

STAFF PAPER

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IASB Meeting

Project	Conceptual Framework		
Paper topic	Sweep issue: boundary of a reporting entity		
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Purpose of paper

1. At its September 2016 meeting, the Board tentatively decided to confirm the concepts on the boundary of the reporting entity proposed in the Exposure Draft *Conceptual Framework for Financial Reporting* (Exposure Draft). The Board also directed the staff to clarify in drafting how the proposed concepts place appropriate limitations on what may constitute a reporting entity in situations when the reporting entity is not a legal entity.
2. This paper:
 - (a) presents the clarifications developed by the staff in drafting; and
 - (b) asks whether the Board is satisfied that those clarifications reflect the tentative decision made at the September 2016 meeting.
3. Appendix A provides illustrative drafting of those clarifications. It is provided for information only. The staff do not plan to discuss detailed drafting points at the meeting.

Background

4. The Exposure Draft proposed that:

- (a) financial statements provide information about the assets, liabilities, equity, income and expenses generated by the set of economic activities that lie within the boundary of the reporting entity;
 - (b) financial statements are sometimes prepared for two or more entities that do not have a parent-subsiidiary relationship;
 - (c) 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:
 - (i) provide the relevant financial information needed by those existing and potential investors, lenders and other creditors who rely on the financial statements; and
 - (ii) faithfully represent the economic activities of the entity.
 - (d) for financial statements to give a faithful representation of the economic activities of the reporting entity, the financial statements need to describe the set of economic activities included within the reporting entity.
5. Approximately half of the respondents to the Exposure Draft commented on the discussion of the boundary of a reporting entity. More than half of those respondents supported the discussion of the boundary of a reporting entity. However, most of those respondents requested more guidance on how to identify that boundary. In particular, they asked the Board to clarify how to identify the boundary of a reporting entity that comprises a portion of an entity, or two or more entities that are not bound by a parent-subsiidiary relationship. Some of those respondents expressed a concern that the notion of a ‘reporting entity’ is too broad and that financial statements could be prepared for any collection of assets and liabilities and provide an incomplete and therefore misleading information.
6. September 2016 Agenda Paper 10B *Reporting Entity* acknowledged those concerns. However, that paper argued that the proposed concepts would place appropriate limitations on what may constitute a reporting entity and would not allow financial statements to be prepared for an incomplete set of economic activities. This is because the proposed concepts:
- (a) refer to a *set of economic activities* that generate assets, liabilities, equity, income and expenses;

- (b) require the boundary of the reporting entity to be set in way that the financial statements:
 - (i) provide relevant information to investors, lenders and other creditors of that reporting entity; and
 - (ii) faithfully represent what they purport to represent.
 - (c) set out the need for financial statements to describe the set of economic activities included within the reporting entity.
7. The staff argued that financial statements prepared for a collection of assets and liabilities that are not bound together by a set of economic activities would not provide relevant information to users of financial statements and would not faithfully represent what they purport to represent. They would therefore not be in compliance with the proposed concepts. Accordingly, the staff recommended that the Board confirm the proposed concepts on the boundary of the reporting entity set out in paragraphs 3.13 and 3.16–3.18 of the Exposure Draft and summarised in paragraph 4 of this paper.
8. As stated in paragraph 1 of this paper, the Board tentatively agreed with the staff recommendation to confirm the proposed concepts but directed the staff to clarify in drafting how those concepts place appropriate limitations on what may constitute a reporting entity in situations when the reporting entity is not a legal entity.

Staff discussion and proposed clarifications

9. The feedback received on the Exposure Draft as well as at previous stages of the Conceptual Framework project suggests that the main concern about the boundary of reporting entity that is not a legal entity relates to preparation of financial statements for an incomplete set of economic activities. Some commentators expressed concerns that the proposal that the financial statements should describe the set of economic activities included within the reporting entity would not sufficiently restrict which entities can be a reporting entity. For example, they argued that a reporting entity that is not a legal entity could exclude its share of overheads from its financial statements as long as it describes the set of economic activities that have been included in the financial statements. In addition, they argued that there may be difficulties in

identifying the claims that should be included in financial statements if the reporting entity is not a legal entity. Those concerns would also apply if the reporting entity were a portion of a group of entities bound together by a parent-subsidary relationship.

10. In the light of the above concerns, the staff have considered the implications of applying the fundamental qualitative characteristic of faithful representation in determining the boundary of a reporting entity as proposed in the Exposure Draft and confirmed by the Board at its September 2016 meeting. In that context, a faithful representation would be provided only if the set of economic activities included within the boundary of a reporting entity is complete, neutral and free from error. Accordingly, the boundary of a reporting entity cannot be set in a way that artificially creates an incomplete and favourable (or unfavourable) picture of economic activities that belong to that entity.
11. Further, applying the fundamental qualitative characteristic of relevance in determining the boundary of a reporting entity would require that information provided in the reporting entity's financial statements is capable of making a difference in the decisions made by the users of those financial statements about providing resources to the entity. To achieve this, the boundary of the reporting entity must be set in a way that the information provided has predictive value, or confirmatory value, or both. Omitting relevant items from the reporting entity (or including irrelevant items) would not result in information that has predictive or confirmatory value or both and would therefore not comply with the revised *Conceptual Framework*.
12. In the light of the above discussion, the staff conclude that spelling out the implications of applying relevance and faithful representation discussed in paragraphs 10-11 above in discussing the boundary of reporting entity that is not a legal entity would help to address concerns about providing an incomplete and misleading information about such an entity. To avoid excessive detail, the *Conceptual Framework* should not provide specific guidance on how to determine whether the boundary of a reporting entity is set in a way that achieves a complete and neutral depiction. Illustrative drafting for those clarifications is provided in Appendix A.

Question for the Board

Is the Board satisfied that the clarifications developed by the staff in drafting reflect the tentative decision made at the September 2016 IASB meeting and reproduced in paragraph 1 of this paper? If not, what do you propose instead?

Appendix A—Illustrative drafting of clarifications on determining the boundary of reporting entity that is not a legal entity

If a reporting entity is not a legal entity, the boundary of the reporting entity is set in such a way that the financial statements:

- (a) provide relevant information to investors, lenders and other creditors of the reporting entity. Relevant information can be used by users of financial statements of the reporting entity to predict future outcomes or provides feedback about previous evaluations or both (see paragraphs 2.8-2.9).
- (b) faithfully represent economic resources and claims, and changes in those resources and claims, generated by the set of the reporting entity's economic activities. Faithful representation requires that the set of economic activities included within the boundary of the reporting entity is complete and results in information that is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated (see paragraphs 2.16-2.17).

A faithful representation of economic resources and claims, and changes in those resources and claims, generated by a set of economic activities includes a description of that set. That description is particularly important if the reporting entity is not a legal entity.