

## Conceptual Framework Reporting Entity

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### PART I: INTRODUCTION

1. There were eight cross-cutting issues identified for the reporting entity project phase (Issues RE1–RE8). This paper brings together all previous Board decisions on those issues and considers all remaining cross cutting issues.
2. Issues RE1–RE8 are set out in the relevant sections of this paper. They are also set out in the Appendix, together with a summary of the Boards' conclusions and staff recommendations<sup>1</sup> on those issues.
3. This paper is set out in five parts, as follows:
  - Part I: Introduction
  - Part II: Individual reporting entity (covers Issue RE1 and disaggregation part of Issue RE2)
  - Part III: Group reporting entity (covers the aggregation part of Issue RE2, plus Issues RE3–RE5)
  - Part IV: Control issues (covers Issues RE6–RE8)
  - Part V: Summary, other comments and next steps
4. The Boards have agreed that the conceptual framework should relate to general purpose external financial reports (GPEFR), rather than other types of financial reports, such as special purpose financial reports. Therefore, it should be noted that this paper considers issues in the context of GPEFR.
5. It should also be noted that the issues addressed in this paper are considered from a conceptual perspective only. Some of these issues are also being considered (or have been considered) by the Boards in related standards-level projects, in particular, in the Boards'

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<sup>1</sup> All staff recommendations and references to a staff view in this paper reflect the views of the staff member leading the reporting entity phase of the project.

respective projects on consolidations. Different considerations may apply at the conceptual level than apply at the standards level. For example, practical considerations may require the Boards to take a different approach to an issue at the standards-level than is taken at the concepts level.

6. In the staff view, when considering issues at the concepts level, the objective should be to determine the “ideal” solution. Factors that determine whether or not that ideal can (or should) be applied in practice should be considered at the standards-level. The staff acknowledges that there is little point in having an ideal that is so fraught with practical difficulties that it can *never* be applied in practice. However, it is more likely that if significant practical difficulties exist, that might result in some modification of the conceptual ideal at the standards-level (such as the use of a proxy), or perhaps a delay in applying the conceptual ideal while practical difficulties are resolved or sufficiently reduced.
7. In the staff view, the fact that a pragmatic solution might be applied at the standards-level should not affect the development of the ideal solution to be included in the conceptual framework, because otherwise the resulting framework would not be a *conceptual* framework.
8. Therefore, the staff has not treated any previous Board decisions (by either or both Boards) in current or previous standards-level projects as setting any precedents for the conceptual framework project. Hence, all references in this paper to previous decisions of the Boards mean decisions reached in the conceptual framework project only, not decisions reached in related standards-level projects.
9. Of course, this does raise some logistical problems—if the Boards are considering particular issues in the conceptual framework project and are also considering similar issues in a current standards-level project, there is potential for different conclusions to be reached within a short time-frame. This might be confusing, for both the Boards and their constituents. These logistical difficulties are exacerbated by the fact that the framework project and the related standards-level projects may be at different stages and each will go through several rounds of deliberations. If different conclusions are reached in the concepts project and related standards-level projects, it would be necessary to evaluate whether those different conclusions result from (a) different considerations that apply at the concepts level and standards level or (b) inconsistent decisions in the concepts project and related standards-level projects.

10. One way to resolve this problem (at least to some extent) is to decide which issues should be addressed in the conceptual framework project and which issues should be addressed in the standards-level projects. In particular, Part IV of this paper (paragraphs 150-189) deals with various control issues that some argue should be addressed at the standards level. These issues are being addressed in this paper because they were identified as cross-cutting issues for the conceptual framework project during the initial project planning phase. The Boards are asked to reconsider whether those issues belong in the conceptual framework project.
11. It should be borne in mind, however, that some conflict between decisions reached in the conceptual framework project and current standards-level projects may be inevitable. In particular, if the Boards decide to adopt an approach at the concepts level that is new or different from an approach being applied in a current standards-level project, it may be necessary to live with some conflicting decisions for a while. Any new or different concepts developed in the conceptual framework project will take some time to be finalised. In the meantime, it likely will be necessary for the related standards-level projects to continue using existing approaches to those concepts.

## **PART II: INDIVIDUAL REPORTING ENTITY**

12. This section addresses cross-cutting issue RE1<sup>2</sup> and the disaggregation part of issue RE2:
  - 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?
13. In December 2005, the Boards decided that they do not wish the reporting entity concept to specify which particular entities should be required (or encouraged) to prepare general purpose external financial reports. Rather, any entity that chooses to, or is required to (e.g., by company legislation), prepare general purpose external financial reports will be a reporting entity.

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<sup>2</sup> Issue RE1 includes the term *economic unit*. The examples in brackets indicate that the term is being used to refer to something that is a subset of a legal entity, such as a branch. However, it might be referring to an *economic entity*, a term often used to describe a group entity formed by combining two or more legal entities. If so, this part of Issue RE1 is dealt with in the next section, on the group reporting entity.

14. Therefore, the answer to the second question in issue RE1 is “no”. The adjective *reporting* is simply used to refer to the entity that is reporting, and does not exclude any particular *entity* from being a *reporting entity*.
15. In March/April 2006, the Boards agreed that what constitutes an entity for financial reporting purposes should not be limited to legal entities, however defined. Exactly what constitutes a legal entity might differ across jurisdictions. It could be defined broadly, to mean something that has some sort of legal standing or recognition in the eyes of the law. Or it could be defined narrowly, to mean something that has a separate legal existence, as distinct from other parties having an interest in it. Given the Boards’ decision, there is no need to define the term.
16. Hence, legal existence (or some sort of legal standing) is a sufficient condition for concluding that an entity exists, but is not necessary condition. Rather, an *entity* includes other types of arrangements or organisational structures, which could be broadly described as a circumscribed area of economic interest.
17. Examples of entities include a natural person, sole proprietorship, company, trust, partnership, association and, in some circumstances, a branch or segment.
18. The staff notes that the above discussion broadly describes, rather than precisely defines, an entity. However, it seems unnecessary to be more definitive. One reason is that what constitutes an entity for financial reporting purposes is often defined by others. For example, in order to establish a requirement to prepare general purpose external financial reports, then the person or body responsible for establishing that requirement (e.g., legislator, regulator, lender or investor) will have to define the “thing” that is required to report.
19. Also, if the Boards were more specific about what constitutes an entity for financial reporting purposes, that might inadvertently result in excluding some things that might choose to, or be required to, prepare general purpose external financial reports. For example, at various points the staff suggested that, for something to be an entity, it had to have some sort of management function or capacity to engage in activities with other parties. However, Board members expressed concerns about what such an approach might exclude. The Boards expressed a preference for a broad notion of what constitutes an entity.
20. By deciding that the reporting entity concept should not specify which particular entities should be required (or encouraged) to prepare general purpose external financial reports, in

effect the Boards have decided not to address the disaggregation part of issue RE2. It will be a matter for others (for example, regulators, legislators, investors, creditors, or the entity itself) to determine when a legal entity (such as a company) should be divided into several reporting entities.

21. Other than what might be necessary to address the remaining cross-cutting issues, the staff does not plan to conduct further research into the issue of what constitutes an individual entity for financial reporting purposes. Hence, the discussion of the reporting entity in the conceptual framework will describe what constitutes an individual entity, along the lines set out above, but will not define it. Instead, the chapter of the framework dealing with the reporting entity will largely focus on what constitutes a “group” entity for financial reporting purposes. (The word *group* is used here loosely. Exactly what is meant by the term—and even whether it should be used at all—will depend upon the Boards’ conclusions on the issues discussed in this paper.)

### **Question for the Boards**

22. Do the Boards agree that:
  - a. other than what might be necessary to address the remaining cross-cutting issues, there is no need to conduct further research into the issue of what constitutes an individual entity for financial reporting purposes?
  - b. the discussion of the reporting entity in the conceptual framework should describe what constitutes an individual entity, along the lines set out in paragraphs 13-17 above, but not define it?

### **PART III: GROUP REPORTING ENTITY**

23. This section considers the aggregation part of Issue RE2 (set out in paragraph 12 above), which asks when consolidation should occur. It also addresses Issues RE3–RE5:

- 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?

24. The discussion begins with Issue RE3. Essentially, the questions in Issue RE3 relate to present practice. It is useful to consider these questions first, to understand more about the concepts underlying current practice, before considering whether we should move to a new approach. As part of this process, in addition to the questions raised by Issue RE3, the discussion below considers the role of control both in the asset definition and in determining the boundaries of a group entity, in current accounting practice.
25. After that, the analysis addresses Issue RE5, Issue RE4 and the aggregation part of Issue RE2. In addressing these questions, the staff considers three approaches to determining what constitutes a group entity for financial reporting purposes: (a) a controlling entity model, (b) a common control model, and (c) a risks and/or rewards model.

### **Parent entity versus group entity**

26. Issue RE3 asks questions about the purpose of consolidated financial statements, and why there are different requirements in different jurisdictions concerning the preparation of parent-only and consolidated financial statements.
27. The question about the purpose of consolidated financial statements was addressed in the December 2005 staff paper.<sup>3</sup> That 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. Thus, based on the Boards' preliminary views and their existing frameworks 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 others, in making 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 what constitutes a "group" is still under discussion.
28. The December 2005 staff paper also included some preliminary staff research on the question about why there might be different requirements in different jurisdictions concerning the preparation of parent-only (separate) financial statements<sup>4</sup> and consolidated financial statements.<sup>5</sup> It was noted that different views about the reporting entity concept, including different views about whether a parent-only entity can be the subject matter of general purpose external financial reports, may be a cause of different reporting requirements.

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<sup>3</sup> IASB Agenda Paper 2B, FASB Memorandum 20, paragraph 111.

<sup>4</sup> The phrase "parent-only financial statements" is used to mean financial statements in which the parent reports an asset, being its investment in other entities, rather than all the underlying assets and liabilities of those other entities.

<sup>5</sup> IASB Agenda Paper 2B, FASB Memorandum 20, paragraphs 113-115.

29. That prompted the Boards to ask the staff to research whether a parent-only entity could be (or should be) a reporting entity. Given that the Boards have agreed that the conceptual framework relates to general purpose external financial reports, rather than other types of financial reports, the question is whether a parent-only entity could be the subject matter of GPEFR. In other words, we are not concerned about situations in which parent-only financial statements are prepared as supplementary or special purpose financial reports. For example, parent-only financial statements might be prepared for tax purposes or for the purposes of determining the amount that may be distributed to shareholders under companies' legislation. Rather, the question is whether the separate financial statements of a parent-only entity could be regarded as GPEFR, either instead of, or in addition to, the group's consolidated financial statements.
30. The Boards considered this question in March/April 06. Overall, most Board members concluded that a parent-only entity could be a reporting entity (i.e., the subject matter of GPEFR), but reached that conclusion using different approaches. These approaches are set out below, together with a summary of the Boards' discussions.
31. At the conceptual level, whether it is necessary for the Boards to agree on one particular approach depends on their conclusions about how they wish a group reporting entity to be defined, as explained further below. At the standards-level, it may be preferable for the Boards to agree on one particular approach, because otherwise it may be difficult to resolve standards-level issues, such as establishing requirements for the preparation of parent-only and/or consolidated financial statements.
32. For the purposes of the discussion below, consider two entities, Company X and Company Y. Assume that Company X has control over Company Y.

**View 1: One Entity – Two Displays** [previously referred to as the *aggregation approach*]

33. Under this approach, the parent entity (Company X) and the group entity are regarded as being one and the same entity. Company Y (the subsidiary) is regarded as being *part of* Company X (the parent), for the purposes of the parent entity's financial reporting. (The subsidiary may also prepare its own general purpose external financial reports.)
34. In addition, under this approach, the consolidated financial statements are regarded as being an alternative way of presenting information about the *same set* of assets, liabilities and activities that appear in the parent-only financial statements. In other words, the investment asset (holding in Company Y) reported in the parent-only financial statements is a combined (or summarised) amount, which comprises all the assets and liabilities of

Company Y that are presented separately in the consolidated financial statements.

Therefore, both the parent-only financial statements and the consolidated financial statements include all of the assets, liabilities, and activities under the control of the parent entity; the difference is whether those assets and liabilities are presented separately as gross amounts, or combined into a single, net amount. We commonly present summarised information about assets and liabilities in the financial statements—so this could be viewed as another example of summarisation.

35. Hence, under this approach, both parent-only financial statements and consolidated financial statements are regarded as general purpose external financial reports. It would be a standards-level issue to determine which presentation approach (i.e., net or gross) should be followed. In other words, it would be a standards-level issue to determine which presentation method would best meet users' information needs.
36. The staff has described this approach as "One Entity – Two Displays". It should be noted that some would support the conclusion that the parent and the group are the same entity, and that there are two different ways of presenting information about that entity, but might use a somewhat different rationale to arrive at that conclusion.
37. For example, some would draw a distinction between the parent as a *legal* entity and the parent as an *economic* entity. That is, in legal terms, Company X and Company Y are regarded as two separate entities, while in economic terms, Company Y is regarded as being part of Company X. Thus, the consolidated financial statements relate to the parent as an economic entity, while the parent-only financial statements relate to the parent as a legal entity.
38. Under another variation of View 1, the assets, liabilities and activities of the subsidiary are regarded as being part of the parent entity, rather than the subsidiary *entity* itself. In other words, because parent entity's control over the subsidiary entity enables the parent to utilise or deal with the subsidiary entity's assets as if they were the parent's own assets, the consolidated financial statements present information about all of the assets, liabilities and activities under the parent entity's control. Essentially, under this variation of View 1, the existence of the subsidiary entity is ignored when preparing the consolidated financial statements, whereas the subsidiary entity's existence is recognised when preparing the parent-only financial statements.
39. Strictly speaking, under View 1 (and under View 2), the consolidated financial statements should not be described as *group* financial statements. The word *group* implies that the financial statements relate to two or more entities, that is, multiple entities. However,



under this approach, the consolidated financial statements are regarded as relating to a single entity only—the parent entity.

**View 2: One Entity – One Display** [previously referred to as the *SAC 1 approach*]

40. This view is similar to the one described above, in that the parent entity and the group entity are regarded as being one and the same entity. Company Y (the subsidiary) is regarded as being *part of* Company X (the parent).
41. However, in contrast to View 1, the consolidated financial statements are regarded as presenting information about a *different set* of assets and liabilities than the set of assets and liabilities that appear in the parent-only financial statements. The consolidated financial statements include all the assets and liabilities of the subsidiaries, which do not appear in the parent-only financial statements. The parent-only financial statements therefore omit assets and liabilities of the parent/group entity.
42. In other words, View 2 rejects the view of View 1 that the investment asset reported in the parent-only financial statements is a summarised amount, comprising the assets and liabilities that are presented separately in the consolidated financial statements. Furthermore, even if that view was accepted, presenting those assets and liabilities as a single net amount would not be regarded as a relevant or faithful representation of the parent entity's assets and liabilities. Although assets and liabilities are commonly aggregated and presented as summarised amounts in the financial statements, they are not offset.<sup>6</sup> For example, the assets and liabilities in a disposal group might be separated from other assets and liabilities, and aggregated, but those highly aggregated amounts of assets and liabilities are not offset and presented as a net amount.<sup>7</sup> To do so would result in the understatement of the parent entity's total assets and total liabilities.
43. Hence, under View 2, the parent-only financial statements are not regarded as being general purpose external financial reports—those financial statements fail to meet the objective of GPEFR and qualitative characteristics of decision-useful information, because they fail to include relevant and complete information about all of the assets, liabilities and activities of the entity. Therefore, under this approach, the consolidated financial statements are, in concept, the only set of financial statements that are regarded as GPEFR. If parent-only financial statements were prepared, as supplementary information, they

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<sup>6</sup> There is at least one exception in accounting practice, involving monetary assets and monetary liabilities, where the counterparty is the same for both the asset and liability, and there is a right of set-off.

<sup>7</sup> For example, see IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*, paragraph 38; SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, paragraph 46.

could not be described as GPEFR nor could they be presented instead of consolidated financial statements.

**View 3: Multiple entities** [previously referred to as the *staff recommended approach*]

44. This approach contrasts with both View 1 and View 2, in that it regards the parent entity and the group entity as being two different entities, both in legal and economic terms. Under this approach, Company Y (the subsidiary) is regarded as being an entity in its own right that is separate from—rather than part of—Company X (the parent). The group entity for financial reporting purposes is formed by combining two separate entities (Company X and Company Y), and presenting the results of that combination *as if* the two entities were a single entity (Group XY). The words “as if” are used deliberately. In both economic and legal terms, the group is regarded as comprising a group of *entities* (i.e., multiple entities). For financial reporting purposes, that group of entities is combined together, and presented *as if* they were a single entity.
45. Thus, the subsidiary is not part of the parent—rather, both the parent and the subsidiary are part of the group. Similarly, the subsidiary’s assets are not assets of the parent—rather, the subsidiary’s assets and the parent’s assets are part of the group’s assets.
46. Under this approach, the parent-only financial statements relate to the parent entity (Company X). The consolidated financial statements relate to the group entity (Group XY). Hence, both sets of financial statements are regarded as general purpose external financial reports. It would be a standards-level issue to determine when financial statements for the parent entity and/or the group entity should be prepared. In other words, if the parent entity chooses to, is required to (e.g., by a regulator), prepare GPEFR, the relevant accounting standard would determine whether that parent entity should prepare:
- a. Financial statements that relate to the parent entity itself;
  - b. Financial statements that relate to the group of entities, comprising the parent entity and other entities under its control; or
  - c. Financial statements for both the parent entity and the group of entities.

**March/April 2006 Board discussions**

47. The FASB agreed with View 3 (Multiple Entities). Five Board members supported View 3 and one Board member supported View 1 (One Entity – Two Displays), with one Board member absent.

48. The IASB expressed mixed views. Initially, seven Board members supported View 1 (One Entity – Two Displays) and six Board members supported View 3 (Multiple Entities), with one Board member absent. However, after further discussion, some who expressed support for View 1 (One Entity – Two Displays) expressed views that were closer to View 2 (One Entity – One Display). Some of these Board members commented that the entity (the parent/group) could not prepare two different presentations that purported to be general purpose external financial reports. In particular, some said that the parent-only financial statements are not GPEFR—those financial statements could be provided as supplementary information, but were not a substitute for the consolidated financial statements.
49. The staff agrees that, if View 1 is applied, the relevant accounting standard would need to specify *which* presentation approach should be followed. That would be consistent with the Boards previous decision that the concepts in their common framework (and hence the accounting standards based upon that framework) should relate to a single set of general purpose external financial reports.<sup>8</sup> That is, given that the parent entity and the group entity are regarded as being one and the same entity under this approach, then that entity should have only one set of financial statements that are regarded as GPEFR. In the staff view, the differences between the parent-only financial statements and the consolidated financial statements are so significant that, in most cases, it would be essential for the relevant accounting standard to include requirements on which presentation approach should be followed. That would not preclude preparing another set of financial statements as supplementary information, but not as a substitute for the parent’s general purpose external financial reports.
50. Before considering further the various views described above, one might ask “does it really matter, at the conceptual level?”
51. On the one hand, it matters in that View 2 (One Entity – One Display) rules out, at the conceptual level, the possibility that a parent-only entity could be the subject matter of general purpose external financial reports. Therefore, at the standards-level, it would place a heavy burden on the Boards to explain why an exception to consolidation might be permitted in a given set of circumstances. Hence, if the Boards were to support View 2, this has implications at both the conceptual and standards level.
52. On the other hand, both View 1 (One Entity – Two Displays) and View 3 (Multiple Entities) leave this as an open issue, to be determined at the standards-level. Hence, if the

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<sup>8</sup> See paragraphs BC1.18-BC1.22 of the Preliminary Views document, *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Information*.

Boards supported *either* View 1 *or* View 3, then we might conclude that no further consideration of this issue is required at the conceptual level. However, leaving this issue unresolved will not result in the helpful conceptual tools that the Boards desire for resolving difficult standards-level issues.

53. After reflecting on the Boards' discussions of this issue in March/April 2006, the staff thinks it likely that the mixed views of Board members were influenced by either or both of (a) how we currently determine what constitutes a group entity for financial reporting purposes and (b) how we might do so in the future.
54. The following paragraphs first discuss some aspects of current thinking about the composition of a group entity for financial reporting purposes, in particular, the role of the asset definition.<sup>9</sup> The staff then considers some other approaches to determining the composition of a group entity. This is followed by a staff recommendation.

**The role of control in determining the composition of a group entity and in the asset definition.**

55. In previous staff papers and Board discussions, it has been noted that, at present, control is used both in the asset definition in existing conceptual frameworks (including the two Boards' frameworks) and in accounting standards for determining the composition of a group entity.
56. At present, assets are defined in terms of "things" the entity controls—those "things" are variously described as resources, economic resources, future economic benefits, or rights to future economic benefits. Control (in some form) is also used to determine the composition of a group entity. That is, a group entity comprises the parent entity and other entities under its control. (The relationship between the current working definition of control and the current working definition of an asset is discussed later in this paper. This section is focusing on the current asset definition and the way in which control is currently used in determining the composition of a group entity.)

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<sup>9</sup> One issue that is not addressed in the discussion of current thinking about the composition of the group entity is where the "parent company approach" to the preparation of consolidated financial statements fits in with the parent/group entity views discussed above. The parent company approach is not consistent with View 3 (Multiple Entities) because the group financial statements are prepared *as if* all entities within the group were a single entity. Consequently, in the group financial statements, no distinction is drawn between the parent entity and other entities within the group. Many supporters of View 1 (One Entity – Two Displays) and View 2 (One Entity – One Display) would also conclude that the parent company approach is not consistent with View 1 or View 2, although using a different rationale—the parent and the group are regarded as being one and the same entity, which means there is no difference between the parent's perspective and the group's perspective. However, it could be argued that View 1 and View 2 *appear* somewhat closer to the thinking behind the parent company approach, because of the greater emphasis placed on the parent entity under these views—the relationship between the parent entity and the group entity is such that the parent is central (and essential) to the composition of the group.

57. At present, under some thinking about the group entity, it is the asset definition that is driving the determination of the boundaries (or composition) of the group entity. This happens as follows:
- a. Start by thinking about an individual entity, such as a company.
  - b. Then apply the asset definition to that entity, by asking “what things does the entity control?”
  - c. When considering the question in (b), suppose we find that the entity has control over shares in another entity, and that share investment gives the first entity (the investor) control over the second entity (the investee), and hence control over the investee’s assets.
  - d. Therefore, we conclude that the second entity’s assets are also assets of the first entity.
  - e. Hence, the first entity is bounded by its control over assets, both those under its direct control (e.g., by ownership or contractual rights) and those under its indirect control through its control over other entities.
58. This line of reasoning can be seen in the UK Statement of Principles’ discussion of the boundaries of a group reporting entity:

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

59. Under this approach to determining what constitutes a group reporting entity and the current definition of assets, the control concept must be used to determine the boundary (or composition) of a group entity, otherwise the process of consolidating the subsidiary’s assets into the group financial statements would result in the parent/group entity reporting things that were not under its control and therefore did not meet the definition of an asset.
60. Note the reference in the previous paragraph to the “parent/group entity”. The reasoning described in paragraph 57 above is consistent with View 1 (One Entity – Two Displays) and View 2 (One Entity – One Display) in the previous section. Both View 1 and View 2 regard the parent and the group as being one and the same entity, and the subsidiary is regarded as being part of the parent, for the purposes of the parent entity’s financial reporting. The reasoning in paragraph 57 above concluded that the parent is bounded by its

control over assets, both those under its direct control and those under its indirect control. Hence, the parent and the group are the same entity. Also, the only way for the same items to be assets of both the parent entity and the subsidiary entity at the same time is for the subsidiary entity to be part of the parent entity (or for the existence of the subsidiary entity to be ignored).

61. But let's return to the reasoning above, whereby it is the asset definition that is driving the determination of the boundaries (composition) of the parent/group entity. Under this approach, any change to the asset definition might also change the boundaries (composition) of the parent/group entity. Thus, under this approach, the Boards would need to first reach some conclusions about how to define assets. Once the Boards have agreed on the asset definition, it would then be a matter of considering in what circumstances the assets of one entity (the subsidiary) are also the assets of another entity (the parent entity).
62. Indeed, under this approach, there may be no need for a reporting entity concept as such. In other words, it could be argued that we need not consider the question of when two or more *entities* should be consolidated or combined together, to form a group entity. Rather, all that is required is guidance on how to apply the asset definition in particular circumstances, which could be addressed at the standards level.
63. However, in the staff view, the asset definition should not be the driving factor. The asset definition itself refers to "the entity", so it seems circular to use the asset definition to determine what constitutes the "entity".
64. Rather, in the staff view, the reporting entity concept should first determine what constitutes the "entity" that is reporting, and only then should the asset definition be applied to *that* entity (together with the other element definitions, recognition criteria, etc).
65. In the context of a group reporting entity, this requires a shift in thinking—we have to go back to the basic question of how *should* we determine the composition of a group reporting entity?
66. It seems easiest to think about this question by using View 3 (Multiple Entities). In the staff view, under both View 1 (One Entity – Two Displays) and View 2 (One Entity – One Display), the reporting entity concept and the asset definition are so inter-related that it is difficult to separate the two. That is not to say that these approaches should be rejected or that View 3 should be adopted. Rather, View 3 is being used as a tool, for the purposes of this discussion.

67. Under View 3, the parent and subsidiary are regarded as two different entities. The group is formed by combining the two entities, and treating them *as if* they were a single entity. Thus, the subsidiary is not part of the parent—rather, both the parent and the subsidiary are part of the group. Similarly, the subsidiary’s assets are not assets of the parent—rather, the subsidiary’s assets and the parent’s assets are part of the group’s assets.
68. By thinking of the group in this manner, we can ask ourselves the question: *when* should two or more entities be combined together, and treated as if they were a single entity?

### **Group reporting entity - approaches**

69. The above analysis concluded by asking when two or more entities should be combined together, and treated as if they were a single entity. This question is considered below. In doing so, the analysis addresses cross-cutting issue RE4, which asks whether control is the right basis for consolidation, and the aggregation part of issue RE2, which asks when consolidation should occur. The discussion in this section refers to the definition of control. Therefore, it seems helpful to first review the Boards’ decisions about the meaning of control, which is the subject of Issue RE5.<sup>10</sup>

### **Meaning of control**

70. In March/April 06, the Boards agreed that control should be defined at the conceptual level. The Boards also agreed that the definition of control should contain both (a) a power element and (b) a benefits element, together with a link between the two.
71. Furthermore, the Boards agreed that:
- a. the power element should relate to the ability to direct the financing and operating policies of the entity;
  - b. the benefits element should refer broadly to benefits or economic benefits, and no minimum level of benefits should be specified; and
  - c. whether one entity has control over another entity involves an assessment of *all* the *present* facts and circumstances.
72. The staff presented a working definition of control, to which the Boards agreed, with some modifications to clarify that benefits can be positive or negative. The modified working definition is as follows:

Control of an entity is the ability to direct the financing and operating policies of an entity, so as to access benefits flowing from that entity (and/or to reduce the incidence of

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<sup>10</sup> Cross-cutting issues RE3–RE5 are set out in paragraph 23 above.

losses) and increase, maintain or protect the amount of those benefits (and/or reduce the amount of those losses).

73. As noted above, the Boards have agreed that whether one entity has control over another entity involves an assessment of *all the present* facts and circumstances. Therefore:
- a. there is no single fact or circumstance that evidences that an entity has control over another entity in all cases, nor should one particular fact or circumstance—such as ownership of a majority voting interest—be regarded as a necessary condition for control to exist;<sup>11</sup> and
  - b. the concept of control does not exclude situations in which control exists but it might be temporary. In other words, the fact that circumstances might change tomorrow is not relevant to an assessment of whether the entity has control over another entity today. (This issue is discussed further below, in Part IV on control issues.)
74. Also, as noted above, the Boards have agreed that the definition of control should contain both a power element and a benefits element. Therefore, *control* is not a synonym for *power*. This contrasts with some past and existing definitions of control, in which control is defined as a synonym for power. And sometimes even when a particular accounting standard includes a benefits element in its definition of control, the accompanying guidance on that definition or accounting practice might focus on the power element rather than the benefits element. This may result in control being regarded as a synonym for power, even if it is not defined that way.
75. Therefore, it is important to bear in mind that, when discussing control in the remainder of this paper, the staff is using the working definition of control set out above, which contains both a power and a benefits element.

### **Objectives of financial reporting**

76. Clearly, any reporting entity concept included in the conceptual framework needs to be consistent with the objective of financial reporting. The objective, as described in the Preliminary Views document for Phase A of the project, is as follows:

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

To help achieve its objective, financial reporting should provide information to help present and potential investors and creditors and others to assess the amounts, timing, and uncertainty of the entity's future cash inflows and outflows (the entity's

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<sup>11</sup> Although ownership of a majority voting interest is not a *necessary* condition for control to exist, typically it would be a *sufficient* condition.



future cash flows). That information is essential in assessing an entity's ability to generate net cash inflows and thus to provide returns to investors and creditors. [OB 3]

77. To consider what reporting entity concept would be consistent with this objective, the qualitative characteristics of decision-useful information are also likely to be helpful, in particular, relevance and faithful representation:

To be useful in making investment, credit, and similar resource allocation decisions, information must be relevant to those decisions. *Relevant* information is capable of making a difference in the decisions of users by helping them to evaluate the potential effects of past, present, or future transactions or other events on future cash flows (*predictive value*) or to confirm or correct their previous evaluations (*confirmatory value*). *Timeliness*—making information available to decision makers before it loses its capacity to influence decisions—is another aspect of relevance. [QC8]

To be useful in making investment, credit, and similar resource allocation decisions, information must be a *faithful representation* of the real-world economic phenomena that it purports to represent. The phenomena represented in financial reports are economic resources and obligations and the transactions and other events and circumstances that change them. To be a faithful representation of those economic phenomena, information must be *verifiable*, *neutral*, and *complete*. [QC16]

78. To be consistent with the objective of financial reporting, the question we are seeking to answer is: “what approach would best suit users’ information needs?”
79. Some might argue that, at the conceptual level, there is no need to answer that question. That is, the conceptual framework should simply say that a group reporting entity consists of a combination of entities about which users require information. For example, suppose a lender had advanced funds to a particular group of entities, and each entity has guaranteed the loans of the other entities. It is likely that group financial statements, in which all the entities in the lending group are combined together and treated as if they were a single entity, would provide useful information to that lender.
80. However, the Boards decided not to adopt a similar notion when first considering the results of the preliminary staff research in the reporting entity project phase. The Boards decided against a concept whereby a *reporting entity* is any entity for which there exists users who require, but are unable to demand, information about that entity. Consistency with that decision implies that a *group reporting entity* should not be defined as a combination of entities about which users require, but are unable to demand, information.
81. Furthermore, simply referring to user information needs does not seem particularly helpful in itself—it seems too vague to help determine when, at the standards-level, particular entities should be combined together, to form a group reporting entity. For example, if someone wanted information about the car industry in Japan, does that mean a group reporting entity exists, comprising all entities in that industry?

82. Essentially, we need something more specific to determine when two or more entities should be combined into a group reporting entity. We need something that binds the group together, i.e., a *unifying factor*.
83. The following approaches are discussed below:
- a. Controlling entity model
  - b. Common control model
  - c. Risks and/or rewards model

#### **Controlling entity model**

84. The controlling entity model discussed in this section is broadly similar to the control model currently used today, but with control defined as set out above (i.e., including both a power element and a benefits element). Under this model, a group entity comprises the controlling entity (the parent) and other entities under its control (its subsidiaries). Hence, the group is united by the parent entity's control over other entities. This approach requires that there be a parent *entity*.
85. The controlling entity model is consistent with the objective of financial reporting. When one entity has control over another, it has the ability to direct the other entity's financing and operating policies, so as to access benefits flowing from that entity (or to reduce the incidence of losses), and to increase, maintain or protect the amount of those benefits. The cash flows from the controlled entity (the subsidiary) to the controlling entity (the parent), and eventually to the parent's investors and creditors, depend significantly on the subsidiary's activities and the parent's actions in directing those activities.
86. Therefore, to assist users in assessing the amounts, timing, and uncertainty of the parent's future cash inflows and outflows, they are likely to require more information than would be provided by the parent's (separate) financial statements alone, even when those financial statements are considered in conjunction with the financial statements of the subsidiary. In this situation, it seems reasonable to conclude that group financial statements, prepared as if the parent and subsidiary were a single entity, would provide relevant information to assist those users in making investment, credit and similar resource allocation decisions.
87. Therefore, the staff thinks that the controlling entity model is consistent with the objective of financial reporting. Hence, at the broadest level, the controlling entity model seems a reasonable approach to determining what constitutes a group entity for financial reporting purposes.

88. However, one issue that frequently arises—at least with the version of the controlling entity model that is used today—is whether it works well in the context of special purpose entities (SPEs).
89. Some would argue that the issue of applying a controlling entity model (no matter what definition of control is used) to SPEs is essentially a standards-level issue. In particular, if difficulties arise because of entity structures that have been established for accounting reasons (that is, to circumvent consolidation standards) rather than for commercial or economic reasons, then that does not imply that controlling entity model is flawed at the conceptual level.
90. Others argue that the problems encountered in practice are significant enough that they might be indicative of problems at the conceptual level. For the latter reason, it is worth giving some thought to SPEs.
91. It should be noted that the discussion below is a brief, high-level discussion of SPEs, which the staff regards as appropriate for a conceptual framework project. Hence, it leaves unanswered many questions that would need to be addressed in a standards-level project.

#### Special purpose entities

92. Some say that, when accounting for SPEs, accounting standards seem more consistent with a risks and rewards model than a control model, because the emphasis seemingly shifts to looking at who benefits and who bears risks, rather than who has power over the entity. It could be argued that this indicates that the controlling entity model is flawed, because it has to be supplemented by another model in order to cope with SPEs.
93. However, there is another way of looking at this issue. As explained above, the working definition of control involves both a power element and a benefits element, together with a link between the two:

Control of an entity is the ability to direct the financing and operating policies of an entity, so as to access benefits flowing from that entity (and/or to reduce the incidence of losses) and increase, maintain or protect the amount of those benefits (and/or reduce the amount of those losses).
94. In the case of special purpose entities, the entity may have predetermined financing and operating policies, that is, the SPE is on autopilot. In this situation, it may seem that no-one—including neither the entity that established the SPE nor the SPE’s own “management” (or administrators)—has the present ability to direct the financing and operating policies of the entity (except perhaps to a very limited extent).

95. This differs from the situation in which the power element and the benefits element are clearly separated, that is, are held by different parties. For example, the trustees of a trust may have the ability to direct the financing and operating policies of the trust, while the ability to benefit from the activities of the trust lies with the beneficiaries. In contrast, for an SPE on autopilot, the issue is not the separation of power and benefits, but rather determining whether the power element exists and with whom power lies.
96. In this situation, in which there is little observable evidence for determining the existence of the power element, accounting standards may look to (or emphasise) the benefits element to determine whether the SPE is under the control of another entity.
97. For example, SIC-12, *Consolidation—Special Purpose Entities*, lists various circumstances that may indicate a relationship in which an entity controls an SPE:
- (a) in substance, the activities of the SPE are being conducted on behalf of the entity according to its specified business needs so that the entity obtains benefits from the SPE's operation;
  - (b) in substance, the entity has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an 'autopilot' mechanism, has delegated these decision-making powers;
  - (c) in substance, the entity has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE; or
  - (d) in substance, the entity retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its operations. (SIC-12, paragraph 10).
98. In these circumstances, the focus is on benefits rather than power, and on the *majority* of benefits. A similar notion is applied in FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, which requires consolidation of a variable interest entity (VIE) in specified circumstances, including when the parent lacks the ability (through voting rights or similar rights) to make decisions about the VIE's activities that have a significant effect on the success of the VIE, but is the primary beneficiary of the VIE.
99. It could be that accounting standards focus on the *majority* of benefits to place some limits on which entities are consolidated, so that the net is not cast too wide. If so, it seems rather arbitrary—why 51% and not 49%, especially as the control model does not, in other circumstances, include any minimum level of benefits?
100. Another argument is that the predetermination of the financing and operating policies means that the major beneficiary does not need to have the ability to direct those policies in order to obtain or protect benefits flowing from the entity. In other words, if benefits can be obtained or protected without a need for present decision-making powers, then the

power element is irrelevant. A problem with this argument is that it is hard to know where to draw the line. For example, suppose one of the predetermined policies is that all surplus profits are automatically distributed to shareholders. Even a 1% shareholder would be able to obtain benefits in this situation, without the need for power over the entity.

101. However, there is another explanation for why accounting standards focus on the majority of benefits. It could be argued that there is an underlying assumption that whichever entity is entitled to the majority of benefits is likely to be the one in control. Typically, it is unusual to have a majority stake in another entity without some capacity to protect that stake. Hence, even though it otherwise might not be *apparent* that the major beneficiary has the ability to direct the financing and operating policies of the second entity, the holding of such a stake is, *in itself*, indicative that the major beneficiary does indeed have that ability.
102. On balance, in the staff view, the difficulties encountered in practice when applying the controlling entity model to SPEs are not necessarily indicative that the *concept* is flawed. However, before drawing any conclusions on the merits or otherwise of the controlling entity model, let us consider some alternative approaches to determining what constitutes a group entity for financial reporting purposes.

#### **Common control model**

103. In December 2005, the Boards agreed that the staff should conduct further research into whether the boundaries of a group reporting entity should be based on a broader concept of control, for example, a concept that encompasses entities under common control.
104. To do so, the staff first considers some situations that the Board members may have had in mind. For example, ARB No. 51, *Consolidated Financial Statements*, discusses circumstances in which *combined* financial statements<sup>12</sup> of commonly controlled companies could be prepared, with examples being companies that are controlled by an individual or under common management.<sup>13</sup>
105. The merits of adopting a common control model are then considered.

#### **Common control by a natural person**

106. Suppose there are five companies, none of which controls any of the others, but all are under the control of a single person.

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<sup>12</sup> In contrast to *consolidated* financial statements, combined financial statements do not include the controlling party (a parent) as part of the group reporting entity.

<sup>13</sup> ARB 51, paragraph 17.

107. When the Boards considered a staff analysis of what constitutes an *entity*, the staff argued that a natural person is an entity. The majority of Board members agreed with that conclusion. Accordingly, in this situation, one could apply the controlling entity model and arrive at the conclusion that there is a group entity, comprising the controlling entity (the person) and the controlled entities (the five companies).
108. Some might ask whether, if a natural person is part of a group entity, does that mean all of that person's assets and liabilities are part of the group's assets and liabilities, including their personal (non-business) assets and liabilities? This is a similar issue to that considered by the Boards when considering whether a sole proprietorship can be an entity. In the case of a sole proprietorship, the entity's assets and activities comprise the business assets and activities of the proprietor, not his/her personal assets and activities. Although there might be cases when making that distinction is difficult in practice, conceptually the distinction can be drawn, based on the nature of the assets and activities. In other words, a sole proprietorship is a *business* entity—the proprietor's business assets and activities represent a 'circumscribed area of economic interest'. Similarly, if an individual has control of several entities, then the group's assets and activities would include that person's business assets and activities, but not their personal assets and activities.<sup>14</sup>
109. Indeed, another way of looking at this situation is that the controlling entity is not the natural person *per se*, but rather the sole proprietorship, comprising the individual's business assets and activities. Hence, the group comprises the sole proprietorship entity and other entities under its control.
110. Of course, the above conclusions would not necessarily result in group financial statements being prepared *in practice*. The Boards previously decided that the reporting entity concept should not specify *which* entities should be required to prepare GPEFR. Therefore, if the parent entity (the natural person or sole proprietorship) is not required to, and does not choose to, prepare GPEFR, then group financial statements would not be prepared, at least by the parent entity.
111. However, there might be an entity within the group that chooses to, or is required to (e.g., by a regulator), prepare GPEFR. If so, the Boards could establish a requirement for that entity to prepare some form of group financial statements. Exactly what that "group" should comprise would need to be considered. Clearly, as a minimum, it would comprise the entity that is required to report and other entities under its control. Whether the group

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<sup>14</sup> A case could also be made that, if the individual has other business assets and activities, in addition to his/her investment in the entities, then the group comprises those entities and the individual's assets and activities that relate to those entities.

should (and could) also include other entities under common control (e.g., sister entities) would need to be considered. This issue is discussed further below.

#### Common control by a family or common shareholder group

112. Consider a situation similar to that described above, except that the five companies are under the control of a group of people. A common situation in which this might arise is a group of companies that are owned by a family, with no single family member holding a controlling interest in the companies. Is a family—or the family’s business interests—an entity?
113. In some situations, the question might be easily answered. For example, there might be a trust, partnership, or other legal arrangement set up for the purposes of managing the family’s business interests. In that case, the trust, partnership or other legal arrangement would likely be the entity that controls the five companies.
114. But suppose there are no formal arrangements—instead, each family member holds their shares in their own names and decisions about the companies’ operations are made by voting at family meetings. It seems possible to describe the family’s business interests as a ‘circumscribed area of economic interest’. However, in this case, that area of economic interest represents the business interests that the family members have *in common*, not their other, individual business interests. In effect, the common business interests of the family are a form of partnership, even if not legally recognised as such.
115. If the common business interests of the family are not considered to be an entity, in the absence of a legal entity or other legal arrangement to manage those interests, then the companies would not be regarded as a group under the controlling entity model, which requires that there be a parent *entity*.
116. Another approach would be to define a group entity for financial reporting purposes as all entities under the common control of the same controlling *body*. The online Oxford concise dictionary defines a body as “an organised group of people with a common function”.<sup>15</sup>
117. Note the use of the term *controlling* body rather than *governing* body. The definition of control includes both a power element and a benefits element. A governing body may have power over whatever it governs, but may not benefit from that power, if that governing body is simply acting as agent for others. For example, the trustees of a trust will be the

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<sup>15</sup> [www.askoxford.com/concise\\_oed?view=uk](http://www.askoxford.com/concise_oed?view=uk)

entity's *governing* body, but if they are not also beneficiaries of the trust, then the trustees are not a *controlling* body.<sup>16</sup>

118. However, it could be argued, given that the Boards have adopted a broad definition of what constitutes an entity, there is no substantive difference between a controlling *entity* and a controlling *body*. If so, the common control model described above is essentially the same as the controlling entity model discussed in the previous section.

119. Also, it should be noted that adopting a common control model would not necessarily result in group financial statements being prepared in practice. It would depend on whether the controlling body is required to (or chooses to) prepare GPEFR. If not, the issue is the same as discussed above in the context of control by a natural person. That is, if an entity within the group is required to, or chooses to, prepare GPEFR, there is the question of whether that entity should be required to prepare group financial statements and, if so, what that "group" should comprise. This issue is considered below.

#### Common management

120. In the staff view, if two or more entities have the same management, that would not constitute a 'common control' situation. As discussed above, control involves having both power *and* the ability to benefit from that power—as principal, not as agent. Therefore, it is not enough that two or more entities have the same management. (However, if two entities have common management, that circumstance might arise because the entities have the same shareholders, a situation that was discussed in the previous sub-section.)

#### Summary and discussion

121. In the above analysis, it was concluded that at the conceptual level some 'common control' situations are:

- a. already captured by the controlling entity model, because there is a controlling entity, such as when the parent entity is a natural person or sole proprietorship
- b. might be captured by the controlling entity model, if we interpreted what constitutes an entity broadly, to include the common business interests of a group of people, such as a family or shareholder group
- c. if not captured by the controlling entity model—because we conclude that the common business interests of a group of people do not constitute an entity—then could be captured by extending the control model, so that a group comprised all

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<sup>16</sup> A trustee might have the ability to obtain some benefits, such as a commission or fee. However, the primary responsibility of a trustee is to use his/her power not to benefit him/herself, but to benefit the trust's beneficiaries.



entities with the same controlling body. (However, if a broad notion of an entity is adopted, arguably there is no substantive difference between a controlling body and a controlling entity.)

- d. not common control situations, because the benefits element of the control definition is missing, as in the case of entities under common management.

122. Also, even if some of these situations were captured by the controlling entity model (or would be captured under a common control model), that might not result in group financial reports being prepared, because the controlling entity (or body) might not be required to prepare GPEFR.

123. However, there remains the issue of what the requirements should be for an entity within the group, which is required to (or chooses to) prepare GPEFR. Consider the earlier example of five companies controlled by a natural person. Suppose that one of the five companies is required to prepare GPEFR. (There might be more than one company in the group with this reporting requirement, but one is sufficient for the purposes of this discussion.) Should that company be required to prepare combined financial statements, comprising the five companies under common control? For the purposes of this discussion, practical considerations (such as whether the company is able to obtain the necessary information) should be set aside.

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

125. But is that so for entities under common control, such as under the common control of a family or the same shareholder group? It is likely that users of the financial statements of an entity under common control would be interested in the effects of transactions with other members of the group. However, disclosures about related party transactions may be sufficient to serve that information need. In the absence of a parent/subsidiary relationship between the entities within the group, would a combined set of financial statements provide decision-useful information?

126. Certainly, *some* situations might arise when such combined financial statements would provide decision-useful information. The lending group example above is a case in point (see paragraph 79). However, what we are looking for is a reason to reach a *general* conclusion that the combined financial statements of a group comprising entities with the same controlling body would provide decision-useful information. In the absence of such a general conclusion, it seems questionable whether there is much to be gained by pursuing the idea of adopting a common control model.
127. It may be that the desire to extend the control model is because of the practice-level issues mentioned earlier, whereby the parent entity may have no requirement to prepare GPEFR, such as when that parent entity is a natural person. Perhaps there is a concern that some groups are deliberately structured this way so as to avoid preparing consolidated financial statements. It might be thought that, if the control model is extended to encompass entities under common control, it would be more acceptable to impose on entities within the group (which choose to, or are required to, prepare GPEFR) a requirement to prepare combined financial statements. However, these practice-level issues do not seem a good reason for change at the concepts level.
128. Alternatively, it might be that because there are *occasions* when combined financial statements of a group comprising entities with a common controlling body/entity would provide decision-useful information, the Boards would prefer to adopt a broader control concept at the conceptual level, and then leave it to the standards-level to determine when that broader concept should be applied.<sup>17</sup>
129. In addition, some argue that the combined financial statements would provide relevant information to investors and creditors of each entity within the group, even in the absence of a parent/subsidiary relationship between members of the group. Being a part of a commonly controlled group may significantly affect the amount, timing and uncertainty of cash flows to a particular entity's investors and creditors. Combined financial statements may provide additional information to assist these users in making investment, credit and similar resource allocation decisions.

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<sup>17</sup> The common control model is broader than the controlling entity model because the entities included in the group are not limited to those that control, or are controlled by, another entity within the group. In other words, there does not need to be a parent/subsidiary relationship between all members of the group. The group also includes entities that are not controlled by another entity within the group, but have the same ultimate controlling body/entity.

## **Risks and/or rewards model**

130. Another approach sometimes suggested is that entities should be combined into a group entity when the activities of the second entity affect the wealth of the residual shareholders (or claimants) of the first entity.
131. This approach, however, seems too broad and undefined to be workable. The nature of a residual interest is such that the activities of virtually every other entity with which the first entity conducts business has the potential to affect that entity and the wealth of its residual shareholders. For example, the activities of major customers of the entity could have a significant effect on that entity and hence its residual shareholders, for example, if the customers withdraw their business or go bankrupt. Similarly, a major supplier with pricing power can affect the entity. This notion would seemingly lead to some suppliers including major customers in their financial statements and perhaps the same major customers including those suppliers in their financial statements.
132. Therefore, if this idea were pursued, that staff thinks that it would be necessary to narrow down or more precisely define the notion, perhaps by identifying some relevant factors. Since we are looking for a relationship where the activities of one entity affect the amounts, timing and uncertainty of the future cash inflows and outflows of another entity, we could focus on situations in which one entity has provided capital to another entity. It would then be necessary to define capital and perhaps narrow the notion down further, to particular types of capital with specific characteristics. Otherwise, for example, a bank would be required to prepare group financial statements that included every entity to which it had advanced funds (capital).
133. Determining the relevant characteristics would likely involve considering factors such as the following:
- a. The nature of the financial interest, that is, whether it exposes the first entity to risks and/or rewards, such as a “residual”, “variable” or an “ownership” interest. One way of doing this would be to link it to the distinction between liabilities and equity. That is, the relevant types of capital are those that give the first entity an equity interest in the second entity. (This is simply a suggestion—the staff acknowledges that distinguishing between liabilities and equity is itself a difficult and complex topic.)
  - b. The extent of exposure to risks and rewards. For example, does the first entity need to be the “major beneficiary” of the second entity? What if there is no single major beneficiary, but the first entity’s interest in the second entity is a significant

investment from the perspective of the first entity? Depending on the relative size of the entities involved, owning 5% of the shares in the second entity could be a major investment of the first entity. Should we instead focus on when the first entity is entitled to a “significant” amount of benefits (and/or exposed to a “significant” level of risk) and, if so, should “significance” be assessed from the perspective of the first entity or the second entity, or perhaps both?

134. The staff is not asking the Boards to answer these questions. Rather, they are simply examples of the sorts of issues that would need to be addressed if we were to consider pursuing a risks and/or rewards model. Once some conclusions had been reached about the relevant characteristics, a group reporting entity would be defined on that basis. In other words, the unifying factor (i.e., the thing that binds the group together) would be the provision of capital with specified characteristics by one entity to other entities.
135. In the earlier discussion of SPEs under the controlling entity model, it was noted that the notion of risks and/or rewards has a role under that model. Whenever it is difficult to determine who has power over an entity, we look to the benefits element instead, to help determine whether the first entity controls the second entity.
136. Hence, there is some cross-over between the controlling entity model, and the risks and/or rewards model described above. However, the risks and/or rewards model described above has the potential to be both broader and narrower than the controlling entity model, for the following reasons:
- a. It is broader, because it does not require a power element, hence could result in entities being combined when the first entity does not have power over the second entity—not only in the SPE situations discussed above, but also when someone else has that power.
  - b. It could be narrower, because it would likely require a focus on particular types of benefits (such as benefits arising from a residual, variable or ownership interest), rather than benefits generally, and also would likely require that a minimum level of benefits be specified (such as when the first entity has an entitlement to a majority or “significant” amount of those benefits).

#### **Staff conclusions and recommendations**

137. This section covers the staff conclusions and recommendations on (a) the group entity model, and (b) the parent entity versus group entity issue.

## Group entity model

138. First, the staff does not recommend the risks and/or rewards model discussed above. From a conceptual perspective, it seems arbitrary. The basic idea is so broad that, in order to place what seem like reasonable and necessary limits on which entities should be combined, it would be necessary to develop criteria that would involve drawing some bright lines, such as the minimum level of exposure to risks and/or rewards. Although *applying* the controlling entity model might sometimes result in bright lines being drawn at the standards level, the concept itself is much more definitive—a control relationship either exists or it does not. The fact that there can be difficulties in practice determining whether the power element of control exists does not negate this conclusion. In the staff view, this is no different from difficulties in determining whether an asset or liability exists. In contrast, the risks and/or rewards model seems to require bright lines to be drawn at the conceptual level, which the staff finds undesirable.
139. Moreover, the lack of a well-defined concept would make it even more problematic to develop principles-based accounting standards, compared with either the controlling entity model or the common control model.
140. Of the two remaining models discussed above, the staff's first preference is the common control model, followed by the controlling entity model. In saying that, the staff thinks that there is a stronger case to conclude that group financial statements would provide relevant information (capable of making a difference to users) to help investors, creditors and others in making resource allocation decisions when there is a parent/subsidiary relationship between members of the group. However, the staff also agrees that, even in the absence of a parent/subsidiary relationship, group financial statements of commonly controlled entities would also likely provide decision-useful information. Rather than adopt a narrow group entity model, the staff recommends adopting a broader model at the concepts level. The Boards could then consider, at the standards level, when that broader model should be applied.
141. For example, suppose an entity that is required to (or chooses to) prepare GPEFR and is part of group of commonly controlled entities. Also suppose that the reporting entity's ultimately controlling body/entity does not produce group financial statements, nor does any intermediate controlling entity of the reporting entity. In this situation, the Boards might consider whether to require or permit the entity to prepare group financial statements, comprising (a) the entity, (b) its sister entities, (c) its subsidiaries and (d) subsidiaries of its sister entities.

142. The adoption of a broader group entity model in the conceptual framework would provide a conceptual foundation for such an approach. Conversely, if the Boards were to adopt the controlling entity model, there seems to be no conceptual foundation for the preparation of combined financial statements for commonly controlled entities.

#### Parent/group entity view

143. The staff recommends the adoption of View 3 (Multiple Entities). That is, a group reporting entity comprises two or more entities, which are combined and presented as if there were a single entity, for the purposes of the group financial statements. This approach is workable under all the group entity models discussed in the previous section, including the common control model recommended by the staff.
144. Conversely, View 1 (One Entity – Two Displays) and View 2 (One Entity – One Display) are inconsistent with a common control model. Those views regard the parent and the group as being the same entity, which is not possible in the absence of a parent/subsidiary relationship between some members of the group. Therefore, if the Boards accept the staff recommendation to adopt a common control model, it follows that the Boards should also accept the staff recommendation to adopt View 3 (Multiple Entities).
145. Furthermore, even if the Boards were to adopt the controlling entity model instead of the common control model, the staff would still recommend View 3 (Multiple Entities). First, the staff thinks this view results in a more faithful representation of the group, that is, the staff thinks that the group is exactly that—a group of entities, not a single entity. Second, the staff thinks it more faithfully represents the relationship between the parent entity and the subsidiary entity, because it acknowledges, rather than ignores, the economic and legal reality of the subsidiary's existence.
146. In contrast, View 1 and View 2 ignore the existence of the subsidiary, at least in the preparation of consolidated financial statements. As noted earlier, under these views, the consolidated financial statements are regarded as relating to a single entity only—the parent entity. Hence, there is no *group* entity as such. In the staff view, there are two problems with this viewpoint:
- a. Like it or not, the subsidiary does exist—particularly when structured as a limited liability company. In the staff view, its existence is a matter of economic reality, not merely a matter of legal form.
  - b. Following on from (a), consolidated financial statements, as prepared in practice today, are not representationally faithful of the financial position or financial

performance of the parent. To be a faithful representation of the financial position and financial performance of the parent, then all assets, liabilities, revenues and expenses recognised in its financial statements must satisfy the element definitions from the perspective of the parent. However, in the staff view, consolidated financial statements include items that do not meet the definitions of elements, if considered from the perspective of the parent. For example, even through the parent’s control over the subsidiary might give it power over the subsidiary’s assets, the parent does not have access to all of the benefits from those assets—the parent usually has only a residual interest, being the amount that remains after the other claimants to the subsidiary’s assets have been satisfied. Similarly, the parent usually has no obligation in respect of the subsidiary’s creditors, when the subsidiary is a limited liability company.

147. In the staff view, a more representationally faithful way of viewing consolidated financial statements, as prepared in practice today and under the controlling entity model described above, is that those financial statements present information about the financial position and financial performance of a group of entities, with the financial statements prepared *as if* those multiple entities were a single entity.

#### **Questions for the Boards**

148. Which group entity model do the Boards support:
- a. Controlling entity model,
  - b. Common control model, or
  - c. Risks and/or rewards model?
149. Which “parent entity versus group entity” view do the Boards support:
- a. View 1 (One Entity – Two Displays),
  - b. View 2 (One Entity – One Display), or
  - c. View 3 (Multiple Entities)?

#### **PART IV: CONTROL ISSUES**

150. This section considers the various issues relating to the control concept, raised by cross-cutting issues RE6–RE8:

- 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)?

151. As noted at the start of this paper (paragraph 10), some argue that the issues discussed in this section should be addressed at standards-level, rather than the concepts-level. Therefore, in addition to considering the issues themselves, the Boards are asked to consider whether all or any of these issues should be covered in the conceptual framework.

#### **Timing issues – determining when present control exists**

152. RE8 asks whether it matters if an entity has control over 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)?
153. These questions raise several related issues about determining when control exists:
- a. temporary control
  - b. de facto or effective control
  - c. latent control and the treatment of options

#### **Temporary control**

154. In March/April 06, the Boards agreed that whether one entity has control over another is based upon an assessment of the *present* facts and circumstances. Therefore, the concept of control does not exclude situations in which control exists but it might be temporary.

#### **De facto or effective control**

155. The staff paper discussed by the Boards in March/April 06 noted that the working definition of control refers to *the ability* to direct the financing and operating policies of the other entity. There might be situations in which the entity has that ability, because of particular circumstances, rather than because of (or solely because of) legal rights held by



the entity. For example, suppose an entity is able to direct the financing and operating policies of another entity, without holding a majority of voting rights, by holding a substantial minority of the voting rights when the holdings of other voting rights are widely dispersed, and those other holders have not organised themselves in such a way to prevent the first entity directing those policies. This is sometimes referred to as *de facto control* or *effective control*. (It should be noted that the staff uses the terms *de facto control* and *effective control*, because those terms are commonly used today in the situations described above. The staff is not endorsing the use of these terms. Some disagree with using the qualifiers *de facto* or *effective* (or any other qualifier) when referring to *control*.)

156. That paper noted that, in the staff view, the control concept should not be limited to circumstances in which the entity has sufficient voting rights or other legal rights to direct the financing and operating policies of another entity, but should be a broad concept that encompasses economically similar circumstances. The staff also acknowledged that a control concept that encompasses *de facto* or *effective control* may give rise to practical difficulties when applied in practice.
157. However, in the staff 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 rights or other means.
158. When the staff paper was discussed in March/April 2006, the IASB agreed with the staff conclusions. The FASB generally agreed, but deferred its conclusions on this issue, pending further consideration of the interaction between these conclusions and (a) the staff conclusion that power is non-shared and (b) the treatment of options. The first issue is discussed below, and the second is discussed in the following sub-section.

#### **Power is non-shared**

159. The March/April staff paper argued that, to satisfy the power element of the definition of control, power should be non-shared—an entity does not have power over another entity if the first entity must obtain the agreement of others to direct the financing and operating policies of the second entity. This does not imply that power must be *absolute*, that is, an entity is not required to have total, unrestricted power over another entity's financing and

operating policies to satisfy the power element.<sup>18</sup> 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.

160. At the FASB meeting, a Board member questioned whether this conclusion is consistent with the staff's conclusion explained above about effective or de facto control. It could be argued that, if the entity is able to exercise control when it owns a minority of voting rights and the holdings of other voting rights are widely dispersed and disorganised, this effectively requires the *passive co-operation* of the holders of the other voting rights. Thus, it is argued, the entity does not *by itself* have the ability to direct another entity's financing and operating policies.

161. The staff disagrees with that argument. In the staff view, the passive co-operation argument treats the holders of the other voting rights as if they were an organised group, which had (in effect) collectively agreed to permit the controlling minority shareholder to exercise control. However, in the situation described, the holders of the other voting rights are widely dispersed and have not organised themselves to work together, either with each other or with the controlling minority shareholder. Therefore, if any of these holders became dissatisfied with the actions of the minority shareholder in directing the financing and operating policies of the entity, they would have to canvass the views of other shareholders and band together in sufficient numbers, in order to *take control* from the minority shareholder. Hence, in the staff view, the conclusion discussed above on effective or de facto control is not inconsistent with the conclusion that power is non-shared.

#### **Latent control and the treatment of options**

162. The above discussion brings us to the issue of latent control. As noted in the March/April 2006 staff paper, the ASB's Statement of Principles notes that if the entity has the ability to control another entity, it is usually presumed that the first entity is exercising control, even if such control is not apparent.<sup>19</sup>

163. The 1986 FASB staff draft, *Reporting Entity—Tentative Conclusions*, states that latent control exists if the unilateral action by one entity will clearly place it in control of another, provided that the economic cost of that action is not so high that it would be irrational to

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<sup>18</sup> There often are limits on power that are imposed by law, regulations, fiduciary responsibilities and contractual rights. Those limits or restrictions are usually protective in nature, and do not usually deprive the controlling entity of the ability to direct the operating and financing policies of the controlled entity (NZ-FRS-37, paragraph 4.22; Canadian Handbook, Section 1590, paragraph .14; EITF Issue No. 96-16, "Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights"; 1995 FASB ED, paragraph 12; and the 1999 FASB ED, paragraph 12).

<sup>19</sup> SoP, paragraph 2.18.

take the action.<sup>20</sup> 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.<sup>21</sup>

164. In the previous section, the staff argued that a minority shareholder could be in control, in a situation in which the holders of the remainder of the voting rights were widely dispersed and disorganised. In that situation, the holders of the remainder of the voting rights would have to organise themselves into a sufficiently large group, in order to take control from the minority shareholder. However, suppose that instead of requiring a large number of shareholders to band together to take control, a single party held sufficient options that, if exercised, would give it the majority of the voting rights. Does this give the option holder the *present* ability to control the entity? This issue is considered below, in the discussion of RE6.

### **Control over entity versus control over assets**

165. Cross-cutting issue RE6 asks whether there is a difference between the concept of “control” in the context of control over another entity and in the context of control over assets.

166. In the context of control over another entity, the Boards have agreed that control comprises both a power element and a benefits element, together with a link between the two. The same can be said for control in the context of control of assets—the entity must have both power over the item in question and the ability to benefit, otherwise it does not have an asset.

167. The current working definition of an asset in Phase B of the project does not specifically refer to control. Nevertheless, the control concept is implicit in that definition. In particular, the working definition refers to the entity's rights or other privileged access to an economic resource. The power element is embedded within the notion of rights or other privileged access. As noted in an earlier staff paper on the asset definition:

Control refers to the ability to direct, manage or have power over something so as to obtain or access benefits, or to increase, maintain or protect those benefits (benefits that have the capacity to give rise to cash inflows)...to have an asset an entity must have rights or other privileged access to an economic resource. What is important in the case of rights or other privileged access to an economic resource is not necessarily whether an entity...[has] power over the

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<sup>20</sup> 1986 FASB draft, paragraph 217.

<sup>21</sup> For example, IAS 27, Canadian Handbook (Section 1590), AASB 1024, and NZ FRS-37.

entire resource. Rather, it is whether the entity...[has] power over its rights to the resource...<sup>22</sup>

168. The benefits element is embedded within the notion of an economic resource. As noted in a previous staff paper on the asset definition, as long as there is a non-zero probability of economic benefit to the entity, then there is an economic resource.<sup>23</sup>
169. It might be argued that, although control in the context of control of an asset is broadly consistent with control in the context of control of an entity, there are some differences between the two. In particular, some argue that, the power element is more “active” than the benefits element in the context of control over an entity, whereas the reverse applies in the context of control over an asset. In other words, in the context of control over an entity, typically the focus is on the power element rather than on the benefits element when determining whether control exists. In contrast, in the context of control over an asset, typically the focus is on the benefits element rather than power element when determining whether control exists.
170. In the staff view, this represents a difference in the application of the control concept, because of different circumstances, rather than a difference in the concept itself. For example, when considering whether one entity has control over another entity, problems in practice typically relate to the power element rather than the benefits element. For example, if the first entity has some sort of financial interest in the second entity (such as debt or equity securities), it seems reasonable to conclude that the first entity has access to benefits flowing from the second entity. However, usually there are many other entities that also have a financial interest in the entity. In particular, there may be other entities that have a similar type (or class) of financial interest in the entity, such as other shareholders. Hence, it is necessary to focus on the power element to determine whether control exists.
171. In contrast, in the case of an asset, the power element might be less troublesome than the benefits element. For example, ownership rights are often held by a single entity. In such situations, it seems obvious that the entity has power over something. However, it may be less obvious exactly what it is that the entity has power over. Focusing on the benefits element—or, more specifically, focusing on identifying the relevant economic resource which has the capacity to produce those benefits—helps to determine what it is that the entity has power over.

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<sup>22</sup> IASB Agenda Paper 3A, FASB Memorandum 30A, July 2006, paragraph 24.

<sup>23</sup> IASB Agenda Paper 8A, FASB Memorandum 25, April 2006, paragraph 19.

172. The preceding paragraphs argue that the control concept when applied in the context of control over an entity is consistent with the control concept when applied in the context of control over an asset. One specific issue that has been raised is whether there is any inconsistency in the treatment of options in the context of (a) options over an entity and (b) options over an asset.
173. Agenda Paper 5/FASB Memorandum 31 argues that one does not control (or have rights or other privileged access to) any underlying item by virtue of having an option over it. Rather, the option itself is the asset.
174. For example, suppose Company A holds options over 100 percent of the ordinary shares in Company X, which are currently held by Company B. In the staff view, Company A does not presently control either the shares in Company X or Company X itself—Company A may have the ability to *take* control of those shares/Company X, but does not *at present* control the shares/Company X. Moreover, in the staff view, Company B has *present* control of both the shares and Company X.
175. In essence, the argument that holding an option (in and of itself) gives the option holder control of the underlying resource over which the option is held is to treat the exercise of the option as inconsequential. In other words, it treats the holding of an option and the holding of the underlying resource as substantially the same. In the staff view, this misrepresents the relationship between the option holder and the thing over which the option is held. The basic purpose of holding an option is to give the holder choice—whether to acquire the underlying or not. In the absence of other circumstances, until the option is exercised, the option holder does not have present control of the underlying resource. Similarly, in the staff view, an option to acquire voting rights does not give the option holder *present* control over those voting rights.
176. In the staff view, latent control does not exist in the situation described in paragraph 174 above. In the staff view, latent control relates to situations in which the first entity has the *present* ability to control another entity, even if such control is not apparent, without the need to take action—whether unilateral or otherwise—to *place it* in control.
177. The staff acknowledges that the staff analysis presented above differs from the conclusions previously reached by the Boards in related standards-level projects. In considering the above analysis, the points made at the start of this paper should be borne in mind—the staff has considered issues from a conceptual perspective only. Different considerations may apply at the conceptual level than apply at the standards level. For example, practical considerations may require the Boards to take a different approach to an issue at the

standards-level than is taken at the concepts level. Those practical considerations include whether adopting a particular approach would provide opportunities for transactions to be structured so as to circumvent the requirements of the accounting standard. However, concerns about financial structuring opportunities should be addressed at the standards-level, not at the concepts level. Therefore, the staff asks that the Boards set aside such concerns when considering the above staff analysis for the purposes of the conceptual framework project.

178. Having argued that holding an option does not, in itself, give the option holder present control of another entity (or the underlying asset, in the case of options over assets), the staff is not ruling out the possibility that there might be situations in which the holding of options, *taken in conjunction with other facts and circumstances*, might lead to the conclusion that the option holder has present control over the other entity. The Boards have agreed that whether one entity has control over another entity should be based on an assessment of *all* the facts and circumstances.
179. In other words, when options are considered in isolation, the fact that an entity holds enough options that, if and when exercised, would place it in control over another entity is not sufficient to establish that the entity has present control of that other entity. However, there could be other facts and circumstances that, taken together, indicate that the entity has present control over the other entity. In particular, there might be facts or circumstances that indicate that the “option” does not have all the usual economic characteristics of an option or that have that effect when considered in conjunction with the option.
180. For example, suppose that Company A holds 40 percent of the voting shares in Company X and holds an option to acquire another 15 percent. Also suppose that, under the option contract, the present holder of the 15 percent must exercise their voting rights as directed by Company A. Although Company A has not yet acquired all the rights associated with the shares under option (for example, the right to receive dividends), Company A has, in effect, acquired the voting rights associated with those shares. In other words, the “option” contract is not a straightforward option contract, as it includes two different assets: (i) the voting rights in respect of the shares and (ii) an option to acquire the remaining rights associated with the shares. The voting rights acquired under the “option” contract, together with the existing voting rights held, result in Company A holding the majority of the voting rights.

## Control, joint control and significant influence

181. Issue RE7 asks about how the control concept fits in with the notion of joint control, which is applied in accounting for interests in joint ventures, and the notion of significant influence, which is applied in accounting for interests in associates.
182. In considering this issue, the staff has not—and does not intend to—conduct research into what currently are, or should be, the accounting requirements for interests in joint ventures or associates. In particular, the staff does not intend addressing the part of RE7 that asks “joint control over an entity or assets?” This question is asking about whether the venturer has an interest in (a) another entity or (b) a collection of assets (and perhaps liabilities). The staff regards this as a standards-level issue. Any attempt to answer the question would require an in-depth analysis of joint venture arrangements, which is beyond the scope of a conceptual framework project.<sup>24</sup>
183. Therefore, in this sub-section, the staff considers the notions of control, joint control and significant influence from a conceptual perspective. What the implications of this analysis might be at the standards-level is not addressed.
184. As noted earlier (paragraph 159), a previous staff paper concluded that control is non-shared.<sup>25</sup> In particular, to satisfy the power element of the definition of control, power must be non-shared—an entity does not have power over another entity if the first entity must obtain the agreement of others to direct the financing and operating policies of the second entity.
185. In contrast, what is referred to as “joint control” seems to include some notion of shared control, for example:
- Joint control is the contractually agreed sharing of control over an economic activity, and exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control (the venturers).<sup>26</sup>
186. In the staff view, whether considered in the context of control of an asset or control of an entity, control exists when *one* entity (not multiple entities) has control over another entity (or over assets).
187. In the case of joint ventures, whereby financing and operating policy decisions require unanimous consent of the venturers, it might be said that, *as a group*, the venturers control the joint venture. However, none of the individual venturers has control over that joint

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<sup>24</sup> This issue is currently under discussion in the IASB short-term convergence project on joint ventures, and also was considered in the work undertaken to date in the IASB research project on joint ventures.

<sup>25</sup> March/April 2006, IASB Agenda Paper 3, FASB Memorandum 23, paragraphs 122-124.

<sup>26</sup> IAS 31, *Interests in Joint Ventures*, paragraph 3.

venture. Therefore, the relationship between an individual venturer and the joint venture is not a control relationship, and therefore should not be described as control, in the staff view.

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

### Questions for the Boards

189. For each of the issues set out below, the Boards are asked to advise (i) whether the issue should be dealt with in the conceptual framework and (ii) whether they agree with the conclusion on that issue. The source of the conclusion (previous Board decision or current staff recommendation) is indicated in brackets:

- a. Temporary control: Control over another is based upon an assessment of the *present* facts and circumstances. Therefore, the concept of control does not exclude situations in which control exists but it might be temporary. [Agreed by both Boards in March/April]
- b. De facto or effective control: The control concept should not be limited to circumstances in which the entity has sufficient voting rights or other legal rights to direct the financing and operating policies of another entity, but should be a broad concept that encompasses economically similar circumstances. [Agreed by IASB in April; to be confirmed by FASB]
- c. Power is 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. [Agreed by IASB in April; to be confirmed by FASB]
- d. Treatment of options: In concept, when options are considered in isolation, the fact that an entity holds enough options that, if and when exercised, would place it in control over another entity is not sufficient, in itself, to establish that the entity has *present* control of that other entity. However, there could be other facts and circumstances that, taken together, indicate that the entity has present control over the other entity. [Staff conclusion in this paper]
- e. Control, joint control and significant influence: Control involves *one* entity (not multiple entities) having control over another entity. Hence, the relationship between an individual venturer and the joint venture should not be described as a control



relationship. Similarly, the relationship referred to as “significant influence” should not be described as a control relationship. [Staff conclusion in this paper]

## **PART V: SUMMARY, OTHER COMMENTS AND NEXT STEPS**

### **Summary**

190. This section summarises the key issues and conclusions reached in this paper:

- a. Individual reporting entity (Part II)
- b. Group reporting entity (Part III)
- c. Control issues (Part IV)

### **Individual reporting entity**

191. Based on the Boards’ decisions in December 2005 and March/April 2006, the staff concludes that the reporting entity chapter of the conceptual framework should describe what constitutes an individual entity for financial reporting purposes, but should not define it.

192. In particular, the conceptual framework should explain that the adjective *reporting* is simply used to refer to the entity that is reporting, and does not exclude any particular *entity* from being a *reporting entity*. Furthermore, what constitutes an entity for financial reporting purposes should not be limited to legal entities. Hence, legal existence (or some sort of legal standing) is a sufficient condition for concluding that an entity exists, but is not necessary condition. Rather, an *entity* includes other types of arrangements or organisational structures, which could be broadly described as a circumscribed area of economic interest. Examples of entities include a natural person, sole proprietorship, company, trust, partnership, association and, in some circumstances, a branch or segment.

### **Group reporting entity**

193. The main focus of the reporting entity chapter of the conceptual framework will be establishing what constitutes a group entity for financial reporting purposes.

194. As a first step to considering whether control should be used as a basis for determining the composition of a group entity, in March/April 2006 the Boards discussed the meaning of control. They agreed that control should be defined at the concepts level. The definition of control should contain both (a) a power element and (b) a benefits element, together with a link between the two. Also:

- a. the power element should relate to the ability to direct the financing and operating policies of the entity;
- b. the benefits element should refer broadly to benefits or economic benefits, and no minimum level of benefits should be specified; and
- c. whether one entity has control over another entity involves an assessment of *all* the *present* facts and circumstances.

195. The modified working definition presented by the staff is as follows:

Control of an entity is the ability to direct the financing and operating policies of an entity, so as to access benefits flowing from that entity (and/or to reduce the incidence of losses) and increase, maintain or protect the amount of those benefits (and/or reduce the amount of those losses).

196. Using this working definition of control, the staff discussed three possible models for determining the composition of a group entity for financial reporting purposes:

- a. Common control model—the group comprises all entities under the common control of the same controlling body/entity.
- b. Controlling entity model—the group comprises the controlling entity and all entities under its control.
- c. Risks and/or rewards model—the group comprises an entity and all other entities to which the first entity has provided capital with specified characteristics.

197. The staff recommends the adoption of the common control model (first preference), or the controlling entity model (second preference), but does not recommended the adoption of the risks and/or rewards model.

198. In addition, in March/April 2006, the Boards considered the question of whether a parent-only entity could be the subject of general purpose external financial reports (GPEFR). Overall, most Board members agreed that a parent-only entity could be the subject of GPEFR, but reached that conclusion using different reasoning. In particular, Board members expressed mixed views about the nature of the relationship between the parent entity and the group entity. Possible ways of viewing that relationship, and the implications for parent-only and consolidated financial statements, include:

- a. View 1 (One Entity – Two Displays). Under this approach, the parent entity and the group entity are regarded as being one and the same entity, with the subsidiary regarded as being part of the parent entity, for the purposes of the parent entity's financial reporting. In addition, under this approach, the investment asset reported in

the parent-only financial is a combined (or summarised) amount, which comprises all the assets and liabilities of the subsidiary that are presented separately in the consolidated financial statements. It would be a standards-level issue to determine which presentation approach (i.e., net or gross) should be followed when preparing the parent/group entity's GPEFR.

- b. View 2 (One Entity – One Display). This approach is similar to View 1, in that the parent entity and the group entity are regarded as being one and the same entity, with the subsidiary regarded as being part of the parent entity, for the purposes of the parent entity's financial reporting. However, under View 2, presenting the assets and liabilities of the subsidiary as a single, net amount would not be regarded as a relevant or faithful representation of the parent entity's assets and liabilities. Therefore, in concept, the consolidated financial statements are the only set of financial statements that are regarded as GPEFR.
- c. View 3 (Multiple Entities). This approach contrasts with both View 1 and View 2, in that it regards the parent entity and the group entity as being two different entities, both in legal and economic terms. Under this approach, the subsidiary is regarded as being an entity in its own right that is separate from—rather than part of—the parent. The group entity for financial reporting purposes is formed by combining two (or more) separate entities, and presenting the results of that combination *as if* those entities were a single entity. It would be a standards-level issue to determine when financial statements for the parent entity and/or the group entity should be prepared.

199. The staff recommends the adoption of View 3 (Multiple Entities).

#### **Control issues**

200. The project phase has also considered various issues relating to control. The Boards are asked to decide whether these issues should be addressed in their common conceptual framework. If so, the Boards are asked whether they agree (or continue to agree) with the following conclusions:

- a. Temporary control: Control over another is based upon an assessment of the *present* facts and circumstances. Therefore, the concept of control does not exclude situations in which control exists but it might be temporary. [Agreed by both Boards in March/April]
- b. De facto or effective control: The control concept should not be limited to circumstances in which the entity has sufficient voting rights or other legal rights to

direct the financing and operating policies of another entity, but should be a broad concept that encompasses economically similar circumstances. [Agreed by IASB in April; to be confirmed by FASB]

- c. Power is 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. [Agreed by IASB in April; to be confirmed by FASB]
- d. Treatment of options: In concept, when options are considered in isolation, the fact that an entity holds enough options that, if and when exercised, would place it in control over another entity is not sufficient, in itself, to establish that the entity has *present* control of that other entity. However, there could be other facts and circumstances that, taken together, indicate that the entity has present control over the other entity. [Staff conclusion in this paper]
- e. Control, joint control and significant influence: Control involves *one* entity (not multiple entities) having control over another entity. Hence, the relationship between an individual venturer and the joint venture should not be described as a control relationship. Similarly, the relationship referred to as “significant influence” should not be described as a control relationship. [Staff conclusion in this paper]

### **Other comments**

- 201. The objective of the reporting entity project phase was to develop an explicit reporting entity concept, and thereby fill a gap in the Boards’ existing conceptual frameworks. Given that the Boards have managed to set accounting standards despite this lack of an explicit reporting entity concept, some might ask how the work undertaken in the reporting entity project phase will provide benefits to the Boards in their standard-setting activities.
- 202. In the staff view, the key benefit is the provision of a conceptual foundation for the preparation of group financial statements. Without an explicit reporting entity concept, resolving standards-level issues is more difficult, particularly when different viewpoints are based on different underlying assumptions about what the group entity represents or should comprise. It is also more difficult to distinguish between convention and concept.
- 203. More specifically, the staff thinks the work undertaken on control is helpful—many of the cross-cutting issues identified for the reporting entity project phase relate to control, both whether control should be retained for the purposes of determining the composition of a group entity and issues relating to the meaning of control.

204. Therefore, by considering whether control should be retained (either as part of a controlling entity model or a broader common control model) or replaced (with a risks and/or rewards model), the work undertaken in the reporting entity project phase is likely to be helpful in addressing basic questions that frequently arise in standards-level projects about the composition of a group entity.
205. In addition, the inclusion of a definition of control in the conceptual framework, which includes both a power element and a benefits element, is likely to be helpful. In particular, it clarifies that control is not a synonym for power, and therefore consideration of the benefits element is also important when determining whether control exists.
206. With regard to the issues relating to the meaning of control (discussed in Part IV of this paper), the staff thinks that, even if the Boards decide not to include everything that has been addressed in this project phase in the conceptual framework itself, the work undertaken in the project phase is likely to be useful in standards-level projects.
207. Having said that, the staff acknowledges that there still remain many standards-level issues to be addressed. However, once the conceptual framework is finalised, the Boards will have an agreed-upon starting point for addressing those issues.

#### **Next steps**

208. As noted at the start of this paper (paragraph 1), the paper brings together all previous Board decisions on the cross-cutting issues identified for the reporting entity project phase, and considers all remaining cross cutting issues. In addressing these issues, the staff has not become aware of any other issues that would need to be addressed for this project phase. Therefore, if the Boards accept the staff recommendations set out in this paper, the next step would be to begin drafting the Preliminary Views document for the reporting entity project phase.
209. Before commencing that step, the staff asks the Boards whether they have become aware of any other issues that should be addressed in the project phase (either in addition to, or in respect of, issues addressed in this paper).

### 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?

Answer:

The adjective *reporting* is simply used to refer to the entity that is reporting, and does not exclude any particular *entity* from being a *reporting entity*. What constitutes an entity for financial reporting purposes should not be limited to legal entities. Hence, legal existence (or some sort of legal standing) is a sufficient condition for concluding that an entity exists, but is not necessary condition. Rather, an *entity* includes other types of arrangements or organisational structures, which could be broadly described as a circumscribed area of economic interest. Examples of entities include a natural person, sole proprietorship, company, trust, partnership, association and, in some circumstances, a branch or segment. [Based on the Boards' decisions in December 2005 and March/April 2006]

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?

Answer:

The aggregation question is answered by RE4 below. The Boards have decided not to address the disaggregation part of issue RE2. It will be a matter for others (for example, regulators, legislators, investors, creditors, or the entity itself) to determine when a legal entity (such as a company) should be divided into several reporting entities. [Based on the Boards' decision in December 2005]

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? Could (or should) a parent-only entity be a reporting entity, that is, the subject matter of GPEFR? (The last question was added in December 2005).

Answer:

- (a) 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. Thus, based on the Boards' preliminary views and their existing frameworks 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 others, in making investment, credit and similar resource allocation decisions. [Based on preliminary staff research, December 2005]
- (b) Different requirements in different jurisdictions may result from different views about the reporting entity concept, including different views about whether a parent-only entity can be the subject matter of general purpose external financial reports. [Based on preliminary staff research, December 2005]
- (c) A parent-only entity could be a reporting entity (i.e., the subject matter of GPEFR). [Based on the Boards' decision, March/April 2006]. However, there is no consensus on the rationale for that conclusion. The staff recommends adopting View 3 (Multiple Entities). Under this approach, the group comprises two or more entities, being the parent entity and other entities under its control. The group entity for financial reporting purposes is formed by combining two or more separate entities, and presenting the results of that combination *as if* those multiple entities were a single entity. Therefore, the parent-only financial statements relate to the parent entity. The consolidated financial statements relate to the group entity. Hence, both sets of financial statements are regarded as general purpose external financial reports. It would be a standards-level issue to determine when financial statements for the parent entity and/or the group entity should be prepared.

RE4: Is control the right basis for consolidation?

Answer:

The staff recommends retaining the control concept, based on the definition set out in response to RE5 below. The staff recommends using control to determine the composition of a group entity for financial reporting purposes, as follows:

- (a) common control model (staff first preference), or

- (b) controlling entity model (staff second preference)

[Staff conclusion in this paper.]

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

Answer:

Control should be defined at the conceptual level. The definition of control should contain both (a) a power element and (b) a benefits element, together with a link between the two. Also:

- (a) the power element should relate to the ability to direct the financing and operating policies of the entity;
- (b) the benefits element should refer broadly to benefits or economic benefits, and no minimum level of benefits should be specified; and
- (c) whether one entity has control over another entity involves an assessment of *all* the *present* facts and circumstances. [Based on the Boards' decisions, March April 2006.]

The modified working definition presented by the staff is as follows:

Control of an entity is the ability to direct the financing and operating policies of an entity, so as to access benefits flowing from that entity (and/or to reduce the incidence of losses) and increase, maintain or protect the amount of those benefits (and/or reduce the amount of those losses).

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

Answer:

At the conceptual level, the same concept is used in both instances, including in the context of options over an asset and options over an entity. With regard to the treatment of options, the holding of an option does not, in itself, give the option holder present control of another entity (or the underlying asset, in the case of options over assets). However, the staff is not ruling out the possibility that there might be situations in which the holding of options, *taken in conjunction with other facts and circumstances*, might lead to the conclusion that the option holder has present control



over the other entity. The Boards have agreed that whether one entity has control over another entity should be based on an assessment of *all* the facts and circumstances.

[Staff conclusion in this paper.]

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?

Answer:

Control involves *one* entity (not multiple entities) having control over another entity. Hence, the relationship between an individual venturer and the joint venture should not be described as a control relationship. Similarly, the relationship referred to as “significant influence” should not be described as a control relationship. [Staff conclusion in this paper]

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)?

Answer:

- (a) The answer to the first question in RE8 is that control over another is based upon an assessment of the *present* facts and circumstances. Therefore, the concept of control does not exclude situations in which control exists but it might be temporary. [Agreed by both Boards in March/April]
- (b) The example in the first question in RE8 refers to what is sometimes described as *de facto* or *effective* control. The control concept should not be limited to circumstances in which the entity has sufficient voting rights or other legal rights to direct the financing and operating policies of another entity, but should be a broad concept that encompasses economically similar circumstances. [Agreed by IASB in April; to be confirmed by FASB]
- (c) The answer to the second question in RE8 follows on from the answer to the first question, given in (a) above. That is, if an entity does not have control today, then control does not exist, irrespective of whether the entity could gain control tomorrow. [Staff conclusion in this paper.]

- (d) The example in the second question in RE8 refers the treatment of options, which is addressed in Issue RE6.