MINUTES

To:	Board Members		
From:	Benson (ext. 446)		
Subject:	Minutes of the September 27, 2006, Conceptual Framework Board Meeting	**Date:**	October 4, 2006
cc:	Leisenring, Bielstein, Smith, MacDonald, Allen, Polley, Glotzer, Carney, Lott, Gabriele, Sutay, Project Team, FASB Intranet, Upton, Hickey, Crook, Lian, Hague, Villmann, Willis, GASB: Reese, Patton		

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement or Interpretation.

Topics:	Elements 7: Asset Definition (VI); Reporting Entity
Basis for Discussion:	FASB Memorandums 31, 32, and 32 supplement
Length of Discussion:	9:00 to 11:15 a.m.
Attendance:	
Board members present:	Herz, Batavick, Linsmeier, Seidman, Trott, and Young
Board members by phone:	Crooch
Staff in charge of topics:	Crook and Hague (by phone)
Staff at Board table:	Bossio, T. Johnson, Bielstein, Zimmerman, and Benson
Other participants:	Leisenring (IASB) By phone: Villmann, Willis, McBeth, Abbate, and Lian

<u>Summary of Decisions Reached</u>:

The Board discussed (a) issues related to Phase D: Reporting Entity and (b) options over assets, which is related to Phase B: Elements and Recognition. The Board planned to discuss the Canadian Accounting Standards Board staff's analysis of the IASB Discussion Paper, *Measurement Bases for Financial Accounting—Measurement on Initial Recognition,* but rescheduled discussions for October 4, 2006, due to time constraints.

Reporting Entity

Concerning reporting entity, the Board discussed a range of issues relating to (a) individual reporting entity, (b) group reporting entity, and (c) control issues. The Board's decisions are summarized below.

Individual reporting entity

The Board had previously agreed (December 2005) that the reporting entity concept should not specify which entities should be required to prepare general purpose external financial reports (GPEFR). Rather, an entity that chooses to, or is required to, prepare GPEFR would be a reporting entity. Also, the Board had previously agreed (April 2006) that what constitutes an entity for financial reporting purposes should not be limited to legal entities. Hence, legal existence is a sufficient condition for determining that an entity exists, but is not a necessary condition. Rather, an entity includes other types of arrangements or organizational structures, which could be broadly described as a circumscribed area of economic interest. Examples include a company, trust, partnership, association, sole proprietorship, natural person, and, in some circumstances, a branch or segment.

The Board agreed that the conceptual framework should describe what constitutes an entity for the purposes of financial reporting, along the lines set out above, but should not define it.

Group reporting entity

The Board agreed that the parent entity and the group entity should be regarded as being one and the same entity. Under this approach, the subsidiaries are regarded as being part of the parent for purposes of the parent entity's financial reporting. The consolidated financial statements present information about a different set of assets and liabilities than the set of assets and liabilities that appear in the parent-only financial statements.

The Board also agreed that a revised controlling entity model should be used to determine the composition of a group entity, whereby the group comprises the controlling entity (the parent) and all other entities under its control. Under this model, the largest possible group consists of the ultimate parent and all entities under its control (including both subsidiaries under its direct control and lower-level subsidiaries under its indirect control). It also would be possible to prepare GPEFR for a subgroup of entities that are part of the larger group. For example, a subgroup might comprise an intermediate parent and that entity's subsidiaries. However, combinations involving entities outside the larger group would be precluded. In other words, control is the unifying factor, and, therefore, a group entity may only consist of a parent entity and other entities under its control. Hence, if an entity was combined with another entity that was not controlled by the first entity, the resulting combined financial statements could not be described as GPEFR prepared in accordance with U.S. GAAP.

Control issues

At an earlier meeting (April 2006), the Board agreed that control should be defined at the concepts level and should contain both (a) a power element and (b) a benefits element together, with a link between the two. At this meeting, the Board also agreed that:

a. Control over another is based upon an assessment of all the present facts and circumstances. Therefore, the concept of control does not exclude situations in which control exists, but it might be temporary.

b. The control concept should not be limited to circumstances in which the entity has sufficient voting rights or other legal rights to direct the financing and operating policies of another entity, but should be a broad concept that encompasses economically similar circumstances.

c. Control cannot be shared, that is, control involves one entity (not multiple entities) having control over another entity.

The Board also discussed the relationship between the control concept and situations in which (a) two or more entities collectively have joint control of a joint venture and (b) an entity has significant influence over another entity. The Board agreed that because control involves one entity (not multiple entities) having control over another entity, an individual venturer does not have control over the joint venture. Similarly, the fact that an entity has significant influence over another entity does not mean it has control over that other entity.

Options over Assets

Concerning an option over an asset, the Board decided that the asset is the entity's present right to the contractual promise to deliver the subject matter of the contract if the option is exercised. The IASB Board reached a similar conclusion at its September 2006 meeting.

Objective of Meeting:

The Board discussed cross-cutting issues related to options over assets and reporting entity. The objective of the meeting was for the Board to agree on the treatment of an option over an asset and address issues relating to an individual reporting entity, group reporting entity, and control. The objectives of the meeting were met.

Matters Discussed and Decisions Reached:

Reporting Entity

1. Ms. Crook led the discussion concerning reporting entity. She stated that first the Board would address cross-cutting issues related to the individual reporting entity, which would bring together the Board’s previous decision that a **reporting entity** is an entity that chooses to, or is required to (for example, by company legislation), prepare GPEFR. Ms. Crook informed

the Board that it would be asked to consider the following questions at the meeting:

a. Does the Board believe the work completed to date on the definition of a reporting entity is sufficient and no further research on an individual entity is necessary?

b. Does the Board agree with the current decision that the conceptual framework will describe what constitutes an entity but will not define it?

2. Mr. Trott stated that he is not sure whether the Board will make progress by answering the staff's questions. He believes it may be necessary to step back and look at the definition of an entity as a "circumscribed area of economic interest" in which legal existence is sufficient but not necessary. He noted that such characteristics might be the focus of the reporting entity discussion concerning parent-subsidiary and brother-sister entity relationships. The Board must determine the need for including and excluding assets and liabilities. He stated that there are concepts of components in FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* and reporting entities in FASB Statement No. 141, *Business Combinations,* and he wondered if entities according to those Statements could qualify for GPEFR. He thinks that such entities would qualify for GPEFR if there is a need and purpose for general purpose financial statements. Thus, he thinks the Board should focus on a high-level definition of an entity and address when GPEFR is appropriate at the conceptual level. The Board should more fully develop ways to determine the "circumscribed area of economic interest" at the standards level.

3. Mr. Linsmeier stated that he would like the Board to define the circumscribed area of economic interest and determine for whom the circumscribed area will benefit. He noted that in Concepts Statement No. 1, the Board takes on an entity theory to account for capital providers of an entity. He thinks the Board should define GPEFR based on the capital providers to give them the best basis for predicting the amount, timing,

and uncertainty of future cash flows. The Board should explore whether it can define an entity at the conceptual level, such that capital providers may use the correct sub-set of net assets to predict the amount, timing, and uncertainty of future cash flows to help settle their capital provision efforts (that is, return to equity holders, payment in compensation, and return to debt holders in principal and interest payments). He thinks a problem arises when one legal entity owns shares or interest in another legal entity. The Board must determine how to represent the ownership relationship to help capital providers predict the amount, timing, and uncertainty of future cash flows. There are several possible levels of ownership interest, including passive, in which an entity is not gaining access to the risks and rewards of the other entity. If there is a passive ownership arrangement, Mr. Linsmeier thinks the Board should account for such ownership as a single line item asset of the parent company. As the ownership interest grows, the Board could change the unit of account or display to begin showing the net assets of the subsidiary on the parent's account. He thinks the Board must determine when the line item assets of an entity should merge with those of another entity, and when the assets should be left as a single line item. Determining to whom an entity provides a financial report will make clear what combinations of entities are most beneficial in predicting the amount, timing, and uncertainty of future cash flows. If someone provides equity or debt capital to the parent organization and the owner has control over the majority of the risks and rewards for another entity, Mr. Linsmeier thinks it is appropriate to require consolidation of some of the net assets of the subsidiary entity as a gross amount. If there is a great enough ownership interest in the subsidiary and the parent must acquire the net assets of the subsidiary as a whole to obtain the risks and rewards, then full consolidation should be required. However, if the parent has significant control over the risks and rewards of the subsidiary with only a portion of the subsidiary's net assets, Mr. Linsmeier believes proportionate consolidation would be sufficient.

4. For a parent-subsidiary relationship, Mr. Linsmeier thinks the only GPEFR is one in which the parent and subsidiary are combined. He does not believe parent-only reporting should be GPEFR, and he does not believe subsidiary-only reporting would be beneficial. He believes the Board must determine who the providers are in order to understand the viable entities.

5. Mr. Trott stated that the Board must determine the appropriate level of detail at the conceptual and standards levels in addressing the circumscribed area of economic interest. He believes the concepts level should generally define the circumscribed area of economic interest, but a standards-level document should address the minimum level of aggregation.

6. Mr. Young asked Mr. Linsmeier if identifying the capital providers to determine a reporting entity would lead to multiple definitions of a reporting entity. Mr. Linsmeier responded that such an approach could lead to different definitions because there are different viable entities depending on the type of capital providers. Concerning a noncontrolling interest in a subsidiary, the subsidiary may be the entity if the net assets of the subsidiary are the only net assets that may be used by the capital providers to garner risks and rewards. Mr. Young responded that the definitions of an asset and a liability do not take into account the point of view of capital providers, and, thus, do not allow the Board to address an approach such as Mr. Linsmeier's.

7. Ms. Seidman affirmed Mr. Young's response. She stated that she views the reporting entity issue as a Venn diagram. The Board has already determined that GPEFR should satisfy the needs of all of the investors and creditors of the entity. There are three areas of overlap in the diagram: (a) the entities (such as subsidiaries or branches), (b) investors and creditors of the entity that require GPEFR, and (c) the definitions of an asset and a liability. Where there is overlap, the collective assets and liabilities of a certain entity for the collective group of investors and creditors would be reported. She does not believe the three overlapping

aspects should be viewed in isolation. Mr. Young asked Ms. Seidman why she only wants one representation of GPEFR. Ms. Seidman responded that, for example, a subsidiary may be an entity. She would determine the assets and liabilities of that subsidiary for the investors and creditors of that subsidiary. As a second example, a parent company with subsidiaries may be an entity. To determine GPEFR, she would determine which of those subsidiaries should be included in the collective grouping with the parent. Depending on the definition of control, one may conclude in certain cases that a capital provider does not have control over all of the assets or liabilities, in which case that capital provider would not be considered part of the collective grouping. Mr. Young noted that Ms. Seidman refers to **control** in terms of risks and rewards, but it has been previously defined by the Board as having a power component and a risks and rewards component. Ms. Seidman responded that it is necessary for the Board to address the issues of control and the existence of GPEFR simultaneously and not in isolation.

8. Mr. Bossio stated that the Board has not identified individuals who are capital providers, yet Board members are referring to capital providers. There may be contractual providers who have a circumscribed area of economic interest as determined by the contract. In such an arrangement, some may argue that there is a need for special purpose financial reports and not GPEFR. Both the IASB and FASB Boards previously decided that they want to allow sufficient flexibility to address disaggregation issues at the standards level. If a branch may be disaggregated, then almost anything could be disaggregated.

9. Mr. Trott argued that Mr. Linsmeier's analysis is too narrow because it focuses on legal entities and because the Board previously decided that legal standing is sufficient but not necessary for a reporting entity. Mr. Trott questioned whether the Board has a common understanding of GPEFR. He suggested the Board solidify a common understanding of GPEFR to help the Board identify appropriate entities and whether such

entities must be legal entities or not. Mr. Linsmeier responded that he believes the Board should determine the set of assets that may help settle claims to a set of capital providers within a legal entity. If a branch has a subset of capital providers who can only control the risks and rewards of the branch, then branch accounting would be appropriate. However, if the capital providers of the branch can control the assets of the entire parent entity, then he thinks branch accounting would not be appropriate. Mr. Trott responded that if the assets of two entities are sufficiently interrelated, one cannot tell what cash flows relate to one party or another. Mr. Linsmeier responded that he would like to look at the net set of assets available to generate returns to a set of capital providers of an entity. If the assets of one legal entity are important for providing a return on the assets of another legal entity, then the entities must be combined. The important question is when an entity must combine its financial reporting with that of another entity. The capital providers of an entity must have represented for them whether their access to assets allows them enough control of the risks and rewards to require gross presentation of all of the assets of an entity instead of a single line item display. This will be dependent upon whether or not the capital providers have significant control over how the assets of an entity perform.

10. Mr. Trott stated that in several cases, there will be a need to consolidate activities in the absence of a question of display. Ms. Seidman noted that such a situation is why the definition of an asset is important. Mr. Trott stated that he thinks there are limits to what the Board can accomplish at the conceptual level regarding consolidation issues. He believes the conceptual framework should include a short definition of an entity that includes the notion of a "circumscribed area of economic interest" and the idea that legal status is sufficient but not necessary for an entity. In addition, the Board should clarify within the Concepts Statements what GPEFR means from an entity's perspective. Then, a number of approaches should be identified that could be used in standards setting.

There would be more specificity at the standards level as to what approach should be used in certain circumstances.

11. Mr. Batavick noted that Mr. Trott's idea would include stating at the conceptual level that GPEFR must address all capital providers. Mr. Crooch stated that he supports a minimal amount of detail at the conceptual level. He prefers defining a reporting entity as having a "circumscribed area of economic interest" and noting that legal status is sufficient but not necessary.

12. Mr. Bossio stated that the IASB decided at its October 2006 meeting that there could be two entities—one that prepares parent-only GPEFR and one that prepares consolidated GPEFR. If the FASB Board thinks that one must identify the capital providers to determine which financial reports qualify as GPEFR, then that is not compatible with the IASB Board's decision. Mr. Young stated that he believes there may be a problem with the current definition of an asset. An asset is currently defined from an entity's perspective instead of a reporting entity's perspective.

13. Ms. Crook summarized the IASB Board's decisions concerning the reporting entity. The IASB Board determined that there should be a reporting entity concept that would identify what constitutes an entity for purposes of GPEFR. In the context of a group entity, the IASB Board decided on an extended view of the controlling entity model, whereby control is the unifying factor that determines when two or more entities may be combined together into a group reporting entity. The extended view of the controlling entity model specifically excludes situations in which an entity that is not a part of the controlled set of entities may be part of the group entity for GPEFR. Concerning the relationship between a parent and a group, the majority of IASB Board members agreed that the relationship would be based on the multiple entities approach. For example, if a group consists of a parent and one subsidiary, there are potentially three reporting entities: the parent entity, the subsidiary entity, and the group entity. She noted that the IASB Board's conclusions were

quite different from the FASB Board's current discussion. She stated that some of the FASB Board members would like a fairly broad definition of reporting entity at the conceptual level and want to reserve analyzing particular user information needs to determine GPEFR for standards-level guidance.

14. Mr. Trott asked Ms. Crook to clarify what she meant by *control.* She replied that *control* includes both a power element and a risks and rewards element. Mr. Trott asked if brother-sister entities would be allowed to create GPEFR under the IASB Board's decision. Ms. Crook responded affirmatively, and noted that the largest group possible would include the parent and all of its subsidiaries. In addition, there could be subgroups within that large group that include sister entities or subsidiary entities.

15. Ms. Seidman stated that the IASB Board's decision as described by Ms. Crook is not necessarily at odds with Ms. Seidman's view. She thinks there needs to be clarification regarding what a parent entity has control of if an entity owns an investment in another entity. Does the entity have control of the investment as a whole or does the entity have control of the specific assets and liabilities? If the latter is true, then she believes a combination of the parent and subsidiary is necessary. She stated that the definition of control in the context of an entity may need to be more specific concerning the assets and liabilities of the entity. If the definition of control is clarified, she may agree with the IASB Board's decision.

16. Mr. Linsmeier stated that the Board must evaluate the entity at the investment level first, and then decide when a combination must be treated differently from simply a line item investment. He believes the Board should expand from an asset view instead of contract from an overarching entity view.

17. Mr. Leisenring asked Ms. Seidman and Mr. Linsmeier if they believe parent-only financial statements should be GPEFR. Mr. Linsmeier stated that parent-only financial statements should not be GPEFR.

18. Mr. Herz noted the need to figure out which assets, returns, and cash flows should be reported to meet the objective of GPEFR. He added that Mr. Young seems to think that the entity should be described in terms of a particular capital provider. Mr. Batavick stated that special purpose financial reports would satisfy Mr. Young's request to identify the needs of particular capital providers. He noted that GPEFR should satisfy the needs of all capital providers collectively. Mr. Linsmeier stated that FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises,* views the entity as a whole and the capital providers as a whole, and, thus, does not lend itself to identifying individual capital providers.

19. Mr. Bossio summarized the combinations of entities that may be defined as group entities under the extended controlling entity model that the IASB Board agreed upon. Mr. Crooch stated that he prefers the one entity-one display model because the parent must be included in a group with the parent's subsidiaries.

20. Ms. Seidman stated that she does not agree with the common control model and believes that the controlling entity model is the correct model. If someone combines two unrelated subsidiaries without including the parent that provides the link between two subsidiaries, she does not believe that fits with the definition of an asset.

21. Mr. Bossio stated that the IASB Board decided on the extended controlling entity model so that two subsidiaries were not precluded from preparing GPEFR at the concepts level; such a decision could be dealt with at the standards level. Mr. Linsmeier noted that the IASB Board's decision seems to contradict Concepts Statement 1. Mr. Trott argued that the activities of two subsidiaries could be so intertwined that not consolidating the activities of the two parties would result in unfaithful representation.

22. Mr. Herz proposed that the Board address the questions concerning the reporting entity cross-cutting issues and asked the staff to consider the Board's responses as tentative decisions pending the staff's further

analysis of the Board's discussion. Mr. Linsmeier asked the staff to consider how the reporting entity project relates to Concepts Statement 1 and the definition of an asset.

23. Concerning the group reporting entity, there are three display approaches: (a) one entity-two displays; (b) one entity-one display; and (c) multiple entities. The Board voted for the one entity-one display approach (four Board members agreed; three did not (EWT, LFS, and GJB)). Mr. Linsmeier stated that he prefers the one entity-one display approach as long as the objective of financial reporting is defined. He thinks that as long as the user of the report is defined, there is only one choice for GPEFR. Mr. Young stated that he thinks there is only one relevant display for every capital provider, which is sort of the one entity-one display approach. He believes there should never be GPEFR for a subsidiary without the parent. He believes the capital supplier must be considered in determining GPEFR.

24. The staff developed three approaches for determining when two or more entities should be combined into a group reporting entity. The three approaches are the (a) controlling entity model; (b) common control model; and (c) risks and/or rewards model.

25. Mr. Trott stated that he does not think that a specific user must be identified to allow GPEFR. He asked Ms. Crook to clarify the IASB Board's decision regarding when two or more entities should be combined into a group reporting entity. Ms. Crook explained that the IASB Board preferred an extended controlling entity model, whereby the control of one entity over another is the overriding concept. Within that concept, there could be subgroups of subsidiaries that exclude the parent. The IASB preferred to call such a model the "extended controlling entity model," rather than the "common control model," on the basis that the ultimate control of the parent is the unifying factor.

26. The Board voted for the controlling entity model (four Board members agreed; three did not (RHH, EWT, and GJB)). Mr. Linsmeier stated that

he prefers the controlling entity model as long as risks and rewards are considered as a separate item. Mr. Trott expressed concern over whether the accounting guidance related to FASB Interpretation No. 46 (revised 2003), *Consolidation of Variable Interest Entities*, corresponds with the controlling entity model. He believes the guidance only fits with the common control model.

27. Mr. Linsmeier stated that the Board members have similar views concerning when two or more entities should be considered a group reporting entity. However, he thinks the common control model focuses more on a parent-subsidiary situation than a brother-sister entities situation. In a parent-subsidiary context, most Board members seem to agree with the controlling entity model. When there are sister entities, however, risks and rewards become more important and it does not matter whether or not there is common control.

28. Ms. Crook stated that the next issues for Board consideration deal with control. Does the Board agree that:

    a. The concept of control does not exclude situations in which control exists but it might be temporary?

    b. The concept of control should not be limited to circumstances in which the entity has sufficient voting rights or other legal rights to direct the financing and operating policies of another entity, but should be a broad concept that encompasses economically similar circumstances?

    c. An entity does not have power over another entity if the first entity must obtain the agreement of others to direct the financing and operating policies of the second entity?

29. Mr. Trott stated that the control issues should be addressed at the concepts level. Concerning issue (b), de facto or effective control must be made operational at the standards level. At the conceptual level, there should be no mention of "the large minority," and instead the Board should simply address the need for effective control.

30. The Board also discussed the relationship between the control concept and situations in which (a) two or more entities collectively have joint control of a joint venture and (b) an entity has significant influence over another entity. The Board agreed that because control involves one entity (not multiple entities) having control over another entity, an individual venturer does not have control over the joint venture. Similarly, the fact that an entity has significant influence over another entity does not mean it has control over that other entity. The Board affirmed the conclusions regarding the three control issues (six Board members agreed; one abstained from voting on the third issue (DMY)).

Options over Assets

31. Mr. Hague led the discussion concerning options over assets. Concerning an option, the entity's asset is the present right to the counterparty's contractual promise to deliver the underlying subject matter if the option is exercised, rather than the right to the subject matter itself. The IASB Board agreed with this approach at its September 2006 Board meeting, provided there is an absence of other related circumstances and assuming that the option contract is a genuine option. Mr. Hague asked for the Board's agreement with the proposal.

32. Mr. Trott stated that abuse-prevention must be addressed at the standards level concerning the assumption that the option is a genuine option. Mr. Linsmeier stated that deep in-the-money options should not result in the subject matter being called an asset. Ms. Seidman agreed with Mr. Linsmeier that in such a situation, the asset is still the present right of the contractual promise and not the underlying subject matter. The Board voted in agreement with the proposed treatment of options over assets (all Board members agreed).

<u>Follow-up Items</u>: The staff will consider the Board's comments concerning reporting entity issues and present an updated analysis at a future Board meeting. In addition, the staff will present the Canadian Accounting Standards

Board staff's analysis of the IASB Discussion Paper, *Measurement Bases for Financial Accounting—Measurement on Initial Recognition,* at the October 4, 2006 Board meeting.

General Announcements: None.