AASB Exposure Draft **ED 193**
March 2010

Conceptual Framework for Financial Reporting: The Reporting Entity

Comments to AASB by 21 June 2010

Australian Government
Australian Accounting Standards Board

Commenting on this AASB Exposure Draft

Constituents are strongly encouraged to respond to the AASB and the IASB. The AASB is seeking comment by 21 June 2010. This will enable the AASB to consider Australian constituents' comments in the process of formulating its own comments to the IASB, which are due by 16 July 2010. Comments should be addressed to:

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Victoria 8007
AUSTRALIA
E-mail: standard@aasb.gov.au

Respondents to the IASB are asked to send their comments electronically through the 'Open to Comment' page on the IASB website (www.iasb.org)

All submissions on possible, proposed or existing financial reporting requirements, or on the standard-setting process, will be placed on the public record unless the Chairman of the AASB agrees to those submissions being treated as confidential. The latter will only occur if the public interest warrants such treatment.

Obtaining a Copy of this AASB Exposure Draft

This AASB Exposure Draft is available on the AASB website: www.aasb.gov.au. Alternatively, printed copies of this AASB Exposure Draft are available by contacting:

The Customer Service Officer
Australian Accounting Standards Board
Level 7
600 Bourke Street
Melbourne Victoria
AUSTRALIA

Phone: (03) 9617 7637
Fax: (03) 9617 7608
E-mail: publications@aasb.gov.au
Postal address:
PO Box 204
Collins Street West Victoria 8007

Other Enquiries

Phone: (03) 9617 7600
Fax: (03) 9617 7608
E-mail: standard@aasb.gov.au

ISSN 1030-5882

BACKGROUND TO IASB-FASB AND IPSASB CONCEPTUAL FRAMEWORK PROJECTS

IASB-FASB Framework

In October 2004, as part of their commitment to achieving harmonisation of financial reporting standards, the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) embarked on a joint project to develop an improved, common conceptual framework that, once finalised, is expected to replace the existing frameworks currently used by the two Boards. The Boards have stated their objective is to produce principle-based financial reporting standards, and a common conceptual framework that is sound, comprehensive and internally consistent will help achieve this. Rather than undertake a fundamental re-think of the existing concepts, the project's aim is to build on the existing IASB and FASB frameworks by refining, updating and converging them into a common framework.

The project is being conducted in eight phases. Initially, the Boards are focusing on developing concepts applicable to business entities in the private sector. In a later phase of the project, the Boards will consider the applicability of those concepts to other types of entities, in particular, not-for-profit entities in the private sector.

This Exposure Draft is the result of work undertaken so far in Phase D of the project, on the reporting entity. In May 2008, the two Boards jointly issued a Discussion Paper for Phase D entitled *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Reporting Entity*, which was reproduced and released by the AASB as Invitation to Comment 17 without amendment in June 2008. The AASB's submission on that Discussion Paper can be accessed on the AASB website. This Exposure Draft is based on the IASB's and FASB's re-deliberations following consideration of the issues raised in the responses to the Discussion Paper.

The following table shows the phases of the IASB-FASB conceptual framework project and the plan for the release of various due process documents, extracted from the IASB Work Plan as at 3 March 2010 (further information about each phase is available on the IASB website):

Phase	*Estimated publication date*						
	2010 Q1	**2010 Q2**	**2010 Q3**	**2010 Q4**	**2011 Q1**	**2011 Q2**	**2011 H2+**
Phase A: Objectives and qualitative characteristics	Final chapter						
Phase B: Elements and recognition				DP		ED	
Phase C: Measurement				DP			ED
Phase D: Reporting entity	ED			Final chapter			
Phase E: Presentation and disclosure	Not yet started						
Phase F: Purpose and status	Not yet started						
Phase G: Application to not-for-profit entities	Not yet started						
Phase H: Remaining Issues	Not yet started						

The IASB and FASB have also decided that each Board, within the context of its respective current GAAP hierarchy, will finalise the common framework as parts (chapters) are completed. However, later phases of the project may include consequential amendments to parts of the framework that were completed in earlier phases.

IPSASB Framework

The International Public Sector Accounting Standards Board (IPSASB) is in the process of developing a public sector conceptual framework which is applicable to the preparation and presentation of general purpose financial reports of public sector entities. It is intended to develop the IPSASB Framework primarily for public sector entities other than Government Business Enterprises.

The Public Sector Conceptual Framework project was initiated in 2006 with a project brief that was approved in November 2006. It is a collaborative project that the IPSASB is leading in conjunction with a number of participating national standards setters and similar organisations.

Although the components of the IPSASB Framework under development are interconnected, the project is being progressed in phases, and the IPSASB will issue consultation papers at the conclusion of each phase, followed by an Exposure Draft of the complete accrual IPSASB Framework. This will:

(a) provide constituents with the opportunity to review and comment on components of the IPSASB Framework as they are developed, as well as the full Exposure Draft; and

(b) allow each stage of project development to be informed by responses to prior consultation papers.

This Exposure Draft is related to Phase 1 of the IPSASB's Framework project, specifically on the topic of the reporting entity. In September 2008, the IPSASB issued a Consultation Paper entitled *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: The Objectives of Financial Reporting, The Scope of Financial Reporting, The Qualitative Characteristics of Information Included in General Purpose Financial Reports, The Reporting Entity*. The AASB also invited comments on the IPSASB's Consultation Paper from Australian constituents, to assist the AASB make its submission to the IPSASB. The AASB's submission on that Consultation Paper can be accessed on the AASB website.

The components of the accrual IPSASB Framework have been grouped, and are being considered in the following sequence (based on information provided on the IPSASB website):

Phase	
Phase 1: Objectives of financial reporting, Scope of financial reporting, Qualitative characteristics of financial information, The reporting entity	Consultation Paper issued in September 2008
Phase 2: Definition and recognition of the "elements" that are reported in financial statements	In progress

Phase 3: Consideration of the measurement basis (or bases) that may validly be adopted for the elements that are recognised in the financial statements	Consultation Paper expected to be published in late 2010
Phase 4: Consideration of concepts that may underpin the cash basis of financial reporting	Currently inactive
Conclusion of all Phases	Exposure Draft covering all phases expected to be published in 2011/2012

The AASB considers that it is important to engage in both the IASB-FASB and IPSASB conceptual framework projects.

AASB REQUEST FOR COMMENTS

In light of the AASB's policy of incorporating International Financial Reporting Standards (IFRSs) into Australian Accounting Standards, the AASB is inviting comments on:

(c) any of the proposals in the attached IASB Exposure Draft, including the specific questions on the proposals as listed in the Invitation to Comment section of the attached IASB Exposure Draft; and

(d) the 'AASB Specific Matters for Comment' listed below.

The AASB would prefer that respondents supplement their opinions with detailed comments, whether supportive or critical, on the major issues. The AASB regards both critical and supportive comments as essential to a balanced review and will consider all submissions, whether they address all specific matters, additional issues or only one issue.

Relationship to other AASB Projects

Not-for-Profit aspects of the Conceptual Framework

The AASB *Framework* applies to all Australian entities that prepare general purpose financial statements. As noted above, the IASB has decided to consider the applicability to not-for-profit entities of the various amendments it makes to the IASB framework in a later phase of its project. Therefore, there are implications for the AASB *Framework* arising from the IASB's plan to finalise parts of its new framework before it has considered the applicability of any new or revised concepts to other types of entities.

The AASB, in conjunction with standard setting boards in Canada, New Zealand and the United Kingdom, has been monitoring the development of the IASB-FASB joint conceptual framework project from the perspective of private and public sector not-for-profit entities. The monitoring group consists of the Chairs and senior staff members of the above standard setters. A consultant is engaged by the group to monitor the IASB-FASB conceptual framework project. The group will provide feedback to the IASB-FASB project staff highlighting the implications of applying the concepts proposed in the Exposure Draft to private sector and public sector not-for-profit entities.

The AASB plans to consider how to incorporate any amendments to the existing IASB framework into the AASB *Framework*. The AASB's preliminary view is that, until such time as the IASB considers the applicability of any new or revised concepts to other types of entities, it may be necessary to limit the applicability of those new or revised concepts to for-profit entities. The New Zealand Financial Reporting Standards Board (FRSB) has the same preliminary views. In other words, if the IASB proceeds with replacing the relevant parts of the existing framework when work on Phase D is completed, then the AASB will consider whether those amendments should apply only to Australian for-profit entities, with the existing AASB *Framework* retained for not-for-profit entities, as an interim measure. Any decision on this issue will be made by the AASB when the IASB finalises the chapter on reporting entity, and will be affected by:

- whether the IASB proceeds with its plan to replace parts of its existing framework before considering the applicability of any new or revised concepts to other types of entities; and
- whether the revised parts of the IASB's framework are substantially different from the relevant parts of its existing framework, upon which the AASB *Framework* is based.

Defining the Reporting Entity in the Public Sector (including consideration of the concept of control)

The AASB expects that the Exposure Draft will have implications for the AASB's joint project with the New Zealand FRSB on Defining the Reporting Entity in the Public Sector (including consideration of the concept of control). That project is addressing issues such as the control of an entity and the control of assets (including administered items) in the public sector. The AASB's project raises fundamental issues such as whether or not government departments are reporting entities in their own right as distinct from arms of government that should be subject to segment-like reporting principles.

The AASB will consider the implications, if any, of the Exposure Draft proposals for this project.

Due Date for Comments to the AASB

Comments should be submitted to the AASB by 21 June 2010. This will enable the AASB to consider those comments in the process of formulating its own comments to the IASB. Constituents are also strongly encouraged to send their response to the IASB.

AASB Specific Matters for Comment

The AASB would particularly value comments on the following:

1. consistent with the initial scope of the IASB-FASB conceptual framework project being for-profit entities in the private sector, are there any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals by for-profit entities in the private sector;

2. as indicated above, the AASB plans to undertake additional consultation with constituents in relation to the applicability of the IASB-FASB proposals in the not-for-profit and public sectors. In the meantime, it would be helpful to the Board to be informed of issues that might arise if the proposals were to be applied in the not-for-profit/public sector. Accordingly, are there any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals relating to:

   (a) not-for-profit entities; and

   (b) public sector entities;

3. whether, overall, the proposals would result in financial statements that would be useful to users; and

4. whether the proposals are in the best interests of the Australian and New Zealand economies.

March 2010

Exposure Draft ED/2010/2

Conceptual Framework for Financial Reporting

The Reporting Entity

Comments to be received by 16 July 2010

International Accounting Standards Board®

Exposure Draft

Conceptual Framework for Financial Reporting: The Reporting Entity

Comments to be received by 16 July 2010

ED/2010/2

This exposure draft *Conceptual Framework for Financial Reporting: The Reporting Entity* is published by the International Accounting Standards Board (IASB) for comment only. The proposal may be modified in the light of the comments received before being issued in final form. Comments on the exposure draft and the Basis for Conclusions should be submitted in writing so as to be received by **16 July 2010.** Respondents are asked to send their comments electronically to the IASB website (www.iasb.org), using the 'Open to Comment' page.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

ISBN: 978-1-907026-65-2

International
Accounting Standards
Board®

Additional copies of this publication may be obtained from:
IASC Foundation Publications Department,
1st Floor, 30 Cannon Street, London EC4M 6XH, United Kingdom.
Tel: +44 (0)20 7332 2730 Fax: +44 (0)20 7332 2749
Email: publications@iasb.org Web: www.iasb.org

CONTENTS

Invitation to comment

The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) 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 IASB or the FASB. The boards will share and consider jointly all comment letters received.

Respondents must submit comments in writing by 16 July 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 IASB and the FASB 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?

Preface

P1 In May 2008 the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) published for public comment a discussion paper, *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Reporting Entity.*

P2 The boards received 84 comment letters on that discussion paper. This exposure draft represents the IASB's views after considering respondents' comments and the views received through other outreach initiatives, including the IASB'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 IASB'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 *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:

- the objective of financial reporting and the qualitative characteristics of financial reporting information
- the elements of financial statements
- 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 consult by publishing 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 IASB's IFRS Advisory Council, the FASB's Financial Accounting Standards Advisory Council and in round-table and other meetings with interested parties.

Authoritative status of the framework

P10 Neither the IASB's *Framework for the Preparation and Presentation of Financial Statements* nor FASB Concepts Statements override authoritative standards even though some 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.[*]

P12 Section 105-10-05 of the FASB *Accounting Standards Codification*™ (ASC) states that FASB Concepts Statements are non-authoritative.[†] 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 non-authoritative guidance from other sources (including Concepts Statements). Although

* IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, paragraphs 10 and 11

† paragraph 105-10-05-3 of the FASB ASC

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.

P13 In a separate project, the two boards are reconsidering the 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.

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.

[DRAFT] 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; and

(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.

Basis for Conclusions on the Reporting Entity

Introduction

BC1 This Basis for Conclusions summarises considerations that members of the International Accounting Standards Board (IASB) 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 IASB and the US Financial Accounting Standards Board (FASB) published for public comment the discussion paper, *Preliminary Views on an improved 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 IASB'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 FASB *Accounting Standards Codification™* Topic 805 *Business Combinations* (originally issued as SFAS 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 (ie 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'. ASC 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 FASB 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 the 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.