



**Australian Government**

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**Australian Accounting  
Standards Board**

# Consolidated and separate/individual Financial Statements XXX 2018

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Note to Board: The title of this Report is a working Title – We may call it Consolidated and Parent/subsidiary financial statements.

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- other AASB staff for their contribution on earlier drafts
- Australian Auditing and Assurance Standards Board staff for their contribution.

Any errors or omissions remain the responsibility of the principal authors.

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### AASB Research Report Series

The AASB Research Centre promotes thought leadership in external reporting standardsetting and policy making through in-depth analysis of financial reporting issues and related empirical work.

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# Executive Summary

## Key findings

Note to Board

This section will be completed near finalisation of the Report

# Introduction

## What is the issue and why is it important?

Financial statements form a cornerstone of a transparent and accountable financial system. From both a preparer's and user's perspective, it is important to reduce the reporting burden by simplifying the requirements and ensuring the information reported is useful. Consistent with this, regulators who focus on a range of matters (some of which relate to financial reporting requirements) need to ensure regulations are relevant and robust and keeping abreast of changes to help maintain confidence in the economy.

This Report focuses on a limited range of current financial reporting requirements with a view to identifying areas where those requirements could be simplified or clarified. It is particularly focused on entities that are structured as groups with parent-subsidary relationships and assesses the suitability of current requirements relating to unconsolidated financial statements of (or unconsolidated financial information about) parent entities and subsidiary entities in light of the fact that consolidated financial statements of the group are typically available. Its aim is to address potential criticisms that the current requirements are too onerous for preparers and burden users with information overload.

The primary issue is whether the financial information about subsidiaries could be provided in a more cost effective way (such as by providing summary financial information in the consolidated financial statements of the parent instead of a complete set of financial statements for the subsidiary). The main impetus for this Report is the current less onerous requirements:

- under the NZ Companies Act 1993 for subsidiary entities (See Appendix B for International Comparisons); and
- for parent's separate financial statements under section 295(2) and Regulation 2M.3.01 of the Australian Corporations Act 2001 (See paragraph 22-27 of this Report).

### Note to Board:

- This section needs to be refined further, to minimise repetition of material contained in later sections and ensure the issue and why it is important is expressed succinctly.
- Although cross-referencing within this document for appendices and paragraphs has been done, that needs to be double-checked

## The relationship of this Report to other AASB projects

This Report is part of the larger 'Australian Financial Reporting Framework' project (commenced in... **Note to Board: the MM/YY will be inserted**) being undertaken by the AASB and the Auditing and Assurance Standards Board (AUASB), the objective of which is to clarify and simplify the Australian financial reporting framework applicable to all sectors by developing more consistent and operational criteria/thresholds grounded in sound principles that specify:

- (a) who needs to prepare and lodge external financial statements on the public record;
- (b) what needs to be reported (reporting requirements); and
- (c) what level of assurance is appropriate (assurance requirements).

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The project aims to achieve financial reporting requirements that are clear, objective and comparable, balancing costs and benefits. It aims to reduce the financial reporting burden by simplifying the requirements where appropriate and ensure the resulting information is useful.

This Report along with the second phase which will address not-for-profit private sector entities and public sector entities will complete the last of the planned Research Reports for the Board's Australian Financial Reporting Framework Project. Other Research Reports, Staff paper and Discussion Papers in relation to the Australian Financial Reporting Framework Project include:

- a. Research Report No.7 *Financial Reporting Requirements Applicable for For-Profit Private Sector Companies* - May 2018, which aims to provide a better understanding of the current Australian requirements (together with an international comparison) for 'For-Profit Private Sector Companies' including reporting challenges such as the 'reporting entity' concept, the basis on which the requirements were developed
- b. Research Report No.6 *Financial Reporting Requirements Applicable to Public Sector Entities* May 2018, which documents the financial reporting requirements applicable to public sector entities in Australia and how these compare internationally
- c. AASB Staff Paper *Improving Financial Reporting for Australian Public Sector* (June 2018), which presents possible reporting options for improving the current framework for public sector entities with illustrative frameworks to demonstrate the impact of these options
- d. Research Report No.5 *Financial Reporting Requirements Applicable to Charities* – October 2017, which documents the financial reporting requirements applicable to charities in Australia and how these compare internationally
- e. AASB Staff Paper *Improving Financial Reporting for Australian Charities* – AASB Discussion Paper November 2017, which presents possible options (and demonstrates the impact of some of these possible options) for improving the current framework that charity stakeholders might find useful in providing input to the ACNC legislative review
- f. *AASB submission to ACNC Legislative Review* – February 2018, which, after seeking the views of charity stakeholders through extensive outreach, recommends further work be undertaken by the ACNC, AASB and the AUASB, in consultation with the sector, to develop a suitable reporting framework for registered charities
- g. AASB Staff Paper *Comparison of Standards for Smaller Entities* – April 2018, which benchmarks six international pronouncements for smaller entities of the International Accounting Standards Board (IASB), United Kingdom (UK) and New Zealand (NZ) and explores the options for modified accrual and cash bases of accounting as additional tiers of financial reporting requirements.

## Why is the AASB addressing this issue?

The AASB's vision<sup>1</sup> is to contribute to stakeholder confidence in the Australian economy, including its capital markets, and in external reporting.

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<sup>1</sup> <http://www.aasb.gov.au/About-the-AASB.aspx>

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Although the AASB (and AUASB) understand that ultimately the requirements for who should prepare financial statements and the level of assurance required are matters for regulators<sup>2</sup>, the AASB (and AUASB), as independent national bodies with responsibility for all sectors, see part of their roles as initiating conversations and working with regulators (and other stakeholders) to achieve the necessary reform to make the Australian financial reporting framework clearer and more objective.

Furthermore, the questions of who should report and what should be reported are inextricably linked, and therefore in pursuing the issues pertinent to this Report, the AASB sees its role as including working with relevant regulators (and other stakeholders) in developing appropriate financial reporting requirements.

The research undertaken for this Report might also help contribute to international developments (another objective of the AASB) by identifying any issues of common interest that may have an impact internationally.

### Where to from here?

The research reported in this Report will provide input to the process through which the AASB (and AUASB) will work with regulators, users, preparers and other stakeholders to reach a clear, effective, broadly accepted framework for financial reporting (and assurance) in Australia. Based on the findings in this Report<sup>3</sup>, suitable suggestions to relevant regulators in Australia will be made.

Furthermore, the findings in this Report (if significant in an international context) will be presented at the Accounting Standards Advisory Forum (ASAF) in October 2018 with the possibility of improving financial reporting requirements internationally.

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<sup>2</sup> [http://www.aasb.gov.au/admin/file/content102/c3/AASB\\_AUASB\\_Strategy\\_2017-2021\\_FAQs.pdf](http://www.aasb.gov.au/admin/file/content102/c3/AASB_AUASB_Strategy_2017-2021_FAQs.pdf). In contrast, the question of what should be reported is regarded as being the domain of standard setters.

<sup>3</sup> It is possible that the outcome of some of the issues being informed by this Report is for standard setters and regulators to support the status quo. Such an outcome is as valid as an outcome that results in change.



## Scope

This Report focuses on the suitability of the current requirements for the preparation of financial statements of entities within parent-subsidary structures – primarily subsidiary requirements and secondarily parent requirements.

The existence of parent-subsidary structures raises the question of how financial reporting could best meet user needs in a cost-effective way. For example, if consolidated financial statements<sup>4</sup> are required to be prepared, should the financial statements of each individual entity within the group also be required - or might summary financial information about those individual entities within the group disclosed in the consolidated financial statements suffice? As detailed in paragraphs 83-115, there are different perspectives and levels of usefulness that information within each of the different types of financial statements (i.e. consolidated financial statements, subsidiary financial statements and parent financial statements) bring to their respective users, for example, depending on whether users are focused on an entity's economic power (control) [which lends itself to consolidated financial statements] or legal rights [which lends itself to unconsolidated financial statements].

In Australia, in many cases, if a parent prepares consolidated financial statements, it is not required to prepare a full set of parent (unconsolidated) separate financial statements. However, in place of the parent separate financial statements, it is required to provide summary financial information with respect to its separate financial statements as a note in the consolidated financial statements of the ultimate Australian parent and the intermediate parent<sup>5</sup> (unless it is exempt under AASB 10 *Consolidated Financial Statements* from preparing consolidated financial statements, in which case such parents need to prepare a full set of separate financial statements). Intermediate subsidiaries are subject to similar requirements. Bottom subsidiaries in a group (that is, subsidiaries without subsidiaries) are required to prepare full sets of individual financial statements,

The following diagram helps visually clarify the scope of this Report. The diagram shows a simplified structure, where:

- P (parent) is the ultimate Australian parent of a group preparing and lodging consolidated financial statements. Under Corporations Act 2001 and ASIC's financial reporting requirements P is not required to prepare its full set of separate financial statements<sup>6</sup>.
- Similarly, S1 (an intermediate parent, whether wholly or partly owned), is required to prepare consolidated financial statements<sup>7</sup> but not its separate financial statements<sup>8</sup>.
- S2 (a bottom subsidiary, whether wholly or partly owned), is required to prepare its individual financial statements.

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<sup>4</sup> Appendix A of AASB 10 defines 'consolidated financial statements' as "the financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity."

<sup>5</sup> Except entities governed by the Australian Prudential Regulation Authority (APRA)

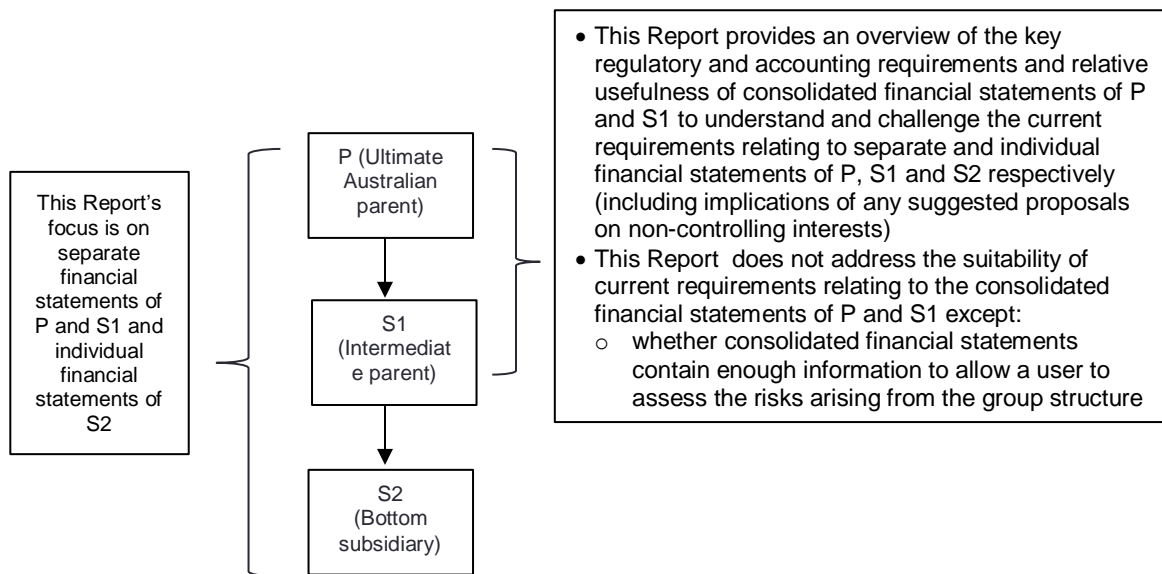
<sup>6</sup> However, if a parent entity wishes to present a full set of separate financial statements as an alternative to summary parent information that would be otherwise required by Regulation 2M.3.01, ASIC's class order 10/654 allows that (see paragraph 32).

<sup>7</sup> Unless exempted under paragraphs 4(a) and Aus 4.1 of AASB 10 *Consolidated Financial Statements*.

<sup>8</sup>

- Subject to ASIC's class order 2016/785 regarding wholly owned subsidiaries and ASIC Instrument 2017/204 regarding Foreign controlled companies (see paragraphs 33-43).
- Unless not exempted under AASB 10.

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*Included within scope: Separate financial statements of parent and individual financial statements of subsidiaries*

In this Report (through addressing the key questions summarised in section 'Key issues addressed' below), we are aiming to determine the impact on users of the current requirements relating to, primarily, subsidiary and, secondarily, parent financial statements (by re-visiting research carried out earlier and undertaking fresh research and outreach to users – see Appendix A of this Report). As noted section 'Key issues addressed', secondary aim of assessing the adequacy of summary financial information that most parent entities are currently required to disclose with respect to their separate financial statements as a note in the consolidated financial statements involves assessing whether there are significant general purpose users who would still need the full set of financial statements of the parent (instead of the summary financial information). Although our aim is not to undertake a detailed post-implementation review of the requirements relating to parents, the results of our research may provide useful input to any such review that might be undertaken in the future.

Based on the results of the analysis of parent reporting, the Report (in pursuing its primary aim) goes on to consider whether it would be appropriate to extend a similar exemption (i.e. disclosure of summary financial information rather than preparation of a full set of financial statements) to subsidiaries. If so, what should that summary information be? As noted in section 'Key issues addressed', the Report will also consider related questions, such as where such an exemption would best be located.

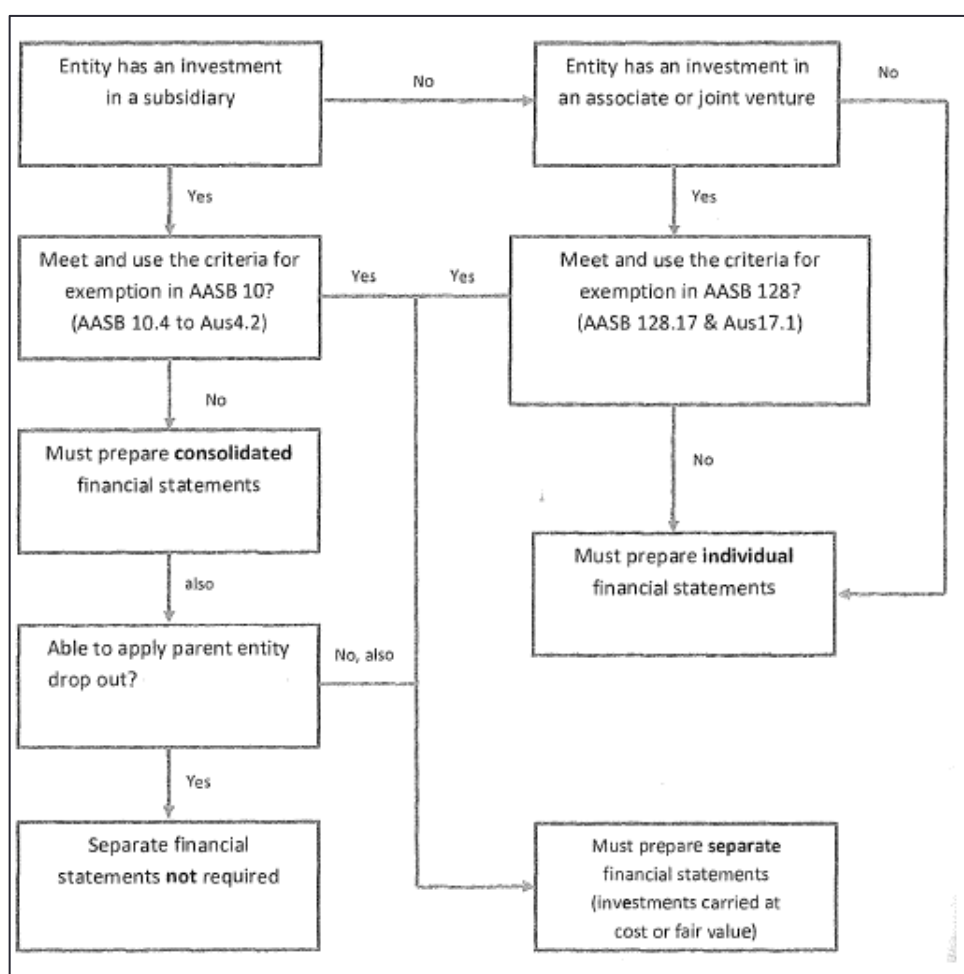
*Issues relating to intermediate parent and nomenclature used in this Report: Consolidated Financial Statements, Individual Financial Statements and Separate Financial Statements*

As noted above, this Report is focused on key issues pertinent to subsidiary and parent financial reporting (see also the 'Key issues addressed' section below). To the extent an intermediate parent is required to prepare consolidated financial statements, the issues as discussed in this Report relating to a parent would be relevant for that intermediate parent. If the intermediate parent is exempt under AASB 10 and thus currently only prepares unconsolidated financial statements, the issues as discussed in this Report relating to a subsidiary are relevant. Therefore, in this Report, we have not separately discussed the financial reporting requirements of intermediate subsidiaries as such. A consequence of this is that specific discussion of subsidiary financial statements in this Report tends to focus on bottom subsidiaries in a group.

**Note to Board:**

We are aware that this paragraph still needs work to more clearly articulate how we deal with intermediate parent financial reporting in this Report, and to use clear language in relation to 'separate' and 'individual' financial statements where a subsidiary has or does not have other subsidiaries or where it has or does not have associates or joint ventures, and whether it is an intermediate or bottom subsidiary. Currently, in this Report, 'separate financial statements' are also referred to as 'parent financial statements', because that is the phrase commonly used. Furthermore, financial statements of the bottom subsidiary in a group are referred as, 'subsidiary-only financial statements'. We intend to include the following flowchart from KPMG's Australian Financial Reporting Manual, June 2014.

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Source: KPMG’s Australian Financial Reporting Manual June 2014

*Excluded from scope: Consolidated financial statements of the parent*

With the exception of the question of whether consolidated financial statements could provide a sufficient but not excessive level of information to make the preparation of parent or subsidiary financial statements redundant and whether it contains enough information to allow a user to assess the risks arising from the group structure (for example, through note disclosure of summary financial information about the parent and subsidiaries), this Report does not address any questions relating to the suitability of current requirements relating to the preparation (nor the method of preparation of) consolidated financial statements of the ultimate parent or the intermediate parent and related exemptions from consolidation contained in AASB 10. This is because the consolidated financial statements of a group are considered useful, which was re-affirmed by the International Accounting Standards Board (IASB) through its Conceptual Framework for Financial Reporting 2018. Consolidated financial statements are accepted as best practice accounting by international standard setters and also submitted at local and international stock exchanges for listing and seeking investment overseas. However, the preparation of parent and subsidiary financial statements is often prescribed by legislation. Thus as part of this Report, the focus is on considering the relevance of parent and subsidiary financial statements and whether there is any scope for reducing the burden on preparers without compromising the needs of users. However, to understand the overall reporting requirements in Australia for parents and subsidiaries and to answer the key research questions it is necessary to understand the key accounting and legislative requirements relating to consolidated financial statements and appreciate the benefits of consolidated financial statements.

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### *Sectors covered*

Issues addressed in this Report are considered in the context of entities within all three sectors, namely:

- For profit private sector
- Not for profit private sector and
- Public sector

#### Note to Board:

When initiating this project, it was thought worthwhile to investigate all three sectors. We have only focused on the for profit private sector to date. The covering memo and project plan (Agenda paper 7.0 and 7.2 respectively) ask Board members the question of whether the Board want us to undertake separate research in relation to not-for-profit private and public sectors, or whether the findings for the for-profit sector would be appropriate for those sectors without us undertaking further research. Additionally the cover memo and project plan have rasked the Board if it could highlight any sector specific issues relating to the not-for-profit private and public sectors at this stage.

### *Jurisdictions covered*

This Report documents the comparative requirements in some international jurisdictions, namely,

- a. Canada;
- b. Hong Kong;
- c. New Zealand;
- d. Singapore;
- e. South Africa;
- f. the United Kingdom; and
- g. the United States of America

These jurisdictions have been selected for consistency with other AASB Research Reports published as part of the AASB's Financial Reporting Framework project noted in paragraph X above. These jurisdictions are relatively comparable in terms of regulatory rigour and are commonly compared with Australia in terms of financial reporting issues. The specific jurisdictional requirements identified in this Report are listed for comparative and information purposes only. Even though this Report does not go so far as to consider the efficacy of those requirements, information about these jurisdictions can be used as input in identifying alternative regulations that could be considered for adoption in Australia.

## Research Approach

#### Not to Board

We intend to cover in this section a reference to the literature review and outreach that we have undertaken to compile the Report. Also the approach that we have taken to which version of the Conceptual Framework we have referred to.

### *Reference to Financial Reporting Framework in this Report*

To ensure this Report is consistent with contemporary thinking, where appropriate, reference is made to the *Conceptual Framework for Financial Reporting* as released by the

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International Accounting Standards Board in March 2018 (referred to in this Report as the IASB's revised Conceptual Framework). Although it has not yet been adopted in Australia, work is currently underway to replace the reporting entity concept currently in Statement of Accounting Concepts (SAC) 1 *Definition of the Reporting Entity* and reform the financial reporting framework in Australia.<sup>9</sup> However, also where appropriate, reference is made in this Report to the current Australian Financial Reporting Framework, including the reporting entity concept in SAC 1.

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<sup>9</sup> [AASB's Consultation Paper](#) explores how to introduce the IASB's revised Conceptual Framework for Financial Reporting into Australia, as well as its impact on financial reporting requirements.

## Key issues addressed

As noted above, the primary focus of this Report is on requirements relating to subsidiary financial reporting. However, the current (different) requirements applicable to parent financial reporting help inform any consideration of subsidiary financial reporting requirements. Accordingly, the key issues listed below address both subsidiary and parent financial reporting issues separately, whilst acknowledging the interrelationships.

### Subsidiary entities

#### Primary issue

- Should subsidiaries continue to be required to prepare and lodge individual financial statements publicly, or would disclosure of certain summary financial information about subsidiaries satisfy user needs in a more cost effective way?

In the process of addressing this primary issue, a number of related issues arise, as noted in the following:

#### Related issues

- If summary financial information were to be allowed/required in lieu of a full set of financial statements:
  - What information should that be? Should it be similar to that specified in Regulation 2M.3.01 of the Corporations Act for parent companies (see the key issue relating to parent entities below)?
  - Should it be allowed/required for only some types of subsidiaries? If so, what criteria should apply to distinguish the types of subsidiaries that should be eligible (e.g. wholly-owned, subject to cross-guarantee, instruments not traded in public market)?
  - Where should the information be required to be disclosed – in the ultimate (Australian) or any intermediate parent's consolidated financial statements or elsewhere?
  - Should the requirement be specified in accounting standards or in regulations?
  - On what basis should the amounts related to the summary financial information i.e. based on amounts that would be included in the subsidiary's own financial statements or amounts included in the consolidated financial statements of the ultimate (Australian) or any intermediate parent to which the summary note is attached?
  - Whether consolidated financial statements provide a sufficient (but not excessive) level of information to make the preparation of parent or subsidiary financial statements redundant and whether it contains enough information to allow a user to assess the risks arising from the group structure

**Note to Board:**

We are trying to obtain information on the number of subsidiary companies that are currently preparing and lodging financial statements with ASIC. This will give us insight into the impact of the reform if our Report concludes that subsidiaries should no longer be required to prepare and publicly lodge a full set of financial statements.

## Parent entities

### Secondary issue

- As input to the primary issue relating to subsidiary financial reporting noted above, where it is currently required, does the summary financial information disclosed in consolidated financial statements of the group about the parent (in lieu of separate financial statements in accordance with Regulation 2M.3.01 of the Corporations Act) satisfy user needs in a cost effective way?

### Related issues

- Should such summary financial information be broadened or narrowed? If so, how?
- In relation to the location of requirements:
  - should the current (or modified) requirements currently specified in Regulation 2M.3.01 be relocated to accounting standards?
  - should the current (or modified) requirements for disclosure of information about cross-guarantees as specified in *ASIC Corporations (Wholly-owned Companies) Instrument 2016/785* be relocated to accounting standards?

Because an analysis of the primary question is dependent on the outcome of the analysis of the secondary question, it is necessary to undertake an analysis of the secondary question first.



Note to Board

Although the sections below have been substantially completed (barring some areas of work in progress highlighted below), we would still need to better link the work below to feed into the key issues.

## Current accounting requirements for the preparation of consolidated, parent and subsidiary separate financial statements/information in Australia

Note to Board:

- We have yet to consider whether this whole section should be relegated to an appendix and a high level summary of it incorporated into the body of the Report.
- The accounting requirements are generally sector neutral and the way the requirements above have been presented are not focused only on for profit private sector. Depending on the Board's decision on whether to have a separate report for the not-for profit private and public sector (as raised in question 6 of the cover memo 7.0), the above section may need an amendment to make it more relevant to for profit private sector.

1. This section outlines the current accounting requirements for the preparation of consolidated, parent and subsidiary financial statements. As noted under the section 'Scope', although this Report does not address the suitability of current accounting requirements relating to consolidated financial statements, it is important to understand those key requirements as a context for addressing parent and subsidiary financial reporting issues.

### General Purpose Financial Statements

2. Consistent with paragraph 40 of Statement of Accounting Concepts (SAC) 1 *Definition of the Reporting Entity*, Appendix A of AASB 1053 *Application of Tiers of Australian Accounting Standards* defines a reporting entity as "an entity in respect of which it is reasonable to expect the existence of users who rely on the entity's general purpose financial statements for information that will be useful to them for making and evaluating decisions about the allocation of resources. A reporting entity can be a single entity or a group comprising a parent and all of its subsidiaries."<sup>10</sup> Paragraph 32 of SAC 1 explains further and states, "The focus on user needs as the basis for determining the existence of a reporting entity implies that the fact that an economic entity (for example, a corporate group or a government) may be a reporting entity does not affect whether the controlling entity or any of the controlled entities are reporting entities in their own right". Paragraph 27 of SAC1 notes that there will exist some entities that will not be regarded as reporting entities, but that form part of an economic entity that is a reporting entity (for example in the case of wholly owned subsidiaries that are of such size or that may have such economic characteristics that users are not interested in the subsidiary

<sup>10</sup> Paragraph Aus7.2 of AASB 101 *Presentation of Financial Statements* states that, in respect of public sector entities, local governments, governments and most, if not all, government departments are reporting entities. (Note to Board: although we have focused on for-profit companies so far, in places we have addressed other sectors)

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financial statements – but they may be interested in the collective information about the group. AASB 1053 defines ‘general purpose financial statements’ (GPFs) as “those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs.”<sup>11</sup>

3. AASB 1057 *Application of Australian Accounting Standards* specifies the types of entities and financial statements to which Australian Accounting Standards apply. Its main requirement is that reporting entities prepare GPFs in accordance with Australian Accounting Standards.
4. AASB 1053 introduces two tiers of reporting requirements for GPFs:
  - a. Tier 1 covers Australian Accounting Standards incorporating International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB) and includes requirements that are specific to Australian entities; and
  - b. Tier 2 comprises the recognition, measurement and presentation requirements of Tier 1<sup>12</sup> but substantially reduced disclosure requirements.
5. AASB 1053 also introduces the concept of ‘public accountability’<sup>13</sup> and requires all for-profit private sector entities that have ‘public accountability’ to comply with Tier 1 reporting requirements. Paragraph 11 of AASB 1053 further requires Tier 1 reporting requirements be applied by the Australian Government and State, Territory and Local Governments. Other ‘reporting entities’ are required to comply with Tier 2 reporting requirements. (However, these entities may elect to apply Tier 1 reporting requirements in preparing GPFs).
6. Although the focus of accounting standards is on GPFs and reporting entities, a handful of standards explicitly apply beyond reporting entities (i.e. they also apply to non-reporting entities that are required to prepare financial reports in accordance with Part 2M.3 of the Corporations Act).<sup>14</sup>

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<sup>11</sup> The IASB’s revised Conceptual Framework, in paragraph 3.10, creates a new definition of reporting entity as ‘...an entity that is required, or chooses, to prepare financial statements. A reporting entity can be a single entity or a portion of an entity or can comprise more than one entity. A reporting entity is not necessarily a legal entity.’ In other words, according to the IASB’s Revised Conceptual Framework, an entity that is required by legislation or otherwise to prepare financial statements is a reporting entity and the financial statements of reporting entities could differ based on the ‘boundary’ of economic activities included in their financial statements (ie a reporting entity’s financial statements could be consolidated financial statements, single entity financial statements or part of an entity’s financial statements). This is fundamentally different from the current definition of reporting entity in Australia, where a reporting entity (as per SAC 1) is an entity that is required to prepare GPFs and an entity that is not a reporting entity (i.e. non-reporting entity) can choose to prepare special purpose financial statements (SPFs). [AASB’s Consultation Paper, Applying the IASB’s Revised Conceptual Framework and Solving the Reporting Entity and Special Purpose Financial Statement Problems](#), May 2018 explores how to introduce the IASB’s revised Conceptual Framework for Financial Reporting into Australia, as well as its impact on financial reporting requirements

<sup>12</sup> Except for the presentation of a third statement of financial position as per AASB 101, which is applicable for Tier 1.

<sup>13</sup> Appendix A of AASB 1053 defines ‘public accountability’ as accountability to those existing and potential resource providers and others external to the entity who make economic decisions but are not in a position to demand reports tailored to meet their particular information needs. It goes on to state that a for-profit private sector entity has public accountability if:

- (a) its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets); or
- (b) it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses. This is typically the case for banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks.

<sup>14</sup> As per Paragraph 7(a) of AASB 1057: AASB 101, AASB 107 *Statement of Cash Flows*, AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*, AASB 1048 *Interpretation of Standards* and AASB 1054 *Australian Additional Disclosures* apply to each entity that is required to prepare financial reports in accordance with Part 2M.3 of the Corporations Act, irrespective of whether it is a reporting entity.

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### Consolidated financial statements

7. As noted in paragraph 1 above, AASB 1053 and SAC 1 define 'reporting entity'. Both AASB 1053 and SAC 1 circumscribe the boundaries of a reporting entity using the concept of control, which, in relation to groups of entities, is given effect through AASB 10 *Consolidated Financial Statements*. Paragraph 6 of AASB 10 states that "an investor controls an investee, when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee"<sup>15</sup>. Further, Appendix A of AASB 10 defines 'consolidated financial statements' as "the financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity." (Also see footnote 11 to paragraph 2 above)
8. AASB 10 generally requires a Tier 1 or Tier 2 reporting entity that is a parent (an entity that controls one or more entities (subsidiaries)) to present consolidated financial statements.
9. However, AASB 10 does not permit consolidation of all subsidiaries. In particular, paragraphs 31-33 of AASB 10 require an 'investment entity'<sup>16</sup> to measure its investment in subsidiaries at fair value through profit or loss as per AASB 9 *Financial Instruments* rather than account for it on a line-by-line consolidation basis. The rationale for this exemption is provided in paragraphs BC215 to BC317 of the basis for conclusions to IFRS 10. To summarise, it is apparent from the Basis for Conclusions accompanying IFRS 10 the IASB concluded that, since an investment entity holds investments for the sole purpose of capital appreciation, investment income or both, the information regarding the fair value of the investments (and an understanding of how the investment entity measures the fair value of its investments) is the most useful information to its users.
10. Further, paragraph 4(a) of AASB 10 exempts a parent that is a reporting entity from the preparation of consolidated financial statements provided all the following conditions are met:
  - i. it is a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;
  - ii. its debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);
  - iii. it did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and
  - iv. its ultimate or any intermediate parent produces financial statements that are available for public use and comply with IFRSs<sup>17</sup>, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with AASB 10.

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<sup>15</sup> Appendix A of AASB 10 defines 'control of an investee as, "An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee."

<sup>16</sup> Appendix A of AASB 10 defines 'investment entity' as "An entity that:

- a. obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services;
- b. commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and
- c. measures and evaluates the performance of substantially all of its investments on a fair value basis."

<sup>17</sup> It is notable that compliance with IFRSs does not necessarily imply full compliance with the Australian Accounting Standards e.g. even with full compliance with IFRSs it is conceivable that an entity may not have complied with AASB 1054 *Australian Additional Disclosures*. However, the exemption provided through paragraph 4(a)(iv) of AASB 10 is consistent with a view that maintaining international comparability through IFRS compliance is the most important.

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11. In addition, in relation to not-for-profit and Tier 2 reporting entities, paragraph Aus4.1 of AASB 10 specifies:  
“Notwithstanding paragraph 4(a)(iv), a parent that meets the criteria in paragraphs 4(a)(i), 4(a)(ii) and 4(a)(iii) need not present consolidated financial statements if its ultimate or any intermediate parent produces financial statements that are available for public use in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with this Standard and:
- (a) the parent and its ultimate or intermediate parent are:
    - i. both not-for-profit entities complying with Australian Accounting Standards; or
    - ii. both entities complying with Australian Accounting Standards – Reduced Disclosure Requirements; or
  - (b) the parent is an entity complying with Australian Accounting Standards – Reduced Disclosure Requirements and its ultimate or intermediate parent is a not-for-profit entity complying with Australian Accounting Standards.”
12. However, in relation to circumstances where there is an ultimate foreign entity, paragraph Aus4.2 of AASB 10 specifies:  
“Notwithstanding paragraphs 4(a) and Aus4.1, the ultimate Australian parent shall present consolidated financial statements that consolidate its investments in subsidiaries in accordance with this Standard when either the parent or the group is a reporting entity or both the parent and the group are reporting entities, except if the ultimate Australian parent is required, in accordance with paragraph 31 of this Standard, to measure all of its subsidiaries at fair value through profit or loss.”<sup>18</sup>
13. Private sector for-profit Tier 1 entities that meet the definition of public accountability are unlikely to satisfy the criteria of paragraph 4(a) of AASB 10 exemption because their debt or equity instruments are traded in a public market. In contrast, many Tier 2 private sector for-profit entities would be expected to qualify for the exemption.
14. The rationale for the exemptions in paragraph 4(a) of AASB 10 is provided in paragraphs BCZ12-BCZ18 of the Basis for Conclusions accompanying IFRS 10. In summary, the IASB retained the exemption that was in the superseded 2001 version of IAS 27 *Consolidated Financial Statement and Accounting for Investments in Subsidiaries* for a parent that is itself a wholly owned subsidiary. This was presumably due to the view that the consolidated financial statements prepared by a parent of that parent provided adequate information and due to the fact that sometimes these entities were required to produce separate financial statements by law (in addition to the consolidated financial statements) and the IASB did not want to unduly burden such entities. Later, in 2003, the IASB noted in paragraph BCZ14 of the Basis for Conclusions to IFRS 10 that “in some circumstances users can find sufficient information for their purposes about a subsidiary from either its separate financial statements or the consolidated financial statements. In addition, the users of financial statements of a subsidiary often have, or can get access to, more information”. In addition, the IASB extended this exemption to a parent that is a partially owned subsidiary of another parent. However, the IASB restricted the exemption to such subsidiaries when the minority interests have been informed about, and do not object to, consolidated financial statements not being presented (presumably to protect minority interests).

Note to Board: The above paragraph is work in progress as we need to clarify the IASB’s rationale provided in the Basis for Conclusions.

<sup>18</sup> The phrase in paragraph Aus4.2 of AASB 10 that states “either the parent or the group is a reporting entity or both the parent and the group are reporting entities”. The staff is investigating the implication of this phrase.

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15. In terms of the exemption as specified in paragraph 4(a)(ii) and (iii) of AASB 10, the IASB believed that the information needs of users of financial statements of entities whose debt or equity instruments are traded in a public market were best served when investments in subsidiaries<sup>19</sup> were accounted for on a consolidated basis – however, the IASB did not provide an explicit basis for its belief. It went on to decide that the exemption from preparing consolidated financial statements should not be available to such entities or to entities in the process of issuing instruments in a public market.
16. The rationale for the exemptions in paragraph Aus4.1 relating to not-for-profit entities and entities complying with Tier 2 Australian Accounting Standards - Reduced Disclosure Requirements is effectively an extension of the rationale for the similar exemptions contained in paragraph 4(a) of AASB 10 (described in paragraph 10 above).
17. Paragraph Aus4.2 limits the paragraph 4.2(a) exemption and states that in cases where the ultimate parent is a foreign entity, even if all other criteria (as listed in paragraphs 4(a)(i)-(iv) and Aus4.1) are met, the ultimate Australian parent is required to present consolidated financial statements.

Note to Board: The above paragraph is work in progress, as consistent with the discussion throughout this Report, the rationale needs to be provided. At this stage the staff thinks that it is related to Australian sovereignty.

### Parent financial statements

18. AASB 127 *Separate Financial Statements* anticipates circumstances where financial statements are prepared by a parent entity on a non-consolidation basis. Paragraph 2 of AASB 127 states “This Standard shall be applied in accounting for investments in subsidiaries, joint ventures and associates when an entity elects, or is required by local regulations, to present separate financial statements.” Paragraph 4 defines ‘separate financial statements’ as “those presented by an entity in which the entity could elect to account for its investments in subsidiaries, joint ventures and associates either at cost or in accordance with AASB 9 *Financial Instruments*, or using the equity method as described in AASB 128 *Investments in Associates and Joint Ventures*.” Paragraph 6 of AASB 127 goes on to explain that separate financial statements are those presented in addition to consolidated financial statements<sup>20</sup>. However paragraph 8 of AASB 127 says that if an entity is exempt from preparing consolidated financial statements based on the requirements of AASB 10 (as summarised in paragraphs 10-12 above), it may present separate financial statements as its only financial statements.
19. Paragraph 7 of AASB 127 clarifies that the financial statements of an entity that does not have a subsidiary, associate or joint venturer’s interest in a joint venture are not separate financial statements – such an entity might be the bottom subsidiary in a group.

It is notable that AASB 127 does not mandate which parent entities should produce separate financial statements. It only applies when a parent entity elects or is required by local regulations to present separate financial statements. Consistent with the IASB views expressed in paragraphs BC216 and BCZ218 of the Basis for Conclusions accompanying IFRS10, the rationale for this is apparently that AASB 10 specifically requires a parent to prepare

<sup>19</sup> Similarly, for investments in joint ventures and associates respectively, the IASB believed that the information needs of users of financial statements of entities whose debt or equity instruments are traded in a public market were best served when such investments are accounted for as per IAS 28 *Investments in Associates and Joint Ventures*.

<sup>20</sup> or in addition to the financial statements of an investor that does not have investments in subsidiaries but has investments in associates or joint ventures that are accounted for using the equity method as required by AASB 128.

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consolidated financial statements in accordance with AASB 10, which best meets users' information needs by revealing the extent of the operations that the parent controls.

### Subsidiary financial statements

20. For intermediate parents, see the discussion about consolidated and parent financial statements above. In relation to a bottom subsidiary, accounting standards apply if it is a Tier1 or Tier 2 reporting entity, in which case it is required to prepare its own (individual) financial statements. If an intermediate parent is exempted under AASB 10 from preparing consolidated financial statements, then to meet the reporting obligations under the Corporations Act it would be required to prepare separate financial statements (and not individual financial statements as exemptions under paragraph 17 of the AASB 128 are similar to those under paragraph 4(a) of the AASB 10.

#### Note to Board

This paragraph on subsidiary financial statements is in the early stages of development.

## Legislative requirements

### Regulations directly related to the preparation of consolidated, parent and subsidiary financial statements/information in Australia

#### Note to Board

The section as currently presented below is detailed. We plan to put these details in an Appendix with a summary of the requirements, perhaps along with a diagrammatic presentation, in the main body here.

21. Typically, regulators require reporting entities to comply with accounting standards.<sup>21</sup> To the extent accounting standards do not address non-reporting entities, regulators specify requirements, typically by also referencing some or all accounting standards (see, for example, ASIC Regulatory Guide 85, referred to in paragraph 31 below). Although accounting standards do not require preparation of both consolidated and parent financial statements, legislation (see paragraph 32 and 44 below) or an entity's governing constitution may require preparation of both sets of financial statements, or entities might prepare both by choice.

<sup>21</sup> Exceptions arise in a not-for-profit and public sector context (**Note to Board: as noted above, this working draft primarily focuses on for-profit private sector companies, although in places we have made observations about the other sectors**). For example:

- a. Regulation 60.25 of Australian Charities and Not-for-profits Commission Regulation 2013, which contemplates 'Collective and joint reporting' (as distinct from consolidated reporting) under the ACNC Act 2012;
- b. Western Australia's Treasurer's Instructions 1105 'Consolidated Financial Statements', which states that "the definitions of 'control', 'parent' and 'subsidiary' advanced by AASB 10 are modified by this instruction to reflect the accountability framework established under the Act and Treasurer's instructions, particularly with respect to related bodies and subsidiary bodies" (**Note to Board: we intend consulting with WA Treasury to ascertain the practical implications of this Instruction**);
- c. In 2016-17, a specific Treasurer's instruction (GBE-08-52-08P Exemption from IFRS 5 for Forestry Tasmania's 2016-17 Financial Statements) was issued to Forestry Tasmania to provide an exemption to the requirements of Australian Accounting Standard AASB 5 *Non-current Assets Held for Sale and Discontinued Operations*. This resulted in the inclusion of an emphasis of matter paragraph in the audit opinion. ([https://www.stas.com.au/sites/default/files/media/documents/annual-reports/170329-Forestry-Tasmania-AR\\_2016-17\\_web.pdf](https://www.stas.com.au/sites/default/files/media/documents/annual-reports/170329-Forestry-Tasmania-AR_2016-17_web.pdf))

## Corporations Act

22. Section 292(1) of the Corporations Act states:

“ A financial report and a directors’ report must be prepared for each financial year by:

- (a) all disclosing entities; and
- (b) all public companies; and
- (c) all large proprietary companies; and
- (d) all registered schemes.”

23. Section 295(2) of the Corporations Act states:

“The financial statements for the year are:

- (a) unless paragraph (b) applies—the financial statements in relation to the company, registered scheme or disclosing entity required by the accounting standards; or
- (b) if the accounting standards require the company, registered scheme or disclosing entity to prepare financial statements in relation to a consolidated entity—the financial statements in relation to the consolidated entity required by the accounting standards.”

24. Section 295(2)(a) of the Corporations Act results in a subsidiary that is at the bottom of a group (although see paragraph 31 below in relation to non-reporting entities), an intermediate or parent company that is exempt from preparing consolidated financial statements under AASB 10 and a company that is not part of a group lodging (unconsolidated) financial statements. However, section 295(2)(b) relieves a parent from preparing unconsolidated financial statements when it prepares consolidated financial statements (if the entity is exempted from consolidation by the accounting standards, it falls under section 295(2)(a))<sup>22</sup>. This relief from the requirement to prepare parent (unconsolidated) financial statements in addition to the consolidated financial statements was introduced through the Corporations Amendment (Corporate Reporting Reform) Act 2010<sup>23</sup>.

### Note to Board

We are still developing this paragraph and seeking further clarification of the interpretation of section 295(2) – particularly the reference to “required by the accounting standards” in section 295(2)(a).

25. However, as a substitute for parent entity financial statements, the following additional disclosures (summary information) in the consolidated financial statements in relation to the parent entity are required by Regulation 2M.3.01 of the Corporations Regulations 2001<sup>24</sup>:

- current assets of the parent entity;
- total assets of the parent entity;
- current liabilities of the parent entity;
- total liabilities of the parent entity;
- shareholders' equity in the parent entity separately showing issued capital and each reserve;
- profit or loss of the parent entity;
- total comprehensive income of the parent company;
- details of any guarantees entered into by the parent entity in relation to the debts of its subsidiaries;
- details of any contingent liabilities of the parent entity;

<sup>22</sup> Similar to section 295, section 303(2) of the Corporations Act 2001 requires a disclosing entity to prepare only consolidated half-yearly financial statements, if required by the accounting standards.

<sup>23</sup> See Appendix C for relevant extracts from the explanatory memorandum, Corporations Amendment (Corporate Reporting Reform) Bill, 2010

<sup>24</sup> [http://www5.austlii.edu.au/au/legis/cth/consol\\_reg/cr2001281/s2m.3.01.html](http://www5.austlii.edu.au/au/legis/cth/consol_reg/cr2001281/s2m.3.01.html)

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- details of any contractual commitments by the parent entity for the acquisition of property, plant or equipment; comparative information for the previous period for each of the above.

26. The question arises as to whether these requirements provide adequate information and whether the regulations or accounting standards are the most appropriate vehicle for housing them. These questions are addressed in section 'Author's views on key issues raised' later in this Report.
27. Regulation 2M.3.01 also specifies that the summary information must be calculated in accordance with accounting standards in force in the financial year to which the disclosure relates. The Regulation does not explicitly state that the accounting policies adopted in the notes must be consistent with the accounting policies adopted in the consolidated financial statements.

Note to Board: Although different accounting policies between parent and the group is possibly unlikely to arise in practice, for completeness we have yet to check what happens in practice

28. Australian financial services (AFS) licensees continue to be required to present both consolidated and parent entity financial statements under Chapter 7 of the Corporation Act 2001. This is because the amendments as per Corporations Amendment (Corporate Reporting Reform) Act 2010 (see paragraph 24-25 above) do not apply to financial reports lodged by AFS licensees under section 989B of Chapter 7 of the Act, where full parent entity financial statements including notes must still be presented.

Note to Board: We have yet to clarify the rationale for the approach taken for AFS licensees. See also paragraph 44 and its 'note to Board'.

29. A question that arises from the above overview of accounting and regulatory requirements is whether a parent that is exempt from AASB 10 but chooses to prepare consolidated financial statements for meeting financial reporting obligations (under the Corporations Act) needs to comply with all the requirements of the accounting standards and those of the Corporations Act (including disclosure of the summary financial information about its separate financial statements as required under Regulation 2M.3.01 – see paragraph 25).

Note to Board:  
We are in the process of clarifying the requirements/practice in this regard.

### ***Basis for providing relief from preparation of parent financial statements***

30. The explanatory memorandum to the Corporations Amendment (Corporate Reporting Reform) Bill 2010 observes that the usefulness of separate parent entity financial statements was debated in Australia for a number of years. In developing the Bill, the government took account of AASB Discussion Report *The Relevance of Parent Entity Financial Reports* (2003)<sup>25</sup> and

<sup>25</sup> AASB Research Report 'Relevance of parent entity financial reports' (2003), proposed a more limited exemption, recommending:

1. "Remove the requirement for parent entity financial reports to be published in the annual report;
2. Retain the requirement for full audited parent entity general purpose financial reports to be lodged with ASIC except for parent entities that:
  - (a) do not conduct substantive operations, including treasury operations;
  - (b) are not borrowing entities;
  - (c) are not single guarantors for the debt of one or more subsidiaries.
3. Require disclosure of the following to be published in the annual report:
  - (a) whether a full audited parent entity report has been lodged with ASIC, and, if not, a statement indicating that each of the exception criteria contained in (2) above are satisfied;



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submissions from the Group of 100, an organisation representing CFOs of Australia's largest entities, in determining what summary financial information should replace full parent entity financial statements. The explanatory memorandum further explains, "This regime strikes an effective balance between the needs of users of parent entity financial information and the cost of preparing such information. Users of parent entity financial statements continue to retain access to relevant financial information relating to the parent entity through the summary report. While some information on the parent entity would no longer be reported, consultation with stakeholders has indicated that this information is not widely used and adds to the complexity of the financial statements. The costs of preparing and auditing summary financial information would be significantly lower than for separate parent entity financial statements — the extent of these costs savings would depend on the size and complexity of the entity and the relativities around the size of the parent as opposed to the consolidated entity."

## Australian Securities & Investments Commission (ASIC)

### **ASIC Regulatory Guide 85 Reporting requirements for non-reporting entities**

31. In relation to non-reporting entities, ASIC Regulatory Guide 85 (RG85) *Reporting requirements for non-reporting entities* states, "the recognition and measurement requirements of accounting standards must ... be applied in order to determine the financial position and profit or loss of any entity preparing financial reports in accordance with the Act" [paragraph 2.5 of RG85]. Further, paragraph 5.5 of RG 85 states, "The sole determining factor as to whether consolidated financial statements are required is whether the group is a reporting entity." There is some difference in opinion in the way paragraph 5.5 of RG85 is interpreted. Some argue that since RG85 requires all recognition and measurement principles be adopted by non-reporting entities required to report and requires preparation of consolidated financial statements only by reporting entities, preparation of consolidated financial statements is not a recognition and measurement issue, it is a presentation issue. On the other hand, others argue that RG85 does not express a view on whether consolidation is a recognition and measurement issue or a presentation issue – paragraph 5.5 of RG85 is merely expressing an exception to the more general requirement in paragraph 2.5.<sup>26</sup>

### **ASIC Class Order 10/654 re Parent entity financial statements**

32. ASIC's Class Order 10/654 allows parent entity financial statements to be presented in addition to consolidated financial statements, as an alternative to summary parent information that would be otherwise required by Regulation 2M.3.01. ASIC states that the rationale for allowing entities to present a full set of parent entity financial statements, despite the relief provided by the Corporations Act (see paragraph 24-27 above), is that "some entities want to present parent entity financial statements:

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(b) parent entity shareholders' funds, including dividends and franking credits, if different from the consolidated amounts;

(c) the manner in which the group is structured, including which entity(s) within the group conduct the major trading and treasury operations;

(d) in which entities the group's borrowings and contingent liabilities reside;

(e) class orders, guarantees and indemnities in place, including which entities are party to the guarantee(s)...."

<sup>26</sup> However, the AASB's project that is reviewing the IASB's revised Conceptual Framework for adoption in Australia is contemplating superseding SAC 1 (see paragraph 2 above). A consequence of that would be for parent entities who are currently preparing special purpose (unconsolidated) financial statements. Such parent entities would now have to prepare consolidated financial statements. (unless exempted under AASB10).

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- to avoid the cost of changing their reporting formats, particularly for 30 June 2010 year ends;
- ...; or
- because they believe that the parent entity financial statements provide useful information to users of their financial reports.<sup>27</sup>

As mentioned in paragraph 28 above, since the AFS licensees are required to prepare a full set of consolidated and separate financial statements under the Corporations Act, ASIC Class Order 10/654 is not applicable to them.

### **ASIC Instrument 2016/785 re Wholly-owned subsidiaries**

33. ASIC's 'Relief for wholly-owned entities under ASIC Corporations (Wholly-owned Companies) Instrument 2016/785 (Instrument)<sup>28</sup> states that certain wholly-owned companies<sup>29</sup> may be relieved from the requirement to prepare and lodge audited financial statements under Chapter 2M of the Corporations Act, where they enter into deeds of cross guarantee with their holding entity<sup>30</sup> and meet certain other conditions (see Appendix D of this Report for details). ASIC explains that "The deed of cross guarantee<sup>31</sup> makes the group of companies that are parties to that deed akin to a single legal entity in many respects. Creditors and potential creditors can then focus on the consolidated position for those entities rather than the individual financial statements of the wholly-owned subsidiaries that are parties to the deed" (footnote added)<sup>32</sup>. The effect of the relief is that many wholly owned companies within a group that are subject to a deed of cross guarantee would be exempt from preparing financial statements<sup>33</sup>. The relief reduces the reporting requirements for such wholly owned subsidiaries forming part of closed

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<sup>27</sup> - <https://www.legislation.gov.au/Details/F2017C00172>;  
- <https://asic.gov.au/about-asic/media-centre/find-a-media-release/2010-releases/10-165ad-asic-provides-relief-for-parent-entity-financial-statements/>

<sup>28</sup> <http://asic.gov.au/regulatory-resources/financial-reporting-and-audit/preparers-of-financial-reports/relief-from-corporate-finance-provisions/relief-for-wholly-owned-entities-under-asic-corporations-wholly-owned-companies-instrument-2016785/>

<sup>29</sup> Paragraph 4 of ASIC Instrument 2016/785 defines wholly-owned entities in relation to a holding entity as collectively meaning "companies and foreign companies:

- (a) all of which are controlled by the holding entity; and
- (b) all of which are closely-held subsidiaries of the holding entity; and
- (c) all of which are parties to the deed of cross guarantee;

but does not include an entity which:

- (d) holds office as trustee or alternative trustee under the deed of cross guarantee; and
- (e) is not a Group Entity (within the meaning of that deed)."

ASIC defines control in the same way as AASB 10. AASB 10 uses the term wholly owned but does not define it.

<sup>30</sup> Paragraph 4 of ASIC Instrument 2016/785 defines holding entity in relation to a company that is party to a deed of cross guarantee as "a company, a disclosing entity which is a body incorporated in Australia, or a registered foreign company:

- (a) of which the company is a closely-held subsidiary; and
- (b) which is a party to the deed; and
- (c) which is not controlled by another of its closely-held subsidiaries which is also a party to the deed."

<sup>31</sup> <http://asic.gov.au/regulatory-resources/financial-reporting-and-audit/preparers-of-financial-reports/relief-from-corporate-finance-provisions/deeds-of-cross-guarantee/>

<sup>32</sup> Also refer to Appendix A of this Report, which provides the results of our outreach seeking bankers' views on the relevance of consolidated financial statements in the case of wholly owned subsidiaries where deeds of cross guarantee are entered into. During our outreach, we were told the extent of reliance on consolidated financial statements in those circumstances primarily depends on the lending policies of each individual bank and on the risk associated with each case. Some might question the appropriateness of ASIC so strongly suggesting that a lender should rely on consolidated financial statements where there are deeds of cross guarantee, given that many bankers have told us that they emphasise the debt servicing capacity of borrowers over security in making lending decisions. It would seem to depend on whether the borrower is regarded as being 'the group' or an individual entity within the group. Accordingly, it depends on specific circumstances whether it is appropriate for a bank to place reliance on a cross guarantee as part of the bank's assessment of servicing capacity, in contrast to its assessment of debt security.

<sup>33</sup> As well as from the requirement of preparing a directors' report, audit of the financial report, requirements to send these reports to members, and to lodge the reports with ASIC.

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groups<sup>34</sup>, who have chosen to 'severally, unconditionally and irrevocably' guarantee each other's debts, i.e., in addition to the parent guaranteeing the debts of wholly owned subsidiaries; each subsidiary would now guarantee the debts of the parent and each other subsidiary within the closed group<sup>35</sup>.

34. The ASIC Instrument clarifies that, to be eligible for the exemption, the wholly owned subsidiary may be a public company, large proprietary company or small foreign controlled proprietary company (section 292(2)(b) of the Corporations Act). However, if such a wholly owned company is a disclosing entity, borrower in relation to debentures, a guarantor of such a borrower or a financial services licensee, then this exemption does not apply, presumably for similar reasons underlying APRA's approach (see paragraph 44 below). Further, to qualify for exemption, no party to the deed of cross guarantee should be a body regulated by APRA and that the parent entity financial year must end on the same date as the financial year of the exempted entity.
35. The Instrument further requires that where the exemption is taken advantage of, the notes to the consolidated financial statements must include the following additional disclosures (see paragraph 6(1)(v) of the Instrument):
- a. a short statement of the nature of the deed of cross guarantee
  - b. details regarding the parties to the deed of cross guarantee separately identifying members of the closed group, other members of the extended closed group
  - c. details of parties to the deed of cross guarantee that have been added, removed or subject to a notice of disposals.
  - d. details of any entities that were eligible for relief (under this instrument or ASIC Class Order [CO 98/1418]<sup>36</sup>) in the immediately preceding financial year but are no longer eligible for relief
  - e. if the consolidated financial statements cover entities that are not members of the closed group or not parties to the deed of cross guarantee), include additional consolidation information (including a statement of financial position, statement of comprehensive income, opening and closing retained earnings, dividends provided for or paid and transfers to and from reserves), for those entities that are members of the closed group or parties to the deed of cross guarantee.
36. Like the question noted in paragraph 26 above, the question arises as to whether these requirements provide adequate information and whether the regulations or accounting standards are the most appropriate vehicle for housing them. These questions are addressed in section 'Author's views on key issues raised' later in this Report.
37. Additionally, the Instrument notes that consolidated financial statements should include adequate provision in relation to the liabilities of any parties to the deed of cross guarantee that are not consolidated where it is probable that those liabilities will not be fully met by those parties.
38. ASIC's 'Relief for wholly-owned entities under ASIC Corporations (Wholly-owned Companies) Instrument 2016/785' is reproduced in Appendix D of this Report.

### ***ASIC Instrument 2017/204 re Foreign controlled companies***

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<sup>34</sup> Closed group means the holding entity and the wholly-owned entities as per ASIC Corporations (Wholly-owned Companies) Instrument 2016/785.

<sup>35</sup> Dean, G., Lockett, P. & Houghton, E. 1993, 'Notional calculations in liquidations revisited: The case of ASC (now called ASIC) Class Order Cross Guarantees', *Companies and Securities Law Journal*; page 207

<sup>36</sup> This Instrument [2016/705] superseded CO 98/1418

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39. As explained in section 1 of the explanatory statement for ASIC Corporations (Foreign-Controlled Company Reports) Instrument 2017/204, paragraph 292(2)(b) of the Corporations Act requires a small proprietary company that was controlled by a foreign company for all or part of a financial year to comply with the financial reporting obligations under Part 2M.3 of the Corporations Act unless it was consolidated for that period in financial statements lodged with ASIC by a registered foreign company, a company, a disclosing entity or a registered scheme.

Paragraph 292(2)(b) results in more onerous financial reporting requirements for small foreign-controlled proprietary companies compared with their Australian counterparts that are not foreign controlled. This particularly applies to those small foreign-controlled proprietary companies that are not required by the law in their place of origin to prepare financial statements.

40. ASIC Corporations (Foreign-Controlled Company Reports) Instrument 2017/204 puts the reporting requirements of small foreign-controlled proprietary companies on a par with other Australian small proprietary companies.

41. To qualify for the relief (apart from the procedural requirements), the Instrument 2017/204 states that such exemption is available to a small proprietary company provided:

- its parent foreign company is registered with ASIC and lodges consolidated financial statements of the group including the activities of such small proprietary company; and
- the small proprietary company is not part of a large group<sup>37</sup>.

42. The purpose of the second condition is to discourage foreign-controlled companies from structuring into smaller companies to avoid financial reporting obligations.

43. ASIC Corporations (Foreign-Controlled Company Reports) Instrument 2017/204 is reproduced in Appendix E of this Report.

### Australian Prudential Regulation Authority (APRA)

44. As noted earlier, APRA requires entities that are AFS licensees regulated by it to provide both consolidated financial statements and parent financial statements. The rationale as given by APRA states, “APRA needs to understand the ability of the parent entity to meet its obligations and support depositors and policyholders, on a standalone as well as a consolidated basis. We wish to fully understand the financial position and risks of the parent. APRA presently accesses parent entity financial statements, including the relevant notes, principally through the group annual financial report. We wish to continue this practice as it is a reliable and efficient means for APRA to obtain this information.” “In those isolated cases where a parent entity is not an AFS licensee but APRA regulated, APRA would prefer that these groups voluntarily continue to include full parent entity financial statements, including notes, in their group annual financial reports.”<sup>38</sup>

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<sup>37</sup> Para 4 of Instrument 2017/204, defines a **large group** as a group which, for a financial year, satisfies at least 2 of the following paragraphs:

(a) the combined revenue of the group for the financial year is \$25 million, or any other amount prescribed for the purposes of paragraph 45A(2)(a) of the Act, or more;

(b) the combined value of gross assets of the group at the end of the financial year is \$12.5 million, or any other amount prescribed for the purposes of paragraph 45A(2)(b) of the Act, or more;

(c) the group has 50, or any other number prescribed for the purposes of paragraph 45A(2)(c) of the Act, or more employees (part-time employees being counted as an appropriate fraction of a full-time equivalent) at the end of the financial year.

<sup>38</sup> <http://www-test.apra.gov.au/CrossIndustry/Pages/Letter-to-industry-parent-entity-financial-statements.aspx>

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Note to Board - The reference in the note is a weblink from APRA, which may not be authoritative enough

- We are in the process of clarifying its level of authority.

- We understand APRA needs to know what is legally available in the entity (in the event other assets in the group are not available) and thus it requires a full set of parent entity financial statements (in place of summary financial information) in addition to the consolidated financial statements. But we need to confront the issue and explain more clearly as to why stakeholders in non-APRA companies aren't similarly exposed.

### Summary of financial reporting regulatory requirements applicable to for-profit private sector companies

45. Currently ultimate parent companies and intermediate parent companies not regulated by APRA are required to prepare and lodge consolidated financial statements with a note presenting summary financial information about the parent in place of presenting a full set of parent financial statements (subject to certain exemptions, conditions and options as discussed above). The ultimate parent and the intermediate parent companies, if exempt under AASB 10 from the preparation of the consolidated financial statements, need to prepare separate/individual (unconsolidated) financial statements. The bottom subsidiary in a group is required to prepare and lodge their subsidiary financial statements, unless exempted (for example, under the provisions governing wholly-owned subsidiaries covered by a deed of cross guarantee). However, APRA continues to require preparation of both consolidated financial statements and parent financial statements for entities it regulates. The basis for this fundamentally different approach taken by APRA compared with ASIC is apparently the perceived different nature of entities regulated by them respectively. The APRA "oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, private health insurance, friendly societies and most members of the superannuation industry."<sup>39</sup> It is apparent that, since many of these companies are entrusted with public money, to safeguard the interests of depositors and policyholders, APRA has taken a stricter view than ASIC.

Note to Board: This summary is very much a first cut.

### Regulations indirectly related to the preparation of consolidated, parent and subsidiary financial statements/information in Australia

Note to Board

The section as currently presented below is detailed. We plan to put these details in an Appendix with a summary of the requirements in the main body here.

46. Regulators of companies aim to play an important role in the economy by facilitating and maintaining a robust and sustainable commercial system. They do so by striving to balance the costs and benefits of regulation. Regulations focus on a range of matters, only some of which are directly related to financial reporting and therefore of greatest relevance to this Report. However, some regulations that are not directly related to financial reporting are indirectly

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<sup>39</sup> <http://www.apra.gov.au/Pages/default.aspx>

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related and therefore may be of some relevance to this Report to the extent they throw light on or have implications for financial reporting matters.

47. As noted in the section 'Scope' above, this Report is focused on businesses that are structured as groups with parent/subsidiary relationships. Regulations have evolved to especially address factors pertinent to those relationships. Paragraphs 21-45 describe the financial reporting regulations applicable to corporate groups. This section describes regulations that do not directly address financial reporting matters but which may be indirectly related to financial reporting by corporate groups.
48. An understanding of the way these regulations treat corporate groups might inform this Report's review of financial reporting regulations for corporate groups – for example, to the extent regulations that are not directly related to financial reporting treat a corporate group as a single economic entity rather than as separate legal entities might be seen as providing a level of justification for taking a consistent approach to the regulation of financial reporting (and, for example, supporting a view that consolidated financial statements with merely note disclosure of subsidiary information is sufficient). It might also throw light on the needs of regulators for financial information about group structures.
49. Accordingly, having a broad understanding of:
- how corporate groups are regulated generally;
  - how regulators view different entities within a group; and
  - the possible impact of these regulations on the financial reporting requirements that currently exist
- will help address the questions that are the subject of this Report (listed in section 'Key issues addressed' above).
50. The Corporations Act contains various provisions that are not directly related to financial reporting and take an economic entity view (and thereby effectively override an otherwise strict application of the separate legal entity approach). Similarly, the courts, in applying the law to corporate groups have taken an economic entity view in some cases<sup>40</sup>. Key regulated activities in this regard include:
- (a) Director's responsibilities, and rights of the minority to remedy unfair treatment;
  - (b) Related party transactions (including intra-group transactions);
  - (c) Insolvent trading by a subsidiary;
  - (d) Pooling arrangements in the event of liquidation; and
  - (e) Dividend distribution.
51. Each of these regulatory matters are addressed in turn below and include our view on whether they are consistent with a 'legal entity' view and/or an 'economic entity' view. The implications our views might have for financial reporting are identified in the section 'Author's views on key issues raised' of this Report.

## Director's responsibilities, and rights of the minority to remedy unfair treatment

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- Section V(E) of the Research Report "Corporate Groups in Australia" by Ian Ramsay and Geof Stapledon (Centre for Corporate Law and Securities Regulation, University of Melbourne, 1998)
- Paragraph 2.14 and 2.16 of the Final report of the Companies & Securities Advisory Committee on 'Corporate Groups' (May 2000)

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52. This issue relates to the question of whether directors are required to act in the interest of a legal entity or the economic entity (i.e. the group).

### *Legislation*

53. Even if a company is part of a group, the Corporations Act requires the directors to act in good faith for that company, as a separate legal entity. Section 181(1) of the Act states, “A director or other officer of a corporation must exercise their powers and discharge their duties: (a) in good faith in the best interests of the corporation; and (b) for a proper purpose.” Further, section 184(1) of the Act states, “A director or other officer of a corporation commits an offence if they: (a) are reckless; or (b) are intentionally dishonest; and fail to exercise their powers and discharge their duties: (c) in good faith in the best interests of the corporation; or (d) for a proper purpose.”

54. However, from a group perspective, section 187 of the Act, which specifically deals with ‘Directors of wholly-owned subsidiaries’, states: “A director of a corporation that is a wholly-owned subsidiary of a body corporate is taken to act in good faith in the best interests of the subsidiary if: (a) the constitution of the subsidiary expressly authorises the director to act in the best interests of the holding company; and (b) the director acts in good faith in the best interests of the holding company; and (c) the subsidiary is not insolvent at the time the director acts and does not become insolvent because of the director’s act.”<sup>41</sup>

55. The above sections of the Act require directors to work in the best interest of the entity of which they are the director (and therefore the directors of a subsidiary are required to act in the best interest of the subsidiary, with the exception for wholly-owned subsidiaries as mentioned in paragraph 54 immediately above).

56. Unlike in NZ (see the **footnote to paragraph 54**), there is no provision in the Corporations Act relating to minority shareholders that explicitly allows directors to act in the best interests of the holding company. However, minority shareholders have a recourse under sections 232 and 233 of the Corporations Act when the affairs of the company are being conducted in a way that is:

- unfair to that shareholder or to other shareholders of the company; or
- against the interests of the company as a whole.

A court may, for example, order the winding up of a company or the appointment of a receiver.

57. Thus, if the directors seem to have overly advantaged the holding company to the detriment of the partly owned subsidiary, the minority shareholders have rights under sections 232 and 233 of Corporations Act.

### *Case law*

58. There have been cases brought before the courts where minority shareholders of a subsidiary have made claims of unfair treatment where directors of a parent have made decisions in the interests of the parent and the group. The courts have found in favour of the directors in some of

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<sup>41</sup> In contrast, section 131(3) of the NZ Companies Act 1993 allows a director to act in the best interests of the holding company (which may not be in the best interest of the subsidiary) even where the subsidiary is not wholly owned, provided the director is expressly permitted to do so by the constitution of the subsidiary company and with the prior agreement of the shareholders (other than its holding company). The reason for the difference between the Australian and NZ approach is ...**(Note to Board: We will contact NZ’s Ministry of Business, Innovation and Employment to understand the rationale for NZ’s approach)**

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these cases on the basis that the directors had taken the least worst course of action that was in the interest of the subsidiary (and the parent and the group).

59. For example, the final report of the Companies & Securities Advisory Committee on 'Corporate Groups' (May 2000) states: "In *Nicholas v Soundcraft Electronics Ltd* [1993] BCLC 360, the minority shareholders of a subsidiary company alleged that by withholding payment of debts due to the subsidiary, the parent company had acted in the affairs of the subsidiary in an unfairly prejudicial manner. .... However, while the Court had jurisdiction to entertain an oppression action, it held that the withholding of debts by the parent company, which deprived the subsidiary company of much-needed funds, did not constitute unfair prejudice, because if the parent company failed to hold off its creditors, the subsidiary company would also suffer. The Court stated (at 366):

"It was in the interests of the [subsidiary] company that the parent should not go into liquidation. The [subsidiary] company had to pay a price to help secure that. It is the fact that the price - the withholding of debts - left the [subsidiary] company critically short of money. But the attempt to keep the group afloat by recourse to the assets of both companies was a reasonable commercial judgment in the circumstances which existed and was not unfair. It no doubt harmed the [subsidiary] company but worse harm [to the subsidiary company] would probably have followed from the liquidation of [the parent]."

60. Similarly, section V(E) of the Research Report "Corporate Groups in Australia" by Ian Ramsay and Geof Stapledon (Centre for Corporate Law and Securities Regulation, University of Melbourne, 1998) states that "although each company in a corporate group must be treated as having its own interests, the courts have acknowledged that to some extent directors, when performing their functions, may properly consider the interests of other companies within the corporate group."

61. Consistent with this, although giving supremacy to the focus remaining on the separate legal entity, the final report of the Companies & Securities Advisory Committee on 'Corporate Groups' (May 2000) in paragraph 2.14 mentions a UK case law principle (known as the Charterbridge principle) in which the judge employed the following test for whether directors have breached their duties:

"whether an intelligent and honest man in the position of a director of the company concerned, could in the whole of the existing circumstances, have reasonably believed that the transactions were for the benefit of the company."

62. The May 2000 report further states at paragraph 2.16 that "The Charterbridge principle has been applied in Australian case law. Directors must exercise their powers for the benefit of the company they direct. Nevertheless, in determining whether to enter into an upstream or lateral intra-group loan or security transaction, directors of group companies may have regard to any direct or derivative commercial benefits to be derived by their company, and the extent to which their company's prosperity or continued existence depends on the well-being of the group as a whole. To that limited extent, directors may consider the wider interests of the group. Therefore, "...actions carried out for the benefit of the group as a whole may, in particular circumstances, be regarded as benefiting as well one or more companies in a group. (Case of *Equiticorp Financial Services Ltd v Bank of New Zealand* (1993) 11 ACSR 642"

*Are regulations relating to directors' responsibilities (and minority shareholders rights) consistent with a 'legal entity' view or an 'economic entity' view?*

63. Regulations relating to directors' responsibilities (and minority shareholders' rights) appear to be



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consistent with a mixed view of a group – ‘legal entity’ or ‘economic entity’, depending on circumstances; although it seems the legal entity view is the more dominant. An economic entity view is only adopted when it is not inconsistent with a legal entity view.

64. Thus, from the way regulators and the courts have viewed director’s responsibilities (and minority shareholders’ rights), directors must balance the interests of the group and the legal entity of which they are the directors, and understand the financial implications of their decisions at both the legal entity and group level.
65. As Jeffrey W. Rubin puts it in his article in the November 2006 edition of the ‘New York Law Journal’, “In each situation where a public company controls a public subsidiary, there exists a need for the board and management of each company to understand the roles and responsibilities of the board and management of the other.” For example “Because matters affecting one entity may also affect the other, it would be prudent for the entities to agree to a protocol for the disclosure to the audit committee of the parent of matters brought to the attention of the subsidiary, and for the disclosure to the audit committee of the subsidiary of matters brought to the attention of the parent that may involve or relate to the subsidiary.”

### Related party transactions (including intra-group transactions)

66. Section 208 of the Corporations Act requires a public company (or an entity that is controlled by a public company) giving a financial benefit to a related party (including a company within the group) to obtain approval from a majority of shareholders of that public company<sup>42</sup> who are not party to the transaction,<sup>43</sup> subject to certain exceptions such as where the financial benefit given is at arm’s length or where the benefit is given to a closely-held subsidiary<sup>44</sup>.
67. This legislative requirement to obtain approval seems consistent with giving primacy to a ‘legal entity’ view but having regard to the ‘economic entity’ perspective.

### Insolvent trading by a subsidiary

68. Under sections 588V and 588W of the Corporations Act a holding company may be held liable if the subsidiary company was insolvent when the subsidiary incurred a debt and there were reasonable grounds for the holding company or any of its directors to believe the the subsidiary is insolvent. The liquidator may recover the loss, incurred by a person to whom the debt was owed, from the holding company, even if the debt was wholly or partially unsecured (also refer ‘pooling arrangements’ discussed in paragraph 59-60 below).
69. This requirement seems to be broadly consistent with an ‘economic entity’ perspective as it effectively requires directors of the parent entity to be aware of the business operations of each and all of its subsidiaries. It is notable that sections 588V and 588W do not distinguish between a wholly or partially owned subsidiary.

### Pooling arrangements in the event of liquidation

70. Section 571 of the Corporations Act requires that, in the case of each company in the group being wound up, the liquidator of one or more companies may (subject to certain conditions)

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<sup>42</sup> If the minority (non-controlling interests) feels disadvantaged they have certain rights - see for example [paragraph 56-57](#)

<sup>43</sup> For procedures for obtaining member approval refer to sections 217 to 227 of the Corporations Act

<sup>44</sup> For details of such exceptions refer sections 210 to 216 of the Corporations Act. For definition of closely-held refer section 214 of the Corporations Act.

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make a 'pooling determination', which is subject to the approval of eligible unsecured creditors (and the court, if an application is made to the courts). If a pooling determination comes into effect, each company in the group is taken to be jointly and severally liable for each debt payable by, and each claim against, each other company in the group.

71. This requirement is potentially more consistent with taking an 'economic entity' view than a 'legal entity' view.

### Dividend distribution

72. Section 254T(1) of the Corporations Act states that "A company must not pay a dividend unless:
- (a) the company's assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend; and
  - (b) the payment of the dividend is fair and reasonable to the company's shareholders as a whole; and
  - (c) the payment of the dividend does not materially prejudice the company's ability to pay its creditors."

73. Prior to 2010, dividends were based on a 'profits test', which required dividends only to be paid out of profits. However, as per PWC's IFRS Spotlight, May 2016, "various legal opinions have concluded that the Net Assets Test has not displaced, but has added to, the historic requirement in Australian case law for the dividend to be paid from profits of the company (commonly referred to as the Profits Test)."<sup>45</sup> It goes on to explain how these tests work in practice and states "This means that when paying dividends up to a holding company and then to shareholders, these respective tests are applied to each legal entity that makes a return to its parent. For example, in a group of companies with extensive and complex holding chains, profit generated by a trading subsidiary at the bottom of the chain will need to pass through each intermediate holding company to reach the parent company. Accumulated losses at any of these intermediate holding companies may result in dividend traps; that is, the losses, depending on when they were incurred and accounted for, may absorb any dividends paid up, preventing those profits from passing to the parent to be distributed to shareholders."

<p>Note to Board</p>
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<p>We need to think further about interaction of this issue re dividends with the tax laws</p>
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74. Given the interrelationship between a parent and its subsidiaries in relation to dividends, the legislative requirements relating to dividends seem consistent with both a 'legal entity' view and an 'economic entity' view. The economic entity view is pertinent because, for example, the ability to distribute dividends between companies within a group and ultimately outside the group is potentially dependent on the level of profits of each entity within the group.

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<sup>45</sup> EY Corporate Law Update (Oceania), August 2016 also confirms this view and states "As it currently stands, the present regime (perhaps inadvertently from the drafters' perspective) limits the circumstances where it is appropriate to declare and pay a dividend far beyond what one would glean from a "first blush" read of section 254T. The prevailing view, despite the expressed intention of the reforming legislation, is that the profits test lives on in the current regime."

# The relationship between business structures and financial reporting

Note to Board:

We need to give further thought to where this section would be best located.

75. The manner in which an entity is structured might have implications for its financial reporting requirements. This is particularly so from a regulatory perspective rather than from an accounting standards perspective because, consistent with user needs, accounting standards typically look through the legal form of an entity to its economic substance.
76. In the context of this Report, a question arises as to whether regulatory requirements (and accounting standards) have an undue (and therefore economically inefficient) influence on the choice of business structure. It is reasonable to conclude that regulations should be reviewed if they are unduly influencing business structures and therefore distorting economic behaviour.
77. On that basis, for completeness, we briefly considered the common types of business structures and the typical factors that lead to them being adopted in practice.
78. In Australia, at a broad level, the four most common types of for-profit business structures are sole trader, partnership, trust and company<sup>46</sup>. Each of these structures have different legal attributes. The key considerations that drive their adoption in practice include<sup>47</sup>:
- Decision making authority and degree of control
  - Limited liability or otherwise
  - Cost and complexity of formation and compliance
  - Sharing of profits
  - Tax considerations.
79. Of further relevance to the subject of this Report is how business activities might be structured within each legal structure – for example whether as branches (within a single legal structure) or subsidiaries (as separate legal entities within an economic group).<sup>48</sup> According to CPA study guide 2018 on ‘Global strategy and leadership’, such choices are primarily driven by market circumstances and the strategic objectives of the organisation. For example, foreign companies establishing a business presence in Australia may establish or acquire an Australian subsidiary company and carry on business in the name of that Australian company or establish a branch office of a foreign company and carry on business in the name of that foreign company. The decision on whether to establish a subsidiary or branch office depends on a variety of considerations including legal, taxation and commercial considerations, as mentioned in paragraph 78 above.
80. Accounting standards make it clear that whether business activities are carried on through, for example, different branches, subsidiaries or various other structures does not absolve the group or management from its financial reporting obligations. For example, the international

<sup>46</sup> <https://www.business.gov.au/info/plan-and-start/start-your-business/business-structure>

<sup>47</sup> <http://www.entrepreneurshipinbox.com/11271/7-factors-legal-structure-business/>  
<https://www.bmgaccountants.com.au/business-structure/>

<sup>48</sup> Other common ways in which business activities might be undertaken is through licensing, franchising, acquisition, joint ventures, associates, foreign direct investment, exporting - see CPA study guide 2018 on ‘Global strategy and leadership’ on ‘Common modes of entry into new geographic markets’. The reason we are focused on branches versus subsidiaries is that the question of consolidated versus separate financial statements (being the focus of this Report) only arises where parent/subsidiary relationships exist.

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accounting standards (and consequently the corresponding Australian Accounting Standards) on consolidation IAS 27 *Consolidated and Separate Financial Statements* and SIC 12 *Consolidation – Special Purpose Entities* were superseded by IFRS 10 *Consolidated Financial Statements* (effective from 1 January 2013) to overcome inconsistent application of the concept of control and thus entities not consolidating their interests in special purpose vehicles (as per paragraph BC 3 of IFRS 10).

81. From the list in paragraph 78 above, the reference to 'compliance' in the third dot point suggests that financial reporting requirements might have some influence on the choice of legal structure and the structuring of business activities (e.g. branches versus subsidiaries, because the financial reporting regulations on parent/subsidiary relationships are potentially more onerous and complex than those imposed on businesses operated only through branches). However, our literature review did not provide any evidence that suggests that financial reporting requirements unduly influence the structures that businesses might choose.

### Note to Board

As part of the proposed outreach we intend reaching out to the preparers and understanding their views on whether financial reporting requirements unduly influence the structures that businesses might choose.

82. Despite that however, parent-subsidiary structures raise the question of whether financial reporting should be required to be on a consolidated or individual entity basis or whether both bases should be required to best meet user needs, whilst balancing the financial reporting costs. As noted in paragraph 83-114, there are different perspectives and levels of usefulness that each of the different types of financial statements (i.e. consolidated financial statements, subsidiary financial statements and parent financial statements) bring to their respective users. An appreciation of the relative usefulness of these different sets of financial statements provides a context for later sections of this Report in which we draw conclusions on which sets of financial statements should be required and whether the information they contain could be presented in a way other than as a full set. Of particular relevance in the context of this Report, the following discussion will throw light on the extent to which (and circumstances under which) consolidated financial statements provide sufficient information about group structures and therefore might be an adequate substitute for:
- parent financial statements, perhaps supplemented with with specific disclosures of summary financial information about the parent; and
  - subsidiary financial statements (even of a subsidiary at the bottom of a group), perhaps supplemented with specific disclosures of summary financial information about the subsidiary.

## The relative usefulness of consolidated, parent and subsidiary financial statements

83. To assess the usefulness of consolidated financial statements in relation to parent and subsidiary financial statements, an understanding of the underlying perspective adopted in consolidated financial statements becomes pertinent. In broad terms, there were two alternative perspectives that were considered by the IASB in developing IFRS 10 (and correspondingly by the AASB in developing AASB 10):
- the 'proprietary' perspective. Under this perspective, the information in the financial statements of the investee and the group is provided from the perspective of the investor (proprietor/owner). For example, one version of the proprietary perspective is, if a parent company has an 80 per cent controlling stake in a subsidiary company, then the financial statements of the investee should reflect 100% of the assets controlled by the investee, with

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the parent's 80% interest reflected as equity of the investee and the 20% non-controlling interest (NCI) reflected as a liability of the subsidiary (ie from the parent's perspective it 'owes' the NCI 20% share of the assets). From the group's perspective, the consolidated financial statements would reflect 100% of the subsidiary's assets and the NCI of 20% would be shown as a liability, reflecting the parent only has an 80% interest in the assets (also see paragraph 86 below). Another version of the proprietary approach would be to reflect only 80% of the assets and no NCI, and this is effectively what a parent only set of financial statements reflects with an investment in the subsidiary reflecting the 80% share.

- b. the 'entity' perspective. Under this perspective there is a basic assumption that all economic activity conducted by a business is separate from that of its owners. Thus, the information in the financial statements of the investee is provided from the perspective of the investee. Using the example in (a) above, if taking the entity view, then the investee financial statements reflect 100% of the assets controlled by the subsidiary, with both the 80% parent investment and the 20% NCI would be reflected as equity contributions – the subsidiary does not have a liability to either the parent or the NCI. The group financial statements would reflect 100 per cent of the assets of the subsidiary, with the non-controlling interest being seen as part of the equity contribution to the group, (ie equity in the subsidiary is also equity in the group, not a liability). However, similar to (a), in the parent only financial statements currently the proprietary approach of an investment in the subsidiary of 80% is reflected.

84. Over time the IASB has more strongly moved away from the 'proprietary' perspective to the 'entity' perspective. This is reflected in the IASB's latest thinking, expressed in the IASB's revised Conceptual Framework, which states in paragraph 3.8 that, "Financial statements provide information about transactions and other events viewed from the perspective of the reporting entity as a whole, not from the perspective of any particular group of the entity's existing or potential investors, lenders or other creditors." In this regard, paragraph BC 3.9 of the Basis for Conclusions to the revised Conceptual Framework states, "The 2018 Conceptual Framework states that financial statements provide information from the perspective of the reporting entity as a whole (often referred to as 'the entity perspective'), not from the perspective of any particular group of the entity's existing or potential investors, lenders or other creditors. This reflects the Board's view that the reporting entity is separate from its investors, lenders and other creditors..."

85. Paragraph BC3.10 of the Basis for Conclusions to the revised Conceptual Framework goes on to state, "The Board adopted the entity perspective because it is consistent with the objective of general purpose financial reporting ... This objective is to provide useful information to existing and potential investors, lenders and other creditors rather than to provide information to a particular subset of those capital providers. If information were to be directed towards the needs of a particular subset of primary users, it might be necessary to provide different sets of financial statements for each subset. That could cause confusion and undermine confidence in financial reporting..."

86. In addition, paragraph BC1.8 of the Basis for Conclusions to the revised Conceptual Framework explains by stating, "Some respondents to the 2008 Exposure Draft said that the reporting entity is not separate from its equity investors or a subset of those equity investors. This view has its roots in the days when most businesses were sole proprietorships and partnerships that were managed by their owners who had unlimited liability for the debts incurred in the course of the business. Over time, the separation between businesses and their owners has grown. The vast majority of today's businesses have legal substance separate from their owners by virtue of their legal form of organisation, numerous investors with limited legal liability and professional managers separate from the owners. Consequently, the Board concluded that financial reports

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should reflect that separation by accounting for the entity (and its economic resources and claims) rather than its primary users and their interests in the reporting entity.”

87. The IASB’s adoption of the entity perspective is also apparent from the amendments made to IAS 27 *Consolidated and Separate Financial Statements* in 2003 when the IASB required minority interests to be presented in the consolidated statement of financial position within equity rather than as a liability. Similarly, the 2005 amendment to IAS 27, which required attribution of a subsidiary’s losses to the minority interests in excess of their interests in the subsidiary’s equity (when such excess was attributed to the majority before the amendment) is another example of IASB further embracing the entity perspective over the proprietary perspective.
88. However, there are some requirements in current accounting standards that appear to acknowledge the proprietary view by requiring information to be presented in a way that is consistent with that view. For example, AASB 101 *Presentation of Financial Statements* requires:
- a. presentation of earnings per share attributable to the ordinary equity holders of the parent entity;
  - b. separate presentation of information about profit or loss and comprehensive income for the period attributable to a) owners of the parent and b) non-controlling interests (paragraphs 81B(a) and (b));
  - c. separate presentation of non-controlling interests within equity (paragraph 54(q))
89. However, paragraph BC6.55 of the revised IASB Conceptual Framework states “the measurement of some individual classes of equity or components of equity would not contradict the entity perspective adopted in financial statements. Those direct measures might provide users of financial statements with information useful in making decisions relating to providing resources to the entity. This information would be provided from the perspective of the entity and reflect the equity claims held against the entity. Such information would not be provided from the perspective of a particular claimholder.”
90. By adopting the entity perspective it is apparent that the IASB does not regard non-controlling interests of subsidiaries as primary users of consolidated financial statements, although the requirements in paragraphs 54(q) and 81B (a) and (b) of AASB 101 are consistent with some acknowledgement of the information needs of non-controlling interests (albeit not at an individual subsidiary level). This could mean that, consistent with our comments in paragraph 92, certain users of subsidiary financial statements and their information needs are catered for in the consolidated financial statements. However, the extent to which the consolidated financial statements are sufficient to meet their needs is considered later in this Report (see paragraphs 91-105) and Appendix A below.

Note to Board: We are continuing to do work on the entity Vs proprietary perspectives and their implications. Accordingly, this section will be improved as we progress further.
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## The Usefulness of Consolidated Financial Statements

91. Although, as described in paragraph 78, entities might organise their various activities and operations through different legal structures, they ultimately operate as a single economic entity. Where an entity is structured through parent/subsidiary relationships, consistent with paragraphs 1.4, 1.13 and 3.15 of the IASB’s revised Conceptual Framework, users such as investors and lenders of a parent require information to understand the overall financial health of the business and how efficiently and effectively the entity’s management has discharged its responsibilities to

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use the entity's economic resources provided by them. Such information helps users assess management's stewardship of those resources and to predict how efficiently and effectively management will use the entity's economic resources in future periods. Hence, the information can be useful for assessing the parent entity's prospects for future net cash inflows. This information is provided through consolidated financial statements of the group presenting a holistic financial information about the group.

92. Information about the consolidated entity might also be useful to users such as **investors and lenders of a subsidiary** as this facilitates a broader understanding of a group's operations and their implications for the subsidiary. Since the activities of the subsidiary are controlled by the parent, investors and lenders of the subsidiary might find it useful to understand the nature, structure and financial performance of the group as a whole controlled by the parent. The users might be interested in evaluating the impact of the financial operations of the group on the subsidiary in which they have invested. For example, in case there is a deed of the cross guarantee the investors of the subsidiary would be expected to be interested in the group information.
93. One potentially relevant factor in identifying the relative usefulness of consolidated, parent and subsidiary financial statements is the accounting requirements for a parent's investment in a subsidiary where unconsolidated financial statements are being prepared. A possible limitation of unconsolidated financial statements is that current accounting standards (AASB 127) allow optional accounting treatments for investments in subsidiaries. In particular, paragraph 4 of AASB 127 defines 'separate financial statements' as "those presented by an entity in which the entity could elect to account for its investments in subsidiaries, joint ventures and associates either at cost or in accordance with AASB 9 *Financial Instruments*, or using the equity method as described in AASB 128 *Investments in Associates and Joint Ventures*." Arguably, the optional accounting treatments could lead to a lack of comparability.<sup>49</sup>
94. In addition to the discussion in **paragraphs 92-93 immediately** above, **paragraphs 95-105 below** provide a list, although not mutually exclusive, of more specific reasons for why consolidated financial statements are regarded as being useful.
95. **Control:** Since the parent entity controls its subsidiaries, it has the power to control the assets and liabilities of the group. By having control, the parent entity has the ability to restructure the group, transfer assets between group entities, push down or pull up resources of the subsidiaries or transfer them between subsidiaries to be utilised to generate benefits for the parent entity or other entities in the group (See paragraph 56 on rights of the minority shareholders). Thus, compared with individual financial statements of each subsidiary, consolidated financial statements portray the overall financial position of a group regardless of which entity in the group records these in its accounting records.
96. **Aids decision making by directors of companies within the group:** As discussed in paragraph 52-65, from the way regulators and courts have viewed director's responsibilities (and minority shareholders' rights), directors must balance the interests of the group and the legal entity of which they are the directors, and understand the financial implications of their decisions at both the legal entity and group level.
97. Thus, it becomes extremely important for directors to understand the group structure (including inter-relationships between various entities of the group) and group's financial information which can be served by the consolidated financial statements of the group. The sound understanding

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<sup>49</sup> This gives rise to a question of whether AASB 127 should be amended to limit the options for accounting for investments in subsidiaries? However, as noted in paragraph X in relation to the scope of this Report, this question is outside the scope.

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of the group's financial information is expected to aid them to understand the rationale behind the transactions, especially intra-group transactions, and how best to safeguard the interests of the specific legal entity in the first place and also the group without being exposed to offences/liabilities under the Corporations Act. The consolidated financial statements become important especially for those directors (for example, of subsidiaries) who are not able to demand group related information from the parent or other subsidiaries.

98. **Summarises net cash flows available to investors:** Consolidated financial statements provide useful information about the consolidated cash flow position of the group through the consolidated statement of cash flows. It presents overall cash generated by the group from operations, major investments by the group, major disposals (for example divesting businesses) and cash flows from financing activities, thus providing information about the operations and overall cash generating capacity of the group as a whole. Information regarding cash flows is an important input, particularly for lending decisions.
99. Specifically, while identifying the usefulness of consolidated financial statements compared with the separate financial statements of the parent, paragraph 3.15 of the IASB's revised Conceptual Framework states "Consolidated financial statements provide information about the assets, liabilities, equity, income and expenses of both the parent and its subsidiaries as a single reporting entity. That information is useful for existing and potential investors, lenders and other creditors of the parent in their assessment of the prospects for future net cash inflows to the parent. This is because net cash inflows to the parent include distributions to the parent from its subsidiaries, and those distributions depend on net cash inflows to the subsidiaries."
100. **Aids in investment/lending decisions by providing information about the overall financial health of the group:** As explained in paragraph 91-92 above, the consolidated financial statements are useful for lenders and investors of both the parent and individual subsidiaries. The consolidated financial statements give a comprehensive perspective of the financial health of the group and an indication about the future prospects of the business. Even if the business is diversified, consolidated financial statements provide information about the key segments in the notes to the financial statements (as per AASB 8 *Operating Segments*) to facilitate decision making. Without consolidated financial statements, the process of evaluating a parent and each subsidiary separately and its relationship with the group as a whole would be long and complex.<sup>50</sup>
101. As also mentioned in paragraph 72-74, the regulatory requirements relating to dividend distribution seem to be consistent with both a 'legal entity' view and an 'economic entity' view. Thus, the consolidated financial statements are relevant especially for the shareholders of the parent (including consolidated financial statements of the intermediate parent) since the parent company will be profitable if the whole group it controls is profitable as accumulated losses at any of the 'intermediate parent' level may act as dividend traps.
102. **Reduction in cost:** There is less Reportwork and less effort involved in preparing and analysing consolidated financial statements compared with preparing and analysing a set of unconsolidated financial statements of a parent and each subsidiary as the consolidated statements summarise the individual financial statements of subsidiaries and their parent into one set.<sup>51</sup> The consolidated financial statements would be particularly useful in case of large groups with multiple subsidiaries as it may get tedious for users to individually go through the financial statements of each of the subsidiary to gain an understanding about the group.

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<sup>50</sup> <https://bizfluent.com/about-5685728-importance-consolidated-financial-statements.html>

<sup>51</sup> <http://www.qvinci.com/the-importance-of-consolidated-financial-statements>



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103. **Cross guarantees:** Consolidated financial statements provide useful information to users who might otherwise be more interested in separate parent and subsidiary financial statements where the group entities have entered into a deed of cross guarantee. Since the parties to the deed of cross guarantee are responsible for each other's debts, the deed arguably effectively renders the group a single legal entity (See paragraph 33). Therefore, where the repayment of a debt through security is a focus of an assessment, it is useful for lenders and creditors (either of an individual subsidiary or the parent) to analyse the consolidated financial statements as input to their assessment of the efficacy of the deed. In addition, understanding the nature of the group and cross guarantees for the purposes of assessing the sustainability of future income might also be important
104. **Insolvency:** The relevance of understanding the overall financial health of the group can also be gathered from the fact that a holding company may be held liable if the subsidiary company was insolvent when the subsidiary incurred a debt and there were reasonable grounds for the holding company or any of its directors to believe the insolvency of the subsidiary (refer paragraph 68-69). Similarly, in case each company in the group is wound up, the liquidator of one or more companies may make a 'pooling determination' (under section 571 of the Corporations Act- discussed in greater detail in paragraph 70-71). If a pooling determination comes into effect, each company in the group is taken to be jointly and severally liable for each debt payable by, and each claim against, each other company in the group. Thus, the information about the consolidated group is important, which is best reflected in the consolidated financial statements of the group<sup>52</sup>. The consolidated financial statements of the whole group can give important insight to the functioning of the group as a whole and whether there are any red flags that the directors need to be aware of. Similarly, such information would be useful for lenders as the consolidated financial statements would include information about a subsidiary which may be facing financial difficulties and having a material impact on the group.
105. In contrast to the above benefits of consolidated financial statements, one limitation is that it is difficult to assess the amounts that can be legally claimed against each of the legal entities (for example, by bankers) forming part of the consolidated group. Legal separation between various entities forming part of a group can significantly affect the cash flows available to existing and potential investors, lenders and other creditors of each entity within a group. Thus, although consolidated financial statements are useful to understanding the overall financial health of the group, lenders such as banks need to ascertain the loan servicing capacity of an individual (legal) borrower within the group for which they seek entity specific information. Again, this is consistent with what we heard during our outreach with banks – see Appendix A of this Report.

Note to Board:

- Need to add that consolidated financial statements are accepted by ATO in some cases.
- We also need to address what's currently in consolidated financial statements – and whether it's enough information to allow a user to assess the risks arising from the group structure
- Also some paragraphs such as relating to 'insolvency' above may sound repetitive in relation to regulatory requirements also discussed earlier. We may need to cross-reference and avoid repetition.

## The Usefulness of Parent Financial Statements

106. Parent financial statements purport to portray the financial health and profitability of the parent separate from the rest of the group. Such separate financial information about the parent may

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<sup>52</sup> In case the going concern assumption is not appropriate, disclosures in the financial statements are required to be made as per paragraph 25 of the AASB 1 *Presentation of Financial Statements*.

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be relevant to ascertain resources legally controlled by the parent. In this regard, paragraph 3.17 of the IASB's revised Conceptual Framework states "Unconsolidated financial statements are designed to provide information about the parent's assets, liabilities, equity, income and expenses, and not about those of its subsidiaries. That information can be useful to existing and potential investors, lenders and other creditors of the parent because:

- a. a claim against the parent typically does not give the holder of that claim a claim against subsidiaries; and
- b. in some jurisdictions, the amounts that can be legally distributed to holders of equity claims against the parent depend on the distributable reserves of the parent...."<sup>53</sup>

107. However, having said that, paragraph 3.18 of the IASB's revised Conceptual Framework highlights the importance of consolidated financial statements compared with unconsolidated financial statements of the parent and states, "Information provided in unconsolidated financial statements is typically not sufficient to meet the information needs of existing and potential investors, lenders and other creditors of the parent. Accordingly, when consolidated financial statements are required, unconsolidated financial statements cannot serve as a substitute for consolidated financial statements. Nevertheless, a parent may be required, or choose, to prepare unconsolidated financial statements in addition to consolidated financial statements." (Refer paragraph 18-19 above)

108. Appendix A to this Report notes that some banks, in making lending decisions, regard the information contained in parent financial statements as important input to those decisions.

### The Usefulness of Subsidiary Financial Statements

109. As paragraph 3.16 of the IASB's revised Conceptual Framework states "Consolidated financial statements are not designed to provide separate information about the assets, liabilities, equity, income and expenses of any particular subsidiary. A subsidiary's own financial statements are designed to provide that information." Specific reasons why subsidiary financial statements are identified as being useful (in addition to, or even instead of, consolidated financial statements) are summarised as follows:

110. **Poor performance of subsidiaries:** Individual profitability of subsidiaries is difficult to assess from the consolidated financial statements. While sharing her views on consolidated financial statements, Angie Mohr, a finance columnist, states "For example, if a subsidiary lost a substantial amount of money in the year as a result of poor sales, financial statement readers may not see that information if the loss is combined with profits of the parent company." So users such as creditors or lenders to individual subsidiaries may still require relevant information about subsidiary's profitability to carry out their risk assessments about that subsidiary.<sup>54</sup> This is consistent with what we heard from our outreach with banks - see Appendix A to this Report.

111. Similarly, financial ratios based on consolidated numbers may not be representative of each entity's ratios. For example, if one of the subsidiaries has a high level of debt compared to the equity of the owners, that leverage would be hidden in consolidated financial statements.

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<sup>53</sup> The IASB paragraph goes on to say "Another way to provide information about some or all assets, liabilities, equity, income and expenses of the parent alone is in consolidated financial statements, in the notes." The suitability of note disclosure in lieu of a full set of parent financial statements is discussed in section.... of this Report.

<sup>54</sup> <https://bizfluent.com/info-8463041-disadvantages-consolidated-financial-statements.html>; <https://bizfluent.com/about-5685728-importance-consolidated-financial-statements.html>

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112. **Establishment of legal rights:** Subsidiary financial statements provides insight into the amounts that can be legally claimed by banks/creditors in case of default by a particular entity. See paragraph 106 above.
113. **Regulatory requirements:** As discussed above, since requirements relating to director's responsibilities, interest of the minority shareholders and dividend distribution seem to take both the economic entity and the legal entity view, the relevance of subsidiary financial information for regulatory purposes should not be underestimated,.
114. In addition to the above benefits of parent financial statements and subsidiary financial statements, one of the potential limitations of the parent and subsidiary financial statements is that they are allowed optional accounting treatments for investments. As paragraph 4 defines 'separate financial statements' as "those presented by an entity in which the entity could elect to account for its investments in subsidiaries, joint ventures and associates either at cost or in accordance with AASB 9 *Financial Instruments*, or using the equity method as described in AASB 128 *Investments in Associates and Joint Ventures*." Thus, optional accounting treatments lead to lack of comparability of financial statements between various peer companies.

## Conclusion

115. The information currently contained in consolidated financial statements, parent financial statements and subsidiary financial statements each has its own relevance to different users in different circumstances. While the usefulness of the consolidated financial statements should not be underestimated (as it provides useful financial information about the group as a whole), certain users (for example banks as lenders) often need more information about the specific entity with which they have a legal relationship and to which large sums of money has been or is to be lent, to ascertain its loan servicing and repaying capacity (refer Appendix A of this Report on feedback from banks). This might even be the case where a deed of cross guarantee exists, particularly where a lender's policy is to lend against the profitability of an entity and use security provided by a cross guarantee as risk mitigation/back up.

Note to Board More robust conclusion to be added
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## Conclusion – Authors’ views on key issues raised

### Note to Board

To be included after conducting more outreach. It’s in this section where we will better link our research to the key questions being addressed.

## Appendices

### Note to Board

The sequence of appendices need to be thought through

### Appendix A- Results of outreach to banks as lenders

Note to Board: We need to develop a summary paragraph that summarises our findings as recorded in this appendix.

1. In an attempt to obtain empirical evidence of user needs in relation to parent-only and subsidiary-only company financial statements or summary financial information in the context of consolidated financial statements, research undertaken for the purpose of this Report included outreach to banks as lenders to companies. This appendix describes our research methodology (including its limitations) prior to listing each question we put to our sample of banks and a summary of the respective responses.
2. The primary purpose of the outreach was to gain an understanding of the views of a significant type of user of GPFs<sup>55</sup> on the relevance of subsidiary-only financial statements (whether themselves consolidated or not) and parent-only financial statements (not consolidated) when the consolidated financial statements of the group are available. We also sought the banks’ thoughts on whether summary financial information about each subsidiary in the consolidated financial statements of the group would be a sufficient replacement for the full set of subsidiary-only financial statements if that summary information were to be disclosed in the consolidated financial statements.

### **Research methodology**

3. We reached out to 4 Australian banks and 1 overseas bank that operates in an Asian country with a total of 11 respondents. (There were 4 large banks (3 Australian and the overseas bank) and 1 second tier Australian bank). The input we received is based on personal interviews

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<sup>55</sup> It could be argued that the banks with whom we conducted outreach are in a position to demand the information they need as input to their lending decisions and therefore are not general purpose users. However, in practice they accept GPFs as satisfying much of their financial information needs and therefore their views on the usefulness of information in GPFs and the manner in which it is presented are worth being understood by regulators/standard setters.

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conducted and/or written responses received from the representatives of the credit departments of these banks. Confidentiality was assured – therefore the results are presented in a way as to not identify the views of individual banks or their officers.

4. Access to these individuals was gained by contacting senior executives from organisations expected to employ such individuals and in one case by knowledge of their relevant experience in the banking sector. To increase the likelihood of gaining access to the type of individuals included in the target sample, many of the senior executives approached were people who had previous contact with the AASB.
5. These senior executives (from 5 organisations) were contacted by telephone and e-mail and were encouraged to respond to the survey questions (shared with them). The survey was in the form of a word document to enable the respondents to provide detailed responses. These executives were given an option of either submitting written responses or sharing their feedback via tele/video conference with AASB staff.
6. There were a total of 11 respondents from these 5 organisations and included representatives from wholesale credit, risk management, corporate and institutional banking, commercial credit and group accounting policy. There is considerable variation in the roles performed by the 11 individuals responding to the survey. This degree of variation helps to ensure that the information needs of bankers working in different roles are obtained. Two respondents submitted written responses. Feedback from other respondents was taken by conducting group interviews (with representatives from one bank forming one group) via tele/video conference.
7. The interviews took a semi-structured form, with the interviewer following a standard set of questions (reproduced below), and then following up with individually tailored questions to clarify answers given or probe reasoning. Despite this, it is difficult to discern from the responses the extent to which they reflect the banks' lending policies compared with lending practices, and the extent to which lending practices differ from lending policies.
8. Given the relatively small sample size of only one type of user (bank lenders to companies), care needs to be taken about generalising from the responses to other user types. However, because the views expressed by different banks were broadly consistent, this could justify generalisations being made, at least for the class of users of GPFs that are lenders.
9. The extent to which the views expressed in the responses should influence the actions of regulators/standard setters should be carefully considered given that regulators/standard setters have a broader responsibility.

### **Summary of research results**

*QUESTION 1: As a lender to the subsidiary, do you think there is a need for full set of individual financial statements of the subsidiary or would the summary financial information about the subsidiary in the parent's/group's consolidated financial statements suffice?*

10. Most of the banks interviewed specifically stated that their lending policies require a thorough and comprehensive process to evaluate the credit-worthiness of a potential borrower. Before granting a loan, their policies require a lending officer to be satisfied primarily about the servicing capacity of the borrower and, secondarily, about the security backing the debt; although servicing capacity and debt security are both important considerations. To make this evaluation, all respondents mentioned that significant reliance is placed on the individual financial statements of the legal borrower.

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11. All the banks mentioned that their need for individual financial statements of the subsidiary depends on to whom they are legally lending within the group, and to whose assets the banks have legal recourse in the case of default. That is, if they have recourse to only the assets of an individual subsidiary to whom they are lending, then the individual financial statements of that subsidiary would be specifically required (presumably in addition to the consolidated financial statements), and summary financial information would not be an adequate substitute.
12. Two of the banks specifically mentioned that it depends on the amount of the borrowing application, the nature of the facility (for example short-term working capital facility or long-term loan) and the risk grade of the borrower. For example, if the subsidiary is wholly owned with a deed of cross guarantee or if the subsidiary is only a non-operating finance subsidiary looking after the treasury function of the whole group, then summary financial information about the subsidiary in the consolidated financial statements of the group may be sufficient. Similarly, in the case where there are deeds of cross guarantee, consolidated financial statements may suffice. However, as the risk grade of the borrower increases, a full set of financial statements of the borrowing subsidiary would be required. It is a case-by-case type of consideration.
13. In summary, based on the above, the banks noted that their answer to the question depends on circumstances. Where a bank is lending to a subsidiary within a group, it is apparent that the answer also depends on the emphasis that bank's lending policies place on servicing capacity relative to debt security. Only in limited circumstances are consolidated financial statements of the group sufficient. More typically consolidated financial statements of the group and the financial statements of the borrowing subsidiary (consolidated and not) are warranted.

*QUESTION 2: If subsidiary financial statements are to be replaced by summary financial information in consolidated financial statements of the parent, would a similar set of information as required for parent entities (as per corporate regulation 2M.3.01) be sufficient or does something need to be added or reduced from that list?*

14. Most of the banks specifically mentioned that, while the summary financial information about a subsidiary (similar to that required by regulation 2M.3.01 for parent entities – see paragraph 23 of this Report) gives useful high level information, lending decisions require a comprehensive analysis of a borrowing subsidiary's full set of financial statements (as mentioned in the responses to question 1).
15. Most of the banks also mentioned that there is no 'one size fits all'. The risk assessment (risk grade – which includes both financial and non-financial factors) of each individual borrower and their respective circumstances provides a guide as to any additional information that may be required beyond the individual financial statements of the borrowing entity. For example, in the case of wholly owned subsidiaries with low risk grade and with a deed of cross guarantee, reliance may be placed only on the consolidated financial statements of the group (including the summary financial information similar to that currently required by Regulation 2M.3.01 for parent entities) but this is not in all cases.
16. In addition to the summary financial information required by Regulation 2M.3.01, key information that banks specifically look at in making lending decisions to a subsidiary (apart from the subsidiary's statement of financial position, statement of profit or loss and other comprehensive income and statement of changes in equity as per AASB 101 *Presentation of Financial Statements*) are listed in the following paragraph (some of which is currently required to be included in subsidiary only financial statements as per current accounting standards, and some of which is not currently so required):
17. Financial information used by banks as lenders that is currently required by the accounting standards in subsidiary only financial statements (where they are prepared):

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- Cash flows
  - Cash flow statement (AASB 107 *Statement of Cash Flows*)
- Income
  - Detailed disclosures for revenue (AASB 15 *Revenue from Contracts with Customers*; and AASB 118 *Revenue*)
- Income taxes
  - Detailed disclosures for income taxes (AASB 112 *Income Taxes*)
- Assets and Liabilities
  - Detailed disclosures for property, plant and equipment (AASB 116 *Property, Plant and Equipment*)
  - Detailed disclosures for impairment (AASB 136 *Impairment of Assets*)
  - Detailed disclosures about liabilities (current loan facilities along with repayment schedule) (AASB 101 *Presentation of Financial Statements*; AASB 7 *Financial Instruments: Disclosures*)
  - Information on working capital, including detailed disclosures for current assets and current liabilities such as inventory, debtors ageing and contractual maturities creditors (AASB 101 *Presentation of Financial Statements*; AASB 7 *Financial Instruments: Disclosures*)
  - Off balance sheet items (for example, information on operating and finance leases as per AASB 117 *Leases*)
  - Commitments and contingent liabilities
  - Cross guarantees (AASB 124 *Related Party Disclosures*; AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*)
- Group structure and business combinations
  - Details of the group structure (AASB 12 *Disclosure of Interests in other Entities*)
  - Related party disclosures (AASB 124 *Related Party Disclosures*)
  - Detailed disclosures for business combinations (for example acquisition of subsidiaries) during the year (AASB 3 *Business Combinations*)

Apart from the information as mentioned in the bullet points above that is available from the individual financial statements of a borrowing subsidiary, additional information such as the following is also required, which may be derived from individual financial statements of the borrowing subsidiary or additionally required (and is arguably outside the scope of GPFs):

- Nature of the borrower: for example if it is a subsidiary to which the banks are lending, whether it is an operating subsidiary or a financing vehicle (i.e. handling treasury operations of the entire group)
- Directors' report
- Auditor's reports
- Project reports or due diligence reports, especially in relation to new ventures
- Cash flow projections
- Legal recourse to which entity in case of default
- Information to calculate various ratios of the borrowing subsidiary such as debt gearing, liquidity and debt service ratios
- Structural subordination of the debt
- Expenditure on property, plant and equipment, distinguishing between expenditure incurred for growth compared with maintenance.

18. In summary, the common response to this question indicates the banks are of a view that if summary financial information about a subsidiary were to replace a full set of financial statements of the subsidiary, the current summary required by Regulation 2M.3.01 is not sufficient for lending decisions. Indeed, given the long list of additional information required by

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banks (see the bullet points in paragraph 17 of this Appendix above), a full set of subsidiary financial statements might continue to be the most efficient way to provide the information.

*QUESTION 3: Do you ask for General Purpose Financial Statements or do you accept special purpose financial statements? What additional information do you ask for (e.g. an independent audit)? If you do accept special purpose financial statements, is there a financial consequence (i.e. penalty due to additional risk)?*

19. Most of the banks mentioned that they require audited GPFs where their clients are required to prepare GPFs as per accounting standards. However, where their clients are not required to prepare GPFs and prepare only special purpose financial statements (SPFs), the banks require their clients to have prepared the SPFs in a manner consistent with all the recognition and measurement requirements in accounting standards (and therefore, presumably, not consolidated – see paragraph 31 above re RG85). However, since SPFs do not require all disclosures as per accounting standards, additional information is sought along the lines of some or all of those listed in bullet points in paragraphs 17 above. Depending on the risk grade of the borrower and information available, security and guarantees for the debt would also be required.
20. To summarise, reliance is placed on audited GPFs, which provide the banks with a greater level of comfort before making lending decisions (except in case of those clients who are not required under accounting standards to prepare GPFs, and even in this case the minimum acceptable is compliance with all recognition and measurement requirements with disclosures specifically required by the bank).

*QUESTION 4: If summary financial information are provided, in your view, should the amounts disclosed be based on subsidiary's individual financial statements or should these be based on consolidated amounts (for example, after adjusting for impact if different accounting policies adopted by the parent)?*

21. Despite the banks' responses to question 2 (in which they essentially rejected the use of summary financial information as a substitute for subsidiary financial statements), they indulged us by responding to this question. One of the issues pertinent to this question is, for example, how should assets be measured for disclosure purposes: at amounts based on their cost when originally acquired by the subsidiary or based on their fair value when the subsidiary was acquired by the group?
22. The majority of the banks expressed a view that the accounting policies should ideally be the same, unless the parent company is merely a shell/holding company and the subsidiary company carries the main operation. Most of the banks expressed a view that in any event they would not expect there to be major areas of different accounting policies between subsidiaries and their parent in practice.
23. Two banks stated that the summary financial information of the subsidiary should be based on the group's accounting policies – for consistency and to avoid users being confused.
24. In contrast, one of the banks mentioned that it is essential to keep the summary financial information about the subsidiary based on subsidiary accounting policies as this may become especially relevant in cases where parent and subsidiaries belong to different industries and it is a diversified group.
25. One bank specifically mentioned that it does not have a preference but noted that it would depend on materiality of the difference in accounting policies between parent and subsidiary.



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26. In summary, the views were somewhat mixed, and might, although not explicitly raised with the respondents, also throw some light on the views of banks on the extent to which the accounting policies adopted by a subsidiary in its separate financial statements should be allowed to differ from the accounting policies adopted in the consolidated financial statements.<sup>56</sup>

### *Lending demographics:*

*QUESTION 5: Do you usually lend to subsidiaries – if so do you require cross guarantees from parents or other group entities?*

*(This question about cross guarantees was raised to get an understanding regarding the extent to which the banks rely on security from the parent entity compared with relying on an assessment of the independent service capacity of the borrowing entity. For example, the former may suggest that consolidated financial statements of the group along with summary information about the borrowing entity may serve the lending decisions of the banks, however the latter would suggest that individual financial statements of the subsidiary would be required for lending decisions rather than mere summary financial information in the consolidated financial statements.)*

27. Most of the banks mentioned they have a diversified portfolio of clients i.e. they lend to parent companies as well as at subsidiary levels.
28. Most of the banks noted that they specifically request deeds of cross guarantee. Some banks mentioned that requesting deeds of cross guarantee depends on the risk grade of the borrowers. One of the banks specifically mentioned that some large public companies may not agree to give deeds of cross guarantee and in those case the individual financial statements of the borrowing subsidiary are required. Similarly, cross guarantees are not common in cases of offshore lending, thus in such cases individual financial statements of the borrowing subsidiary are required.
29. Having said that, most banks mentioned that deeds of cross guarantee act as an additional comfort in that they enable a greater reliance to be placed on the consolidated financial statements. But, on a case by case basis, this does not completely rule out the relevance of individual financial statements of the borrowing subsidiary after having regard to a combination of multiple factors including risk grade, amount of the borrowing and nature of the loan facility, group structure, existing lending arrangements, cash flow projections, project reports, and due diligence reports especially in the case of a new venture.
30. Further, it also depends on whether the subsidiary to which the loan facility is being granted is a purely treasury company (i.e. handling the treasury operations of the group) or whether that subsidiary is an operating subsidiary having its own operations, assets and stream of income. This is additionally a deciding factor of whether deeds of cross guarantee would be sought. For example, where the subsidiary is an operating subsidiary, reliance generally is placed on the cash flow generation capacity of the subsidiary rather than the deed of cross guarantee.
31. In summary, the banks responses to this question are consistent with the comments made in paragraph X above where their lending policies emphasise debt servicing capacity of the individual borrowing entity but also give significant weight to security, with the different emphases being circumstance specific.

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<sup>56</sup> This gives rise to a question of the extent to which the accounting policies adopted by a subsidiary in its individual financial statements could be different from the accounting policies of the group. This question is outside the scope of this Research Report.

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*QUESTION 6: What type of information do you require if a group gets into financial difficulties? If the subsidiary gets into financial difficulties, does the group take over subsidiary's financial obligation or "walk away"?*

*(The reason for asking this question in the context of this Report is similar to the reason for question 5 i.e. if the group stands behind the subsidiary in case of financial difficulties faced by the subsidiary, then consolidated financial statements of the group with summary financial information about the borrowing subsidiary may suffice instead of individual financial statements of the borrowing subsidiary.)*

32. The majority of banks mentioned they have knowledge of cases where a holding company does not support a subsidiary when the latter becomes insolvent.
33. The banks mentioned that in these cases the financial statements of the subsidiary become more important, especially where the banks do not have access to the group cash flows, unless the debts are guaranteed by the parent, in which case it will be required to fulfil its obligations as a guarantor. Two banks specifically mentioned that if the subsidiary is of a significant scale and size, its insolvency will have an overwhelming impact on the group as a whole and that the whole group becomes insolvent.

*QUESTION 7: Do you lend to parent entities? Is summary financial information as per corporate regulation 2M.3.01 generally sufficient for making lending decisions to parents?*

34. As also noted in their responses to question 6, most of the banks mentioned they have a diversified portfolio of clients i.e. they lend to parent companies as well as at subsidiary levels.
35. Two of the banks mentioned they are very selective in lending to parent entities especially overseas unless they are backed by high external rating/investment grade and credit worthiness.
36. Most of the banks mentioned they would require an understanding of how the debt is structurally subordinated. The comments relating to parent only financial statements are broadly consistent with those made about subsidiary financial statements as listed in paragraphs 10-33 of this Appendix above i.e. it depends on a case by case consideration.

### DRAFT CONCLUSION

Based on the outcome of our outreach reported in appendix X of this Report, it is apparent that lending decisions are very circumstance specific and based on a lender's judgement on what different documentation or different parts of financial statements or other information they regard as relevant to their decision.

Examples of factors that influence the perceived need for separate subsidiary/parent financial statements (and/or summary information thereon) include risk grades, deeds of cross guarantee, debt subordination, group structure, nature and operations of the borrowing entity, previous history of the borrower, current outstanding facilities, and the nature of the lending facility requested.

Thus, based on feedback received from banks it cannot be concluded that disclosure of summary financial information about the subsidiary in the consolidated financial statements (similar the 'parent entities separate financial information' as currently required in the consolidated financial statements of the group by Regulation 2M.3.01 (Refer paragraph XX))

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would be a sufficient replacement for the individual financial statements of the borrowing subsidiary in all cases.

### Note to Board

We may relocate the conclusion to appropriate places in the Report

Also, a more robust conclusion needs to be inserted, to explicitly state the extent to which our review of the relative usefulness of CFS, parent and subsidiary financial statements along with feedback from the outreach throws light on the question of 'whether CFS can be a substitute for parent/subsidiary financial statements'.

## Appendix B: International comparison

Note to Board: This section is pending to be completed

## Appendix C: Extracts from Explanatory memorandum to the Corporations Amendment (Corporate Reporting Reform) Bill 2010

### “Parent entity financial statements

#### **Problem**

10.36 The Corporations Act requires companies to prepare audited financial statements for both the consolidated entity and the parent entity. This results in companies having to include a minimum of four columns in their financial statements ie figures for the current financial year and the preceding financial year for both the parent entity and the consolidated entity.

10.37 The presentation of full parent entity financial statements together with the consolidated financial statements clutters the annual report with unnecessary detail and is potentially confusing to users. The

Group of 100 (comprising the Chief Financial Officers of Australia's largest entities) in a submission to Treasury noted that the replacement of full parent entity financial statements with summary information would reduce the burden of regulation on business, reduce business costs and remove unnecessary disclosures from an entity's annual report.

10.38 The issue of the usefulness and value of separate parent entity financial statements has been debated in Australia for a number of years. In 2003, the Australian Accounting Standards Board (AASB) commissioned a research project on the relevance of parent entity financial reports and issued a discussion Report titled *The Relevance of Parent Entity Financial Reports*. The AASB believes that there is a need for revision in respect of parent entity reporting.

10.39 The costs associated with the preparation and audit of full parent entity financial statements will be dependent on the size and complexity of the entity and relativities around the size of the parent as opposed to the consolidated entity. The Group of 100 have indicated that the removal of the requirement to prepare parent entity financial statements would result in significant cost savings in external audit alone with the incremental audit costs for parent entity financial statements being in the vicinity of \$20,000 to \$25,000 for the top 150 ASX companies.

10.40 While a number of stakeholders have indicated that full parent entity financial statements do not provide useful and relevant information to most users of financial information, they have noted that there would be value in the presentation of key financial information on the parent entity in a summarised form.

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### **Objective**

10.41 The objectives are: to ensure that all stakeholders have access to an appropriate level of parent entity financial information; and, at the same time, to reduce the compliance burden on entities that produce full parent entity financial statements.

### **Options**

#### **Option A: Do nothing**

10.42 The current requirement to prepare and have audited full parent entity financial statements would be retained under this option.

#### **Option B: Allow companies to prepare summary financial information in relation to the parent entity**

10.43 Under this option, full parent entity financial statements would be replaced by summary data for the parent entity consisting of: the parent entity's current and total assets; current and total liabilities and total shareholders' equity; the parent entity's net profit after tax and total retained earnings; details of any guarantees entered into by the parent entity in relation to the debts of its subsidiaries; and details of any contingent liabilities applicable to the parent entity and the parent entity's capital commitments.

#### **Option C: Allow companies to not report any financial information in relation to the parent entity**

10.44 This option proposes that the parent entity would not include any separate parent entity financial information in its financial statements.

### **Impact analysis**

#### **Impact group identification**

10.45 Affected groups:

- users of financial statements;
- preparers of financial statements; and
- regulatory Government agencies that rely on financial statements to conduct their supervisory duties.

#### **Assessment of costs and benefits**

##### **Option A: Do nothing**

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	<i>Benefits</i>	<i>Costs</i>
Users	Users of company financial statements would continue to have the access to a full range of information on the parent entity and the consolidated entity.	Retains an added level of complexity in the presentation of the financial reports for those users who may not understand the correlation, if any, between the operations of the company and the parent entity.
Preparers		Significant resource and time costs would continue to be incurred in preparing and auditing parent entity information.
Government/regulators		

**Option B: Allow companies to prepare summary financial information in relation to the parent entity**

	<i>Benefits</i>	<i>Costs</i>
Users	Reduced complexity for users of company financial statements. [+1]	Decrease in the level of information available to users of company financial statements. [-1]
Preparers	Substantial decrease in compliance costs resulting from a reduction in the level of resources needed to prepare and audit parent entity data. [+2]	A reduction in potential savings through having to maintain separate parent entity financial statements for prudential purposes. [-1]
Government/regulators		
Sub-rating	+3	-2
Overall rating	+1	

**Option C: Allow companies to not report any financial information in relation to the parent entity**

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	<i>Benefits</i>	<i>Costs</i>
Users	Reduced complexity for users of company financial reports. [+1]	Decrease in the level of information available to users of company financial reports. [-3]
Preparers	Significant decrease in compliance costs resulting from a reduction in the level of resources needed to prepare and audit parent entity data. [+3]	A reduction in potential savings through having to produce parent entity financial statements on request for specific shareholders and creditors as well as APRA. [-2]
Government/regulators		
Sub-rating	+4	-5
Overall rating	-1	

**Consultation**

10.46 Targeted consultation occurred on this proposal in August 2008.

10.47 A number of stakeholders have called for the removal of the requirement to prepare (and audit) separate parent entity financial statements to be replaced by summarised information. Stakeholders include the Group of 100, the professional accounting bodies (The Institute of Chartered Accountants Australia, CPA Australia and the National Institute of Accountants), a number of audit firms and individual companies.

**Conclusion and recommended option**

10.48 Option A is not preferred. While the current requirements provide significant information to stakeholders, questions have been raised as to whether stakeholders require or understand the financial statements as presented. As compliance costs associated with preparing and auditing parent entity financial statements are significant, the value of this information appears to be disproportionate to its cost.

10.49 Option B is the preferred option. This option strikes a more effective balance between the needs of users of parent entity financial information and the cost of preparing such information. Users of parent entity financial statements, including shareholders would still retain access to relevant financial information relating to the parent entity through the summary report. While some information on the parent entity would no longer be reported, stakeholders have indicated that this information is not widely used and only adds to the complexity of the financial statements. The costs to prepare and audit of summary financial information will be significantly lower than the costs to prepare and audit separate parent entity financial statements — the extent of these costs savings will be dependent on the size and complexity of the entity and the relativities around the size of the parent as opposed to the consolidated entity. The Group of 100 estimates that the incremental savings from audit alone would be in the vicinity of \$20,000 to \$25,000 for large listed companies.

10.50 Option C is not preferred because the trade-off in reduced preparation expenses for industry is likely to be offset by the need to produce parent entity financial statements, or some form of summary parent entity information, on request for specific stakeholders. The impact of producing

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this information may be compounded by the fact that different data would be requested by different stakeholders, meaning that information may need to be customised. The impact on those stakeholders who do not have the capacity to request this information is also increased, as these users would then have no way of accessing financial information on the parent entity.”

### **Appendix D: ASIC’s ‘Relief for wholly-owned entities under ASIC Corporations (Wholly-owned Companies) Instrument 2016/785**

The ASIC’s ‘Relief for wholly-owned entities under ASIC Corporations (Wholly-owned Companies) Instrument 2016/785 can be found at <https://www.legislation.gov.au/Details/F2016C01085>

### **Appendix E: ASIC Corporations (Foreign-Controlled Company Reports) Instrument 2017/204**

The ASIC Corporations (Foreign-Controlled Company Reports) Instrument 2017/204 can be found at <https://www.legislation.gov.au/Details/F2017L00307>

### **Appendix F History of consolidated financial statements**

Note to Board: This section is pending to be completed
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