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Financial Reporting Policy Committee

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Response to the Conceptual Framework for Financial Reporting: The Reporting Entity¹

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INTRODUCTION

The Financial Reporting Policy Committee (“Committee”) of the Financial Accounting and Reporting Section of the American Accounting Association (“AAA”) is charged with responding to discussion papers and exposure drafts related to financial accounting and reporting issues.² The Committee is pleased to respond to the Preliminary Views on the *Conceptual Framework for Financial Reporting: The Reporting Entity* issued jointly by the Financial Accounting Standards Board and the International Accounting Standards Board (the “Boards”).

In general, the Committee agrees that the conceptual framework should broadly define a reporting entity. As discussed more completely in our response, a long and continuing stream of literature in accounting and economics addresses boundaries of the firm. This literature could potentially be useful in evaluating and integrating issues suggested in the Preliminary Views document, including identifying the reporting entity, describing control, and defining assets.

¹ This comment letter was developed by the members of the Financial Reporting Policy Committee of the Financial Accounting and Reporting Section of the American Accounting Association and does not represent an official position of the American Accounting Association.

² The Committee is independent of the Financial Accounting Standards Committee (FASC) of the American Accounting Association.

The *Preliminary Views* document includes thirteen questions summarized on pages 32-33. The remainder of this document contains the Committee's response to those questions; each question posed is stated in bold and our response follows each of the questions.

Section 1: The reporting entity concept

Q1. Do you agree that what constitutes a reporting entity should not be limited to business activities that are structured as legal entities? If not, why?

Response:

Yes, we agree that the criteria for determining a reporting entity should not be limited to business activities that are structured as legal entities. Laws and regulations provide certain incentives, such as limited liability or taxation, to form legal entities. However, the economic activities of a group of related enterprises that are of interest to shareholders and creditors may be broader than those of a legal entity. This view that a reporting entity is more broadly defined than a legal entity has long-standing support in the accounting academic literature (Moonitz 1942).

Q2. Do you agree that the conceptual framework should broadly describe (rather than precisely define) a reporting entity as a circumscribed area of business activity of interest to present and potential equity investors, lenders, and other capital providers? If not, why? For example, do you believe that the conceptual framework should establish a precise definition of a *reporting entity*? If so, how would you define the term? Do you disagree with including reference to equity investors, lenders, and other capital providers in the description (or definition) of a reporting entity? If so, why?

Response:

Because of the difficulties in formulating a precise definition, we agree that the conceptual framework should broadly define a reporting entity. The *Preliminary Views* document seeks to first define the reporting entity and then identify, through the definition of

control, the items included as part of the reporting entity. Attempting to define the reporting entity separately from control causes the definitions of each to become circular and incomplete.

A long literature in accounting and economics addresses the boundaries of the firm that could potentially be useful in defining a reporting entity and determining control (Coase 1937; Jensen and Meckling 1976; Grossman Hart 1994). Based on Jensen and Meckling (1976, p. 88) a common view of the firm is that of a nexus of contracts between various constituencies or stakeholder groups where there exists divisible residual claims on assets and cash flows which can generally be sold without permission of the other contracting individuals. This view is based in part on the role of property rights in defining the firm. Further, the view of the firm as a nexus of contracts links decision rights and the asset ownership, seemingly important in defining a reporting entity through a controlling relationship. According to the property rights view, the “owner” of an asset is identified as the party having residual rights of control over the asset. The residual right of control is the right to make all decisions concerning that asset including those that have not been specified in a contract or that are not inconsistent with some law (Hart 2001). The holder of residual rights then controls the asset. Such an approach encompasses benefits from assets as well as recognizes claims on the assets, which is not explicitly addressed in the current document. The view of the firm as a nexus of contracts can be broad, encompassing property rights held by many different stakeholders. In defining a reporting entity for financial reporting purposes, the residual rights in question would be those held by the shareholders and exercised by their representatives, the board of directors.

The view of the firm as a nexus of contracts also includes the notion of an asset over which some residual rights exist. Counter to this view, paragraph 53 of the *Preliminary Views* document questions whether an asset definition is relevant to determining the composition of a group entity and paragraph 62 asserts that it is not. Paragraph 51 notes that part of the concern with defining assets at this stage is that the concept of control is unclear as it is used both in the definition of assets and in determining the composition of a group reporting entity in existing frameworks and standards. So, the focus should be on the definition of a group reporting entity first. We believe that the definition of an asset is fundamental in determining the controlled economic rights and, thus, in defining a group

reporting entity. Therefore, as is suggested in paragraph 62, it may be beneficial to align the basis for determining the composition of a group reporting entity with the definition of an asset.

Additionally, aligning the composition of a group reporting entity with a definition of assets would allow for a clearer definition of income. In particular, under a Hicksian notion of income, income is partially defined as a function of the change in the value of (net) assets (see Baillie 1985).

Finally, if a reporting entity is viewed as “a circumscribed area of business activity of interest to present and potential equity investors, lenders, and other capital providers” the reference to equity investors, lenders, and other capital providers is consistent with the objective of general purpose financial reporting in OB2 in the “Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information.”

Section 2: Group reporting entity

Q3. Do you agree that the risks and rewards model does not provide a conceptually robust basis for determining the composition of a group reporting entity and that, except to the extent that it overlaps with the controlling entity model (as discussed in paragraphs 102 and 103), the risks and rewards model should not be considered further in the reporting entity phase of the conceptual framework project? If not, why?

Response:

We do not necessarily agree that the risks and rewards model does not provide a conceptually robust basis for determining the composition of a group reporting entity. As noted in paragraph 99 of the *Preliminary Views* document, the model would need to be further developed. We believe that some elements overlap with the controlling entity model, including the idea of residual rights, could be incorporated in defining control. The Committee recommends that the Boards continue to develop (and consider) the risk and rewards model.

Q4. Assuming that control is used as the basis for determining the composition of a group reporting entity, do you agree that: (a) control should be defined at the conceptual level? (b) the definition of control should refer to both power and benefits? If not, why? For example, do you have an alternative proposed definition of control?

Response:

Assuming that control is used as the basis for determining the composition of a group reporting entity, control should be defined at the conceptual level, and refer to both power and benefits. Additionally, control should incorporate some description of claims on the benefits or residual rights.

Q5. Do you agree that the composition of a group reporting entity should be based on control? If not, why? For example, if you consider that another basis should be used, which basis do you propose and why?

Response:

See response to Q2 above.

Q6. Assuming that control is used as the basis for determining the composition of a group reporting entity, do you agree that the controlling entity model should be used as the primary basis for determining the composition of a group entity? If not, why?

Response:

Yes, assuming that control is used as the basis for determining the composition of a group reporting entity, control should be the *primary* basis for determining the composition of a group entity. Also, see response to Q2 above.

Q7. Do you agree that the common control model should be used in some circumstances only? If not, why? For example, would you limit the composition of a group reporting entity to the controlling entity model only? Or would you widen the use of the common

control model? If you support the use of the common control model, at least in some circumstances, do you regard it as an exception to (or substitute for) the controlling entity model in those circumstances, or is it a distinct approach in its own right? Please provide reasons for your responses.

Response:

The controlling entity model, as broadly viewed, should encompass the common control model rather than compete with it. If control is adequately defined, the two models are not necessarily mutually exclusive alternatives.

Section 3: Parent entity financial reporting

Q8. Do you agree that consolidated financial statements should be presented from the perspective of the group reporting entity, not from the perspective of the parent company's shareholders? If not, why?

Response:

The view that consolidated financial statements should be presented from the perspective of the group reporting entity, not from the perspective of the parent company's shareholders, is consistent with that expressed in the Chapter 1 of the Exposure Draft, "Conceptual Framework for Financial Reporting, The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting," and recent standards on business combinations issued by the FASB (FASB Statement No. 160, "Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51"). The Committee generally supports this position: it is consistent with our response to the Exposure Draft, in which we suggest that meeting the needs of the providers of equity financing necessitates also meeting the information needs of the providers of debt financing.

Q9. Do you agree that consolidated financial statements provide useful information to equity investors, lenders, and other capital providers? If not, why?

Response:

Yes, we agree that consolidated financial statements provide useful information to equity investors, lenders, and other capital providers. A significant body of research finds that consolidated earnings are relevant to equity market participants. Studies also indicate that consolidated statements are more relevant to investors in valuation than non-consolidated or parent-only statements; although, this relevance could vary based on institutional arrangements (Abad et al. 2000; Hermann et al. 2001; Niskanen et al. 1998). Other research has found that providers of debt capital base debt covenants on financial statement information that is reported in consolidated or parent only statements (Rosman 1992). This suggests that consolidated financial statements could provide useful information to lenders.

Differences in debt and debt ratios, however, are significant between consolidated or parent only statements (Francis 1986).

Finally, the Committee cautions that the providers of equity capital often do not have the same contractual ability as providers of debt capital to demand information such as parent company statements (see Bharath, Sunder, and Sunder 2008). Accordingly, it is important that the Boards ensure the information needs of providers of equity capital are satisfied.

Q10. Do you agree that the conceptual framework should not preclude the presentation of parent-only financial statements, provided that they are included in the same financial report as consolidated financial statements? If not, why? 33

Response:

The conceptual framework should affirm consolidated financial reporting. The presentation of parent-only financial statements should be addressed at a standards-level, similar to segment reporting, not at the conceptual level. Additionally, those parties interested in parent-only financial statements such as providers of debt capital or those that otherwise contract with the parent may have a contractual ability to demand such information.

Section 4: Control Issues

Q11. With regard to the concept of control, in the context of one entity having control over another, do you agree that: (a) establishing whether control exists involves assessing *all* the *existing* facts and circumstances and, therefore, that there are no single facts or circumstances that evidence that one entity has control over another entity in all cases, nor should any particular fact or circumstances—such as ownership of a majority voting interest—be a necessary condition for control to exist? If not, why? (b) the concept of control should include situations in which control exists but might be temporary? If not, why? (c) 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 rather should be a broad concept that encompasses economically similar circumstances? If not, why? (d) in the absence of other facts and circumstances, the fact that an entity holds enough options over voting rights that, if and when exercised, would place it in control over another entity is not sufficient, in itself, to establish that the entity currently controls that other entity? If not, why? (e) to satisfy the power element of the definition of control, power must be held by one entity only? In other words, do you agree that the power element is not satisfied if an entity must obtain the agreement of others to direct the financing and operating policies of another entity? If not, why? (f) having “significant influence” over another entity’s financing and operating policy decisions is not sufficient to establish the existence of control of that other entity? If not, why?

Response:

(a) In establishing whether control exists, we agree that such a determination involves assessing *all* the *existing* facts and circumstances. To be more inclusive of *all* the *existing* facts and circumstances, we would suggest not defining particular facts or circumstances that should be considered necessary or sufficient. As mentioned in our response to Q2, the Committee suggests that the control concept can be expanded to include the residual right of control.

(b) The Committee expressed differing views on whether the concept of control should include situations in which control exists but might be temporary. One view is that if definition of control (whatever the final definition may be) is met at any point whether the control is temporary or not is not relevant. At some point in time, one entity can exercise control over another. Another view is that unless the entity intends to hold indefinitely, control does not exist. That is, if control is intended to be temporary, such as the case where one company makes an investment in other to hold until a suitable buyer is found, then whether or not control is temporary matters. For example, analysts and other users of general financial statements may view the results of operations and the status of an entity under temporary control differently.

(c) We agree that 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 rather should be a broad concept that encompasses economically similar circumstances.

(d) We agree that the fact that whether an entity holds enough options over voting rights that, if and when exercised, would place it in control over another entity is not enough to establish that the entity currently controls that other entity. An option to purchase a security does not entail the ability to control the entity. Rather, the ability to control the entity exists when the decision is made to exercise those options. Consistent with paragraph 156, some Committee members expressed the view that options held should be viewed in the context of the other facts and circumstances and may be one of the factors that result in control.

(e) We do not necessarily agree that the power element is not satisfied if an entity must obtain the agreement of others to direct the financing and operating policies of another entity. For instance, even if a majority of shares are held, minority shareholders may need to be considered depending on company bylaws and other relevant contracts, laws or regulations. Hence, power is not absolute in these circumstances but control may exist. Again, this reinforces the position expressed in (a) above that *all the existing* facts and circumstances must be considered.

(f) We agree with the Boards that having “significant influence” over another entity’s financing and operating policy decisions is not sufficient to establish the existence of control of that other entity. The substance of the arrangement, rather than legal form, should determine the existence of control.

Q12. Should any of the above control issues be addressed at the standards-level rather than at the concepts level? If so, which issues and why?

Response:

Control should clearly be defined at the conceptual level. We suggest that allowing parent-company financial statements could be addressed at the standards-level similar to segment reporting. See response to Q10.

Q13. Are there any other conceptual issues, relating either to the control concept or to some other aspect of the reporting entity concept, that are not addressed in this Preliminary Views and should be addressed at the conceptual level? If so, which issues and why?

Response:

We believe that the Boards should consider contractual relationships for defining the boundaries of firm, and thus control and the group reporting entity, as we discuss in our response to Q2,

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