

Conceptual Framework for Financial Reporting – The Reporting Entity

The ABI's Response to the IASB's Exposure Draft ED/2012/2

Introduction

1. The ABI is the voice of the insurance and investment industry. Its members constitute over 90 per cent of the insurance market in the UK and 20 per cent across the EU. They control assets equivalent to a quarter of the UK's capital. They are the risk managers of the UK's economy and society. Through the ABI their voice is heard in Government and in public debate on insurance, savings, and investment matters.
2. The ABI is grateful to the *International Accounting Standards Board (IASB)* for the opportunity to respond to its invitation to comment on its Exposure Draft ED/2010/2, *Conceptual Framework for Financial Reporting: The Reporting Entity*.

General Comments

3. We find this exposure draft to be disappointing both in its conclusions and in the analysis by which it reaches them and we are doubtful that its existence will help guide future development of international financial reporting standards along a better path than might otherwise be followed. We believe that the deficiencies in the exposure draft may owe much to the Board's adoption of an 'entity' rather than 'parent company' or 'proprietary' perspective in developing this part of the conceptual framework. We remain unconvinced of the merits of the 'entity' approach.
4. We expand on the above in our answers to the Board's questions in the annex to this letter.

ANNEX

Questions for Consultation

Q1 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?

No, we do not think this to be a sound or useful definition. It does not cover the structural basis on which the entity has a relationship with those that provide the entity with resources. This is important because areas of economic activities do not of themselves undertake anything that the definition would have them do.

Economic activities do not themselves report but those who are carrying them out may well do. An entity will report if it is obliged to by law, regulation or contractual arrangement, or in accordance with the requirements of its owners. This will only make sense in respect of identifiable bodies against which the obligation can be made enforceable or where a concept of ownership exists. Shareholders, lenders and other creditors must contract explicitly or implicitly, if not with natural persons, with a legal entity and it is unclear what meaning they would see in the accounts of 'activities' or what the meaning of liabilities and equity, and therefore expenses and profit, would be within such accounts. It is difficult to envisage circumstances in which 'general purpose financial reporting' will be undertaken otherwise than in respect of, or at the behest of, a legal entity. In the EU it is listed companies that are the relevant reporting entities together with those other companies that choose to follow international financial reporting standards.

We agree that financial reports are useful in facilitating an assessment of whether the management and the governing board of that entity have made efficient and effective use of the resources provided.

Q2 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?

We think that the opportunity should have been taken to think afresh about the purpose of consolidated accounts. For investors, the primary justification is that this provides a view more in accordance with economic substance than would be provided by parent company accounts. The secondary justification is that to understand the full universe of resources under control of management allows a richer understanding of their stewardship and ability to create overall value. However, shareholders' ultimate interest is in the risks and rewards that accrue to themselves and in certain respects proportionate consolidation can represent the most relevant accounting treatment.

Lenders' and other creditors' interest will be in the particular group company with which they have a contractual relationship and the financial circumstances of other

group companies in certain circumstances may, but need not, have any relevance to such parties.

We do not therefore consider that the Board is justified (as per BC26) in disregarding proportionate consolidation apparently on the grounds of being a misnomer and merely a method of accounting for an investment in another entity. Accounting appropriately for investments in other entities is a subject of key importance for accounting standards setters. The entity is the entity. Preparing fully consolidated accounts in respect of it is a method of accounting for that entity bearing in mind its investments in other entities. It may or may not be considered a misnomer on this account.

The Basis of Conclusions provides an extremely poor justification for full consolidation. It demonstrates correctly that where business activities are undertaken anywhere within a group of companies whose ultimate ownership resides fully in the parent company shareholders the economic risks and rewards will be the same irrespective of the internal corporate structure. This will not be the case, though, where outside shareholders have holdings in a relevant group company, irrespective of how 'control' of relevant companies is exercised.

We agree with the definition of control of an entity. However, users of accounts are also interested in ensuring that accounting is consistent with a risks and reward perspective. It would be usual for arrangements regarding control of an entity to reflect the nature of risks and rewards as between that entity and others with an interest in it. In cases where control is unclear it may therefore be useful also to have regard to the risks and rewards arising from the relationship between the two entities. We note that this need may be met at the standards level. But we suggest that it would afford a firmer basis for the development of standards if such a reference was made in the conceptual framework as well.

Q3 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?

A company that is a subsidiary is a legal entity in its own right and therefore could be a reporting entity. Where a portion of an entity can be identified it would likely be possible to draw up accounts that related to the resources within and economic activities conducted by the management of that portion but we would regard this as an example of segmental reporting within a single reporting entity.

Q4 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?

We agree that there is no obvious rationale for delay purely on account of a desire for consistency with future converged standards between IASB and FASB on consolidation. However we question whether the ED has sufficient value to justify its being taken forward at the present time and hence deferral should be considered in any event.