# AP 07

# Information deficiencies of today's group f/s and the specific role of consolidation regarding these

## ASAF meeting

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***The views offered in this presentation are used to stimulate debate only and should not be attributed to the ASCG. Official positions of the ASCG are reached only after extensive due process and deliberations.***

***I gratefully acknowledge the many useful comments by individual members of the standard-setting community with whom I had engaged in debates on a prior version of this presentation. I am particularly indebted to Günther Gebhardt (Goethe University Frankfurt ) for bringing this topic to my intention and sharing his views with me.***

# Motivation

The following presentation is meant to stimulate debate about information gaps in current group financial statements and the role of consolidation, specifically, in contributing to these (perhaps unintentionally).

Whilst it is widely acknowledged that transactions with and between members of the same group should not influence the outside appearance of that group and therefore be eliminated, such eliminations do result in a loss of information which is definitely and finally lost for outside users of f/s.

Further, much of today's complexity in the environment is not captured in the group's f/s although it could highly influence the position, performance and cash flows of the group (e.g. strategic alliances, negative synergies).

This presentation is not meant to suggest changes to the accounting literature or to present solutions to the points raised but to allow ASAF members to step back and make them aware of and sensitive to the issues, esp. when engaging in standard-setting activity.

# What we all learned...

- From a widely used German university textbook:

*Group f/s are the separate f/s of the economic unit 'group'. The individual legal units that make up the group prepare their own individual f/s following local GAAP; however, these are not fit for purpose when it comes to analysing assets, liabilities, performance, and cash flows. Intra-group relations, such as internal supply and finance relationships, compromise the validity of individual f/s. Therefore, group f/s aim at providing a holistic picture of the assets, liabilities, performance, and cash flows of the group.*

*Existing economic dependencies between group entities lead to their f/s being distorted due to structuring of transactions. Further, entities can undermine legal provisions that are targeted towards legally and economically separate entities through structuring. When doing so, the individual f/s of group entities loose much of their explanatory power. Any resulting deficiencies of the individual f/s are meant to be compensated by providing the group f/s in addition.*

Source: Coenenberg et al., 24th ed. 2016, p. 615 and 617 (my translation)

# Two (conflicting) theories of group f/s

| Entity theory | Parent company theory |
|---|---|
| → Group is viewed and defined as a **single economic entity in its own right** | → Group is viewed as an **extension to the parent** (“parent *plus*”) |
| → Treats legally separate entities as fully dependent business locations | → Presents the interests of the parent entity shareholders in the net assets of the group |

Impact on: Equity? Performance? SBP? …?


Neither IFRSs nor U.S. GAAP use a single and stringent concept –
These GAAPs use aspects of both, thus questioning the benefits assumed!

# In a nutshell: We are advocating a hypothetical construct!

It is based on assumptions that may or may not be true, most notably the control principle (*"as-if accounts"*); this seems to be unproblematic only under the following two conditions/restrictions:

a) The group consists entirely of 100% investments, and there is *'real'* power being exercised upon the next subsequent layer(s);
b) All group entities underlie the same legal and socio-economic framework (i.e. same laws, same currency, same rate of inflation, same regulatory environment, same cultural background, etc.);

The more one deviates from these conditions, the more questionable the resulting explanatory power of the group f/s, because one ignores legally and/or commercially existing, thus relevant, balances, transactions or events to achieve only one specified purpose (i.e. to eliminate intra-group relationships)!

# The dilemma...

The greatest (asserted) benefits of consolidation are associated with acknowledging intra-group relations through their elimination.

However, it is *by* doing so that one – potentially significantly – looses explanatory power, such as information about:

- The physical location of any resources (e.g. cash!);
- The accessibility of those resources (control?);
- FX position for any group entity with a different functional currency than the parent, impacting, e.g., the profitability of resources (constant currency reporting?);
- Solvency and liquidity of individual group entities (insolvency/bankruptcy laws);
- Different accounting policies existing in individual group entities for legitimate reasons (culture, tradition, religion, custom, competitors, etc. – looked at as an example on slide 9);
- ...

# What does the Framework say on groups?

- OB2:

> *The objective of GPFR is to provide financial information about the reporting entity that is useful [...] in making decisions about providing resources to the entity.*

- OB4:

> *To assess an entity's prospects for future net cash inflows, [users] need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.*

## Question 1 – the boundary of the group (I) – defining *'the entity'*

- What or who precisely is 'the entity' in a group context when talking about "an entity's prospects" and "resources of/claims against the entity"?

# What does the Framework say on groups? (cont'd)

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- BC1.29 (The objective of financial reporting for different types of entities):

*The Board also considered whether the objective of general purpose financial reporting should differ for different types of entities. Possibilities include:*

*(a) smaller entities versus larger entities;*

*(b) entities with listed (publicly traded) debt or equity financial instruments versus those without such instruments; and*

*(c) closely held entities versus those with widely dispersed ownership.*

## Question 2 – different types of entities

- Does an entity 'group' differ from individual legal entities? If so, does that difference justify a different/its own objective for financial reporting?

# What does IFRS 10 say on uniform accounting policies?

- #19

*A parent shall prepare consolidated f/s using uniform accounting policies for like transactions and other events in similar circumstances.*

- B87 Uniform accounting policies

*If a member of the group uses accounting policies other than those adopted in the consolidated f/s for like transactions and events in similar circumstances, appropriate adjustments are made to that group member's f/s in preparing the consolidated f/s to ensure conformity with the group's accounting policies.*

## Question 3 – uniform accounting policies

- When precisely are 'like transactions and events' "like"? How could one establish whether 'similar circumstances' are truly "similar"? Is there a hidden bias to ignore (certain) legal and socio-economic backgrounds?

*E.g.: Is establishing a loan at nil interest in London the same, similar or different from establishing a loan in regions where charging interest is forbidden and, thus, effectively nil as well?*

# Further areas for discussion

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## Question 4 – the boundary of the group (II) – control principle

- Control over an entity vs. control over an asset: Can a parent (P) avoid subsidiary (S) liquidate assets? If not, what information content do we assign to presenting P's assets the same way as S's assets in the group's f/s?
- Are all control relationships the same? 100% vs. 51% vs. temporary control vs. de facto control? If not, how do we depict differences in them (if at all)?
- What do we do (if anything) for 'groups' where there is no parent? (common control, joint control, shared control, an individual at the top, etc.)

## Question 5 – compensating for the loss of information

There are some factors listed on slide 6 where arguably information is definitely and fully lost on consolidation (e.g. the FX position) whilst there are others that can be compensated for (e.g. by presenting the individual f/s in addition to the group f/s).

- But how could we compensate for information that gets drowned in consolida-tion? Outside of the f/s (e.g. MC)? Through presentation/disclosure? Else?

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## Question 6 – negative effects from trade relationships

Suppose, Parent P is domiciled in Germany and has two Subs, S1 domiciled in Italy and S2 domiciled in Mexico. Both subs supply P with the similar products that could be used interchangeably. P needs a limited number of products and will not buy any inventory in excess. The subs are free to engage in whatever contracts they believe are commercially sensible from their point of view.

Entities E1 and 2 both belong to another, unrelated group and are based in Italy and Mexico, respectively. They each hold trade relationships with S1 and 2, as all entities are doing business in substitutive products. Since P only needs a certain quantity of inputs from S1 and 2, there is a *'de facto competition'* between S1 and 2: The more S1 engages in trade with E1, the less business S2 is doing with E2, vice versa.

Given that S1 and S2 are domiciled in different countries with different currencies, legislation etc., the actual sourcing by P could have an impact on the group f/s.

- How and where in the group f/s (if at all) do we depict such negative effects?

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## Question 7 – strategic alliances

Airlines 1, 2 and 3 are joining forces and have negotiated a wide-ranging cooperation agreement. Apart from pure code-sharing agreements (i.e. one carrier is flying under three flight numbers that enables each airline to book contingents on that carrier without having to operate the route with their own equipment), there are many more benefits, including but not limited to:

- Alignment of flight timetables and routes, thus giving customers access to a much wider network of places flown to
- Customers earning and redeeming miles on any airline's routes
- Access to airport slots, terminal capacity, ground handling, etc.

The airlines have no shareholdings into each other, so are not members of a group. Nonetheless, it is widely acknowledged that such alliances bring tangible advantages to their members.

- How and where in the group f/s (if at all) do we depict such alliances and the benefits, risks and opportunities brought about by them?

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