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International Accounting Standards Board 30 Cannon Street
London EC4M 6XH
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ED: The reporting entity

Sir.

Before answering your specific questions I would like to take the opportunity to comment on the authoritative status of the conceptual framework ("CF") as described in P10 thru P13. A CF, which has no authoritative status, cannot be considered part of a set of standards, which is claimed to be "principle based". Such a claim can only be made if all the principles are described and to what extent these principles override the rules. If the intention of the Board is that the principles are to be exclusively laid down in the CF, it is clear that the CF is not yet complete and neither cohesive. Consequently, the claim that the set of standards is "principle based" is unfounded. Furthermore, whether or not a set of standards is "rule based" or "principle based" is merely a discussion about the position on a continuum ranging from fully principle based to fully rule based. In absence of any authoritative status the set of standards of the IASB will, once the CF is finally complete, in my opinion be much closer to the rule based end of this continuum than the principle based end.

As it clear that sources and the fundaments of the current set of standards are not a coherent framework of principles, one can only wonder what the basis is for the current set of standards. Common practice by preparers and auditors, but unfortunately also events like bankruptcies, whereby reality was misrepresented in the financial reports and the aftermath of the financial crisis appear to play an important role.

I would suggest that the Board follows up on its claim that the set of standards are principle based by indicating in each current and future standard, which principles are applied in the standard and how these principles are applied. To make it a real principle based set of standards, completion of the CF is required and I would recommend the Board to direct all its efforts to this aim.

On the basis of the description of the reporting entity as suggested by the Board some interesting observations (perhaps: assumptions about the line of thought of the Board) can be made:

- a. equity investors, lenders and other creditors (note: the word "other" suggests that lenders are creditors as well) are engaged in providing resources
- b. equity investors, lenders and other creditors have a need to be informed about the use (what and how) that has been made of the resources provided
- c. equity investors, lender and other creditors have no other means for obtaining that information than by means of a financial report

These elements lead to the assumption that the Board would concur with the conclusion that financial reporting is about presenting information about the resources provided and the use made of these resources and would concur with my description of a reporting entity and the reasoning supporting it, as explained in following paragraphs.

Any definition of a reporting entity must result in all resources provided to it being reported on. Consequently, what constitutes an entity includes the resources provided to it. As resources might not be provided for free the providers may require rewards. Logically the description of an entity should include a reference to these rewards.

The function of an entity is to convert resources provided and to exchange these in a market. Resource providers are investors (=equity holders) and creditors, the distinction between those two categories being based on the conditions at which these resources have been provided. Provided means that control over these resources has been transferred, i.e. the benefits embodied in the resources will flow to the transferee at the discretion of the transferee. The aim of any entity is to realize the benefits embodied in the resources provided to it, so that these benefits flow as rewards firstly to creditors and secondly to equity holders. To accomplish this, control over these resources has been given up by equity holders and creditors and the realization of the benefits embodied in these resources by means of a conversion and exchange process has been entrusted to management. The essence of an entity is that an entity itself is not an end station of the benefits, but only an intermediate stop. The end station of the benefits is the equity holder once all obligations to all creditors have been settled. A reporting entity could thus be described as the aggregate of resources, the benefits of which will be realized by means of an exchange and conversion process and which will flow to creditors and equity holders.

Q1: No.

The suggested description of the reporting entity suffers from the same flaw as the objective of financial reporting. In my various previous comment letters I have pointed out that I strongly belief that the objective of financial reporting as adopted by the Board is incorrect. The most important problem with the Board's objective of financial reporting is that it introduces the "usefulness" criterion for information to be included, while no guidance at all is offered about how usefulness is to be determined. As a consequence no idea, no concept or no principle exists about what financial information is to be provided.

The description of a reporting entity is no more than a repetition of the objective of financial reporting, with elements added. Hence, it has the same shortcoming as the Board's stated

objective of financial reporting. The elements that are added give rise to some remarks and questions:

- a. "circumscribed area". How and by whom is the "circumscription" to be done? What period it to be covered? The reporting period? The reporting date? Should resources and obligations and results thereon be excluded from financial reports, if these fall outside the circumscribed area? I cannot imagine that the answers to these questions will lead to a reporting entity concept that will excel in ease of application.
- b. "economic activities". What exactly is meant? And what happens to an activity that is not considered economic. Is that to be excluded from financial reports or still to be included if it is somehow deemed useful to someone?
- c. The objective of financial reporting states: "...financial information that <u>is</u> useful". The description of the reporting entity states: "<u>has the potential to</u> be useful". Why this difference in the approach of usefulness?
- d. The description of the reporting entity states: "...who cannot directly obtain the information". Does that mean that financial information that can be directly obtained is not to be included in a financial report?

Q2:

- I do agree that if an entity controls one or more entities it should present consolidated financial reports. However, some exceptions must be made to this general principle. Firstly, controlled entities of which the controlling entity intends to dispose of its control, should not be consolidated. Secondly, an entity that has control over another entity, but does not actively exercises its control (nor has any intention to do so) should not consolidate that controlled entity. Presenting assets and liabilities added together only because these are under common control would in my opinion not portray reality, because it suggests to present the outcome of an actively managed, integrated conversion and exchange process, while in actual fact this actively managed integrated process might not exist.
- In S2 a new definition of control is introduced. I note that many of my criticisms with respect to the suggested definitions in the earlier ED's on reporting entity and consolidated financial statements as described in my related comment letters have been addressed. Nevertheless, some remarks should be made. The main problem with the definition remains, namely that it is different from that used for other assets. This is especially true in relation to the current working definition of an asset (see also my correspondence with the related project leader, which correspondence is enclosed for your convenience). Furthermore, the essence of control (in the context of financial reporting by an entity) is that benefits embodied in a resource can be made to flow to the entity. It is irrelevant if the entity does so by "directing the activities" or by any other means. The word "generate" is confusing in the sense that it is unclear whether control only exist if the benefits actually flow to the controlling entity. I would suggest that in the CF it is made clear the benefits can be both positive and negative, so that it is not necessary to indicate that, when the term is used in a standard.

Q3: No. Refer my reasoning above.

Q4: Yes.	Standards on	consolidation	of financial	information	of entitie	s can not p	ossibly be
develope	d without a d	efinition of an	entity and k	nowledge ab	out what	constitutes	an entity!

Please note that the above views are my personal views, not the views of any of the organizations I am related to.

Sincerely Yours,

P.A. Pieterse van Wijck

Dear Madam, Dear Sir,

The Conceptual Framework of Financial Reporting should in my opinion be the fundament for setting future IFRS and improving current IFRS. Therefore I follow the project with great interest and I have provided my comments on its several publications. Although the current phase B is not open to comment I do believe that on the crucial matter of definitions the project might perhaps benefit from my views as put forward below.

The current definition of an asset is: "an asset is a resource controlled by the entity as a result of past events and from which future benefits are expected to flow to the entity". Although I concur with the Board that this definition has some shortcomings, I believe that these are merely a matter of wording. The basic concept behind the definition of an asset is principally right: a resource, the benefits of which will flow to the entity.

The currently suggested definition is: "An asset of an entity is a present economic resource to which the entity has a right or other access that others do not have". This definition has some shortcomings as well, as I will explain below, and in my opinion far worse than the earlier definition.

If assets, liabilities and equity are the elements of an entity's financial position the definitions of these elements need to collectively describe these elements of financial position, be internally consistent and be mutually exclusive, i.e. leave no doubt at all that something is either an asset, or a liability or equity. Any definition of one of these elements must be accompanied by definitions of the others to ascertain that these criteria are met. The offered suggested definitions of asset and liability do in my opinion not meet these logical criteria, while a definition of equity is absent.

Another major weakness of the definition is that it refers to access. Access is a static notion and tells nothing about the flow of the benefits embodied in the resource, be it cash or other forms of benefits. The question whether these benefits flow to the entity or not, is not addressed in the definition.

The second part of the suggested definition concerns this access notion by stating: "the entity has a right or other access that others have not". The wording "... or other access" suggests that "a right" is a subset of all forms of access and unless there is a specific reason of naming this subset separately it should be omitted. The addition "that others have not" introduces a condition that apparently must be met (why else stating it?) and this condition is yet another major weakness of the suggested definition. In practice it can never be determined that others do not have that access unless these "others" are fully transparent about their access. It seems likely that this transparency will in practice seldom exist.

The original definition of asset referred to "expected to flow". The use of the word "expected" was unfortunate, because it generally refers to someone's personal, subjective observation. The word "probable" would have been better, as this originally refers to a more objective measure. The key matter however in the original definition is that it did not explicitly require certainty as to the benefits flowing to the entity. The currently suggested definition fails to address this point and therefore suggest that unquestionable certainty is required with respect to the entity's access and lack of access of others. In my opinion this is a major weakness.

The description of economic resource refers to cash. Unfortunately so, because that suggests that a resource is an asset only if it is capable of "producing cash inflows or reducing cash outflows". If it is capable of producing inflows of something else than cash (resp. reducing outflows of something else than cash) it is apparently not an asset. I can't imagine that such is envisaged by the Board and rewording might be considered. Cash is just one form of a benefit a resource might produce, so a suggested description might be: a resource is something that produces benefits.

I cannot but conclude that the suggested definition is not at all an improvement over the prior one.

In my opinion a common feature of assets, liabilities and equity is that these all concern economic resources. The distinction between those elements is that the direction of the flow of benefits represented by these resources is determined by someone else (or the same person or entity in a different role) for each of the elements. The common feature of equity and liability is that these find there origin in someone having provided resources to the entity. In my comment letters on various subjects I have indicated, what a distinction between liability and equity might be and I refer to those for further explanations.

Definitions of assets, liabilities and equity should be based on, if not naturally flow from the description of the purpose of financial reporting. I am convinced that this description as currently used by the IASB/FASB is wrong and consequently I believe that the conceptual framework project will not achieve its goals. The above noted weaknesses in the currently suggested definition of assets are a first sign thereof.

Please note that the above views are my personal views, not the views of any of the organizations I am related to.

Sincerely Yours,

P.A. Pieterse van Wijck