

29 September 2008

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THE INSTITUTE  
OF CHARTERED  
ACCOUNTANTS  
IN ENGLAND AND WALES

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By email: [commentletter@efrag.org](mailto:commentletter@efrag.org)

Dear Stig

**DRAFT COMMENT LETTER - PRELIMINARY VIEWS ON AN IMPROVED  
CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING - THE REPORTING  
ENTITY**

The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to respond to EFRAG's Invitation to Comment on its draft comment letter on the IASB Discussion Paper *Preliminary Views on an Improved Conceptual Framework for Financial Reporting - The Reporting Entity*.

The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world-leading professional accountancy body, the Institute provides leadership and practical support to over 130,000 members in more than 140 countries.

We are broadly in agreement with EFRAG's draft comment letter. Our views on EFRAG's main comments are as follows.

- (a) We agree with EFRAG and the DP that the Framework should contain a broad description of a reporting entity.
- (b) Although we have no overwhelming objection to the broad description proposed, we do believe that a 'circumscribed area of business activity' is missing something important in terms of 'unity' or 'cohesion' of business activity. In our view, there must be a cohesive purpose to the 'entity' around which the line is drawn.
- We agree with EFRAG that control alone should not be used as the basis for determining the composition of a group reporting entity. A pure control model could not be made operational without some application of risk and rewards concepts.
- We agree with EFRAG and the Discussion Paper that the controlling entity model should be used when using control to determine the composition of a group reporting entity; and that in some circumstances the common control model will provide additional, useful information.

- (a) We agree with EFRAG and the Discussion Paper that whether or not control exists will depend on assessing the practical implications of all the existing facts and circumstances. We would additionally make the point that there is a separate project on control, so any comments at this stage can only be taken as preliminary.
- (b) We also agree that, to satisfy the power element of the definition of control, power must be held by one entity only.
- We agree entirely with EFRAG's comment that it would be premature to reach a conclusion on the perspective from which the consolidated financial statements should be presented before an in-depth analysis of all the issues involved has been developed and debated. The analysis in this Discussion Paper and in the Framework ED on Objectives and Qualitative Characteristics is inadequate. While we do not necessarily disagree that the entity perspective is the most appropriate one, it is important to ensure that the conceptual framework will continue to support the provision of information to parent company shareholders on gains and losses arising from transactions with minorities, and to address cognate issues in relation to goodwill.
- We agree that consolidated financial statements provide useful information to meet the objective of financial reporting, and 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. We believe it is important to ensure that the very practical approach to exemptions for intermediate holding companies is maintained and so care is required as to the approach taken in the conceptual framework to separate financial statements. Separate entity financial statements should still be classed as general purpose financial statements to which IFRS can be applied.

In addition to the major points made by EFRAG in its draft response, we believe it may be worth emphasising that although the Discussion Paper rightly refers to equity investors, lenders and other capital providers in the description of a reporting entity, it is important to continue to make clear that there is a wider group of stakeholders, including the public interest, with a legitimate interest in general purpose financial statements.

Our responses to the questions to constituents specifically raised by EFRAG are set out below.

**The DP assumes that control is something an entity either does have or does not have. Yet many jurisdictions have legislation or regulations that protect minority interests to varying degrees, and the effect of this is that there are more restrictions on what a 51% shareholder can do with its investment than on what a, say, 90% shareholder can do. Some EFRAG members think the discussion in the DP—and eventually in the revised Framework—would be richer if it discussed this in terms of its control definition. (For example, one possible way of discussing the issue might be to say that, although the control definition requires the controller to have a power to direct the financing and operating policies of the controlled entity, the definition does not require the controller to have absolute power to do whatever it wanted.)**

**Do you think this matter should be addressed in the Framework and, if you do, what do you think it should say and why?**

We agree that this is an important issue, and we have made the point in our response that it is the power to direct that is important. We agree that this issue could have been helpfully explored in the Discussion Paper, and we would expect to see it developed in an ED.

**The majority of EFRAG members agree with the statement in (e) (ie that to satisfy the power element of the definition of control, power must be held by one entity only). In their view, 'control' and 'joint control' are very different things when viewed from the perspective of the controlling entity or entities. However, some EFRAG members would have liked the notion of joint control to be explored in the DP, particularly bearing in mind that they believe its application to certain transactions can result in information that is more useful than the application of the control notion. Do you have any comments on this issue?**

We agree that it would have been helpful if the Discussion Paper had considered the issues of joint control and joint ventures, and we have made that point in our response. We have not developed our own views at this stage.

**So far, EFRAG has not identified any further conceptual issues that should be addressed in the DP. Do constituents believe there are any such issues?**

Our attached response suggests a number of areas in which further consideration is needed, including the following (paragraph references are to our response to the IASB):


- (a) the need to import some idea of a cohesive unit into the description of a reporting entity (paragraph 2.2 );
- (b) issues around the ability to direct the entity, such as temporary control, 'autopilot' issues and so on, in determining control (paragraph 3.3 );
- (c) possible uses of the common control model (paragraph 7.1 );
- (d) use of the entity perspective vs the parent perspective when presenting consolidated accounts (paragraph 8.1 ).

However, we are not entirely clear whether these are the sort of 'further conceptual issues' that the IASB is referring to.

Our full response to the IASB is attached.

Please contact me if you would like to discuss any of the points raised in this response.

Yours sincerely



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THE INSTITUTE  
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29 September 2008

Our ref: ICAEW Rep 107/08

Your ref:

Sir David Tweedie  
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Dear David

**PRELIMINARY VIEWS ON AN IMPROVED CONCEPTUAL FRAMEWORK FOR  
FINANCIAL REPORTING - THE REPORTING ENTITY**

The Institute of Chartered Accountants in England and Wales (the Institute) is pleased to respond to your request for comments on the Discussion Paper *Preliminary Views on an Improved Conceptual Framework for Financial Reporting - The Reporting Entity*, published in May 2008.

Please contact me if you would like to discuss any of the points raised in the attached response.

Yours sincerely

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## ICAEW Representation

ICAEW REP 107/08

### PRELIMINARY VIEWS ON AN IMPROVED CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING - THE REPORTING ENTITY

Memorandum of comment submitted in September 2008 by The Institute of Chartered Accountants in England and Wales, in response to International Accounting Standards Board Discussion Paper *Preliminary Views on an Improved Conceptual Framework for Financial Reporting - The Reporting Entity*, published in May 2008.

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## **INTRODUCTION**

1. The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to comment on the International Accounting Standards Board Discussion Paper *Preliminary Views on an Improved Conceptual Framework for Financial Reporting - The Reporting Entity*, published in May 2008.

## **WHO WE ARE**

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 130,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.
4. Our members occupy a wide range of roles throughout the economy. This response was developed by the Financial Reporting Committee of the Institute, which includes preparers, analysts, standard-setters and academics as well as senior members of accounting firms.

## **MAJOR POINTS**

5. We welcome the Discussion Paper as the first step in establishing a reporting entity concept in the Framework being developed jointly by the IASB and the Financial Accounting Standards Board. We are generally supportive of the preliminary views set out in the Discussion Paper, but we have certain reservations and believe that further work will be required before the Discussion Paper can be developed into an Exposure Draft.

## **Users of financial statements**

6. The draft refers to equity investors, lenders and other capital providers in the description of a reporting entity. We agree that this is the correct approach, because the information model of capital providers also serves other users who have a legitimate interest in financial statements. The current Framework uses the needs of providers of risk capital to the entity as a proxy for the needs of other users. For the purpose of developing standards, it is important to acknowledge that there is a wider group of stakeholders, including the public interest, with a legitimate interest in general purpose financial statements.

## **The reporting entity**

7. We agree that the reporting entity should not be limited to legal entities and that a broad description is preferable to a precise definition. However, we

suggest that the proposed description may be too broad, and may need to be reconsidered in order to emphasise that an entity implies a cohesive business unit, and cannot be a collection of otherwise unrelated entities that happen to be in the same business. (See paragraph 15 below.)

### **Group reporting entity**

8. There are issues about the boundaries between a reporting entity and a group reporting entity that need to be explored further in developing the reporting entity concept. As noted above, we see a need for a narrower definition of the reporting entity in order to scope out loose agglomerations of entities. The Discussion Paper rightly states that a reporting entity can be a group of entities. We suggest that in practice a reporting entity can be no larger than a legal entity, and that more clarity is needed in determining the interrelationship between legal entities, reporting entities and group reporting entities. We think that there should be clearer expression than is currently in the Discussion Paper that IFRS financial statements can be prepared by reporting entities within a group reporting entity as well as at the group reporting entity level.

### **Control**

9. We do not believe a pure control model could be used for determining the composition of a group reporting entity, because it could not be made operational without some application of risk and rewards concepts. The risks and rewards model should therefore continue to be considered in the reporting entity phase of the conceptual framework project. We accept that control is likely to be the dominant model, but believe far more work needs to be done in considering issues around the ability to direct the entity, such as temporary control, 'autopilot' issues and so on. We accept that some, at least, of this could be done at standards level. (See paragraph 20 below.)
10. Assuming that the control model is adopted, we agree that the controlling entity model should be used as the primary basis for determining the basis of a group entity.

### **Common control model**

11. We agree that the common control model should be used in some limited circumstances, such as where, for example, there is some kind of economic cohesion between the entities. We believe this issue needs to be explored further in developing this aspect of the Framework. (See paragraph 27 below.)

### **Parent entity**

12. While we do not disagree with the conclusion that the entity perspective is appropriate, it is possible to see shareholders of the parent entity are one of the main user groups of consolidated financial statements. Parent entity shareholders look to the consolidated accounts for information about, inter alia, gains and losses arising from transactions with non-controlling interests, and goodwill attributable to non-controlling interests. We do not believe that these issues have been adequately explored by the Board in this Discussion Paper or elsewhere. (See paragraph 29 et seq below.)

## **SPECIFIC QUESTIONS**

### **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?**

13. Yes. An adherence to legal entities would constitute a form over substance approach.

#### **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?**

14. We agree that the conceptual framework should give a broad description of a reporting entity. We do not believe that a precise definition is necessary and in fact attempting one would run the risk of not fitting all relevant fact patterns when applied in practice. The framework should be set at a broad conceptual level, with the standards defining how and when they should be applied. The definition can thus be widely drawn, providing standards deal with operationalising the definition.
15. While we agree that it is preferable not to define an entity too tightly, we think the reference in the Discussion Paper to a 'circumscribed area of business activity' is missing something important in terms of 'unity' or 'cohesion' of business activity. We suggest that there must be a cohesive purpose to the 'entity' around which the line is drawn. This would generally be evidenced by the ability to 'direct' the entity, an idea that is explicit in the definition of control. Therefore, we believe the Framework should include a statement to the effect that an entity will usually have a framework to set and implement financing and operating policies. The idea of a 'circumscribed' area of business activity should be expanded by saying that the area will usually be circumscribed by legal or contractual rights or, in their absence, by an effective mechanism of sanctions (for this last point we have in mind local branches of a central political or charitable organisation).
16. We agree with the inclusion of a reference to equity investors, lenders and other capital providers in the description. The information needs of capital providers provide the appropriate economic framework for standard setters in developing general purpose financial statements. However, it is important not to imply that financial statements are only of interest to capital providers. The information model of capital providers also serves other users who have a legitimate interest in financial statements. It is important not to lose sight of



the legitimate interests of other users of financial statements, and of the public interest, when considering the usefulness of general purpose financial statements.

## **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?**

17. It is difficult to comment definitively on the material on control while there is a separate project looking at the subject, particularly as the Discussion Paper is very high level. Our comments therefore need to be seen as preliminary in that context.
18. We agree that the risks and rewards model alone does not provide a conceptually robust basis for determining the composition of a group reporting entity. However, we are not convinced that a pure control model will work. Any exposure draft based on the proposals in the Discussion Paper would need to explain how the control model catered for all circumstances. It may be that the high-level concept that should be applied to circumscribe the area of business activity involves both control and risks and rewards.
19. We are not convinced that it is conceptually correct or helpful in practice to separate the control and risks and rewards models. Usually, risks and rewards follow control. In the minority of instances when they diverge, it is necessary to take a pragmatic approach to determining the status of the entity in question. It is also potentially confusing to use both the terms 'benefits' and 'rewards' when these mean the same thing.
20. Thus, although we tend at present to favour the control model as the dominant model, there is much more work to do (whether at the framework or standard level) to deal with 'autopilot' entities and similar issues. The issues relate to the ability to direct. How 'present' does the ability to direct need to be? Presumably intervention must be possible at regular and appropriately frequent intervals rather than continuously? Related to that, where an irrevocable direction is given to hand control to a third party, but the entity continues to be exposed to risks and rewards, does that mean control is still present or is this more a derecognition question?
21. It is also necessary to consider situations in which there may be risks without commensurate on-going benefits, such as guarantees or liquidity lines. (See also paragraph 28 below.)
22. We therefore believe that, for the time being, the Board should continue to keep under consideration a risks and rewards model in the reporting entity phase of the conceptual framework project, although possibly only in the context of how it might be used as a secondary criterion where the control model could not be applied to all circumstances.

#### **Question 4**

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

23. We do not necessarily agree that at this stage that control alone should be used as the basis for determining the composition of a group reporting entity. However, assuming that it is, our views are set out below.

**(a) control should be defined at the conceptual level?**

24. Yes at this level, although some additional guidance to operationalise the concept would seem necessary within the relevant standard(s).

**(b) the definition of control should refer to both power and benefits?**

25. Yes. The definition should refer specifically to the power to direct.

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

#### **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?**

26. No, because control on its own may not be determinative in all circumstances.

#### **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?**

27. We are not certain that that control alone should be used as the basis for determining the composition of a group reporting entity. However, assuming that it is, we agree that the controlling entity model should be used as the primary basis for determining the basis of a group entity.

#### **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.**

28. We agree that the common control model should be used in some limited circumstances. The common control approach may be appropriate where, for example, there is some kind of economic cohesion between the entities.

Related party disclosures may not be sufficient in such circumstances, and consolidation – or some kind of combined financial statements - will provide useful information. It may be appropriate within family networks, perhaps even where there is no control but where there are guarantees. We do not believe that the Discussion Paper has fully explored these issues. We accept that application of the common control approach will generally be a standards-level issue, but we believe that the conceptual foundation must be laid in the Framework

29. We find it somewhat strange that, in the discussion on common control or elsewhere, the discussion paper does not tackle the issue of dual-listed companies. These are where shareholders are identical across two entities and have equalised rights in each through a contractual agreement. Some discussion of what is not an uncommon situation would be helpful.

### **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?**

30. While we do not disagree with the conclusion that the entity perspective is the most appropriate one for financial reporting by companies, the discussion at BC1.11-16 (of Exposure Draft of *An improved Conceptual Framework for Financial Reporting: Chapter 1: The Objective of Financial Reporting*) does not seem to be conclusive.
31. We have previously called for a full conceptual debate about the merits of the entity model in relation to the current model, and we do not believe that the Boards have yet made an unarguable case for the entity model. While the entity model may have certain merits, we believe it is necessary to consider fully the effects of adopting the entity model in the key areas of non-controlling interests and goodwill.
32. Notwithstanding our comments above about the users of general purpose financial statements, some debate is required as to whether the shareholders of the parent entity have different information needs to other capital providers. Parent entity shareholders look to the consolidated accounts for information to enable them to make decisions, including whether a transaction results in a gain or loss to them. Although the consolidated accounts will also be of interest to minority shareholders in a subsidiary entity, they will also perhaps need to look for further information from the accounts of that subsidiary company. Accordingly, we believe that the Boards need to ensure that the conceptual framework will continue to support the provision of information to parent shareholders on gains and losses arising from transactions with minorities.
33. Similarly, issues arise in relation to goodwill, with questions as to whether goodwill should exclude amounts attributable to non-controlling interests or reflect the full amount.
34. We accept that certain of these issues are standards-level issues. However, we believe it is essential that there is a comprehensive and in-depth debate

about the perspective from which general purpose financial statements should be presented before a conclusion is reached on the subject. And in order to have that debate, a much more comprehensive analysis of the issue is needed than is set out in either the Exposure Draft or this Discussion Paper.

35. It might have been helpful if the Boards had given further consideration in the Discussion Paper to the question of joint control and how to deal with joint ventures. We are inclined to agree that joint control does not amount to a controlling relationship for the purposes of determining the reporting entity. Given the emphasis on control over assets in ED 9 *Joint Arrangements*, we assume that joint control will be dealt with in the Framework in the context of assets, but it would be helpful if the Boards elaborated their thinking to some extent at this stage.
36. There may be circumstances when proportionate consolidation would provide useful information and therefore the standard setters should leave open the option to include proportionate consolidation, perhaps not as an option but as an extra.

#### **Question 9**

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

37. We agree that consolidated financial statements provide useful information to meet the objective of financial reporting.

#### **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?**

38. The Framework should not preclude the presentation of parent-only financial statements - provided that they are issued at the same time as the consolidated financial statements but not necessarily in the same financial report. For example, there will be circumstances in which users will want to know which assets, liabilities and cash flows sit in the parent entity. We would normally expect parent-only financial statements to be accompanied by the consolidated accounts, but as long as they are clearly labelled as to what they represent, they are unlikely to be misleading even if published alone. Similarly, the separate financial statements of subsidiaries and intermediate holding companies will have their own informational value to users and are still general purpose financial statements.

### **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?**
39. We agree. Whether or not control exists will depend on assessing the practical implications of all the existing facts and circumstances. It is therefore not possible to establish required attributes of control, nor desirable to seek to do so in a principles-based approach.
- (b) **the concept of control should include situations in which control exists but might be temporary? If not, why?**
40. We agree. The possibility that circumstances might change in the future, and that such a change in circumstances might result in the loss of control, does not affect whether control exists at present.
- (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?**
41. We agree.
- (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?**
42. We agree. Holding enough options over voting rights may lead to a presumption of control. However, there may be facts and circumstances that indicate otherwise. For example, there may be no practical mechanism for the option-holder to make its views known and, as a practical matter, if the option holder cannot obtain sufficient financial information from the entity in order to consolidate it, this may indicate that control is not present.
- (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?**
43. We agree. (See our comment in paragraph 35 above).
- (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?**
44. We agree. By definition, influence is less than control.

## 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?**

45. The overriding conceptual framework should be just that, and the specifics should be left to the standard. Thus issues (a) (incorporating (b) and (c)) and (e) should be addressed at the concepts level, and the other issues ((d) and (f)) are perhaps better dealt with at the standards 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?**

46. We suggested above a number of areas in which further consideration is needed, including:
- (a) the need to import some idea of a cohesive unit into the description of a reporting entity (paragraph 15 above);
  - (b) issues around the ability to direct the entity, such as temporary control, 'autopilot' issues and so on, in determining control (paragraph 20 above);
  - (c) possible uses of the common control model (paragraph 28 above);
  - (d) use of the entity perspective vs the parent perspective when presenting consolidated accounts (paragraph 30 above).

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