STAFF PAPER

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IASB Meeting

Project	**Conceptual Framework**
Paper topic	Feedback summary—Chapter 3—*Financial statements and the reporting entity*

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Purpose of paper

1. This paper summarises the feedback received on the following sections of Chapter 3−*Financial statements and the reporting entity* of the Exposure Draft *Conceptual Framework for Financial Reporting* ('the Exposure Draft'):

    (a) the description of a reporting entity (paragraphs 3.11-3.12);

    (b) the boundary of a reporting entity (paragraphs 3.13-3.25);

    (c) the going concern assumption (paragraph 3.10); and

    (d) the perspective from which financial statements are prepared (paragraph 3.9).

2. Paragraphs 3.2-3.8 of the Exposure Draft discuss the role of financial statements. Feedback on the role of financial statements is discussed in AP 10J—*Feedback summary—Presentation and disclosure*.

3. This paper provides a high-level summary of the comments received. Where appropriate, we will provide a more detailed breakdown of the comments for future meetings.

Summary of key messages

4. In summary:

   (a) many support the proposals on the description and boundary of a reporting entity. However, some of those respondents think more guidance is needed;

   (b) using control to determine the boundaries of a reporting entity is generally welcomed. However, some respondents found the terms ‘direct control’ and ‘indirect control’ confusing, noting that the terms are not used in IFRS 10 *Consolidated Financial Statements*;

   (c) some respondents support the discussion of combined financial statements but asked for more guidance on when preparing those statements might be appropriate;

   (d) many respondents disagreed that consolidated financial statements are more likely to provide useful information than unconsolidated financial statements;

   (e) many of those who commented on the going concern assumption agreed with its proposed description; and

   (f) views were mixed about the statement in the Exposure Draft that financial statements are prepared from the perspective of the entity as a whole, instead of from the perspective of any particular group of investors, lenders or other creditors.

Structure of paper

5. This paper is structured as follows:

   (a) description of the reporting entity (paragraphs 6–17);

   (b) boundary of the reporting entity (paragraphs 18–38);

   (c) the going concern assumption (paragraphs 39–40); and

(d) the perspective from which financial statements are prepared (paragraphs 41–47).

Description of the reporting entity

Exposure Draft proposals (Paragraphs 3.11–3.12 and BC3.5–BC3.9)

6. The Exposure Draft describes a reporting entity as an entity that chooses, or is required, to prepare general purpose financial statements. Further, it states that a reporting entity does not have to be a legal entity and can comprise only a portion of an entity or two or more entities.

7. In developing the proposals in the Exposure Draft, the Board noted that it has no authority to determine who must or should prepare general purpose financial statements and, hence, decided to provide a general description of a reporting entity rather than state who must or should prepare general purpose financial statements.

8. The Board asked whether stakeholders agreed with the proposed description of the reporting entity.

Summary of feedback

9. Approximately half of the respondents commented on the proposed description of a reporting entity.

10. Many supported the Board's proposal to describe a reporting entity as an entity that chooses, or is required, to prepare general purpose financial statements. A few highlighted that the description is in line with the objective of financial reporting as described in Chapters 1 and 2. However, one standard-setter expressed the view that the description of a reporting entity should directly link to the objective of financial reporting.

11. Although supporting the description of a reporting entity, many of the respondents requested more guidance. Some respondents asked for clarification about when a portion of an entity or an entity that is not a legal entity can be a reporting entity. In addition, some respondents encouraged the Board to provide examples of:

(a) reporting entities that are not legal entities; and

(b) different types of legal entities that are reporting entities such as corporations or trusts.

12. A few respondents, mainly accounting firms, asked for a definition of an 'entity' noting that this term is widely used in existing IFRS Standards but is nowhere clearly defined.

13. Some respondents expressed the view that the definition of a reporting entity is circular:

> The definition of a reporting entity is not particularly useful, and it is indeed somewhat circular in that it refers to 'general purpose financial statements' whose definition in turn refers to reporting entities, (…).*The Institute of Chartered Accountants in England and Wales (ICAEW)*

14. Some respondents, mainly standard-setters and accounting firms, suggested that the description of a reporting entity could be improved if the *Conceptual Framework* included material from the Exposure Draft *Conceptual Framework for Financial Reporting—The Reporting Entity* that was issued in 2010 ('the Reporting Entity Exposure Draft').

> The Basis for Conclusions notes that the 2010 Reporting Entity Exposure Draft stated inter alia that a reporting entity should be 'a circumscribed area of economic activity' and that its 'economic activities can be objectively distinguished from those of other entities and from the economic environment in which the entity exists'. It would be helpful to include these points as it would imply that, where these conditions are not met, the financial statements may not be reliable or representationally faithful. *Financial Reporting Council (FRC)*

15. One standard-setter accepted that the Board does not have the authority to determine who must or should prepare general purpose financial statements, but encouraged the Board to identify the types of entities that it has in mind when it develops IFRS Standards. Another standard-setter expressed the view that the

Conceptual Framework should state explicitly that a reporting entity is a for-profit entity.

16. One standard-setter expressed the view that the requirement in IFRS 10 for an entity to prepare consolidated financial statements is inconsistent with the statement in the Basis for Conclusions of the Exposure Draft that the Board has no authority to determine who must or should prepare general purpose financial statements.

17. Only a few respondents disagreed with the proposed description of a reporting entity. Those respondents stated that the description of a reporting entity is too broad and asked for a narrower definition. One academic organisation stated that the description of a reporting entity has no conceptual element, ie it appeared to them that financial statements could be prepared for any collection of assets and liabilities that preparers deem useful to investors, and that give a faithful representation of what they purport to represent.

Boundary of the reporting entity

Exposure Draft proposals (Paragraphs 3.13–3.25 and BC3.10–BC3.17)

18. The Exposure Draft proposes that when one entity (the parent) has control over another entity (the subsidiary), the boundary of the reporting entity can be determined by either direct control only (leading to unconsolidated financial statements) or by direct and indirect control (leading to consolidated financial statements).

19. The Exposure Draft also states that financial statements are sometimes prepared for two or more entities that do not have a parent-subsidiary relationship and refers to such financial statements as combined financial statements.

20. The Exposure Draft further states that if a reporting entity is not a legal entity, the boundary of the reporting entity needs to be set in such a way that the financial statements:

    (a) provide the relevant financial information needed by those existing and potential investors, lenders and other creditors who rely on the financial statements; and

(b) faithfully represent the economic activities of the entity.

21. The Exposure Draft also states that:

(a) in general, consolidated financial statements are more likely to provide useful information to users of financial statements than unconsolidated financial statements;

(b) consolidated financial statements of the parent entity are not intended to provide information to users of the subsidiary's financial statements; and

(c) if an entity chooses, or is required, to prepare unconsolidated financial statements, it would need to disclose how users may obtain the consolidated financial statements.

Summary of feedback

22. Approximately half of the respondents to the Exposure Draft commented on the discussion of the boundary of a reporting entity.

23. More than half of those respondents supported the Board's proposals. However, most of them encouraged the Board to provide more guidance on how to identify the boundary of a reporting entity, or to include additional guidance on specific issues, for example on carve-out statements or combined financial statements.

24. One preparer did not see the need for guidance on the boundary of a reporting entity in the *Conceptual Framework* because in most jurisdictions the preparation of consolidated financial statements is required by local commercial law.

25. Respondents also commented on the following:

(a) the use of control to define the boundary of a reporting entity (paragraphs 26-31);

(b) the discussion of combined financial statements (paragraphs 32-33); and

(c) the discussion of consolidated and unconsolidated financial statements (paragraphs 34-38).

Control

26. Some respondents, mainly standard-setters and academics, stated that they agree with the proposal to use control to determine the boundaries of a reporting entity. A few of those respondents expressed the view that the proposals were consistent with IFRS 10. However, a few encouraged the Board to provide a better explanation of why the boundary of a reporting entity is based on control.

27. One academic organisation stated that using ‘control’ to determine the boundaries of a reporting entity was appropriate. However, they noted that this notion is already included in IFRS 10 and expressed the view that the *Conceptual Framework* should provide a more conceptual basis for the requirements of IFRS 10.

28. One accounting firm did not agree that control should be used to define the boundaries of the reporting entity. They stated that there may be situations when, to provide useful information to users of financial statements, the boundary of a reporting entity should include entities that are not controlled by the reporting entity. Hence, this respondent suggested that the Board should develop the discussion on the boundary of a reporting entity further before adding a section on this topic to the *Conceptual Framework*.

29. Some respondents expressed the view that the notion of control in the Exposure Draft is not aligned to the notion of control used in IFRS 10. In particular, some stated that it appears counterintuitive that the Exposure Draft uses the terms ‘direct control’ and ‘indirect control’ whereas IFRS 10 does not.

30. Some respondents found the terms ‘direct control’ and ‘indirect control’ confusing because they are used in the Exposure Draft differently from how the terms are normally used. For example, one regulator expressed the view that the term ‘direct control’ refers to the relationship between a subsidiary and its immediate parent and the term ‘indirect control’ refers to a relationship between a subsidiary that is controlled by the ultimate parent via an intermediate parent company. A broad mix of respondents suggested clarifying these terms.

31. Some respondents also felt that the Exposure Draft should refer to notions such as joint control, significant influence and joint operations. A few respondents suggested

including some material from the Reporting Entity Exposure Draft on joint control and significant influence.

Combined financial statements

32. Some respondents find it helpful that the Exposure Draft acknowledges in paragraph 3.17 the existence of combined financial statements. However, many of them requested more guidance on when preparing combined financial statements might be appropriate.

33. Respondents also expressed the following views on combined financial statements:

    (a) One accountancy body wanted better linkage between the description of a reporting entity in paragraphs 3.11-3.12 and the paragraphs that follow describing combined financial statements.

    (b) Some respondents would like the Board to clarify that combined financial statements can be compliant with IFRS Standards and encouraged the Board to provide more guidance on this or include the guidance in an IFRS Standard that would also address carve-out statements.

    (c) One accounting firm disagreed with the proposals because it was not sufficiently clear if carve-out statements would be considered general purpose financial statements.

    (d) One regulator felt that the Exposure Draft should describe situations in which combined financial statements might provide more useful information than consolidated financial statements.

    (e) A few respondents expressed the view that some material on the discussion of combined financial statements that was included in the Reporting Entity Exposure Draft should have been included in the Exposure Draft.

Consolidated and unconsolidated financial statements

34. Many of those who commented disagreed with the statement in the Exposure Draft that consolidated financial statements are more likely to provide useful information than unconsolidated financial statements. They argued that the usefulness of financial statements depends on the user's needs and that consolidated and unconsolidated

financial statements are generally prepared to serve different purposes. Hence, they suggested deleting that paragraph.

35. Some respondents disagreed with the statement in paragraph 3.24 of the Exposure Draft that consolidated financial statements of the parent are not intended to provide information to users of a subsidiary's financial statements. One user group expressed the view that both the financial statements of a subsidiary and the consolidated financial statements of the parent are crucial to developing an adequate assessment of the risks associated with that subsidiary. One accounting firm also questioned the statement in paragraph 3.24. Whilst it agreed that investors and analysts of a subsidiary primarily look to the subsidiary's financial statements for information, it noted that consolidated financial statements can provide important contextual information. Two standard-setters encouraged the Board to delete paragraph 3.24, because they deemed it too detailed for a *Conceptual Framework*. However, one user of financial statements welcomed the statement that investors should get information through the financial statements of the subsidiary, and not through the parent's consolidated financial statements.

36. Some respondents welcomed the statement in paragraph 3.25 of the Exposure Draft that an entity can choose, or be required, to prepare unconsolidated financial statements in addition to its consolidated statements. However, many of those respondents think that the requirement to disclose how those unconsolidated financial statements can be obtained does not belong in the *Conceptual Framework* but is, instead, a Standards-level issue.

37. One academic noted that the Exposure Draft does not define 'consolidated'. He stated that, in the absence of a definition, the interaction between the *Conceptual Framework* and IFRS 3 *Business Combinations* appeared circular—if you have control then consolidate, and consolidate if you have control.

38. Some also suggested that there are inconsistencies between the wording used in the Exposure Draft and that used in IAS 27 *Separate Financial Statements*. This IFRS Standard uses the term 'separate financial statements', whereas the Exposure Draft refers to 'unconsolidated financial statements'. Furthermore, one standard-setter stated that IAS 27 applied to more types of financial statements than the Exposure Draft explicitly mentions (for example, the financial statements of an entity that does

not have a subsidiary but has an equity-accounted investment) and would like the Board to clarify if such statements are 'unconsolidated financial statements'.

Going concern

Exposure Draft proposals (paragraphs 3.10 and BC3.4)

39. The Exposure Draft brought forward the going concern assumption largely unchanged from the existing *Conceptual Framework*. The Board only suggested an editorial change to align the wording in the Exposure Draft to both IAS 1 *Presentation of Financial Statements* and IAS 10 *Events after the Reporting Period* that use 'cease trading' instead of 'curtail materially the scale of its operations'. Consequently, the Board did not ask a specific question on the going concern assumption.

> 3.10 This [draft] *Conceptual Framework* is based on the assumption that the reporting entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or cease trading. If such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed in the financial statements.

Summary of feedback

40. Some respondents commented on the going concern assumption, most of them agreeing with the proposal. A few accountancy bodies who supported the proposed description asked the Board to provide more guidance for cases in which the entity is no longer a going concern. In particular, they asked the Board to clarify the terms 'different basis' and 'foreseeable future'. One standard-setter disagreed with the proposal because they believe the proposed wording is weaker than the wording in the existing *Conceptual Framework.*

The perspective from which financial statements are prepared

Exposure Draft proposals (paragraphs 3.9 and BC3.3)

41. The Exposure Draft states that financial statements are prepared from the perspective of the entity as a whole instead of from the perspective of any particular group of investors, lenders or other creditors.

42. The Basis for Conclusions on the Exposure Draft noted that this statement is consistent with the Board's reasoning in paragraph BC1.8 of the Basis for Conclusions on the existing *Conceptual Framework*.

Summary of feedback

43. Although the Exposure Draft did not include a specific question on the statement about the perspective from which the entity prepares its financial statements, some respondents commented. The responses were mixed.

44. Some of those who commented supported the statement. However, many of them asked for more guidance and explanation, for example on potential consequences.

45. Some respondents disagreed. One preparer organisation stated that the statement is ambiguous and that its intention is misleading. A few thought the statement in paragraph 3.9 of the Exposure Draft was inconsistent with the treatment of goodwill in IFRS 3.

46. One standard-setter thought the paragraph should be amended to clarify:

    (a) whether an entity should be assumed to have substance of its own separate from its owners; and

    (b) the perspective from which consolidated financial statements are prepared.

47. A few respondents asked the Board to either explain why it adopted the 'entity approach' and not the 'proprietary approach' or at least give more guidance and explanation on this matter.[1]

[1] Those approaches were suggested in the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting*.