

[Meeting of National Standard Setters, Seoul, April 2010, Supplement to Paper 9]

## Conceptual Framework: The Reporting Entity

This paper is provided for information and out-of-session discussion and reflection, rather than for discussion during the meeting of National Standard Setters. During the session on Agenda Item 9, time will be provided for meeting participants to ask the Australian participants questions about this information paper. The Australian participants are also available to answer questions out of session.

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### Introduction

1. A generally agreed purpose of the concept of a reporting entity is to determine the substance of an entity that prepares general purpose financial reports (GPFs). This includes identifying the boundaries of such an entity, and the circumstances in which consolidated financial statements should be prepared. This purpose is reflected in the IASB's and FASB's Exposure Draft ED/2010/2 *Conceptual Framework for Financial Reporting: The Reporting Entity* (March 2010).
2. The IASB-FASB ED does not provide much background on the underlying reasons why the Boards propose this purpose of a reporting entity concept. Nevertheless, sound reasons that could be ascribed to this purpose are to provide a conceptual basis for ensuring that (a) entities preparing GPFs have economic substance, and (b) the GPFs of those entities have appropriate boundaries. In relation to the 'boundaries' aspect, it is important that GPFs are complete (that is, they include all of the entity's economic resources and obligations, and changes in them) while excluding items that do not belong to the entity.
3. The issue explored in this paper is whether the concept of a reporting entity should also serve other purposes.

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<sup>1</sup> The views in this paper are those of the author. In relation to existing and proposed pronouncements mentioned herein, these views do not necessarily represent the views of the IASB, FASB or AASB and do not preclude other interpretations of those pronouncements.

4. To explore this issue, this paper considers the experience in Australia, where the concept of a reporting entity in Statement of Accounting Concepts SAC 1 *Definition of the Reporting Entity* was developed with a broader purpose in mind. This paper poses some questions for consideration, regarding possible purposes of a reporting entity concept (which would not necessarily be limited to the purpose identified in Australian Statement SAC 1).

**ED/2010/2 Conceptual Framework for Financial Reporting: The Reporting Entity**

5. Before examining Australian Statement SAC 1, this paper notes some key aspects of the IASB-FASB ED on The Reporting Entity. The ED describes a ‘reporting entity’ as:

“a circumscribed area of economic activities whose financial information has the potential to be useful to existing and potential equity investors, lenders and other creditors who cannot directly obtain the information they need in making decisions about providing resources to the entity and in assessing whether management and the governing board of that entity have made efficient and effective use of the resources provided” (paragraph RE2).

6. The ED, in effect, explains the phrase ‘a circumscribed area of economic activities’ in the abovementioned description of a ‘reporting entity’ as follows: “those economic activities can be objectively distinguished from those of other entities and from the economic environment in which the entity exists” (paragraph RE3(b)).
7. The IASB-FASB ED adopts control as the basis for defining the boundaries of a group reporting entity. Specifically, it proposes that, if an entity that controls one or more entities prepares financial reports, it should present consolidated financial statements (paragraph RE8).
8. Adopting the concept of control as the basis for determining the boundaries of a group reporting entity means that the manner in which a group is structured legally is irrelevant to how a group reporting entity is identified. This is discussed in paragraphs BC18 – BC22 of the Basis for Conclusions on the IASB-FASB ED.

## **Link with the Objective**

9. The IASB-FASB ED on The Reporting Entity explicitly links the concept of the reporting entity with the objective of general purpose financial reporting. It does this in the following ways:
  - (a) the Introduction paragraph (RE1) says the reporting entity concept is intended to further the ‘objective’;
  - (b) paragraph RE2 describes a reporting entity as a circumscribed area of economic activities whose financial information has the potential to satisfy the objective of financial reporting<sup>2</sup> for users<sup>3</sup> who cannot directly obtain the information they need; and
  - (c) Basis for Conclusions paragraph BC4 says a reporting entity needs to be identified to achieve the ‘objective’, which refers to a reporting entity.
10. The implications of this explicit link between the concept of the reporting entity and the ‘objective’ in the IASB-FASB ED are that:
  - (a) the concept of a reporting entity is restricted to entities about which information has the potential to satisfy the objective of financial reporting; and
  - (b) the concept of a reporting entity is focused on meeting the objective in relation to users who cannot directly obtain the information they need (hereinafter, ‘dependent users’). Therefore, it excludes entities with only users who can directly obtain the information they need. Examples of such entities are some closely-held private businesses.

## **Australian Statement of Accounting Concepts SAC 1 Definition of the Reporting Entity**

11. In August 1990, the Australian standard setter (the Australian Accounting Research Foundation) issued SAC 1. Upon adoption of IFRSs and the IASB *Framework* (with

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<sup>2</sup> Paragraph RE2 does not explicitly refer to satisfying the ‘objective’. Instead, it repeats the words included in the description of the ‘objective’ in paragraph RE1, namely, ‘to be useful in making decisions about providing resources to the entity and in assessing whether the management and the governing board of that entity have made efficient and effective use of the resources provided’.

limited modifications for not-for-profit entities) in Australia with effect from 2005, SAC 1 was retained (by cross-reference from the *Framework*) to define the concept of a reporting entity.

12. SAC 1 defines ‘entity’ and ‘reporting entities’ as follows:

“‘entity’ means any legal, administrative, or fiduciary arrangement, organisational structure or other party (including a person) having the capacity to deploy scarce resources in order to achieve objectives” (paragraph 6); and

“Reporting entities are all entities (including economic entities) in respect of which it is reasonable to expect the existence of users dependent on general purpose financial reports for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources” (paragraph 40).

13. SAC 1 explains its purpose as follows:

“The purpose of this Statement is to define and explain the concept of a reporting entity and to establish a benchmark for the minimum required quality of financial reporting for such an entity.<sup>4</sup> This Statement outlines the circumstances in which an entity or economic entity should be identified as a reporting entity. It also outlines the criterion for determining, for financial reporting purposes, the boundaries of a reporting entity.” (paragraph 3)

“In relation to the benchmark for the minimum required quality of financial reporting, this Statement specifies that reporting entities shall prepare general purpose financial reports and that these are reports which comply with Statements of Accounting Concepts and Accounting Standards.”<sup>5</sup> (paragraph 4)

<sup>3</sup> In this paper, ‘users’ is used as an abbreviation of ‘existing and potential equity investors, lenders and other creditors’. No difference in meaning is intended.

<sup>4</sup> “In the Discussion section of this Statement, the term ‘entity’ should be read as referring also to an economic entity, except where the narrower meaning of the term is specified.”

<sup>5</sup> In 1995, the Australian professional accounting bodies removed the mandatory status of Statements of Accounting Concepts for members of those bodies.

“If Statements of Accounting Concepts and Accounting Standards are to be effective in ensuring adequate disclosure of information to users of general purpose financial reports, it is necessary that all those entities which should report, do report. In addition, if the regulation of general purpose financial reporting is to be developed on a rational and efficient basis, it is equally important that those entities for which there is no justification to report are not required to report.” (paragraph 7)

14. Like the IASB-FASB ED on The Reporting Entity, SAC 1 explicitly links the concept of the reporting entity with the objective of general purpose financial reporting, with the same implications as those identified in paragraph 10 in respect of the IASB-FASB ED.
15. Like the IASB-FASB ED, SAC 1 adopts control as the basis for defining the boundaries of a group reporting entity. This complements the use of control in the definition of an asset. Therefore, regardless of whether separate entities exist, and thus whether it is necessary to prepare consolidated financial statements, the boundaries of the reporting entity will be the same. This statement is based on one condition, which is that the recognition criteria for the elements of financial statements are consistent with the criteria for determining the boundaries of the consolidated financial statements. If they are, then it makes no difference whether economic resources are controlled directly, or indirectly through a controlled entity.
16. SAC 1 seems to go further than the IASB-FASB ED in applying the concept of control. This is discussed in paragraph 33 below.

#### **Key difference between the IASB-FASB ED and SAC 1**

17. The key difference between the IASB-FASB ED and SAC 1 is that SAC 1 specifies that reporting entities shall prepare GPFRs. In other words, not only does SAC 1 provide a conceptual basis for ensuring that entities preparing GPFRs have economic substance and that their GPFRs have appropriate boundaries, but it also specifies the characteristics of entities that should prepare GPFRs.

18. The Australian standard setting boards who developed SAC 1<sup>6</sup> took the view that addressing the information needs of those who cannot command the presentation of particular information through their position as management or through contractual arrangement falls within the domain of public policy formulation. Providing useful information to these parties assists the functioning of capital markets and other markets in the economy. Those boards considered that a logical extension of specifying, in concept, the information content of financial reports for those who cannot command the presentation of particular information to them (that is, defining the nature of a public good) is specifying, in concept, which entities should provide that information (public good).
19. By specifying the characteristics of entities that should prepare GPFRs, SAC 1 also provided a conceptual basis for identifying entities that should *not* be required to prepare GPFRs. Thus, it provided a coherent basis for significantly reducing the ‘accounting standards overload’ that existed at the time, where various entities were required to prepare GPFRs complying with all Australian Accounting Standards despite not having users dependent on those GPFRs for making and evaluating resource allocation decisions (including assessing the accountability of management for its use of the entity’s resources).
20. Currently, the reporting entity concept is given legal force directly in Australian Accounting Standards. The application clauses of those Standards specify that those Standards must be applied by reporting entities in their GPFRs.
21. Some commentators argue that accounting standards should not specify which entities should prepare GPFRs, because doing so falls within the role of legislators/regulators responsible for regulating different sectors of the economy. However, the reporting entity concept does not need to be mandated by standard setters. It can simply provide guidance for consideration by legislators/regulators in making their own assessments of which entities should be required to prepare GPFRs.

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<sup>6</sup> The Accounting Standards Review Board and the Public Sector Accounting Standards Board.

22. Important reasons why standard setters should consider setting out a concept of a reporting entity that identifies the principle for identifying which entities should prepare GPFs, and characteristics of such entities, are:
- (a) it provides assurance that the basis for determining which entities should prepare GPFs will be linked with the objective of GPFs; and
  - (b) it provides leadership on the issue, reducing the risk that decisions about which entities are required to prepare GPFs will be *ad hoc* in nature. In this sense, by setting out the concept for determining which entities should prepare GPFs, the standard setter is not a hostage to different perspectives of legislators/regulators in different sectors and industries regarding which entities should prepare GPFs. (In some sectors or industries, it is debatable whether much attention is given to whether entities with particular characteristics should be required to prepare GPFs. Examples are privately owned companies with market dominance in economically key industries, religious organisations, independent schools and shared title real estate arrangements such as condominiums and strata title plans.)
23. An additional reason for the IASB to consider providing guidance on the characteristics of entities that should prepare GPFs complying with IFRSs is that, as a global standard setter, it can provide conceptual guidance to inform regulatory decisions made at a jurisdictional level. This can reduce the likelihood of each jurisdiction ‘reinventing the wheel’ by developing its own criteria for determining which entities should prepare GPFs.
24. The IASB and FASB previously decided not to define a reporting entity as an entity with specified characteristics, because they were concerned that doing so could preclude entities without those characteristics from preparing financial statements that purport to be GPFs prepared in accordance with IFRSs or US GAAP. However:
- (a) the IASB-FASB ED proposes to restrict the concept of a reporting entity by specifying that it has objectively distinguishable economic activities (paragraphs RE3(a) and (b)); and

(b) in Australia, a concept of a reporting entity that identifies the characteristics of entities that should prepare GPFs has not been an impediment to other entities preparing IFRS-compliant GPFs. The application clauses of Australian Accounting Standards specify that the Standards apply to general purpose financial statements of each reporting entity *and* to financial statements that are, or are held out to be, general purpose financial statements.

25. SAC 1 is not the only Concepts Statement to indicate that reporting entities should prepare GPFs. The UK Accounting Standards Board's *Statement of Principles for Financial Reporting* (December 1999), Chapter 2, *The Reporting Entity*, states that:

“It is essential that entities that ought to prepare and publish financial statements do, in fact, do so. ...” (paragraph 2.1)

“For the preparation of financial statements to be justified in any particular case, there needs to be a legitimate demand for the information that the financial statements would provide. That means, inter alia, that the information provided by the financial statements will need to be useful and that the benefits to be derived by providing the financial statements will need to exceed the costs of doing so.” (paragraph 2.2)

“... if the information provided by the financial statements is to be useful, the entity that is the subject of the financial statements (the reporting entity) needs to be a cohesive economic unit. This ensures accountability—the reporting entity is held to account for all of the things it can control—and it gives the reporting entity a determinable boundary—because activities and resources are either within its control or outside its control.” (paragraph 2.3)

#### Primary characteristics of entities that should prepare GPFs, as identified in SAC 1

26. SAC 1 notes that in many instances, it will be readily apparent whether, in relation to an entity, users exist who are dependent on general purpose financial reports as a basis for making and evaluating resource allocation decisions and assessing the accountability of management. For those entities in respect of which it is not readily apparent whether such dependent users exist, SAC 1 identifies the following primary characteristics of entities that should prepare GPFs:

- (a) separation of management from economic interest;
- (b) economic or political importance or influence; and
- (c) financial characteristics, such as the amount of resources controlled to provide goods and services and the amount of indebtedness.

27. SAC 1 explains those characteristics as follows:

*“Separation of management from economic interest*

The greater the spread of ownership/membership and the greater the extent of the separation between management and owners/members or others with an economic interest in the entity, the more likely it is that there will exist users dependent on general purpose financial reports as a basis for making and evaluating resource allocation decisions.” (paragraph 20)

*“Economic or political importance or influence*

Economic or political importance/influence refers to the ability of an entity to make a significant impact on the welfare of external parties. The greater the economic or political importance of an entity, the more likely it is that there will exist users dependent on general purpose financial reports as a basis for making and evaluating resource allocation decisions. Reporting entities identified on the basis of this factor are likely to include organisations which enjoy dominant positions in markets and those which are concerned with balancing the interests of significant groups, for example, employer/employee associations and public sector entities which have regulatory powers.” (paragraph 21)

*“Financial characteristics*

Financial characteristics that should be considered include the size (for example, value of sales or assets, or number of employees or customers) or indebtedness of an entity. In the case of non-business entities in particular, the amount of resources provided or allocated by governments or other parties to the activities conducted by the entities should be considered. The larger the size or the greater the indebtedness or resources allocated, the more likely it is that there will exist users dependent on

general purpose financial reports as a basis for making and evaluating resource allocation decisions.” (paragraph 22)

28. SAC 1 emphasises the indicative nature of these characteristics and that they are not the only characteristics that will be relevant in determining whether, in a particular circumstance, an entity should prepare GPFs.

**Question 1 (not for discussion in the meeting of National Standard Setters)**

*This question assumes it is agreed that the concept of a reporting entity should determine the substance of an entity that prepares GPFs and thus identify the boundaries of such an entity. The question is:*

Should the concept of a reporting entity also specify the following matters:

- (a) the principle for identifying entities that should prepare GPFs; and
- (b) the characteristics of entities that should prepare GPFs?

**Other Issues**

**Differences between the IASB-FASB ED and SAC 1 regarding the concept of an entity**

29. SAC 1 appears to place greater emphasis on the concept of an entity than does the IASB-FASB ED. As noted in paragraph 12, SAC 1 defines an ‘entity’ as “any legal, administrative, or fiduciary arrangement, organisational structure or other party (including a person) having the capacity to deploy scarce resources in order to achieve objectives”.
30. The IASB-FASB ED does not include a definition or description of an entity. This may seem unimportant, because the IASB-FASB ED specifies that a reporting entity has economic activities that can be objectively distinguished from economic activities of other entities and from the economic environment in which the entity exists (paragraph RE3).
31. However, the definition of an entity in SAC 1 seems more restrictive than the abovementioned limitation in the IASB-FASB ED. ‘Having the capacity to deploy

scarce resources in order to achieve objectives' is, in substance, having control. Therefore, the SAC 1 definition of an 'entity' requires economic activities, a management, *and includes all economic activities controlled by that management*. In contrast, any set of objectively distinguishable economic activities (which may be a component of an entity as defined in SAC 1) could qualify as a reporting entity under the IASB-FASB ED, provided that financial information about those activities is potentially useful to dependent users. For example, it would appear that a collection of assets composing a business unit that could be sold separately (such as a hotel and associated operating licence) could qualify as a reporting entity under the IASB-FASB ED. This interpretation seems consistent with paragraph RE6 of that ED, which refers to a portion of an entity, such as a branch or a division, potentially qualifying as a reporting entity.

32. AASB staff are concerned that a clear distinction does not appear to have been made in the IASB-FASB ED between entities and groups of assets of potential interest to users. If any objectively distinguishable set of economic activities could be regarded as a reporting entity if a dependent user (including a single potential equity investor) is interested in information about them, a reporting entity that is a component ('portion') of an entity could be identified on any basis consistent with an individual user's information needs. Given that an entity may encompass numerous objectively distinguishable sets of economic activities, and different users may have different interests in particular sets of economic activities, the implications of paragraph RE6 are that the boundaries of a reporting entity may be almost indeterminate, especially because the intentions of potential investors would often be unknowable.
33. In addition, identifying portions of entities as potential reporting entities seems inconsistent with the control criterion proposed in the IASB-FASB ED for identifying the boundaries of a *group* reporting entity (in paragraph RE8). In other words, it implies control determines the boundaries of group reporting entities but not necessarily individual reporting entities. This contrasts with SAC 1, under which the boundaries of the reporting entity will be the same regardless of the structure of its components (in other words, under SAC 1, the boundaries of a reporting entity will be the same regardless of whether the reporting entity is comprised of separate entities, and thus it is necessary to prepare consolidated financial statements, or is comprised

of a single entity). Under any structure, the boundaries of the reporting entity are determined by control under SAC 1.

34. The SAC 1 definition of an entity, while constraining the identification of reporting entities, does not preclude the reporting of information about business units within a reporting entity. Rather, such information would be treated as a matter of display about components of a reporting entity, with such components identified on the basis of the information needs of dependent users.
35. An implication of the principle in SAC 1 that the boundaries of all reporting entities are based on control is that neither a controlling entity nor a controlled entity (including a controlled entity that is an intermediate controlling entity within a group) would be an entity in its own right. However, information about a controlling entity or a controlled entity could be provided separately when it is useful to users to disaggregate information about the group entity on that basis. Under this perspective, the key issues of when sub-consolidations are needed and whether separate controlling entity-only financial reports are necessary or appropriate would be treated as matters of display.

#### Entity perspective

36. SAC 1's emphasis on an 'entity' in determining the existence and boundaries of a reporting entity is unambiguously consistent with adopting an entity perspective to general purpose financial reporting. Under an entity perspective, the entity is the subject of financial reporting, rather than, for example, the interests of its owners. The entity's owners are treated as clearly separate from the entity preparing GPFs. Similarly, the information needs of particular external parties, such as owners, about particular components of an entity do not override the focus on the entity as a living economic organism. Therefore, a reporting entity must always be an entity.
37. The IASB-FASB ED on The Reporting Entity is not as unambiguously consistent with the adoption of an entity perspective, for which the IASB and FASB expressed support in their ED of a Conceptual Framework Chapter on *The Objective of Financial Reporting* (May 2008). Once the nexus between 'entity' and 'reporting entity' is broken, there seems no obvious reason why a reporting entity's boundaries could not be based on the interests of particular stakeholders such as owners.

38. The risk described in paragraph 37 seems to be increased by the focus of both the ‘Objective’ ED and the ‘Reporting Entity’ ED on providing information relevant for assessing cash flow prospects. Under an entity perspective of financial reporting, the primary focus should be on resources themselves, not necessarily the cash inflows they are expected to generate. The capability embodied in assets to provide goods and services, or to be converted into other assets, and the savings in cash outflows resulting from possessing those assets, are also relevant.
39. The ‘Objective’ ED says that an entity’s capital providers are directly interested in the amount, timing and uncertainty of cash flows from dividends, interest and the sale, redemption or maturity of securities or loans (paragraph OB10). The ‘Reporting Entity’ ED, in arguing for consolidated financial statements, says “If one entity controls another entity, the cash flows and other benefits flowing from the controlling entity to its equity investors, lenders and other creditors often depend significantly on the cash flows and other benefits obtained from the entities it controls, which in turn depend on those entities’ activities and the controlling entity’s direction of those activities” (paragraph RE8). This quote seems to focus particularly on the cash flows flowing to equity investors, lenders and other creditors of the controlling entity. Because of its emphasis on cash flows, it could be read as implying an economic activity (a single cash-generating process beginning with the controlled entities) that includes equity investors, lenders and other creditors, the controlling entity and its controlled entities.

**Question 2 (not for discussion in the meeting of National Standard Setters)**

Should the *Framework* chapter on the concept of a reporting entity include a definition of an ‘entity’ and specify that a reporting entity must satisfy the definition of an entity?

**Relevance of the reporting entity concept to standard setters**

40. An apparent omission from the IASB-FASB ED on The Reporting Entity is that it does not indicate the relevance of the ‘reporting entity’ concept to standard setters. Standard setters require consolidated financial statements, financial statements of pension plans and differential reporting based on their views as to what constitutes a reporting entity. The Boards’ ED on the Qualitative Characteristics discusses how

standard setters may use the qualitative characteristics in developing standards, but the ED on The Reporting Entity does not give the same level of prominence to how the concepts therein may be used in developing standards. This is discussed in paragraphs 41 – 44.

### **Financial statements held out to be prepared in accordance with IFRSs**

41. The absence of a discussion of financial statements held out to be prepared in accordance with IFRSs is a significant concern. This issue is important because it offers a possible solution to an apparent inconsistency between paragraphs RE5 and RE11 of the ED on The Reporting Entity. The first sentence of paragraph RE5 implies that a single legal entity, by itself, would not qualify as a reporting entity if it controls one or more other entities. However, paragraph RE11 says ‘parent-only’ financial statements might provide useful information if they are presented together with consolidated financial statements. In other words, parent-only financial statements may be presented about legal entities that are not reporting entities.
42. Financial statements held out to be prepared in accordance with IFRSs and therefore to be general purpose financial reports may be deemed to be prepared in respect of reporting entities. This may be asserted on the basis that their preparation provides a *prima facie* indication of the existence of users who depend on financial information about the entity in order to make resource allocation decisions. For example, a parent or subsidiary within a group may hold out its financial statements to be prepared in accordance with IFRSs (and therefore a general purpose financial report) and thus be deemed a reporting entity. This policy position might be adopted to protect the user and the IFRS brand.
43. Alternatively, as discussed in paragraph 35, this deeming approach may be regarded as unnecessary if financial information about a parent or subsidiary is regarded as a disaggregation of information about the group and not necessarily information about a ‘reporting entity’. Whichever conclusion is drawn, we think this is a key issue that should be discussed in the eventual Reporting Entity Chapter or its Basis for Conclusions.

## Conditional exemption from having to prepare consolidated financial statements

44. Another standard setting issue not addressed by the ED on The Reporting Entity relates to an aspect of IAS 27 *Consolidated and Separate Financial Statements*. IAS 27 provides parent entities a conditional exemption from having to prepare consolidated financial statements if they are wholly-owned subsidiaries and, in effect, are not publicly accountable.<sup>7</sup> The proposed concepts do not provide a basis for assessing whether that exemption should continue or for explaining why wholly-owned subsidiaries that are publicly accountable should be required to prepare consolidated financial statements. From a standard setter's perspective, it is important for the *Framework* to provide a foundation for assessing whether there is a conceptual reason for the exemption.

### Question 3 (*not for discussion in the meeting of National Standard Setters*)

Are any issues not dealt with in the ED that should have been included?

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<sup>7</sup> For the sake of simplicity, these comments do not address the different conditional exemption for parent entities that are partially-owned subsidiaries.