STAFF PAPER

May 2014

REG IASB Meeting

Project	**Conceptual Framework**
Paper topic	Reporting entity – General

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Purpose of paper

1. The purpose of this paper is to discuss issues related to the reporting entity for inclusion in the forthcoming Exposure Draft. However, this paper does not discuss the perspective from which financial statements should be prepared. This will be discussed in Agenda Paper 10E.

2. This paper addresses the following subjects:

    (a) description of a reporting entity (paragraphs 5-10);

    (b) control of an entity (paragraphs 11-14);

    (c) joint control and significant influence (paragraphs 15-17);

    (d) boundaries of a reporting entity, unconsolidated financial statements and consolidated financial statements (paragraphs 18-28); and

    (e) combined financial statements and dual listed companies (paragraphs 29-32).

3. Appendix A presents a preliminary draft of the reporting entity section for inclusion in the forthcoming Exposure Draft.

Summary of staff recommendations

4. In this paper, the staff recommend that:

(a) A reporting entity is an entity that chooses, or is required, to present general purpose financial statements (paragraph 9);

(b) A reporting entity need not be a legal entity but could comprise a portion of an entity, or two or more entities (paragraph 10);

(c) The *Conceptual Framework* should not discuss joint control and significant influence (paragraph 17);

(d) When an entity has control over another entity, the IASB needs to decide whether the boundaries of that reporting entity are determined by both direct and indirect control (which lead to consolidated financial statements) or by direct control only (which lead to unconsolidated[1] financial statements) (paragraph 22);

(e) Generally, consolidated financial statements are more likely than unconsolidated financial statements to provide more useful information to more users (paragraph 27);

(f) When an entity is required to present consolidated financial statements, that entity may also choose, or be required, to present unconsolidated financial statements. Those unconsolidated financial statements should disclose how users may obtain the consolidated financial statements (paragraph 28);

(g) The *Conceptual Framework* should not discuss how to specify which combinations of entities could constitute a reporting entity that could legitimately prepare combined financial statements (paragraph 32).

Description of a reporting entity

Proposal in the 2010 ED and feedback received

5. In the Exposure Draft, *Conceptual Framework for Financial Reporting: The Reporting Entity* issued in March 2010 (hereinafter referred to as 'the 2010 ED'),

[1] This paper uses the term 'unconsolidated financial statements' to contrast with 'consolidated financial statements'. The staff think 'unconsolidated financial statements' mean the same thing as 'separate financial statements' in IAS 27 *Separate Financial Statements* and 'parent-only financial statements' in the 2010 ED.

the IASB provided a description of a reporting entity and described the features of a reporting entity:

> RE2 A reporting entity is a circumscribed area of economic activities whose financial information has the potential to be useful to existing and potential equity investors, lenders and other creditors who cannot directly obtain the information they need in making decisions about providing resources to the entity and in assessing whether management and the governing board of that entity have made efficient and effective use of the resources provided.
>
> RE3 A reporting entity has three features:
>
> (a) economic activities of an entity are being conducted, have been conducted or will be conducted;
>
> (b) those economic activities can be objectively distinguished from those of other entities and from the economic environment in which the entity exists; and
>
> (c) financial information about the economic activities of that entity has the potential to be useful in making decisions about providing resources to the entity and in assessing whether the management and the governing board have made efficient and effective use of the resources provided.
>
> These features are necessary but not always sufficient to identify a reporting entity.

6. Many respondents stated that the 2010 ED did not clearly articulate whether entities that met the description of a reporting entity *must*, *should* or *could* prepare general purpose financial reports. Many of these respondents also stated that the responsibility for deciding who is required to prepare general purpose financial reports lies with governments and regulators and not with the IASB.

7. The 2010 ED also stated that the existence of a legal entity is neither necessary nor sufficient to identify a reporting entity and that a reporting entity can include more than one entity or it can be a portion of an entity.

8. Many respondents to the 2010 ED stated that many jurisdictions require all legal entities to prepare financial statements in accordance with IFRSs and were concerned that some of these entities may not be permitted to present general purpose financial statements in accordance with IFRSs if they do not qualify as a reporting entity. A few respondents to the 2010 ED stated that only legal entities should qualify as a reporting entity.

Staff analysis and recommendation

9. The IASB does not have the authority to determine who must or should prepare general purpose financial statements. Accordingly, the staff recommend that the *Conceptual Framework* should simply state that a reporting entity is an entity that chooses, or is required, to present general purpose financial statements. Described in this way:

   (a) all legal entities that are required to prepare financial statements in accordance with IFRSs would qualify as a reporting entity; and

   (b) portions of entities, or two or more entities, could qualify as a reporting entity if they choose to present general purpose financial statements.

10. Given that some respondents to the 2010 ED stated that only legal entities should qualify as a reporting entity, the staff recommend that the *Conceptual Framework* should clarify that a reporting entity need not be a legal entity but could comprise a portion of an entity, or two or more entities.

Questions for the IASB

1. Does the IASB agree that a reporting entity should be described as an entity that chooses, or is required, to present general purpose financial statements (paragraph 9)?

2. Does the IASB agree that a reporting entity need not be a legal entity but could comprise a portion of an entity, or two or more entities (paragraph 10)?

Control of an entity

Proposal in the 2010 ED and feedback received

11. In the 2010 ED, the IASB provided a high-level definition of 'control of an entity' and stated that the boundaries of a reporting entity (ie the extent of the economic resources and claims and changes in those resources and claims, that should be included in the entity's financial statements) should be determined by the notion of 'control of an entity'.

12. Many respondents to the 2010 ED agreed with the proposed high-level definition of 'control of an entity'.

Staff analysis

13. The IASB issued IFRS 10 *Consolidated Financial Statements* in May 2011, after the 2010 ED was issued. IFRS 10 defines control of an investee.

14. Determining the boundaries of a reporting entity is not the only place where the notion of 'control' is likely to be relevant. The definition of an asset also includes the notion of control of an asset and the staff think that the boundaries of a reporting entity can be described using that notion. The staff plan to discuss the 'control' notion including a definition of control at a future meeting.

Joint control and significant influence

Proposal in the 2010 ED and feedback received

15. The 2010 ED stated that joint control and significant influence do not give rise to control.

16. Most respondents to the 2010 ED did not comment on this issue. However, some respondents stated that the IASB should not dismiss the use of proportionate consolidation for jointly controlled entities.

Staff analysis and recommendation

17. The staff think that the discussions on joint control (including proportionate consolidation) and significant influence are too detailed to be discussed in the *Conceptual Framework* and, accordingly, should not be included in the *Conceptual Framework*. The staff think the issue should be discussed at the Standards-level.

Question for the IASB
3. Does the IASB agree that the *Conceptual Framework* should not discuss joint control and significant influence (paragraph 17)?

Boundaries of a reporting entity, unconsolidated financial statements and consolidated financial statements

Proposal in the 2010 ED and feedback received

18. The 2010 ED proposed that the boundaries of a reporting entity should be determined by ‘control of an entity’ and if an entity that controls one or more entities prepares financial reports, it should present consolidated financial statements (ie financial statements in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single unit).

19. Most respondents to the 2010 ED agreed that an entity that controls one or more entities should present consolidated financial statements.

20. The 2010 ED also stated that parent-only financial statements might provide useful information if they are presented together with consolidated financial statements.

21. Some respondents disagreed with the IASB's proposal that parent-only financial statements must be accompanied by consolidated financial statements for the following reasons:

    (a) entities should be permitted to present their parent-only financial statements in a document that is different from their consolidated financial statements, possibly issued on a different date; and

    (b) the proposal is inconsistent with requirements in certain jurisdictions where governments and regulators require the presentation of parent-only financial statements (with or without accompanying consolidated financial statements).

Staff analysis and recommendation

Boundaries of a reporting entity

22. The staff think that, when a reporting entity has control over another entity, the IASB needs to decide whether the boundaries of that reporting entity are determined by both direct and indirect control (which lead to consolidated financial statements) or by direct control only (which lead to unconsolidated financial statements).

Both direct and indirect control and consolidated financial statements

23. When the boundary of the reporting entity is based on both direct and indirect control, an entity would report on:

    (a) the economic resources it (the parent) controls directly and those it controls indirectly by controlling another entity (a subsidiary); and

    (b) the direct claims against the reporting entity and claims that arise against the reporting entity indirectly through claims against a subsidiary.

Hence, economic resources and claims of the subsidiary would be reported as part of the economic resources and claims of the reporting entity. Financial statements of a reporting entity whose boundaries are determined in this way are commonly referred to as consolidated financial statements.

24. When an entity (the parent) has control over another entity (a subsidiary), the cash flows and other benefits flowing from the parent to its capital providers often depend partly on the cash flows and other benefits obtained from the subsidiary, which in turn depend on the subsidiary's activities and the parent's actions in directing the subsidiary. Hence, reporting the assets, liabilities, income and expense of the parent and the subsidiary as a single unit provides useful information to users of the financial statements of the reporting entity.

Direct control only and unconsolidated financial statements

25. When the boundary of the reporting entity is based on direct control only, the reporting entity would report on:

(a) the economic resources it (the parent) controls directly; and

(b) the direct claims against the reporting entity.

Hence, the investment in the controlled entity (the subsidiary) would be reported as a financial instrument. Financial statements of a reporting entity whose boundaries are determined in this way are commonly referred to as unconsolidated financial statements.

26. When an entity (the parent) has control over another entity (a subsidiary), the amount available for distribution to investors of the parent is in some jurisdictions based on the (unconsolidated) distributable profits of the parent. Furthermore, the lenders and other creditors of the parent typically have a claim against the assets of the parent but not against the assets of the subsidiary. Hence, distinguishing assets held directly by the parent from those held indirectly (ie the assets held by the subsidiary) can provide useful information to users of financial statements.

Consolidated and unconsolidated financial statements

27. The staff think both consolidated financial statements and unconsolidated financial statements can provide useful information to users of financial statements. However, for the reason stated in paragraph 24, generally,

consolidated financial statements are more likely than unconsolidated financial statements to provide more useful information to more users. This view is consistent with the IASB's view stated in the 2010 ED and, therefore, the staff recommend including this statement in the *Conceptual Framework*.

28. When an entity is required to present consolidated financial statements, that entity may also choose, or be required, to present unconsolidated financial statements. As noted in paragraph 26 , the staff think that unconsolidated financial statements can provide useful information and, therefore, think that:

(a) entities should not be precluded from preparing unconsolidated financial statements in accordance with IFRSs, in addition to consolidated financial statements; and

(b) when the IASB concludes that consolidated financial statements will provide more useful information to users of financial statements:

(i) entities should not be permitted to prepare unconsolidated financial statements *instead of* consolidated financial statements. In those circumstances, unconsolidated financial statements would not provide sufficient information to users;

(ii) users of unconsolidated financial statements should be informed that consolidated financial statements exist and about how users may obtain them. However, the *Conceptual Framework* should not specify when and how the entity should make those consolidated financial statements available to users.

Questions for the IASB

4. Does the IASB agree that, when an entity has control over another entity, the IASB needs to decide whether the boundaries of that reporting entity are determined by both direct and indirect control (which lead to consolidated financial statements) or by direct control only (which lead to unconsolidated financial statements) (paragraph 22)?

5. Does the IASB agree that, generally, consolidated financial statements are more likely than unconsolidated financial statements to provide more useful information to more users (paragraph 27)?

> 6. Does the IASB agree that unconsolidated financial statements need not be accompanied by consolidated financial statements as long as the unconsolidated financial statements disclose how users may obtain the consolidated financial statements (paragraph 28)?

Combined financial statements and dual listed companies

Proposal in the 2010 ED and feedback received

29. In the 2010 ED, the IASB stated that combined financial statements might provide useful information about commonly controlled entities as a group. Many of the respondents to the 2010 ED who commented on this issue welcomed the IASB's intention to discuss combined financial statements in the *Conceptual Framework* but disagreed with the IASB's proposal that combined financial statements should be limited to the combination of entities under common control.

30. A few respondents to the 2010 ED stated that it was unclear how the reporting entity concept should be applied to dual listed companies[2], stapled entities[3] and similar entities.

Staff analysis and recommendation

31. Based on the staff recommendations in this paper:

    (a) a reporting entity is an entity that chooses, or is required to present general purpose financial statements; and

    (b) a reporting entity can comprise two or more entities.

    Accordingly, at least conceptually, two or more entities would not be precluded from presenting combined financial statements. This would include the case of dual listed companies, stapled entities and similar entities.

[2] Under a typical dual listed company (DLC) arrangement, the activities of two entities are managed as a single economic entity under a contractual arrangement, while retaining their separate legal identities. The securities of the entities comprising the DLC arrangement are normally quoted, traded or transferred independently of each other in different capital markets.

[3] Under a typical stapling arrangement, equity holders in two entities agree to 'staple' their securities together. Stapled securities cannot be traded or transferred independently and are quoted at a single price.

32. However, the staff think the IASB would need to develop Standards-level guidance in order to specify when and how an entity could prepare combined financial statements. The staff recommend that the *Conceptual Framework* should not discuss how to specify which combinations of entities could constitute a reporting entity (such as those under common control or common management) that could legitimately prepare combined financial statements.

Question for the IASB
7. Does the IASB agree that the *Conceptual Framework* should not discuss how to specify which combinations of entities could constitute a reporting entity that could legitimately prepare combined financial statements (paragraph 32)?

Appendix A: Preliminary draft of the Reporting entity section for inclusion in the forthcoming Exposure Draft

Reporting entity

A1. A reporting entity is an entity that chooses, or is required, to present general purpose financial statements.

A2. A reporting entity is not necessarily a legal entity. It can comprise a portion of an entity, or two or more entities.

Boundaries of a reporting entity

A3. When an entity has control over another entity, the IASB needs to decide whether the boundaries of that reporting entity are determined by both direct and indirect control or by direct control only.

Both direct and indirect control

A4. When the boundary of the reporting entity is based on both direct and indirect control, the reporting entity would report on:

(a) the economic resources it (the parent) controls directly and those it controls indirectly by controlling another entity (a subsidiary); and

(b) the direct claims against the reporting entity and claims that arise against the reporting entity indirectly through claims against a subsidiary.

Hence, the economic resources and claims of the subsidiary would be reported as part of the economic resources of the reporting entity.

A5. When an entity (the parent) has control over another entity (a subsidiary), the cash flows and other benefits flowing from the parent to its capital providers often depend partly on the cash flows and other benefits obtained from the subsidiary, which in turn depend on the subsidiary's activities and the parent's actions in directing the subsidiary. Hence, reporting the assets, liabilities, income and expense of the parent and the subsidiary as a single unit provide useful information to users of the financial statements of the reporting entity.

Direct control only

A6. When the boundary of the reporting entity is determined by direct control only, an entity would report on:

(a) the economic resources it (the parent) controls directly; and

(b) the direct claims against the entity.

Hence, the investment in the controlled entity (the subsidiary) would be reported as financial instruments.

A7. When an entity (the parent) has control over another entity (a subsidiary), the amount available for distribution to investors of the parent is in some jurisdictions based on the (unconsolidated) distributable profits of the parent. Furthermore, the lenders and other creditors of the parent typically have a claim against the assets of the parent but not the assets of the subsidiary. Hence, distinguishing assets held directly by the parent from those held indirectly (ie the assets held by the subsidiary) can provide useful information to users of financial statements.

Financial statements of a reporting entity

A8. When an entity has control over another entity, financial statements of a reporting entity whose boundaries are based on both direct and indirect control are commonly referred to as consolidated financial statements.

A9. When an entity has control over another entity, financial statements of a reporting entity whose boundaries are based on direct control only are commonly referred to as unconsolidated financial statements.

A10. Generally, consolidated financial statements are more likely than unconsolidated financial statements to provide more useful information to more users.

A11. When an entity is required to present consolidated financial statements, that entity may also choose, or be required, to present unconsolidated financial statements. Those unconsolidated financial statements should disclose how users may obtain the consolidated financial statements.

A12. Consolidated financial statements of the parent are not intended primarily to provide information to users of a subsidiary's financial statements. Providers of capital to a subsidiary seek information about that entity's resources, and the claims against that entity, from financial statements of the subsidiary.

A13. When two or more entities that do not have a parent-subsidiary relationship with each other, choose, or are required, to present general purpose financial statements, the financial statements of such a reporting entity are commonly referred to as combined financial statements.