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STAFF PAPER

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Project	**Conceptual Framework**		
Paper topic	Reporting entity – Perspective		
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Purpose of paper

1. The purpose of this paper is to discuss the perspective from which financial statements should be prepared. Other issues related to the reporting entity are discussed in Agenda Paper 10D *Reporting entity - General*.

2. Based on the IASB's tentative decisions made in April 2014, this paper assumes that the *Conceptual Framework* would define two elements that represent the claims against the reporting entity (ie liabilities and equity).

Summary of staff recommendations

3. The staff recommend that the IASB confirm its view that financial statements should be prepared from the perspective of the entity as a whole (paragraph 28).

Background

The 2006 DP

4. In the Discussion Paper, *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information* issued in July 2006 (hereinafter referred to as 'the 2006 DP'), the IASB discussed the entity perspective:

> OB10 The information provided by general purpose external financial reporting is directed to the needs of a wide range of users rather than only to the needs of a single group. [...] Accordingly, financial reports reflect the perspective of the entity rather than only the perspective of the entity's owners (existing ordinary shareholders or ordinary shareholders of the parent entity in consolidated financial statements) or any other single group of users. However, adopting the entity perspective as the basic perspective underlying financial reporting does not preclude also including in financial reports information that is primarily directed to the entity's owners or to another group of users. [...]

5. The IASB explained its reasons for adopting the entity perspective as follows:

> BC1.9 Questions continue to be raised in standards-level projects about whether financial reporting should be directed to, or reflect the perspective of, existing ordinary shareholders only. Many, though not all, of those questions involve the effects of adopting the *proprietary perspective* or the *entity perspective*. [...] The two perspectives are important primarily for consolidated financial statements and for determining the distinction between liabilities and equity. They affect whether the effects of transactions and other events are viewed from the perspective of the entire consolidated group or solely from the perspective of the parent entity.

> BC1.10 The boards decided to retain the focus on a wide range of users because it is more consistent with the objective of providing information that is useful for resource allocation decisions by investors, creditors, and other users than a narrower focus on existing ordinary shareholders would be. [...]

The 2006 DP did not define the two perspectives.

The 2008 ED and the 2008 DP

6. In the Exposure Draft, *An improved Conceptual Framework for Financial Reporting: Chapter 1: The Objective of Financial Reporting and Chapter 2: Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information* (hereinafter referred to as 'the 2008 ED'), and the Discussion Paper, *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Reporting Entity* (hereinafter referred to as 'the 2008 DP'), both issued in May 2008, the IASB concluded that general purpose financial reports should reflect the entity's perspective rather than the owners' (ie proprietors') perspective. The 2008 DP described the two perspectives as follows:

> 108. Under the proprietary perspective, no distinction is drawn between the entity and its owners – the entity does not exist separately from the owners. The resources of owners remain their resources and do not become resources of an entity because the entity does not exist separately from its owners. Lenders and other creditors provide economic resources to the owners of an entity in exchange for a claim against the resources that would otherwise accrue to the benefit of the owners. In other words, the claims of lenders and other creditors reduce the owner's equity in the resources associated with the reporting entity. Thus, the proprietary perspective places the owners in the central position of financial reporting. Assets represent resources of the owners, liabilities are debts or obligations of the owners, and revenues and expenses represent changes in the net residual of owners' equity.
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> 109. In contrast, under the entity perspective the entity exists separately from its owners. This separate existence is supported by legislation in the case of corporations. However, the entity perspective is not only applicable to corporations. Under the entity perspective, economic resources provided by

> owners or other capital providers become resources of the entity and cease to be resources of the owners or other capital providers. In exchange for the resources provided, capital providers are granted claims on the economic resources of the reporting entity. Thus, the entity is the focus of financial reporting, rather than its owners or others who have an interest in it. For example, the financial statements focus on information about the entity's economic resources (ie *its* assets), claims on those resources (eg *its* liabilities and equity interests), and the effects of transactions and other events and circumstances that change the entity's resources and claims on them (eg *its* revenues and expenses).

7. The IASB's rationale for this conclusion was that the entity perspective was more consistent with the fact that the vast majority of entities today are separate and distinct from their capital providers and, as such, the proprietary perspective generally does not reflect a realistic view of financial reporting.

8. Although it was not clearly stated in the 2008 ED and the 2008 DP, the IASB confirmed at its February 2008 Board meeting that general purpose financial reporting is directed at the reporting by an entity to its capital providers rather than reporting from the perspective of a particular class of capital providers.[1]

9. Most respondents to the 2008 ED and the 2008 DP agreed with the IASB that the entity exists separately from its owners and that financial statements should be presented from the perspective of the entity as a whole.

10. However, some respondents to these documents stated that, while they agree that the entity is separate from its owners, they did not believe that financial reports are of equal importance to all interested parties. Specifically, these respondents expressed the view that information regarding an entity's performance from the perspective of the parent entity's shareholders was of primary importance.

[1] From the February 2008 IASB Update.

11. Yet some other respondents were uncomfortable with the IASB's choice of the entity perspective because they did not believe that the IASB had fully explored its full implications for financial reporting.

The 2010 ED

12. In the Exposure Draft , *Conceptual Framework for Financial Reporting: The Reporting Entity* issued in March 2010 (hereinafter referred to as 'the 2010 ED'), the IASB did not discuss the perspective issue.

13. Many respondents to the 2010 ED requested that the reporting entity section should include a discussion of the perspective from which financial statements are presented. Some respondents expressed support for the entity perspective while others expressed support for the proprietary perspective.

Existing Conceptual Framework

14. Paragraph OB12 of the existing *Conceptual Framework* issued in September 2010 states:

> General purpose financial reports provide information about the financial position of a reporting entity, which is information about the entity's economic resources and the claims against the reporting entity. Financial reports also provide information about the effects of transactions and other events that change a reporting entity's economic resources and claims. Both types of information provide useful input for decisions about providing resources to an entity.

15. Paragraph OB12 implicitly says that the entity exists separately from its owners. Paragraph BC1.8 of the existing *Conceptual Framework* explains the rationale for this notion by stating that:

> Some respondents to the exposure draft said that the reporting entity is not separate from its equity investors or a subset of those equity investors. This view has its roots in the days when most businesses were sole

proprietorships and partnerships that were managed by their owners who had unlimited liability for the debts incurred in the course of the business. Over time, the separation between businesses and their owners has grown. The vast majority of today's businesses have legal substance separate from their owners by virtue of their legal form of organisation, numerous investors with limited legal liability and professional managers separate from the owners. Consequently, the Board concluded that financial reports should reflect that separation by accounting for the entity (and its economic resources and claims) rather than its primary users and their interests in the reporting entity.

The 2013 DP

16. In the Discussion Paper, *A Review of the Conceptual Framework for Financial Reporting* issued in July 2013 (hereinafter referred to as 'the 2013 DP'), the IASB did not discuss the perspective issue.

17. Nevertheless, some respondents to the 2013 DP stated that the perspective from which financial statements are presented may be controversial but is critical and, therefore, should be discussed in the *Conceptual Framework*. A few respondents suggested that, before attempting to differentiate between equity and liabilities, it is essential to first clarify if this is done from an entity perspective or a proprietary perspective. The distinction between equity and liabilities will be discussed in more detail at a future meeting.

Perspective

What is the issue?

18. The staff observe that past discussions regarding the perspective have focused on two separate issues:

    (a) whether the reporting entity exists separately from its owners; and

(b) whether financial statements of a reporting entity should be prepared from the perspective of a specific class (or classes) of capital providers or from the perspective of the entity as a whole (ie all capital providers).

19. Because the existing *Conceptual Framework* states that the reporting entity exists separately from its owners, the staff think the discussion should focus on whether financial statements should be prepared from the perspective of a specific class (or classes) of capital providers or from the perspective of the entity as a whole (ie all capital providers).

Perspective of a specific class (or classes) of capital providers

20. If financial statements should be prepared from the perspective of a particular class (or classes) of capital providers, the implications for financial statements would depend on how the class (or classes) is specified. If the capital providers were specified as all holders of instruments that do not create a obligation to transfer the entity's economic resources, the outcome is likely to be the same as presenting financial statements from the perspective of the entity as a whole (discussed in the next section) and is likely to be compatible with the strict obligation approach that was proposed in the 2013 DP.

21. On the other hand, if the capital providers were specified as the most residual class of claims, then this perspective is likely to be compatible with the narrow equity approach that was proposed in the 2013 DP.

22. One particular aspect to consider is the treatment of non-controlling interests. It is sometimes suggested that the financial statements should be prepared from the perspective of the shareholders of the parent entity. This would have the following results, which differ from the requirements of existing Standards:

(a) non-controlling interests would be presented outside of equity;

(b) profit or loss attributable to non-controlling interests would not be treated as profit or loss of the entity because it is not attributable to shareholders of the parent entity; and

(c) transactions between the reporting entity and owners of non-controlling interests would be regarded as transactions with parties other than the entity's owners and, thus, profit or loss could arise on such transactions.

23. Some argue that the advantage of this perspective is that it is consistent with the stewardship notion because investors of the parent entity would receive information that adopts their perspective.

24. However, the staff think this perspective has some shortcomings:

(a) it can be argued that it is inconsistent with the *Conceptual Framework*, which states that the primary users are not limited to existing shareholders or the controlling entity's majority shareholders; and

(b) it may be difficult to specify the class (or classes) of capital providers from whose perspective the financial statements should be presented.

Perspective of entity as a whole (all capital providers)

25. When financial reports of a reporting entity are prepared from the perspective of the entity as a whole, the perspective would not indicate how liabilities and equity should be defined.

26. Nevertheless, because the existing *Conceptual Framework* defines equity as the residual interest in the reporting entity's assets after deducting all its liabilities, claims on a subsidiary that do not meet the definition of a liability (non-controlling interests) are classified as equity in the consolidated financial statements. Therefore, profit or loss attributable to non-controlling interests would be treated as part of the profit or loss of the entity, and transactions between the parent entity and holders of non-controlling interests would be accounted for similarly to transactions between the parent entity and holders of the parent's equity.

27. Some argue that the advantages of this perspective are that:

(a) it is more consistent with the existing *Conceptual Framework* which states that the primary users are not limited to existing shareholders or the controlling entity's majority shareholders;

(b) it is consistent with the accounting for non-controlling interests in existing standards, such as in IFRS 3 *Business Combinations* and IAS 1 *Presentation of Financial Statements*; and

(c) there is no need to specify the class (or classes) of capital providers from whose perspective the financial statements should be presented.

Staff analysis and recommendation

28. Considering the advantages of presenting financial statements from the perspective of the entity discussed in paragraph 27 and the shortcomings of presenting financial statements from the perspective of a specific class (or classes) of capital providers discussed in paragraph 24, the staff recommend that the IASB confirm its view that financial statements should be presented from the perspective of the entity as a whole.

29. As discussed in earlier documents, presenting financial statements from the perspective of the entity as a whole does not mean that the information needs of the parent entity's shareholders would be ignored. Paragraph OB8 of the existing *Conceptual Framework* states that focusing on common information needs does not prevent the reporting entity from including additional information that is most useful to a particular set of primary users. Accordingly, the IASB may require the disclosure of information that is primarily directed to the needs of a particular class (or classes) of capital providers.

Question for the IASB
Does the IASB agree that financial reports should be presented from the perspective of the entity as a whole?