FINANCIAL ACCOUNTING SERIES

EXPOSURE DRAFT

Proposed Statement of Financial Accounting Concepts

Issued: March 11, 2010
Comments Due: July 16, 2010

Conceptual Framework for Financial Reporting:

The Reporting Entity

This Exposure Draft of a proposed Statement of Financial Accounting Concepts is issued by the Board for public comment. Written comments should be addressed to:

Technical Director
File Reference No. 1770-100

Financial Accounting Standards Board
of the Financial Accounting Foundation

Responses from interested parties wishing to comment on the Exposure Draft must be *received* in writing by July 16, 2010. Interested parties should submit their comments by email to director@fasb.org, File Reference No. 1770-100. Those without email may send their comments to the "Technical Director, File Reference No. 1770-100, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116." Do not send responses by fax. Please send only one comment letter to either the FASB or the International Accounting Standards Board (IASB), which is also requesting comments on this jointly issued Exposure Draft. The FASB and the IASB will share and consider jointly all comment letters received.

Comments are most helpful if they:

a. Indicate the specific paragraph or paragraphs to which the comments relate
b. Contain a clear rationale
c. Include any alternative the Boards should consider.

All comments received constitute part of the FASB's public file. The FASB will make all comments publicly available by posting them to its website and by making them available in its public reference room in Norwalk, Connecticut.

An electronic copy of this Exposure Draft is available on the FASB's website until the FASB issues a final document.

Financial Accounting Standards Board
of the Financial Accounting Foundation
401 Merritt 7, PO Box 5116, Norwalk, Connecticut 06856-5116

NOTICE FOR RECIPIENTS

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) invite comments on all matters in this Exposure Draft. Comments are helpful if they:

(a) Indicate the specific paragraph or paragraphs to which the comments relate
(b) Contain a clear rationale
(c) Include any alternative the Boards should consider.

Respondents should submit one comment letter to either the FASB or the IASB. The Boards will share and consider jointly all comment letters received.

Respondents must submit comments in writing by July 16, 2010.

Respondents are also invited to comment on the following questions.

1. Do you agree 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 the management and the governing board of that entity have made efficient and effective use of the resources provided? (See paragraphs RE2 and BC4–BC7.) If not, why?
2. Do you agree that if an entity that controls one or more entities prepares financial reports, it should present consolidated financial statements? Do you agree with the

definition of control of an entity? (See paragraphs RE7–RE8 and BC18–BC23.) If not, why?

3. Do you agree that a portion of an entity could qualify as a reporting entity if the economic activities of that portion can be distinguished from the rest of the entity and financial information about that portion of the entity has the potential to be useful in making decisions about providing resources to that portion of the entity? (See paragraphs RE6 and BC10.) If not, why?
4. The FASB and the IASB are working together to develop common standards on consolidation that would apply to all types of entities. Do you agree that completion of the reporting entity concept should not be delayed until those standards have been issued? (See paragraph BC27.) If not, why?

Proposed Statement of Financial Accounting Concepts

Conceptual Framework for Financial Reporting: The Reporting Entity

March 11, 2010

CONTENTS

Paragraph Numbers

PREFACE

P1. In May 2008, the FASB and the IASB published for public comment a Discussion Paper, *Preliminary Views – Conceptual Framework for Financial Reporting: The Reporting Entity.*

P2. The Boards received 84 comment letters on that Discussion Paper. This Exposure Draft represents the FASB's views after considering respondents' comments and the views received through other outreach initiatives, including the FASB's reasons for modifying some of its preliminary views.

P3. Both Boards have published this common Exposure Draft for public comment. It relates to one part of the FASB's conceptual framework. The Boards share the ultimate goal of adopting the improved framework as a replacement of their present frameworks.

P4. The Boards' Exposure Draft, *Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information*, explains why the Boards are reconsidering their conceptual frameworks. It also explains the process for developing the common conceptual framework. For convenience, some aspects of this process are also explained below.

Developing the Common Conceptual Framework

P5. The Boards concluded that a comprehensive reconsideration of all concepts would not be an efficient use of their resources. Many aspects of their frameworks are consistent with each other and do not seem to need fundamental revision. Instead, the Boards adopted an approach that focuses mainly on the improvement and convergence of their existing frameworks, giving priority to issues that are likely to yield standard-setting benefits in the near term.

P6. The Boards decided to focus initially on concepts applicable to business entities in the private sector. Once concepts for those entities are developed, the Boards will consider the applicability of those concepts to financial reporting by other types of entities, such as not-for-profit entities in the private sector and, in some jurisdictions, business entities in the public (governmental) sector.

P7. In this phase of the conceptual framework project the Boards are considering conceptual matters relating to the reporting entity. Other active phases are considering many conceptual matters, such as:

(a) The objective of financial reporting and the qualitative characteristics of financial reporting information
(b) The elements of financial statements
(c) Measurement.

P8. The Boards will consider, in later phases, matters of presentation and disclosure and, as discussed above, the applicability of the concepts in earlier phases to other types of entities.

Due Process

P9. As part of their due process, the Boards plan to consult interested parties by publishing common Discussion Papers and Exposure Drafts of the common and improved framework. The Boards may also publish other due process documents to seek views on particular issues before developing preliminary views on those issues. The Boards also expect to continue to consult in other ways, such as through discussions with the FASB's Financial Accounting Standards Advisory Council, the IFRS Advisory

Council, and in roundtable and other meetings with interested parties.

Authoritative Status of the Framework

P10. Neither FASB Concepts Statements nor the IASB's *Framework for the Preparation and Presentation of Financial Statements* overrides authoritative standards, even though some standards may be inconsistent with them.

P11. IAS 1, *Presentation of Financial Statements,* requires an entity preparing financial statements in accordance with International Financial Reporting Standards (IFRSs) to consider the IASB's *Framework* when there is no standard or interpretation that specifically applies to a transaction, other event, or condition that deals with a similar and related issue.[1]

P12. Section 105-10-05 of the *FASB Accounting Standards Codification*™ states that FASB Concepts Statements are nonauthoritative.[2] If guidance for a transaction or event is not specified within a source of authoritative generally accepted accounting principles (GAAP) for that entity, an entity must first consider accounting principles for similar transactions or events within authoritative GAAP and then consider nonauthoritative guidance from other sources (including Concepts Statements). Although there is currently no firm plan, the FASB expects to reconsider the authoritative status of the FASB Concepts Statements at completion of the Conceptual Framework project, which could result in elevating its status to authoritative.

---

[1]IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors,* paragraphs 10 and 11.

[2]Paragraph 105-10-05-3 of the Accounting Standards Codification.

P13. In a separate project, the two Boards are reconsidering the existing requirements for preparing consolidated financial statements. The Boards believe that the reporting entity concept in this Exposure Draft is consistent with the approaches they are likely to pursue in the standards-level project.

P14. In preparing responses to this Exposure Draft, respondents should consider the differences in status of the Concepts Statements and the Accounting Standards Codification, as well as the possibility that the FASB Concepts Statements could be elevated to authoritative status in the future.

SUMMARY

The Reporting Entity

S1. 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 the management and the governing board of that entity have made efficient and effective use of the resources provided.

S2. 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. If an entity that controls one or more entities prepares financial reports, it should present consolidated financial statements.

S3. A portion of an entity could qualify as a reporting entity if the economic activities of that portion can be distinguished objectively from the rest of the entity and financial information about that portion of the entity has the potential to be useful in making decisions about providing resources to that portion of the entity.

CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

The Reporting Entity

Introduction

RE1. The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful in making decisions about providing resources to the entity and in assessing whether the management and the governing board of that entity have made efficient and effective use of the resources provided. The reporting entity concept is intended to further this objective.

Description

RE2. 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.

RE3. A reporting entity has three features:

a. Economic activities of an entity 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 of that entity has the potential to be useful in making decisions about providing resources to the entity and in assessing whether the management and the governing board have made efficient and effective use of the resources provided.

These features are necessary but not always sufficient to identify a reporting entity.

RE4. Identifying a reporting entity in a specific situation requires consideration of the boundary of the economic activities that are being conducted, have been conducted, or will be conducted. The existence of a legal entity is neither necessary nor sufficient to identify a reporting entity. A reporting entity can include more than one entity or it can be a portion of a single entity.

RE5. A single legal entity that conducts economic activities and does not control any other entity is likely to qualify as a reporting entity. Most, if not all, legal entities have the potential to be reporting entities. However, a single legal entity may not qualify as a reporting entity if, for example, its economic activities are commingled with the economic activities of another entity and there is no basis for objectively distinguishing their activities. In some jurisdictions, there may be questions about whether those entities are separate entities under the law.

RE6. A portion of an entity could qualify as a reporting entity if the economic activities of that portion can be distinguished objectively from the rest of the entity and financial information about that portion of the entity has the potential to be useful in making decisions about providing resources to that portion of the entity. For example, a potential equity investor could be considering a purchase of a branch or division of an entity.

Consolidated Financial Statements

RE7. 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.

RE8. If one entity controls another entity, the cash flows and other benefits flowing from the controlling entity to its equity investors, lenders, and other creditors often depend significantly on the cash flows and other benefits obtained from the entities it controls, which in turn depend on those entities' activities and the controlling entity's direction of those activities. Accordingly, if an entity that controls one or more entities prepares financial reports, it should present consolidated financial statements. Consolidated financial statements are most likely to provide useful information to the greatest number of users.

RE9. Two or more entities may share the power to direct the activities of another entity to generate benefits for (or limit losses to) themselves. In this case, none of the entities that share the power to direct the activities of this other entity individually controls this other entity. Accordingly, none of these entities would present information about itself and this other entity on a consolidated basis.

RE10. If one entity has *significant influence* over another entity, it does not control that other entity. The entity's ability to influence the activities of another entity without actually being able to direct those activities does not constitute power over that other entity.

Other Types of Financial Statements

Parent-Only Financial Statements

RE11. A controlling entity may present financial statements that provide information about its investments in the entities it controls, and the returns on those investments, rather than the economic resources and claims, and changes in those economic resources and claims, of those entities it controls. Such "parent-only" financial statements might provide useful information if they are presented together with consolidated financial statements.

Combined Financial Statements

RE12. Combined financial statements include information about two or more commonly controlled entities. Combined financial statements do not include information about the controlling entity and are often prepared when the controlling entity does not prepare financial reports. Combined financial statements might provide useful information about the commonly controlled entities as a group.

This proposed Concepts Statement was approved for publication by the unanimous vote of the five members of the Financial Accounting Standards Board:

Robert H. Herz, *Chairman*
Thomas J. Linsmeier
Leslie F. Seidman
Marc A. Siegel
Lawrence W. Smith

APPENDIX: BASIS FOR CONCLUSIONS

Introduction

BC1. This Basis for Conclusions summarizes considerations that members of the Financial Accounting Standards Board (FASB) thought significant in reaching the conclusions about the reporting entity concept. It includes reasons for accepting some alternatives and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC2. In May 2008, the FASB and the International Accounting Standards Board (IASB) published for public comment the Discussion Paper, *Preliminary Views – Conceptual Framework for Financial Reporting: The Reporting Entity*. The two Boards received 84 comment letters on that Discussion Paper. This Exposure Draft sets out the FASB's views, including its reasons for modifying some of its preliminary views, after considering respondents' comments and information received through other outreach initiatives.

The Reporting Entity

Introduction

BC3. The IASB's *Framework for the Preparation and Presentation of Financial Statements* defines the *reporting entity* as "an entity for which there are users who rely on the financial statements as their major source of financial information about the entity" (paragraph 8). The FASB's Statements of Financial Accounting Concepts do not contain a definition of a reporting entity or a discussion of how to identify one.

Description of a Reporting Entity

BC4. The description of a reporting entity in this conceptual framework is designed to be consistent with the objective of financial reporting. That objective refers to a reporting entity, and therefore a reporting entity needs to be identified to achieve this objective.

BC5. The Discussion Paper proposed that reporting entities should not be limited to legal entities but should be described as “a circumscribed area of business activity of interest to present and potential equity investors, lenders, and other capital providers.” Most respondents to the Discussion Paper agreed that a reporting entity should not be limited to business activities that are structured as legal entities.

BC6. However, many respondents asked the Boards to clarify whether the term *business* in the description of a reporting entity in the Discussion Paper had the same meaning as that defined in IFRS 3, *Business Combinations* (as revised in 2008), or of the Accounting Standards Codification Topic 805, Business Combinations (originally issued as FASB Statement No. 141 (revised 2007), *Business Combinations*). Some respondents suggested that the Boards should consider other descriptions. The Board concluded that the definition of a *business* in those standards was intended for a different purpose and was too restrictive for use in the reporting entity concept. The term *economic* avoids that problem, and is likely to work better when the Boards consider how the concepts apply to not-for-profit entities.

BC7. Some respondents to the Discussion Paper asked the Boards to clarify the nature of the “interest” of investors, lenders, and other creditors as discussed in the description of the reporting entity. As a result, the reporting entity description now includes the phrase “useful . . . in making decisions . . .” rather than “of interest.” That phrase conveys the intended meaning more clearly.

BC8. Some respondents said that the description of a reporting entity in the Discussion Paper would preclude inactive entities or entities that have not begun to operate from being a reporting entity. The Board did not intend to exclude those entities and that point is explicit in paragraph RE3(a).

BC9. Some respondents said that all legal entities should qualify as reporting entities by themselves. The Board disagreed because in some situations the boundaries between two legal entities may be artificial. For example, two legal entities may commingle their resources, claims, and operations to the extent that the economic activities of the two entities cannot be objectively distinguished. Rather, two such entities are likely to constitute a single reporting entity.

BC10. The Board affirmed its preliminary view that a reporting entity need not be a legal entity. Although many economic activities are conducted within a legal structure, such as a corporation, trust, partnership, or incorporated society, not all are conducted that way. Some economic activities might be conducted by a sole proprietorship that is not legally separate from its owner, but there may be need for a general purpose financial report relating to those activities, for example, to seek funding from a bank or to provide information to prospective purchasers of the set of economic activities. In some jurisdictions, an unincorporated branch of an overseas corporation might be required to provide financial information to existing and potential lenders or other creditors of that branch.

Control of an Entity

BC11. The Discussion Paper addressed issues related to *control of an entity* in detail. Although respondents generally agreed with the Board's preliminary views, some said that the issues should be dealt with at the standards level. The Board agreed and concluded that the conceptual framework should define *control of an entity* in general terms only and that the details should be specified at the standards level.

BC12. The concept of control is used both in the definitions of assets in existing conceptual frameworks and in accounting standards for determining the composition of a group of entities to be reported on as a single reporting entity. The Board affirmed its view in the Discussion Paper that it is not necessary to align the basis for determining the composition of a group of entities to be reported on as a single reporting entity with the definition of assets. The definitions of assets in existing conceptual frameworks refer to an entity and, thus, it could be argued that it is circular to use the definition of assets to determine what constitutes the entity. The same reasoning could apply to the definition of liabilities and other elements of financial statements. Accordingly, the Board concluded that the reporting entity concept should first determine what constitutes the entity that is reporting, and only then should the definition of assets (and other elements of financial statements) be applied to *that* entity.

BC13. In its ordinary sense, *control* is defined as follows:

> The fact of controlling, or of checking and directing action; the function or power of directing and regulating; domination, command, sway. [*Oxford English Dictionary*, Second Edition, 1989.]

Therefore, *control* may be viewed as a synonym of power, in particular, the power to direct something.

BC14. However, for financial reporting purposes, control also has a benefit element that serves to exclude situations in which one entity may have power over another entity as a trustee or agent for a third party. This is consistent with most, if not all, current definitions of *control of an entity* used in the accounting literature.

BC15. *Control of an entity* refers to both power and benefits. The benefits referred to are both positive and negative and could have been loosely described as risks and rewards. Some respondents to the Discussion Paper urged the Boards to base the composition of a group reporting entity on risks and rewards alone (that is, without the notion of power). The Discussion Paper presented the view of the Boards that the notion of risks and rewards, by itself, is not a conceptually robust basis for determining the composition of a group reporting entity. The basic idea was so broad that in order to place what seem like reasonable and necessary limits on which parties should be included in the group, it would be necessary to develop criteria that would involve drawing some bright lines, such as the minimum level of exposure to risks or entitlement to rewards. Most respondents agreed that determining the composition of a group reporting entity based on risks and rewards alone was not appropriate.

BC16. Some respondents to the Discussion Paper asked the Boards to clarify how to determine a reporting entity when two or more entities share the power to direct the activities of another entity. The Board concluded that, if two or more entities have *joint control* of another entity, none of the entities that share the power to direct the activities of this other entity individually controls this other entity.

BC17. Both Boards have standards for reporting relationships, referred to as *significant influence*. IAS 28, *Investments in Associates,* defines *significant influence* as "the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies." Accounting Standards Codification Topic 323, Investments—Equity Method and Joint Ventures (originally issued as Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*), has a similar definition. The Board affirmed its preliminary view that if an entity has *significant influence* over another entity, it does not control that other entity. Unlike control, significant influence is not exclusive. Only one entity can control an entity, but several entities can have significant influence over it.

Consolidated Financial Statements

BC18. Identifying the boundary of a reporting entity is not usually difficult if the economic activities are conducted within a single legal entity and that entity does not control any other entity. However, the same (or very similar) economic activities could be conducted using two or more entities, one of which controls the other(s).

BC19. The following example illustrates this point. Entity A conducts two sets of economic activities within the same entity. The prospects for future cash flows from Entity A to its equity investors, lenders, and other creditors depend on the success of both sets of economic activities. Because the degree of risk, expected profitability, opportunities for expansion, and other important factors may be different for the two sets of economic activities, the entity's cash flow prospects are affected by how management allocates resources between the two sets of economic activities. An equity investor, for example, cannot invest in one set of economic activities without simultaneously investing in the other. Thus, both are part of the same circumscribed area of economic activities that is Entity A.

BC20. Entity B conducts the same two sets of economic activities as Entity A, but it uses two legal entities. One legal entity conducts the first set of economic activities and holds all of the voting equity of the second legal entity, which conducts the second set of economic activities. In this case, the first legal entity's management or governing board has the power over both legal entities, one directly and one through its ability to participate in choosing the management or the members of the governing board of the second legal entity. The equity investors of the first legal entity have investments in both sets of economic activities. Their returns depend on the success or failure of the two legal entities viewed together as a single unit.

BC21. Although Entity A and Entity B are structured differently, the circumscribed area whose financial information has the potential to be useful to the greatest number of equity investors, lenders, and other creditors of the two entities who cannot directly obtain the information they need would include the economic activities of both entities.

BC22. The Board concluded that the boundaries of a reporting entity should be determined on the basis of *control of an entity*. 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.

BC23. Consolidated financial statements include information about the resources and claims, and changes in those resources and claims, of a controlling entity and all entities it controls. The Board concluded that if an entity that controls one or more entities prepares financial reports, it should present consolidated financial statements.

Parent-Only Financial Statements

BC24. In some jurisdictions, it is common for both parent-only financial statements and consolidated financial statements to be presented when an entity controls one or more entities. As discussed in paragraph RE7, the Board concluded that if an entity that controls one or more entities prepares financial reports, it should present consolidated financial statements. However, the Board also concluded that parent-only financial statements might provide useful information if they are presented together with consolidated financial statements. For example, parent-only financial statements might be helpful in assessing the level of dividends the controlling entity is legally able to pay without depending on transferring funds from the controlled entities.

Combined Financial Statements

BC25. As noted in paragraph RE7, the Board concluded that if an entity that controls one or more entities prepares financial reports, it should present consolidated financial statements. However, not all controlling entities prepare financial reports. For example, the controlling entity could be an individual or a group of individuals, such as a family. If so, combined financial statements might provide useful information about the commonly controlled entities as a group.

Proportionate Consolidation

BC26. Despite its name, proportionate consolidation is a method of accounting for an investment in another entity, instead of a method of reporting economic resources and claims of a controlled entity. Thus, the Board decided not to address proportionate consolidation.

Standards-Level Project on Consolidation

BC27. Some respondents to the Discussion Paper said that the Boards should work on the reporting entity concept only when they have completed their standards-level projects on consolidation. The Board acknowledged that it was working together with the IASB to develop common standards on consolidation that would apply to all types of entities. However, the main purpose of the conceptual framework is to aid in developing standards, which implies that concepts come first. In any case, the reporting entity concept is stated in general terms and is not likely to conflict with any conclusions that the Board has reached to date in standards-level projects. Accordingly, the Board concluded that the publication of this Exposure Draft and the completion of the reporting entity concept should not be delayed until the common standards on consolidation have been issued.