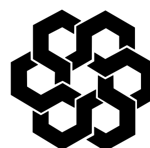

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These notes are based on the staff papers prepared for the IASB and FASB. Paragraph numbers correspond to paragraph numbers used in the joint IASB-FASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IASB/FASB Meeting:	**21 April 2008, London**
Project:	**Conceptual Framework: Phase A**
Subject:	**Perspectives of Financial Reporting (Agenda paper 2)**

Introduction

1. At the February 20, 2008 FASB meeting and the February 2008 IASB meeting, the Boards discussed the entity and proprietary perspectives of financial reporting. At those meetings, the Boards directed the staff to prepare a paper summarizing the implications of the Boards' earlier decision to adopt the entity perspective during their deliberations on the objective of financial reporting. Some Board members were concerned that the decision and its implications have not been adequately communicated to constituents through the due process documents that have been published to date as part of the conceptual framework project. Those Board members asked to the staff to develop a plan for communicating the rationale for the Boards' decision to adopt the entity perspective, as well as the extent to which that

decision may or may not affect future phases of the framework project. This paper is in response to that request.

Perspectives of Financial Reporting

2. The FASB's and the IASB's existing conceptual frameworks both discuss the objective of financial reporting/statements in terms of information that is useful to a wide range of users in making economic decisions. Both frameworks identify a variety of present and potential users including, investors, creditors, employees, suppliers, customers, and governmental agencies.

3. Questions continue to be raised in standards-level projects about whether financial reporting should be directed to, or reflect the perspective of, existing common shareholders only. Many, though not all, of those questions involve the effects of adopting the proprietary perspective or the entity perspective.

4. Different terms are sometimes used to describe the competing views of financial reporting perspective. In addition to entity and proprietary *perspective*, some refer to the entity and proprietary *theories* and others refer to the entity and proprietary *orientation postulates*. Some staff think that each of these terms means different things, and might argue that adoption of a particular *perspective* might not involve embracing the entire *theory* by the same name. However, there is no clear consensus about which labels describe which aspects of each view and about how far the implications of each extend. To simplify the discussion, this paper uses *perspective* exclusively from this point forward.

5. The perspectives differ not only in the question of which perspective is used in preparing the reporting (the entity or its proprietors) but also who is the intended beneficiary of that reporting (the proprietors or the capital providers as a group). Under a proprietary perspective, the objective of general purpose financial reporting is to provide financial information about the proprietor's business to the proprietor. Under the entity perspective, the objective is to provide financial information about the entity's business to the entity's capital providers. Each perspective has different implications for concepts and standards of financial reporting.

6. The first two sections of this document describe the proprietary perspective and a description of the entity perspective, respectively. The next section discusses the implications on the objective of financial reporting of adopting one or the other perspective. The next sections discuss potential implications on other phases of the framework project beyond the objective.

Drafts of relevant sections of the two due process documents are attached to this memo as appendices. [The appendices are omitted from observer note].

Proprietary Perspective

7. Before the advent of the corporate form of business ownership, most businesses were owned and operated by sole proprietors or partnerships and their accounting was based on the proprietary perspective. Under the proprietary perspective, the reporting entity is assumed to have no substance of its own separate from that of its proprietors or owners. The resources that the proprietors dedicate to the business remain their resources and do not become resources of a business entity because the entity does not exist separately from its owners. Creditors provide economic resources not to the business entity but to the owners in exchange for a claim against the resources that would otherwise accrue to the benefit of the owners. In other words, the claims of creditors reduce the proprietors' equity. Therefore, financial reporting from the proprietary perspective involves reporting on the assets of the owners, the liabilities of the owners to their creditors, and the net residual owners' equity in the reporting entity accruing to the owners. Under the proprietary perspective, there is a fundamental distinction between owners of the reporting entity (who retain ownership of the resources used in the business) and other capital providers such as lenders and other creditors (who have a contractual relationship directly with the owners of the reporting entity). This distinction arose because under the proprietary perspective as it was originally applied, financial reporting was prepared solely for the benefit of the proprietors.

8. The proprietary perspective places the owners in the central position of financial reporting and the accounting equation. Assets represent resources of the owners; liabilities are obligations of the owners; and revenues and expenses represent changes in ownership or proprietorship.

9. The proprietary perspective is also viewed as a wealth concept: proprietorship is the net value of the business to its owners. Net income accrues directly to the owners and thus represents an increase in their wealth. Hence, some regard the proprietary perspective as "balance sheet orientated," and consistent with the use of current values rather than historical costs.

10. The accounting equation under the proprietary perspective is therefore:

    Assets - Liabilities = Proprietorship (or Equity)

    Or, simplifying,

Net Assets = Proprietorship (or Equity).

11. Under the proprietary perspective, liabilities and equity are fundamentally different in concept. The following comments of Sprague[1], made while rejecting the notion that the proprietors' interest should be treated as part of an entity's liabilities, illustrates the proprietary perspective of equity:

> Surely The Business does not stand in the same relation to its proprietors or its capitalists as to its "other" liabilities. It would seem more appropriate to say that it is "owned by" than "owes" the proprietors. (page 57)

12. The proprietary perspective views the entity's liabilities as being obligations, while its equity is not in any sense an obligation. An obligation requires the entity to transfer resources, such as money, goods or services, from the entity to another party *outside the entity* at some time in the future. Because the entity is not viewed as existing separately from the proprietors, the proprietors are not "outside" the entity. Hence, proprietors' equity is not an obligation of the entity.

13. Some maintain that the proprietary perspective requires commingling of the proprietor's personal activities and assets with those of the business. They argue that because the entity does not have substance and the assets of the business are in fact the assets of the proprietor, there is no conceptual basis with which to separate business assets and activities from personal assets and activities. On the other hand, Zeff, in his examination of what he calls the entity and proprietary theories, argues that "both theories presume that separate records are kept for business and (the owner's) household affairs."[2] In today's environment, the fact that the non-business assets of owners should be excluded from the financial reporting of business entities is nearly universally accepted. To argue otherwise serves only as a distraction from the differences between the competing perspectives that are legitimately argued by knowledgeable accountants.

Entity Perspective

14. Under the entity perspective, the entity is assumed to have substance of its own, separate and distinct from that of its owners. Economic resources provided by capital providers (including

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[1] Sprague, C. E. 1907. *The Philosophy of Accounts*. Reprinted 1972. Lawrence, Kansas: Scholars Book Company.

[2] Zeff, Stephen A., A Critical Examination of the Orientation Postulate in Accounting, p2

equity capital) become resources of the entity and cease to be resources of the capital providers. In exchange for the resources provided, capital providers, including equity capital providers, are granted claims to the economic resources of the reporting entity. The claims of different capital providers generally have different priorities and different rights with respect to the reporting entity, but the distinction between ownership claims and nonownership claims is not as fundamental as it is under the proprietary perspective. Therefore, financial reporting from the perspective of the entity involves reporting on the economic resources of that entity and the claims to those resources held by its capital providers.

15. Under the entity perspective, the fundamental accounting equation is:

Assets = Creditor Equities + Owner Equities, or

Assets = Creditor Claims + Owner Claims, or

Assets = Claims

16. In other words, assets represent rights accruing to the entity, while capital providers have claims on those assets. (In most cases, capital providers have claims not on specific assets but on the general assets of the entity.) Under an entity perspective, some argue that there is no conceptual distinction between the various parties who have a financial interest in the entity; they are all capital providers or claimants. That is, the interests of both creditors and owners form part of the total claims, irrespective of any differences in the rights and conditions attached to the various financial interests. Owners' equity is thus considered to be the claim of the owners on the entity, in the same manner as the obligations to creditors represent claims.

Implications for the Conceptual Framework

Implications for the Objective of Financial Reporting

17. Chapter 1 of the draft Exposure Draft (ED), *Conceptual Framework for Financial Reporting, Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Information* (Phase A ED), identifies capital providers as the primary user group benefiting from financial reporting information. The Phase A ED also states that information that satisfies the needs of that particular group of users is likely to meet most of the needs of other users.

18. Present and potential capital providers are the most prominent external users of financial reports. They have the most direct and immediate need for the information in financial reports. They are interested in an entity's ability to generate future net cash inflows, which significantly affects the entity's ability to distribute cash to them in the form of dividends or other types of distributions to owners, or interest and repayment of borrowing. Because present and potential capital providers have the most direct and immediate interest in an entity's ability to generate net cash inflows, the Boards decided to designate them as the primary users of financial reporting information.

19. A primary user group composed of all capital providers is consistent with the entity perspective of financial reporting. Equity investors and creditors both have claims against the entity under the entity perspective, and the distinction between an ownership claim and a nonownership claim is deemphasized. Therefore, it follows that financial reporting should serve all capital providers rather than only one group. This contrasts with the proprietary perspective, in which it follows that only equity capital providers should be the primary user group because that perspective is aimed at determining the amount of proprietorship.

20. Although the Boards adopted the entity perspective as the basic perspective underlying financial reports when deliberating the Phase A ED, they observed that financial reports could include information that is primarily directed to or useful to equity investors, existing or potential (that is, decision-useful information is appropriate regardless of whether it is considered more consistent with the proprietary perspective or the entity perspective). The Boards observed that adopting the entity perspective does not preclude providing information in financial statements to meet the different information needs of the primary user group that might be viewed as consistent with a proprietary perspective.

21. The Boards observed that a broader focus on the needs of the full range of capital providers is appropriate both in jurisdictions with a corporate governance model defined in the context of shareholders and in those with a corporate governance model that focuses on a broader group of stakeholders.

Potential Implications for Defining Elements of Financial Statements

22. In practice today, a fundamental distinction between liabilities and equity still exists; liabilities are defined in terms of present obligations to transfer resources to other parties; equity is intended to represent the owners' interests; and equity interests are regarded as imposing no present obligation on the entity to transfer resources except in the event of the entity's liquidation. These characteristics are often argued to be consistent with the proprietary perspective of financial reporting.

23. In contrast, the entity is now regarded as existing separately from the owners. Accordingly, owners' interests are no longer excluded from liabilities on the basis of the owners' inseparability from the business, as they would be under a proprietary perspective. Instead, they are excluded from liabilities based on the notion that the entity is not obligated to transfer resources to owners until some formal act occurs, such as the declaration of a dividend.

24. Therefore, the key question for standard setters when distinguishing a particular financial interest as a liability or equity has become 'is the entity obligated to transfer resources to the interest holder at a fixed or determinable future date?' or 'does the particular financial interest impose a settlement obligation on the entity or does it represent a residual claim?'

> "…liabilities…involve *nondiscretionary* future sacrifices of assets that must be satisfied on demand, at a specified or determinable date, or on the occurrence of a specified event….distributions to owners are *discretionary*…Generally, an enterprise is not obligated to transfer assets to owners except in the event of the enterprise's liquidation unless the enterprise acts formally to distribute assets to owners, for example, by declaring a dividend…" (FASB SFAC6 54 and 61, emphasis added)

25. However, more recently, the notion that financial interests to be classified as equity should have the characteristics associated with owners' interests has been re-introduced, (for example, SFAS 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*). Some argue that today's practice is probably best described as a modified version of a proprietary perspective, where a fundamental distinction between liabilities and equity remains despite the acknowledgement of the business as a separate entity from the proprietor.

26. Hatfield[3] and Canning[4] underscored the distinction between liabilities and equity by taking that view that liabilities are negative assets. For example:

> "In the matter of valuation, liabilities do not differ from assets except in characteristic direction of flow. Those writers who urge consideration of liabilities as negative assets express a view more fruitfully suggestive than do those who habitually associate liabilities and net proprietorship in their discussion." (Canning 1929, p. 50-51)

27. This statement is consistent with the IASB and FASB frameworks, not only in their respective definitions of liabilities, which are essentially the negative of the definition of assets, but because the amount of equity is dependent upon the difference between assets and liabilities.

28. However, the formulation of the accounting equation Asset – Liabilities = Proprietorship does not necessarily follow logically for modern business forms like corporation as it does with sole proprietorships and partnerships. A corporation's creditors and shareholders have more in common than is usually supposed. Generally speaking, their commonalities are as follows:

    a. They all supply capital to the corporation

    b. All their claims are against the corporation itself and they lack recourse to any other party

    c. Their claims are to interests in the corporation, not to the specific assets of the corporation

    d. They all demand a return on their invested capital

    e. They are not directly involved in the management of the corporation's business activities.

29. Collectively, therefore, they might better be described as corporate claimants or claimholders rather than as creditors and shareholders.

30. Clearly, there are also differences between the claims of creditors and those of equity investors. Those differences include the relative priority of their claims on the entity and their

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[3] Hatfield, H. R. 1909. Modern Accounting: Its Principles and Some of Its Problems. New York: D. Appleton and Company.

[4] Canning, J. B. 1929. The Economics of Accountancy: The Ronald Press Company.

relative rights or ability to exercise control over the entity and its management. However, those are not differences in character, but rather differences in degree.

31. If we accept that the fundamental accounting equation under the entity perspective is Assets = Claims, as posited above, some would argue that there are obvious implications for defining the elements of financial statements. Under the strictest application of the entity perspective, the balance sheet elements would be limited to assets and claims. The distinction between different types of claims (for example, liabilities and equity) would cease to be elemental, although it would undoubtedly continue to be useful for some purposes. While some might argue that a strict application of an entity perspective precludes distinguishing between liabilities and equity at the conceptual level, others might argue that it is possible and ultimately useful to draw conceptual distinctions between different categories of claims. They argue that a Board's decision to make any particularly useful distinction at the element level rather than leaving that distinction to a matter of display (reporting) is a matter of choice and is not necessarily consistent or inconsistent with an entity perspective.

32. Even if the balance sheet were limited to two elements (assets and claims) at the conceptual level, the Boards would continue to be free to draw distinctions between different types of claims at the standards level. For example, claims could be sorted and ordered by liquidity, with demand liabilities at one end of the spectrum and perpetual instruments at the other. That distinction might prove useful to capital providers concerned about liquidity, solvency, or priority as it relates to the particular claim of the capital provider. Because characteristics of ownership or control inherent in some instruments and not others may not be relevant to liquidity or priority, the ordering of claims by liquidity need not be encumbered by ownership characteristics.

33. Claims could also be distinguished between variable interests and nonvariable interests, useful for application of a control-based model of consolidation, again ignoring the traditional distinction between liabilities and equity. In that case the relevant attribute is the behavior of the return to the capital provider – is it a residual return that varies with the performance of the entity or is it a fixed return?

34. A distinction also might be made between claims arising from operating activities (accounts payable, warranty obligations), and those arising from financing activities (long-term capital).

Such a distinction might be useful in the definition of income, comprehensive income, or other periodic measures of balance sheet changes.

35. There are perhaps other examples of useful distinctions that can be made between claims with differing characteristics which may be useful for decision making. In can be argued that the strict application of the entity perspective, and the resultant elimination of the **conceptual** distinction between liabilities and equity **as separate elements of financial statements**, might alleviate some constraints on standard setting caused by adherence to the proprietary perspective notion of an elemental distinction between liabilities and equity. In other words, once the standard setter is freed from the constraint of the liability/equity distinction as an all-purpose differentiation at the conceptual level, the standard setter is free to distinguish between the claims characteristics that are relevant to a particular decision context.

Implications for the Reporting Entity phase and Consolidation Policy

36. The implications of adopting the entity perspective in the context of consolidated financial statements primarily concern the implications for the parent company approach to consolidated statements. Under the parent company approach, the focus is on the owners of the parent company and the consolidated statements are seen as extensions of the parent company's statements. Some regard the parent company perspective as being an extension of the proprietary perspective, because the parent's owners are the center of interest, and a clear distinction is drawn between the interests of the majority and minority interests. Others regard the parent company approach as falling between the proprietary perspective and entity perspective because it combines elements of both, as discussed in Appendix B [Appendix B is omitted from observer note]. Irrespective of whether the parent company approach is seen as an extension of the proprietary perspective or a distinct perspective in its own right, it is clear that the parent company approach is not consistent with the entity perspective, as explained briefly below and further in Appendix B.

37. Traditionally, consolidated financial statements have been prepared using the parent company approach. For example, non-controlling interests have been presented outside of equity, either as a liability or between liabilities and equity. It was argued that, because non-controlling interests were not shareholders of the parent company, they were not regarded as having an ownership interest in the reporting entity. Similarly, gains and losses were recognized from

transactions between the parent company and non-controlling interests because they were regarded as transactions with non-owners.

38. Under the entity perspective, the financial reports are prepared from the perspective of the reporting entity, not from the perspective of one particular group of capital providers. Hence, in the context of a group reporting entity, financial statements are prepared from the perspective of that group, not from the perspective of the parent company's shareholders. Also, legal form is disregarded when presenting information about a group reporting entity. Instead, the two or more legal entities that comprise the group are presented as a single unit. This presentation is consistent with the entity perspective.

39. Furthermore, the presentation of different types of claims on the entity's assets, such as controlling and non-controlling interests, depends on the nature of those claims on the entity's assets from the entity's perspective. As noted above, whether different types of claims should be divided into two (or more) categories, and the basis for distinguishing between those categories, depends on the outcome of the Boards' deliberations in Phase B of the conceptual framework project.

40. Although the Boards have decided to adopt the entity perspective, this decision does not mean that they have rejected the parent company approach **in its entirety**. The parent company approach developed in practice as a means of providing useful information to one particular group of capital providers, namely the parent company's shareholders. The entity perspective has a broader focus than the parent company approach, because the objective of financial reporting under the entity perspective is to provide useful information to all capital providers. But that does not mean that the information needs of the parent company's shareholders are ignored under the entity perspective. As noted in the Exposure Draft for Phase A and its basis for conclusions, adopting the entity perspective does not preclude including in financial reports information that is primarily directed to the needs of a particular group of capital providers. (For example, in the standards recently issued on business combinations, the Boards have specified requirements to disclose the amount of non-controlling interests separately from controlling interests, and the amount of profit or loss attributable to non-controlling interests.)

41. Appendix B contains an extract from the draft Discussion Paper for Phase D, setting out a revised discussion of the parent company approach, including the implications for that

approach of the Boards' decision in Phase A to adopt the entity perspective. [Appendix B omitted from observer note].

Conclusions and Staff Recommendation

42. In developing the objective of financial reporting, the Boards deliberated the two perspectives of financial reporting. The Boards made affirmative decisions to adopt the entity perspective for the purposes of establishing the objective of financial reporting and designating the primary user group. Those decisions were affirmed during the redeliberations that led to the conclusions contained in the draft Phase A ED. The Boards' rationale for those decisions is described in the basis for conclusions that accompanies the draft Phase A ED. The latest draft of the relevant section of that basis for conclusions is attached to this memo as Appendix A. [Appendix A is omitted from observer note].

43. In contrast, the Boards have not yet completed their initial deliberations in other phases of the project, such as Phase B – Elements. As such, the staff can only speculate as to what the implications of adopting the entity perspective might ultimately be on those phases. There is no clear consensus among the staff as to what those implications will ultimately be, or whether the Board has "locked itself in" to a particular path with regard to either of those phases. The staff thinks that analysis belongs in those phases. The staff acknowledges that there is a temptation on the part of the Boards, the staff, and constituents to want to "peek ahead" and understand all of the implications that these decisions will have on future work. However, to do so impedes progress on the Phase A ED. More importantly, by peeking ahead to the implications of decisions made in Phase A, the Board runs the risk of making those Phase A decisions based on engineering a particular result downstream rather than reasoning from first principles and then building upon those principles. In addition, discussions with Board advisers to date indicate that the primary concern is the potential implications of adopting the entity perspective for the reporting entity phase of the project. Those potential implications have been considered in Phase D, as explained in Appendix B. [Appendix B is omitted from observer note.]

44. The staff recommends that the decisions made to date by the Boards regarding the perspective of financial reporting be communicated to constituents via the basis for conclusions accompanying the Phase A ED. The staff further recommends that implications of those decisions on future phases be analyzed in due course in those phases and communicated to

constituents at that time. The staff thinks that a full examination of the implications of perspective on all future phases of the framework and on future standard-setting initiatives cannot and need not be conducted before finalizing and publishing the Phase A ED for public comment. Accordingly, the staff recommends that the Boards proceed with publication of the Phase A ED without delay.

45. The staff has modified the draft basis for conclusions of the Phase A ED to explain the decisions that have been reached with regard to perspective as well as the implications that have not yet been deliberated, along with the plan for deliberating those implications in the future. The relevant section of that draft is attached to this memo as Appendix A. The staff has also modified its draft of the Phase D preliminary views document to build off of the framework developed in Phase A. The relevant section of the draft of the Phase D document is attached to this memo as Appendix B. [Appendices A and B are omitted from observer note.]

Question for the Boards

46. Do the Boards agree with the staff's recommendations for addressing the issue of perspective in the conceptual framework project? If not, what approach would the Boards prefer?