

DRAFT COMMENT LETTER

Comments should be sent to commentletters@efrag.org by 25 June 2010

XX XXXX 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.

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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, for example 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.

- (a) 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;
- (b) We consider that a definition of 'control' 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;
- (c) The Reporting Entity chapter should identify control of economic entities or activities as the principle of aggregation for the preparation of consolidated financial statements, combined financial statements or parent-only financial statements;
- (d) 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;
- (e) EFRAG agrees that completion of the reporting entity chapter of the *Conceptual Framework* should not be delayed until the completion of the standards on consolidation. Indeed, we understand that no fundamental change in principle from the existing IAS 27 is being considered in the active project on Consolidation. As a general principle, regardless of the sequence in which they are developed, the *Conceptual Framework* and standards should be consistent. Accordingly, EFRAG considers that no part or phase of the *Conceptual Framework* project should be completed until the current active phases of *Conceptual Framework* project are ready to be finalised. We continue to urge the IASB to give the completion of the different chapters of the *Conceptual Framework* a high priority;
- (f) EFRAG agrees that 'parent-only' financial statements can provide useful information;
- (g) EFRAG thinks the IASB should examine more comprehensively whether the application of a joint control approach for determining the boundaries of the group reporting entity provides decision-useful information; and
- (h) 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.

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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

Stig Enevoldsen

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?

Notes for EFRAG's constituents

1 *The ED suggests the following description of a reporting entity:*

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.

2 *The ED states that a reporting entity has the following three features:*

- (a) *economic activities of an entity are being conducted, have been conducted or will be conducted;*
- (b) *those economic activities can be objectively distinguished from those of other entities and from the economic environment in which the entity exists; and*
- (c) *financial information about the economic activities of that entity has the potential to be useful in making decisions about providing resources to the entity and in assessing whether the management and the governing board have made efficient and effective use of the resources provided.*

EFRAG's response

EFRAG's view

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| <ul style="list-style-type: none">• EFRAG agrees with the proposed broad description of a reporting entity. |
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3 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 those who provide capital. EFRAG agrees that a *description* of a reporting entity rather than a precise

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definition is a satisfactory way to capture the concept of a 'reporting entity'. EFRAG is also broadly satisfied with the proposed description.

- 4 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

- 5 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.
- 6 Bearing this in mind, EFRAG agrees that the ED should include a reference to potential equity investors, lenders and other creditors as this reference provides an appropriate link to the objective of general purpose financial statements clear.
- 7 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 to 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.

Efficient and effective use of resources provided

- 8 EFRAG agrees that the ability to assess stewardship is an 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.

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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 absolute certainty about 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 how this feature is intended to be applied in practice.

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?

Notes for EFRAG's constituents

- 12 *The ED states that if an entity that controls one or more entities prepares financial reports, it should present consolidated financial statements because they are most likely to provide useful information to the greatest number of users. The reasoning is that if one entity has control of another entity, the cash flows and other benefits flowing from the controlling entity to its capital providers 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.*
- 13 *According to the ED 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.*

EFRAG's response

EFRAG's views

- 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.

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- The Reporting Entity chapter should identify control as the basis for the aggregation of economic activities in preparing financial statements.

- 14 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.
- 15 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.
- 16 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?

Notes for EFRAG’s constituents

- 17 *The ED explicitly states that 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. It is noted in the ED that a potential equity investor could be considering the purchase of a branch or division of an entity.*

EFRAG’s response

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.

- 18 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.

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?

Notes for EFRAG's constituents

- 19 *While developing this ED, the IASB and the FASB are working together to potentially align their standards on consolidation.*
- 20 *The IASB has noted that the concepts of the Conceptual Framework project are stated in general terms and would not conflict with the standards-level project. Accordingly, the IASB has tentatively concluded that the publication of an ED on the reporting entity and the work done on the project should not be delayed until converged standards on consolidation have been issued by both boards.*

EFRAG's response

EFRAG's view

- EFRAG agrees that the project should not be delayed until the standards on consolidation have been issued.
 - EFRAG continues to urge the IASB to give the completion of the different chapters of the *Conceptual Framework* a high priority.
- 21 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.
- 22 EFRAG remains strongly of the view that no part of the *Conceptual Framework* should be completed until the current active phases of *Conceptual Framework* project are ready to be finalised. We believe that is important to ensure that the principles within the *Conceptual Framework* are internally consistent. Accordingly, it is not possible to assess parts of the *Conceptual Framework* in isolation because, by their very nature, many of the principles are interdependent and flow in logical sequence from the stated objective of financial reporting.

Appendix 2 Some additional observations

- 23 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

Notes for EFRAG’s constituents

- 24 *According to the ED, a controlling entity may present financial statements that provide information about its investments in the entities it controls, and the returns on those investments, rather than the underlying economic resources and claims, and changes therein, of those entities its controls. Such ‘parent-only’ financial statements might provide useful information if they are presented together with consolidated financial statements.*

EFRAG’s response

EFRAG’s view

- EFRAG strongly supports that the *Conceptual Framework* affirms that ‘parent-only’ financial statements can provide useful information. However, detail about the timing and issuance of those financial statements should not be included in the *Conceptual Framework*.
- 25 EFRAG strongly supports that the *Conceptual Framework* affirms that “parent-only” financial statements can provide useful information. EFRAG believes that any further guidance related to “parent-only” financial statements does not belong in the *Conceptual Framework*.
- 26 In our view, the *Conceptual Framework* is not the right place to deal with detailed issues such as: (1) when ‘parent-only’ 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.
- 27 In addition, EFRAG notes that the reference to parent-only financial statements does not refer exclusively to parent-only financial statements prepared under IFRS. In Europe, for example, “parent-only” 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 financial statements prepared under IFRS.

Joint control and shared control

Notes for EFRAG’s constituents

- 28 *According to the ED, when two or more entities collectively have the power to direct the activities of another entity to generate benefits for (or limit losses to) themselves, none of the entities that share the power to direct the activities of this other entity individually controls this other entity. Accordingly, none of the entities*

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constituting the controlling group would present information about itself and this other entity on a consolidated basis.

29 *In its Basis for Conclusions, the IASB states:*

Despite its name, proportionate consolidation is a method of accounting for an investment in another entity, instead of a method of reporting economic resources and claims of a controlled entity. Thus, the Board decided not to address proportionate consolidation.

EFRAG's response

EFRAG's view

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| <ul style="list-style-type: none">• 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. |
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30 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.

31 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.

32 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.

33 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

Notes for EFRAG's constituents

- 34 Unlike the DP, the ED does not discuss from what perspective the consolidated financial statements should be presented. The DP explicitly stated on paragraphs 107-118 that the consolidated financial statements should be presented from the perspective of the group reporting entity rather than from the perspective of the parent company's shareholders.

EFRAG's response

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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- 35 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.
- 36 EFRAG agrees that the approach described as the proprietary perspective may not be a satisfactory perspective to use when preparing general purpose financial reports.
- 37 The ED does not clearly articulate whether the IASB has a preference for the entity perspective. As noted previously in paragraph 7, 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.
- 38 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.