Bruce Pounder, CMA, CFM, Editor

"Boundary Issues" in Financial Reporting

The FASB and IASB have jointly proposed new principles for determining a reporting entity's boundaries.

For any financial report to be meaningful, the entity whose economic activities are being reported must be clearly identified. Because the *reporting entity* concept is so fundamental to financial reporting, standards such as U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) contain guidance on identifying entities for which financial statements should be prepared. But such guidance currently differs between U.S. GAAP and IFRS, and in both cases it lacks the support of robust principles for objectively determining the appropriate boundaries of the reporting entity.

In conjunction with their ongoing efforts to converge U.S. GAAP and IFRS at the standard level, the U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are developing a common conceptual framework that will be the foundation of future converged standards. On March 11, 2010, the Boards reached a key milestone in their joint conceptual framework project when they issued an exposure draft (ED) on the concept of a reporting entity. The ED defines a reporting entity and states the related principles on which the Boards intend to rely in the future. In this month's column, I'll explain what the Boards have proposed and how it would improve financial reporting.

Reporting Entities vs. Legal Entities

The ED defines a reporting entity as "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."

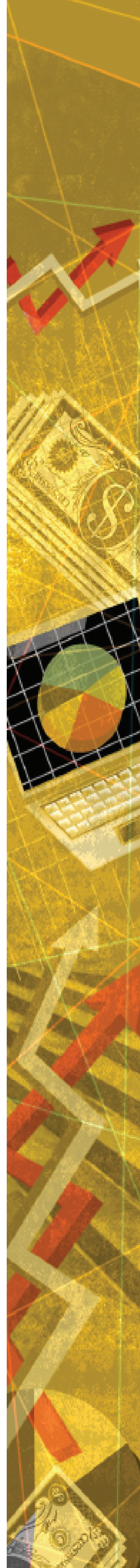
The ED goes on to identify three necessary features of a reporting entity. Two of the features are rather obvious from the definition of a reporting entity, but the third is more subtle: It must be possible to objectively distinguish the economic activities of the entity from those of other entities and from the economic environment in which the entity exists.

Under the proposed definition, it would be common for a reporting entity to be the same as a legal entity (e.g., a corporation). But the ED emphasizes that this isn't necessarily so. A reporting entity could include multiple legal entities, it could be just a portion of a legal entity, or it might not be organized as a legal entity at all. I'll now explore each of these possibilities.

Consolidation: It's All About Control

According to the ED, if a legal entity controls one or more other legal entities, it should prepare financial statements on a consolidated basis. In other words, the financial statements should reflect the economic resources and claims—and changes in those resources and claims—of the group of entities as a whole, even when third parties hold noncontrolling interests in one or more of the controlled entities. Thus can multiple legal entities comprise a single reporting entity.

Of course, applying this principle in practice requires an opera-



tional definition of *control*, which the Boards have provided: "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."

Note that this definition isn't couched in terms of the portion of an entity's voting stock that might be held by another entity. Furthermore, the definition doesn't refer indiscriminately to any power to direct an entity's activities; such power must be accompanied by a benefit (or loss-limiting) element in order to establish control. Similarly, a legal entity that's exposed to the risks and/or rewards of another legal entity's economic activities may not have the power to direct the other entity's activities, in which case control wouldn't exist and consolidation shouldn't occur.

What about a situation in which no one entity alone has the power to direct the activities of another entity to generate benefits for (or limit losses to) itself, but two or more entities jointly exercise such power? A simple, common example of this situation is a 50-50 joint venture. The ED makes it clear that, in such situations, neither venturer alone has control, so neither venturer would consolidate the joint venture in whole or in part. Likewise, consolidation wouldn't be appropriate in a situation where an entity has only "significant influence"—but not control—over another entity.

Other Situations

According to the ED, "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." Consequently, one branch or division of a legal entity could be a separate reporting entity if, for example, a potential buyer were considering the purchase of that one branch or division.

As the Boards point out in the ED, some economic activities aren't conducted through a legal entity at all, such as economic activities conducted by a sole proprietorship that isn't legally separate from its owner. If there's a need for general-purpose financial reporting relating to those activities (e.g., to apply for a bank loan), then a reporting entity may be identified in the absence of a legal entity.

Basing rules on core principles will lead to greater consistency among rules.

How Financial Reporting Would Improve

The proposed principles relating to the concept of a reporting entity would improve future financial reporting standards in three ways. First, the principles articulated in the ED would help the Boards address the problem of significant assets and/or liabilities not appearing on a reporting entity's balance sheet thanks to clever use of separate legal entities that aren't required to be consolidated under current standards. This problem has received considerable attention, especially in the wake of the global financial crisis (see, for example, "Is It Time to Consolidate?" in the February 2010 issue of *Strategic Finance*).

The second improvement would come from the Boards' ability to base specific reporting-entity rules in future financial reporting standards on robust principles, which simply don't exist in the conceptual frameworks of U.S. GAAP and IFRS today. Basing rules on core principles will lead to greater consistency among rules.

Finally, the mutual support of the FASB and IASB for a single set of reporting-entity principles will lead to greater consistency in financial reporting on a global scale, which benefits users of financial statements by fostering greater comparability. This benefit will become particularly apparent in the Boards' continuing efforts to improve and converge the consolidation provisions of U.S. GAAP and IFRS.

The ED comment period ends on July 16, 2010. Electronic versions of the ED are freely available at both the FASB and IASB websites (www.fasb.org and www.iasb.org, respectively). **SF**

Bruce Pounder, CMA, CFM, DipIFR (ACCA), is president of Leveraged Logic, a provider of educational products and services for accounting professionals. He is chair of IMA's Small Business Financial and Regulatory Affairs Committee and the liaison from that Committee to IMA's Financial Reporting Committee. You can reach Bruce at BPounder@LeveragedLogic.com.