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IASB publishes Exposure Draft on Conceptual Framework Description of the Reporting Entity

On 11 March 2010, the International Accounting Standards Board (IASB) published Exposure Draft ED/2010/2 (ED) Conceptual Framework for Financial Reporting – The Reporting Entity. This ED forms part of the multi-phased joint IASB and US Financial Accounting Standard Board (FASB) project to develop a common conceptual framework. The Boards believe that establishing a common definition of the reporting entity concept at the framework level will assist in developing a consistent approach on the consolidation project at the standard-level.

The ED retains the key concepts that were proposed in the Discussion Paper (DP) published in May 2008 but addresses some of the concerns expressed by respondents at that time. Comments on the ED are due by 16 July 2010.

Importance of the reporting entity concept

As part of phase A "Objectives and Qualitative Characteristics" of the Conceptual Framework Project, the Board 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 those capacities. In order to achieve this objective, it is therefore important to define the subject of financial reporting, i.e. *the reporting entity*.

Definition of a reporting entity

The ED proposes that 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."

The ED specifies three necessary features of a reporting entity as follows:

- economic activities are being conducted, have been conducted, or will be conducted;
- the economic activities can be objectively distinguished from those of other entities and from the economic environment in which the entity exists; and
- financial information about the economic activities has the potential to be useful to existing and potential equity investors, lenders and other creditors.

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The ED reconfirms that the existence of a legal structure is not determinative of the existence of a reporting entity. Instead of placing emphasis on the legal structure, the ED focuses on the 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 represent a 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. Instead, in such a case, the reporting entity would constitute 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 change to the DP, the ED defines control only in very broad terms and establishes 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". The detailed definitions and implementation guidance will be established at the standard level as part of the consolidation project which is expected to be completed by the IASB in the fourth quarter of 2010.

Other types of financial statements

The ED mandates the presentation of consolidated financial statements whenever a parent controls one or more entities. However, the Boards recognise that other types of financial statements may provide useful information. Therefore, the ED 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 ED 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, combined financial statements are no substitute for consolidated financial statements.

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