APPENDIX 2

SECTION 1: THE REPORTING ENTITY CONCEPT

Introduction

16. As noted earlier, the objective of this phase of the project is to develop a reporting entity concept for inclusion in the boards' common conceptual framework. That concept is intended to assist the boards when developing standards for general purpose external financial reports prepared in accordance with International Financial Reporting Standards (IFRS) or US generally accepted accounting principles (US GAAP).

17. General purpose external financial reports provide information about a particular *reporting entity*. For example, those reports provide information about the entity's economic resources (ie its assets), claims to those resources (ie its liabilities and equity), and the effects of transactions and other events and circumstances that change an entity's resources and the claims to them. In other words, it is the entity itself that is the subject of financial reporting, not its owners or others having an interest in the entity. Thus, a distinction can be drawn between the *subject* of general purpose external financial reports and the *users* of those reports (such as investors and creditors).

18. In its most general sense, the term *reporting entity* is used to refer to the specific entity that is the subject of a particular set of financial reports. However, merely describing or defining a *reporting entity* as being an entity that reports would not be helpful. Hence, something more is required if the boards are to develop a reporting entity concept that assists them in their standard-setting activities.

19. Because of the lack of a reporting entity concept in the boards' existing conceptual frameworks, there is no clearly established starting point. Hence, the first issue to address in the project phase is to more clearly establish the objective of this phase.

Definition of a reporting entity

20. Some might argue that the project phase should aim to develop a clear and precise definition of a "reporting entity", to establish which particular "things" qualify as being appropriate or acceptable subjects of general purpose external financial reports. Such an approach would be similar, for example, to defining *assets.* The term *asset* is defined in the boards' existing conceptual frameworks (and in the frameworks of other standard-setting bodies). That definition is then applied in financial reporting standards such that, in general, something has to meet the definition of an asset before it qualifies as a potential candidate for recognition in a set of general purpose external financial reports.

21. Similarly, the boards could define a *reporting entity*. That definition could then be applied in the boards' financial reporting standards, such that the subject of a particular set of financial reports must meet the definition of a reporting entity before those financial reports can be described as being general purpose external financial statements prepared in compliance with IFRSs or US GAAP.

22. Some may support this approach, because it would put some limits on what is permitted to be the subject of general purpose external financial reports. Without those limits, it is argued, preparers of financial reports would have a completely free hand to select the subject of what are purported to be general purpose external financial reports. If so, that may result in the presentation of financial reports to investors and creditors that do not meet the objective of general purpose external financial reporting. For example, suppose a corporation prepared a financial report on its highly profitable operations, but excluded from that report information about its poorly performing (or loss-making) operations. Even if the "reporting entity" was clearly described, many would regard such a report to be incomplete, and potentially misleading to users of that report.

23. However, others would regard such concerns as being unfounded. For example, the boards' financial reporting standards do not specify which "things" are permitted to be the subject of general purpose external financial reports prepared in compliance with those standards. Yet that lack of such requirements has not resulted in the occurrence of situations similar to that described above (at least, not in the context of an individual entity, ie an entity that does not have an interest in another entity).

24. Moreover, being too prescriptive—as opposed to not being prescriptive enough—could also result in a failure to meet the objective of general purpose external financial reporting. For example, the boards considered whether, for something to be a reporting entity, it should have 'the capacity to deploy resources' [1] or some similar notion, such as the capacity to engage in transactions with other parties. However, the boards were concerned that defining a reporting entity in this manner might result in some organisations failing to satisfy that definition. For example, a special purpose entity, with a narrowly defined purpose and pre-determined financing and operating policies, might have a very limited capacity to deploy resources or engage in transactions with other parties. Yet there could be external investors or creditors who require information about that entity but who lack the ability to prescribe the information they need.

[1] SAC 1, *Definition of the Reporting Entity*, paragraph 6.

25. Although developing a precise definition of a reporting entity might be problematic and unnecessary, there remains the question of whether the conceptual framework should provide some concepts or guidelines for determining which particular "things" are regarded as being appropriate subjects of general purpose external financial reports.

26. In particular, an important issue, both conceptually and when setting financial reporting standards, is the relevance of legal structure when determining what constitutes a reporting entity. Questions arise about the relevance of legal structure when determining which particular resources, claims to those resources, and changes in those resources and claims fall within the boundary of the entity reporting. Conceptually, this could be divided into two types of boundary issues:

    a. Dissaggregation issues, in particular, whether a component of a legal entity, such as unincorporated branch, is a suitable subject of general purpose external financial reports; and

    b. Aggregation issues, in particular, determining when the legal boundary between two or more legally separate entities should be disregarded, so that they are instead presented as a single economic unit.

27. The remainder of this section focuses on disaggregation. Section 2 focuses on the more complex issues relating to aggregation.

Business activities that are not structured as separate legal entities

28. In many cases, businesses are conducted using some form of legal structure, such as a corporation, trust, partnership or incorporated society. These types of legal structures help to identify the "thing" that is the subject of financial reports, and distinguish it from the investors and creditors who are the capital providers to that "thing". In other words, legal existence helps to distinguish between the *subject* of general purpose external financial reports and the present and potential *users* of those reports.

29. Moreover, legal existence can help to establish the boundaries of the reporting entity. In particular, it helps to determine which resources, claims to those resources, and changes in those resources or claims should be included in the entity's financial reports. For example, a small business that is owned and operated by an individual person could be structured as a sole proprietorship or as a corporation (or some other form of legal structure). If the business is operated through a separate legal entity, this often would assist in distinguishing between that person's business and non-business assets, liabilities and activities. Thus, typically it would be easier to determine which assets, liabilities and activities should be

included in—or should be excluded from—the financial reports prepared for that business. (Of course, practical difficulties may still arise in some cases, as discussed further below.)

30. However, not all types of business activities are structured as a legally separate entity. As discussed above, a business owned and operated by an individual person might not be operated through a separate legal entity. Yet general purpose external financial reports might be prepared for that sole proprietorship, for example, when seeking funding from a bank or when providing financial information to prospective purchasers of the business.

31. Similarly, in some jurisdictions, an unincorporated branch of an overseas corporation might be required to (or choose to) prepare general purpose external financial reports, for example, to provide financial information to existing and potential creditors of that branch.

32. Some might argue that an unincorporated branch or a sole proprietorship (or any other business activity that does not have its own separate legal existence) should not be regarded as a reporting entity for the purposes of general purpose external financial reports. They argue that, although such an "entity" could prepare special purpose financial reports, it is not a suitable subject of general purpose external financial reports. Some might argue for such a conclusion on the grounds of practical difficulties of distinguishing between the resources, claims to those resources, and changes in those resources and claims of the unincorporated branch or sole proprietorship and those of the wider legal entity of which it is a component. Because of those practical difficulties, it is argued, it may be difficult to ensure that the financial report provides a complete and faithful representation of all the resources, claims to those resources, and changes in those resources and claims of the unincorporated branch or sole proprietorship. Others might argue for such a conclusion on the grounds that a legal structure is necessary to establish that the "entity" exists in its own right. For example, creditors of a sole proprietorship typically have recourse not only to the business assets of the proprietor but also to the proprietor's personal assets; the creditors of an unincorporated branch typically have recourse to the assets of the wider legal entity of which that branch is a component, not only to the assets of the branch. This suggests that the sole proprietorship or an unincorporated branch is not an "entity" in its own right. Also, the financial reports of a sole proprietorship or unincorporated branch could be regarded as incomplete, because they would not include all of the assets against which the creditors have claims.

33. However, the boards did not agree with the above arguments. They noted that:

    a. Practical difficulties of the type described above could occur, irrespective of whether a separate legal entity exists. For example, the owner/operator of a business operated using a corporate structure might use the corporation's bank account for both business and personal transactions. If so, it may be difficult, in some cases, to distinguish between the two types of transactions.

b. The fact that there could be *practical* difficulties establishing the boundary of a particular area of business activity which does not have its own separate legal existence is not sufficient reason to conclude that, *in concept*, it is not a suitable subject for general purpose external financial reports.

c. If the existence of a reporting entity is dependent upon whether a particular business activity is structured as a separate legal entity, this would imply that legal form is more important than economic substance. Thus, economically similar types of organisations might or might not be reporting entities for the purposes of general purpose external financial reports, depending on their legal form or the jurisdiction in which they operate, given that legal structures may differ across different jurisdictions.

d. The fact that creditors may have recourse to other assets, in addition to the assets of the reporting entity, does not mean that the reporting entity itself does not exist or that its reports are incomplete because those other assets are not included. For example, the creditors of a partnership typically have recourse to the personal assets of the partners. The creditors of a corporation may have recourse to the personal assets of the corporation's shareholders (eg because of a personal guarantee). But that does not mean that the partnership or corporation does not exist or that its financial reports are incomplete because the personal assets of the partners/shareholders are excluded. Rather, it may be necessary for the reporting entity's financial reports to provide information about the other assets that provide security for creditors' claims. In some cases, it may be appropriate to recognise a capital contribution from owners, for example, if the provision of a personal guarantee by a shareholder results in a corporation paying a lower interest rate. However, these are issues to be addressed at the standards-level.

e. Developing a reporting entity concept that is limited to legal entities would serve no useful purpose—it would simply create problems for the boards and their constituents, including the users of general purpose external financial reports. For example, a sole proprietorship might not be a legal entity, but there is no reason why it should be precluded from being the subject of general purpose external financial reports. On the contrary, to do so would result in the loss of decision-useful information to external users of those reports, such as lenders, other creditors, and prospective purchasers of the business.

34. Thus, the boards' preliminary view is that a *reporting entity* should not be limited to business activities that are structured as separate legal entities. Rather, a reporting entity could be broadly described as being a circumscribed area of business activity. This would include, for example, a sole proprietorship, branch, corporation, trading trust, or partnership.

The link with the objective of general purpose external financial reporting

35. Broadly describing a reporting entity as a *circumscribed area of business activity* may be too vague to be of use when developing financial reporting standards, in particular, because it does not provide a clear link to the objective of general purpose external financial reporting. Given that the conceptual framework establishes concepts for general purpose external financial reports, any discussion in the framework of the reporting entity should be clearly linked to that objective.

36. The boards considered the objective of general purpose financial reporting in the first phase of the conceptual framework project. Their tentative conclusion is that the objective of general purpose external financial reporting is to provide financial information about the reporting entity that is useful to present and potential investors and creditors in making the decisions in their capacity as capital providers. [*Staff note: this is the latest proposed wording for the objective – revise or revert to earlier wording if no decisions have been reached in Phase A redeliberations at the time this DP is published*.] Thus, to provide a link to this objective, a reporting entity could be described as being a circumscribed area of business activity of interest to present and potential investors and creditors. That description could then be used, for example, when determining the aggregation issue described earlier, that is, determining when the legal boundary between two or more legally separate entities should be disregarded, and presented as a single economic unit, as discussed in Section 2.

37. Describing a reporting entity in this manner may also be useful for other purposes, in addition to the boards' standard-setting activities. As noted earlier, in many jurisdictions, there are legislative or regulatory requirements that establish which particular entities should prepare general purpose external financial reports in accordance with IFRSs or US GAAP. It is not within the authority of the boards to specify which particular entities should be required to apply their standards. However, by describing a *reporting entity* in their common framework in a manner that links it with the objective of general purpose

external financial reporting, that may assist regulators and legislators in deciding which particular entities should be required to prepare such reports in compliance with IFRSs or US GAAP.

38. Some might have conceptual concerns about specifically referring to external users (investors and creditors) in the description of a reporting entity. In particular, they might be concerned that doing so implies that the existence of a "circumscribed area of business activity" depends upon the existence of external investors and creditors that are interested in that organisation. Such an implication would make little sense, because the organisation itself exists, irrespective of whether there are external investors or creditors interested in it or whether it presents financial reports to any external users.

39. However, by linking the description of a reporting entity to the objective of financial reporting, the intention is to convey that the conceptual framework is *focused* on those particular circumscribed areas of business activity that are of interest to present and potential investors and creditors. Having such a focus is consistent with the framework's focus on general purpose external financial reporting, rather than all types of financial reporting. In addition, focusing on a particular type of financial reporting—or a particular area of business activity—does not imply that the concepts in the framework cannot be applied more broadly. For example, suppose a family-owned business had no external investors or creditors, and its owner/managers no intentions of seeking external funding in the future. Although the framework would not be focused on this type of organisation, that would not prevent the entity from preparing financial reports by applying the concepts in the framework, if it wished to do so.

40. Furthermore, as noted above, focusing on the objective of general purpose external financial reporting is likely to assist the boards when considering boundary issues relating to the reporting entity, both at the conceptual and standards level. In particular, an important issue to be addressed in the reporting entity project phase is determining when the relationship between one legally separate entity and another is such that the legal boundary between the two should be disregarded for financial reporting purposes. That issue needs to be addressed because, when a particular corporation (or trust, association or other type of organisation) prepares general purpose external financial reports, it is necessary to determine which resources, claims to those resources, and changes in those resources or claims should be included in its financial reports. Thus, when an entity has an interest in, or relationship with, another legally separate entity, guidance is needed to determine when presenting information about those entities as a single economic unit

would meet the objective of financial reporting. In other words, guidance is needed to establish when two or more legally separate entities should be regarded as “a circumscribed area of business activity of interest to present and potential investors and creditors”. That issue is addressed in Section 2 of this paper.