Australian Government

Australian Accounting Standards Board

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19 August 2010

Sir David Tweedie
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UNITED KINGDOM

Dear David

Exposure Draft ED/2010/2 *Conceptual Framework for Financial Reporting: The Reporting Entity*

The Australian Accounting Standards Board (AASB) is pleased to provide its comments on Exposure Draft ED/2010/2 *Conceptual Framework for Financial Reporting: The Reporting Entity*. In formulating these comments, the AASB sought and considered the views of Australian constituents. The comment letters received are published on the AASB's website.

The AASB generally supports the IASB's proposed purposes for the Reporting Entity chapter of the revised IASB *Framework*, namely, to identify the boundaries of an entity that prepares general purpose financial reports (GPFRs) and identify the circumstances in which consolidated financial statements should be prepared.

The AASB also agrees with the IASB's proposals that are the subject of the four questions in the ED's Invitation to Comment. The AASB does, however, have some concerns and recommendations for addressing them which are set out below.

Identifying characteristics of entities that should be required to prepare general purpose financial reports

In essence standard-setting, when focussed on the needs of users of GPFRs, is engaging in public policy formulation. Providing useful information to these parties assists the functioning of capital markets and other markets in the economy. A logical extension of specifying, in concept, the information content of financial reports (that is, defining the nature of a public good) is specifying, in concept, which entities should provide that information (public good).

In each jurisdiction, legislators mandate which entities are to prepare GPFRs. Nevertheless, accounting standard setters have an important role to play in establishing the concepts that legislators can use to determine which entities should be required to prepare GPFRs. The AASB considers that accounting standard setters are better placed than any other parties to provide thought leadership on the principles for identifying which entities should be required to report. It is implicit in their standard-setting that they have expectations as to who will report, and even (as for example in IFRS for SMEs) what categories of those reporting entities should exist.

Expressed differently, it would seem odd that the Conceptual Framework would contain materials defining financial reporting, its objectives, the qualitative characteristics of information and the means by which the objectives might be met (recognition, measurement and display), but have no concept of who should report.

Currently, the IFRS reporting model has no floor to the scope of the IFRS for SMEs standard. And yet would the IASB expect micro entities to follow it? Surely it could be argued to be too complex for many such entities. But where are the clues for regulators that would lead them to understand that standard-setters would not want standards applied to every entity?

Might it be that entities need to have the existence or potential existence of a range of users that could be expected to be dependent upon published financial statements for economic decision-making? Might it be that when entities hold out their financial statements to be general purpose that they should be of a certain quality? Does the economic significance of an entity to its economy, or its role in handling the money of others, matter? These are not new matters to the proposed draft, but they are not synthesised into guidance for determining when an entity should have to produce GPFRs.

In summary, the revised IASB *Framework* should provide guidance for identifying which entities should be required to prepare GPFRs as:

(a) it would provide assurance that the basis for determining which entities should prepare GPFRs will be linked with the objective of GPFRs;

(b) it would reduce the risk that decisions about which entities are required to prepare GPFRs will be *ad hoc* in nature; and

(c) as a global standard setter, the IASB can provide conceptual guidance to inform regulatory decisions made at a jurisdictional level, and reduce the likelihood of each jurisdiction 'reinventing the wheel' by developing its own criteria for determining which entities should prepare GPFRs.

Identifying characteristics of portions of entities that should not be required to prepare general purpose financial reports

Exposure Draft ED/2010/2 does not provide a conceptual basis for identifying the circumstances in which an entity need not prepare GPFRs if it is a portion of an entity that prepares GPFRs. As explained below, this is an important issue for IFRSs. Therefore, the AASB recommends including in the revised IASB *Framework* an explanation of the circumstances in which an entity need not prepare GPFRs if it is a portion of an entity that prepares GPFRs, and the rationale for that position.

Exposure Draft ED/2010/2 proposes permitting virtually any economic activities to be identified as a reporting entity, based on user needs for information about those activities. The AASB agrees with that proposal. However, taking the position that GPFRs can be prepared at a very low level of disaggregation provokes the question: When would it be unnecessary to report on particular economic activities if GPFRs are prepared for a group entity that includes those economic activities?

This issue is regulated by IAS 27 *Consolidated and Separate Financial Statements*, but without a conceptual basis for the rules in that Standard. The AASB considers that a conceptual basis is needed for the IASB and its constituents to assess whether IAS 27 should retain:

(a) the exemption for a parent from having to present consolidated financial statements if:

  (i) it has a parent that produces publicly available IFRS-compliant consolidated financial statements;

  (ii) it is, in effect, not publicly accountable; and

  (iii) it is either:

    (A) a wholly-owned subsidiary; or

    (B) a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;

  and

(b) the requirement for parent entities that are publicly accountable to prepare consolidated financial statements regardless of whether they would otherwise meet the criteria for exemption mentioned in (a) above.

For example, it is not apparent why the exemption from having to prepare consolidated financial statements applies only if the parent meets the criteria in paragraph (a)(iii) above. Nor is it apparent why a determinant of whether full IFRSs or IFRSs for SMEs should be applied—namely, public accountability—should also be the determinant of whether the exemption from having to prepare consolidated financial statements applies to intermediate parent entities. (The logic would be more apparent if public accountability were a determinant of whether an entity should prepare any type of GPFR.)

The AASB considers that setting out a conceptual basis for identifying particular circumstances in which an entity need not prepare GPFRs (namely, if it is a portion of an entity that prepares GPFRs) is closely related to setting out a conceptual basis for identifying which entities should be required to prepare GPFRs.

The AASB's specific comments on the questions in the ED are set out in Appendix A. The AASB staff's editorial comments on the ED are set out in Appendix B.

If you have any questions regarding this submission, please contact me or Jim Paul (jpaul@aasb.gov.au).

Yours sincerely

Kevin M. Stevenson
Chairman and CEO

APPENDIX A

AASB's Specific Comments on the Questions in ED/2010/2

Question 1

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? If not, why?

The AASB agrees with the proposed description of a reporting entity.

The AASB also supports the proposed description of a circumscribed area of economic activities as "those economic activities (that) can be objectively distinguished from those of other entities and from the economic environment in which the entity exists".

Question 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? If not, why?

The AASB agrees with both proposals.

Question 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? If not, why?

The AASB agrees that a portion of an entity could qualify as a reporting entity in the circumstances described in the question. For example, the AASB agrees that economic activities conducted with a collection of assets working together may qualify as a reporting entity.

The AASB's qualification is that a GPFR for a portion of an entity should not be purported to be that of the only entity to which that collection of assets belongs. Therefore, to ensure GPFRs are representationally faithful and understandable, the AASB recommends adding guidance that a GPFR of a portion of an entity should disclose the entity to which that portion belongs. In terms of alerting users of GPFRs to the existence of broader reporting entities, such guidance would be similar to the link made in paragraph RE11 between 'parent-only' financial statements and related consolidated financial statements.

Question 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? If not, why?

The AASB agrees that completion of the reporting entity concept should not be delayed until Standards on consolidation are issued.

APPENDIX B

AASB Staff's Editorial Comments on ED/2010/2

Most significant comments

Paragraph	**Comment**
RE2	We think the concept of a reporting entity set out in paragraph RE2 should be presented as a definition, rather than a description. This is because: • Merely presenting this concept as a description implies the concept is less important than concepts defined in other chapters of the revised IASB *Framework*. We would not support such an implication; and • In general usage, a description of an item does not necessarily identify the essential nature of that item; it only needs to identify particular features. However, the concept of an item is synonymous with the essential nature of the item. Therefore, we think the concept of a reporting entity is more than a description of it.
RE2, RE3	Paragraph RE2 indicates that an essential characteristic of a reporting entity is that users of financial information "cannot directly obtain the information they need" for making decisions about the economic activities composing that entity. However, this characteristic is not included in the three features of a reporting entity set out in paragraph RE3. We recommend modifying paragraph RE3(c) to refer to financial information that is decision-useful to dependent users.

Other comments

Paragraph	**Comment**
RE2	In the first line, we suggest replacing 'whose' with 'about which'. This is because 'whose' should only be used in relation to a person (or people). In the fifth line, we suggest inserting 'the' before 'management'.
RE3	The last sentence implies a reporting entity may have other essential characteristics than those identified in (a) – (c). If other essential characteristics exist, they should be identified. We assume that the Boards did not have other essential characteristics in mind, and therefore found the meaning of the last sentence confusing.

<table>
<tr><th>Paragraph</th><th>Comment</th></tr>
<tr><td>BC10</td><td>The third sentence mentions banks (as lenders) and prospective purchasers (implicitly, potential direct investors) as examples of users that may require a general purpose financial report relating to particular economic activities. It is not clear why these are appropriate examples of when economic activities within a broader entity may qualify as reporting entities. This is because:

paragraph RE2 of the ED describes a reporting entity as economic activities about which users of financial information "cannot directly obtain the information they need" for making decisions; but
banks and potential direct investors would generally possess the power to directly obtain the financial information they need about the economic activities discussed in paragraph BC10.
</td></tr>
<tr><td>BC19</td><td>In the fourth sentence, we suggest adding 'and the governing board' after 'management'. Elsewhere, the ED uses 'management and the governing board' (treating 'management' as an apparent synonym with 'the governing board'). Our suggested amendment in this paragraph would achieve consistency with that approach.</td></tr>
<tr><td>BC22</td><td>The first sentence says the Board concluded that the boundaries of a reporting entity should be determined on the basis of control of an entity. However, under the ED, control of an entity is only relevant to determining the boundaries of a group reporting entity. This is because:

under the ED, an individual reporting entity is composed of virtually any objectively distinguishable economic activities, to which the concept of control is irrelevant; and
similarly, control is mentioned in the draft Reporting Entity chapter only in the context of consolidated financial statements, parent-only financial statements and combined financial statements. It is not mentioned in the context of individual reporting entities (even when it is referred to in respect of parent-only financial statements, such reference is only made in the context of permitting financial statements other than consolidated financial statements when a group exists).

Therefore, we recommend, in the first line of paragraph BC22, amending 'boundaries of a reporting entity' to 'boundaries of a group reporting entity'.</td></tr>
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