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

DRAFT COMMENT LETTER

Comments should be sent to Commentletter@efrag.org or uploaded via our website www.efrag.org by 26 September 2008

Dear Sir/Madam

Discussion Paper *Preliminary Views on an improved 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 Discussion Paper *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Reporting Entity (the DP)*. This letter is submitted in EFRAG's capacity of contributing to the IASB's due process.

The DP considers various issues for the purposes of developing a reporting entity concept for inclusion in a revised, converged IASB Framework. In particular, it considers:

(a) the extent to which (if at all) the Framework needs to explain what is a reporting entity. The DP suggests that the Framework should contain a broad description: "a circumscribed area of business activity of interest to present and potential investors, lenders and capital providers".

(b) how to circumscribe the area of business activity that represents a reporting entity. The DP notes that, when more than one entity is involved, control is generally used to circumscribe the area of business activity.

(c) what control should mean in this context. The DP suggests control over another entity entails both power over that entity and the ability to obtain benefits.

(d) which approach should be used to circumscribe the area of a business activity: the controlling entity model, the common control model and/or the risks and rewards model. The DP suggests that the controlling entity model should be used as the primary basis for determining the composition of a group reporting entity.

(e) whether consolidated financial statements should be prepared from the perspective of the group reporting entity or from the parent company shareholders. The DP suggests it should be the former.

(f) whether both the consolidated financial statements of the group and the separate financial statements of the parent of that group are general purpose financial statements. The DP suggests that consolidated financial statements are general purpose financial statements, but the Board members have differing views on the separate financial statements of the parent.

(g) various issues relating to control, such as latent control and the treatment of options over voting rights.

Our detailed comments on the DP are set out in the appendix. We have structured those comments as answers to the questions asked in the IASB's Invitation to Comment. Set out below is a brief summary of our main comments.

- We agree with the DP's proposal that the Framework should contain a broad description of a reporting entity. We are also broadly happy with the broad description proposed.

- We do not agree with the DP's proposal that control should be used as the basis for determining the composition of a group reporting entity. In our view the high-level concept that should be applied to circumscribe the area of business activity involves both control and risks and rewards.

- We agree that, when using control to determine the composition of a group reporting entity, the controlling entity model should be used (although we also agree that in some circumstances the common control model will provide additional, useful information). We further agree broadly with how the DP proposes to define 'control' in this context. In particular, we agree that establishing whether control exists involves assessing all the existing facts and circumstances, that no single fact or circumstance will be evidence that one entity has control over another entity in all cases, and that no particular fact or circumstance should be a necessary condition for control to exist. We also agree that, to satisfy the power element of the definition of control, power must be held by one entity only.

- We think it would be premature to reach a conclusion on the perspective from which the consolidated financial statements should be presented until an in-depth analysis of all the issues involved has been carried out and that analysis has been comprehensively debated. The analysis in this DP and in the Framework ED on Objectives and Qualitative Characteristics is not sufficient for these purposes.

- We agree that, if an entity that is a parent prepares a set of financial statements and accompanying notes that contain no information prepared on a consolidated basis, those financial statements will often not meet the proposed objective for general purpose financial reporting and will often need to be supplemented by a full set of consolidated financial statements for the objective to be met. It is also our view that, if a set of primary financial statements and accompanying notes contain only information prepared on a consolidated basis, they will also often not be sufficient to meet the proposed objective; at least some parent-only information also needs to be provided to enable the objective to be met.

If you would like further clarification of the points raised in this letter, please do not hesitate to contact me or Sigvard Heurlin.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix:
EFRAG's responses to the questions asked in the Discussion Paper

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 EFRAG agrees that what constitutes a reporting entity should not be limited to business activities that are structured as legal entities. As the DP argues (in paragraphs 16-22), not all businesses are operated through legal entities. It *can* sometimes be difficult in practice to determine exactly where the boundaries are of an entity that is not a legal entity, but that is an issue that is, in EFRAG's view, best addressed 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?

Should the Framework contain some sort of description or definition of a reporting entity?

2 In EFRAG's view, the notion of a reporting entity is central to the Framework. For example, the ED setting out proposed new chapters 1 and 2 of the Framework proposes that the objective of financial statements and other general purpose financial reporting is "to provide financial information about *the reporting entity* that is useful to [capital providers] in making decisions in their capacity as capital providers" (emphasis added). In later chapters the Framework will presumably explain what represents an asset and a liability *of the reporting entity*. Even characteristics such as relevance and completeness depend on there being a notion of what is being reported on (the reporting entity) and what is not.

3 Bearing that in mind, EFRAG believes the Framework needs to say something on the subject and to contain some sort of description or definition of a reporting entity.

4 EFRAG recognises, as the DP itself acknowledges, that it is for each jurisdiction to decide which entities should be required to provide regular financial reports and what form these reports should take. We do not however see any contradiction between that and the proposal that the Framework should set out some sort of description or definition of a reporting entity; in effect it is the law that is saying whether or not an entity should report, and the Framework and standards that set out the scope of that entity (ie where its boundaries are). Local law cannot reasonably be expected to deal with the kind of concepts and qualitative characteristics that are included in the Framework and IFRS for this purpose.

Is the broad description of a reporting entity proposed in the DP sufficient and appropriate?

5 The DP proposes to go no further in its description or definition of a reporting entity than to say it is a circumscribed area of business activity of interest to present and potential capital providers. We do not disagree with this description—we too believe that a reporting entity is some sort of cohesive economic unit about which users want information.

6 We have discussed at some length whether the description is too vague to be of much use, which is an issue that the DP itself discusses in paragraphs 23 and 24. (The DP concludes that this broad description is not too vague to be of use when developing standards.) We doubt that the DP's broad description is precise enough to help an entity that is, for example, trying to use the Framework to determine whether something is within the scope of the reporting entity. That might be a concern, bearing in mind that the IASB´s Framework is sometimes applied at the standards level via the IAS 8 hierarchy.

7 However, we do not think it *is* a concern. What the DP's broad description is saying is that a reporting entity is a collection of business activities which are in some way connected (hence the 'circumscribed') about which those who finance the collection of business activities wish to receive information. Later sections of the DP discuss what that connection should be, so the fact that the broad description is, when judged in isolation, rather vague is not an issue. Therefore, EFRAG agrees that a broad description of a reporting entity as a circumscribed area of business activity rather than a precise definition is a satisfactory way to capture the subject of a reporting entity.

The reference to capital providers in the description (or definition) of a reporting entity

8 The Framework ED on 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 and potential capital providers. If that is indeed the objective—and EFRAG is concerned about the reference to capital providers because it appears to lead to the conclusion that financial statements should be presented from an entity perspective—EFRAG believes it follows that it is appropriate for the DP's broad description to include a reference to equity investors, lenders and other capital providers. This reference makes the link to the objective of general purpose financial statements clear. .

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?

9 EFRAG does not believe that the DP has reached the right conclusions about the so-called 'risks and rewards model'. Furthermore, we are puzzled as to why the DP argues that the risks and rewards model should not be considered further in the reporting entity phase of the conceptual framework project, but then acknowledges that the model has a role to play. (For example, in paragraph 75 on the discussion of SPEs it is noted 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)…".) In our view, if the

risks and rewards model has a role to play at the standards level, there is a good case for dealing with it at the concepts level too.

10 In paragraph 7 above, we explained that we interpret the DP's broad description as saying that a reporting entity is a collection of business activities which are in some way connected and about which those who finance the collection of business activities wish to receive information. We think that, by picking a model based on control rather than a risks and rewards model, the DP is proposing that the connection should be based on control.

11 We are not convinced that control on its own is sufficient. In our opinion, the fact that a risks and rewards model is proposed to deal with SPEs is evidence of that. Furthermore, we do not see risks and rewards and control as competing approaches. In our view, they are part of a single approach, with the risks and rewards approach being used when it is proving difficult working out whether control exists.

12 We have seen it argued that this reliance on the risks and rewards model in certain cases is acceptable within a control model because the risks and rewards model is about control ("no entity would accept an exposure to risks and rewards that it cannot control"). For example, SIC 12 lists a number of circumstances which may indicate a relationship in which an entity controls an SPE. One of these examples is the case when an entity has the right to obtain the majority of the benefits of an SPE and therefore may be exposed to risks incident to the activities of the SPE. However, we think that would require changes in the way we understand the notion of control, because in this example no power to direct is present.

13 Another possibility is that control is just one example of the application of the risks and rewards model, and therefore that the connection is about exposure to risks and rewards. Our instinct though is that the risks and rewards model is too broad in itself.

14 Another possibility is that either control or risks and rewards is the primary test and the other one a secondary test, but we do not see how that would work conceptually. We think there needs to be a single concept.

15 We have therefore concluded that the connection is about *both* control and risks and rewards. However, we have struggled in the time available to find the best way of articulating this as a single concept.

16 We recognise that the approach the IASB is developing at a standards level is to apply a control model in most cases, and to supplement that with a risks and rewards model in certain cases. We do not believe that that is inconsistent with our conclusion that the connection between the business activities included in a reporting entity is about control and risks and rewards. In effect, the high-level concept is simply being expressed at the standards level in terms of a primary test (probably control) and secondary test (risks and rewards). That works if there is a high-degree of overlap between the two tests, which we think there is.

17 We recognise that it is not enough to talk simply of "risks and rewards". The notions and underlying models need to be developed further if they are to be made operational and robust. The DP does this only for the notion of control; not for risks and rewards.

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?

18 As explained in our response to question 3 above, EFRAG does not agree that it should be assumed that control is used as the basis for determining the composition of a group reporting entity. However, in order to be helpful, the remainder of our answer to this question is based on the premise that we accept that assumption.

19 EFRAG agrees that, if control should be used as the basis for determining the composition of a group reporting entity, control should be defined at the concepts level—it is too important a notion for the Framework to stay silent about—and that the definition of control should refer to both power and benefits.

20 The DP proposes the following working definition of control:

> 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).

21 EFRAG believes that this proposed definition achieves a satisfactory balance between an operational definition and high concepts, and that standards can be used to fill in the detail.

22 We do however have a few detailed comments on the proposed definition.

(a) We think the working definition will need to be refined to make it clear that the benefit criterion is not intended to capture trustees, asset managers and others who are delegated a power to direct in return for a fee that is sometimes based on the value of the assets underlying that direction, or even a performance-related fee.

(b) We are not convinced that the last part of the proposed working definition ("and increase, maintain or protect the amounts of these benefits (or reduce the amount of those benefits)") adds anything. This could mean that the significance of the words is not sufficiently clear, but could also mean that the words are superfluous.

(c) It has become clear during our discussions, that the use and positioning of the words "so as to" in the definition is difficult for some non-native English speakers to understand. We encourage the IASB to find a simpler form of words.

Question to constituents

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?

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?

23 As already explained in our response to question 3, we do not agree that the composition of a group reporting entity should be based on control alone. In our view, at the concepts level the composition of a group reporting entity should be determined by considering both control and risks and rewards; circumscription is about both risks and rewards and control.

24 As also explained in our response to question 3, we accept that for practical purposes this high-level concept translates into applying a control model in most cases, and supplementing it with the risks and rewards model in certain limited 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?

25 As explained in our response to question 3 above, EFRAG does not agree that it should be assumed that control is used as the basis for determining the composition of a group reporting entity. However, in order to be helpful, the remainder of our answer to this question is based on the premise that we accept that assumption.

26 The DP discusses three possible approaches—the controlling entity model, the common control model and the risks and rewards model—before eventually settling on the controlling entity model. As might have become clear already from the way we have discussed the risks and rewards model, we think the DP's approach to this issue is not quite right. In our view, one first defines the notion that should be treated as the thing that links together entities within a group reporting entity—the DP proposes it should be control; we have proposed that it should be both control and risks and rewards—and then decide exactly how that linking notion should be used to identify the entities forming the group reporting entity—in the DP's case it proposes the controlling entity model should be used to implement a linking notion based on control. Question 6 is about the second issue (deciding how the linking notion should be used) and we think this is the wrong place to be discussing the risks and rewards model.

27 However, focusing specifically on the question asked, , we agree that the controlling entity model should be used rather than the common control model as the primary basis for determining the composition of a group reporting entity when control is

being used as the determinant. That is because we believe that the group reporting entity should include the controlling entity, as well as those entities it controls.

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 Although EFRAG believes that the controlling entity model is appropriate to apply to determine the composition of a group reporting entity when control is being used as the determinant , it also believes that useful additional information would sometimes be obtained from the common control model. For example this could be the case when entities are under common control of a family. In such situations cash is often transferred between the entities and an aggregate view might be required to reflect properly the financial position of something which obviously works as a group in certain respects.

29 However, in those circumstances in which the common control model would provide additional information, we would not wish it to be used instead of the controlling entity model. Rather, it would be used to provide information that is additional to that provided by applying the controlling entity model.

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 We note that the IASB Framework ED on Chapters 1 and 2: Objectives and Qualitative Characteristics proposes the adoption of the entity perspective. It is our understanding that, although the wording used is slightly different, the ED's references to the entity perspective and the DP's references to the perspective of the group reporting entity are references to the same thing.

31 Bearing that in mind, we repeat the comments we have made in response to the ED's proposal. We believe that 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 that set out in either the ED or DP.

Question 9

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

32 Before answering this question and question 10, we thought it would be helpful to make some general comments. We are making those comments now because we do not think they respond directly to the questions asked but are important, both in themselves and in order to understand our responses to questions 9 and 10.

(a) In our view, if a set of primary financial statements and accompanying notes contain only information prepared on a consolidated basis, they will often not be sufficient to meet the proposed objective for general purpose financial reporting set out in OB2 of the ED on Objectives and Qualitative Characteristics; at least some parent-only information also needs to be provided to enable the objective to be met. Nevertheless, consolidated financial statements do provide information that is useful to equity investors, lenders and other capital providers.

(b) Similarly, if an entity that is a parent prepares a set of primary financial statements and accompanying notes that contain no information prepared on a consolidated basis, in our view those financial statements will often also not meet the proposed objective; although in this case we believe that *a full set of consolidated financial statements* needs to be provided to enable the objective to be met. Having said that, parent-only financial statements do still provide information that is useful to equity investors, lenders and other capital providers.

(c) We think it follows from this that consolidated financial statements are general purpose financial statements, but we have different views on what it means for parent-only financial statements. Some members believe that, as parent-only financial statements are not capable of meeting the objective of general purpose financial reports unless they are supplemented by a full set of consolidated financial statements. It would follow from that that parent-only financial statements are not general purpose financial statements.

(d) We also debated what the reporting entity is that is the subject of a set of consolidated financial statements: is it the group or the parent? EFRAG members have different views on this issue with some arguing that the DP's description of a reporting entity (in effect, an area of business activity circumscribed by control) implies that only the group is a reporting entity. This view also leads to the conclusion that parent-only financial statements are not general purpose financial statements. Other EFRAG members have different views.

33 Turning now to the specific question asked: yes, EFRAG agrees that consolidated financial statements provide useful information to meet the objective of financial reporting. However, in our view providing only consolidated information will *not* be sufficient to enable the financial statements to meet the objective set out in the Framework; the consolidated information needs to be supplemented with parent-only financial statements or extracts thereof.

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?

34 We would be grateful if you could read our answer to this question in the context of the comments made in paragraph 32 above.

35 In EFRAG's view, 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. We do not however think it is essential that the parent-only financial statements and consolidated financial statements are included in the same financial report.

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?***

36 EFRAG agrees with the statement in (a). Frameworks should be based on principles and it would be inconsistent with that to establish whether control exists without considering all the facts and circumstances or by applying a rule that control cannot exist if a particular fact or circumstance is not present. As we are strong supporters of a principles-based approach to standard-setting, we are in favour of all the concepts in the Framework—including the control notion—being operationalised at the standards level without resorting to rules.

37 In view of our comment above (that the existence of control should be determined by considering all the facts and circumstances and by applying principles rather than rules), we do not think it is really necessary to respond to (b) and (c) separately; they are simply sub-issues of the issues addressed in (a). However, for the record our answer in both cases is 'yes': the concept of control should not preclude situations in which the control that exists is temporary and should not be limited to circumstances in which the entity has sufficient voting or other legal rights to direct the policies of the another entity.

38 We have not yet reached a conclusion on issue (d) and in any case believe this to be an issue that is best debated and resolved at the standards-level.

39 EFRAG agrees with the statements in (e) and (f). An entity does not have the power to direct referred to in the DP definition of control if it cannot act unilaterally or if it

only has influence.

Questions to constituents

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?

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?

40 EFRAG has not debated this issue at great length. However, its initial view is that 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?

Question for constituents

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?