

15 July 2010

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UK

Dear Sir/Madam

Exposure Draft *Conceptual Framework for Financial Reporting: The Reporting Entity*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the IASB Exposure Draft *Conceptual Framework for Financial Reporting: The Reporting Entity* which was issued in March 2010 (the 'ED'). This letter is submitted in EFRAG's capacity of contributing to the IASB's due process.

We note some of the key principles set out in the ED:

- (a) a reporting entity is 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;
- (b) a portion of an entity could qualify as a reporting entity if the economic activities of that portion can be distinguished objectively from the rest of the entity and financial information about that portion of the entity has the potential to be useful in making decisions about providing resources to that portion of the entity;
- (c) if an entity controls one or more entities it should present consolidated financial statements;
- (d) an entity has control of another entity when it has the power to direct the activities of that other entity to generate benefits for (or limit losses to) itself; and
- (e) 'parent-only' financial statements potentially provide useful information if they are presented together with consolidated financial statements.

Unlike the Discussion Paper *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Reporting Entity* (the 'DP'), we note that the ED does not explicitly state from which perspective the financial statements should be prepared, that is the so-called entity or proprietary perspectives.

EFRAG's detailed comments on the Exposure Draft are set out in the appendices. Appendix 1 contains answers to the questions asked in the IASB's *Invitation to*

Comment. Appendix 2 contains some additional comments. Set out below is a brief summary of our main comments.

We agree with the Exposure Draft's proposal that the *Conceptual Framework* should contain a description of a 'reporting entity'. Also, we broadly agree with the description proposed.

We consider that a definition of 'control' (of an 'entity' and, in general, of the different elements of financial statements) should be included in the *Conceptual Framework*. However EFRAG believes that this definition should not be developed in the chapter dealing with the Reporting Entity; rather it should be developed at higher level than in the Reporting Entity chapter so that it can apply more broadly.

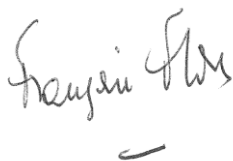
The Reporting Entity chapter should deal specifically with control of economic entities or activities as the principle of aggregation for the preparation of consolidated financial statements, why and how this principle will provide most relevant information to investors. EFRAG thinks the IASB should examine whether the application of a joint control approach for determining the boundaries of the group reporting entity provides decision-useful information, as reasons for retaining exclusive control – and exclusive control only - are not fully explained. It should also explain the usefulness of combined financial statements and of parent-only financial statements.

EFRAG agrees that completion of the Reporting Entity chapter of the *Conceptual Framework* should not be delayed until the completion of the standards dealing with consolidation. Consistency between the *Conceptual Framework* and standards should be set as a general principle in IFRS standard setting. Hence no change in fundamental concepts should be implemented at standard level before being fully debated at the conceptual level. We continue to urge the IASB to give the completion of the different chapters of the *Conceptual Framework* a higher priority than has been afforded to date. This would allow improvements in financial reporting to follow a thorough debate of why and how concepts should evolve, and ensure that standards are developed in full consistency with the conceptual framework, rare and circumscribed well reasoned exceptions being put aside.

We consider that the perspective from which financial statements are presented is critical and should be discussed in the *Conceptual Framework*. Clarifying the 'perspective' is important in assessing how to resolve accounting policy issues and is central to considering how to satisfy the objective of financial reporting. Accordingly, we think it is necessary to carry out an in-depth analysis of the implications of adopting either perspective and to ensure they are properly debated.

If you would like further clarification of the points raised in this letter, please do not hesitate to contact either Joaquin Sanchez-Horneros or me.

Yours sincerely



Françoise Flores

EFRAG, Chairman

Appendix 1

EFRAG's response to the questions asked in the ED

Question 1: Do you agree that a reporting entity is 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 the management and the governing board of that entity have made efficient and effective use of the resources provided? If not, why?

EFRAG's response

Summary of EFRAG's view

- EFRAG agrees with the proposed broad description of a reporting entity.

- 1 EFRAG thinks that the concept of a reporting entity is central to the preparation of financial statements. Bearing that in mind, EFRAG believes the *Conceptual Framework* needs to articulate that concept by providing a description of a reporting entity. EFRAG understands that the description in the Exposure Draft identifies the following characteristics of a reporting entity: it comprises a collection of business activities that are connected in some way (hence the 'circumscribed') and information about which is potentially useful for those who provide capital. EFRAG agrees that a *description* of a reporting entity rather than a precise *definition* is a satisfactory way to capture the concept of a 'reporting entity'. EFRAG is also broadly satisfied with the proposed description.
- 2 However, EFRAG considers that it is a matter for national legislative bodies or regulatory authorities to decide who should report under IFRSs and whether the application of IFRSs is required or permitted for entities. It should be made clear that the 'reporting entity' concept does not override those requirements.
- 3 Below, EFRAG has commented on some of the specific characteristics of the proposed description and the proposed features of a reporting entity.

Specific comments to elements of the proposed description

Reference to potential equity investors, lenders and other creditors

- 4 The *Conceptual Framework* ED on Phase A: *Objectives and Qualitative Characteristics* proposes that the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to present to potential equity investors, lenders and other creditors in making decisions in their capacity as capital providers.
- 5 Bearing this in mind, EFRAG agrees that the ED should include a reference to users as this reference provides an appropriate link to the objective of general purpose financial statements.
- 6 However, EFRAG has some concerns in relation to including the reference to capital providers in the objective of general purpose financial statements stated in paragraph OB5 of the exposure draft of Phase A of the *Conceptual Framework*

because it may lead to the conclusion that financial statements should be presented from an entity perspective. EFRAG understands that potential equity investors, lenders and other creditors can be considered capital providers and identifying them without articulating which perspective underpins the financial statements may lead to the conclusion that the entity perspective applies. EFRAG considers that there must be a deeper analysis of the conclusions of adopting such perspective. These concerns are further discussed in Appendix 2.

- 7 The ED has replaced the term “other capital providers” (included in the Discussion Paper previous to the ED) with “other creditors”. The reference in the DP to capital providers was consistent with the the exposure draft of Phase A of the *Conceptual Framework*. EFRAG understands that the reason for the use of the term “other capital providers” was to accommodate not-for-profit entities and other entity structures, such as co-operatives, that typically do not have investors as their primary users. This is potentially an issue, for example, for for-profit groups applying IFRSs which include not-for-profit entities (e.g., charitable foundations) and other corporate structures that do not have ‘investors’ as such.

Efficient and effective use of resources provided

- 8 EFRAG agrees that the ability to assess stewardship is an important objective of general purpose financial reporting. The proposed description includes the following reference to stewardship: “in making decisions about [...] whether management and the governing board of that entity have made efficient and effective use of the resources provided”. EFRAG does not think it is clear why it is necessary to include ‘efficient and effective’ in the description. Accordingly, in EFRAG’s view it would be sufficient to simply state “how management has made use of the resources provided”.

Link to management

- 9 EFRAG is concerned about the current wording which refers to “management and the governing board of that entity”. This could be read as requiring a reporting entity to have had a form of management in place. We are concerned that could be problematic when for example parts of existing companies are carved out and one set of financial statements is prepared for the parts carved out that do not have a common management yet in place.

Specific comments to the proposed features of a reporting entity

‘Will be conducted’

- 10 The ED states that one of the features of a reporting entity is that economic activities are being conducted, have been conducted or will be conducted. EFRAG understands that the purpose of this feature is to specify that entities that have resources (such as cash) and are about to start an activity (however, without this being certain) could be reporting entities. Accordingly, it may be more appropriate to replace ‘will be’ with ‘has the potential to be’, ‘planned to be’ or ‘capable of being conducted’, as it is not clear that the nature and scope of an entity’s future activities is an essential factor.

'Those economic activities can be objectively distinguished from those of other entities and from the economic environment in which the entity exists'

- 11 EFRAG is aware, that in order to be able to prepare a set of financial statements, it is necessary to have some kind of boundary between those economic activities that should be reflected in the financial statements and those that should not. However, EFRAG does not think it is clear how 'objectively distinguished' is intended to operate. Is it effectively another form of words to describe by 'reference to facts and circumstances' or is 'objectively' here referring to some specific characteristic? We think the IASB should clarify what is intended with this element of the description of a reporting entity.

Question 2: Do you agree that, if an entity that controls one or more entities prepares financial reports, it should present consolidated financial statements? Do you agree with the definition of control of an entity?

EFRAG's response

Summary of EFRAG's view

- EFRAG considers that a definition of 'control' should be included in the *Conceptual Framework*. However, EFRAG believes that the definition of 'control' should not be developed in the chapter dealing with the Reporting Entity; rather it should be developed so that its application can be considered more broadly.
- The Reporting Entity chapter should identify 'control' as the basis for the aggregation of economic activities in preparing financial statements.

- 12 EFRAG notes that the definition of 'control' does not only apply as the principle of aggregation that is used to define the boundaries of the reporting entity. Control is a pervasive notion that also applies in determining the existence of an asset and is used in other parts of accounting literature.
- 13 For those reasons, EFRAG believes that the definition of 'control' should be developed in the *Conceptual Framework* at a higher level than in the Reporting Entity chapter. The Reporting Entity chapter should identify control as the basis for aggregation of economic entities and activities, and refer to the appropriate chapter of the *Conceptual Framework* where the definition of 'control' is developed.
- 14 The application and practical implementation of the definition of 'control' should be set out at standards level to deal with specific issues such as consolidation (as is currently the case with IAS 27 *Consolidated and Separate Financial Statements*). We refer the IASB to our comments on ED 10 *Consolidated Financial Statements* where we set out our views on the definition of 'control' in the context of consolidated financial statements.

Question 3:

Do you agree that a portion of an entity could qualify as a reporting entity if the economic activities of that portion can be distinguished from the rest of the entity and financial information about that portion of the entity has the potential to be useful in making decisions about providing resources to that portion of the entity? If not, why?

EFRAG's response

Summary of EFRAG's view

- EFRAG agrees that a portion of an entity can qualify as a reporting entity if that portion meets the description and characteristics of a reporting entity.

- 15 EFRAG notes that the proposed description of a reporting entity is not limited to business activities that are structured as legal entities, and agrees with this. EFRAG therefore agrees that a portion of an entity can qualify as a reporting entity if that portion meets the description and characteristics of a reporting entity. In addition, EFRAG also thinks that a combination of portions of different legal entities can constitute a reporting entity if this combination meets the description and characteristics of a reporting entity. EFRAG also considers that a reporting entity can include more than one reporting entity (i.e. what was previously referred to as an economic entity or group). In our view, these different configurations of activities which may constitute a reporting entity should be clarified.

Question 4: The IASB and the FASB are working together to develop common standards on consolidation that would apply to all types of entities. Do you agree that completion of the Reporting Entity chapter of the *Conceptual Framework* should not be delayed until those standards have been issued? If not, why?

EFRAG's response

Summary of EFRAG's view

- EFRAG agrees that completion of the Reporting Entity chapter of the *Conceptual Framework* should not be delayed until the standards on consolidation have been issued. However, we understand that no fundamental change in principle from the existing IAS 27 is being considered in the active project on Consolidation.
- EFRAG continues to urge the IASB to give the completion of the different chapters of the *Conceptual Framework* a higher priority.

- 16 EFRAG agrees that this project should not be delayed until the standards on consolidation have been issued but those standards issued in the future must not introduce any fundamental new concepts as they should first be debated at the conceptual level. Notwithstanding the order in which these principles are developed, it is imperative that there is consistency between standards and concepts.
- 17 We believe that it is important to ensure that the principles within the *Conceptual Framework* are internally consistent. It may be necessary to revise the different parts of the *Conceptual Framework* once the different phases have been finalised in order to assure this consistency because, by their very nature, many of the principles which appear in the *Conceptual Framework* are interdependent and flow in logical sequence from the stated objective of financial reporting.

Appendix 2

Some additional observations

- 18 In addition to the issues raised in the questions asked by the IASB in the 'Invitation to Comment' part of the ED, EFRAG would like to comment on some other aspects of the ED.

Parent-Only Financial Statements

EFRAG's response

Summary of EFRAG's view

- EFRAG strongly supports that the *Conceptual Framework* acknowledges that 'parent-only' separate financial statements provide useful information. However, detail about the timing and issuance of those financial statements should not be included in the *Conceptual Framework*.

- 19 EFRAG strongly supports that the Conceptual Framework affirms that "parent-only" separate financial statements provide useful information. EFRAG believes that any further guidance related to "parent-only" separate financial statements does not belong in the Conceptual Framework.
- 20 In our view, the *Conceptual Framework* is not the right place to deal with detailed issues such as: (1) when 'parent-only' separate financial statements should be issued, (2) whether or not they must be issued at the same time as consolidated financial statements, and (3) whether or not they should be included in the same financial report.
- 21 In addition, EFRAG notes that the reference to parent-only separate financial statements does not refer exclusively to parent-only separate financial statements prepared under IFRS. In Europe, for example, "parent-only" separate financial statements are commonly prepared, and referred to as prepared, in accordance with national GAAP. EFRAG believes that the wording should be changed to make clear that it refers specifically to parent-only separate financial statements prepared under IFRS.

Joint control and shared control

EFRAG's response

Summary of EFRAG's view

- EFRAG thinks it would be useful for the IASB to analyse whether the use of a joint control approach for determining the boundaries of the group reporting entity provides useful information to equity investors, lenders and other creditors.

- 22 In the ED, either an entity has control or it does not. EFRAG thinks it would be useful, before a final chapter is issued, to provide an analysis of the decision-usefulness of the information derived from using joint control or shared control concepts to determine the boundaries of the group reporting entity. It is not explained in the ED why control needs to be exclusive and what the difference

between exclusive and non-exclusive control is in terms of usefulness of the resulting financial information.

- 23 The IASB's argument for focusing on control in relation to consolidation is stated in paragraph RE8 of the ED:

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. Accordingly, if an entity that controls one of more entities prepares financial reports, it should present consolidated financial statements. Consolidated financial statements are most likely to provide useful information to the greatest number of users.

- 24 Without further clarification, it seems this argument could also be used for including many jointly controlled entities in consolidated financial statements, although an entity would only be able to jointly control the activities of the jointly controlled entity.

- 25 Some joint ventures are established in jurisdictions where having exclusive control is not possible because of government imposed restrictions. In spite of that circumstance, the description stated in paragraph RE8 is met because the cash flows and benefits of the entity that set up the joint venture have a significant dependence on the cash flows and benefits obtained from the joint venture.

Perspective from which financial statements should be presented

EFRAG's response

Summary of EFRAG's view

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| <ul style="list-style-type: none">• EFRAG considers that the perspective from which financial statements should be presented needs to be debated and set out in the <i>Conceptual Framework</i>. |
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- 26 In its Discussion Paper *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Reporting Entity*, the IASB had included a discussion on what perspective the consolidated financial should be presented. Consistent with the *Conceptual Framework* ED on Phase A: Objectives and Qualitative Characteristics, the DP concluded that the entity perspective is more consistent with the fact that the vast majority of today's business entities engaged in financial reporting have an identity distinct from that of their capital providers.

- 27 The ED does not clearly articulate whether the IASB has a preference for the entity perspective. As noted previously in paragraph 6, the reference to capital providers may lead one to assume that financial statements are drawn up from the perspective of the entity rather than its owners but the wording in the ED is not conclusive.

- 28 Accordingly, EFRAG reaffirms its view that the perspective from which financial statements should be presented is critical to the *Conceptual Framework* and it is therefore essential to ensure that there is a thorough debate on this issue before a conclusion is reached. The conceptual Framework would therefore be deficient if it does not address the perspective from which the financial statements are presented.

Combined Financial Statements EFRAG's response

Summary of EFRAG's view

- EFRAG considers that references to entities under common control should be removed.

29 Combined financial statements are often seen in the course of carve-outs and spin-offs but there are more situations where this kind of financial information is prepared without the existence of common control (e.g., cooperatives).

Authoritative status of the Framework

EFRAG's response

Summary of EFRAG's view

- Conceptual Framework should be considered to have a formal authoritative status in an explicit way. EFRAG supports IASB the IASB maintaining the hierarchy in IAS 8.

30 It seems from paragraph P10 of the ED that standards may be established based on principles that are inconsistent with the Conceptual Framework. EFRAG considers all standards are based on Conceptual Framework. In our view every departure from the Conceptual Framework at a standards-level needs to be clearly explained and justified. The status of the Conceptual Framework in the GAAP hierarchy in IAS 8 should be retained for resolving accounting policy issues not covered at the standards level.