



December 20, 2006

Memorandum

To: Members of the Board  
*Wendy M. Comes*

Through: Wendy M. Comes, Executive Director

From: Melissa L. Loughan

Subj: **Federal Entity Project Plan -Tab G<sup>1</sup>**

As part of the Conceptual Framework Project, the Board requested that a project on Federal Entity be initiated. FASAB addresses the entity issue in SFFAC 2, *Entity and Display*. The Board is aware of a number of entity issues. While SFFAC 2 provides criteria for determining if an entity should be included as a federal entity, questions continue regarding whether certain activities should be included with an entity. This phase (Phase 5 of the overall Conceptual Framework Project) will address the following:

- Definition of entity / reporting entity
- Guidance / characteristics for identifying reporting entities
- Criteria for including entities / boundary of the entities
- Criteria for consolidating entities
- Reporting on other relationships--joint ventures, non-profit partnerships, other relationships that lead to an assumption of federal support without consolidation being required, etc
- Potential disclosures

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<sup>1</sup> The staff prepares Board meeting materials to facilitate discussion of issues at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect authoritative views of the FASAB or its staff. Official positions of the FASAB are determined only after extensive due process and deliberations.

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The Board issued SFFAC 2 in April 1995, and for the most part, the first half of SFFAC 2 (paragraphs 1 through 53) addresses the entity issue. SFFAC 2 addresses:

- Reasons for Defining Reporting Entities
- Structure of the Federal Government
- Identifying the Reporting Entities for General Purpose Financial Reporting
- Criteria for Including Components in a Reporting Entity
- Other Aspects Concerning the Completeness of the Entity

Ultimately this phase will result in potentially both a proposed concept and one or more proposed standards. The resulting concept and standards would rescind the sections of SFFAC 2<sup>2</sup> relating to entity.

Attached to this transmittal is the detailed Federal Entity Project Plan. The project plan includes several appendices that contain pertinent excerpts from existing concepts, standards, and other reports that relate to the entity and consolidation issue from U.S., national and international standard setters. The excerpts are provided for additional background to accompany the Federal Entity Project Plan. Staff provided pertinent excerpts (versus full copies of the concepts, standards, and other reports) in an attempt to provide members with a manageable stack of reference materials. Relevant portions of each of the referenced concepts, standards, and other reports will be analyzed in greater detail throughout the project.

The goal for the January Board meeting will be to seek the Board's input on the plan. Specifically, staff requests the Board's feedback on the following:

- Does the Board agree with the scope of the project?
- Does the Board agree with the overall approach of the project?
- Does the Board agree with the Issue areas identified?
- Does the Board agree with the tentative milestones?
- Are there other issues or considerations that the Board would like to cover in the Federal Entity Project?

Please feel free to contact me at 202-512-5976 or by email at [loughanm@fasab.gov](mailto:loughanm@fasab.gov) to discuss any comments or questions you may have.

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<sup>2</sup> Phase 3, Statement and Notes of the Conceptual Framework Project would address the remainder of SFFAC 2 related to the Display of Financial Information. Ultimately, the completion of Phase 3 and Phase 5 would rescind SFFAC 2 in its entirety.

# **FEDERAL ENTITY PROJECT PLAN**

## **PHASE 5 OF THE CONCEPTUAL FRAMEWORK PROJECT**

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## OVERALL CONCEPTUAL FRAMEWORK PLAN

The Board developed a core set of accounting standards and initial concepts statements on reporting objectives and entity and display early in its first six years of operation. Concepts and initial standards were developed concurrently. At this time, the Board believes that it should review and add to or modify concepts statements.<sup>3</sup> However, the Board does not believe that this effort should come at the expense of developing new standards that would enhance federal financial reports. Thus, the Board is undertaking a concepts project that (1) is linked to ongoing and future standards projects and (2) envisions phases so that incremental progress can be made. Active consideration of conceptual framework issues began in June 2003.

### Primary Objective:

To ensure Federal Financial Accounting Standards are based on a sound framework of objectives and fundamental concepts regarding the nature of accounting, financial statements, and other communications methods. The framework should:

- provide structure by describing the nature and limits of federal financial reporting,<sup>4</sup>
- identify objectives that give direction to standard setters,
- define the elements critical to meeting financial reporting objectives and describe the statements used to present elements,
- identify means of communicating information necessary to meeting objectives and describe when a particular means should be used, and
- enable those affected by or interested in standards to understand better the purposes, content, and characteristics of information provided in federal financial reports.

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<sup>3</sup> The Board's desire to evaluate concepts after 12 years of substantial progress is stimulated by a perception that (1) some critical concepts that have been relied on are not yet included in a concepts statement, (2) certain aspects of the concepts – notably the liability definition – are not widely accepted, and (3) there is a need to communicate clearly to the growing community of federal financial report users, preparers and auditors.

<sup>4</sup> Federal financial reporting has changed dramatically since FASAB's inception. Some changes have been the result of FASAB's efforts and others have been the result of legislation, OMB directives or preparer enhancements. Today, most CFO Act agencies prepare a Performance and Accountability Report. This report includes many reports related to financial and program performance previously issued separately. Through the course of this concepts project, FASAB will attempt to be clear regarding the scope of its efforts. However, FASAB will need to refer broadly to "financial reporting" to assess how current objectives are or may be met. To prioritize its own efforts to meet financial reporting objectives, the Board will need to be explicit with respect to aspects of financial reporting that are the result of other requirements (e.g., components of the auditors report).

## Phases of the Overall Conceptual Framework Project:

**PHASE 1: Evaluate Objectives:** Strategic Directions Paper issued November 2006.

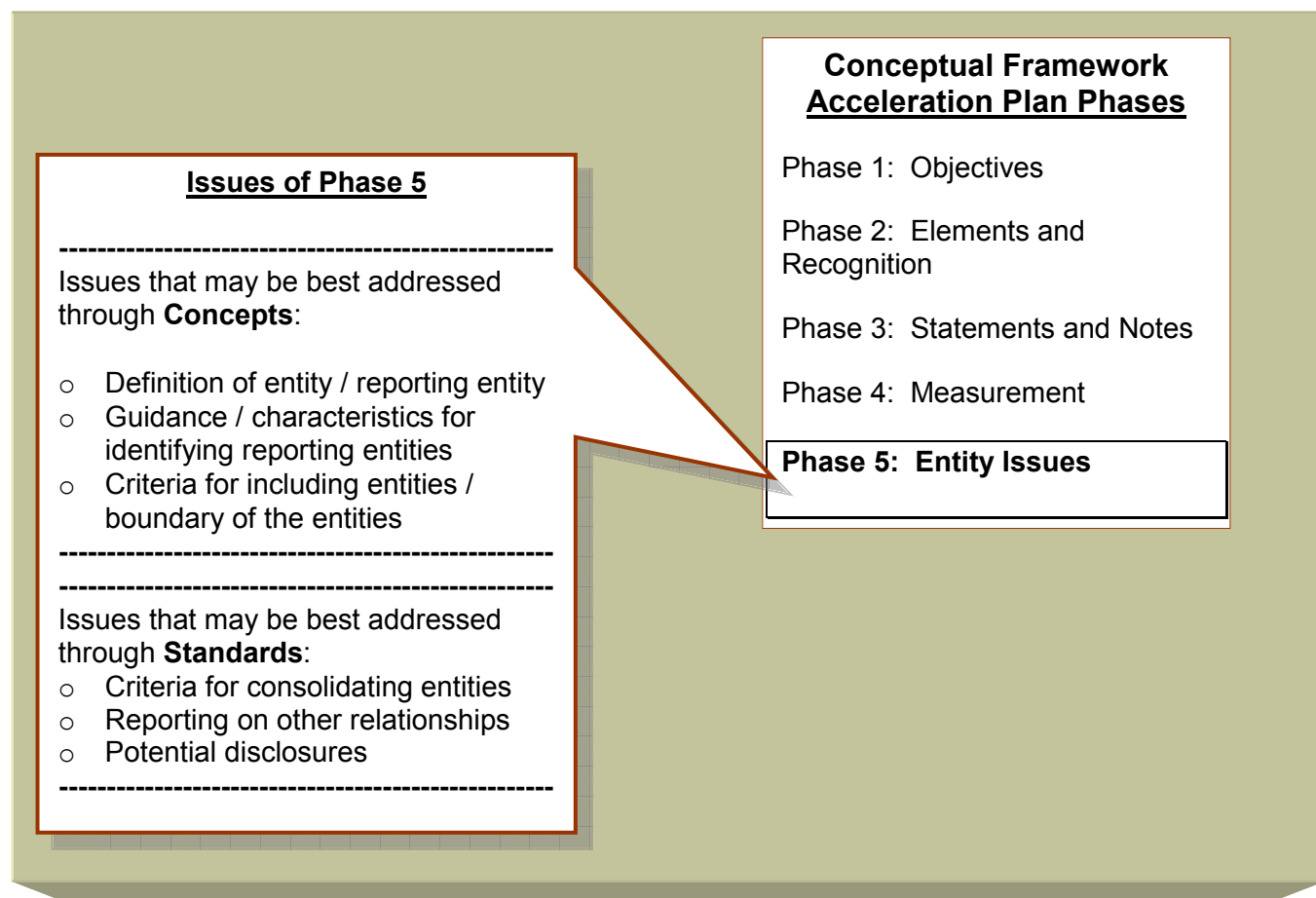
**PHASE 2: Elements and Recognition:** Exposure Draft issued in June 2006.

**PHASE 3: Statements and Notes:** Phase 3 initiated in September 2006.

**PHASE 4: Measurement:** Phase 4 may be pursued in 2007.

**PHASE 5: Entity Issues:** Phase 5 initiated. Exhibit 1 provides a pictorial of the how Phase 5 fits in the overall conceptual framework project. The Federal Entity project will address both the conceptual framework and standards issues. Ultimately this phase will result in potentially both a proposed concept and one or more proposed standards. A high level issue that will be considered throughout the project is what information regarding Entity and Consolidation should be in a Concepts Statement versus a Standard.

## Exhibit 1--Relationship of Phase 5 to the Overall Conceptual Framework Acceleration Plan



## THE FEDERAL ENTITY – Concepts and Standards

### Primary Objective and Scope:

FASAB addresses the entity issue in its Statement of Federal Financial Accounting Concepts (SFFAC) 2, *Entity and Display*. SFFAC 2 addresses:

- Reasons for Defining Reporting Entities
- Structure of the Federal Government
- Identifying the Reporting Entities for General Purpose Financial Reporting
- Criteria for Including Components in a Reporting Entity
- Other Aspects Concerning the Completeness of the Entity

The Board is aware of a number of entity issues. While SFFAC 2 provides criteria for determining if an entity should be included as a federal entity, questions continue regarding whether certain activities should be included with an entity. The Federal Entity project will address both the conceptual framework and standards issues. Ultimately this phase will result in potentially both a proposed concept and one or more proposed standards. A high level issue that will be considered throughout the project is what information regarding Entity and Consolidation should be in a Concepts Statement versus a Standard. The Board will consider the following issues:

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#### Issues that may be best addressed through **Concepts**:

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- Definition of entity / reporting entity
- Guidance / characteristics for identifying reporting entities
- Criteria for including entities / boundary of the entities

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#### Issues that may be best addressed through **Standards**:

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- Criteria for consolidating entities
- Reporting on other relationships--joint ventures, non-profit partnerships, other relationships that lead to an assumption of federal support without consolidation being required, etc
- Potential disclosures



While this project includes a review of the above issues and foundational notions of reporting entity contained in SFFAC 2, it focuses most heavily on the conclusive and indicative criteria. Thus, we anticipate a focus on questions relating to inclusion or exclusion of entities from the reporting entity. Nonetheless, staff will review SFFAC 2 in its entirety to identify any additional issues (such as clarity of SFFAC 2 explanations regarding entity, reporting entity and the forms taken by entities). This project will address both the conceptual framework and standards issues.

In addition, the following other entity related issues are being addressed, but not in the Federal Entity project. They are being addressed in current efforts as follows:

- Appropriate Source of GAAP- There are government corporations, government sponsored entities and other federal entities currently producing FASB GAAP statements. What, if any, Federal entities using FASB standards should continue to do so? (Staff effort underway. Draft staff-level Guidance is anticipated in mid to late 2007.)
- Reporting on “national” vs “governmental” indicators (Will be addressed in the sustainability sub-section of phase 3—Statement and Notes of the Conceptual Framework Project.)

## Importance of the Entity Concept

The reporting entity concept and consolidation issues are very important. Most would agree that accounting information pertains to ‘entities.’ Entities use financial reports to communicate information to people concerned or interested in the entity.

The primary reason for defining the reporting entity is to ensure that users of the financial reports will be provided with complete financial information about the entity and its involvements. By clearly defining the financial activities relevant to the reporting entity, reports would provide users an ability to understand the activities encompassed by the organization. The structure of the federal government has become increasingly complex and, as such, it is important to identify component units and activities to be consolidated with each entity’s financial statements.

Understanding the reporting entity is important to both internal and external users. For internal users, government organizations are primarily concerned with maintaining a level of services for their constituents. Defining the entity clearly allows government officials to monitor activities undertaken by diverse component entities. The issue of defining the entity and those components to consolidate is also of interest and use to government entities when deciding which departments are to prepare financial statements.

As for external users, SFFAC 1 *Objectives of Financial Reporting* offers uses of the Federal Government financial statements. Clearly defining the reporting entity and the components consolidated in the statements allows users to make the best use of the information. Identifying the entities for inclusion in the Federal Government’s financial

statements (consolidation) are critical to creating transparent reports to support accountability. As a democracy, elected officials are to be held accountable to the public and financial statements provide them with a means of doing so.<sup>5</sup> In order to achieve accountability, the content and structure of the financial reports should be clear, complete and comprehensive to citizens.

## **Current FASAB Concepts and Standards Addressing the Entity issue**

### **Statement of Federal Financial Accounting Concepts (SFFAC) 2, Entity and Display**

As stated above, FASAB addresses the entity concept in its SFFAC 2, *Entity and Display*. The Board issued SFFAC 2 in April 1995, and for the most part, the first half of SFFAC 2 (paragraphs 1 through 53) addresses the entity issue. APPENDIX 1 includes an excerpt of SFFAC 2 paragraphs 1-53 for your reference.

SFFAC 2 par. 29 states “reporting entities are entities that issue general purpose financial statements to communicate financial and related information about the entity.” Briefly, SFFAC 2 also:

1. identifies reasons for defining reporting entities,
2. explains that the federal government is an extremely complex organizational structure which may be viewed from various perspectives,
3. lists three criteria for an entity to be a “reporting entity”:
  - a. There is a management responsible for controlling and deploying resources, producing outputs and outcomes, executing the budget or a portion thereof, and held accountable for the entity’s performance.
  - b. The entity’s scope is such that its financial statements would provide a meaningful representation of operations and financial condition.
  - c. There are likely to be users of the financial statements who are interested in and could use the information in the statements to help them make resource allocation and other decisions and hold the entity accountable for its deployment and use of resources.
4. provides that budget accounts and programs are not to be considered reporting entities because they generally do not meet the criteria to be considered a reporting entity,
5. highlights a general expectation that reporting entities will be organizationally based but will provide disaggregation by sub-organization and possibly program,

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<sup>5</sup> Par. 74, SFFAC 1, *Objectives of Financial Reporting*.

6. establishes a conclusive criterion such that any organization, program or account included in the budget would require inclusion in the U.S. Federal Government financial statements and the financial statements of the organization with which it appears (e.g., department or agency),
7. establishes six indicative criteria that may lead to inclusion in a financial reporting entity in the Federal Government, and
8. excludes the Federal Reserve System, Government Sponsored Entities, and bailout entities from the Federal Government and its components while suggesting that disclosures may be needed in some cases.

With respect to the consolidated financial report (CFR) of the US Government, SFFAC 2 par. 38 states the following overall objective of consolidation:

The ultimate aggregation of entities is into the entire Federal Government which, in reality, is the only independent economic entity—although some would say the entire country is the ultimate economic entity. The Federal Government entity would encompass all of the resources and responsibilities existing within the component entities, whether they are part of the Executive, Legislative, or Judicial branches (although, as noted in paragraph 5, FASAB’s recommendations pertain only to the Executive Branch). The aggregation would include organizations for which the Federal Government is financially accountable as well as other organizations for which the nature and significance of their relationship with the government (see paragraphs 39 through 50) are such that their exclusion would cause the Federal Government’s financial statements to be misleading or incomplete. (emphasis added)

### **Other FASAB References to “Entity”**

There are many “entity” terms used in FASAB’s literature—entity, reporting entity, federal reporting entity, component entity, component reporting entity, Federal Government entity.

For example, SFFAC 1 and other standards uses the term “entity” generically to refer, depending on the context, to the U.S. Government as a whole, organizational component units of the Government, e.g., an agency, or to other kinds of potential reporting units such as programs.

The Original Pronouncements Consolidated Glossary includes the following definition for Entity: A unit within the federal government, such as a department, agency, bureau, or program, for which a set of financial statements would be prepared. Entity also encompasses a group of related or unrelated commercial functions, revolving funds, trust funds, and/or other accounts for which financial statements will be prepared in accordance with OMB annual guidance on Form and Content of Financial Statements.

## Proposed Actions and Milestones

### Project Initiation and Project Planning

November 2006-January 2007

- Review FASAB current standards and concepts on Entity
- Determine other relevant research sources on Entity
- Literature review of other standard-setters
- Determine overall approach, scope, and plan
- Develop Federal Entity Project Plan
- Seek Board's input on approach and scope and approval of plan

### Monitoring "Entity" projects of other standard-setters

Ongoing

--Several other standard-setters are currently working on projects that relate to reporting entity and/or consolidation issues. Staff will monitor the progress and determine relevance of ongoing issues throughout the project.

--Specifically, the IASB, FASB, IPSASP and GASB all have current projects or projects on the current agenda that relate to reporting entity and/or consolidation issues. See the section **Overview of Other Standard-Setters--Current Projects** for a summary of these projects and status.

--Staff will provide Board members with relevant updates and issue papers as appropriate.

**Concepts versus Standards****Ongoing**

-- The most apparent shortcoming in the FASAB literature is that the discussion on entity resides entirely in a concept statement. Thus, it is not equivalent in force to level A GAAP literature.

--A high level issue that will be considered throughout this project is what principles regarding Entity and Consolidation should be in a Concepts Statement versus a Standard. Application issues are best accomplished at the standards level. This issue and the potential line will become clearer as the Board deliberates the various issues. Based on developing this project plan, staff initially foresees the following:

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Issues that may be best addressed through **Concepts**:  
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- Definition of entity / reporting entity
- Guidance / characteristics for identifying reporting entities
- Criteria for including entities / boundary of the entities

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Issues that may be best addressed through **Standards**:  
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- Criteria for consolidating entities
- Reporting on other relationships--joint ventures, non-profit partnerships, other relationships that lead to an assumption of federal support without consolidation being required, etc
- Potential disclosures

-- Staff will prepare an analysis of what U.S. standard-setters and National and International standard-setters have currently in Concepts versus Standards on the Entity and Consolidation issues.

--Should guidance regarding consolidation be included in standards instead of concepts? In the absence of a standard on consolidation, are component entities able to avoid application of the conclusive and indicative criteria?

**ISSUE 1:****Definition of Entity / Reporting Entity****February 2007-May 2007**

--There are many “entity” terms used in FASAB’s literature—entity, reporting entity, federal reporting entity, component entity, component reporting entity, Federal Government entity.

--Staff will explore the different terms used in FASAB literature and if they have been defined.

--SFFAC 2 explains that the federal government is an extremely complex organizational structure which may be viewed from various perspectives and identifies reasons for defining entities.

--SFFAC 2 par. 29 states “reporting entities are entities that issue general purpose financial statements to communicate financial and related information about the entity.” Is this considered a definition?

--SFFAC 1 and other standards uses the term “entity” generically to refer, depending on the context, to the U.S. Government as a whole, organizational component units of the Government, e.g., an agency, or to other kinds of potential reporting units such as programs.

--The Original Pronouncements Consolidated Glossary includes the following definition for Entity: A unit within the federal government, such as a department, agency, bureau, or program, for which a set of financial statements would be prepared. Entity also encompasses a group of related or unrelated commercial functions, revolving funds, trust funds, and/or other accounts for which financial statements will be prepared in accordance with OMB annual guidance on Form and Content of Financial Statements.

--Is there a relationship between the reporting entity concept and the objectives of federal financial reporting? If so, should this be articulated?

--Staff will prepare an analysis of what U.S. standard-setters and National and International standard-setters have for the definition of Entity /Reporting Entity.

--This phase of the project will :

- Determine most appropriate terms to be used.
- Determine which terms, if any, need to be defined. For example, would there be separate definitions for entity and reporting entity?

--Concepts versus Standards?

**ISSUE 2:  
Characteristics of a Reporting Entity****June 2007- September 2007**

--SFFAC 2 states for an entity to be a reporting entity, "it would need to meet all of the following criteria:

- There is a management responsible for controlling and deploying resources, producing outputs and outcomes, executing the budget or a portion thereof, and held accountable for the entity's performance.
- The entity's scope is such that its financial statements would provide a meaningful representation of operations and financial condition.
- There are likely to be users of the financial statements who are interested in and could use the information in the statements to help them make resource allocation and other decisions and hold the entity accountable for its deployment and use of resources."

--Is there a relationship between the reporting entity concept and the objectives of federal financial reporting? If so, should this be articulated?

--Staff will prepare an analysis of what U.S. standard-setters and National and International standard-setters have for the characteristics or criteria or reporting entities?

--This phase of the project will:

- Determine if it is appropriate or necessary to list such criteria? (This would naturally be contingent upon results of the Definition phase above.)
- If so, is the list sufficient?
- Would it be more appropriate to list characteristics instead of criteria that must be met?

--Concepts versus Standards?

**Develop Working Draft****October 2007-December 2007**

--Develop a working draft based on results and decisions of above definition issues to ensure agreement on these areas:

- Reasons for Defining Entities
- Definition of Entities and/or Other Terms
- Characteristics of Entities

--Concepts versus Standards?

--Draft will be the basis for the Consolidation issues below.

**ISSUE 3:  
Consolidation Criteria****January 2008 - June 2008**

--With respect to the consolidated financial report (CFR) of the US Government, SFFAC 2 states the following overall objective of consolidation:

38. The ultimate aggregation of entities is into the entire Federal Government which, in reality, is the only independent economic entity—although some would say the entire country is the ultimate economic entity. The Federal Government entity would encompass all of the resources and responsibilities existing within the component entities, whether they are part of the Executive, Legislative, or Judicial branches (although, as noted in paragraph 5, FASAB's recommendations pertain only to the Executive Branch). The aggregation would include organizations for which the Federal Government is financially accountable as well as other organizations for which the nature and significance of their relationship with the government (see paragraphs 39 through 50) are such that their exclusion would cause the Federal Government's financial statements to be misleading or incomplete. (emphasis added)

--SFFAC 2 provides there are two types of criteria that should be considered when deciding what to include as part of a financial reporting entity. The first is a **conclusive criterion**, i.e., an inherent conclusion that for financial reporting purposes, any organization meeting this criterion is part of a specified larger entity.

--SFFAC 2 establishes a conclusive criterion such that any organization, program or account included in the budget would require inclusion in the U.S. Federal Government financial statements and the financial statements of the organization with which it appears (e.g., department or agency).



--SFFAC 2 provides the second type of criteria as **indicative criteria** that should be considered in the aggregate for defining a financial reporting entity in the Federal Government.

--SFFAC 2 establishes six indicative criteria as follows (summarized):

- It exercises any sovereign power of the government to carry out Federal functions.
- It is owned by the Federal Government.
- It is subject to the direct or continuing administrative control of the reporting entity.
- It carries out Federal missions and objectives.
- It determines the outcome or disposition of matters affecting the recipients of services that the Federal Government provides.
- It has a fiduciary relationship with a reporting entity.

--Staff will prepare an analysis of what U.S. standard-setters and National and International standard-setters have for the characteristics or criteria? Based on an initial review of other standard-setters, **control** is the main consideration factor for many in consolidation.

-- This phase of the project will:

- Determine if the existing conclusive and indicative criteria are necessary and sufficient by considering:
  - Are the criteria resulting in consistent and appropriate consolidated practices?
  - Are the criteria sufficient to address evolving entity models?
  - Is each criterion necessary?
  - Are there additional criteria that should be considered?
  - Is there a need for explanatory language regarding:
    - i. the meaning of each criterion, or
    - ii. when sufficient criteria are met and consolidation is required?
- Are there exclusive criteria that could be considered? For example, are there certain situations or certain conditions when it would not be appropriate to consolidate?
- Would a flowchart or diagram be useful to depict the criteria and process that is involved in determining if an entity is consolidated?

--Concepts versus Standards?

**ISSUE 4:  
Consolidation of Other Relationships and  
Other Unique Situations****July 2008 - October 2008**

--The Board is aware of a number of entity issues. While SFFAC 2 provides criteria for determining if an entity should be included as a federal entity, questions continue regarding whether certain activities should be included.

--Staff will prepare an analysis of what U.S. standard-setters and National and International standard-setters have for these types of relationships—joint ventures, special purpose entities, etc.

--This phase of the project will consider the following:

--If an entity is designated “not an agency or establishment of the United States Government” in law, is it a candidate for consolidation with any government entity? If so, how is its legal standing reconciled with the necessity to consolidate it with a federal reporting entity?

-- How should the criteria apply to joint ventures (ventures in which two or more entities share control equally)? If not consolidated, what information is needed regarding joint ventures?

--How should the criteria apply to consolidating special-purpose entities? For example, FASAB research on capital and operating leases discussed a need for consolidating special-purpose entities. Specifically, this issue focuses on a special purpose entity that is established to obtain financing for, design, construct, and operate, a Federal asset in a public/private venture. The research identified that the special purpose entity is not recognized or disclosed in the Federal agency’s financial statements. An argument can be made that the special purpose entity should be consolidated since the federal agency is the primary beneficiary.

--Should standards address disclosures relative to those entities not qualifying for consolidation but presenting significant financial or other accountability issues for the federal government? For example, should disclosure be required where there is:

- risk associated with entities having an implied federal guarantee?
- substantial support offered by non-government entities which share a common mission with a federal entity and collaborate on service delivery?
- Federal property used by non-federal entities?

--Is guidance needed to address component entity<sup>6</sup> issues? Such as:

- Determining whether to consolidate a separate entity first in a component entity financial statement.
- Determining which component entity among two or more component entities having roles and responsibilities related to the entity in question should consolidate that entity.

--Concepts versus Standards?

**ISSUE 5:****Consolidation Testing with Case Studies****November 2008 – December 2008**

--Based on results of Consolidation issues above, test final criteria:

- Development of case studies for:
  - i. Federally funded research and development centers
  - ii. Lease arrangements
  - iii. Newly created organizations
  - iv. Financing arrangements (partnerships)
  - v. Others?
- Outreach to preparers and auditors for other special cases for consideration

--Determine if case studies would be helpful as an Appendix to the Exposure Drafts

**Exposure Drafts of Proposed Concepts and/or Standards—Mid 2009**

Exposure Drafts of Proposed Concepts and/or Standards would be issued in mid-2009 based on the above project plan. Exposure Drafts of Proposed Concepts and/or Standards will build upon the Working Draft and Issue Papers detailed above. Exposure Drafts will naturally evolve and be drafted concurrently as the Board deliberates the issue areas noted above.

<sup>6</sup> The term “component entity” is used to distinguish between the U.S. Federal Government and its components. The U.S. Federal Government as a whole is composed of organizations that manage resources and are responsible for operations, i.e., delivering services. These include major departments and independent agencies, which are generally divided into suborganizations, i.e., smaller organizational units with a wide variety of titles, including bureaus, administrations, agencies, and corporations. (SFFAC No. 2, Entity and Display, pars. 11-12).

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## Overview of Other Standard-Setters

### Current Projects

It should be noted that there are several other standard-setters that have current projects relating to reporting entity and/or consolidation as follows:

- **IASB and FASB**—The Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) objective in the Joint Conceptual Framework Project is to develop a common conceptual framework that is complete and internally consistent. Phase D of the joint project is *Reporting Entity*. Neither of the Board's existing frameworks contains a robust reporting entity concept. The Reporting Entity phase will examine, refine, and clearly articulate the implicit reporting entity concept that exists. The focus of the Board's discussion in this project has been on the reporting entity concept and the concept of control. A summary of the major decisions to date is as follows<sup>7</sup>:

The Boards have tentatively decided that the conceptual framework should describe what constitutes an entity for the purposes of financial reporting but should not define it. Specifically, the Boards have tentatively decided 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, or is required (by legislation), to prepare GPEFR would be a reporting entity. Also, the Boards have tentatively decided that what constitutes an entity for financial reporting purposes should not be limited to legal entities. Rather, an entity can result from other types of arrangements or organizational structures. Examples include a company, trust, partnership, association, sole proprietorship, natural person and, in some circumstances, a branch or segment.

The Board also tentatively decided that the control concept should be used to determine the composition of a group entity and combinations. Guidance on possible combinations of entities that are part of the larger group would be provided at the standards, rather than concepts level. The Boards have tentatively decided 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. The Board also tentatively decided that:

- control is based upon an assessment of all the current facts and circumstances. Therefore, the concept of control includes all

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<sup>7</sup> Summary based on IASB website, September 2006 Meeting Summary and Observer Notes

situations in which control exists even though it might be temporary.

- 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.
- control cannot be shared, ie control involves a single entity (not multiple entities) having control over another entity.

The Boards discussed the relationship between the control concept and situations in which (a) two or more entities collectively have joint control of a joint venture or (b) an entity has significant influence over another entity. The Boards tentatively decided that, because control involves a single 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 Boards plan to complete initial deliberations on the concept of the reporting entity, which is expected to lead to a discussion document that contains the Boards' preliminary views.

In addition, FASB has a research project included on its agenda for Consolidations: Policy and Procedure. FASB has this on its agenda as a long-term research project to develop comprehensive guidance on accounting for affiliations between entities, including the reconsideration of ARB No. 51, *Consolidated Financial Statements*. The IASB also has this on its active project agenda. The objective of both projects is the development of a common, high-quality standard on consolidation policy. The IASB project is expected to yield a Discussion Paper in mid 2007, at which time FASB will consider whether to issue an Invitation to Comment based on the IASB document.

- **IPSASB**—International Public Sector Accounting Standards Board (IPSASB) initiated a collaborative project on the Public Sector Conceptual Framework. The objective of this project is to develop a Public Sector Conceptual Framework which is applicable to the preparation and presentation of general purpose financial reports of public sector entities. One phase of the project includes the concept of reporting entity and the characteristics of the reporting entity. IPSASB is in the early stages of the project as they are currently reviewing a revised Project Brief for the overall Conceptual Framework Project.

- **GASB**—The Governmental Accounting Standards Board’s (GASB) most recent Technical Plan includes the project Reporting Units Presentation/Statement 14 Reexamination. The focus of this project is to research potential requirements that could constitute GAAP for separately-issued financial statements for reporting units comprising less than a separate legal entity. The project will also reexamine the requirements of GASB 14, *The Financial Reporting Entity*, as amended, to determine the effectiveness of the current standard and whether reporting entities applying the standard were including appropriate organizations and excluding ones that should not be included.

Staff will monitor the progress of these projects and provide Board members with relevant updates and issue papers as appropriate.

## Existing Standards

As noted above, several standard-setters have current projects relating to the entity issue. However, there is much language in existing standards and concepts related to the entity concept and consolidation issues that will be considered. Specifically, research of existing standards, concepts, and other reports of other standard-setters included many references that contain information on the entity and consolidation issues. Below is a high-level summary of existing standards, concepts, and other reports for other standard-setters. This high-level summary is to provide an overview of the existing standards for the Federal Entity Project Plan, and should not be considered an in-depth analysis. A more detailed analysis and comparison will be prepared by issue areas identified in the **Proposed Actions and Milestones** section above. In addition, relevant excerpts for each of referenced standards, concepts, and other reports are included in the Appendices to this project plan.

## Governmental Accounting Standards Board (GASB)

### GASB Reference Materials

- GASB 14, *The Financial Reporting Entity*
- GASB 39, *Determining Whether Certain Organizations are Component Units*
- GASB J50, *Accounting for Participation in Joint Venture and Jointly Governed Organizations*

**See Appendix 2 for Excerpts of the reference materials.**

In 1994, GASB issued GASB 14, *The Financial Reporting Entity*, portions of which were amended and superseded by GASBS 34 and 35, to establish standards for defining the financial reporting entity for state and local governments. GASB cites Concepts statement No. 1, *Objectives of Financial Reporting*, as reasoning for financial reporting based on an accountability perspective. GASB Codification Section 2100 (Statement 34 edition) further explains the implementation of GASBS 14 as amended and superseded by GASBS 34 and 35.

According to GASB, the financial statements of the reporting entity should allow users to distinguish between the primary government and its component units rather than creating an impression that they are one legal entity. Information about the components and their relationship to the primary government should be conveyed to users in the financials. This is accomplished by discrete presentation of components by using separate columns and rows to distinguish financial data between components and the primary government.<sup>8</sup>

### GASB Financial Reporting Entity

As stated above, the GASB financial reporting entity includes the primary government, organizations for which the primary government is financially accountable and, other related organizations that if excluded, would cause the financial statements to be misleading or incomplete.

The Primary government is the core of the financial reporting entity and thus is typically of most interest to users of the financial statements. The primary government is any state government or general purpose local government (municipality or county) and consists of all of the organizations that make up its legal entity. Additionally, a primary

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<sup>8</sup> GASB Codification (Statement 34 Edition) Section 2100.111

government is any special-purpose government (a school district) that has a separately elected governing board, is legally separate, and is fiscally independent of other state and local governments.<sup>9</sup>

GASB requires that each of the funds, organizations, institutions, agencies, departments, and offices that are part of the primary government include its financial data with the primary government.

### **GASB Component Units**

Component units are legally separate organizations for which elected officials of the primary government are financially accountable. They can also take on the form of other organizations for which the nature and significance of the relationship with the primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete.<sup>10</sup>

GASB uses the term **financial accountability**, rather than accountability, to describe the kind of relationship warranting inclusion of a legally separate organization in the reporting entity of another government.<sup>11</sup> A primary government is financially accountable for legally separate components under either of the following circumstances.

- a. If the primary government appoints a voting majority of the organization's governing body and (1) it is able to impose its will on that organization or (2) there is a potential for the organization to provide specific financial benefits to, or impose specific financial burdens on the primary government.
- b. If an organization is fiscally dependent on the primary government regardless of whether the organization has (1) a separately elected governing board, (2) a governing board appointed by a higher level of government, or (3) a jointly appointed board.<sup>12</sup>

GASB notes that in evaluating component units, an organization may meet the benchmark for inclusion in more than one reporting entity. However, an organization should be included as a component unit of only one reporting entity. GASB states that judgment needs to be exercised and that usually, fiscal dependency on a local government, not the financial burden on the state should govern in determining the appropriate reporting entity.<sup>13</sup>

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<sup>9</sup> GASB Codification (Statement 34 Edition) Section 2100.112-13

<sup>10</sup> GASB Codification (Statement 34 Edition) Section 2100.119

<sup>11</sup> GASB Codification (Statement 34 Edition) Section 2100.120

<sup>12</sup> GASB Codification (Statement 34 Edition) Section 2100.120

<sup>13</sup> GASB Codification (Statement 34 Edition) Section 2100.137



GASB requires that certain organizations should be included as component units if the nature and significance of their relationship with the primary government, including their ongoing financial support of the primary government or its other component units, are such that exclusion from the financial reporting entity would render the financial reporting entity's financial statements incomplete or misleading. GASB states that it is a matter of professional judgment to determine whether the nature and the significance of a potential component unit's relationship with the primary government warrant inclusion in the reporting entity.

GASB requires that a legally separate, tax-exempt organization should be reported as a component unit of a reporting entity if all of the following criteria are met:

- a. The economic resources received or held by the separate organization are entirely or almost entirely for the direct benefit of the primary government, its component units, or its constituents.
- b. The primary government, or its component units, is entitled to, or has the ability to otherwise access, a majority of the economic resources received or held by the separate organization.
- c. The economic resources received or held by an individual organization that the specific primary government, or its component units, is entitled to, or has the ability to otherwise access, are significant to that primary government.<sup>14</sup>

In addition, GASB has developed a flowchart for evaluating component units. (See Appendix 2 for the flowchart.)

### **GASB Joint Ventures**

A joint venture is a legal entity or other organization that is created by a contractual arrangement and is owned, operated, or governed by two or more parties. The agreement is subject to joint control in which the parties must retain an ongoing financial interest and or an ongoing financial responsibility for the venture. Joint control indicates that no single party has unilateral control over the financial or operating policies of the joint venture.

According to GASB J50, *Accounting for Participation in Joint Ventures and Jointly Governed Organizations*, two types of joint ventures exist for financial reporting purposes: (a) joint ventures whose parties have an equity interest and (b) joint ventures whose parties do not have an equity interest.<sup>15</sup>

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<sup>14</sup> GASB Codification (Statement 34 Edition) Section 2100.140

<sup>15</sup> GASB Codification (Statement 34 Edition) J50, *Accounting for Participation in Joint Ventures and Jointly Governed Organizations*, Section .105

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Joint ventures whose parties have an equity interest are discretely presented in the government-wide financial statements to allow users to distinguish between the venture and the primary government.<sup>16</sup>

Joint ventures whose parties do not have an equity interest are only required to prepare disclosures pertaining to related party transactions as outlined in section 2300 of the Codification.

Regardless of whether there is an equity interest, GASB requires certain disclosure requirements for joint venture participants (in addition to the related party transaction disclosures). Joint venture participants are required to disclose a general description of each joint venture, including:

- 1) Description of the participating government's ongoing financial interest (including its equity interest, if applicable) or ongoing financial responsibility. This disclosure should also include information to allow the reader to evaluate whether the joint venture is accumulating significant financial resources or is experiencing fiscal stress that may cause an additional financial benefit to or burden on the participating government in the future.
- 2) Information about the availability of separate financial statements of the joint venture.<sup>17</sup>

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<sup>16</sup> GASB Codification (Statement 34 Edition) J50, Section .108 and Section 2200.112-3

<sup>17</sup> GASB Codification (Statement 34 Edition) J50, Section .109

## Financial Accounting Standards Board (FASB)

### FASB Reference Materials

- Concepts 6, *Elements of Financial Statements*
- SFAS 94, *Consolidation of All Majority Owned Subsidiaries*
- ARB 51, *Consolidated Financial Statements*
- APB 18, *The Equity Method of Accounting for Investments in Common Stock*
- FIN 35, *Criteria for Applying the Equity Method of Accounting for Investments in Common Stock*
- FIN 46, *Consolidation of Variable Interest Entities*
- Outstanding Exposure Drafts & Other Documents:
  - 1995 Consolidated Financial Statements: Policy & Procedures
  - 1999 Consolidated Financial Statements: Purpose & Policy
  - 1986 Draft Document *Reporting Entity-Tentative Conclusions*

**See Appendix 3 for Excerpts of the reference materials.**

FASB's existing framework does not contain a robust reporting entity concept, but an implicit reporting entity concept exists. For example, the FASB framework does not contain a definition for reporting entity.<sup>18</sup> There is some description in FASB Concepts Statement No. 6, *Elements of Financial Statements*. Specifically, par. 24 states:

All elements are defined in relation to a particular entity, which may be a business enterprise, an educational or charitable organization, a natural person, or the like. An item that qualifies under the definitions is a particular entity's asset, liability, revenue, expense, or so forth. An entity may comprise two or more affiliated entities and does not necessarily correspond to what is often

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<sup>18</sup> The FASB/IASB Joint Conceptual Framework Project, Phase D *Reporting Entity* will examine, refine, and clearly articulate the implicit reporting entity concept that exists. See Current Projects section above for additional information on the project.

described as a "legal entity." The definitions may also refer to "other entity," "other entities," or "entities other than the enterprise," which may include individuals, business enterprises, not-for-profit organizations, and the like. For example, employees, suppliers, customers or beneficiaries, lenders, stockholders, donors, and governments are all "other entities" to a particular entity. A subsidiary company that is part of the same entity as its parent company in consolidated financial statements is an "other entity" in the separate financial statements of its parent.

ARB-51, *Consolidated Financial Statements*, as amended by SFAS-94, *Consolidation of All Majority-Owned Subsidiaries*, is the FASB's primary source of guidance on the issue of consolidated financial statements. According to ARB-51, the purpose of reporting consolidated financial statements is to present information about a parent company and its subsidiaries as if it was one legal entity. There is a presumption that consolidated financial statements are more useful than presenting separate statements and that consolidated statements more accurately represent the business and its involvements.<sup>19</sup>

### Consolidation Policy

The general rule of consolidation policy as outlined in ARB-51 and SFAS-94 is **controlling financial interest**, usually obtained through ownership of a majority voting interest. A majority voting interest is typically obtained by a company directly or indirectly owning greater than fifty percent of the outstanding voting shares of another company.<sup>20</sup> There are however, instances where exclusion of majority owned subsidiaries are permitted. These include situations where control is likely to be temporary, or where control does not rest with the majority owners as in bankruptcy or corporate reorganizations.<sup>21</sup>

ARB-51 presents an option for reporting combined financial statements under certain circumstances. Consolidated financial statements are used when the controlling financial interest is attributed to one of the companies included in the consolidation. When no financial control exists, it may be useful to present combined financial statements to achieve the same results for a group of companies that fall under common management influence.

SFAS-94 describes two instances where consolidation is not mandatory. In the event that control is temporary or where it does not rest with the majority owners, the equity method, explained in APB No. 18, *The Equity Method of Accounting for Investments in*

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<sup>19</sup> par. 1, ARB No. 51, *Consolidated Financial Statements*

<sup>20</sup> Par. 2, SFAS No. 94, *Consolidation of All Majority-Owned Subsidiaries*

<sup>21</sup> Par. 4, SFAS No. 94

*Common Stock*, as amended, is an option that the preparer of financial statements can utilize.

Interpretation No. 46, *Consolidation of Variable Interest Entities* (FIN 46) clarifies portions of ARB-51 relating to the entities in which equity investors either (1) do not have the characteristics of a controlling financial interest or (2) do not have sufficient equity invested for the entity to finance its activities without additional financial support.<sup>22</sup> This interpretation explains the characteristics of a variable interest entity and also provides guidance for an enterprise to assess its interests in a variable interest entity to determine whether it should be consolidated.

FIN 46 requires an enterprise to consolidate a variable interest entity if it will be responsible for absorbing a majority of the entity's expected losses or receiving a majority of the expected benefits, or both.<sup>23</sup> The enterprise that consolidates a variable interest entity is considered the primary beneficiary.

FIN 46 requires the primary beneficiary of a variable interest entity to disclose the following:

- a. The nature, purpose, size and activities of the variable interest entity.
- b. The carrying amount and classification of consolidated assets that are collateral for the variable interest entity's obligations.
- c. Lack of recourse if creditors (or beneficial interest holders) of a consolidated variable interest entity have no recourse to the general credit of the primary beneficiary.<sup>24</sup>

An enterprise that holds a significant variable interest in a variable interest entity but is not the primary beneficiary must disclose:

- a. The nature of its involvement with the variable interest entity and when that involvement began.
- b. The nature, purpose, size and activities of the variable interest entity.
- c. The enterprise's maximum exposure to loss as a result of its involvement with the variable interest entity.<sup>25</sup>

APB Opinion No. 18 (APB 18), *The Equity Method of Accounting for Investments in Common Stock*, as amended by SFAS-94, *Consolidation of All Majority-Owned*

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<sup>22</sup> Par. 1, FIN No. 46, *Consolidation of Variable Interest Entities*

<sup>23</sup> Par. 14, FIN No. 46

<sup>24</sup> Par. 23, FIN 46

<sup>25</sup> Par. 24, FIN 46

*Subsidiaries*, provides guidance on accounting for investments where the owner does not meet the majority ownership requirement of a subsidiary however, is in a position to exert significant influence over the investee. This method allows an investor to include its share of the investee's earnings or losses because the investor is partially responsible for its return on investment.<sup>26</sup>

APB 18 warrants the use of the equity method when an investor has the ability to exert significant influence over the investee. Significant influence according to the opinion is typically presumed when an investor has at least a 20% ownership in the investee. Interpretation No. 35 *Criteria for Applying the Equity Method of Accounting for Investments in Common Stock*, (FIN 35) clarifies a presumption in APB 18, that 20% ownership, clearly grants an investor the ability to exert significant influence and provides examples of these situations. It is important to understand that the 20% ownership is only a benchmark as significant influence can be obtained with a lesser degree of ownership and conversely, an investor may not have the ability to influence when it owns greater than 20%. Careful judgment and evaluation of the situation is necessary.

## International Accounting Standards Board (IASB)

### IASB Reference Materials

- IAS 27, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*
- IAS 28, *Accounting for Investments in Associates*
- IAS 31, *Interests in Joint Ventures*
- SIC Interpretation 12, *Consolidation—Special Purpose Entities*
- SIC Interpretation 33, *Consolidation and Equity Method – Potential Voting Rights and Allocation of Ownership Interests*

**See Appendix 4 for Excerpts of the reference materials.**

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<sup>26</sup> Par. 12, APB 18, *The Equity Method of Accounting for Investments in Common Stock*

IASB's framework does not contain a robust reporting entity concept.<sup>27</sup> IAS 27, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*, provides international guidance on accounting for consolidated financial statements and accounting for investments in subsidiaries. IAS 27 requires consolidation of all foreign and domestic subsidiaries unless they meet the requirements for exclusion. IAS 27 requirement for inclusion in the consolidated financial statements is **control**. The standard also describes several disclosures that are required when consolidating or excluding subsidiaries from the consolidated financial statements.

### IASB Characteristics of Control

1. Control is presumed to exist when the parent owns more than 50% of the voting power directly or indirectly.
2. Control also exists when less than 50% of the voting power is owned under the following situations:
  - a) An agreement with other investors grants the parent more than 50% of the voting rights.
  - b) An agreement or statute grants the parent the power to govern the financial and operating policies of the enterprise.
  - c) The parent has the power to appoint or remove members of the governing board.
  - d) The parent has the power to cast a majority of the votes at board meetings.<sup>28</sup>

### IASB Criteria for Exclusion

The IASB criteria for **excluding** a subsidiary from the consolidated financial statements are when either of the following situations exists<sup>29</sup>:

1. Control is intended to be temporary.
2. The subsidiary operates under severe long-term restrictions that impair its ability to transfer funds to the parent.<sup>30</sup>

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<sup>27</sup> The FASB/IASB Joint Conceptual Framework Project, Phase D *Reporting Entity* will examine, refine, and clearly articulate the implicit reporting entity concept that exists. See Current Projects section above for additional information on the project.

<sup>28</sup> Par. 12, IAS 27, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*

<sup>29</sup> It should be noted that the criteria for excluding a subsidiary from the consolidated financial statements is very similar to that indicated in IPSAS No. 6 which is discussed in the IPSASB section that follows.

<sup>30</sup> Par. 13, IAS 27

Excluding subsidiaries from the consolidated financial statements on the grounds that the activities it undertakes are dissimilar from those of the rest of the parent company is not permitted.<sup>31</sup>

### Required Disclosures

The following are a partial list of the relevant disclosures that IAS 27 requires in consolidated financial statements.

- A listing of significant subsidiaries including proportion of ownership interest and proportion of voting power held (if different).
- Reasons for not consolidating a subsidiary.
- A description of the relationship between the parent and subsidiary of which the parent does not own more than one half of the voting power.<sup>32</sup>

### Consolidation of Special Purpose Entities

According to SIC Interpretation No. 12, *Consolidation—Special Purpose Entities*, a special purpose entity is an entity created to accomplish a narrow and well-defined objective (e.g., to effect a lease, research and development activities or a securitization of financial assets).<sup>33</sup> Interpretation 12 provides additional guidance to determine whether consolidation of a special purpose entity is appropriate. IAS 27 provided circumstances where control may exist despite an enterprise having less than half of the voting power (See “Characteristics of Control” above). The following list indicates additional circumstances where an enterprise may control a special purpose entity:

- a. The activities of the special purpose entity are performed according to the business needs of the enterprise so that it benefits from the special purpose entity’s operation.
- b. The enterprise has the decision-making powers to obtain the majority of the benefits of the special purpose entity’s operations.
- c. The enterprise has the rights to receive the majority of the benefits of the special purpose entity and therefore may be exposed to the risks of the entity’s activities.
- d. The enterprise retains the majority of the ownership risks of the special purpose entity.<sup>34</sup>

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<sup>31</sup> Par. 14, IAS 27

<sup>32</sup> Par. 32, IAS 27

<sup>33</sup> Par. 1, SIC Interpretation 12, *Consolidation – Special Purpose Entities (IAS 27)*

<sup>34</sup> Par. 10, SIC Interpretation 12



## Accounting for Investments in Associates

IAS 28, *Accounting for Investments in Associates*, provides guidance on accounting for Investments in Associates. An associate is an enterprise in which an investor has the ability to exert significant influence. Significant influence (similar to the definition outlined by FASB and the IPSAS) is presumed to exist when the investor holds 20% or more of the voting power indirectly or directly.<sup>35</sup> The following list of circumstances generally indicates the existence of significant influence:

- a. Representation on the governing board.
- b. Participation in the process of forming policies.
- c. Material transactions between the investor and investee.
- d. Interchange of management personnel.
- e. Provision of essential technical information.<sup>36</sup>

Investments in associates are accounted for utilizing the equity method except under the following circumstances:

- a. Investment acquired with the intent to dispose of in near future.
- b. Investment's ability to transfer funds to investor is significantly impaired by restrictions.<sup>37</sup>

## Joint Ventures

IAS 31, *Interest in Joint Ventures*, was issued in December 2003 and was applicable to annual periods beginning on or after 1 January 2005. IAS 31 applies in accounting for interests in joint ventures and the reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers, regardless of the structures or forms under which the joint venture activities take place.

IAS 31 describes a joint venture is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control. There are three types as follows: jointly controlled operations, jointly controlled assets, and jointly controlled entities. IAS 31 states joint control exists only when the strategic, financial and operating decisions relating to the economic activity require the unanimous consent of the parties sharing control.

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<sup>35</sup> Par. 4, IAS 28, *Accounting for Investments in Associates*

<sup>36</sup> Par. 5, IAS 28

<sup>37</sup> Par. 8, IAS 28

## Voting Rights

SIC Interpretation No. 33, *Consolidation and Equity Method – Potential Voting Rights and Allocation of Ownership Interests*, discusses the issue of whether the existence of control and significant influence is determined based on present ownership or potential ownership interests. According to the Interpretation No. 33, the existence of potential voting rights that are currently exercisable should be considered when evaluating control or significant influence as described in IAS 27 and 28.<sup>38</sup> Potential voting rights that are not presently exercisable should not be considered.

## International Public Sector Accounting Standards Board (IPSASB)

### IPSASB Reference Materials

- IPSAS 6, *Consolidated Financial Statements and Accounting for Controlled Entities*
- IPSAS 7, *Accounting for Investments in Associates*
- IPSAS 8, *Financial Reporting of Interests in Joint Ventures*
- Public Sector Accounting Study 8—*The Government Financial Reporting Entity*

**See Appendix 5 for Excerpts of the reference materials.**

In May of 2000, the International Federation of Accountants established International Public Sector Accounting Standard (IPSAS) No. 6, *Consolidated Financial Statements and Accounting for Controlled Entities*, to provide guidance for preparing and presenting consolidated financial statements by public sector entities. IPSAS 6, par. 9 defines economic entity as “*The term ‘economic entity’ is used in this Standard to define, for financial reporting purposes, a group of entities comprising the controlling entity and any controlled entities.*” IPSAS No. 7, *Accounting for Investments in Associates*, prescribes the use of the equity method to account for investments when control does not exist but the investor may still possess the ability to exert “significant influence.”

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<sup>38</sup> Par. 3, SIC No. 33, *Consolidation and Equity Method – Potential Voting Rights and Allocation of Ownership Interests*

## Criteria for Inclusion

IPSAS 6 requires public sector entities to consolidate those entities which it **controls**. The standard provides two components (power and benefit) of control to determine whether control of an entity exists as follows:

1. The power to govern the financial and operating policies of another entity.
2. The ability to benefit from the activities of another entity.<sup>39</sup>

IPSAS also developed a flowchart to assist in determining the existence of control of another entity. The flowchart is included in Appendix 5.

## Determining the Existence of Control

IPSAS 6 provides a list of conditions that demonstrate the power and benefit elements that must exist for control to be established. The standard requires that a controlling entity possess at least one power condition and one or more benefit conditions among the following.

### Power Conditions

1. Ownership of a majority voting interest in the entity.
2. Power to appoint or remove governing board members.
3. Power to cast or regulate the casting of a majority of the votes at general meetings.
4. Power to cast a majority of the votes at a governing board meeting.

### Benefit Conditions

1. Ability to dissolve the other entity and obtain significant level of the residual economic benefits or bear significant obligations.
2. Ability to extract distributions of assets or be subject to liabilities of the other entity.<sup>40</sup>

The existence of at least one power condition and one benefit condition from the list above are indicators that control exists unless strong evidence suggests control is held by another entity. The standard also provides an additional listing of indicators that can be used to identify whether control exists in the event that the conditions above are not satisfied. These indicators may not be as easy to identify as those conditions above and therefore, careful examination of each relationship is necessary.

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<sup>39</sup> Par. 26, IPSAS No. 6, *Consolidated Financial Statements and Accounting for Controlled Entities*

<sup>40</sup> Par. 35, IPSAS 6

### Exclusion of Controlled Entities

According to IPSAS 6, controlled entities are to be consolidated unless they meet one of two exceptions.

1. In the event that control is temporary because it is likely that the entity will be disposed of in the short term.
2. The controlled entity operates under external long-term restrictions that prevent the controlling entity from receiving any benefits of its operations.<sup>41</sup>

### Accounting for Investments in Associates

According to IPSAS No. 7, *Accounting for Investments in Associates*, an associate is an entity in which the investor has significant influence and which is neither a controlled entity nor a joint venture of the investor.<sup>42</sup> Associates are accounted for utilizing the equity method and are included in the consolidated financial statements. This standard applies to all public sector entities that possess an ownership interest in an associate. Government Business Enterprises are required to comply with International Accounting Standards and thus are not included in this standard.

IPSAS 7 provides the following list of indicators that generally indicate that a public sector entity has the ability to exert significant influence over an associate. These indicators are identical to those outlined in IAS 28.

- a. Representation on the governing board.
- b. Participation in the process of forming policies.
- c. Material transactions between the investor and investee.
- d. Interchange of management personnel.
- e. Provision of essential technical information.<sup>43</sup>

Additionally, when ownership can be determined by amount of shares held by the investor, a 20% or greater holding implies the ability to exert significant influence.<sup>44</sup> This, similar to APB 18, is only a bench-mark and requires judgment in evaluating each situation to determine if other factors clearly indicate the existence or lack of the ability to exert significant influence.

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<sup>41</sup> Par. 22, IPSAS No. 6

<sup>42</sup> Par. 6, IPSAS No. 7, *Accounting for Investments in Associates*

<sup>43</sup> Par. 16, IPSAS 7

<sup>44</sup> Par. 17, IPSAS 7

## Joint Ventures

According to IPSAS No. 8, *Financial Reporting of Interests in Joint Ventures*, a joint venture is a binding arrangement whereby two or more parties are committed to undertake an activity which is subject to joint control.<sup>45</sup> The binding agreement differentiates joint control derived from a joint venture and joint control from an investment in an associate. The arrangement signifies that no one party has unilateral control of the activity.<sup>46</sup>

IPSAS No. 8 identifies two characteristics of all joint ventures:

1. The existence of two or more parties that are bound by an arrangement.
2. The arrangement establishes joint control between the parties.

The standard identifies three common types of joint ventures: 1) jointly controlled operations 2) jointly controlled assets, and 3) jointly controlled entities.

### Jointly Controlled Operations

This type of joint venture results when the assets and resources owned by the parties in agreement are utilized rather than establishing a new corporation or entity. Each party uses its own property, plant & equipment and carries its own inventory. With respect to jointly controlled operations, the consolidated financial statements should include the following information:

- a. The assets controlled and liabilities incurred by each party to the venture.
- b. The expenses incurred by each party and its share of revenues earned from the venture.<sup>47</sup>

### Jointly Controlled Assets

Joint ventures may also involve joint ownership of one or more assets that are contributed to or acquired for the purpose of the venture. Similar to the jointly controlled operations, this type of joint venture does not involve the creation of a separate entity. With respect to jointly controlled assets, the consolidated financial statements of each party should include the following information:

- a. Its share of jointly controlled assets, classified according to the nature of the assets.

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<sup>45</sup> Par. 5, IPSAS No. 8, *Financial Reporting of Interests in Joint Ventures*

<sup>46</sup> Par. 8, IPSAS 8

<sup>47</sup> Par. 20, IPSAS 8

- b. Any liabilities, which it has incurred.
- c. Its share of any joint liabilities incurred in respect to the venture.
- d. Its share of any revenue earned and expenses relating the sale or use of the output produced by the joint venture.
- e. Any expenses incurred relating to its interest in the joint venture.<sup>48</sup>

### **Jointly Controlled Entities**

A jointly controlled entity involves the establishment of corporation, partnership or other entity in which each party has an interest. The entity controls assets and incurs liabilities. It also incurs expenses and earns revenues in relation to the joint venture. IPSAS 8 recommends using either of two reporting formats for proportionate consolidation of a jointly controlled entity. Proportionate consolidation refers to the share of assets owned or liabilities incurred that a party to joint venture is responsible for. The consolidated statement also includes a party's share of revenues and expenses of the jointly controlled entity.<sup>49</sup> The following is a list of the appropriate formats for reporting proportionate consolidation.

1. Party may combine its share of assets, liabilities, revenues and expenses of a jointly controlled entity with similar items in its consolidated financial statements on a line-by-line basis or;
2. The party may include separate line items for its share of assets, liabilities, revenues and expenses of the jointly controlled entity in its consolidated financial statements.<sup>50</sup>

An alternative treatment of accounting for the joint venture is the equity method, however, it is not a recommended method in the statement. IPSAS 8 states that proportionate consolidation better reflects the substance and economic reality of a party's interest in a joint venture.<sup>51</sup>

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<sup>48</sup> Par. 26, IPSAS 8

<sup>49</sup> Par. 38, IPSAS 8

<sup>50</sup> Par. 39, IPSAS 8

<sup>51</sup> Par. 44, IPSAS 8

## NATIONAL STANDARDS—Australia and Canada

### National Standards Reference Materials

#### Australia

- SAC 1, *Definition of the Reporting Entity*
- AAS 24, *Consolidated Financial Reports*
- AAS 29, *Financial Reporting for Government Departments*

#### Canada

- CICA Public Sector Accounting Concepts and Principles Section 1300, *Government Reporting Entity*

**See Appendix 6 for Excerpts of the reference materials.**

## Australia

The Australian Conceptual Framework contains one of the longest and most developed discussions of the reporting entity concept to be found in other standard setters' frameworks. Statement of Accounting Concepts (SAC) 1, *Definition of the Reporting Entity*, was issued in 1990 and applies to all reporting entities, including both business and not for profit.

The concept of the reporting entity established by SAC 1 is one linked to the information needs of users of general purpose financial reports in making and evaluating resource allocation decisions. The provision of information for these purposes is the criterion used to determine the boundaries of a particular reporting entity.

SAC 1 provides that in some instances a reporting entity will comprise an individual entity, in other instances a reporting entity will comprise a group of entities, some of which individually may be reporting entities. SAC 1 discussed that one of the entities within the group will control the other entities so that they operate together to achieve objectives consistent with those of the controlling entity.

SAC 1 provides the following factors to be considered in determining whether control exists: extent and implications of financial dependence, capacity to appoint or remove managements or governing bodies, and power to direct operations.

SAC 1 provides the identification of an entity as a reporting entity is linked to the information needs of users of general-purpose financial reports. In many instances, it will be readily apparent whether, in relation to an entity, there exist users who are dependent on general-purpose financial reports as a basis for making and evaluating resource allocation decisions. For those entities where it is not readily apparent whether users exist, SAC 1 provides the following factors for consideration and identification of whether dependent users exist:

1. Separation of management from economic interest
2. Economic or political importance/influence
3. Financial characteristics

SAC 1 notes that the factors are indicative only, and are not the only factors that will be relevant in determining whether, in a particular circumstance, an entity is a reporting entity. SAC 1 also stresses that judgment is required in determining whether an entity satisfies criteria.

*AAS 29, Financial Reporting for Government Departments* requires public sector entities to prepare consolidated financial statements according to *AAS 24, Consolidated Financial Reports*. *AAS 24* provides guidance on preparing consolidated financial reports and for determining the appropriateness of including entities in the consolidated financial statements of a reporting entity. The standard requires a parent entity to include within its consolidated financial statements, all entities that it **controls**.

A significant difference between *AAS 24* and other standards discussed previously is the requirement for a parent entity to consolidate any controlled entity without exception, regardless of whether control is either temporary or impaired.<sup>52</sup>

The determining criterion for including an entity within the consolidated financial statements of a parent entity is control. The standard defines control as the capacity of an entity to dominate decision-making, directly or indirectly, in relation to the financial and operating policies of another entity so as to enable that other entity to operate with it in pursuing the objectives of the controlling entity.<sup>53</sup>

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<sup>52</sup> Par. 9-13, *AAS 24, Consolidated Financial Reports*

<sup>53</sup> Par. 8, *AAS 24*



## Characteristics of Control

The following list provides indicators that normally demonstrate the existence of control of one entity over another.

- a. The ability to dominate the composition of the governing board of another entity.
- b. The ability to appoint or remove at least a majority of the board members of another entity.
- c. The ability to control the casting of a majority of the votes at board meetings of another entity.
- d. The ability to cast or regulate the casting of a majority of the votes at general meetings of another entity.
- e. The existence of a statute or agreement, which grants an entity the ability to receive a majority of the benefits and to be exposed to a majority of the risks of another entity.<sup>54</sup>

The standard also includes additional factors that may indicate the existence of control. Ownership of a majority interest is normally accompanied by the existence of control. In this case however, the ability to have a majority of the voting rights constitutes control and not the ownership interest.

Another more common occurrence in the public sector is the existence of control specified by legislative or executive authority where a controlling entity has the power to give policy directions.<sup>55</sup>

## Canada

### Defining the Government Reporting Entity

The CICA Public Sector Accounting Concepts and Principles Section 1300, *Government Reporting Entity* provides guidance for determining which entities are consolidated in the financial statements of a government. The requirement for including an entity within the consolidated financial statements of the reporting entity according to PS 1300 is **control**.<sup>56</sup> Control is defined as the power to govern the financial and operating policies of another organization with expected benefits or the risk of loss to the government from the other organization's activities.<sup>57</sup>

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<sup>54</sup> Par. 22, AAS 24

<sup>55</sup> Par. 24, AAS 24

<sup>56</sup> Par. 7, CICA PS 1300, *Government Reporting Entity*

<sup>57</sup> Par. 8, CICA PS 1300

## Indicators of Control

Professional judgment must be used when determining whether a reporting entity controls another organization. Control generally exists when the government:

- a. Has power to unilaterally appoint or remove a majority of the governing board members of another organization;
- b. Has access to another organization's assets or has the ability to direct the use of the assets, or is responsible for the losses;
- c. Holds a voting majority or a "golden share"<sup>58</sup> that allows it to govern the financial and operating policies of the organization; and
- d. Has the unilateral power to dissolve the organization having access to the assets and bearing responsibility for the responsibilities.<sup>59</sup>

The following list may be an indication that controls exists when the government has the power to:

- a. Provide significant input into the appointment of board members;
- b. Appoint or remove key executives or personnel;
- c. Implement or alter the organization's mission;
- d. Approve the budgets or business plans of the organization;
- e. Establish limits on borrowing and investing of the organization;
- f. Limit the capacity to generate revenue for the organization; and
- g. Establish or change management policies including those relating to accounting, personnel, compensation, collective bargaining or deployment of resources.<sup>60</sup>

## Limitations on Control

The following is circumstances do not indicate the existence of control without further evidence that indicates otherwise.

- a. The ability to temporarily control an organization in extreme circumstances.
- b. The ability to regulate an organization or industry that it operates in.
- c. The financial dependence of an organization on the government.

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<sup>58</sup> "Golden Share" gives a holder specified powers that typically exceed the powers normally associated with the holder's ownership interest.

<sup>59</sup> Par. 18, CICA PS 1300

<sup>60</sup> Par. 19, CICA PS 1300

## High-level Comparison Charts

Figure 1 presents a high-level summary of the SFFAC 2 guidance regarding conclusive and indicative criteria as well as the requirements of the Governmental Accounting Standards Board and the Financial Accounting Standards Board. Figure 2 presents a high-level summary of selected international requirements on the subject. More detailed comparisons will be developed on each issue area identified in the project plan.

The most apparent shortcoming in the FASAB literature is that it resides entirely in a concept statement. Thus, it is not equivalent in force to level A GAAP literature. Of the references provided in Figures 1 and 2, FASAB is the only standard setter that has not included in its standards requirements for consolidation.

Figure 1: Comparison of U.S. Standards

Figure 1: Comparison of U.S. Standards				
Country	Document	Scope	Consolidation Requirement	Definition / Criteria
United States of America	FASAB Statement of Federal Financial Accounting Concepts No. 2, <i>Entity and Display</i>	Federal Sector	Financial Accountability and existence of a Significant Relationship where exclusion would cause the financial statements to be misleading or incomplete. (¶ 38)	<p>Conclusive criterion</p> <ul style="list-style-type: none"> <li>Any organization, program, or budget account, including off-budget accounts and government corporations, included in the Federal budget section currently entitled "Federal Programs by Agency and Account."</li> </ul> <p>Indicative criteria</p> <ul style="list-style-type: none"> <li>It exercises any sovereign power of the government to carry out Federal functions.</li> <li>It is owned by the Federal Government</li> <li>It is subject to the direct or continuing administrative control of the reporting entity.</li> <li>It carries out Federal missions and objectives.</li> <li>It determines the outcome or disposition of matters affecting the recipients of services that the Federal Government provides.</li> <li>It has a fiduciary relationship with a reporting entity.</li> </ul>
	GASB Statement No. 14, <i>The Financial Reporting Entity</i>	State and Local Government Entities	Financial Accountability	<p>A primary government is financially accountable for legally separate components under either of the following circumstances:</p> <ol style="list-style-type: none"> <li>The primary government appoints a voting majority of the organization's governing board and (1) it is able to impose its will on that organization or (2) there is potential for the organization to provide specific financial benefits to, or impose specific financial burdens on the primary government.</li> <li>If an organization is fiscally dependent on the primary government. (¶ 20)</li> </ol>
	FASB Statement of Financial Accounting Standards No. 96	Private Sector Entities	Controlling Financial Interest	<p>The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one company, directly or indirectly, of over fifty percent of the outstanding voting shares of another company is a condition pointing toward consolidation. (¶ 13)</p>

**Figure 2: Comparison of National and International Standards**

<b>Figure 2: Comparison of National and International Standards</b>				
<b>Country</b>	<b>Document</b>	<b>Scope</b>	<b>Consolidation Requirement</b>	<b>Definition / Criteria</b>
Australia	Australian Accounting Standard AAS 24, <i>Consolidated Financial Reports</i>	Private and public sector entities, excluding those at the "whole-of-government" level for each State, Territory and the Federal Government	Control	Control means the capacity of an entity to dominate decision making, directly or indirectly, in relation to the financial and operating policies of another entity so as to enable that other entity to operate with it in pursuing the objectives of the controlling entity. (¶ 18)
Canada	CICA Handbook Section 1590, <i>Subsidiaries</i>	Profit-oriented enterprises	Control	Control of an enterprise is the continuing power to determine its strategic operating investing and financing policies without the co-operation of others. (¶ .03)
	Public Sector Accounting Recommendations, Section PS 1300, <i>Government Reporting Entity</i>	Federal, provincial, territorial and local governments	Control	Control is the power to govern the financial and operating policies of another organization with expected benefits or the risk of loss to the government from the other organization's activities. (¶ .08)
International Accounting Standards Board	International Accounting Standard IAS 27, <i>Consolidated Financial Statements and Accounting for Investments in Subsidiaries</i>	Private sector parent entities	Control	Control is the power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities. (¶ 6)
International Federation of Accountants	International Public Sector Accounting Standard 6, <i>Consolidated Financial Statements and Accounting for Controlled Entities</i>	Public sector entities other than Government Business Enterprises	Control	Control is the power to govern the financial and operating policies of another entity so as to benefit from its activities. (¶ 8)

## **APPENDICES**

The appendices that follow contain pertinent excerpts from concepts, standards, and other reports that relate to the entity and consolidation issue. The excerpts are provided for additional background to accompany the Federal Entity Project Plan. Staff provided pertinent excerpts (versus full copies of the concepts, standards, and other reports) in an attempt to provide members with a manageable stack of reference materials. Full copies will be provided to members upon request.

Relevant portions of each of the referenced concepts, standards, and other reports will be analyzed in greater detail throughout the project.

## APPENDIX 1

### SFFAC No. 2: *Entity and Display*—Excerpt, paragraphs 1 through 53

#### *Introduction*

1. A basic postulate of accounting is that accounting information pertains to entities, i.e., circumscribed legal, administrative, fiduciary, or other organizational structures. Another basic postulate is that entities use financial reports to communicate financial and related information about the entity to persons concerned with the entity.
2. The purpose of this statement of accounting concepts is to provide guidance as to what would be encompassed by a Federal Government entity's financial report. The statement specifies the types of entities for which there ought to be financial reports (hereinafter called reporting entities), establishes guidelines for defining the makeup of each type of reporting entity, identifies types of financial reports for communicating the information for each type of reporting entity, and suggests the types of information each type of report would convey.
3. A statement of financial accounting concepts is intended to guide the members of the Federal Accounting Standards Advisory Board (FASAB) as they deliberate and recommend accounting standards for the Federal Government. It also would be useful to the Office of Management and Budget (OMB), when it carries out its statutory responsibilities for specifying who should prepare financial statements and the form and content of those statements;<sup>61</sup> and as broad guidance for preparers, auditors, and users of financial statements of Federal agencies. A statement of financial accounting concepts does not, in and of itself, represent standards that would be considered generally accepted accounting principles for Federal agencies to be followed for the preparation of financial statements.
4. This statement does not try to define which reporting entities must prepare and issue financial statements. That authority and responsibility resides with the Congress, OMB, and other oversight organizations and resource providers.
5. The specification of reporting entities intends to be suitable for all organizations within the Executive branch of the Federal Government, including the Departments,

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<sup>61</sup>OMB specifies the form and content of agency and governmentwide financial statements, pursuant to authority assigned in the Chief Financial Officers Act of 1990, as amended (title 31, U. S. Code, section 3515(d) and section 331(e)(1)) through periodic issuance of OMB Bulletins. OMB intends to base the form and content on the concepts contained in this statement.

independent agencies,<sup>62</sup> commissions, and corporations. FASAB does not propose to recommend accounting concepts and standards for the Legislative and Judicial branches. However, the concepts recommended in this statement would be appropriate for those branches.

6. The concepts, as defined in this statement, are intended primarily for the general purpose financial reporting performed by Federal entities. This is the financial reporting that these entities would undertake to help meet the objectives defined in Statement of Federal Financial Accounting Concepts (SFFAC) No. 1, "Objectives of Federal Financial Reporting." These objectives are as follows:

- **Budgetary integrity.** Federal financial reporting should assist in fulfilling the government's duty to be publicly accountable for monies raised through taxes and other means and for their expenditure in accordance with the appropriations laws that establish the government's budget for a particular fiscal year and related laws and regulations.
- **Operating performance.** Federal financial reporting should assist report users in evaluating the service efforts, costs, and accomplishments of the reporting entity; the manner in which these efforts and accomplishments have been financed; and the management of the entity's assets and liabilities.
- **Stewardship.** Federal financial reporting should assist report users in assessing the impact on the country of the government's operations and investments for the period and how, as a result, the government's and the nation's financial conditions have changed and may change in the future.
- **Systems and control.** Federal financial reporting should assist report users in understanding whether financial management systems and internal accounting and administrative controls are adequate to ensure proper execution of transactions, safeguard assets, and support performance measurement.

7. The concepts are also intended, as FASAB's mission statement requires, to help in meeting the financial and budgetary information needs of executive agencies and Congressional oversight groups, and to strengthen the conceptual basis and consistency of Federal accounting data.

8. The entity and display concepts presented in this statement do not preclude the specification of ad hoc or temporary reporting entities to meet special reporting needs of users of Federal agencies' financial information. Nor do they preclude a reporting entity from preparing special purpose financial reports to meet the specific needs of persons

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<sup>62</sup>"Independent agencies" is a term used to distinguish agencies that are independent of a Cabinet department from the agencies that are part of the Cabinet departments. Independent agencies report directly to the President and are part of the U. S. Government.



in the reporting entity or in response to requests from persons outside the entity for certain financial information; or from preparing a so-called "popular report," which provides a simplified, highly readable, easily understandable description of a reporting entity's finances. These statements would not necessarily purport to be presented in accordance with generally accepted accounting principles.

### *Reasons for Defining Reporting Entities*

9. The most basic reason for having an explicit understanding of what the reporting entity entails is to ensure that the users of the entity's financial reports are provided with all the information that is relevant to the reporting entity, subject to cost and time constraints. Clearly defining the boundaries of the reporting entity provides the users with a clear understanding of what the reporting entity encompasses. It helps to establish what information is relevant to the financial statements and what information is not.

10. Other reasons for having an explicit understanding of what the reporting entity entails are to:

- Ensure that for the aggregation of information at each reporting level, no entity is omitted, and to provide for consolidations and/or combinations of information from reporting units at the same level, as appropriate;
- Assist in making comparisons among comparable reporting entities by reducing the possibility of unintended or arbitrary exclusions or inclusions of entities;
- Assist in making comparisons among alternative ways to provide similar services or products;
- Be able to distribute costs properly and fully and to properly attribute the responsibility for assets and liabilities; and
- Facilitate evaluating performance, responsibility, and control, especially where one agency is the provider or recipient of services attributable to or financed by another agency.

### *Structure of the Federal Government*

11. The Federal Government is an extremely complex organization composed of many different components. For accounting and reporting purposes, it may be viewed from at least three perspectives. However, the nature of each type of component and the relationships among the components and perspectives are not always consistent.

### **Organization Perspective**

12. The first type of perspective is the organization perspective. The Federal Government is composed of organizations that manage resources and are responsible for operations, i.e., delivering services. These include the major Departments and independent agencies, which are generally divided into suborganizations, i.e., smaller organizational units with a wide variety of titles, including bureaus, administrations, agencies, services, and corporations. Many of these are further divided into even smaller suborganizations. On the other hand, there are small agencies for which division into smaller units is generally not considered appropriate.

### **Budget Perspective**

13. From another perspective, the government is composed of accounts presented in the budget, hereinafter referred to as budget accounts. Budget accounts are composed of expenditure (appropriations or fund) accounts and receipt (including offsetting receipt) accounts. The size and scope of these accounts varies according to Congressional preference. They can vary from very small accounts, which are useful for constraining management, to very large accounts, which can be used to finance many activities.

14. Budget accounts are not the same as Treasury accounts. The latter are accounts established in the Treasury to, among other purposes, record the appropriations and other budgetary resources provided by statutes and the transactions affecting those accounts. For the most part, budget accounts are aggregations of Treasury accounts. Also, Treasury accounts include deposit accounts as well as budget accounts.

15. Nor are budget accounts the same as the uniform ledger accounts established by the U. S. Government Standard General Ledger (SGL). SGL accounts record specific homogeneous types of transactions and balances that aggregate to specific classifications on the financial statements. They have been established so that agencies can establish control over their financial transactions and balances, meet the basic financial reporting requirements, and integrate budgetary and financial accounting in the same general ledger.

16. A budget account may coincide with an organization or one or more of its suborganizations. Other times, several budget accounts need to be aggregated to constitute an organization or sub-organization.

17. Budget accounts are classified as federal funds or trust funds. Any account that is designated by the laws governing the federal budget as being a trust fund is so classified. Federal funds comprise the larger group and include all transactions not classified by law as trust funds. Three components make up federal funds: the general fund, special funds, and revolving funds. The definition of each of these categories can be found in the OMB circular A-11 and the GAO Glossary of Terms Used in the Federal Budget Process.

18. Care must be taken in determining the nature of all trust funds and their relationship to the entity responsible for them. A few trust funds are truly fiduciary in nature. Most trust funds included in the budget are not of a fiduciary nature and are used in federal financing in a way that differs from the common understanding of trust funds outside the federal government. In many ways, these trust funds can be similar to revolving or special funds in that their spending is financed by earmarked collections.

19. In customary usage, the term "trust fund" refers to money belonging to one party held "in trust" by another party operating as a fiduciary. The money in a trust fund must be used in accordance with the trust's terms, which the trustee cannot unilaterally modify, and is maintained separately and not commingled with the trustee's own funds. This is not the case for most federal trust funds that are included in the budget—the fiduciary relationship usually does not exist. The beneficiaries do not own the funds and the terms in the law that created the trust fund can be unilaterally altered by Congress.

20. Special funds and trust funds, except trust revolving funds, are aggregates of budget accounts. They normally consist of one or more receipt accounts and one or more expenditure accounts. Among the trust funds, social insurance programs (such as social security and unemployment compensation) have the largest amount of funds and federal employee programs (such as retirement and health benefits) the second largest. Together they make up about 90 percent of all trust fund receipts. Other trust funds include excise tax financed programs for highway construction, airports and airway operations, and other public works. Like other budget accounts, trust funds are usually the responsibility of a single organization, although sometimes they are the responsibility of more than one organization.

21. Budget accounts are also categorized, as mandated by law and defined by OMB, into functions and subfunctions that represent national needs of continuing national importance and substantial expenditures of resources. Examples of functions are national defense and health.

### **Program Perspective**

22. From a third perspective, the government is composed of programs and activities, i.e., the services the organizations provide and the specific lines of work they perform. Each program and activity is responsible for producing certain outputs in order to achieve desired outcomes.

23. There is no firm definition for the term "program;" it varies in the eye of the beholder. For example, the Highway program could relate to the entire Federal highway program, the program to build interstate highways (in contrast to city streets, secondary roads, etc.), or a program to build a highway between two specific points. Moreover, in accordance with the sequester provisions of the Balanced Budget and Emergency Deficit Control Act of 1985, as amended, the House and Senate Appropriations Subcommittees annually define, in the Committee Reports, the meaning of "Programs, Projects, and Activities" as they relate to each of the Appropriations Acts.

## **APPENDIX 1**

24. The term "program" is also often used interchangeably with the terms "function" and "sub-function" (see paragraph 21). Generally, however, the term "function" would be used only for the functions defined in the budget. Otherwise, the term "program" would be used.

### **Intertwining of the Perspectives**

25. The programs are administered by the organizations and financed by the budget accounts. In a few instances, there is a one-to-one relationship among the three perspectives. A single budget account finances a single program and organization. Thus, the program is carried out only by the single organization and the organization performs only one program.

26. However, most programs are financed by more than one budget account, some of which might not be under the control of the organizational unit administering the program. Some programs are even administered by more than one organization. Likewise, a single organization or budget account could be responsible for several programs. In some instances, a program could also be considered an organizational unit, e.g., the Center for Disease Control and Prevention.

27. Furthermore, some of the support necessary to perform a program is frequently provided by other organizations and/or financed by other budget accounts. Examples are the computer support for a program that is obtained from a central unit within the department, or retirement health costs for a program's current and former employees.

28. This complex situation is the result of the evolution of Federal organizations, programs, and budgetary structures over many years. As Federal missions and programs have expanded and changed, new departments have been created, new organizations have been added to existing departments, and new duties have been assigned to existing organizations on the basis of various considerations. Similarly, the budget structure has evolved in response to the needs of the Congress; its committees and subcommittees; and various initiatives by the President, program managers, and interest groups.

### ***Identifying the Reporting Entity for General Purpose Financial Reporting***

29. As stated, reporting entities are entities that issue general purpose financial statements to communicate financial and related information about the entity. For any entity to be a reporting entity, as defined by this Statement of Federal Financial Accounting Concepts, it would need to meet all of the following criteria.

- There is a management responsible for controlling and deploying resources, producing outputs and outcomes, executing the budget or a portion thereof (assuming that the entity is included in the budget), and held accountable for the entity's performance.

- The entity's scope is such that its financial statements would provide a meaningful representation of operations and financial condition.
- There are likely to be users of the financial statements who are interested in and could use the information in the statements to help them make resource allocation and other decisions and hold the entity accountable for its deployment and use of resources.

30. Budget accounts, in and of themselves, do not meet the criteria in the preceding paragraph and, therefore, would not be considered a reporting entity for the purposes of issuing general purpose financial statements. Also, the size and scope of the budget accounts across all government agencies lack sufficient consistency for them to be universally considered as the reporting entity. Similarly, programs generally do not meet the criteria in paragraph 29 and, therefore, would not be a considered a reporting entity that prepares general purpose financial statements.

31. On the other hand, organizations, and particularly larger organizations, meet the criteria in paragraph 29. While the occasional overlap of programs and budget accounts among more than one organizational unit could complicate financial reporting, the association of data with the responsibility centers, revenue centers, profit centers, cost centers, etc. which managers typically use for organizing and operating permit the following:

- aggregating information for not only the organization (and suborganizations), but also for one or more of the programs performed by the organization, and one or more of the budget accounts for which the organization is responsible, and
- the subsequent arraying of the information not only by organization, but also by sub-organization, program, and/or budget accounts.

32. This approach to defining the appropriate reporting entities in the Federal Government supports establishment of accountability in the organizations (and suborganizations) while still enabling them to provide information pertaining to their programs.

33. Although a reporting entity might not control all the budget accounts used to finance one or more of the programs it administers, any revenues attributable to or costs incurred on behalf of the programs it administers should be associated with that reporting entity. This notion holds true regardless of whether the reporting entity maintains personnel on a payroll.

34. The departments and major independent agencies are organizational units and therefore would be the primary reporting entities. However, in many instances, financial statements that present aggregations of information into suborganization entities, i.e., bureaus, administrations, or agencies, may be more useful than statements that present only aggregations into organizational entities. The former can provide a better understanding of the financial results and status of the many individual suborganizations and programs constituting a department or major independent agency. They can reveal

instances where programs are carried out by several suborganizations within the department or major independent agency.

35. Similar to other budget accounts, trust funds, special funds, and revolving funds are usually administered by a single organization. For financial reporting purposes, the organization would be the reporting entity; the trust fund or revolving fund would be a component of the organization that administers the fund in the same manner that a suborganization or other type of budget account is a component of the organization. This would not preclude separate reporting for the trust fund, special fund, or revolving fund by the managing organization, nor would it preclude disclosure of trust fund, special fund, or revolving fund information within the organization's report when there is sufficient interest.<sup>63</sup>

36. Likewise, some programs are coterminous, i.e., share the same boundaries, with an organization or sub-organization, while other programs—such as student loan programs—are the component for which resources are deployed, are responsible for achieving objectives, and/or are of great interest to outsiders. In both instances, the financial operations and results of the program might warrant highlighting or even separate reporting by the organization or suborganization which manages the program.

37. Financial statements for organizationally-based reporting entities may be audited and issued to external parties, unaudited and used for internal management purposes, or, perhaps to be more relevant and meaningful, combined with financial statements from other organizationally-based reporting entities.

38. The ultimate aggregation of entities is into the entire Federal Government which, in reality, is the only independent economic entity—although some would say the entire country is the ultimate economic entity. The Federal Government entity would encompass all of the resources and responsibilities existing within the component entities, whether they are part of the Executive, Legislative, or Judicial branches (although, as noted in paragraph 5, FASAB's recommendations pertain only to the Executive Branch). The aggregation would include organizations for which the Federal Government is financially accountable as well as other organizations for which the nature and significance of their relationship with the government (see paragraphs 39 through 50) are such that their exclusion would cause the Federal Government's financial statements to be misleading or incomplete.

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<sup>63</sup> For some trust funds, the collection of the revenues is performed by an organizational entity acting in a custodial capacity that differs from the organizational entity that administers the trust fund. In those instances, the organizational entity that collects the revenues would be responsible for reporting only the collection and subsequent disposition of the funds. The organizational entity responsible for carrying out the program(s) financed by a trust fund, or in the case of multiple responsible entities, the entity with the preponderance of fund activity, will report all assets, liabilities, revenues, and expense of the fund, notwithstanding the fact that another entity has custodial responsibility for the assets.

### *Criteria for Including Components in a Reporting Entity*

39. Regardless of whether a reporting entity is the U.S. Federal Government, or an organization, suborganization, or program, there can be uncertainty as to what should be included and inconsistency as to what is included in the reporting entity. The identification and application of specified criteria can reduce this uncertainty and inconsistency.

40. The Governmental Accounting Standards Board (GASB) has established criteria for what would be included in a state or local government reporting entity. These criteria relate to financial accountability, which includes appointment of a voting majority of the organization's governing board, together with imposition of will, and financial benefit to or burden on a primary government. These criteria, while in part relevant, must be tailored to the Federal Government environment. First, there are not as many different types of entities in the Federal Government as there are in state and local governments. Second, the Congress and others with oversight authority frequently establish explicit rules for what to include as part of a Federal reporting entity. Finally, as indicated, with the exception of the Federal Government as a whole, all the reporting units are components of a larger entity, namely the Federal Government, rather than independent economic entities.

### *Conclusive Criterion*

41. There are two types of criteria that should be considered when deciding what to include as part of a financial reporting entity. The first is a **conclusive criterion**, i.e., an inherent conclusion that for financial reporting purposes, any organization meeting this criterion is part of a specified larger entity.

42. Appearance in the Federal budget section currently entitled "Federal Programs by Agency and Account" is a conclusive criterion. Any organization, program, or budget account, including off-budget accounts and government corporations, included in that section should be considered part of the U.S. Federal Government, as well as part of the organization with which it appears. This does not mean, however, that an appropriation that finances a subsidy to a non-Federal entity would, by itself, require the recipient to be included in the financial statements of the organization or program that expends the appropriation.

### *Indicative Criterion*

43. There are instances when, for political or other reasons, an organization (including a government corporation), program, or account is not listed in the "Federal Programs by Agency and Account," yet the general purpose financial statements would be misleading or incomplete—in regard to the objectives for Federal financial reporting—if the organization, program, or account were not included therein. These organizations, programs, or accounts would normally be considered to be operating at the "margin" of what would be considered a governmental function in contrast to

providing a more basic governmental function. Thus, in addition to the conclusive criterion, there are several **indicative criteria** that should be considered in the aggregate for defining a financial reporting entity in the Federal Government. No single indicative criterion is a conclusive criterion in the manner that appearance in the “Federal Programs by Agency and Account” section of the budget is. Nor can weights be assigned to the indicative criteria. Thus, while the indicative criteria are presented in descending order of importance, judgment must be based on a consideration of all of the indicative criteria.

44. The indicative criteria for determining whether an organization not listed in the “Federal Programs by Agency and Account” section of the budget is nevertheless part of a financial reporting entity are as follows:

- It exercises any sovereign power of the government to carry out Federal functions. Evidence of sovereign powers are the power to collect compulsory payments, e.g., taxes, fines, or other compulsory assessments; use police powers; conduct negotiations involving the interests of the United States with other nations; or borrow funds for Government use.
- It is owned by the Federal Government, particularly if the ownership is of the organization and not just the property. Ownership is also established by considering who is at risk if the organization fails, or identifying for whom the organization’s employees work.
- It is subject to the direct or continuing administrative control of the reporting entity, as revealed by such features as (1) the ability to select or remove the governing authority or the ability to designate management, particularly if there is to be a significant continuing relationship with the governing authority or management with respect to carrying out important public functions (in contrast to selections and designations in which there is little continuing communication with, or accountability to, the appointing official); (2) authority to review and modify or approve budget requests, budgetary adjustments, or amendments or rate or fee changes; (3) ability to veto, overrule, or modify governing body decisions or otherwise significantly influence normal operations; (4) authority to sign contracts as the contracting authority; (5) approval of hiring, reassignment, and removal of key personnel; (6) title to, ability to transfer title to, and/or exercise control over facilities and property; and (7) right to require audits that do more than just support the granting of contracts. (While many of these criteria exist in a client contractor relationship, it is not necessarily intended that an entity’s contractor be considered as part of the reporting entity.)
- It carries out Federal missions and objectives.
- It determines the outcome or disposition of matters affecting the recipients of services that the Federal Government provides.
- It has a fiduciary relationship with a reporting entity, as indicated by such factors as the ability of a reporting entity to commit the other entity financially or control the collection and disbursement of funds; and other manifestations of financial interdependency, such as a reporting entity’s responsibility for financing deficits,



entitlement to surpluses (although not necessarily the assets acquired from failed units), or the guarantee of or “moral responsibility” for debt or other obligations.

45. The entity or any of the above criteria are likely to remain in existence for a time, i.e., the interest in the entity and its governmental characteristics is more than fleeting.

46. In applying the indicative criteria, the materiality of the entities and their relationship with one another should be considered. Materiality should not be measured solely in dollars. Potential embarrassment to any of the entities’ stakeholders should also be considered. Thus, a bias toward expansiveness and comprehensiveness would be justified, particularly if it could contribute to maintenance of fiscal control.<sup>64</sup>

### **Federal Reserve System**

47. In establishing and monitoring monetary policy, the Federal Reserve System, i.e., the Board of Governors of the Federal Reserve System and the Federal Reserve Banks, could be considered as functioning consistent with the indicative criteria presented in paragraph 44. However, in the United States, the organization and functions pertaining to monetary policy are traditionally separated from and independent of the other central government organizations and functions in order to achieve more effective monetary and fiscal policies and economic results. Therefore, the Federal Reserve System would not be considered part of the government-wide reporting entity. Payments made to or collections received from the Federal Reserve System would be reported in the financial statements of the Federal Government. Certain other disclosures might also be appropriate in the financial statement for the entire government.

### **Government Sponsored Enterprises**

48. There are also several Federally chartered but privately owned and operated financial institutions that have been established as financial intermediaries to facilitate the flow of investment funds to specific segments of the private sector. These entities are called government sponsored enterprises (GSE). Examples are the Federal National Mortgage Association, the Farm Credit Banks, and the Federal Home Loan Banks. By law, each of these GSEs is subject to oversight from a specific Federal agency. However, they are not included in the Federal budget section entitled "Federal Programs by Agency and Account." Nor, as currently constituted, do they function in a manner consistent with the indicative criteria presented in paragraph 44. Thus they would not be considered part of the government-wide reporting entity nor the reporting entity to which they have been assigned for oversight.

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<sup>64</sup> Any uncertainty as to what to consider as a reporting entity would be resolved by OMB in consultation with the appropriate Congressional committees.

49. On the other hand, there are "political expectations" associated with the GSEs, the most significant of which is an expectation that legislation would be enacted to support a GSE experiencing severe financial difficulties. (Political expectations are different than "moral obligations" established by many states. There is no statutory authority that defines whether and how a political expectation would be met. With a moral obligation, the manner in which it may be met is usually explicitly defined in statute.) Therefore, agencies assigned oversight responsibility for a GSE(s) would need to consider making disclosures of the government's relationship with the GSE(s) and other information that would provide an understanding of the possibility of a contingent liability.<sup>65</sup>

### **Bailout Entities**

50. The Federal Government occasionally bails out, i.e., guarantees or pays debt, for a privately owned entity whose failure could have an adverse impact on the nation's economy, commerce, national security, etc. As a condition of the bail out, the Federal Government frequently obtains rights similar to the authorities associated with the indicative criteria presented in paragraph 44. The existence of these rights does not make the bailed out entity part of the Federal Government reporting entity or any of the other reporting entities that are part of the Federal Government. Disclosure of the relationship(s) with the bailed out entity(ies) and any actual or potential material costs or liabilities would be appropriate.

### ***OTHER ASPECTS CONCERNING THE COMPLETENESS OF THE ENTITY***

51. The application of specified criteria to delineate the reporting entity is one aspect of ensuring that the users of a reporting entity's financial reports are provided with all the information relevant to the reporting entity. However, because the only independent economic entity is the entire Federal Government, financial resources or free services are often provided from one component in the government to another component without a quid pro quo. For example, a portion of the retirement costs of Federal employees is reported by the Office of Personnel Management rather than the

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<sup>65</sup> The term government sponsored enterprise is also sometimes used in a broader manner to encompass other entities established by the Federal Government to further a public policy and that are also not included in the budget section "Federal Programs by Agency and Account." Examples are the Financing Corporation, Resolution Funding Corporation, Amtrak, and even, on occasion, the American National Red Cross. These entities have varied characteristics and different types of relationships to the Federal Government, and therefore, in some cases, may be included with the above mentioned GSEs in sections or tables of Federal budget documents. These entities need to be judged individually with respect to the indicative criteria presented in paragraph 39 in order to determine whether they should be considered part of a Federal reporting entity.

organizational entities employing the persons. Thus, within the parameters explained in paragraphs 52 and 53, it is important to ensure that the reporting entity's financial reports include amounts that are attributable to the reporting entity's activities, even though they are recorded elsewhere. This is particularly important for costs associated with the use of human resources; personnel services are such a major part of most government activities. It is also important for the costs of services provided by other reporting entities, such as computer services provided by another unit.

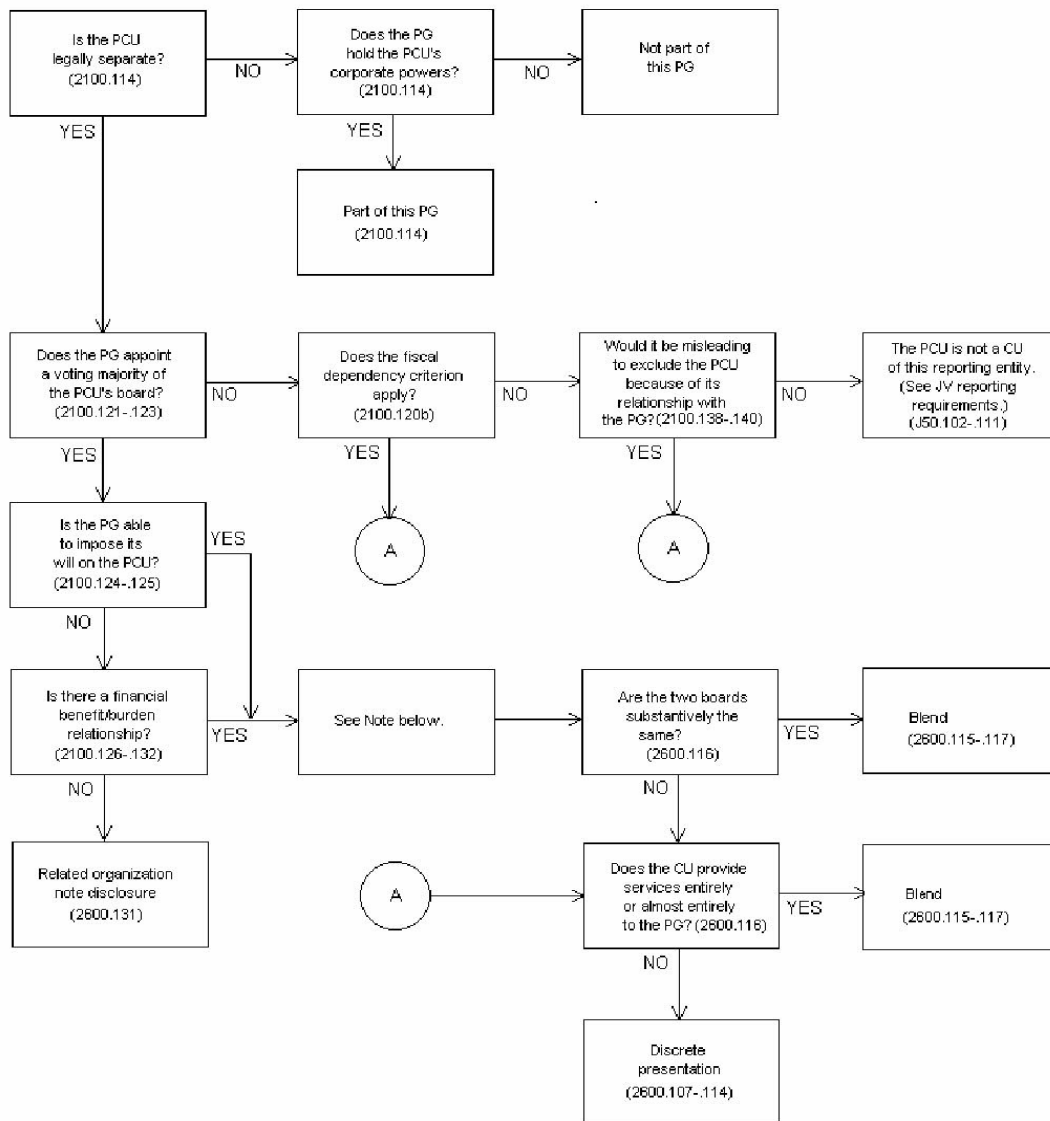
52. A process in which the reporting entity is billed and pays for the amounts attributable to its activities is normally the most desirable approach for recording and reporting these amounts. However, when this type of direct debiting or crediting is not done, the decision as to whether to capture and report attributable amounts would be based on such criteria as the magnitude of the attributable amounts, the decision usefulness of the information to its likely users, the costs of capturing the data, whether a decision would be made differently as a result of having the information, and whether the information would have a policy impact.

53. It might be appropriate to consider the interest expense inherent in devoting a sum of capital to an organization or program as part of the total costs incurred in operating the organization or performing the program. This principle has already been adopted for the accounting for loans and loan guarantees, whereby a loan program is charged for the cost of capital provided by the U. S. Treasury.

## APPENDIX 2--GASB Excerpts and Reference Materials

### Flowchart for Evaluating Potential Component Units

PCU = Potential component unit    CU = Component unit    PG = Primary government    JV = Joint venture



Note: A potential component unit for which a primary government is financially accountable may be fiscally dependent on another government. An organization should be included as a component unit of only one reporting entity. Professional judgment should be used to determine the most appropriate reporting entity (paragraphs .120b and .133–.137). A primary government that appoints a voting majority of the governing board of a component unit of another government should make the disclosures required by Section 2600, paragraph .131, for related organizations.<sup>66</sup>

<sup>66</sup> Par. 14, GASB 14

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## EXCERPTS FROM GASB CODIFICATION, (STATEMENT 34 EDITION)

### Section 2100, *Defining the Financial Reporting Entity*

#### The Financial Reporting Entity Concept

.109 The concept underlying the definition of the financial reporting entity is that elected officials are accountable to their constituents for their actions. Because one of the objectives of financial reporting is to provide users of financial statements with a basis for assessing the accountability of those elected officials, the definition of the financial reporting entity should be based on accountability. Because providing public services is, ultimately, the responsibility of elected officials, all governmental organizations are responsible to elected officials at the federal, state, or local level. Financial reporting by a state or local government should report the elected officials' accountability for those organizations. [GASBS 14, ¶10]

.110 The financial statements of the reporting entity should allow users to distinguish between the primary government and its component units by communicating information about the component units and their relationships with the primary government rather than creating the perception that the primary government and all of its component units are one legal entity. To accomplish this goal, the reporting entity's financial statements should present the fund types and account groups of the primary government (including its blended component units, which are, in substance, part of the primary government) and provide an overview of the discretely presented component units. [GASBS 14, ¶11]

.111 As discussed in detail below, the financial reporting entity consists of (a) the primary government, (b) organizations for which the primary government is financially accountable (see paragraphs .120–.136), and (c) other organizations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete (see paragraphs .138–.140). The nucleus of a financial reporting entity usually is a primary government. However, a governmental organization other than a primary government (such as a component unit, a joint venture, a jointly governed organization, or an other stand-alone government) serves as the nucleus for its own reporting entity when it issues separate financial reports. Although this section is written from the perspective of the primary government, its requirements apply to the separately issued basic financial statements of governmental component units, joint ventures, jointly governed organizations, and other stand-alone governments. These organizations should apply the provisions of this section as if they were a primary government. [GASBS 14, ¶12, as amended by GASBS 34, ¶6]

## Primary Governments

### DEFINITION OF A PRIMARY GOVERNMENT

.112 The foundation of a primary government is a separately elected governing body—one that is elected by the citizens in a general, popular election. As the nucleus of the financial reporting entity, the primary government generally is the focal point for the users of the financial statements. Thus, it is important to define the primary government and determine what it comprises. A primary government is any state government or general purpose local government (municipality or county). A primary government is also a special-purpose government (for example, a school district or a park district) that meets all of the following criteria:

- a. It has a separately elected governing body.
- b. It is legally separate (see paragraph .114).
- c. It is fiscally independent of other state and local governments (see paragraphs .115–.117). [GASBS 14, ¶13]

.113 A primary government consists of all the organizations that make up its legal entity. All funds, organizations, institutions, agencies, departments, and offices that are not legally separate are, for financial reporting purposes, part of a primary government. If an organization is part of a primary government, its financial data should be included with the financial data of the primary government. [GASBS 14, ¶14]

### DETERMINING SEPARATE LEGAL STANDING

.114 An organization has separate legal standing if it is created as a body corporate or a body corporate and politic, or if it otherwise possesses the corporate powers that would distinguish it as being legally separate from the primary government. Generally, corporate powers give an organization the capacity to have a name; the right to sue and be sued in its own name without recourse to a state or local governmental unit; and the right to buy, sell, lease, and mortgage property in its own name. The corporate powers granted to a separate organization are enumerated in its corporate charter or in the legislation authorizing its creation. A special-purpose government (or any other organization) that is not legally separate should be considered, for financial reporting purposes, part of the primary government that holds the corporate powers. [GASBS 14, ¶15]

### Determining Fiscal Independence or Dependence

.115 A special-purpose government is fiscally independent if it has the ability to complete certain essential fiscal events without substantive approval by a primary government.<sup>2</sup> A special-purpose government is fiscally independent if it has the authority to do all three of the following:

- a. Determine its budget without another government's having the authority to approve and modify that budget.

## APPENDIX 2

- b. Levy taxes or set rates or charges without approval by another government.
- c. Issue bonded debt without approval by another government.

A special-purpose government that is not fiscally independent is fiscally dependent on the primary government that holds one or more of those powers. A special-purpose government may be fiscally dependent on another state or local government regardless of whether it receives financial assistance from that state or local government; fiscal dependency does not necessarily imply that a financial benefit or burden relationship exists. [GASBS 14, ¶16]

.116 In determining whether a special-purpose government is fiscally independent, a distinction should be made between substantive approvals and ministerial (or compliance) approvals. Special-purpose governments typically are subject to the general oversight of their respective state governments, and sometimes to the oversight of county or other local governments as well. Often, this general oversight responsibility includes an approval process that is more ministerial or compliance oriented than substantive. Examples of approvals that are likely to be ministerial or compliance oriented in nature rather than substantive are:

- a. A requirement for a state agency to approve local government debt after review for compliance with certain limitations, such as a debt margin calculation based on a percentage of assessed valuation.
- b. A requirement for a state agency, such as a department of education, to review a local government's budget in evaluating qualifications for state funding.
- c. A requirement for a county government official, such as the county clerk, to approve tax rates and levy amounts after review for compliance with tax rate and levy limitations. [GASBS 14, ¶17]

.117 A special-purpose government subject to substantive approvals should not be considered a primary government for purposes of this section. For example, budgetary approval is substantive if a government has the authority to reduce or modify a special-purpose government's budget. On the other hand, a special-purpose government that is statutorily prohibited from incurring debt may be fiscally independent if it possesses the other two powers because the statutory prohibition does not subordinate the special-purpose government to another government for debt approval. It may be necessary to ascertain whether approvals or restrictions have the effect of impairing the special-purpose government's fiscal independence. [GASBS 14, ¶18]

### Reporting the Primary Government

.118 The financial data of the primary government (and its blended component units as discussed in Section 2600, paragraphs .112–.114) should be reported in accordance with the provisions of Section 2200. This section does not modify fund reporting requirements referred to in that section. Regardless of entity considerations, a primary government should report its fiduciary funds according to Section 2200, paragraphs

.172 through .176. For example, there may be organizations that do not meet the definition for inclusion in the financial reporting entity. They should, nevertheless, be reported as a fiduciary fund of the primary government if the primary government has a fiduciary responsibility for them. [GASBS 14, ¶19, as amended by GASBS 35, ¶5]

## Component Units

### Definition of Component Units

.119 Component units are legally separate organizations for which the elected officials of the primary government are financially accountable (as discussed in paragraphs .120–.136). In addition, component units can be other organizations for which the nature and significance of their relationship with a primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete (as discussed in paragraphs .138–.140). [GASBS 14, ¶20]

### Financial Accountability

.120 Accountability flows from the notion that individuals are obliged to account for their acts, including the acts of the officials they appoint to operate governmental agencies. Thus, elected officials are accountable for an organization if they appoint a voting majority of the organization's governing board. Sometimes, however, appointments are not substantive; other governments (usually at a lower level) may have oversight responsibility for those officials. This section uses the term financial accountability, rather than accountability, to describe the kind of relationship warranting the inclusion of a legally separate organization in the reporting entity of another government. The following circumstances set forth a primary government's financial accountability for a legally separate organization.

- a. The primary government is financially accountable if it appoints a voting majority of the organization's governing body and (1) it is able to impose its will on that organization (paragraphs .124–.125) or (2) there is a potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the primary government (paragraphs .126–.132).
- b. The primary government may be financially accountable if an organization is fiscally dependent (paragraphs .115–.117) on the primary government regardless of whether the organization has (1) a separately elected governing board, (2) a governing board appointed by a higher level of government, or (3) a jointly appointed board (paragraphs .133–.137). [GASBS 14, ¶21]

### Appointment of a Voting Majority

.121 If a primary government appoints a simple majority of the organization's governing board, it usually has a voting majority. However, if financial decisions require



the approval of more than a simple majority, the primary government is not accountable for the organization. [GASBS 14, ¶22]

.122 For purposes of determining whether accountability exists, a primary government's appointment authority should be substantive. In some cases the appointment authority of a primary government's officials may be limited by a nomination process. For example, state statutes or local ordinances may require a primary government to select its appointees from a slate of candidates provided by one or more individuals or groups other than the primary government's officials or appointees. A primary government's appointment authority is not substantive if the number of candidates is severely limited by the nominating process, for example, if a primary government must select three appointees from a single slate of five candidates. Additionally, a primary government's appointment authority may not be substantive if its responsibility is limited to confirming appointments made by individuals or groups other than the primary government's officials or appointees. [GASBS 14, ¶23]

.123 In most instances, legal provisions for appointment of an organization's officials also provide for continuing appointment authority. However, in the absence of continuing appointment authority, the ability of a primary government to unilaterally abolish an organization also provides the basis for ongoing accountability. Thus, a primary government that creates an organization (creation is tantamount to the initial appointment of the governing body) is accountable for the organization if the primary government can unilaterally abolish it. A primary government is considered to be accountable for an organization as long as continuing appointments are made by the primary government, even if those appointments are made by a subsequent administration. [GASBS 14, ¶24]

#### Imposition of Will

.124 A primary government that is accountable for an organization because it appoints a voting majority of that organization's governing body frequently has the ability to affect that organization's operations. Sometimes, however, based on the provisions of law or contract, the primary government has little influence over the organization's operations. Certain conditions indicate the primary government's ability to affect the day-to-day operations of an organization. These conditions are referred to in this section as a government's ability to impose its will on an organization. If a primary government appoints a voting majority of an organization's officials and has the ability to impose its will on the organization, the primary government is financially accountable for that organization. [GASBS 14, ¶25]

.125 A primary government has the ability to impose its will on an organization if it can significantly influence the programs, projects, activities, or level of services performed or provided by the organization. The existence of any one of the following conditions clearly indicates that a primary government has the ability to impose its will on an organization:

- a. The ability to remove appointed members of the organization's governing board at will.
- b. The ability to modify or approve the budget of the organization.
- c. The ability to modify or approve rate or fee changes affecting revenues, such as water usage rate increases.
- d. The ability to veto, overrule, or modify the decisions (other than those in b and c) of the organization's governing body.
- e. The ability to appoint, hire, reassign, or dismiss those persons responsible for the day-to-day operations (management) of the organization.

Other conditions may also indicate that a primary government has the ability to impose its will on an organization. In determining whether imposition of will exists, a distinction should be made between substantive approvals and ministerial (or compliance) approvals as discussed in paragraphs .116 and .117. [GASBS 14, ¶26]

#### Financial Benefit to or Burden on a Primary Government

.126 An organization can provide a financial benefit to, or impose a financial burden on, a primary government in a variety of ways. The benefit or burden may result from legal entitlements or obligations, or it may be less formalized and exist because of decisions made by the primary government or agreements between the primary government and a component unit. If a primary government appoints a voting majority of an organization's officials and there is a potential for that organization either to provide specific financial benefits to or to impose specific financial burdens on the primary government, the primary government is financially accountable for that organization. An organization has a financial benefit or burden relationship with the primary government if any one of these conditions exists:

- a. The primary government is legally entitled to or can otherwise access the organization's resources.
- b. The primary government is legally obligated or has otherwise assumed the obligation to finance the deficits of, or provide financial support to, the organization.
- c. The primary government is obligated in some manner for the debt of the organization.

Exchange transactions between organizations and the primary government should not be considered manifestations of a financial benefit or burden relationship. In an exchange transaction, such as a purchase or sale of goods or services, each participant (the government or its employees rather than the citizenry) directly receives and sacrifices value. For example, funding by a primary government for higher education is not equivalent to purchasing educational services and would be considered a manifestation of a financial burden on the primary government. [GASBS 14, ¶27]

.127 The effect of the financial benefits or burdens on the primary government can be either direct or indirect. A direct financial benefit or burden occurs when the primary government itself is entitled to the resources or is obligated for the deficits or debts of the organization. An indirect benefit or burden exists if one or more of the primary government's component units are entitled to the resources or is obligated for the deficits or debts of the organization. For purposes of this section, a financial benefit or burden relationship exists if the primary government is either directly or indirectly entitled to the resources or is either directly or indirectly obligated for the deficits or debts of an organization. [GASBS 14, ¶28]

.128 Legally Entitled to or Can Otherwise Access the Organization's Resources. The ability to access the resources of an organization—not necessarily whether there was an actual transaction during the period—is the important factor for determining when a primary government is entitled to an organization's resources. However, the ability to access the resources of an organization should be judged in light of the organization as a going concern; that is, a residual interest in the net assets of an organization in the event of dissolution is not equivalent to being entitled to its resources. If a primary government appoints a voting majority of an organization's officials and is legally entitled to or can otherwise access the organization's resources, the primary government is financially accountable for that organization. [GASBS 14, ¶29]

.129 Resources may flow from a component unit to a primary government for several reasons. Some organizations may operate activities, such as off-track betting or lotteries, for the principal purpose of generating net revenues that are accessible to the primary government. These organizations provide financial benefits to the primary government. Other organizations may operate activities (for example, public utilities) for the purpose of providing basic public services and charge rates sufficiently high to also provide a financial benefit to the primary government. These benefits may be characterized as "payments in lieu of taxes" or "contributions," or they may simply be amounts remitted on request of the primary government. These organizations also provide financial benefits to the primary government. [GASBS 14, ¶30]

.130 Legally Obligated or Has Otherwise Assumed the Obligation to Finance the Deficits of, or Provide Financial Support to, the Organization. A primary government may be obligated to finance the deficits of, or provide financial support to, an organization in different ways. It could be legally obligated to do so, or it may choose to do so for a variety of reasons. If a primary government appoints a voting majority of an organization's officials and is legally obligated or has otherwise assumed the obligation to finance the deficits of, or provide financial support to, that organization, the primary government is financially accountable for that organization. The following are examples of financial burdens assumed by a primary government in support of certain organizations:

- a. Some organizations provide public services financed by user charges that are not expected to be sufficient to sustain their operations. This situation often results from providing services such as mass transit, higher education, and healthcare. In these cases, public policy may dictate that a state or local

government provide financial support to the organization to increase the availability and affordability of the service to a broader segment of the citizenry. Examples of support include annual appropriations to help meet operating expenditures/expenses, periodic capital grants, and direct payment of capital expenditures or debt service.

- b. A primary government may assume an obligation to finance the deficits of an organization. These deficits may or may not be expected to recur annually. A financial burden exists if the primary government is obligated to finance an organization's deficits even though there has not been, and may never be, a deficit to subsidize. [GASBS 14, ¶31]

.131 Some organizations' operations are fully or partially funded by revenues generated through tax increment financing. Legally separate development or redevelopment authorities sometimes receive the incremental taxes that result from a tax increment financing arrangement. When this is done, a taxing government temporarily waives its right to receive the incremental taxes from its own levy. The incremental taxes instead are remitted to the separate organization. For purposes of this section, this type of tax increment financing should be considered evidence of an obligation to provide financial support to an organization (a financial burden), regardless of whether the primary government collects the taxes and remits them to the organization or the incremental taxes are paid directly to the organization. [GASBS 14, ¶32]

.132 Obligated in Some Manner for the Debt of an Organization. An obligation for the debt of an organization is similar to the notion that a primary government may be obligated for future operating deficits. The obligation can be either expressed or implied. A primary government is obligated in some manner for the debt of an organization if (a) it is legally obligated to assume all or part of the debt in the event of default or (b) it may take certain actions to assume secondary liability for all or part of the debt, and the government takes, or has given indications that it will take, those actions. Conditions that indicate that a primary government is obligated in some manner include:

- a. The primary government is legally obligated to honor deficiencies to the extent that proceeds from other default remedies are insufficient.
- b. The primary government is required to temporarily cover deficiencies with its own resources until funds from the primary repayment source or other default remedies are available.
- c. The primary government is required to provide funding for reserves maintained by the debtor organization, or to establish its own reserve or guarantee fund for the debt.
- d. The primary government is authorized to provide funding for reserves maintained by the debtor organization or to establish its own reserve or guarantee fund and the primary government establishes such a fund. (If a fund is not established, the considerations in subparagraphs f and g may nevertheless provide evidence that the primary government is obligated in some manner.)

- e. The primary government is authorized to provide financing for a fund maintained by the debtor organization for the purpose of purchasing or redeeming the organization's debt, or to establish a similar fund of its own, and the primary government establishes such a fund. (If a fund is not established, the considerations in subparagraphs f and g may nevertheless provide evidence that the primary government is obligated in some manner.)
- f. The debtor government explicitly indicates by contract, such as the bond agreement or offering statement, that in the event of default the primary government may cover deficiencies although it has no legal obligation to do so. That is, the bond offering statement may specifically refer to a law that authorizes the primary government to include an appropriation in its budget to provide funds, if necessary, to honor the debt of the organization.
- g. Legal decisions within the state or previous actions by the primary government related to actual or potential defaults on another organization's debt make it probable that the primary government will assume responsibility for the debt in the event of default.

If a primary government appoints a voting majority of an organization's officials and is obligated in some manner for the debt of that organization, the primary government is financially accountable for that organization. [GASBS 14, ¶33]

#### Financial Accountability as a Result of Fiscal Dependency

.133 A primary government may be financially accountable for a fiscally dependent government regardless of whether the fiscally dependent government has a separately elected governing board, a board appointed by another government, or a jointly appointed board. Paragraphs .115–.117 provide the criteria for determining fiscal independence or dependence. [GASBS 14, ¶34]

.134 Special-Purpose Governments with Separately Elected Governing Boards. Many special-purpose governments have separately elected governing boards. Some are fiscally independent, and others are fiscally dependent on another government. For example, many local school boards are separately elected. However, a local general purpose government may approve the school board's budgets and levy a property tax for the school district. These school districts (sometimes called "dependent school districts") should be reported as component units of the primary government on which they are fiscally dependent. [GASBS 14, ¶35]

.135 Governmental Organizations with Boards Appointed by Another Government. Governmental organizations may be fiscally dependent on a local government even when their governing boards are appointed by a higher level of government. For example, local school boards in some jurisdictions may be appointed by state officials, but the responsibility for approving the school boards' budgets, authorizing the issuance of debt, and levying their property taxes may be vested in the local general purpose governments (cities or counties) where the school boards are located. As discussed in paragraph .137, these school boards usually would be included in the local

government's financial reporting entity because of their fiscal dependency on the local government even though the local government does not appoint any members of the school district's governing board. [GASBS 14, ¶36]

.136 **Governmental Organizations with Jointly Appointed Boards.** In some states there may be governmental organizations, such as port authorities, transportation authorities, river authorities, and other regional governments, that are governed by boards that are appointed by officials of more than one government (for example, a group of local governments, or a state and certain local governments), but none appoints a voting majority. If, however, a governmental organization is fiscally dependent on only one of the appointing governments (for example, a port authority may not be empowered to issue debt without substantive state approval), it should be included as a component unit of that government. [GASBS 14, ¶37]

#### Potential for Dual Inclusion

.137 In some instances, the financial accountability criteria of paragraph .120a indicate that an organization is a component unit of a particular primary government. However, that organization may also be fiscally dependent on another state or local government (as discussed in paragraphs .115–.117). In these situations, the organization meets the benchmark for inclusion in more than one reporting entity. However, an organization should be included as a component unit of only one reporting entity. For example, state governments, in particular, mandate functions to be performed by local governments and provide financial aid for a portion of the expenditures. Elementary and secondary education typically is financed through a combination of local taxation and state aid distributed in accordance with legislatively established formulas. In most such instances, the entity status of a school district will be readily apparent as either a primary government or a component unit of a local government because either its governing board is separately elected or a voting majority is appointed by the local government. In some instances, however, school district governing boards are appointed by state officials, and the state may appear to be financially accountable for the district because of the state aid distribution. Judgment needs to be exercised as to whether the district should be considered a component unit of the state or of a local government. Usually, fiscal dependency on a local government, not the financial burden on the state created by legislatively established aid distribution formulas, should govern in determining the appropriate reporting entity of such school districts. [GASBS 14, ¶38]

#### Organizations Included in the Reporting Entity Although the Primary Government Is Not Financially Accountable

.138 Paragraph .111(c) requires that certain organizations should be included as component units if the nature and significance of their relationship with the primary government, including their ongoing financial support of the primary government or its other component units, are such that exclusion from the financial reporting entity would render the financial reporting entity's financial statements incomplete or misleading. [GASBS 14, ¶39; GASBS 39, ¶5]

.139 In some states, authorities with state-appointed boards may be created to provide temporary fiscal assistance to a local government to alleviate that local government's fiscal distress. The authority should be evaluated as a potential component unit of the local government. If the authority issues debt on behalf of the local government and serves as a conduit for receiving dedicated revenues of the local government that are designated for repayment of the debt, the nature and significance of the relationship between the authority and the local government would warrant including the authority as a component unit of the local government. The temporary nature of the state-created authority emphasizes that the debt and revenues are, in substance, the debt and revenues of the local government. [GASBS 14, ¶40]

.140 A legally separate, tax-exempt organization should be reported as a component unit of a reporting entity if all of the following criteria are met:

- d. The economic resources received or held by the separate organization are entirely or almost entirely for the direct benefit of the primary government, its component units, or its constituents.
- e. The primary government, or its component units, is entitled to, or has the ability to otherwise access, a majority of the economic resources received or held by the separate organization.
- f. The economic resources received or held by an individual organization that the specific primary government, or its component units, is entitled to, or has the ability to otherwise access, are significant to that primary government. [GASBS 39, ¶5]

.141 In addition, other organizations should be evaluated as potential component units if they are closely related to, or financially integrated with, the primary government. It is a matter of professional judgment to determine whether the nature and the significance of a potential component unit's relationship with the primary government warrant inclusion in the reporting entity. [GASBS 14, ¶41; GASBS 39, ¶6]

### Reporting Component Units

.142 Financial statements of the reporting entity should provide an overview of the entity, yet allow users to distinguish between the primary government and its component units. Because of the closeness of their relationships with the primary government, some component units that meet the criteria of Section 2600, paragraph .113, should be blended as though they are part of the primary government. However, most component units, including those that meet the criteria of paragraph .140, should be discretely presented. Both blending and discrete presentation are discussed in Section 2600. [GASBS 14, ¶42; GASBS 39, ¶7]

.143 An organization that is a component unit of a financial reporting entity may have component units of its own. The component unit financial data that are incorporated into a reporting entity's financial statements should include the data from all of its component units. In effect, this section should be applied in layers "from the bottom

up." At each layer, the definition and display provisions should be applied before the layer is included in the financial statements of the next level of the reporting government. For example, a school district may be a component unit of a municipality because the municipality appoints the governing board of the district and the district imposes a financial burden on the municipality. If the school district is financially accountable for another organization (a building authority, for example), the district should apply the definition and display provisions of this section to the building authority. The municipality should apply the definition and display provisions of this section to the school district's "entity," which includes the building authority. The building authority is not a component unit of the municipality per se; however, its financial data would be included in the primary government's financial reporting entity as a part of the school district. [GASBS 14, ¶43]

#### Reporting Requirements for Financial Reports of Component Units, Joint Ventures, and Jointly Governed Organizations

.144 The provisions of this section apply to separate financial reporting by component units, joint ventures, and jointly governed organizations. Section 2600 provides guidance on presenting component unit financial information, both in combined financial reports of the reporting entity and in separately issued component unit financial reports. Section J50 provides guidance on reporting an entity's participation in a joint venture. [GASBS 14, ¶9]

### **Section J50, *Accounting for Participation in Joint Ventures and Jointly Governed Organizations***

#### JOINT VENTURES

.102 A joint venture is a legal entity or other organization that results from a contractual arrangement and that is owned, operated, or governed by two or more participants as a separate and specific activity subject to joint control, in which the participants retain (a) an ongoing financial interest or (b) an ongoing financial responsibility. Generally, the purpose of a joint venture is to pool resources and share the costs, risks, and rewards of providing goods or services to the venture participants directly, or for the benefit of the general public or specific service recipients. Joint control means that no single participant has the ability to unilaterally control the financial or operating policies of the joint venture. If the organization is jointly controlled but the participants do not have an ongoing financial interest or ongoing financial responsibility, as defined in paragraphs .103 and .104, it is a jointly governed organization, rather than a joint venture.



### Ongoing Financial Interest

.103 An ongoing financial interest in a joint venture includes an equity interest, as defined in paragraph .105, and any other arrangement that causes a participating government to have access to the joint venture's resources. Access to the joint venture's resources occurs directly, such as when the joint venture pays its surpluses to the participants, or indirectly, such as when the joint venture undertakes projects of interest to the participants. For example, indirect access occurs when the participating governments are able to influence the management of the joint venture so that the joint venture uses its surplus resources to undertake special projects for the participants' citizenry. [GASBS 14, ¶70]

### Ongoing Financial Responsibility

.104 A participating government has an ongoing financial responsibility for a joint venture if it is obligated in some manner for the debts (as described in Section 2100, paragraph .132) of the joint venture, or if the joint venture's continued existence depends on continued funding by the government. Often, joint ventures are created by two or more governments to provide goods or services directly to the governments or to provide goods or services to their constituencies on behalf of the governments. Consequently, a participating government is responsible for financing the operations of the joint venture, either by purchasing the joint venture's goods or services for its own use or by subsidizing the provision of the joint venture's services to the citizenry. For example, if a city/county public safety operation and facility is dependent on ongoing funding by the city and the county, the city and the county both have an ongoing financial responsibility. Similarly, the continued existence of a regional sewer utility that provides sewage treatment services to three cities (in relatively equal proportions) is dependent on the ongoing revenues from each of the three cities; therefore, each of the cities has an ongoing financial responsibility. On the other hand, an electric utility cooperative that generates power for sixteen cities (in relatively equal proportions) does not depend on the revenues from any single participant to continue in existence. Thus, one can conclude that none of the sixteen participants has a financial responsibility for the utility, unless one or more of the participants is obligated in some manner for the debt of the utility. [GASBS 14, ¶71]

### Equity Interest

.105 For financial reporting purposes, there are two types of joint ventures: (a) joint ventures whose participants have equity interests and (b) joint ventures whose participants do not have equity interests. An equity interest in a joint venture is manifest in the ownership of shares of joint venture stock or by otherwise having an explicit, measurable right to the net resources of a joint venture that is usually based on an investment of financial or capital resources by a participating government. An equity interest may or may not change over time as a result of an interest in the net income or loss of the joint venture. An equity interest is explicit and measurable if the joint venture agreement stipulates that the participants have a present or future claim to the net resources of the joint venture and sets forth the method to determine the participants'

shares of the joint venture's net resources. As discussed below, if the government has an equity interest in the joint venture, that equity interest should be reported as an asset of the fund that has the equity interest.

#### Reporting in the Government-wide Financial Statements for Participation in Joint Ventures in Which There Is an Equity Interest

.108 In the government-wide financial statements, equity interests in joint ventures should be reported in the same manner as in proprietary funds. (See paragraph .106.) As discussed in Section 2200, paragraphs .112 and .113, reporting should distinguish between the primary government and discretely presented component units and between governmental and business-type activities of the primary government. [GASBS 34, ¶¶14–¶16]

#### Disclosure Requirements for Joint Venture Participants

.109 Regardless of whether there is an equity interest, joint venture participants should make these disclosures in the notes to the financial statements:

- a. A general description of each joint venture, including:
  - 3) Description of the participating government's ongoing financial interest (including its equity interest, if applicable) or ongoing financial responsibility. This disclosure should also include information to allow the reader to evaluate whether the joint venture is accumulating significant financial resources or is experiencing fiscal stress that may cause an additional financial benefit to or burden on the participating government in the future.
  - 4) Information about the availability of separate financial statements of the joint venture.
- b. The participating government should also disclose any other information required by Section 2300, "Notes to Financial Statements," paragraph .107f.

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## APPENDIX 3—FASB Excerpts and Reference Materials

### ARB 51, *Consolidated Financial Statements*

#### Purpose of Consolidated Statements

1. The purpose of consolidated statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions. There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies.

#### Consolidation Policy

2. The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one company, directly or indirectly, of over fifty per cent of the outstanding voting shares of another company is a condition pointing toward consolidation. However, there are exceptions to this general rule. For example, a subsidiary should not be consolidated where control is likely to be temporary, or where it does not rest with the majority owners (as, for instance, where the subsidiary is in legal reorganization or in bankruptcy). There may also be situations where the minority interest in the subsidiary is so large, in relation to the equity of the shareholders of the parent in the consolidated net assets, that the presentation of separate financial statements for the two companies would be more meaningful and useful. However, the fact that the subsidiary has a relatively large indebtedness to bondholders or others is not in itself a valid argument for exclusion of the subsidiary from consolidation. (Also, see Chapter 12 of Accounting Research Bulletin No. 43 for the treatment of foreign subsidiaries.)<sup>67</sup>

3. In deciding upon consolidation policy, the aim should be to make the financial presentation which is most meaningful in the circumstances. The reader should be given information which is suitable to his needs, but he should not be burdened with unnecessary detail. Thus, even though a group of companies is heterogeneous in character, it may be better to make a full consolidation than to present a large number of separate statements. On the other hand, separate statements or combined statements would be preferable for a subsidiary or group of subsidiaries if the presentation of financial information concerning the particular activities of such

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<sup>67</sup> This paragraph is amended by SFAS 94, par. 13.

subsidiaries would be more informative to shareholders and creditors of the parent company than would the inclusion of such subsidiaries in the consolidation. For example, separate statements may be required for a subsidiary which is a bank or an insurance company and may be preferable for a finance company where the parent and the other subsidiaries are engaged in manufacturing operations.<sup>68</sup>

4. A difference in fiscal periods of a parent and a subsidiary does not of itself justify the exclusion of the subsidiary from consolidation. It ordinarily is feasible for the subsidiary to prepare, for consolidation purposes, statements for a period which corresponds with or closely approaches the fiscal period of the parent. However, where the difference is not more than about three months, it usually is acceptable to use, for consolidation purposes, the subsidiary's statements for its fiscal period; when this is done, recognition should be given by disclosure or otherwise to the effect of intervening events which materially affect the financial position or results of operations.

5. Consolidated statements should disclose the consolidation policy which is being followed. In most cases this can be made apparent by the headings or other information in the statements, but in other cases a footnote is required.

#### Unconsolidated Subsidiaries in Consolidated Statements

19. There are two methods of dealing with unconsolidated subsidiaries in consolidated statements. Whichever method is adopted should be used for all unconsolidated subsidiaries, subject to appropriate modification in special circumstances. The preferable method, in the view of the committee, is to adjust the investment through income currently to take up the share of the controlling company or companies in the subsidiaries' net income or net loss, except where the subsidiary was excluded because of exchange restrictions or other reasons which raise the question of whether the increase in equity has accrued to the credit of the group. (Adjustments of the investment would also be made for "special" debits or credits shown on the income statements of the unconsolidated subsidiaries below the net income for the period, and for similar items shown in the schedule of earned surplus.) The other method, more commonly used at present, is to carry the investment at cost, and to take up income as dividends are received; however, provision should be made for any material impairment of the investment, such as through losses sustained by the subsidiaries, unless it is deemed to be temporary. When the latter method is followed, the consolidated statements should disclose, by footnote or otherwise, the cost of the investment in the unconsolidated subsidiaries, the equity of the consolidated group of companies in their net assets, the dividends received from them in the current period, and the equity of the

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<sup>68</sup> This paragraph is amended by SFAS 94, par. 13.

consolidated group in their earnings for the period; this information may be given in total or by individual subsidiaries or groups of subsidiaries.<sup>69</sup>

20. Whichever method of dealing with unconsolidated subsidiaries is followed, if there is a difference between the cost of the investment and the equity in net assets at the date of acquisition, appropriate recognition should be given to the possibility that, had the subsidiaries been consolidated, part of such difference would have been reflected in adjusted depreciation or amortization. Also, appropriate recognition should be given to the necessity for an adjustment for intercompany gains or losses on transactions with unconsolidated subsidiaries. If sales are made to unconsolidated subsidiaries and the investment in the subsidiaries is carried at cost plus the equity in undistributed earnings, an elimination of unrealized intercompany gains and losses should be made to the same extent as if the subsidiaries were consolidated. The same applies where intercompany sales are made by the unconsolidated subsidiaries. If, however, the investment is carried at cost, it is not necessary to eliminate the intercompany gain on sales to such subsidiaries, if the gain on the sales does not exceed the unrecorded equity in undistributed earnings of the unconsolidated subsidiaries. If such gain is material, it should be appropriately disclosed. Where the sales are made by the unconsolidated subsidiaries to companies included in the consolidated group, the intercompany gains or losses should be eliminated in arriving at the amount of the equity in the undistributed earnings of the unconsolidated subsidiaries which will be disclosed in a footnote or otherwise. (See paragraph 19.)<sup>70</sup>

21. Where the unconsolidated subsidiaries are, in the aggregate, material in relation to the consolidated financial position or operating results, summarized information as to their assets, liabilities and operating results should be given in the footnotes or separate statements should be presented for such subsidiaries, either individually or in groups, as appropriate.

### Combined Statements

22. To justify the preparation of consolidated statements, the controlling financial interest should rest directly or indirectly in one of the companies included in the consolidation. There are circumstances, however, where combined financial statements (as distinguished from consolidated statements) of commonly controlled companies are likely to be more meaningful than their separate statements. For example, combined financial statements would be useful where one individual owns a controlling interest in several corporations which are related in their operations. Combined statements would also be used to present the financial position and the

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<sup>69</sup> This paragraph as amended by SFAS 94, is superseded by SFAS 131 par. 130. Statement 131 states "Paragraph 19 of ARB No. 51, Consolidated Financial Statements, as amended by FASB Statement No. 94, Consolidation of All Majority-Owned Subsidiaries, is deleted.

<sup>70</sup> The heading for par. 19-21 has been changed per SFAS 94 to read: "Disclosure About Formerly Unconsolidated Majority-Owned Subsidiaries."

results of operations of a group of unconsolidated subsidiaries. They might also be used to combine the financial statements of companies under common management.

23. Where combined statements are prepared for a group of related companies, such as a group of unconsolidated subsidiaries or a group of commonly controlled companies, intercompany transactions and profits or losses should be eliminated, and if there are problems in connection with such matters as minority interests, foreign operations, different fiscal periods, or income taxes, they should be treated in the same manner as in consolidated statements.

## **SFAS 94, *Consolidation of All Majority-Owned Subsidiaries***

### Introduction

1. Accounting Research Bulletin No. 51, Consolidated Financial Statements, adopted by the Committee on Accounting Procedure of the AICPA in 1959, concisely describes the purpose of consolidated financial statements in its first paragraph.

The purpose of consolidated statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions. There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies.

2. Similarly, the first sentence of paragraph 2 describes its general rule of consolidation policy.

The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one company, directly or indirectly, of over fifty per cent of the outstanding voting shares of another company is a condition pointing toward consolidation.

3. While ARB 51's general rule is to consolidate all majority-owned subsidiaries, its paragraphs 2 and 3 describe "exceptions to that general rule."

4. Paragraph 2 precludes consolidation of a majority-owned subsidiary under two conditions—"where control is likely to be temporary, or where it does not rest with the majority owners (as, for instance, where the subsidiary is in legal reorganization or in bankruptcy)." It also permits exclusion from consolidation of a subsidiary having a relatively large minority interest and of a foreign subsidiary.

5. The exception in paragraph 3 of ARB 51 has become the basis for excluding from consolidation the greatest number of majority-owned subsidiaries. It has often been called exclusion of "nonhomogeneous" operations because of its wording:

. . . even though a group of companies is heterogeneous in character, it may be better to make a full consolidation than to present a large number of separate statements. On the other hand, separate statements or combined statements would be preferable for a subsidiary or group of subsidiaries if the presentation of financial information concerning the particular activities of such subsidiaries would be more informative to shareholders and creditors of the parent company than would the inclusion of such subsidiaries in the consolidation. For example, separate statements may be required for a subsidiary which is a bank or an insurance company and may be preferable for a finance company where the parent and the other subsidiaries are engaged in manufacturing operations.

6. Business enterprises have increasingly used "nonhomogeneity" as a basis for excluding from consolidation majority-owned (even wholly owned) subsidiaries considered different in character from the parent and its other affiliates. Subsidiaries most commonly not consolidated on that basis have been finance, insurance, real estate, and leasing subsidiaries of manufacturing and merchandising enterprises.

7. However, certain diversified enterprises consolidate all of their majority-owned subsidiaries despite differences in their operations, and significant questions about the "nonhomogeneity" exception have arisen. Present practice has been criticized not only because apparently similar enterprises use different consolidation policies but also because excluding some subsidiaries from consolidation results in the omission of significant amounts of assets, liabilities, revenues, and expenses from the consolidated statements of many enterprises. Omissions of large amounts of liabilities, especially those of finance and similar subsidiaries, have led to the criticism that not consolidating those subsidiaries is an important factor in what is often called "off-balance-sheet financing."

8. The "nonhomogeneity" exception has only relatively recently become the most prominent reason for excluding majority-owned subsidiaries from consolidation. When ARB 51 was issued, other restrictive consolidation policies—to consolidate only wholly owned subsidiaries, only subsidiaries owned to a specified degree (such as 66 2/3 percent, 75 percent, or 80 percent), only domestic subsidiaries, only North American subsidiaries, and the like—were more common. Those other restrictive policies have become less widely used while exclusion for "nonhomogeneity" has become more widespread.

#### Consolidation

9. This Statement eliminates three exceptions to the general rule that majority-owned subsidiaries should be consolidated: the exceptions for "nonhomogeneous" operations, for relatively large minority interests (which apparently is seldom used in

practice), and for other restrictive policies. It amends ARB No. 43, Chapter 12, "Foreign Operations and Foreign Exchange," to narrow the exception for a majority-owned foreign subsidiary from one that permits exclusion from consolidation of any or all foreign subsidiaries to one that effectively eliminates distinctions between foreign and domestic subsidiaries.

10. The other exceptions noted in paragraph 4—control that is likely to be temporary and control that does not rest with the majority owner because of, for example, corporate reorganization or bankruptcy—have not been reconsidered in this Statement. They relate to the concept of control and its place in consolidation policy, which are not within the scope of this Statement but are part of a broader FASB project on the reporting entity, including consolidations and the equity method (paragraphs 19 and 20). Similarly, consolidation of subsidiaries controlled by means other than ownership of a majority voting interest—control by significant minority ownership, by contract, lease, or agreement with other stockholders, by court decree, or otherwise—has not been reconsidered in this Statement because that subject also is part of the project on the reporting entity.

#### Continued Disclosure

11. The FASB project on the reporting entity, including consolidations and the equity method, will consider what disaggregated information should be disclosed with consolidated financial statements. To prevent loss in the meantime of information about unconsolidated subsidiaries now required by APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, this Statement requires continued disclosure of that information for subsidiaries that are consolidated as a result of this Statement.

12. The time between issuance of this Statement and one that would require disclosure of specified disaggregated information provides an opportunity for business enterprises to explore ways to provide additional information that is useful to investors, creditors, and others in understanding and assessing the effects of the differing risks and returns of various activities. A number of enterprises have been providing information about consolidated subsidiaries that goes beyond that required by Opinion 18 and FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*, and the Board encourages them to continue with and to strive to improve that disclosure and encourages others to follow their example. That experimentation not only should result in improved disclosure but also will provide the Board and its constituents with experience on which to draw in considering the broad issue of disclosures of disaggregated information.

#### Amendments of ARB No. 51, APB Opinion No. 18, and ARB No. 43, Chapter 12

13. Paragraphs 2 and 3 of ARB 51 are amended to read:

2. The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one



company, directly or indirectly, of over fifty percent of the outstanding voting shares of another company is a condition pointing toward consolidation. However, there are exceptions to this general rule. A majority-owned subsidiary shall not be consolidated if control is likely to be temporary or if it does not rest with the majority owner (as, for instance, if the subsidiary is in legal reorganization or in bankruptcy or operates under foreign exchange restrictions, controls, or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent's ability to control the subsidiary).

3. All majority-owned subsidiaries—all companies in which a parent has a controlling financial interest through direct or indirect ownership of a majority voting interest—shall be consolidated except those described in the last sentence of paragraph 2.

14. The heading "Unconsolidated Subsidiaries in Consolidated Statements" and paragraphs 19-21 of ARB 51 are deleted and replaced by the following heading and new paragraph 19<sup>71</sup>:

#### DISCLOSURE ABOUT FORMERLY UNCONSOLIDATED MAJORITY-OWNED SUBSIDIARIES

19. Information that was disclosed under APB Opinion No. 18, paragraph 20(c), about majority-owned subsidiaries that were unconsolidated in financial statements for fiscal years 1986 or 1987 shall continue to be disclosed for them after they are consolidated pursuant to the provisions of this pronouncement as amended by FASB Statement No. 94. That is, summarized information about the assets, liabilities, and results of operations (or separate statements) shall be provided for those subsidiaries, either individually or in groups, as appropriate, in the consolidated financial statements or notes.

15. Opinion 18 is amended to eliminate its requirement to use the equity method to account in consolidated financial statements for unconsolidated majority-owned subsidiaries and to eliminate its provisions applying to "parent-company financial statements prepared for issuance to stockholders as the financial statements of the primary reporting entity," which are precluded by this Statement. The paragraphs primarily affected are 1, 14, 16, and 17 and the footnotes to them; changes in other paragraphs primarily remove "subsidiaries" or "unconsolidated subsidiaries" from expressions such as "subsidiaries, joint ventures, and other investees which qualify for the equity method" or remove other words or sentences that no longer apply.

a. The second sentence of paragraph 1 is amended to read:

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<sup>71</sup> SFAS 131 ¶ 134 amends SFAS 94 to read "Paragraph 14 of Statement 94 is deleted."

This Opinion extends the applicability of the equity method of accounting (paragraph 6(b)) to investments in common stock of corporate joint ventures and certain other investments in common stock.

The third sentence and footnote 1 are deleted.

- b. Footnote 3 to paragraph 4 is amended to read:

See paragraphs 2 and 3 of ARB No. 51 as amended by FASB Statement No. 94.

- c. Paragraph 14 is amended to read:

14. ARB No. 51, paragraphs 2 and 3 (as amended by FASB Statement No. 94), requires consolidation of all majority-owned subsidiaries except the few that meet conditions described in paragraph 2. The equity method is not a valid substitute for consolidation. Moreover, since ARB No. 51 as amended requires the general-purpose financial statements of companies having one or more majority-owned subsidiaries to be consolidated statements, parent-company statements are not a valid substitute for consolidated financial statements.

- d. Paragraph 14, footnote 4, is amended to read:

Paragraphs 2 and 3 of ARB No. 51 (as amended by FASB Statement No. 94) describe the conditions under which a majority-owned subsidiary shall not be consolidated. The limitations in paragraphs 2 and 3 of ARB No. 51 (as amended by FASB Statement No. 94) should also be applied as limitations to the use of the equity method.

- e. The second sentence of paragraph 16 is amended to read:

Therefore, investors should account for investments in common stock of corporate joint ventures by the equity method in consolidated financial statements.<sup>6</sup>

- f. The last sentence of paragraph 17 is deleted.

- g. The first two sentences of paragraph 19 are deleted.

- h. In the third sentence of paragraph 19, the words "unconsolidated subsidiaries" are deleted.

- i. In the first sentence of paragraph 19(a), the word "subsidiary" is deleted.

- j. Paragraph 20(c) is deleted.

- k. Paragraph 20(d) is amended to delete "of 50% or less" from the first sentence.

16. Paragraphs 8 and 9 of ARB 43, Chapter 12, "Foreign Operations and Foreign Exchange," are deleted. (Paragraph 8 and part of 9 are quoted in footnote 1 of this Statement.)

### **FIN 46, Consolidation of Variable Interest Entities, an interpretation of ARB No. 51**

This Interpretation of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, addresses consolidation by business enterprises of variable interest entities, which have one or both of the following characteristics:

- i. The equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties, which is provided through other interests that will absorb some or all of the expected losses of the entity.
- ii. The equity investors lack one or more of the following essential characteristics of a controlling financial interest:
  - a. The direct or indirect ability to make decisions about the entity's activities through voting rights or similar rights
  - b. The obligation to absorb the expected losses of the entity if they occur, which makes it possible for the entity to finance its activities
  - c. The right to receive the expected residual returns of the entity if they occur, which is the compensation for the risk of absorbing the expected losses.

#### INTRODUCTION

1. This Interpretation clarifies the application of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. Paragraph 1 of ARB 51 states that consolidated financial statements are "usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies." Paragraph 2 states that "the usual condition for a controlling financial interest is ownership of a majority voting interest. . . ." However, application of the majority voting interest requirement in ARB 51 to certain types of entities may not identify the party with a controlling financial interest because the controlling financial interest may be achieved through arrangements that do not involve voting interests.

#### VARIABLE INTEREST ENTITIES

5. An entity shall be subject to consolidation according to the provisions of this Interpretation if, by design, either of the following conditions exists:

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- a. The total equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties. That is, the equity investment at risk is not greater than the expected losses of the entity. For this purpose, the total equity investment at risk:
1. Includes only equity investments in the entity that participate significantly in profits and losses even if those investments do not carry voting rights.
  2. Does not include equity interests that the entity issued in exchange for subordinated interests in other variable interest entities.
  3. Does not include amounts provided to the equity investor directly or indirectly by the entity or by other parties involved with the entity (for example, by fees, charitable contributions, or other payments), unless the provider is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor.
  4. Does not include amounts financed for the equity investor (for example, by loans or guarantees of loans) directly by the entity or by other parties involved with the entity, unless that party is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor.
- b. As a group the holders of the equity investment at risk lack any one of the following three characteristics of a controlling financial interest:
1. The direct or indirect ability to make decisions about an entity's activities through voting rights or similar rights. The investors do not have that ability through voting rights or similar rights if no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation or a general partner in a partnership).
  2. The obligation to absorb the expected losses of the entity if they occur. The investor or investors do not have that obligation if they are directly or indirectly protected from the expected losses or are guaranteed a return by the entity itself or by other parties involved with the entity.
  3. The right to receive the expected residual returns of the entity if they occur. The investors do not have that right if their return is capped by the entity's governing documents or arrangements with other variable interest holders or with the entity.

The equity investors as a group also are considered to lack characteristic (b)(1) if (i) the voting rights of some investors are not proportional to their obligations to absorb the expected losses of the entity, to receive the expected residual returns of the entity, or both and (ii) substantially all of the entity's activities (for example, providing financing or buying assets) either involve or are conducted on behalf of an investor 6 that has disproportionately few voting rights.

6. An entity subject to this Interpretation is called a variable interest entity. The investments or other interests that will absorb portions of a variable interest entity's expected losses if they occur or receive portions of the entity's expected residual returns if they occur are called variable interests. The initial determination of whether an entity is a variable interest entity shall be made on the date at which an enterprise becomes involved with the entity. That determination shall be based on the circumstances on that date including future changes that are required in existing governing documents and existing contractual arrangements. An enterprise is not required to determine whether an entity with which it is involved is a variable interest entity if it is apparent that the enterprise's interest would not be a significant variable interest and if the enterprise, its related parties, and its de facto agents (as described in paragraph 16) were not involved in forming the entity.

#### Expected Losses and Expected Residual Returns

8. A variable interest entity's expected losses and expected residual returns shall include (a) the expected variability in the entity's net income or loss, (b) the expected variability in the fair value of the entity's assets (except as explained in paragraph 12) if it is not included in net income or loss, (c) fees to the decision maker (if there is a decision maker), and (d) fees to providers of guarantees of the values of all or substantially all of the entity's assets (including writers of put options and other instruments with similar results) and providers of guarantees that all or substantially all of the entity's liabilities will be paid.

9. An equity investment of less than 10 percent of the entity's total assets shall not be considered sufficient to permit the entity to finance its activities without subordinated financial support in addition to the equity investment unless the equity investment can be demonstrated to be sufficient in at least one of the following three ways:

- a. The entity has demonstrated that it can finance its activities without additional subordinated financial support.
- b. The entity has at least as much equity invested as other entities that hold only similar assets of similar quality in similar amounts and operate with no additional subordinated financial support.
- c. The amount of equity invested in the entity exceeds the estimate of the entity's expected losses based on reasonable quantitative evidence.

#### Consolidation Based on Variable Interests

14. An enterprise shall consolidate a variable interest entity if that enterprise has a variable interest (or combination of variable interests) that will absorb a majority of the entity's expected losses if they occur, receive a majority of the entity's expected residual returns if they occur, or both. An enterprise shall consider the rights and obligations conveyed by its variable interests and the relationship of its variable interests with variable interests held by other parties to determine whether its variable interests will absorb a majority of a variable interest entity's expected losses, receive a majority of the

entity's expected residual returns, or both. A direct or indirect ability to make decisions that significantly affect the results of the activities of a variable interest entity is a strong indication that an enterprise has one or both of the characteristics that would require consolidation of the variable interest entity. If one enterprise will absorb a majority of a variable interest entity's expected losses and another enterprise will receive a majority of that entity's expected residual returns, the enterprise absorbing a majority of the losses shall consolidate the variable interest entity.

15. The enterprise that consolidates a variable interest entity is called the primary beneficiary of that entity. An enterprise shall determine whether it is the primary beneficiary of a variable interest entity at the time the enterprise becomes involved with the entity. An enterprise with an interest in a variable interest entity shall reconsider whether it is the primary beneficiary of the entity if the entity's governing documents or the contractual arrangements among the parties involved change. The primary beneficiary also shall reconsider its initial decision to consolidate a variable interest entity if the primary beneficiary sells or otherwise disposes of all or part of its variable interest to unrelated parties. A holder of a variable interest that is not the primary beneficiary also shall reconsider whether it is the primary beneficiary of a variable interest entity if the enterprise acquires newly issued interests in the entity or a portion of the primary beneficiary's interest in the entity.

## DISCLOSURE

23. In addition to disclosures required by other standards, the primary beneficiary of a variable interest entity shall disclose the following (unless the primary beneficiary also holds a majority voting interest):

- a. The nature, purpose, size, and activities of the variable interest entity.
- b. The carrying amount and classification of consolidated assets that are collateral for the variable interest entity's obligations.
- c. Lack of recourse if creditors (or beneficial interest holders) of a consolidated variable interest entity have no recourse to the general credit of the primary beneficiary.

24. An enterprise that holds a significant variable interest in a variable interest entity but is not the primary beneficiary shall disclose:

- a. The nature of its involvement with the variable interest entity and when that involvement began.
- b. The nature, purpose, size, and activities of the variable interest entity.
- c. The enterprise's maximum exposure to loss as a result of its involvement with the variable interest entity.

## ***APB 18, The Equity Method of Accounting for Investments in Common Stock***

12. The equity method tends to be most appropriate if an investment enables the investor to influence the operating or financial decisions of the investee. The investor then has a degree of responsibility for the return on its investment, and it is appropriate to include in the results of operations of the investor its share of the earnings or losses of the investee. Influence tends to be more effective as the investor's percent of ownership in the voting stock of the investee increases. Investments of relatively small percentages of voting stock of an investee tend to be passive in nature and enable the investor to have little or no influence on the operations of the investee.

13. Some hold the view that neither the market value method nor the equity method is appropriate accounting for investments in common stock where the investor holds less than majority ownership of the voting stock. They would account for such investments at cost. Under that view the investor is not entitled to recognize earnings on its investment until a right to claim the earnings arises, and that claim arises only to the extent dividends are declared. The investor is considered to have no earnings on its investment unless it is in a position to control the distribution of earnings. Likewise, an investment or an investor's operations are not affected by losses of an investee unless those losses indicate a loss in value of the investment that should be recognized.

17. The Board concludes that the equity method of accounting for an investment in common stock should also be followed by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less of the voting stock. Ability to exercise that influence may be indicated in several ways, such as representation on the board of directors, participation in policy making processes, material intercompany transactions, interchange of managerial personnel, or technological dependency. Another important consideration is the extent of ownership by an investor in relation to the concentration of other shareholdings, but substantial or majority ownership of the voting stock of an investee by another investor does not necessarily preclude the ability to exercise significant influence by the investor. The Board recognizes that determining the ability of an investor to exercise such influence is not always clear and applying judgment is necessary to assess the status of each investment. In order to achieve a reasonable degree of uniformity in application, the Board concludes that an investment (direct or indirect) of 20% or more of the voting stock of an investee should lead to a presumption that in the absence of evidence to the contrary an investor has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20% of the voting stock of an investee should lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated.

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**FIN 35, *Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an interpretation of APB Opinion No. 18***

This Interpretation clarifies the criteria for applying the equity method of accounting for investments of 50 percent or less of the voting stock of an investee enterprise (other than a corporate joint venture). APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, states that use of the equity method of accounting for the investment is required if the investor has the ability to exercise significant influence over operating and financial policies of the investee. Opinion 18 includes presumptions, based on the investor's percentage ownership, as to whether the investor has that ability, but those presumptions can be overcome by evidence to the contrary and do not override the need for judgment. If there is an indication that an investor owning 20 percent or more of an investee's voting stock is unable to exercise significant influence over the investee's operating and financial policies, all the facts and circumstances related to the investment shall be evaluated to determine whether the presumption of ability to exercise significant influence over the investee is overcome.

**INTERPRETATION**

2. Opinion 18 requires that the equity method of accounting be followed by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee. The presumptions in paragraph 17 of Opinion 18 are intended to provide a reasonable degree of uniformity in applying the equity method. The presumptions can be overcome by predominant evidence to the contrary.
3. Evidence that an investor owning 20 percent or more of the voting stock of an investee may be unable to exercise significant influence over the investee's operating and financial policies requires an evaluation of all the facts and circumstances relating to the investment. The presumption that the investor has the ability to exercise significant influence over the investee's operating and financial policies stands until overcome by predominant evidence to the contrary.
4. Examples of indications that an investor may be unable to exercise significant influence over the operating and financial policies of an investee include:
  - a. Opposition by the investee, such as litigation or complaints to governmental regulatory authorities, challenges the investor's ability to exercise significant influence.
  - b. The investor and investee sign an agreement under which the investor surrenders significant rights as a shareholder.
  - c. Majority ownership of the investee is concentrated among a small group of shareholders who operate the investee without regard to the views of the investor.



- d. The investor needs or wants more financial information to apply the equity method than is available to the investee's other shareholders (for example, the investor wants quarterly financial information from an investee that publicly reports only annually), tries to obtain that information, and fails.
- e. The investor tries and fails to obtain representation on the investee's board of directors.

This list is illustrative and is not all-inclusive. None of the individual circumstances is necessarily conclusive that the investor is unable to exercise significant influence over the investee's operating and financial policies. However, if any of these or similar circumstances exists, an investor with ownership of 20 percent or more shall evaluate all facts and circumstances relating to the investment to reach a judgment about whether the presumption that the investor has the ability to exercise significant influence over the investee's operating and financial policies is overcome. It may be necessary to evaluate the facts and circumstances for a period of time before reaching a judgment.

## **Exposure Draft: *Consolidated Financial Statements - Purpose and Policy***

### Summary

This proposed Statement would establish standards that specify when entities should be included in consolidated financial statements. It would apply to business enterprises and not for-profit organizations that control other entities regardless of the legal form of the controlling and controlled entities. This proposed Statement would not apply to financial statements of certain reporting entities, such as pension plans and investment companies, that in accordance with generally accepted accounting principles carry substantially all of their assets, including investments in controlled entities, at fair value with all changes in value reported in a statement of net income or financial performance.

This proposed Statement would require that a controlling entity (parent) consolidate all entities that it controls (subsidiaries) unless control is temporary at the time the entity becomes a subsidiary. For purposes of that requirement, control of an entity is a non-shared decision making ability of an entity to direct the policies and management that guide the ongoing activities of another entity so as to increase its benefits and limit its losses from that other entity's activities.

This proposed Statement would preclude consolidation of a new subsidiary if a parent's control is temporary at the date that control is obtained. Control of a newly acquired subsidiary would be considered temporary if at the date of acquisition the parent either has committed to a plan to relinquish control of that subsidiary or is obligated to do so and it is likely that loss of control will occur within one year. However, control also would

be considered temporary if at the date of acquisition circumstances beyond management's control are likely to require more than one year to complete the ultimate disposition.

This proposed Statement would supersede the provisions of paragraphs 1–3 and 5 of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, as previously amended by FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, and would amend ARB 51 to extend its provisions to not-for-profit organizations. It also would supersede or amend other accounting pronouncements listed in Appendix C.

This proposed Statement would be effective for financial statements for annual periods beginning after December 15, 1999, and all interim periods in the year of adoption. Earlier application would be encouraged. The proposed Statement would be applied by restatement of comparative financial statements for earlier periods. However, retroactive restatement would not be required for those entities for which (a) control was relinquished or (b) management has committed to a plan to relinquish control or is obligated to do so and that relinquishment is likely to occur within one year of the fiscal year-end in which this proposed Statement is first applied.

#### Definition of Control and Its Implementation Guidance

*Issue 1:* This proposed Statement would define control as “the ability of an entity to direct the policies and management that guide the ongoing activities of another entity so as to increase its benefits and limit its losses from that other entity’s activities. For purposes of consolidated financial statements, control involves decision-making ability that is not shared with others” (paragraph 6). In certain respects, that definition differs from the October 1995 proposed Statement that focused on decision-making powers for another entity’s “individual assets” rather than its policies and management that in turn are used to direct activities, including the use of assets. The revised definition also encompasses a more explicit condition that the decision-making powers must provide the controlling entity with the ability to increase the benefits and limit the losses that it can derive from that decision-making power. (That latter revision is similar to the explicit condition included in definitions of control adopted in the United Kingdom and by the International Accounting Standards Committee.) Does the revised definition, together with the discussion of the characteristics of control (paragraphs 10–14) and descriptive guidance (paragraphs 15–23 and 30–47), help clarify when one entity controls another entity? Will the revised definition and guidance lead to common understandings and application of this Statement’s definition of control? Paragraphs 188–196 and 205–213 provide the basis for the Board’s conclusions.

*Issue 2:* This proposed Statement would provide guidance for applying its definition of control. That guidance includes certain situations, which are identified in paragraphs 18 and 21 of this proposed Statement, that would lead to reputable presumptions of control. They are those circumstances in which an entity:

- a. Has a majority voting interest in the election of a corporation’s governing body or a right to appoint a majority of the members of its governing body

- b. Has a large minority voting interest in the election of a corporation's governing body and no other party or organized group of parties has a significant voting interest
- c. Has a unilateral ability to (1) obtain a majority voting interest in the election of a corporation's governing body or (2) obtain a right to appoint a majority of the corporation's governing body through the present ownership of convertible securities or other rights that are currently exercisable at the option of the holder and the expected benefit from converting those securities or exercising that right exceeds its expected cost
- d. Is the only general partner in a limited partnership and no other partner or organized group of partners has the current ability to dissolve the limited partnership or otherwise remove the general partner.

Will guidance in the form of reputable presumptions of control be necessary? Do the circumstances described in each of the situations above provide a reasonable basis for presuming that one entity controls another entity in the absence of evidence that demonstrates or proves otherwise? Are they sufficiently clear and operational? Are additional presumptions of control necessary for specific circumstances? (If so, please identify those circumstances.)

Paragraphs 238–241 provide the basis for the Board's conclusions and paragraphs 248–256 provide an alternative view on the use of reputable presumptions to provide guidance for applying the proposed Statement's definition of control.

### Control of a Subsidiary

10. Control, as defined by this Statement, involves the presence of two essential characteristics: (a) a parent's non-shared decision-making ability that enables it to guide the ongoing activities of its subsidiary and (b) a parent's ability to use that power to increase the benefits that it derives and limit the losses that it suffers from the activities of that subsidiary. Those interrelated characteristics generally stem from a single source such as a controlling block of voting equity shares, but they may stem from multiple sources. For example, a parent's decision-making powers may stem from a subsidiary's governing instrument (articles of incorporation, partnership agreement, or trust indenture), contractual arrangements with holders of voting rights, a voting trust, or other legal device, while its ability to derive benefits stems from a holding of nonvoting equity shares or other beneficial interest.

### Decision-Making Ability That Is Not Shared

11. The first essential characteristic of control is that a parent must have the ability by itself to make the decisions that guide the ongoing activities of another entity (subsidiary). That decision-making ability cannot be shared, and it must enable the parent to:

- a. Direct the use of and access to another entity's assets, generally by having the power to set the policies that guide how those assets are used in ongoing activities.
- b. Hold the management of that other entity accountable for the conduct of its ongoing activities, including the use of that entity's assets, generally by having the power to select, terminate, and determine the compensation of the management responsible for carrying out the directives of the parent.

The decision-making ability that enables a parent to control a subsidiary is an exclusionary power—if A controls B, no other entity can control B. That power distinguishes a parent-subsidiary relationship from other relationships in which decision-making powers are shared, divided, or exercised jointly by two or more partners or co-owners. An ability to participate in making and carrying out decisions that guide the ongoing activities of another entity that requires the cooperation of one or more other partners or co-owners to continue those activities usually characterizes a general partnership or joint venture relationship. That is, a parent-subsidiary relationship does not exist if, as a result of rights of others, an investor in a corporation, partnership, or other entity must obtain the consent of one or more other shareholders, partners, or other parties to set or establish the direction for that entity's ongoing activities (item (a) above) or carry out or enforce its directives (item (b) above) or if that investor's decisions can be overridden by another party.

12. A parent's decision-making ability often is constrained by laws, regulations, corporate charters, shareholder and partnership agreements, debt covenants, and other agreements that impose limits to protect the interests of non-controlling investors, creditors, and others. However, protective rights, by themselves, generally do not result in shared control or otherwise deny a parent's control of its subsidiary. Paragraphs 39–47 provide guidance for distinguishing between a parent-subsidiary relationship that involves constraints that merely limit a parent's non-shared decision-making ability and other relationships in which the rights of others result in shared decision making—the absence of control.

13. The non-shared decision-making ability of a parent also differs from the delegated decision-making authority of an agent or manager, which derives from a principal or employer who can remove or change the agent's or manager's authority.

#### Ability to Increase Benefits and Limit Losses

14. The second essential characteristic of control is that a parent must have the ability to increase the benefits that it derives and limit the losses that it suffers from the ongoing activities of its subsidiary (paragraph 10). This Statement, however, does not require that a parent have an exclusive right to those potential increased benefits; rather, non-controlling investors, creditors, and others also often benefit from a parent's guidance of its subsidiary. A parent usually has the opportunity to increase the benefits that it derives from the activities of a subsidiary by having an interest in its income and residual net assets, but an ownership type of benefit or a minimum level of ownership is not a required characteristic. A parent also can increase its benefits through other

means, for example, by initiating actions that result in revenue enhancements or cost savings through synergies between the subsidiary and the parent or its affiliates.

### Assessing Whether a Relationship Involves Control

15. Determining whether a particular relationship between two entities is a parent-subsidiary relationship requires an assessment of the surrounding facts and circumstances and a judgment about whether one entity controls the other entity. This Statement provides guidance for applying its definition of control, which includes identifying circumstances that lead to reputable presumptions of control. That guidance, however, does not remove the need to assess and apply judgment about whether one entity has the required non-shared ability to direct the policies and management that guide the ongoing activities of the other entity so as to increase its benefits and limit its losses from those activities (paragraph 6).

16. An entity shall review and assess all of the facts and circumstances surrounding its relationship with another entity whenever events or changes in circumstances suggest that control of that other entity may have been obtained or lost. For example, the surrounding facts and circumstances of a relationship should be assessed if an entity:

- a. Increases or decreases its ownership of voting shares or rights to elect or appoint the members of a corporation's governing body
- b. Increases or decreases its ownership of securities, such as convertible debt, convertible preferred stock, stock options, warrants, or other rights, that enable the holder to obtain a significant ownership of voting shares or rights to elect or appoint the members of a corporation's governing body
- c. Has significant involvement in the formation or funding of an entity, such as establishing fundamental provisions of its articles of incorporation, partnership agreement, or other governing instrument or providing a significant amount of its capital.
- d. Obtains or transfers a right to cause an entity to cease its operations
- e. Obtains or transfers a right to participate in a distribution of an entity's assets (or net assets) in the event of its liquidation.

The assessment shall include weighing the significance of the relevant facts and circumstances surrounding a particular relationship. Rarely do individual facts, events, or circumstances, such as those described above, by themselves provide evidence of sufficient weight to reach a conclusive judgment or lead to a presumption about whether control is present. Rather, the weight given to the surrounding facts and circumstances should be commensurate with all available evidence.

17. Paragraphs 18–23 discuss ways in which control of a corporation, partnership, or other entity might be achieved. Paragraphs 18 and 21 also identify certain specific situations that usually provide strong evidence pointing toward the existence of control and, for purposes of applying this Statement, lead to specific reputable presumptions of control. However, those situations represent only a few of the most common ways that control of an entity might be achieved. The absence of one of those specific situations does not lead to a presumption that control is not present.

#### Corporations

18. The powers of a corporation and the conduct of its activities usually are exercised by and are under the authority and direction of its board of directors. Unless its articles of incorporation provide otherwise, a corporation has the same powers, within the limits of law, as an individual to do all things necessary or convenient to carry out its business and affairs. Thus, control of a corporation usually is obtained through ownership of sufficient voting rights or appointment rights by a single owner-holder that enables that holder to dominate that corporation's governing board. For purposes of applying the provisions of paragraph 9 of this Statement, in the absence of evidence that demonstrates otherwise, the existence of control of a corporation shall be presumed if an entity (including its subsidiaries):

- a. Has a majority voting interest in the election of a corporation's governing body or a right to appoint a majority of the members of its governing body.
- b. Has a large minority voting interest<sup>2</sup> in the election of a corporation's governing body and no other party or organized group of parties has a significant voting interest.
- c. Has a unilateral ability to (1) obtain a majority voting interest in the election of a corporation's governing body or (2) obtain a right to appoint a majority of the corporation's governing body through the present ownership of convertible securities or other rights that are currently exercisable at the option of the holder and the expected benefit from converting those securities or exercising that right exceeds its expected cost. Situations (a) and (b) above are mutually exclusive; however, with regard to a particular relationship, one entity may meet the conditions described in situation (c) while another entity meets the conditions described in either (a) or (b). In those rare circumstances, in the absence of conclusive evidence that demonstrates otherwise, the entity that has the unilateral ability described in (c) shall be presumed to be the controlling entity.

19. Some corporations are created without a governing board or with a governing board that has limited authority. They include closely held corporations (50 or fewer shareholders) that often have special or limited purposes. Those corporations may be controlled corporate subsidiaries or "family controlled" or "jointly controlled" corporations that are not subsidiaries. Their articles of incorporation usually describe who will perform some or all of the duties of a board of directors, such as designated "trustees," "agents," or "managers" that may be selected in ways other than by shareholder

elections. If a corporation is established without an elected or appointed governing body, the situations leading to presumptions of control described in paragraph 18 do not apply. The assessment of control in those circumstances would focus on the facts and circumstances surrounding the establishment of that corporation. They include factors such as whether one or more entities provided significant funding and whether an entity has or shares (a) the decision-making powers and duties typical of a board of directors, especially those that relate to directing the use of and regulating access to the corporation's assets and the selection, retention, and compensation of its management or designated "trustee" or "agent," (b) rights to change the corporation's articles of incorporation, or (c) significant risks and rewards of ownership in that corporation.<sup>3</sup> An assessment of those factors and all other facts and circumstances usually will help distinguish a parent-subsidary relationship from other relationships in which control is shared or otherwise rests with no single party.

## APPENDIX 4-- IASB Excerpts and Reference Materials

### ***IAS 27, Consolidated Financial Statements and Accounting for Investments in Subsidiaries***

#### SCOPE

1. This Standard should be applied in the preparation and presentation of consolidated financial statements for a group of enterprises under the control of a parent.
2. This Standard should also be applied in accounting for investments in subsidiaries in a parent's separate financial statements.
11. A parent which issues consolidated financial statements should consolidate all subsidiaries, foreign and domestic, other than those referred to in paragraph 13.
12. The consolidated financial statements include all enterprises that are controlled by the parent, other than those subsidiaries excluded for the reasons set out in paragraph 13. Control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than one half of the voting power of an enterprise unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control. Control also exists even when the parent owns one half or less of the voting power of an enterprise when there is:
  - a. Power over more than one half of the voting rights by virtue of an agreement with other investors;
  - b. Power to govern the financial and operating policies of the enterprise under a statute or an agreement;
  - c. Power to appoint or remove the majority of the members of the board of directors or equivalent governing body; or
  - d. Power to cast the majority of votes at meetings of the board of directors or equivalent governing body.
13. A subsidiary should be excluded from consolidation when:
  - a. Control is intended to be temporary because the subsidiary is acquired and held exclusively with a view to its subsequent disposal in the near future; or
  - b. It operates under severe long-term restrictions which significantly impair its ability to transfer funds to the parent.



14. A subsidiary is not excluded from consolidation because its business activities are dissimilar from those of the other enterprises within the group. Better information is provided by consolidating such subsidiaries and disclosing additional information in the consolidated financial statements about the different business activities of subsidiaries. For example, the disclosures required by IAS 14 Segment Reporting, help to explain the significance of different business activities within the group.

## DISCLOSURE

32. In addition to those disclosures required by paragraphs 8 and 21, the following disclosures should be made:
- a. In consolidated financial statements a listing of significant subsidiaries including the name, country of incorporation or residence, proportion of ownership interest and, if different, proportion of voting power held;
  - b. In consolidated financial statements, where applicable:
    1. The reasons for not consolidating a subsidiary;
    2. The nature of the relationship between the parent and a subsidiary of which the parent does not own, directly or indirectly through subsidiaries, more than one half of the voting power;
    3. The name of an enterprise in which more than one half of the voting power is owned, directly or indirectly through subsidiaries, but which, because of the absence of control, is not a subsidiary; and
    4. The effect of the acquisition and disposal of subsidiaries on the financial position at the reporting date, the results for the reporting period and on the corresponding amounts for the preceding period; and
  - c. In the parent's separate financial statements, a description of the method used to account for subsidiaries.

## **SIC Interpretation No. 12, *Consolidation of Special Purpose Entities***

### ISSUE

1. An entity may be created to accomplish a narrow and well-defined objective (e.g., to effect a lease, research and development activities or a securitisation of financial assets). Such a special purpose entity ("SPE") may take the form of a corporation, trust, partnership or unincorporated entity. SPEs often are created with legal arrangements that impose strict and sometimes permanent limits on the decision-making powers of their governing board, trustee or management over the operations of the SPE. Frequently, these provisions specify that the policy guiding the ongoing activities of the SPE cannot be modified, other than perhaps by its creator or sponsor (i.e., they operate on so-called "autopilot").

2. The sponsor (or enterprise on whose behalf the SPE was created) frequently transfers assets to the SPE, obtains the right to use assets held by the SPE or performs services for the SPE, while other parties ("capital providers") may provide the funding to the SPE. An enterprise that engages in transactions with an SPE (frequently the creator or sponsor) may in substance control the SPE.

3. A beneficial interest in an SPE may, for example, take the form of a debt instrument, an equity instrument, a participation right, a residual interest or a lease. Some beneficial interests may simply provide the holder with a fixed or stated rate of return, while others give the holder rights or access to other future economic benefits of the SPE's activities. In most cases, the creator or sponsor (or the enterprise on whose behalf the SPE was created) retains a significant beneficial interest in the SPE's activities, even though it may own little or none of the SPE's equity.

## CONSENSUS

8. An SPE should be consolidated when the substance of the relationship between an enterprise and the SPE indicates that the SPE is controlled by that enterprise.

9. In the context of an SPE, control may arise through the predetermination of the activities of the SPE (operating on "autopilot") or otherwise. IAS 27 indicates several circumstances which result in control even in cases where an enterprise owns one half or less of the voting power of another enterprise. Similarly, control may exist even in cases where an enterprise owns little or none of the SPE's equity. The application of the control concept requires, in each case, judgement in the context of all relevant factors.

10. In addition to the situations described in IAS 27, the following circumstances, for example, may indicate a relationship in which an enterprise controls an SPE and consequently should consolidate the SPE:

- a. In substance, the activities of the SPE are being conducted on behalf of the enterprise according to its specific business needs so that the enterprise obtains benefits from the SPE's operation;
- b. In substance, the enterprise has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an "autopilot" mechanism, the enterprise has delegated these decision making powers;
- c. In substance, the enterprise has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE;  
or
- d. In substance, the enterprise retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.

11. Predetermination of the ongoing activities of an SPE by an enterprise (the sponsor or other party with a beneficial interest) would not represent the type of restrictions referred to in IAS 27.13(b).

## Indicators of control over an SPE

The examples in paragraph 10 of this Interpretation are intended to indicate types of circumstances that should be considered in evaluating a particular arrangement in light of the substance-over-form principle. The guidance provided in the Interpretation and in this Appendix is not intended to be used as "a comprehensive checklist" of conditions that must be met cumulatively in order to require consolidation of an SPE.

### a. Activities

The activities of the SPE, in substance, are being conducted on behalf of the reporting enterprise, which directly or indirectly created the SPE according to its specific business needs.

Examples are:

- the SPE is principally engaged in providing a source of long-term capital to an enterprise or funding to support an enterprise's ongoing major or central operations; or
- the SPE provides a supply of goods or services that is consistent with an enterprise's ongoing major or central operations which, without the existence of the SPE, would have to be provided by the enterprise itself.

Economic dependence of an entity on the reporting enterprise (such as relations of suppliers to a significant customer) does not, by itself, lead to control.

### b. Decision-making

The reporting enterprise, in substance, has the decision-making powers to control or to obtain control of the SPE or its assets, including certain decision-making powers coming into existence after the formation of the SPE. Such decision-making powers may have been delegated by establishing an "autopilot" mechanism.

Examples are:

- power to unilaterally dissolve an SPE;
- power to change the SPE's charter or bylaws; or
- power to veto proposed changes of the SPE's charter or bylaws.

### c. Benefits

The reporting enterprise, in substance, has rights to obtain a majority of the benefits of the SPE's activities through a statute, contract, agreement, or trust deed, or any other scheme, arrangement or device. Such rights to benefits in the SPE may be indicators of control when they are specified in favour of an

enterprise that is engaged in transactions with an SPE and that enterprise stands to gain those benefits from the financial performance of the SPE.

Examples are:

- rights to a majority of any economic benefits distributed by an entity in the form of future net cash flows, earnings, net assets, or other economic benefits; or
- rights to majority residual interests in scheduled residual distributions or in a liquidation of the SPE.

#### d. Risks

An indication of control may be obtained by evaluating the risks of each party engaging in transactions with an SPE. Frequently, the reporting enterprise guarantees a return or credit protection directly or indirectly through the SPE to outside investors who provide substantially all of the capital to the SPE. As a result of the guarantee, the enterprise retains residual or ownership risks and the investors are, in substance, only lenders because their exposure to gains and losses is limited.

Examples are:

- the capital providers do not have a significant interest in the underlying net assets of the SPE;
- the capital providers do not have rights to the future economic benefits of the SPE;
- the capital providers are not substantively exposed to the inherent risks of the underlying net assets or operations of the SPE; or
- in substance, the capital providers receive mainly consideration equivalent to a lender's return through a debt or equity interest.

## **IAS 28, *Accounting for Investments in Associations***

### **SIGNIFICANT INFLUENCE**

4. If an investor holds, directly or indirectly through subsidiaries, 20% or more of the voting power of the investee, it is presumed that the investor does have significant influence, unless it can be clearly demonstrated that this is not the case. \* Conversely, if the investor holds, directly or indirectly through subsidiaries, less than 20% of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

5. The existence of significant influence by an investor is usually evidenced in one or more of the following ways:
- a. representation on the board of directors or equivalent governing body of the investee;
  - b. participation in policy making processes;
  - c. material transactions between the investor and the investee;
  - d. interchange of managerial personnel; or
  - e. provision of essential technical information.

#### Consolidated Financial Statements

8. An investment in an associate should be accounted for in consolidated financial statements under the equity method except when:
- a. the investment is acquired and held exclusively with a view to its subsequent disposal in the near future; or
  - b. it operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor.

Such investments should be accounted for in accordance with IAS 39 Financial Instruments: Recognition and Measurement.

9. The recognition of income on the basis of distributions received may not be an adequate measure of the income earned by an investor on an investment in an associate because the distributions received may bear little relationship to the performance of the associate. As the investor has significant influence over the associate, the investor has a measure of responsibility for the associate's performance and, as a result, the return on its investment. The investor accounts for this stewardship by extending the scope of its consolidated financial statements to include its share of results of such an associate and so provides an analysis of earnings and investment from which more useful ratios can be calculated. As a result, the application of the equity method provides more informative reporting of the net assets and net income of the investor.

10. [Deleted]

11. An investor should discontinue the use of the equity method from the date that:
- a. it ceases to have significant influence in an associate but retains, either in whole or in part, its investment; or
  - b. the use of the equity method is no longer appropriate because the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor.

The carrying amount of the investment at that date should be regarded as cost thereafter.

#### Disclosure

27. The following disclosures should be made:

- a. an appropriate listing and description of significant associates including the proportion of ownership interest and, if different, the proportion of voting power held; and
- b. the methods used to account for such investments.

28. Investments in associates accounted for using the equity method should be classified as long-term assets and disclosed as a separate item in the balance sheet. The investor's share of the profits or losses of such investments should be disclosed as a separate item in the income statement. The investor's share of any extraordinary or prior period items should also be separately disclosed.

### **SIC Interpretation 33, *Consolidation and Equity Method – Potential Voting Rights and Allocation of Ownership Interests***

#### ISSUE

1. An enterprise may own share warrants, share call options, debt or equity instruments that are convertible into ordinary shares, or other similar instruments that have the potential, if exercised or converted, to give the enterprise voting power or reduce another party's voting power over the financial and operating policies of another enterprise (potential voting rights).
2. The issues are:
  - a. when assessing whether an enterprise controls or significantly influences another enterprise according to IAS 27 and IAS 28 respectively,
    1. Whether the existence and effect of potential voting rights should be considered, in addition to the factors described in IAS 27.12 and IAS 28.4-.5; and
    2. If so, whether any other facts and circumstances related to potential voting rights should be assessed;
  - b. whether the proportion allocated to the parent and minority interests in preparing consolidated financial statements under IAS 27, and the proportion allocated to an investor that accounts for its investment in an associate using the equity

method under IAS 28, should be determined based on present ownership interests or ownership interests that would be held if the potential voting rights were exercised or converted; and

- c. the appropriate accounting treatment for potential voting rights until they are exercised or expire.

## CONSENSUS

3. The existence and effect of potential voting rights that are presently (i.e., currently) exercisable or presently convertible should be considered, in addition to the factors described in IAS 27.12 and IAS 28.4-.5, when assessing whether an enterprise controls (as defined in IAS 27.6) or significantly influences (as defined in IAS 28.3) another enterprise. All potential voting rights should be considered, including potential voting rights held by other enterprises. Potential voting rights are not presently exercisable or presently convertible when, for example, they cannot be exercised or converted until a future date or upon the occurrence of a future event.

4. All facts and circumstances that affect potential voting rights considered in accordance with paragraph 3 of this Interpretation should be examined, except the intention of management and the financial capability to exercise or convert. Other facts that should be considered include the terms of exercise of the potential voting rights and possible linked transactions. (Appendix A provides illustrations of application of this Interpretation.)

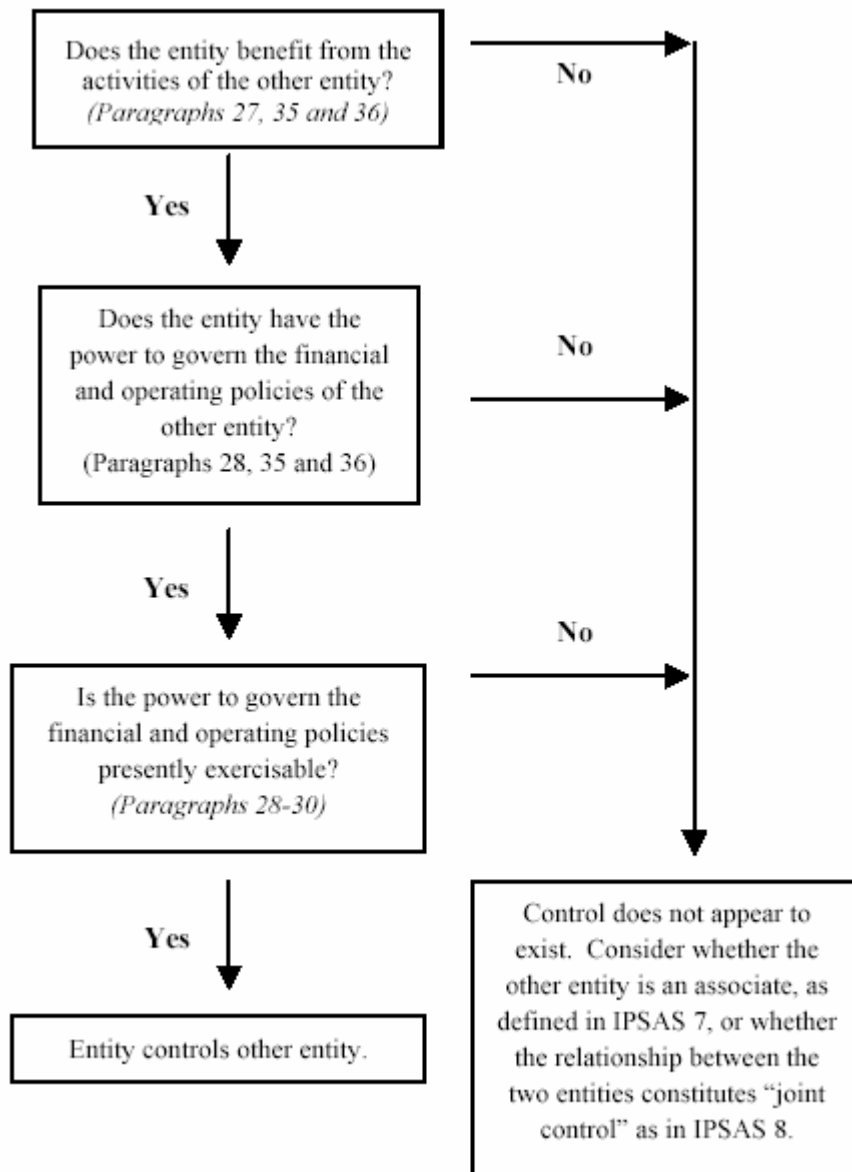
5. The proportion allocated to the parent and minority interests in preparing consolidated financial statements under IAS 27, and the proportion allocated to an investor that accounts for its investment using the equity method under IAS 28, should be determined based solely on present ownership interests. An enterprise may, in substance, have a present ownership interest when for example, it sells and simultaneously agrees to repurchase, but does not lose control of, access to economic benefits associated with an ownership interest. In this circumstance, the proportion allocated should be determined taking into account the eventual exercise of potential voting rights and other derivatives that, in substance, presently give access to the economic benefits associated with an ownership interest. (Appendix B provides illustrations of application of this Interpretation.)

6. When applying the consolidation and the equity method of accounting, instruments containing potential voting rights should be accounted for as part of the investment in a subsidiary and the investment in an associate respectively only when the proportion of ownership interests is allocated by taking into account the eventual exercise of those potential voting rights in accordance with paragraph 5 of this Interpretation. In all other circumstances, instruments containing potential voting rights should be accounted for in accordance with IAS 39.

## APPENDIX 5-- IPSASB Excerpts and Reference Materials

### IPSAS Flowchart for Establishing Control of another Entity

NOTE: The following diagram indicates the basic steps involved in establishing control of another entity. It should be read in conjunction with paragraphs 26 to 36 (Establishing Control of another Entity for Financial Reporting Purposes) of IPSAS 6.





## **IPSAS 6, Consolidated Financial Statements and Accounting for Controlled Entities**

### ECONOMIC ENTITY

9. The term “economic entity” is used in this Standard to define, for financial reporting purposes, a group of entities comprising the controlling entity and any controlled entities.

### Scope of Consolidated Financial Statements

21. A controlling entity which issues consolidated financial statements should consolidate all controlled entities, foreign and domestic, other than those referred to in paragraph 22.

22. A controlled entity should be excluded from consolidation when:

- a. Control is intended to be temporary because the controlled entity is acquired and held exclusively with a view to its subsequent disposal in the near future; or
- b. It operates under severe external long-term restrictions which prevent the controlling entity from benefiting from its activities.

24. An example of temporary control is where a controlled entity is acquired with a firm plan to dispose of it in the short term. This may occur where an economic entity is acquired and an entity within it is to be disposed of because its activities are dissimilar to those of the acquirer. Temporary control also occurs where the controlling entity intends to cede control over a controlled entity to another entity — for example a national government may transfer its interest in a controlled entity to a local government. For this exemption to apply, the controlling entity must be demonstrably committed to a formal plan to dispose of, or no longer control, the entity that is subject to temporary control. For the exemption to apply at more than one successive reporting date, the controlling entity must demonstrate an ongoing intent to dispose of, or no longer control, the entity that is subject to temporary control. An entity is demonstrably committed to dispose of, or no longer control, another entity when it has a formal plan to do so and there is no realistic possibility of withdrawal from that plan.

25. An entity may be subject to severe restrictions that prevent the other entity from benefiting from its activities. For example, a foreign government may sequester the operating assets of a foreign controlled entity. Under these circumstances, control is unlikely to exist and the consolidation procedures in this Standard would no longer apply.

## ESTABLISHING CONTROL OF ANOTHER ENTITY FOR FINANCIAL REPORTING PURPOSES

26. Whether an entity controls another entity for financial reporting purposes is a matter of judgment based on the definition of control in this Standard and the particular circumstances of each case. That is, consideration needs to be given to the nature of the relationship between the two entities. In particular, the two elements of the definition of control in this Standard need to be considered. These are the power element (the power to govern the financial and operating policies of another entity) and the benefit element (which represents the ability of the controlling entity to benefit from the activities of the other entity).

27. For the purposes of establishing control, the controlling entity needs to benefit from the activities of the other entity. For example, an entity may benefit from the activities of another entity in terms of a distribution of its surpluses (such as a dividend) and is exposed to the risk of a potential loss. In other cases, an entity may not obtain any financial benefits from the other entity but may benefit from its ability to direct the other entity to work with it to achieve its objectives. It may also be possible for an entity to derive both financial and nonfinancial benefits from the activities of another entity. For example, a GBE may provide a controlling entity with a dividend and also enable it to achieve some of its social policy objectives.

### Control for Financial Reporting Purposes

28. For the purposes of financial reporting, control stems from an entity's power to govern the financial and operating policies of another entity and does not necessarily require an entity to hold a majority shareholding or other equity interest in the other entity. The power to control must be presently exercisable. That is, the entity must already have had this power conferred upon it by legislation or some formal agreement. The power to control is not presently exercisable if it requires changing legislation or renegotiating agreements in order to be effective. This should be distinguished from the fact that the existence of the power to control another entity is not dependent upon the probability or likelihood of that power being exercised.

29. Similarly, the existence of control does not require an entity to have responsibility for the management of (or involvement in) the day-to-day operations of the other entity. In many cases, an entity may only exercise its power to control another entity where there is a breach or revocation of an agreement between the controlled entity and its controlling entity.

30. For example, a government department may have an ownership interest in a rail authority, which operates as a GBE. The rail authority is allowed to operate autonomously and does not rely on the government for funding but has raised capital through significant borrowings that are guaranteed by the government. The rail authority has not returned a dividend to government for several years. The government has the power to appoint and remove a majority of the members of the governing body of the rail authority. The government has never exercised the power to remove members of

the governing body and would be reluctant to do so because of sensitivity in the electorate regarding the previous government's involvement in the operation of the rail network. In this case, the power to control is presently exercisable but under the existing relationship between the controlled entity and controlling entity, an event has not occurred to warrant the controlling entity exercising its powers over the controlled entity. Accordingly, control exists because the power to control is sufficient even though the controlling entity may choose not to exercise that power.

31. The existence of separate legislative powers does not, of itself, preclude an entity from being controlled by another entity. For example, the Office of the Government Statistician usually has statutory powers to operate independently of the government. That is, the Office of the Government Statistician may have the power to obtain information and report on its findings without recourse to government or any other body. The existence of control does not require an entity to have responsibility over the day-to-day operations of another entity or the manner in which professional functions are performed by the entity.

32. The power of one entity to govern decision-making in relation to the financial and operating policies of another entity is insufficient, in itself, to ensure the existence of control as defined in this Standard. The controlling entity needs to be able to govern decision-making so as to be able to benefit from its activities, for example by enabling the other entity to operate with it as part of an economic entity in pursuing its objectives. This will have the effect of excluding from the definitions of a "controlling entity" and "controlled entity" relationships which do not extend beyond, for instance, that of a liquidator and the entity being liquidated, and would normally exclude a lender and borrower relationship. Similarly, a trustee whose relationship with a trust does not extend beyond the normal responsibilities of a trustee would not be considered to control the trust for the purposes of this Standard.

#### Regulatory and Purchase Power

33. Governments and their agencies have the power to regulate the behavior of many entities by use of their sovereign or legislative powers. Regulatory and purchase powers do not constitute control for the purposes of financial reporting. To ensure that the financial statements of public sector entities include only those resources that they control and can benefit from, the meaning of control for the purposes of this Standard does not extend to:

- a. The power of the legislature to establish the regulatory framework within which entities operate and to impose conditions or sanctions on their operations. Such power does not constitute control by a public sector entity of the assets deployed by these entities. For example, a pollution control authority may have the power to close down the operations of entities that are not complying with environmental regulations. However, this power does not constitute control because the pollution control authority only has the power to regulate; or
- b. Entities that are economically dependent on a public sector entity. That is, where an entity retains discretion as to whether it will take funding from, or do business

with, a public sector entity, that entity has the ultimate power to govern its own financial or operating policies, and accordingly is not controlled by the public sector entity. For example, a government department may be able to influence the financial and operating policies of an entity which is dependent on it for funding (such as a charity) or a profit-orientated entity that is economically dependent on business from it. Accordingly, the government department has some power as a purchaser but not to govern the entity's financial and operating policies.

## DETERMINING WHETHER CONTROL EXISTS FOR FINANCIAL REPORTING PURPOSES

34. Public sector entities may create other entities to achieve some of their objectives. In some cases it may be clear that an entity is controlled, and hence should be consolidated. In other cases it may not be clear. Paragraphs 35 and 36 provide guidance to help determine whether or not control exists for financial reporting purposes.

35. In examining the relationship between two entities, control is presumed to exist when at least one of the following power conditions and one of the following benefit conditions exists, unless there is clear evidence of control being held by another entity.

### POWER CONDITIONS

- a. The entity has, directly or indirectly through controlled entities, ownership of a majority voting interest in the other entity.
- b. The entity has the power, either granted by or exercised within existing legislation, to appoint or remove a majority of the members of the governing body of the other entity.
- c. The entity has the power to cast, or regulate the casting of, a majority of the votes that are likely to be cast at a general meeting of the other entity.
- d. The entity has the power to cast the majority of votes at meetings of the board of directors or equivalent governing body.

### BENEFIT CONDITIONS

- a. The entity has the power to dissolve the other entity and obtain a significant level of the residual economic benefits or bear significant obligations. For example the benefit condition may be met if an entity had responsibility for the residual liabilities of another entity.
- b. The entity has the power to extract distributions of assets from the other entity, and/or may be liable for certain obligations of the other entity.

36. When one or more of the circumstances listed in paragraph 35 does not exist, the following factors are likely, either individually or collectively, to be indicative of the existence of control.

#### POWER INDICATORS

- a. The entity has the ability to veto operating and capital budgets of the other entity.
- b. The entity has the ability to veto, overrule, or modify governing body decisions of the other entity.
- c. The entity has the ability to approve the hiring, reassignment and removal of key personnel of the other entity.
- d. The mandate of the other entity is established and limited by, legislation.
- e. The entity holds a “golden share”<sup>72</sup> (or equivalent) in the other entity that confers rights to govern the financial and operating policies of that other entity.

#### BENEFIT INDICATORS

- a. The entity holds direct or indirect title to the net assets/equity of the other entity with an ongoing right to access these.
- b. The entity has a right to a significant level of the net assets/equity of the other entity in the event of a liquidation or in a distribution other than a liquidation.
- c. The entity is able to direct the other entity to co-operate with it in achieving its objectives.
- d. The entity is exposed to the residual liabilities of the other entity.

37. SEE FLOWCHART

38. Sometimes a controlled entity is excluded from consolidation when its activities are dissimilar to those of other entities within the economic entity, for example, the consolidation of GBEs with entities in the budget sector. Exclusion on these grounds is not justified because better information would be provided by consolidating such controlled entities and disclosing additional information in the consolidated financial statements about the different activities of controlled entities. For example, disaggregated disclosures can help to explain the significance of different activities within the economic entity.

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<sup>72</sup> “Golden share” refers to a class of share that entitles the holder to specified powers or rights generally exceeding those normally associated with the holder’s ownership interest or representation on the governing body.

## **IPSAS 7, *Accounting for Investments in Associates***

### SCOPE

1. An entity which prepares and presents financial statements under the accrual basis of accounting should apply this Standard in accounting by an investor for investments in associates where the investment in the associate leads to the holding of an ownership interest in the form of a shareholding or other formal equity structure.
2. This Standard provides the basis for accounting for ownership interests in associates. That is, the investment in the other entity confers on the investor the risks and rewards incidental to an ownership interest. The Standard applies only to investments in the formal equity structure (or its equivalent) of an investee. A formal equity structure means share capital or an equivalent form of unitized capital, such as units in a property trust, but may also include other equity structures in which the investor's interest can be measured reliably. Where the equity structure is poorly defined it may not be possible to obtain a reliable measure of the ownership interest.
3. Some contributions made by public sector entities may be referred to as an "investment" but may not give rise to an ownership interest. For example, a public sector entity may make a substantial investment in the development of a hospital that is owned and operated by a charity. Whilst such contributions are non-reciprocal in nature, they allow the public sector entity to participate in the operation of the hospital, and the charity is accountable to the public sector entity for its use of public monies. However, the contributions made by the public sector entity do not constitute an ownership interest, as the charity could seek alternative funding and thereby prevent the public sector entity from participating in the operation of the hospital. Accordingly, the public sector entity is not exposed to the risks nor does it enjoy the rewards which are incidental to an ownership interest.
4. This Standard applies to all public sector entities other than Government Business Enterprises.
5. Government Business Enterprises (GBEs) are required to comply with International Accounting Standards (IASs) issued by the International Accounting Standards Committee. The Public Sector Committee's Guideline No. 1 "Financial Reporting by Government Business Enterprises" notes that IASs are relevant to all business enterprises, regardless of whether they are in the private or public sector.

Accordingly, Guideline No. 1 recommends that GBEs should present financial statements that conform, in all material respects, to IASs.

### Economic Entity

8. The term “economic entity” is used in this Standard to define, for financial reporting purposes, a group of entities comprising the controlling entity and any controlled entities.

10. An economic entity may include entities with both social policy and commercial objectives. For example, a government housing department may be an economic entity which includes entities that provide housing for a nominal charge, as well as entities that provide accommodation on a commercial basis.

### Significant Influence

15. Whether an investor has significant influence over the investee is a matter of judgment based on the nature of the relationship between the investor and the investee, and on the definition of significant influence in this Standard. This Standard applies only to those associates in which an entity holds an ownership interest.

16. The existence of significant influence by an investor is usually evidenced in one or more of the following ways:

- a. Representation on the board of directors or equivalent governing body of the investee;
- b. Participation in policy-making processes;
- c. Material transactions between the investor and the investee;
- d. Interchange of managerial personnel; or
- e. Provision of essential technical information.

17. If the investor’s ownership interest is in the form of shares and it holds, directly or indirectly through controlled entities, 20% or more of the voting power of the investee, it is presumed that the investor does have significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly through controlled entities, less than 20% of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

### Consolidated Financial Statements

18. An investment in an associate should be accounted for in consolidated financial statements under the equity method except when the investment is acquired and held exclusively with a view to its disposal in the near future, in which case it should be accounted for under the cost method.

## **IPSAS 8, *Financial Reporting of Interests in Joint Ventures***

### Binding Arrangement

6. The existence of a binding arrangement distinguishes interests which involve joint control from investments in associates where the investor has significant influence (see International Public Sector Accounting Standard (IPSAS) 7 “Accounting for Investments in Associates”). For the purposes of this Standard, an arrangement includes all binding arrangements between venturers. That is, in substance, the arrangement confers similar rights and obligations on the parties to it as if it were in the form of a contract. For instance, two government departments may enter into a formal arrangement to undertake a joint venture but the arrangement may not constitute a legal contract because, in that jurisdiction, individual departments may not be separate legal entities with the power to contract. Activities which have no binding arrangement to establish joint control are not joint ventures for the purposes of this

### Standard

7. The arrangement may be evidenced in a number of ways, for example by a contract between the venturers or minutes of discussions between the venturers. In some cases, the arrangement is incorporated in the enabling legislation, articles or other by-laws of the joint venture. Whatever its form, the arrangement is usually in writing and deals with such matters as: (a) The activity, duration and reporting obligations of the joint venture; (b) The appointment of the board of directors or equivalent governing body of the joint venture and the voting rights of the venturers; (c) Capital contributions by the venturers; and (d) The sharing by the venturers of the output, revenue, expenses, surpluses or deficits, or cash flows of the joint venture.

8. The arrangement establishes joint control over the joint venture. Such a requirement ensures that no single venturer is in a position to unilaterally control the activity. The arrangement identifies those decisions in areas essential to the goals of the joint venture which require the consent of all the venturers and those decisions which may require the consent of a specified majority of the venturers.

9. The arrangement may identify one venturer as the operator or manager of the joint venture. The operator does not control the joint venture but acts within the financial and operating policies which have been agreed by the venturers in accordance with the arrangement and delegated to the operator. If the operator has the power to



govern the financial and operating policies of the activity, it controls the venture and the venture is a controlled entity of the operator and not a joint venture.

### Forms of Joint Venture

13. Many public sector entities establish joint ventures to undertake a variety of activities. The nature of these activities ranges from commercial undertakings to provision of community services at no charge. The terms of a joint venture are set out in a contract or other binding arrangement and usually specify the initial contribution from each joint venturer and the share of revenues or other benefits (if any), and expenses of each of the joint venturers.

14. Joint ventures take many different forms and structures. This Standard identifies three broad types — jointly controlled operations, jointly controlled assets and jointly controlled entities — which are commonly described as, and meet the definition of, joint ventures. The following characteristics are common to all joint ventures:

- a. Two or more venturers are bound by an arrangement; and
- b. The arrangement establishes joint control.

### Jointly Controlled Operations

18. The operation of some joint ventures involves the use of the assets and other resources of the venturers rather than the establishment of a corporation, partnership or other entity, or a financial structure that is separate from the venturers themselves. Each venturer uses its own property, plant and equipment and carries its own inventories. It also incurs its own expenses and liabilities and raises its own finance, which represent its own obligations. The joint venture activities may be carried out by the venturer's employees alongside the venturer's similar activities. The joint venture agreement usually provides a means by which the revenue from the sale or provision of the joint product or service and any expenses incurred in common are shared among the venturers.

19. An example of a jointly controlled operation is when two or more venturers combine their operations, resources and expertise in order to manufacture, market and distribute jointly a particular product, such as aircraft. Different parts of the manufacturing process are carried out by each of the venturers. Each venturer bears its own costs and takes a share of the revenue from the sale of the aircraft, such share being determined in accordance with the arrangement. A further example is when two entities combine their operations, resources and expertise in order to jointly deliver a service, such as aged care where, in accordance with an agreement, a local government offers domestic services and a local hospital offers medical care. Each venturer bears its own costs and takes a share of revenue, such as user charges and government grants; such share being determined in accordance with the agreement.

20. In respect of its interests in jointly controlled operations, a venturer should recognize in its separate financial statements and consequently in its consolidated financial statements:

- a. The assets that it controls and the liabilities that it incurs; and
- b. The expenses that it incurs and its share of the revenue that it earns from the sale or provision of goods or services by the joint venture.

### Jointly Controlled Assets

23. Some joint ventures involve the joint control, and often the joint ownership by the venturers, of one or more assets contributed to, or acquired for the purpose of, the joint venture and dedicated to the purposes of the joint venture. The assets are used to obtain benefits for the venturers. Each venturer may take a share of the output from the assets and each bears an agreed share of the expenses incurred.

24. These joint ventures do not involve the establishment of a corporation, partnership or other entity, or a financial structure that is separate from the venturers themselves. Each venturer has control over its share of future economic benefits or service potential through its share in the jointly controlled asset.

25. Some activities in the public sector involve jointly controlled assets. For example, a local government may enter into an arrangement with a private sector corporation to construct a toll road. The road provides the citizens with improved access between the local government's industrial estate and its port facilities. The road also provides the private sector corporation with direct access between its manufacturing plant and the port. The agreement between the local authority and the private sector corporation specifies each party's share of revenues and expenses associated with the toll road. Accordingly, each venturer derives economic benefits or service potential from the jointly controlled asset and bears an agreed proportion of the costs of operating the road. Similarly, many activities in the oil, gas and mineral extraction industries involve jointly controlled assets; for example, a number of oil production companies may jointly control and operate an oil pipeline. Each venturer uses the pipeline to transport its own product in return for which it bears an agreed proportion of the expenses of operating the pipeline. Another example of a jointly controlled asset is when two entities jointly control a property, each taking a share of rents received and bearing a share of the expenses.

26. In respect of its interest in jointly controlled assets, a venturer should recognize in its separate financial statements and consequently in its consolidated financial statements:

- a. Its share of the jointly controlled assets, classified according to the nature of the assets;
- b. Any liabilities which it has incurred;

- c. Its share of any liabilities incurred jointly with the other venturers in relation to the joint venture;
- d. Any revenue from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture; and
- e. Any expenses which it has incurred in respect of its interest in the joint venture.

27. In respect of its interest in jointly controlled assets, each venturer includes in its accounting records and recognizes in its separate financial statements and consequently in its consolidated financial statements:

- a. Its share of the jointly controlled assets, classified according to the nature of the assets rather than as an investment. For example, a share of a jointly controlled road is classified as property, plant and equipment;
- b. Any liabilities which it has incurred, for example those incurred in financing its share of the assets;
- c. Its share of any liabilities incurred jointly with other venturers in relation to the joint venture;
- d. Any revenue from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture; and
- e. Any expenses which it has incurred in respect of its interest in the joint venture, for example those related to financing the venturer's interest in the assets and selling its share of the output.

### Jointly Controlled Entities

30. A jointly controlled entity is a joint venture which involves the establishment of a corporation, partnership or other entity in which each venturer has an interest. The entity operates in the same way as other entities, except that an arrangement between the venturers establishes joint control over the activity of the entity.

31. A jointly controlled entity controls the assets of the joint venture, incurs liabilities and expenses and earns revenue. It may enter into contracts in its own name and raise finance for the purposes of the joint venture activity. Each venturer is entitled to a share of the results of the jointly controlled entity, although some jointly controlled entities also involve a sharing of the output of the joint venture.

32. A common example of a jointly controlled entity is when two entities combine their activities in a particular line of service delivery by transferring the relevant assets and liabilities into a jointly controlled entity. Another example arises when an entity commences a business in a foreign country in conjunction with a government or other agency in that country, by establishing a separate entity which is jointly controlled by the entity and the government or agency in the foreign country.

### Consolidated Financial Statements of a Venturer

#### Benchmark Treatment — Proportionate Consolidation

## APPENDIX 5

36. In its consolidated financial statements, a venturer should report its interest in a jointly controlled entity using one of the two reporting formats for proportionate consolidation.

37. When reporting an interest in a jointly controlled entity in consolidated financial statements, it is essential that a venturer reflects the substance and economic reality of the arrangement, rather than the joint venture's particular structure or form. In a jointly controlled entity, a venturer has control over its share of future economic benefits or service potential through its share of the assets and liabilities of the venture. This substance and economic reality is reflected in the consolidated financial statements of the venturer when the venturer reports its interests in the assets, liabilities, revenue and expenses of the jointly controlled entity by using one of the two reporting formats for proportionate consolidation described in paragraph 39. 38.

38. The application of proportionate consolidation means that the consolidated statement of financial position of the venturer includes its share of the assets that it controls jointly and its share of the liabilities for which it is jointly responsible. The consolidated statement of financial performance of the venturer includes its share of the revenue and expenses of the jointly controlled entity. Many of the procedures appropriate for the application of proportionate consolidation are similar to the procedures for the consolidation of investments in controlled entities, which are set out in IPSAS 6.

39. Different reporting formats may be used to give effect to proportionate consolidation. The venturer may combine its share of each of the assets, liabilities, revenue and expenses of the jointly controlled entity with the similar items in its consolidated financial statements on a line-by-line basis. For example, it may combine its share of the jointly controlled entity's inventory with the inventory of the economic entity and its share of the jointly controlled entity's property, plant and equipment with the same items of the economic entity. Alternatively, the venturer may include separate line items for its share of the assets, liabilities, revenue and expenses of the jointly controlled entity in its consolidated financial statements. For example, it may show its share of the current assets of the jointly controlled entity separately as part of the current assets of the economic entity; it may show its share of the property, plant and equipment of the jointly controlled entity separately as part of the property, plant and equipment of the economic entity. Both these reporting formats result in the reporting of identical amounts of net revenue and expenses; both formats are acceptable for the purposes of this Standard.

#### Allowed Alternative Treatment — Equity Method

43. In its consolidated financial statements, a venturer should report its interest in a jointly controlled entity using the equity method.

44. Some venturers report their interests in jointly controlled entities using the equity method, as described in IPSAS 7. The use of the equity method is supported by those who argue that it is inappropriate to combine controlled items with jointly controlled

items and by those who believe that venturers have significant influence, rather than joint control, in a jointly controlled entity. This Standard does not recommend the use of the equity method because proportionate consolidation better reflects the substance and economic reality of a venturer's interest in a jointly controlled entity — that is control over the venturer's share of the future economic benefits or service potential. Nevertheless, this Standard permits the use of the equity method, as an allowed alternative treatment, when reporting interests in jointly controlled entities.

## APPENDIX 6-- NATIONAL STANDARDS Excerpts and Reference Materials

### Australia—SAC 1, *Definition of the Reporting Entity*

#### INTRODUCTION

3. The purpose of this Statement is to define and explain the concept of a reporting entity and to establish a benchmark for the minimum required quality of financial reporting for such an entity. This Statement outlines the circumstances in which an entity or economic entity should be identified as a reporting entity. It also outlines the criterion for determining, for financial reporting purposes, the boundaries of a reporting entity.
4. In relation to the benchmark for the minimum required quality of financial reporting, this Statement specifies that reporting entities shall prepare general purpose financial reports and that these are reports which comply with Statements of Accounting Concepts and Accounting Standards.
5. This Statement does not consider techniques of accounting for and the method of presentation of financial information about a reporting entity. Such considerations are included in Accounting Standards.

#### DEFINITIONS

6 For the purposes of this Statement:

**"control"** means the capacity of an entity to dominate decision-making, directly or indirectly, in relation to the financial and operating policies of another entity so as to enable that other entity to operate with it in achieving the objectives of the controlling entity;

**"economic entity"** means a group of entities comprising a controlling entity and one or more controlled entities operating together to achieve objectives consistent with those of the controlling entity;

**"entity"** means any legal, administrative, or fiduciary arrangement, organisational structure or other party (including a person) having the capacity to deploy scarce resources in order to achieve objectives; and

**"general purpose financial report"** means a financial report intended to meet the information needs common to users who are unable to command the preparation of reports tailored so as to satisfy, specifically, all of their information needs.

## *DISCUSSION*

### *General Purpose Financial Reporting*

7. Statement of Accounting Concepts SAC 2 "Objective of General Purpose Financial Reporting" states that general purpose financial reports are prepared to provide users with information about the reporting entity which is useful for making and evaluating decisions about the allocation of scarce resources (hereinafter "resources"). When general purpose financial reports meet this objective they will also be a means by which managements and governing bodies discharge their accountability to those users. If Statements of Accounting Concepts and Accounting Standards are to be effective in ensuring adequate disclosure of information to users of general purpose financial reports, it is necessary that all those entities which should report, do report. In addition, if the regulation of general purpose financial reporting is to be developed on a rational and efficient basis, it is equally important that those entities for which there is no justification to report are not required to report.

8. Financial reports which meet the objective of general purpose financial reporting are general purpose financial reports. General purpose financial reports should be prepared when there exists, in relation to an entity, users whose information needs have common elements, and those users cannot command the preparation of information to satisfy their individual information needs. Such reports will provide users with appropriate information for making decisions relating to the efficient allocation of resources.

9. Efficient allocation of resources is facilitated by ensuring that general purpose financial reports contain information of at least the minimum required quality. Accordingly, general purpose financial reports should be prepared in accordance with Statements of Accounting Concepts and Accounting Standards.

### *The Reporting Entity Concept*

10. A number of alternative concepts of the reporting entity are implicit in existing legislation and regulations which specify the entities which should prepare general purpose financial reports. These concepts include the legal entity concept, which has been employed in legislation in the private sector, and a broad concept based on accountability of elected representatives and appointed officials, which has been employed in the public sector. In the private sector it has been common for entities to be required to report whenever they have had legal status (for example, companies have been so obliged). In the public sector the accent on accountability has seen widespread application of the fund concept of reporting, which implies a concern with reporting the results of individual funds. In other cases, the concept based on accountability of

elected representatives and appointed officials has led to entities which have such representatives and/or officials preparing general purpose financial reports.

11. The concepts referred to in paragraph 10 do not give adequate consideration to user needs in identifying the reporting entity. In the private sector it is possible that users exist in respect of reporting entities which are not legal entities and for which legislation requiring the preparation of general purpose financial reports does not exist, for example, partnerships, most trusts, and associations. Similarly, in the public sector it is possible that users exist in respect of entities other than the fund or the electoral entity, for example, in respect of individual statutory authorities, departments and governments. If accounting concepts, developed within a framework which identifies users' information needs as primary, are to satisfy the objective of general purpose financial reporting, those concepts must be related to users' information needs.

12. This Statement adopts a concept of the reporting entity which is tied to the information needs of users and the nature of general purpose financial reports. The concept requires that individual reporting entities be identified by reference to the existence of users who are dependent on general purpose financial reports for information for making and evaluating resource allocation decisions. This means that a class of entity defined under another concept, such as the legal or fund concepts (for example, proprietary companies or special and general purpose funds), may include some entities which should be identified as reporting entities, by virtue of the existence of users dependent on general purpose financial reports prepared by the entity, and other entities which should not be so identified.

13. It should therefore be noted that the concept of the reporting entity adopted by this Statement is not dependent on the sector - public or private - within which the entity operates, the purpose for which the entity was created - business or non-business/profit or not-for-profit - or the manner in which the entity is constituted - legal or other. It is a concept which is tied to the objective of general purpose financial reporting and, as noted in paragraph 12, is a concept which requires all entities with users dependent on general purpose financial reports for information to prepare such reports.

14. The concept of the reporting entity and the identification of the boundaries of a reporting entity are related. For example: (a) if the concept of the reporting entity adopted was based on a class of legal entity (such as a company), this would imply identification of the boundaries of the entity by reference to legal considerations, which would mean that only entities of that legal class could be aggregated to form a reporting entity; and (b) if the fund concept of the reporting entity was adopted, this would imply identification of the boundaries of the reporting entity by reference to the functional uses for which resources were designated and deployed. This would (unless more than one concept of the reporting entity was adopted) render illogical and inoperative the concept of aggregating separate funds to recognise the existence of a reporting entity.



15. However, the concept of the reporting entity established by this Statement is one linked to the information needs of users of general purpose financial reports in making and evaluating resource allocation decisions. The provision of information for these purposes is the criterion used to determine the boundaries of a particular reporting entity.

16. The disclosure of the resources that an entity has the capacity to deploy, and the results of their deployment, will assist users to determine the performance and financial position of the entity. Such information will assist users in making resource allocation decisions and is necessary for the evaluation of past decisions. For these purposes, information about all resources able to be deployed by a reporting entity is relevant, whatever the legal or administrative structure established to manage those resources. Thus, where an entity controls other entities, there should be disclosed information regarding the resources of controlled entities as well as the resources of the controlling entity because all of these resources may be deployed by the controlling entity for its own advantage.

17. Accordingly, while in some instances a reporting entity will comprise an individual entity, in other instances a reporting entity will comprise a group of entities, some of which individually may be reporting entities. One of the entities within the group will control the other entities so that they operate together to achieve objectives consistent with those of the controlling entity. The group, which may be termed an economic entity, will be a reporting entity where there exist users dependent on general purpose financial reports for making and evaluating resource allocation decisions regarding the collective operation of the group of entities. Whether one entity has the capacity to control other entities, and therefore whether an economic entity exists, will depend on an evaluation of the circumstances of the particular entities. In determining whether control exists, the factors to be considered include the following: extent and implications of financial dependence, capacity to appoint or remove managements or governing bodies, and power to direct operations.

18 For the purposes of this Statement, an individual would normally constitute an entity as defined in paragraph 6. However, it should be noted that individuals with the capacity to deploy resources, but not in order to achieve their own objectives, will not meet the definition of an economic entity, for example: a trustee whose relationship with a trust does not extend beyond the normal responsibilities of a trustee, and a liquidator of an entity.

#### *Identification of Whether Dependent Users Exist*

19. For the purposes of this Statement, the identification of an entity as a reporting entity is linked to the information needs of users of general purpose financial reports. In many instances, it will be readily apparent whether, in relation to an entity, there exist users who are dependent on general purpose financial reports as a basis for making and evaluating resource allocation decisions. For those entities in respect of which it is not readily apparent whether such dependent users exist, the factors outlined in

paragraphs 20 to 22 are identified as the primary factors to be considered in determining whether a reporting entity exists. These factors are indicative only, and are not the only factors that will be relevant in determining whether, in a particular circumstance, an entity is a reporting entity.

#### *Separation of management from economic interest*

20. The greater the spread of ownership/membership and the greater the extent of the separation between management and owners/members or others with an economic interest in the entity, the more likely it is that there will exist users dependent on general purpose financial reports as a basis for making and evaluating resource allocation decisions.

#### *Economic or political importance/influence*

21. Economic or political importance/influence refers to the ability of an entity to make a significant impact on the welfare of external parties. The greater the economic or political importance of an entity, the more likely it is that there will exist users dependent on general purpose financial reports as a basis for making and evaluating resource allocation decisions. Reporting entities identified on the basis of this factor are likely to include organisations which enjoy dominant positions in markets and those which are concerned with balancing the interests of significant groups, for example, employer/employee associations and public sector entities which have regulatory powers.

#### *Financial characteristics*

22. Financial characteristics that should be considered include the size (for example, value of sales or assets, or number of employees or customers) or indebtedness of an entity. In the case of non-business entities in particular, the amount of resources provided or allocated by governments or other parties to the activities conducted by the entities should be considered. The larger the size or the greater the indebtedness or resources allocated, the more likely it is that there will exist users dependent on general purpose financial reports as a basis for making and evaluating resource allocation decisions.

#### *Implications of Application of the Reporting Entity Concept* *Implications of the criterion for identification of a reporting entity*

23. As the concept of the reporting entity reflected in this Statement is related to the information needs of users, it is evident that the creation of a company, statutory authority or other organizational structure does not of itself mean that the entity or organisation will qualify as a reporting entity. Judgement will be required in determining whether an entity satisfies the criterion for being so classified.

24. For entities which operate in the public sector, the implications of the factors listed in paragraphs 20 to 22 are that most government departments and statutory authorities will be reporting entities. This arises by virtue of the separation between the parties with an economic interest in the activities undertaken in the sector and the parties responsible for the management of those activities. (Management is elected by the parties which have an economic interest in the activities, that is, members of the public, or is appointed by others who have been so elected.) It is fundamental that those who manage resources on behalf of others should account for their performance to those who have provided the resources. Thus, in the public sector, the practical use of the factors listed in paragraphs 20 to 22 will be to identify entities which are not reporting entities. For example, medical centres established and controlled by a hospital may not be considered to be reporting entities where, individually, the amount of resources allocated to each is very low relative to the total resource allocation to the hospital and, because of that and other factors, there do not exist users dependent on general purpose financial reports relating to each centre. In such circumstances, information about the medical centres controlled by the hospital would be incorporated into the general purpose financial report of the hospital. This does not mean that the hospital will not require financial information from each of the centres for making resource allocation decisions. Rather, the implication is that financial reports prepared for this purpose by the centres would not be in the nature of general purpose financial reports, but instead would be in the nature of special purpose financial reports.

25. An implication of applying the reporting entity concept in the public sector is that a government as a whole, whether at the Federal, State, Territorial or local government level, would be identified as a reporting entity because it is reasonable to expect that users will require general purpose financial reports to facilitate their decision-making in relation to the resource allocations made by, and the accountability of, those governments. At a lower level of reporting, a number of individual statutory authorities and departments (and the entities they control) may also be defined as individual reporting entities because of their economic or political significance and/or their financial characteristics (for example, resources controlled and level of indebtedness). In some cases, these factors may also identify a ministerial portfolio as a reporting entity.

26. In the private sector, the factors listed in paragraphs 20 to 22 will identify as reporting entities all entities in which there is significant separation of ownership/membership and management, for example public companies and listed trusts. In contrast, entities in which the members and management are an identical group, as would be the case for most sole traders, partnerships and exempt proprietary companies, would usually not be identified as reporting entities on the basis of this factor. However, there will exist circumstances in which entities such as these ought to be regarded as reporting entities. For example, an entity which undertakes the raising of debt or equity funds from the public will become a reporting entity because there will exist potential resource providers who require general purpose financial reports as a basis for making resource allocation decisions. For similar reasons, undertaking to sell an entity may result in the identification of the entity as a reporting entity. Also, the size

and/or economic significance of some entities to their suppliers, clients or employees or to the public may dictate that those entities are reporting entities even though the members manage the entity. Examples of this would be professional partnerships which service a very large number of customers or clients and which enjoy a special status in the community, and exempt proprietary companies which attract a special public interest because of their financial characteristics.

27. There will exist some entities which will not be regarded as reporting entities, but which form part of an economic entity which is a reporting entity. This would be the case, for example, where a company is a wholly-owned subsidiary of another entity in the economic entity, and the size and other economic characteristics of the company are such that there do not exist users dependent on general purpose financial reports as a source of information for making and evaluating resource allocation decisions about the wholly-owned company. Instead, users are interested in information about the collective operation of the company and the other entities comprising the economic entity. Similarly, a segment of an economic entity is unlikely to be regarded as a reporting entity because information about a segment is usually directed at improving the knowledge of users of the general purpose financial reports for the whole reporting entity, rather than catering for the needs of those users interested only in information about that segment.

28. Classification as a reporting entity may not be constant from one reporting period to the next. For example, a partnership or company established for the conduct of a family business may not, under normal circumstances, qualify as a reporting entity. However, where one or more partners or owners become distanced from the business or are in dispute with other participants, or where new nonfamily shareholders are admitted to the company, users dependent on general purpose financial reports may exist in respect of the financial reports for the periods during which disputations or non family shareholdings occur. As such, the partnership or company would meet the conditions for classification as a reporting entity in respect of one or more reporting periods.

#### *Groups of entities as reporting entities*

29. The concept of control as the basis for identifying an economic entity has important implications. In the public sector, the entities making up the budget sector (that is, those entities which are heavily reliant on the budget for resources) may individually be identified as reporting entities. Because they are controlled by a government, those entities together with that government and the other entities that the government controls would, as an economic entity, meet the definition of a reporting entity. In preparing a general purpose financial report for this reporting entity, that is, for the government as a whole, it may be desirable to report detailed information regarding the operation of particular segments of the government as a whole, for example, the budget sector. This Statement does not, however, require the preparation of a separate general purpose financial report relating to the group of entities comprising the budget sector

because, without their controlling entity (the government as a whole), they do not form an economic entity.

30. In the private sector, it has been common practice for groups of entities to be recognised as an economic entity only where the entities making up the group are established in the same legal form (for example, all are companies). An implication of the concept of control is that an economic entity may comprise entities which are established in a form different from that of the controlling entity, and such entities may be parts of, or a combination of, entities recognised for other purposes.

31. Because an economic entity, as defined in this Statement, comprises only the controlling entity and controlled entities, those entities which are significantly influenced, but not controlled, by a member of the economic entity do not form part of the economic entity. (Entities which are significantly influenced are termed associated entities.) This means that in preparing the general purpose financial report for the economic entity, additional information about an investment in an associated entity may be reported, possibly in a supplementary form, but it would not be reported on the basis of the associated entity forming part of the economic entity.

32. The focus on user needs as the basis for determining the existence of a reporting entity implies that the fact that an economic entity (for example, a corporate group or a government) may be a reporting entity does not affect whether the controlling entity or any of the controlled entities are reporting entities in their own right.

#### *Implications of the reporting entity concept for current practice*

33. It is likely that application of this Statement will result in substantial changes to current practice. For example, it will result in some partnerships, trusts, government departments, statutory authorities and other organisations that currently do not prepare general purpose financial reports being identified as reporting entities which therefore ought to prepare such reports in accordance with Statements of Accounting Concepts and Accounting Standards. Similarly, it will result in a government as a whole being identified as a reporting entity which therefore ought to prepare general purpose financial reports. Other entities, for example some private companies, which currently prepare general purpose financial reports may not meet the criterion for identification as reporting entities. This Statement would not, therefore, require such entities to prepare general purpose financial reports. In this regard, however, it should be noted that the fact that this Statement may not require a particular entity to prepare general purpose financial reports does not preclude other parties, for example, regulatory authorities and financial institutions, from imposing a requirement on that entity to prepare general purpose financial reports.

#### *Implications of the Reporting Entity Concept for Differential Reporting*

34. Statements of Accounting Concepts and Accounting Standards are applicable to all entities which prepare general purpose financial reports. It is sometimes proposed

that certain entities should be permitted to depart from all or certain of these Statements and Standards in the preparation of their financial reports. This notion is referred to as differential applicability of Statements of Accounting Concepts and Accounting Standards, or differential reporting.

35. Bases that have been proposed for identifying the entities which should be permitted to depart from these Statements and Standards are:

(a) the size of the entity - that is, entities classed as small in relation to certain size benchmarks, based on any combination of turnover, assets and number of employees, would be permitted to depart;

(b) ownership characteristics - for example, privately-owned entities would be permitted to depart, whereas publicly owned entities would not be permitted to depart; and

(c) a combination of size and ownership characteristics – for example, privately-owned entities which are classed as small would be permitted to depart from the Statements and Standards.

36. In this Statement the need to prepare general purpose financial reports is linked to the existence of users dependent on those reports as a basis for making and evaluating resource allocation decisions. The existence of users dependent on general purpose financial reports is not determined by either the size or the ownership characteristics of an entity. Accordingly, the bases outlined in paragraph 35 are not supported by this Statement. However, the reporting entity concept enunciated herein embodies a concept of differential reporting in that certain entities will not be identified as reporting entities and thus would not be required to prepare general purpose financial reports or comply with Statements of Accounting Concepts and Accounting Standards in the preparation of other financial reports. The entities which need not prepare general purpose financial reports are those in respect of which it is reasonable to expect that users dependent upon information contained in general purpose financial reports for making and evaluating resource allocation decisions do not exist.

37. As paragraphs 24 to 28 outline, it is likely that some types of entities will be identified as reporting entities by this Statement, while others will not. Accordingly, in most instances the following private sector entities are unlikely to be required by this Statement to prepare general purpose financial reports: sole traders, partnerships, privately-owned companies and trusts other than those where funds are subscribed by the public. There may be some instances when it is considered necessary or desirable that a general purpose financial report about an entity in these categories be prepared, for example when a privately-owned company intends to raise funds from the public. In these circumstances the report is required to comply with all Statements of Accounting Concepts and Accounting Standards. In the public sector, although most government departments and statutory authorities are likely to be required to prepare general purpose financial reports, the financial characteristics of some authorities and government agencies will mean that they will not be required by this Statement to

prepare such reports. Types of entities which always would be identified as reporting entities and types of entities that are or are not likely to be identified as reporting entities are indicated in Professional Statement APS 1 "Conformity with Statements of Accounting Concepts and Accounting Standards", issued by the Australian Society of Certified Practising Accountants and The Institute of Chartered Accountants in Australia.

## *ACCOUNTING CONCEPTS*

### *Discussion and Definitions*

38. The following concepts shall be interpreted in the context of paragraphs 1 to 37 of this Statement.

39. Paragraph 6 (definitions) shall be read as forming part of the accounting concepts set out in this Statement.

### *Concept of the Reporting Entity*

40. Reporting entities are all entities (including economic entities) in respect of which it is reasonable to expect the existence of users dependent on general purpose financial reports for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources.

### *Preparation of general purpose financial reports*

41. Reporting entities shall prepare general purpose financial reports. Such reports shall be prepared in accordance with Statements of Accounting Concepts and Accounting Standards.

## **Australia--AAS 24, Consolidated Financial Reports**

### APPLYING THIS STANDARD TO ECONOMIC ENTITIES

6. Adoption of the criterion of control for defining an economic entity has significant implications in respect of the parent entity/subsidiary relationships identified in accordance with this Standard and the legal form of the entities involved. Adoption of the criterion of control will enable a complete economic entity to be reflected in a consolidated financial report even though, for example, some of the subsidiaries may be in the form of partnerships or trusts.

7. This Standard requires the presentation of consolidated financial reports for each economic entity which can be identified as a reporting entity. The economic entity would comprise the parent entity and each of the entities under its control and in the public sector could include, for instance, government agencies, authorities, companies, partnerships and trusts. Where a general purpose financial report involves the

combination of the financial reports of a number of entities, this Standard requires that the general purpose financial report comprise a consolidated financial report prepared in accordance with the consolidation techniques set out herein. This Standard does not address whether consolidated financial reports ought to be prepared at the whole-of-government level for each State and Territory and the Federal Government. Consideration of the content and form of reporting for whole-of government is currently being addressed in a separate project.

8. There may be circumstances where an economic entity is not a reporting entity as defined in this Standard. This might occur, for instance, where the economic entity is within another economic entity which is a reporting entity. Where an economic entity is not a reporting entity, the preparation of consolidated financial reports for that entity is not required by this Standard.

#### CLAIMS FOR EXCLUSION FROM SCOPE OF THE STANDARD

9. It is sometimes argued that in certain circumstances parent entity/subsidiary relationships should be exempted from the requirement to prepare consolidated financial reports. However, the adoption in this Standard of control as the criterion for determining a parent entity/subsidiary relationship enables identification of an economic entity for which consolidated financial reports may be prepared and, provided the economic entity is a reporting entity, no exemptions from the standards set out in this Standard are justified. Some commonly suggested exclusions are identified below and explanations are provided as to why they do not constitute exclusions from the standards set out in this Standard.

##### Temporary control

10. Temporary control does not of itself affect the economic entity for which consolidated financial reports are to be prepared. During the time that control is held and until such time as control ceases, the subsidiary is part of the economic entity and needs to be reflected in the consolidated financial reports.

##### Impaired control

11. The existence of severe restrictions which impair control means that the consolidation criterion is not satisfied and would result in the entity in question no longer being part of the economic entity. This would include, for instance, where a subsidiary is located in a country in which the government has undertaken certain actions, such as adopting legislation to provide for expropriation of the assets of the subsidiary, which impair control by the parent entity. Another example would be where a subsidiary is in the process of being liquidated. While the existence of such restrictions would generally constitute an impairment of the parent entity's control, each case would need to be assessed in the light of the prevailing circumstances. No exclusion or exemption is necessary where control is impaired since consolidation of the entity in these circumstances would contravene the standards set out in this Standard.

##### Dissimilar activities



12. Where the activities of entities within the economic entity are dissimilar it is sometimes claimed that aggregation of the financial report of each of the component entities may reduce the usefulness of the consolidated financial report. However, since the objective in preparing consolidated financial reports is to reflect the economic entity as a single reporting entity, it does not matter whether the entities comprising the economic entity are involved in dissimilar activities. Where economic entities are involved in dissimilar activities, the extent of this involvement can be conveyed in consolidated financial reports by the provision of disaggregated information on the various lines of activity. Australian Accounting Standard AAS 16 "Financial Reporting by Segments" provides guidance on the provision of information about significant industry and geographical segments. In the case of non-business entities which are not companies, the presentation of disaggregated information on a functional or program basis may be more relevant.

Parent entity holds a minority ownership interest in a subsidiary

13. Exemption from the requirement to include a subsidiary in a consolidated financial report is also sometimes proposed where the parent entity does not hold a majority ownership interest in the subsidiary. However, because control rather than ownership interest is the consolidation criterion in this Standard, the absence of a majority ownership interest does not affect the economic entity or the requirement to prepare a consolidated financial report, provided that control exists. The extent of the parent entity's ownership interest in the subsidiary will be evident from the equity disclosures in the consolidated financial report.

#### STATEMENT OF PURPOSE

14. The purpose of this Standard is to:

- a. identify for financial reporting purposes parent entities and subsidiaries; and
- b. prescribe the circumstances in which consolidated financial reports are to be prepared and the financial information to be included in those reports; so that the consolidated financial reports reflect the performance, financial position and financing and investing of a group of related entities as a single economic entity.

15. In this Standard, the concept of the reporting entity is extended from the legal entity or other single entity to recognise the existence of an economic entity stemming from interrelationships between entities. The objective underlying the preparation of financial reports for this economic entity is to provide relevant and reliable financial information about the related entities as a single reporting entity to reflect that these entities operate as a single economic unit. For a number of entities to be able to operate together as a single economic unit, they need to be under common direction, thereby providing consistency in the objectives being pursued. This occurs when entities are related by being under the common control of one entity. Hence, in this Standard it is contended that it is control rather than ownership that provides the criterion which is fundamental to identification of the group of related entities for which the presentation of

consolidated financial reports is required. The preparation of consolidated financial reports for this economic entity is consistent with Statement of Accounting Concepts SAC 2 "Objective of General Purpose Financial Reporting", which states that general purpose financial reports shall provide information useful to users for making and evaluating decisions about the allocation of scarce resources.

## CONTROL

21. Whether an entity has control of another entity will always be a question to be decided in the light of the prevailing circumstances. The definition of control depends upon substance rather than form and, accordingly, determination of the existence of control will involve the preparer of the financial reports in exercising professional skill and judgement.

22. Any of the following factors would normally indicate the existence of control by one entity of another entity:

- a. the capacity to dominate the composition of the board of directors or governing board of another entity;
- b. the capacity to appoint or remove all or a majority of the directors or governing members of another entity;
- c. the capacity to control the casting of a majority of the votes cast at a meeting of the board of directors or governing board of another entity;
- d. the capacity to cast, or regulate the casting of, a majority of the votes that are likely to be cast at a general meeting of another entity, irrespective of whether the capacity is held through shares or options; and
- e. the existence of a statute, agreement, or trust deed, or any other scheme, arrangement or device, which, in substance, gives an entity the capacity to enjoy the majority of the benefits and to be exposed to the majority of the risks of that entity, notwithstanding that control may appear to be vested in another party.

23. Another factor which may indicate the existence of control is ownership interest. The holding of an ownership interest usually entitles the investor to an equivalent percentage interest in the voting rights of the investee. Consequently, a majority ownership interest would normally, though not necessarily, be accompanied by the existence of control. However, it is the voting rights rather than the ownership interest that provide the potential for control. In fact, it may be possible to control another entity without holding any ownership interest in that entity. This would be rare in the private sector where it is normal for an entity to have owners with an equity interest therein, especially where a third unrelated party holds a majority ownership interest. However, in the case of nonbusiness entities in the public sector where the holding of an equity interest is frequently not possible, control without ownership will usually be the case.

24. In the public sector, a parent entity/subsidiary relationship could be established in the manner outlined in the preceding paragraphs or, as is more frequently the case, the existence of control might be specified by legislative or executive authority or by

administrative arrangements where there is power to give policy directions. In determining whether the relationship between similar organizations within the public sector constitutes a control relationship, the following factors would be among those which should be considered either singly or in combination: ministerial approval being required for operating budgets; the power of the Minister or a central authority to appoint and remove members of the board of management; or a ministerial power of direction. Where the relationship between a public hospital, for instance, and a central authority constitutes a control relationship, this Standard would require consolidated financial reports to be prepared for the economic entity comprising the central authority and the controlled hospital.

25. The concept of control is defined as a capacity, thereby allowing for the role of dominance to be a passive one rather than one which is necessarily actively exercised. If doubt exists as to whether an entity has the capacity to dominate another entity, there may, on occasions, need to be an active demonstration of control. This may be evident, for instance, by an entity being able to obtain financial information, internal management forecasts and budgets, and entity records from the other entity on request.

26. It may be possible to control the voting rights of another entity without holding a majority interest in the voting rights. This would happen where, in the absence of another entity dominating the composition of the board of directors, voting rights held by one entity, while less than 50 per cent, constitute a majority of those voting rights which are exercised.

27. The indicators of control outlined in the preceding paragraphs need to be distinguished from the circumstance where control of a particular entity is jointly held by two or more unrelated entities such that none unilaterally controls that entity. In this case none of the entities would qualify as the parent entity; however, it is important to consider the substance of the relationship between the entities which are deemed to have joint control of that other entity. For example, it is not unusual for an entity to be established to avoid recognising certain assets and liabilities in a financial report. While ownership interests and board representation of the new entity may be vested equally in the entity which sought to establish the new entity and in its financiers or legal advisors, this relationship may not constitute joint control as discussed above. To determine with whom control lies, it will be necessary to examine the manner in which major policy decisions are reached and the nature of the control over ongoing activities of the entity, rather than accepting that the nominal powers reflect the substance of the relationship.

28. The definition of "control" is such that, on rare occasions, an entity may appear to be the subsidiary of two unrelated entities. An example of this would occur where an entity exercises dominance of the decision-making in relation to the operating policies of another entity while another entity simultaneously possesses the capacity to dominate decision-making without exercising that power. This form of control, while rare, may be evident where institutional investors hold investments with the objective of generating positive cash flows through dividends and capital gains rather than for the purpose of managing the operations of the other entity. It is important to establish that the entity actually exercising dominance over the operating policies is not merely doing so, either

implicitly or explicitly, in accordance with the wishes of the other "controlling" entity. The concept of control employed in this Standard is defined in terms of dominance of both the financial and operating policy decisions, which implies a singular line of power. In the example cited in this paragraph, if neither of the entities is in the position of absolute dominance over the third entity, the relationship would be one of joint control determined by implicit agreement rather than control.

29. Sometimes an entity is regarded as being economically dependent on another entity. This is usually the case when the viability of the ongoing operations of one entity depends on funding by, or on a significant volume of business with, another entity. However, it ought not to be assumed that economic dependence is synonymous with control. While economic dependence would usually give rise to a relationship based on influence it is unlikely, in the absence of some very restrictive contractual condition, that it would enable an entity to dominate decision-making in relation to both the financial and operating policies of the other entity as would be necessary for control to exist.

30. The capacity of one entity to dominate decision-making, in relation to the financial and operating policies of another entity, is insufficient in itself to ensure the existence of control as defined in this Standard. The parent entity needs to be able to dominate decision-making so as to enable that other entity to operate with it as part of an economic entity in pursuing its objectives. This will have the effect of excluding from the definitions of "parent entity" and "subsidiary" relationships which do not extend beyond, for instance, that of a liquidator and the entity being liquidated and would normally exclude a lender and borrower relationship and a receivership relationship. Similarly, a trustee whose relationship with a trust does not extend beyond the normal responsibilities of a trustee would not be considered to control the trust for the purposes of this Standard.

31. Where control appears to be vested entirely with one party, another party might, in substance, be the controlling party. Consider, for example, a trust where the capacity for decision-making appears to rest entirely with the trustee, even to the extent that the trust deed precludes the unit holders from changing the trustee or holding effective meetings. Because the trustee's capacity to dominate decision-making is governed by the trustee's fiduciary responsibility at law to act in the best interests of the beneficiaries of the trust, those beneficiaries indirectly have the capacity to dominate decision-making in respect of the net assets of the trust.

## **Canada--Section PS 1300, *Government Reporting Entity***

### DEFINING THE GOVERNMENT REPORTING ENTITY

.07 *The government reporting entity should comprise the organizations that are controlled by the government.* [APRIL 2005]

.08 Control is the power to govern the financial and operating policies of another organization with expected benefits or the risk of loss to the government from the other organization's activities.

.09 A government may choose not to exercise its power; nevertheless, control exists by virtue of the government's ability to do so. Control must exist at the financial statement date, without the need to amend legislation or agreements.

.10 Whether a government controls an organization is a question of fact that must be determined by reference to the definition of control established in paragraph PS 1300.08 and the particular circumstances of each case. The determination of the fact that control exists will require the application of professional judgment. Government achieves its objectives through a wide range of organizations which individually will fall somewhere along a continuum. At one end of the continuum, it will be clear that an organization does not have the power to act independently and is controlled by the government. At the other end, the organization will have the power to act independently and, while government will have a level of influence on the organization, it will be clear that it does not have control. Along the continuum, consideration needs to be given to the nature of the relationship between the government and the organization in order to determine whether control exists. This Section provides guidance intended to assist in this assessment.

.11 In applying this guidance, it is necessary to determine the substance of the relationship between the government and the organization. The true nature of certain relationships may not be completely reflected by their legal form. All relevant aspects and implications of the relationship would be considered in determining whether or not the government controls the organization. Where various aspects of the relationship are designed, in effect, to achieve an overall objective, they would be viewed as a whole.

.12 Control does not stem simply from the government having constitutional responsibility, but rather from the nature of the relationship between the government and the organization. For example, where a government has constitutional responsibility for health care, the government may choose to deliver those services through a controlled organization, such as a government department, or through an independent contractor. Constitutional responsibility does not mean that the government controls the entities that are used in delivering the services.

.13 Financial and operating policies are principles and practices that determine how an organization conducts its activities. The ability to govern these policies is an important element of government control because it establishes the fundamental basis for the conduct of the organization's operations and the achievement of its mission and mandate.

.14 There are a variety of ways to govern the financial and operating policies of an organization. For example:

- a. a government may establish an organization's fundamental purpose and eliminate or significantly limit the ability of the organization to make future decisions by predetermining the financial and operating policies of the organization;
- b. a government may direct the financial and operating policies of an organization on an ongoing basis; or
- c. a government may veto, overrule or modify the financial and operating policies established by an organization.

.15 A government does not need to manage an organization's activities on a day-to-day basis to control the organization. It is the government's existing authority to determine the policies governing those activities that is important.

.16 For the purposes of this Section, it is assumed that where the government has the power to govern the financial and operating policies of an organization, it expects to derive a financial or non-financial benefit. The government may also be exposed to the risk of loss.

#### DETERMINING WHETHER CONTROL EXISTS

.17 As noted in paragraphs PS 1300.10-.11, whether a government controls an organization is a question of fact that requires the application of professional judgment based on the definition of control in this Section and the substance of the relationship in each case. The following guidance would be applied in the context of the definition of control and the particular circumstances of each case. It is the preponderance of evidence that would be considered in assessing whether a government controls an organization.

#### INDICATORS OF CONTROL

.18 There are certain indicators that provide more persuasive evidence of control:

- a. government has the power to unilaterally appoint or remove a majority of the members of the governing body of the organization;
- b. government has ongoing access to the assets of the organization, has the ability to direct the ongoing use of those assets, or has ongoing responsibility for losses;
- c. government holds the majority of the voting shares or a "golden share" that confers the power to govern the financial and operating policies of the organization; and
- d. government has the unilateral power to dissolve the organization and thereby access its assets and become responsible for its obligations.

.19 Other indicators that may provide evidence of control exist when the government has the power to:

- a. provide significant input into the appointment of members of the governing body of the organization by appointing a majority of those members from a list of nominees provided by others or being otherwise involved in the appointment or removal of a significant number of members;
- b. appoint or remove the CEO or other key personnel;
- c. establish or amend the mission or mandate of the organization
- d. approve the business plans or budgets for the organization and require; amendments, either on a net or line-by-line basis;
- e. establish borrowing or investment limits or restrict the organization's investments;
- f. restrict the revenue-generating capacity of the organization, notably the sources of revenue; and
- g. establish or amend the policies that the organization uses to manage, such as those relating to accounting, personnel, compensation, collective bargaining or deployment of resources.

.20 For each indicator that applies in a particular circumstance, the degree of government influence would determine its importance as evidence of control. In weighing the evidence, it would be necessary to consider the indicators collectively as well as individually. For example, where an organization is governed by a publicly elected board, this is not necessarily, in and of itself, sufficient evidence to conclude that the government does not control the organization. Similarly, where a government appoints a majority of the members of the governing body of an organization, this is not necessarily, in and of itself, sufficient evidence that the government controls the organization.

.21 The degree of importance of the indicators of control, as set out in paragraphs PS 1300.18-.19, further depends on the particular circumstances in each case. In some situations, a particular indicator may provide a high degree of evidence of control whereas, in other situations, the importance of the same indicator may not be as significant.

.22 A government's ability to take temporary control of another organization in exceptional circumstances, such as a crisis situation like bankruptcy or a board failure, does not, in and of itself, constitute control for the purposes of this Section. Such circumstances would arise as a result of a specific event that caused the government to intervene in the activities of the organization. Temporary control is short term in nature with the intention to relinquish control as soon as the crisis has been addressed.

.23 A government's ability to regulate an organization does not, in and of itself, constitute control. Government may establish the regulatory environment in an industry or sector within which organizations operate and impose conditions or sanctions on their operations. The governing bodies of those regulated organizations make independent decisions within the regulatory framework. A government may require the organization to submit reports to demonstrate compliance with the regulations. These reports are not considered evidence of control because the government's interest in these organizations extends only to the regulatory aspects of operations.

.24 An organization's financial dependence on the government, in and of itself, does not constitute control. While financial dependence would usually give rise to a relationship based on influence, it is unlikely that financial dependence alone would enable the government to control an organization. The governing body of that organization may make independent decisions on its financial and operating policies. A government may require the organization to submit reports to demonstrate compliance with the terms and conditions of funding. These reports are not considered evidence of control because the government's interest in the organization extends only to the funding aspects of operations. For example, a private sector day care service that receives government funding may be required to demonstrate compliance with the terms and conditions of government funding. However, the governing body retains discretion as to whether it will take funding from, or do business with, the government.

## ACCOUNTING FOR GOVERNMENT ORGANIZATIONS

.25 Reporting on a consolidated basis presents summary information that aggregates the individual financial statements of organizations comprising a reporting entity. Consolidation is a method of accounting that combines the accounts of those organizations line-by-line on a uniform basis of accounting and eliminates inter-organizational balances and transactions. The mechanics of preparing government consolidated financial statements are outlined in BASIC PRINCIPLES OF CONSOLIDATION, Section PS 2500, and ADDITIONAL AREAS OF CONSOLIDATION, Section PS 2510.

.26 Consolidation is the most appropriate method of accounting for organizations integral to the overall operations of government in directly performing its executive function. Such organizations include, for example, government departments, funds and government organizations that exist primarily to provide services to government.

*.27 Government financial statements should consolidate the financial statements of organizations comprising the government reporting entity, except for government business enterprises.* <sup>3</sup> [JUNE 1996]

## DEFINING A GOVERNMENT BUSINESS ENTERPRISE

.28 A government business enterprise is an organization that has all of the following characteristics:

- a. it is a separate legal entity with the power to contract in its own name and that can sue and be sued;
- b. it has been delegated the financial and operational authority to carry on a business;
- c. it sells goods and services to individuals and organizations outside of the government reporting entity as its principal activity; and
- d. it can, in the normal course of its operations, maintain its operations and meet its liabilities from revenues received from sources outside of the government reporting entity.



