



## Accounting Standards Board

Aldwych House, 71-91 Aldwych, London WC2B 4HN

Telephone: 020 7492 2300 Fax: 020 7492 2399

[www.frc.org.uk/asb](http://www.frc.org.uk/asb)



Paul Ebling  
Technical Director  
EFRAG  
13-14 Avenue des Arts  
1210 Brussels  
Belgium

25 September 2008

Dear Paul

***EFRAG's draft comment letter on the IASB Discussion Paper 'Preliminary Views on an Improved Conceptual Framework for Financial Reporting: The Reporting Entity'***

This letter sets out the UK Accounting Standards Board's (ASB's) comments on EFRAG's draft comment letter on the IASB Discussion Paper mentioned above (DP).

The ASB shares the main concerns raised by EFRAG in relation to the proposals in the IASB DP. We have the following answers to the questions to constituents asked in your letter:

1. *Levels of control and percentage ownership* (Page 6-7) – We do not believe discussion on this issue should be included in the conceptual framework. We firmly believe that conceptual frameworks should deal with high level principles which can then be elaborated upon in the standards. Discussions on whether the control definition requires the controller to have some power or absolute power to direct the financing and operating policies of the controlling entity are better placed within standards where the discussion can be directed to particular situations.
2. *Discussion on joint control* (Page 11) – We would agree that the notion of joint control is particularly problematic in application. However, we believe that notion of joint control is a subset of the control and requires careful consideration of individual transactions. As such, we believe that it would be best explored at a standards level where it can be considered in more detail.
3. *Other conceptual issues* (Page 11) – We have no further conceptual issues that should be addressed in the DP.

We also enclose our response to the IASB for your information. If you would like to discuss any of the comments made above then please contact Seema Jamil-O'Neill on 020 7492 2422 or myself on 020 7492 2434.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Ian Mackintosh', written in a cursive style.

Ian Mackintosh

Chairman

DDI: 020 7492 2434

Email: [i.mackintosh@frc-asb.org.uk](mailto:i.mackintosh@frc-asb.org.uk)



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Nobu Kawanishi  
International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH

25 September 2008

Dear Nobu

### ***IASB Discussion Paper 'Preliminary Views on an Improved Conceptual Framework for Financial Reporting: The Reporting Entity'***

The UK Accounting Standards Board (ASB) welcomes the opportunity to comment on the IASB Discussion Paper '*Preliminary Views on an Improved Conceptual Framework for Financial Reporting: The Reporting Entity*' (DP).

We have provided detailed responses to the questions included in the DP in the appendix to this letter. Overall, we agree with the proposal that the conceptual framework should contain a broad description of a reporting entity. However, we have a number of key concerns with the PVs set out in the DP, as follows:

1. The ASB believes that both the controlling entity model and the risks and rewards model have a place in an international conceptual framework. We are concerned that by choosing not to develop the risks and rewards model at the conceptual level the IASB will be narrowing the focus of the conceptual framework in general and the consolidation of reporting entities in particular at too early a stage and without fully considering all the potential implications of such a decision. The model to be applied in particular cases can be decided at the standards level. In the recent months it has become increasingly clear that the risks and rewards model of SIC 12 has played and continues to play an important role in determining which SPVs are judged to be on or off-balance sheet by reporting entities. Given the increase in business complexity it is desirable in our opinion to retain a model that continues to play such a key role in providing answers in the more difficult cases. The IASB will also need to consider carefully the implications of the consolidation project to this part of the Framework.

2. We do not believe that the definition of control in the DP is sufficient as the basis for the controlling entity model in particular when the applying the model to SPEs. The ASB would recommend that the control definition is amended to make an overt reference not only to the benefits but also the exposure to risks that arise from one entity controlling another entity.
3. We are concerned about the adoption of the entity perspective at such an early stage in the discussion. We do not believe that the IASB analysis of the issues and potential implications of adopting this perspective at the expense of the others (proprietary, parent-only) have been sufficiently thought through for a conclusion to be made. Before we are able to provide a conclusive answer on this issue we would like more information on the potential benefits of adopting the entity perspective as well as the perceived shortcomings of the parent-only perspective.
4. We are concerned that some of the PV decisions presented in the DP are unlikely to be applicable for not-for-profit entities. In particular, the description of the reporting entity and the concept of control need further work before they can be applied to these entities. This is explored further in the report on the application to not-for-profit entities of the IASB's DP proposals produced by the chairs and senior staff of the Australian, Canadian, New Zealand and UK Accounting Standards Board. We attach this report at the end of this letter for your information.

If you would like to discuss any of the comments made above then please contact Seema Jamil-O'Neill on 020 7492 2422 or myself on 020 7492 2434.

Yours sincerely



Ian Mackintosh  
Chairman

DDI: 020 7492 2434

Email: [i.mackintosh@frc-asb.org.uk](mailto:i.mackintosh@frc-asb.org.uk)

## Appendix : Questions for respondents

### Section 1: The reporting entity concept

#### Question 1

Do you agree that what constitutes a reporting entity should not be limited to business activities that are structured as legal entities? If not, why?

1. The ASB agrees with the IASB's Preliminary view (PV) that a reporting entity should not be limited to business activities that are structured as legal entities. As noted in paragraph 21(c) of the DP concepts should reflect the economic phenomena rather than rely the legal structuring of business entities. The ASB is a strong believer in reporting the substance rather than the legal form and considers that, in concept, areas of business activity should not be prohibited from producing financial reports if they are not set up as legal entities. Any practical difficulties can be handled at the standards level.

#### Question 2

Do you agree that the conceptual framework should broadly describe (rather than precisely define) a reporting entity as a circumscribed area of business activity of interest to present and potential equity investors, lenders and other capital providers? If not, why? For example, do you believe that the conceptual framework should establish a precise definition of a reporting entity? If so, how would you define the term? Do you disagree with including reference to equity investors, lenders and other capital providers in the description (or definition) of a reporting entity? If so, why?

2. The ASB agrees that the conceptual framework should broadly describe a reporting entity as a circumscribed area of business activity of interest to present and potential equity investors, lenders and other capital providers.
3. However, the ASB notes that including the reference to equity investors, lenders and other capital providers in the description of a reporting entity is likely to have an impact on the not-for-profit sector. The choice of primary users of financial reporting is troublesome for that sector as the users there are often not equity investors or lenders. Not-for-profit entities have a different group of users, including funders, financial supporters and the recipients of goods and services of the entities. Therefore, inclusion of the primary user group of the for-profit sector in the definition of reporting entity means that it will need to be amended when the IASB considers not-for-profit entities in phase G of the framework project.

## Section 2: Group reporting entity

### Question 3

Do you agree that the risks and rewards model does not provide a conceptually robust basis for determining the composition of a group reporting entity and that, except to the extent that it overlaps with the controlling entity model (as discussed in paragraphs 102 and 103), the risks and rewards model should not be considered further in the reporting entity phase of the conceptual framework project? If not, why?

4. The ASB does not agree that the risks and rewards model so lacks conceptual robustness that it cannot be used as the basis for determining the composition of a group reporting entity. We would recommend that at the concepts level the IASB should develop both the controlling entity model and the risks and rewards model as both are useful in different circumstances.
5. It is clear from the discussion in the DP (paragraphs 71-79) that in certain circumstances, in particular when considering SPEs, the controlling entity model will be supplemented by the risks and rewards model. The discussion states that reliance on control alone will not be sufficient “when there is little observable evidence for ascertaining whether power exists or with whom power lies...” In such cases, the DP notes that accounting standards will need to look to the ability to obtain benefits (or exposure to risk) to determine whether the SPE is controlled by another entity. If it is conceded that future accounting standards will need to supplement the control model by looking at benefits or exposure to risk (in other words risks and rewards) then it is sensible to ensure a sufficiently coherent model is available in the Framework.
6. We believe that the model’s so called “overlap” with the controlling entity model is sufficient to justify its presence in the Framework and justifies it being developed further.
7. It appears that the reason the IASB has backed away from the model is that “such a broad and undefined notion is unlikely to be workable” (paragraph 98). Paragraph 103 then notes that the “risks and rewards model has the potential to be both broader and narrower than the controlling entity model”. It then further notes that the risks and rewards model is broader because “it could result in entities being combined” when the first entity does not have power over the second entity.
8. Paragraph 103 (b) paradoxically also notes that the risks and rewards model can be narrower than the controlling entity model “because it may require a focus on particular types of risks and rewards, such as risks and rewards arising from a residual or ownership interest, rather than risks and rewards generally, and may require a minimum level of risks and/or rewards to be specified, such as when the first entity has an entitlement to a majority or ‘significant’ amount of those rewards or exposure to the majority of risk.”

9. We believe that the above passages demonstrate that the risks and rewards model has not been sufficiently developed by the IASB to be able to definitively conclude on whether the model is broader or narrower than the controlling entity model. It is also noteworthy that the IASB goes on to reject the risks and rewards model by concluding in paragraph 104 that “the risks and rewards model would require bright lines to be drawn at the conceptual level, which the boards found undesirable.” However, when considering the controlling entity model IASB have already drawn several bright lines at the concepts level including: that there will always be a controlling entity (the parent) and other entities will be under its control (ie its subsidiaries); that control means that the parent entity will have the “ability to direct the other entity’s financing and operating policies” (paragraph 68); etc.

**Question 4**

Assuming that control is used as the basis for determining the composition of a group reporting entity, do you agree that:

- (a) control should be defined at the conceptual level?
- (b) the definition of control should refer to both power and benefits?

If not, why? For example, do you have an alternative proposed definition of control?

10. As noted in the answer to question 3 above we do not believe that control should be the sole basis for determining the composition of a group reporting entity at the concepts level. Consideration needs to be given to developing a complementary risks and rewards model at that level.

11. However, we do believe that a definition of control at the concepts level will be beneficial and that it should refer to power as well as risks and rewards. The working definition of control included in paragraph 49 of the DP is as follows:

“Control of an entity is the ability to direct the financing and operating policies of an entity, so as to access benefits from that entity (or to reduce the incidence of losses) and increase, maintain or protect the amount of those benefits (or reduce the amount of those losses)”

12. Paragraph 75 of the DP notes that “when there is little observable evidence for ascertaining whether power exists or with whom power lies, accounting standards may look to or emphasise the ability to obtain benefits (or exposure to risk) to determine whether the SPE is controlled by another entity.” The reference to the “access to benefits” is the equivalent to the rewards from an entity. It could thus easily be applied to a whole spectrum of benefits – both quantitative (eg. Profits) and qualitative (eg. Ownership rights such as ability to change management). However, the reference to the ability “to reduce the incidence of losses” is another benefit or reward to be obtained. The definition makes no reference to the exposure to the risk element that is often important when determining in practice whether a particular SPE is consolidated or not. In fact, a number of SPEs including autopilots are structured so that the benefits are spread between various parties to the contract. A more holistic review has to be

taken by taking into consideration the benefits as well as the exposure to risk to determine who should consolidate the entity.

13. As a result, we do not believe that this definition is sufficient as the basis for the controlling entity model as described in paragraphs 64-79 of the DP and, in particular, we do not feel that it will sufficiently support the application of the controlling entity model to SPEs. The ASB would recommend that the control definition is amended to make an overt reference to not only to the benefits but also the exposure to risks.

**Question 5**

Do you agree that the composition of a group reporting entity should be based on control? If not, why? For example, if you consider that another basis should be used, which basis do you propose and why?

14. As noted in our answer to question 3 above we believe that the composition of a group reporting entity should be based on risks and rewards as well as control. In practice, we anticipate that this approach would lead to the control model being used as the basic model which could then be supplemented with the principles of the risks and rewards model.

**Question 6**

Assuming that control is used as the basis for determining the composition of a group reporting entity, do you agree that the controlling entity model should be used as the primary basis for determining the composition of a group entity? If not, why?

15. As noted in our answers to the questions above we do not agree that control should be the sole basis for determining the composition of a group reporting entity. We believe that a better basis for determining the composition of a group entity is if the controlling entity model retains elements of both the concept of control and of risks and rewards.

**Question 7**

Do you agree that the common control model should be used in some circumstances only? If not why? For example would you limit the composition of a group reporting entity to the controlling entity model only? Or would you widen the use of the common control model? If you support the use of the common control model at least in some circumstances do you regard it as an exception to (or substitute for) the controlling entity model in those circumstances or is it a distinct approach in its own right? Please provide reasons for your responses.

16. We agree that the common control model is appropriate for use in some circumstances. An example of its use is in the government sector where the financial reports of the various departments under ministerial control can be aggregated using this model.



### Section 3: Parent entity financial reporting

#### Question 8

Do you agree that consolidated financial statements should be presented from the perspective of the group reporting entity, not from the perspective of the parent company's shareholders? If not, why?

17. In the ASB's view, adopting the entity perspective is a fundamentally different approach to that generally practiced in many parts of the world when producing financial reports. This approach is likely to have a fundamental impact on later phases of the Framework project as well as on the development of new accounting standards.
18. The discussion in paragraphs 107-118 of the DP provides a description of the various perspectives – entity, proprietary and parent company – and the composition of the consolidated financial statements. However, as noted in our response to the IASB ED on Chapters 1 and 2, the ASB is not convinced that a full debate has yet taken place to justify the shift from the parent company perspective commonly used in financial reporting to the entity perspective as espoused by the IASB. The discussion in the above paragraphs does not allay our concerns on this matter. Therefore, we would advise the IASB to provide a more comprehensive analysis of the issues involved, the consequences for financial reporting and the advantages and disadvantages of adopting entity approach versus any of the other approaches to enable a debate to take place both at the Board level as well as among the constituents.

#### Question 9

Do you agree that consolidated financial statements provide useful information to equity investors, lenders and other capital providers? If not, why?

19. We agree that consolidated financial statements provide useful information to equity investors, lenders and other capital providers.

#### Question 10

Do you agree that the conceptual framework should not preclude the presentation of parent-only financial statements, provided that they are included in the same financial report as consolidated financial statements? If not, why?

20. The ASB believes that parent-only financial statements provide important information not only to the equity investors of the parent company but also to its lenders and other capital providers. In particular, solvency information for the parent company can not be obtained if only consolidated financial statements were produced. Therefore, we agree with the IASB's PV that presentation of parent-only financial statements should not be precluded from the conceptual framework.

## Section 4: Control issues

### Question 11

With regard to the concept of control, in the context of one entity having control over another, do you agree that:

- (a) establishing whether control exists involves assessing all the existing facts and circumstances and, therefore, that there are no single facts or circumstances that evidence that one entity has control over another entity in all cases, nor should any particular fact or circumstances – such as ownership of a majority voting interest – be a necessary condition for control to exist? If not, why?
- (b) the concept of control should include situations in which control exists but might be temporary? If not, why?
- (c) the control concept should not be limited to circumstances in which the entity has sufficient voting rights or other legal rights to direct the financing and operating policies of another entity, but rather should be a broad concept that encompasses economically similar circumstances? If not, why?
- (d) in the absence of other facts and circumstances, the fact that an entity holds enough options over voting rights that, if and when exercised, would place it in control over another entity is not sufficient, in itself, to establish that the entity currently controls that other entity? If not, why?
- (e) to satisfy the power element of the definition of control, power must be held by one entity only? In other words, do you agree that the power element is not satisfied if an entity must obtain the agreement of others to direct the financing and operating policies of another entity? If not, why?
- (f) having 'significant influence' over another entity's financing and operating policy decisions is not sufficient to establish the existence of control of that other entity? If not, why?

- 21. We agree with section (a) above that establishment of control involves assessing all the relevant facts and circumstances and cannot be based on single facts alone.
- 22. Leading on from our answer to (a) above, it is obvious that (b) and (c) above are subsets of the same questions. Both temporary control and circumstances that are economically similar to the direct financing and operating policies of an entity are some of the many circumstances that would be taken into account when considering whether an entity has control over another.
- 23. The situation in (d) above represents a single criterion that may determine control. As already noted above we do not believe that a single factor can determine control and that other facts and circumstances would need to be taken into account before reaching a decision. In the circumstance where an entity holds enough options over voting rights that, when exercised, would place it in control over another entity, other circumstances would need to be considered before a decision can be reached.
- 24. At a conceptual level we agree with the assertions in (e) and (f).

**Question 12**

Should any of the above control issues be addressed at the standards-level rather than at the concepts level? If so, which issues and why?

25. We believe that issues 11 (d), (e) and (f) are more appropriately considered at the standards level rather than at the concepts level.

**Question 13**

Are there any other conceptual issues, relating either to the control concept or to some other aspect of the reporting entity concept, that are not addressed in this discussion paper and should be addressed at the concepts level? If so, which issues and why?

26. ASB has no other conceptual issues that have not already been noted above.