7: Joint ventures—concept of joint control; joint control over entity or assets? What about 'significant influence'—how does that fit in with the control concept?

RE8: Does it matter if an entity has control of another entity today but might lose control later (e.g., control today only because of dispersion of other shareholdings)? What if an entity does not have control today, but could gain control of another entity tomorrow (e.g., by exercise of an option)?