MINUTES

Financial Accounting Standards Board

To:	Board Members		
From:	Gibbons (ext. 446)		
Subject:	Minutes of the April 5, 2006, Conceptual Framework Board Meeting	**Date:**	April 10, 2006
cc:	Leisenring, Bielstein, Smith, MacDonald, Mahoney, Polley, Carney, Lott, Gabriele, Sutay, Project Team; E-mail: FASB Intranet, Upton, Hickey, Crook, Rees, Lian, Hague, Villmann, Willis, GASB: Reese, Patton		

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Topics: Reporting Entity
Comment Letter Summary—Invitation to Comment: *Selected Issues Related to Assets and Liabilities with Uncertainties*

Basis for Discussion: FASB Memoranda 23 and 24

Length of Discussion: 9:00 a.m. to 10:55 a.m.

Attendance:

Board members present:	Herz, Batavick, Schipper, Seidman, Trott, and Young
Board members absent:	Crooch
Staff in charge of topics:	Crook and McBeth
Staff at Board table:	Bielstein, T. Johnson, Bullen, Bossio, McBeth, Abbate, Gibbons, and Zimmerman
Other participants:	by phone: Crook and Willis

Summary of Decisions Reached:

The Board continued its deliberations on the joint FASB/IASB conceptual framework project by discussing the reporting entity concept and the comments received on the FASB Invitation to Comment, *Selected Issues Related to Assets and Liabilities with Uncertainties*.

Reporting Entity

1. The Board discussed (a) the meaning of the term *entity*, (b) whether a parent-only entity may be the subject of general purpose financial reporting, and (c) the meaning of control, in the context of one entity having control over another entity.

The Meaning of Entity

2. The Board agreed that an entity for financial reporting purposes should not be limited to legal entities, such as companies, trusts, and partnerships. Rather, an entity should be defined more broadly to include other types of organizational structures, including a natural person, a sole proprietorship, and, in some circumstances, a branch or segment of a legal entity.

Parent-Only Entity

3. The Board agreed that a parent-only entity could be a reporting entity. Most Board members reached that conclusion by viewing the parent-only entity and a group entity as different entities. Those Board members regard the (a) separate (parent-only) financial statements of the parent as a stand-alone entity (for example, a parent with its investments in subsidiaries but excluding the assets, liabilities, and activities of its subsidiaries) as relating to the parent-only entity and (b) consolidated financial statements of the parent and its subsidiaries as relating to a group entity that combines the parent with one or more other entities, as if they were a single entity. Some Board members reached the conclusion that a parent-only entity could be a reporting entity but view the parent-only financial statements and the consolidated financial statements as different forms of presentation for the same entity.

The Meaning of Control

4. Board members generally agreed that control should be defined in the conceptual framework. They agreed with the definition of control proposed by the staff, which includes the notions of *power* and *benefits*, and offered suggestions for improving the definition.

Invitation to Comment

5. The staff presented an analysis of the comments received on the Invitation to Comment. The comments will be used during deliberations relating to the effects of uncertainty on the definition, recognition, and measurement of assets and liabilities in the conceptual framework project.

<u>Objective of Meeting</u>:

The Board discussed the reporting entity concept and the comments received on the Invitation to Comment. The objective of the meeting was to obtain decisions on the reporting entity concept and to discuss the use of the comments received on the Invitation to Comment during deliberations in the conceptual framework project. The objectives of the meeting were met.

<u>Matters Discussed and Decisions Reached</u>:

Reporting Entity

What Is an Entity?

1. Ms. Crook began the discussion on the reporting entity concept by stating that at the December 2005 meetings, the FASB and the IASB (Boards) decided that the reporting entity concept should be a broad concept that encompasses all types of entities, not only those entities that have external users who are unable to demand the information that they require. The first issue discussed at the meeting was to identify an entity that is the subject of general purpose financial reporting, consistent with the objective of financial reporting. The staff proposed the following working definition of an entity:

An entity is an economic unit that has the capacity to deploy resources.

2. Ms. Crook noted that the staff will refine the wording in the definition during the course of the project phase. The definition is intended to convey the notion that for financial reporting purposes, an entity:

   a. Is broader than legal entities, hence the use of the term *economic*

   b. Has a cohesive or unified organizational structure, such that is has observable boundaries and therefore can be distinguished from other parties that have an interest in it, such as investors and creditors

   c. Has a management function included within that organizational structure to enable it to engage in business activities, such as acquiring and disposing of assets, incurring and settling liabilities, purchasing or selling goods or services, and, more generally, engaging in transactions with other parties.

3. During its March 30, 2006 meeting, the IASB Board generally agreed with the staff conclusions, but suggested changes to the definition to provide more descriptive wording and to incorporate the broader notion of *engaging in transactions with other entities* rather than the narrower notion of *deploying resources.*

4. Ms. Seidman stated that she is satisfied with the definition but open to enhancements, including those suggested by the IASB. She agreed that *entity* should not be limited to legal constructs and suggested that some of the issues be addressed at the standards level.

5. Mr. Trott stated that he is not satisfied with the definition. He said that the notion in paragraph 2(a) is broad and expands the definition beyond legal entities—this is appropriate. However, paragraph 2(b) creates problems because it is difficult to define boundaries between a sole proprietorship and a natural person and it is unclear how recourse impacts the boundaries. Ms. Crook stated that the same argument could be made for a general partnership. In her view, the nature of the activities determines the boundary; business activities separate the sole proprietor from the natural person. Mr. Trott stated that in his view, a sole proprietorship

should meet the definition of an entity, but that does not seem to fit clearly with the notions in paragraphs 2(a)–2(c). Mr. Trott stated that paragraph 2(c) is a very limiting; requiring a management function to be included within the organization structure will unintentionally exclude items from the definition of an entity (for example, a subsidiary without a management function).

6. Mr. Batavick stated that he is supportive of the staff conclusions, but agrees that the definition should be enhanced by Board member recommendations and should include the notion of the ability to raise capital. The refined definition should be tested with examples to determine whether it achieves the desired result.

7. Ms. Schipper stated that she does not agree with the staff conclusions. In her view, the staff is focusing on two problematic and anomalous issues:

   a. Passivity: Paragraph 2(c) is problematic for situations in which the entity engages in transactions with others, but those transactions are pre-prescribed. In those situations, legal separation demarcates the boundaries fairly well. Paragraph 2(c) can be recrafted by including a notion of an ability to engage in transactions with others and removing the requirement that an entity have a management function.

   b. Recourse: In the event of recourse, the Board struggles with using a legal notion to demarcate the boundaries of an entity.

   Ms. Schipper stated that the definition is being skewed to encompass these cases. The notion of observable boundaries in paragraph 2(b) is circular in that it asserts that an entity ends where a boundary is drawn. The notions in paragraphs 2(a) and 2(c) can be improved. . Mr. Trott stated that business and personal assets in a sole proprietorship are often commingled and that the boundary is unclear. That is, the assertion in paragraph 2(b) is not operational for sole proprietors because the boundary between a sole proprietor and a natural person is fluid.

8. Mr. Bossio stated that subsidiaries are not necessarily independent entities and that intercompany transactions make separation difficult. The Board should consider what issues to resolve at the concepts level or the

standards level. For example, is the requirement in paragraph 2(b) a standards-level issue?

9. Mr. Trott suggested using the definition but omitting the supporting language in paragraphs 2(a)–2(c). One may have a reporting obligation for general purpose financial reports for a reporting unit. Ms. Seidman stated that if a reporting unit is identified, then a boundary has been drawn.

10. Mr. Young stated that he agrees with Mr. Batavick's suggestion to add "the capacity to raise capital" to the definition of an entity, and he would also include the "capacity to absorb resources." He agrees that an entity for financial reporting purposes is broader than a legal entity (paragraph 2(a)), but he disagrees with the approach in paragraphs 2(b) and 2(c). The reporting entity should be defined around the returns to the capital providers. The current focus is on assets, and the Board should focus more on capital structure to define the reporting entity. Mr. Herz agreed with the comments made by Mr. Young. In his view, the supporting text in paragraphs 2(b) and 2(c) and the discussion of what an entity is may not be particularly helpful at the conceptual level.

11. Ms. Crook asked Board members whether they would support an approach in which a narrative describes a reporting entity as including all entities and that this is broader than legal entities. Examples of items that are considered reporting entities, such as sole proprietorships, could be provided. Board members supported this approach.

Parent-Only Entity as the Subject Matter of General-Purpose Financial Reporting

12. Ms. Crook began the discussion on whether a parent-only entity may be the subject matter of general-purpose financial reports. In researching this issue, the staff explored five approaches:

a. Approach 1: SAC 1, *Definition of the Reporting Entity,* Approach (from the Australian conceptual framework). This approach uses the control concept to *look through* the legal or administrative structure that separates one entity from another.

b. Approach 2: Statement of Principles for Financial Reporting (SoP), Chapter 2, *The Reporting Entity,* Approach (from the United Kingdom's conceptual framework). This approach divides control into direct control and indirect control and states that the boundary of the reporting entity can be determined by direct control alone, or by both direct control and indirect control.

c. Approach 3: Legal versus Economic Boundaries Approach. This approach states that a reporting entity could be defined by either its legal boundaries or its economic boundaries, or both.

d. Approach 4: Aggregation Approach. This approach would view consolidated financial statements are an alternative way of presenting information about the same resources that appear in the parent-only financial statements. In other words, the investment asset reported in the parent-only financial statements is an aggregate amount, comprising the assets and liabilities that are presented separately in the consolidated financial statements.

e. Approach 5: An Approach that Distinguishes between the Parent Entity and the Group Entity. This approach would view the parent entity and the group entity as being two different entities.

13. Ms. Crook stated that under approach 1, a parent-only entity is not a reporting entity. Under approaches 2–5, a parent-only entity may be a reporting entity, but the approaches use different rationale for reaching that conclusion. During the IASB meeting on March 30, 2006, the IASB agreed that a parent-only entity may be the subject of general-purpose financial reporting. The IASB Board members, however, disagreed on the approach that led to that conclusion—six IASB Board members supported approach 5 and seven supported approach 4. However, of the seven Board members that initially supported approach 4, some expressed views that were close to approach 1.

14. Ms. Schipper stated that in many cases a parent would meet the definition of an entity. The next step is to determine whether all items that qualify as entities could be reporting entities, but the Board has not yet determined the criteria for *reporting entities*. The *reporting entity* may be driven by the need for decision-useful information. If that is the case, the question of whether a parent can be a reporting entity would seem to hinge on whether the parent engages in activities with outsiders that involve raising capital, and sometimes they do. She stated that she would support either approach 4 or 5, but that she prefers approach 5. .

15. Mr. Batavick stated that he supports approach 5 because it allows for a parent or subsidiary to be viewed as a separate entity, depending on user needs, which provides more flexibility. Mr. Young stated that the determination of an entity should be based on the capital structure of an organization and that approach 5 somewhat encompasses that notion.

16. Mr. Trott stated that he supports approach 4 and that in his view, there is a significant difference between approaches 4 and 5. If a holding company is used to obtain capital, information about the use of the capital is necessary. Once the boundaries are determined, which should include the parent and its controlled subsidiaries, the information about the entity can be displayed in different ways—approach 4 would allow this. In his view, however, approach 4 rules out the ability to measure the investment using a cost basis. Ms. Willis asked if approach 4 would result in pro rata consolidation or whatever consolidation approach is compatible with the parent company theory. That is, the description of approach 4 implies that the only difference between the parent-only statements and the consolidated statements is in the display of the parent's investment in a subsidiary. Mr. Bossio stated that presentation and measurement are standards-level issues.

17. Ms. Seidman stated that she agrees with Ms. Schipper's conclusions—she supports approach 5. Approach 4 appears to presuppose how a consolidation should be performed, while approach 5 leaves open the

possibility of different presentation and measurement approaches, for example, measuring the investment in a subsidiary at fair value.

18. Mr. McBeth stated that he views approach 4 as allowing only one relevant presentation (which would be determined at the standards level), whereas approach 5 allows for more than one presentation, depending on user needs. Mr. Trott stated that he disagrees.

19. Mr. Herz stated that he agrees with comments made by Ms. Schipper, Ms. Seidman, and Mr. Young. The relevant presentation may differ depending on the intended users of the financial reports. Approach 5 allows for more flexibility at the standards level. Based on a Board member vote, five Board members supported approach 5, while one Board member (Mr. Trott) supported approach 4.

Meaning of Control

20. Ms. Crook introduced the final topic for the meeting's reporting entity discussions: the meaning of control in the context of one entity having control over another entity. She stated that in the staff's view, it is necessary to have some description of control at the concepts level, but that the extent of that description is unclear. The staff is proposing a definition of control with *power* and *benefits* criteria, along the lines of the IASB's consolidations project:

> *Control of an entity is the ability to direct the ~~strategic~~ financing and operating policies of an entity so as to access the benefits flowing from the entity and increase, maintain, or protect the amount of those benefits.*[1]

a. With regard to the *power* element:

(1) Power relates to the entity's *financing and operating policies*. (The staff does not recommend including the modifier *strategic)*.

(2) Power is *non-shared*.

[1] The conceptual framework project staff does not recommend including the modifier *strategic* as proposed in the IASB's consolidations project.

(3) The *ability* to direct the financing and operating policies of the other entity is sufficient; hence, in concept, control is broader than legal control, in particular, it includes de facto or effective control.

(4) Whether one entity has control over another entity should be based upon an assessment of the present facts and circumstances, and therefore the control concept should not exclude situations in which control might be temporary.

b. With regard to the *benefits* element:

(1) The control definition should refer broadly to benefits or economic benefits, rather than specific types of benefits.

(2) Leaving aside the issue of special-purpose entities, the control definition should not specify a minimum level of benefits.

c. Ms. Crook stated that the conceptual framework should explain that determining whether one entity has control over another entity involves an assessment of all the facts and circumstances; there is no single fact or circumstance that evidences that an entity has control over another entity in all cases, nor should one particular fact or circumstance—such as ownership of a majority voting interest—be regarded as a necessary condition for control to exist.

21. Mr. Batavick stated that he agrees with defining control at the conceptual level and supports the *power* and *benefits* approach. He also would include a notion of exposure to risk in the definition. Ms. Seidman agreed with Mr. Batavick's comments.

22. Mr. Trott stated that he agrees with aspects of the staff's approach. He agrees that control of an entity is the ability to direct financing and operating policies. He does not agree that power is non-shared; there are instances where an entity may be in control when an entity does not have unilateral control. Requiring that power be non-shared may cause de facto control or effective control situations to fail the control definition. In his view, latent control describes a situation in which an entity may have the ability to control an entity, but has not yet exercised that ability. This issue, as well as whether an entity has the unilateral ability to control an entity, should be considered at the standards level. He would also delete the phrase "hence, in concept, control is broader than legal control" from the supporting text for the *power* element. Ms. Seidman stated that she

supports the definition and that de facto and effective control should be reconsidered at a later meeting.

23. Mr. Young stated that the risk and reward model should be the first step, which may often provide the same results as the control model. Mr. Herz agreed with Mr. Young. Ms. Schipper asked how he would alter the control definition. Mr. Young stated that he supports the definition of control that the staff is proposing, but that he would not use it to define the reporting entity.

24. Ms. Schipper stated that control, in the context of another entity, should be defined at the concepts level. In her view, this definition is an improvement over current GAAP in ARB 51, *Consolidated Financial Statements*. She stated that benefits can represent payoffs, some of which may be negative. In the supporting text, a *present* ability is required for control. Ms. Schipper stated that she agrees that the control concept should not exclude situations in which control might be temporary. Mr. Trott asked which entity has control in the case of an entity with a warrant to obtain a majority of another entity’s voting stock. Ms. Schipper stated that it is the entity with present control rather than the entity that may be in control in the future upon exercise of the warrant.

25. Ms. Crook stated that the staff will consider the interaction of the proposed definition with de facto control and issues related to option over an asset versus an option over an entity for a future meeting. Ms. Crook summarized the discussion on the meaning of control by stating that the Board generally agrees with the meaning of control proposed by the staff. The larger issue is whether to use control, or another concept, to determine the boundaries of the reporting entity.

Invitation to Comment

26. Mr. McBeth introduced this topic by stating that the staff developed the Invitation to Comment based on issues relevant to the conceptual framework in the IASB Exposure Draft, *Amendments to IAS 37* Provisions, Contingent Liabilities and Contingent Assets *and IAS 19* Employee Benefits. At the meeting, the staff presented an analysis of the comments received on the Invitation to Comment.

27. Mr. Abbate presented the summary of the comments by stating that the comment period for the Invitation to Comment ended on January 3, 2006. The Board received the following comments from 34 respondents:

a. ***Question 1:*** Do you agree with eliminating the notion of contingent asset? If not, why not?

(1) The respondents to this question were equally divided.

(2) Respondents who agreed generally reasoned that the notion is ambiguous, confusing, and counter-intuitive.

(3) Respondents who disagreed generally reasoned that:

(a) The notion is not confusing.

(b) Eliminating the notion would not improve financial reporting.

(c) The notion is presently understood.

(d) A more effective way to achieve the desired result is to change the definition of an asset.

b. ***Question 2:*** Do you agree with the IASB's analysis of unconditional and conditional rights in contractual settings, as summarized in paragraphs 30 and 31 of this Invitation to Comment and paragraphs BC10–BC13 of the IASB Exposure Draft? If not, why not?

(1) The majority of those respondents who disagreed reasoned that:

(a) Identification of the appropriate unit of account may be difficult to determine.

(b) The proposal becomes unworkable when applied to precontractual items.

(c) The model could give management greater control over the timing of recognition.

(d) Application of the model to nonfinancial contingent assets is difficult to apply.

(e) The FASB Statement No. 5, *Accounting for Contingencies,* approach results in superior financial reporting.

c. ***Question 3:*** If you answered yes to question 2, do you agree that the IASB has appropriately applied the notion and supporting reasoning referred to therein in the analysis of examples 1–3 in paragraphs 33–35 of this Invitations to Comment? If not, why not?

(1) Of the respondents who commented on question 2, a minority responded in the affirmative. Those respondents provided little rationale for their views.

d. ***Question 4:*** Do you agree with the IASB's proposal to classify as intangible assets those unconditional rights that are associated with conditional rights and that satisfy the definition of an asset, without shifting the consideration of the uncertainty surrounding the conditional rights from recognition to measurement?

(1) The responses to this question were equally divided.

(2) Those who agreed generally reasoned that an item that meets the definition of an asset also may meet the IASB definition of an intangible asset.

(3) Those who disagreed reasoned that:

(a) Contingent assets have significantly different characteristics than intangible assets.

(b) Greater inconsistency would exist between recognition criteria and balance sheet classification of assets that arise from similar sources.

(c) It is unclear how to implement IAS 38, *Intangible Assets,* in conjunction with the proposed model.

e. ***Question 5:*** Do you agree with eliminating the notion of contingent liability? If not, why not?

(1) Generally, respondents who commented on question 1 also commented on this question and, similarly, their responses were equally divided and provided similar rationale.

f. ***Question 6:*** Do you agree with the IASB's analysis of unconditional and conditional obligations in contractual settings, as summarized in paragraphs 39 and 40 of this Invitation to Comment and paragraphs BC24–BC28 of the IASB Exposure Draft? If not, why not?

(1) The majority of respondents to this question disagreed and reasoned that:

(a) Identification of the appropriate unit of account may be difficult to determine.

(b) The resulting information will not be more useful.

(c) The guidance is unclear.

(d) In most cases, the unconditional and conditional obligations are inseparable.

g. ***Question 7:*** If you answer yes to question 5, do you agree that the IASB has appropriately applied the notion and supporting reasoning referred to therein in the analysis of the example in paragraph 41 of this Invitation to Comment? If not, why not?

(1) A majority of respondents who answered in the affirmative to question 5 disagreed with this question and generally reasoned that:

(a) There are no substantive differences between the scenarios described in paragraphs 41 and 42 of the Invitation to Comment.

(b) The analysis is confusing and results in accounting information that treats economically different events the same.

(c) There is more potential for abuse.

h. ***Question 8:*** Do you agree with omitting the probability criterion for recognition of nonfinancial liabilities? If not, why not?

(1) The majority disagreed and reasoned that:

(a) There is an element of probability in the recognition of obligations as well as with measurement.

(b) In some cases, financial statements will not be representationally faithful, reliable, or relevant.

(c) It is unclear whether omitting the criterion could be applicable to non-contractual obligations.

(d) A larger population will require recognition.

(e) Current guidance is practical to apply and the information provided is understandable to users.

i. ***Question 9:*** Do you agree with the proposed measurement requirements for nonfinancial liabilities? If not, why not?

(1) The majority of the respondents to this question disagreed and reasoned that:

(a) Without having quoted market values, marking contingencies to market would be very judgmental, complicated, and exceedingly time consuming.

(b) The current requirements of Statement 5 are adequate.

(c) Less relevant information will result for contingencies that management believes are unlikely to result in actual liabilities; particularly when such liabilities are highly unlikely or remote.

(d) Measuring a single potential liability is not statistically reliable due to the subjectivity of the assumptions.

(e) There is potential for management to smooth earnings.

(f) Most nonfinancial liabilities are not managed on a fair value basis.

(g) The amount that a third party would charge to assume the obligation is not representative of the liability that exists at the balance sheet date.

(2) Respondents who agreed generally reasoned that:

(a) The exchange of consideration provides evidence of its existence and of its fair value.

(b) A mark-to-market requirement would eliminate the judgment aspect in measuring the liability.

(c) The overall cash flow estimate is likely to be realistic for a class of similar obligations.

j. **Other Comments**

(1) Roughly a quarter of respondents who commented on the Invitation to Comment expressed concern that the costs of applying the guidance would far outweigh the benefits to financial statement users.

(2) Some respondents suggested that specific disclosures be provided.

28. Mr. McBeth stated that in the staff's view, the comments received on questions 2, 3, 6, and 7 include newer arguments and analysis that will enrich deliberations. The staff plans to further explore those comments for use in discussions on the definition, recognition, and measurement of assets and liabilities. Ms. Seidman asked whether well known views included in comment letters also would be included in the process. Mr.

McBeth confirmed that they would be, but for purposes of the summary at this meeting, the staff identified views that are both new and informative.

Follow-up Items: None.

General Announcements: None.