

Heads Up

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FASB and IASB Publish Exposure Draft on Reporting Entity Concept for the Conceptual Framework

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As part of the FASB’s and the IASB’s multi-phased joint project to develop a common conceptual framework, the Boards published an exposure draft, *Conceptual Framework for Financial Reporting: The Reporting Entity*, on March 11. The Boards believe that establishing a common definition of the “reporting entity concept” at the framework level will yield greater consistency in the consolidation project at the standards level.

The exposure draft incorporates the key concepts proposed in the FASB’s May 2008 discussion paper¹ (“2008 DP”) and addresses some of its respondents’ concerns. Comments on the exposure draft are due by July 16, 2010.

Importance of the Reporting Entity Concept

The 2008 DP notes that in the first phase of their conceptual framework project, the Boards tentatively decided that the “objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders and other creditors in making decisions in their capacity as capital providers.” The Boards expressed their belief that to achieve this objective, they must first define “the subject of financial reporting” — that is, the reporting entity.

Definition of a Reporting Entity

The exposure draft proposes the following definition:

A reporting entity is a circumscribed area of economic activities whose financial information has the potential to be useful to existing and potential equity investors, lenders and other creditors who cannot directly obtain the information they need in making decisions about providing resources to the entity and in assessing whether management and the governing board of that entity have made efficient and effective use of the resources provided.

Further, the exposure draft outlines three features that are “necessary but not always sufficient to identify a reporting entity”:

- a. Economic activities are being conducted, have been conducted, or will be conducted
- b. Those economic activities can be objectively distinguished from those of other entities and from the economic environment in which the entity exists
- c. Financial information about the economic activities has the potential to be useful [to existing and potential equity investors, lenders and other creditors].

The exposure draft also outlines the Boards’ position that legal structure is not determinative of the existence of a reporting entity and that the focus should be on the entity’s economic activities. This approach may result in a portion of a legal entity being considered a reporting entity. For example, a division of a legal entity may constitute a

¹ FASB Preliminary Views, *Conceptual Framework for Financial Reporting: The Reporting Entity*.

reporting entity if its economic activities can be distinguished objectively from the rest of the legal entity. Conversely, a single legal entity may not represent a reporting entity when its economic activities are so commingled with the economic activities of another entity that they cannot be objectively distinguished. In such a case, the reporting entity would comprise both legal entities.

Consolidated Financial Statements

The identification of control is the primary means for determining which entities should be reported as a single unit in consolidated financial statements. When an entity (parent) controls another entity, the parent should present consolidated financial statements. In a departure from the 2008 DP, the exposure draft defines control only in very broad terms, noting that “an entity controls another entity when it has the power to direct the activities of that other entity to generate benefits for (or limit losses to) itself.” Detailed definitions and implementation guidance will be developed at the standards level as part of the Boards’ joint consolidation project.

Editor’s Note: Although the FASB’s and IASB’s convergence project on consolidation remains active, the FASB believed that an immediate improvement to the consolidation model in the United States was necessary and therefore issued Statement 167² (codified by ASU 2009-17³) in 2009. At monthly meetings, the FASB and IASB continue to deliberate issues on consolidation guidance for all entities, and the Boards are expected to issue exposure drafts related to this project in the second quarter of 2010.

Some respondents to the 2008 DP suggested that the Boards complete the consolidation project before issuing an exposure draft on the reporting entity concept. In the exposure draft’s Basis for Conclusion, the Boards acknowledge this feedback and indicate that the conceptual framework is an “aid in developing standards” and that because the reporting entity concept is stated in general terms, it is unlikely to conflict with conclusions preliminarily reached in standards-level projects. Accordingly, the Boards believe that developing the reporting entity concept while also participating in the consolidation project is beneficial and should continue.

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Other Types of Financial Statements

The exposure draft mandates the presentation of consolidated financial statements whenever a parent controls one or more entities. However, the Boards recognize that other types of financial statements may provide useful information. Therefore, the exposure draft proposes that a parent entity may present *parent-only* financial statements as long as they are presented together with the consolidated financial statements. Similarly, the exposure draft acknowledges that *combined* financial statements that include two or more commonly controlled entities may provide useful information about those commonly controlled entities as a group. However, the Boards noted that combined financial statements are no substitute for consolidated financial statements.

² FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*.

³ FASB Accounting Standards Update No. 2009-17, *Improvements to Financial Reporting by Enterprises Involved With Variable Interest Entities*.

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