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Australia

21 June 2010

The Chairman  
International Accounting Standards Board

Dear Chairman

**ED 2010-02: Conceptual Framework for Financial Reporting: The Reporting Entity**

My brief comments on the proposals in ED 2010-02 are attached.

If you wish to discuss any of the issues raised in the submission I can be contacted by email at [ian@company-accounting.com](mailto:ian@company-accounting.com).

Best wishes

Ian Langfield-Smith FCPA

## Structure of the Exposure Draft

*No section containing relevant definitions:*

It strikes me as peculiar that there is no section in which formal definitions of the important terms used in the document can be found. For definitions to be useful and lacking in ambiguity, they must be clearly distinguished from the discussion of those definitions. This has not been done in the Exposure Draft, and consequently it is infinitely more difficult to understand.

It may be that this omission is due to the fact that ED 193 will ultimately form part of a unified conceptual framework; however this could be appropriately dealt with by adopting an structure that allows for this.

*Indication that terms are defined (use of italics) but no definition included*

I note that several terms are in italics (for example significant influence), which suggests that they are or should be defined. However, no definition of those terms is included. Such sloppiness is inexcusable.

I note that the Boards are apparently providing a description of a reporting entity rather than a definition ... but it is unclear why they have decided to do so. Descriptions are not definitions and cannot logically be used to develop an coherent and logically derived conceptual framework.

## Lack of logic in development of reporting entity

One would expect that before attempting to define reporting entity that a stand-alone and independent definition of entity would first be addressed. A failure to do so indicates a lack of rigour and has the potential to cause considerable confusion. By first defining the term entity it is then much easier to define reporting entity and much easier to distinguish reporting entities from those entities that are not reporting entities.

## Description/definition of reporting entity

The approach taken completely fails to distinguish the role of common economic activity and associated grouping of users who cannot directly obtain information when identifying the boundaries of a reporting entity. While it is clear from the discussion that one legal entity may comprise two separate reporting entities or that two or more legal entities may comprise a single reporting entity, and it appears that there can otherwise be multiple reporting entities, there is no nexus drawn between such multiplicity and the existence of distinct and separate information needs of some groups of users. For example, in a pyramid group structure, where at each level there is non-controlling shareholders, it would seem that the common economic activity in which users are interested will differ depending on whether they are, for examples, shareholders of the ultimate parent or shareholders of an intermediate parent (that is non-controlling shareholders). It is doubtful that consolidated financial statements of the entities controlled by the ultimate parent will adequately meet the information needs of non-controlling shareholders several levels down the pyramid. It is the commonality of information needs about a particular economic activity, and the inability to require the entity to provide it, that is often important in determining the boundaries of a particular reporting entity, rather than solely relying on 'circumscribed area of economic activities'. This fact is not adequately reflected in the description in RE2 or the following discussion.

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I have further considered the issues raised by ED 2010-02 and the outcome of that further consideration are attached.

If you wish to discuss any of the issues raised in the submission I can be contacted by email at [ian@company-accounting.com](mailto:ian@company-accounting.com).

Best wishes

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## Description/definition of reporting entity

Rather than have a description of a reporting entity it is a simple task to develop separate definitions of entity and reporting entity. This has previously been done by standard setters with not adverse outcomes. For example, in Australia the following definitions were included in SAC 1 *Definition of the Reporting Entity* and SAC 2 *Objective of General Purpose Financial Reporting*:

**“entity” means any legal, administrative, or fiduciary arrangement, organisational structure or other party (including a person) having the capacity to deploy scarce resources in order to achieve objectives; (SAC 1, para 5)**

**“reporting entity” means an entity (including an economic entity) in respect of which it is reasonable to expect the existence of users dependent on general purpose financial reports for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources. (SAC 2, para 5)**

Such an approach avoids the considerable adverse consequences of providing an inadequate description of what is a reporting entity. A useful conceptual framework must, at the very minimum, be based on rigorous and comprehensive definitions of the key elements. A failure to do will allow the framework to be used to support accounting standards that fail to meet the expectations of users. The lack of rigour is inconsistent with a professional approach to the standard setting process.

## Control of entities v control of assets

The basis of conclusions is correct in separating the treatment of control in the context of asset definition and recognition and control in the context of one entity controlling another. While control of an entity means that the entity exercising control controls the assets of the controlled entity, it does not in any way change the definition of asset.

## Groups of individuals exercising control and consolidation

In the basis for conclusions, it is suggested that a group of individuals may be able to exercise control over an entity. This would mean that those individual would have to prepare a consolidation including the controlled entity. While it is possible in very limited circumstance for this to be so, the discussion provided gives no hint of when this may happen. At a minimum, those individuals must not be exercising joint control, since joint control does not result in control needed for consolidation. It seems to follow, that those individuals must collectively constitute a separate entity, and for this to be the case, it is essential that there is a ‘constitutional framework’ governing the exercise of control by that entity. That is, there needs to be an agreed set of rules governing the exercise of control. It is doubtful that such a set of rules can be inferred by the conduct of the individuals.

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I have further considered the issues raised by ED 2010-02 and the outcome of that further consideration are attached. In addition, I have included responses to the questions raised at the beginning of the ED.

If you wish to discuss any of the issues raised in the submission I can be contacted by email at [ian@company-accounting.com](mailto:ian@company-accounting.com).

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## Responses to questions asked by the Board

Do you agree that a reporting entity is a circumscribed area of economic activities whose financial information has the potential to be useful to existing and potential equity investors, lenders and other creditors who cannot directly obtain the information they need in making decisions about providing resources to the entity and in assessing whether the management and the governing board of that entity have made efficient and effective use of the resources provided? (See paragraphs RE2 and BC4–BC7.) If not, why?

For the reasons given in my initial submission, I believe that the wrong question is being asked. There must be, in my view, a two-stage process. The first stage is to define an entity, and the second is to provide a definition of a reporting entity. No doing so results in such an absence of precision that renders the process pointless. It is not as if the two stage process has been shown to be hopelessly flawed – indeed the Australian experience suggest that few, if any problems arose from such a process. This issue is discussed further under the heading “Description/definition of reporting entity”.

The proposed definition is inappropriately narrow. The users identified should not be limited to ‘equity investors, lenders and other creditors’ – it should extend to all those whose economic interests are impacted on by the entity. This would include employees and those who consume its output.

2 Do you agree that if an entity that controls one or more entities prepares financial reports, it should present consolidated financial statements? Do you agree with the definition of control of an entity? (See paragraphs RE7, RE8 and BC18–BC23.) If not, why?

I agree that the entities include in consolidated financial reports should comprise the entity preparing the report and the entities that that entity controls. The definition of control appears to be appropriate. In this context, I stress that control must be the only permissible basis on which entities are included in the consolidated financial statements. I have seen suggestions that exposure to risk and benefits should also be considered, a proposition that must be rejected. It is possible to be subject to risks and benefits but have no ability to change their influence over their extent other than by disposal or acquisition of ownership interests in another entity. Such risks and benefits are best reflected through the carrying amount of the investment and the reported returns on that investment. Risks and benefits without power to direct the activities is insufficient reason to include an entity in consolidated financial statements.

3 Do you agree that a portion of an entity could qualify as a reporting entity if the economic activities of that portion can be distinguished from the rest of the entity and financial information about that portion of the entity has the potential to be useful in making decisions about providing resources to that portion of the entity? (See paragraphs RE6 and BC10.) If not, why?

Yes, I agree that this can be the case.

4 The IASB and the FASB are working together to develop common standards on consolidation that would apply to all types of entities. Do you agree that completion of the reporting entity concept should not be delayed until those standards have been issued? (See paragraph BC27.) If not, why?

Yes, I agree that the completing of the reporting entity component of the conceptual framework should not be contingent on completion of the review of the consolidation standards.

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