Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Our Ref.: C/FRSC

Sent electronically through the IASB Website (www.iasb.org)

16 July 2010

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sirs,

IASB Exposure Draft on *Conceptual Framework for Financial Reporting: The Reporting Entity*

The Hong Kong Institute of Certified Public Accountants is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on the captioned Exposure Draft (ED). Our responses to the questions raised in your ED are set out in the Appendix for your consideration.

The IASB's existing conceptual framework does not include a reporting entity concept. It is believed that by describing the reporting entity within the conceptual framework, it should be easier for preparers to determine what should be included or excluded from the reporting entity's financial statements. We generally agree with the ED's proposed description of a reporting entity which attempts to cover a broad range of financial information. We note it will include what normally would not be regarded as general purpose financial statements. If the intention is to make it as wide as possible, we believe it could be perhaps described more simply as "a separately identifiable unit of economic activities whose financial information provides useful information to its proposed intended users".

Although we agree that a reporting entity need not necessarily be a legal entity, we believe using a legal entity as starting reference point is useful in explaining the concept of a reporting entity as the existence of a legal entity normally triggers a reporting requirement either under the law of its place of incorporation or under accounting standards.

We note the ED describes how to determine a reporting entity and also touches on "control" in determining the circumscribed area. We believe this complicates the issue and believe that the meaning of "control" could be developed and expanded elsewhere in detailed accounting standards which provide guidance on "how" and "what" information on the reporting entity should be presented.

We note that IAS 27 *Consolidated and Separate Financial Statements* exempts a parent entity from preparing consolidated financial statements in specified circumstances (IAS 27.10). This exemption is inconsistent with the proposal in the ED that parent-only financial statements should only be presented together with consolidated financial statements. Also, we believe that this would create inconsistency with regulatory requirements in jurisdictions that require the preparation of financial statements for the parent alone. In our view, the question of the type of financial statements published by a parent entity (i.e. whether consolidated or parent-only) should be primarily a matter for local company legislation to mandate. IFRS may mandate additional disclosures beyond those required by legislation and should focus primarily only with the content of those different types of financial statements.

Given the project on the conceptual framework is of critical importance, we agree that this project should not be delayed until the standards on consolidation have been issued. However, it is important to ensure that those standards that are issued at the standards level in the future must not introduce any fundamental new concepts as they should first be debated at the conceptual level.

If you have any questions on our comments, please do not hesitate to contact me at ong@hkicpa.org.hk.

Yours faithfully,

Steve Ong, FCPA, FCA
Director, Standard Setting Department

SO/WC/jn

Encl.

Hong Kong Institute of CPAs

IASB Exposure Draft on *Conceptual Framework for Financial Reporting: The Reporting Entity*

<u>Question 1</u>

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?

We generally agree with the ED's proposed description of a reporting entity which attempts to cover a broad range of financial information. We note it will include what normally would not be regarded as general purpose financial statements such as carve-out financial statements for spin-off businesses, entities that are engaged in merger and acquisition activities and entities preparing for listing. If the intention is to make it as wide as possible, we believe it could be perhaps described more simply as "a separately identifiable unit of economic activities whose financial information provides useful information to its proposed intended users".

We have some concerns in relation to including the reference to capital providers in the proposed description of a reporting entity because it may lead to the conclusion that financial statements should be presented from an entity perspective rather than from the perspective of its owners. Unlike the Discussion Paper issued in 2008, the ED does not discuss from what perspective the consolidated financial statements should be presented. We consider that the perspective from which financial statements should be presented needs to be debated and set out in the Conceptual Framework.

<u>Question 2</u>

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 note the ED describes how to determine a reporting entity and also touches on "control" in determining the circumscribed area. We believe this complicates the issue and believe that the meaning of "control" could be developed and expanded elsewhere in detailed accounting standards which provide guidance on "how" and "what" information on the reporting entity should be presented.

(1) Levels of control

The ED introduces several levels of "control" as follows:

(a) "Control" under paragraph RE7 – *"An entity <u>controls</u> another entity when it has the <u>power to direct the activities of that other entity</u> to generate benefits for (or limit losses to) itself."*

(b) "Joint control" under paragraph RE9 – *"Two or more entities may share the power to direct the activities of another entity to generate benefits for (or limit losses to) themselves."*

(c) "Significant influence" under paragraph RE10 – *"If one entity has significant influence over another entity, it does not control that other entity."*

(d) "Entities under common control" under paragraph RE12 – *"Combined financial statements include information about two or more commonly controlled entities."*

We do not believe the different levels of "control" are sufficiently explained together with their significance, and as they do not relate to the conceptual issue of the reporting entity they need not be mentioned. However, if there is a need to mention control to introduce the concept of a group controlled by a reporting entity we would suggest the word "control" should be consistently described and have the same meaning in all detailed accounting standards.

(2) Methods of presenting financial statements of the reporting entity

The ED briefly discusses the following types of financial statements:

(a) Parent-only financial statements;
(b) Consolidated financial statements;
(c) Combined financial statements;
(d) Proportionate consolidation; and
(e) Branch accounts and carve-outs.

We are of the opinion that the above types of financial statement are just methods of presenting financial statements. As the method of presenting financial statements depends on the purpose of preparing the financial statements, we believe that it is unnecessary for the Conceptual Framework to address the specific methods of presentation as this would fall under specific standards which should include detailed guidance.

However, if the IASB decides to retain a discussion on the methods of presentation, we have the following comments: -

(a) "A reporting entity" versus "General purpose financial statements"

General purpose financial statements are usually those prepared for shareholders of a company who are not involved in the day-to-day management of the company. General purpose financial statements are also important to creditors of the company. We believe general purpose financial statements are normally regarded as synonymous to financial statements presented to shareholders at the annual general meeting of a company. These are different from financial statements that merely comprise the branch of the legal entity which would normally only be relevant to management. Moreover, carve-out information would normally only be relevant for management purposes although this method is sometimes used for specific purposes such as in an initial public offering prospectus and transaction circulars. We therefore firmly believe that how information is presented (namely, financial statements) is a separate issue from the concept of a reporting entity.

(b) *"Consolidated financial statements" versus "Parent-only financial statements"*

The ED states in paragraph RE8 that *"…. if an entity that controls one or more entities prepares financial reports, it should present consolidated financial statements".* We believe this is too prescriptive and is also inconsistent with the current requirements in paragraph 10 of IAS 27 which states that:

"A parent need not present consolidated financial statements if and only if:

(a) the parent is itself a wholly-owned subsidiary, or is 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;

(b) the parent's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);

(c) the parent did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market; and

(d) the ultimate or any intermediate parent of the parent produces consolidated financial statements available for public use that comply with International Financial Reporting Standards."

We would also point out that consolidated financial statements is only one form of presenting group financial statements that may be permitted in some jurisdictions such as under the current Hong Kong Companies Ordinance. Accordingly, it may be more appropriate to add "normally" in paragraph RE8 of the ED to read as follows:

"Accordingly, if an entity that controls one or more entities prepares financial reports, it should normally present consolidated financial statements."

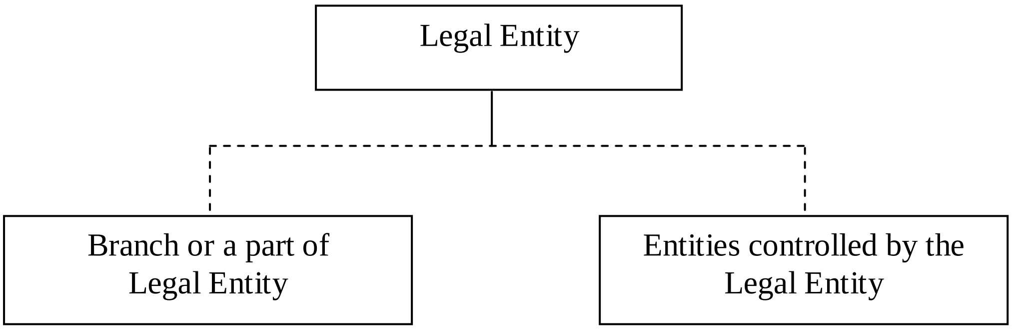
We note that paragraph RE11 of the ED states that *"Such 'parent-only' financial statements might provide useful information if they are presented together with consolidated financial statements".* We agree that 'parent-only' financial statements together with consolidated financial statements will be useful especially where the parent has substantive transactions in its own right and also for listed companies where investors are interested in resources and dividends that are legally distributable by the listed entity.

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? (See paragraphs RE6 and BC10.) If not, why?

Although we agree that a reporting entity need not necessarily be a legal entity, we believe using a legal entity as starting reference point is useful in explaining the concept of a reporting entity as the existence of a legal entity normally triggers a reporting requirement either under the law of its place of incorporation or under accounting standards. As illustrated in the below diagram, a reporting entity depends on the perspective one looks:

(a) At the legal entity level;
(b) At the branch level;
(c) At the group level.



Depending on the proposed users' requirements and needs, as proposed under the ED it is also possible to have any "carve out" of the information of any part(s) of the above. We believe the use of a pictorial diagram with reference to a legal entity as a starting point will promote understanding and should be used.

Sufficiency of legal entity

We note that paragraph RE4 of the ED states that *"The existence of a legal entity is neither necessary nor sufficient to identity a reporting entity"*. We disagree with this statement and believe that the existence of a legal entity would normally be sufficient to identify a reporting entity and this is in fact the case under section 126 of the Hong Kong Companies Ordinance which currently requires the financial statements of the company (the legal entity) to be prepared in the first instance, and if the company has subsidiaries, the need to prepare "group accounts" which may not necessarily be presented in the form of "consolidated financial statements".

Commingled activities

Paragraph RE5 of the Exposure Draft states that "*a single legal entity may not qualify as a reporting entity if, for example, its economic activities are commingled with the economic activities of another entity and there is no basis for objectively distinguishing their activities*".

Paragraph BC9 of the Exposure Draft further states that "*Some respondents said that all legal entities should qualify as reporting entities by themselves. The Board disagreed because in some situations the boundaries between two legal entities may be artificial. For example, two legal entities may commingle their resources, claims and operations to the extent that the economic activities of the two entities cannot be objectively distinguished*".

We believe that the meaning of "*commingled*" should be further explained by including an illustrative example as we believe that commingling without objectively distinguishable activities will not be a common occurrence. Moreover, if a legal entity does exist, it is likely that it would have reporting and other filing obligations (e.g. tax) which would require it to be able to distinguish its activities from others even if the activities are somehow commingled with others.

We have similar views to the "some respondents" as explained above in our reference to the current requirements of the Hong Kong Companies Ordinance. A legal entity will normally create a reporting entity but this does not preclude the legal entity from preparing information on a wider reporting entity, namely, group accounts where this is useful information.

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? (See paragraph BC27.) If not, why?

We agree that this project should not be delayed until the standards on consolidation have been issued but those standards that are issued at the standards level in the future must not introduce any fundamental new concepts as they should first be debated at the conceptual level.

In addition, we support the Boards' efforts to improve and update their Conceptual Frameworks and acknowledge that later phases of the Boards' joint Conceptual Framework project may include amendments to parts of the Conceptual Framework completed in previous phases. Accordingly, we continue to believe that constituents should have the opportunity to comment on the entire revised Conceptual Framework before it is finished.

Other comments:

IASB to consider a "Definition" chapter

To simplify accounting standards and to avoid the use of similar terms with different meanings, we recommend that the IASB should consider amending its approach to writing accounting standards by creating a separate standard or a chapter that deals with "definitions" that are used throughout the Conceptual Framework and detailed accounting standards. When these terms appear in an individual standard or statement, the terms should be shown in bold or a specific type-face to indicate that the term has a specific and defined meaning. This will promote consistency and would remove the need to repeat definitions in each individual standard. For example, the ED uses the term "parent-only financial statements" which is different from the term *"separate financial statements"* currently used in IAS 27 – the Consolidated and Separate Financial Statements. We believe that the IASB should use consistent terms to avoid confusion.