13 September 2002

Marie-Christine Batt
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

Dear Madam

**LSCA TECHNICAL COMMITTEE RESPONSE TO EXPOSURE DRAFT OF PROPOSED IMPROVEMENTS TO INTERNATIONAL ACCOUNTING STANDARDS, SPECIFICALLY RE: IAS 33 "EARNINGS PER SHARE"**

With a membership of 30,000, the London Society of Chartered Accountants (LSCA) is the largest of the regional bodies which form the Institute of Chartered Accountants in England & Wales. London members, like those of the Institute as a whole, work in practice or in business. The London Society operates a wide range of specialist committees including Technical (accounting and auditing), Tax, Regulation and Ethics Review and Financial Services and Insolvency, which scrutinise and make representations to issuing bodies such as yourselves. The LSCA Technical Committee welcomes the opportunity to respond to the International Accounting Standards Board ('the Board') regarding the revision to International Accounting Standard IAS 33, 'Earnings per share', published by the Board for comment in May 2002.

We have reviewed the exposure draft (ED) and set out below a number of comments. We comment on the specific issues raised by the Board in the exposure draft together with a number of other significant matters. Note that we have expressed our views on specific UK issues in a separate letter to the UK Accounting Standards Board; however, as the ASB has stated that it is seeking to converge with international standards to the greatest extent possible, the views in this letter should be taken as our primary input into the process of developing and improving standards that will apply directly in the UK.

## Year-to-date calculation

1. We do not agree with the approach outlined in question (ii) regarding the year-to-date calculation of diluted earnings per share. Our objections are set out below.

(a) If there were three companies that were identical in all respects other than the frequency of their interim reporting, one reporting quarterly, another reporting half-yearly and the third not disclosing interim results at all, the approach outlined in question (ii) would lead to them reporting different diluted eps figures in their annual financial statements.

(b) We are not convinced that the approach produces useful information, particularly for seasonal businesses. Volatile movements in the denominator result from the approach because the use of projected future earnings in assessing whether the contingency will occur is not permitted. Using year-to-date numbers with a full year target the movement in diluted eps quarter on quarter in example 7 of appendix B appears to have little value, which would be accentuated in a seasonal business. It would be preferable to either use a best estimate throughout the year on whether the contingency would be met, based on current forecasts, or wait until the end of the full year and then restate the full year numbers for the impact of the contingency.

(c) We believe that the approach outlined in question (ii), which is not discussed in the standard, including appendix A (which is an integral part of the requirements of the standard), is contrary to the requirements of the standard. For example, paragraph 36 of the standard requires that when bringing options into the calculation of diluted eps, fair value is the average market price of the shares "during the period". When reporting full year figures, any reference to "period" is to the full year. However, this has not been applied in the "year-to-date" approach.

(d) The "year-to-date" approach has not been applied consistently (possibly because the approach is not dealt with in the standard?). For example, in example 12 of appendix B, the approach has been applied to the warrants but not to the convertible preference shares. If the "year-to-date" approach were applied to convertible preference shares, 400,000, not 450,000, would have been included in the calculation of the full year diluted eps.

(e) Since the approach used in appendix B, which is illustrative only and does not form part of the standard, is not referred to anywhere in the standard (including appendix A) it would appear to be voluntary. Accordingly, since it is contrary to the standard (see (b) above), it ought not to be applied by any entity.

**Additional eps**

2. Paragraph 65 should not prescribe that any additional eps figures "shall be …… presented in the notes to the financial statements". The sentence should end after the words "equal prominence" and the words "and presented in the notes to the financial statements" should be deleted. In the UK it is common practice to disclose an additional eps figure alongside the eps required by

FRS 14; we are not aware of any abuses or of users of financial statements being misled. On the contrary, where the profit and loss account has been presented in a columnar format it would be bizarre to present the eps required by the standard under the relevant column and to only present the eps relating to the information in the other column(s) in the notes to the accounts. Putting additional information on the face of the profit and loss account should not be discouraged if it aids understanding of the results.

3. In 1993 the Institute of Investment Management and Research (IIMR) published a Statement of Investment Practice defining a different measure called “Headline Earnings”. The purpose of “Headline” EPS is to provide:

(1) a measure of the company’s maintainable earnings capacity, suitable in particular as a basis for forecasts and for inter-year comparisons, and for use on a per share basis in the calculation of the price/earnings ratio; and

(2) a factual “headline” figure for historic earnings which can be a benchmark figure for the trading outcome for the year.

The Financial Times uses the IIMR measure for its calculation of price/earnings ratios. We therefore believe that companies should be permitted to present additional EPS figures on the face of the profit and loss account.

4. Both paragraphs 65 and 66 require that the denominator used in calculating an additional eps shall be calculated in accordance with the standard. Where the control number for calculating diluted EPS is a loss and the adjusted eps is a profit, such that an adjusted control number is a profit, the adjusted diluted eps should be calculated by using the adjusted control number to determine whether potential ordinary shares are dilutive. However, it is unclear whether the standard intends the original or adjusted control number to be used. The standard should clarify that the adjusted control number should be used.

**Contracts that may be settled in ordinary shares or in cash**

5. We agree with the approach taken in paragraph 51 with respect to contracts that may be settled in ordinary shares or in cash. However, the paragraph applies only where the issuer has the choice of settlement, and we do not agree that it should be limited in this way. Paragraph 51 should apply regardless of whether the choice lies with the issuer or the holder. Paragraph 52 should then be deleted.

**Contracts that may be settled using new or existing ordinary shares**

6. We believe that it would be helpful if the standard included guidance on how to deal with contracts that may be settled using new or existing ordinary shares. There are differing views on how to deal with such contracts. The use of the phrase “would be issued” in paragraph 31 implies that where a contract will be settled using existing shares this need not be brought into the calculation of diluted eps. A similar principle to that in paragraph 51 should

be applied where the contract can be settled either by issuing new shares or by buying existing shares.

**In-substance share repurchase**

7. Where the overall effect of a combination of a special dividend and a share consolidation is a share repurchase at fair value, paragraph 25 of revised IAS 33 requires the transactions to be reflected in the EPS calculation as if a share repurchase at fair value has occurred, rather than in accordance with the legal form of the constituent transactions.

8. We fully support this approach and welcome its inclusion in the standard. However, we would prefer paragraph 25 to be re-drafted as a principle, rather than as a rule. Transactions should be reflected in the EPS calculation as a share repurchase at fair value where the overall effect is a share repurchase at fair value. An example of another in-substance share repurchase at fair value is where 'B' shares are issued by way of bonus issue or share split, subsequently redeemed and there is a share consolidation of the original shares.

**Convertible debt and convertible preference shares**

9. Paragraph 33 states that "when more than one basis of conversion exists, the calculation assumes the most advantageous conversion rate or exercise price from the standpoint of the holder of the potential ordinary shares". This might imply that where debt or preference shares are convertible and redeemable they are brought into the calculation of diluted eps based on which option looks the most advantageous to the holder. This would be consistent with the approach in the standard for options and warrants; only those options that are 'in-the-money' when exercise price is compared with average share price for the period are treated as dilutive and brought into the calculation of diluted eps. This approach would also be consistent with how we recommend paragraphs 51 and 52 are revised.

10. However, the illustrative examples do not refer to whether conversion or redemption is the most advantageous given the company's share price (at year-end or average for the year).

11. Even where there is no redemption option, there is still a choice unless conversion is mandatory; the option is whether to convert or take interest into perpetuity.

12. The standard should be revised to clarify that the approach that we have outlined above is correct.

13. Under IAS 32 convertible debt is accounted for by separating it into its component parts: a liability (loan) and an equity instrument (option or forward contract, depending upon whether the conversion is mandatory, to issue shares). Options are brought into the calculation of diluted eps by adding to the denominator the number of shares deemed to be issued for no proceeds.

However, example 4 of appendix B does not suggest bringing convertible debt into the calculation of diluted eps using the options method. We question whether this is appropriate. The footnote to the example states that "This example does not illustrate the classification of convertible financial instruments between liabilities and equity or the classification of related interest and dividends between expenses and equity as required by IAS 32". If the different classification leads to a different treatment in the calculation of diluted eps this would helpfully be reflected in the example.

14. Finally, on this topic, we would add that the meaning of paragraph A5 in appendix A is not at all clear. Paragraph A5 deals with the situation where the options or warrants "permit or require the tendering of debt or other securities of the entity in payment of all of a portion of the exercise price". The paragraph explains when such an option would be considered to have a dilutive effect. We would find it helpful if an example was provided to aid the understanding of the paragraph. Paragraph A6 extends the application of paragraph A5 to a situation where the holder has preference shares rather than options or warrants. However, the treatment of options in the diluted eps calculation is not the same as the approach for preference shares and therefore we believe that paragraph A6 implies a meaning that is not evident from paragraph A5 alone.

**Diluted eps**

15. Paragraph 4 of the standard defines dilution as a "reduction in earnings per share *or an increase in loss per share* (our emphasis)". Paragraph 39 is consistent with this, albeit phrased the other way round, stating that "potential ordinary shares are *anti*-dilutive when their conversion to ordinary shares would increase earnings per share from continuing operations *or decrease loss per share from continuing operations* (our emphasis)".

16. Paragraph 37, on the other hand, is incomplete, stating only that potential ordinary shares are dilutive "when, and only when, their conversion to ordinary shares would decrease earnings per share from continuing operations". Paragraph 37 should be amended to be consistent with paragraphs 4 and 39.

17. Paragraph 35 states that "the assumed proceeds from these issues [exercise of dilutive potential ordinary shares] shall be regarded as having been received from the issue of ordinary shares at fair value. The difference between the number of ordinary shares issued and the number of ordinary shares that would have been issued at fair value shall be treated as an issue of ordinary shares for no consideration". However, the illustrative examples appended to the standard only apply such a method to options and warrants (and there is therefore an inference that such a method should be applied only where fresh cash comes into the entity upon the conversion of potential ordinary shares). The method is not applied to convertible debt or convertible preference shares. We question in paragraph 14 above whether illustrative example 4 is wrong. If it is not wrong, a suggested solution is to insert a sub-heading (say, 'Options, warrants and similar potential ordinary shares' or 'Options, warrants

and their equivalents') immediately before the paragraph. Alternatively, there is already a separate section dealing with such instruments (currently paragraphs 42 to 44) and paragraph 35 could be moved to this section.

**Rights issues**

18. In paragraph A1 in appendix A would the bonus element in the rights issue not be better calculated by substituting fair value immediately before announcement of the rights issue (rather than immediately before exercise of the rights)?

19. If the above change is not made, the final sentence of paragraph A1 should be changed by reversing the words "shares" and "rights" the first time they are used. The revised sentence would therefore read "where the shares are to be publicly traded separately from the rights before the exercise date, fair value for the purposes of this calculation is established at the close of the last day on which the shares are traded together with the rights".

**Structure of the standard**

20. We prefer the structure of the existing IAS 33 to the structure of the exposure draft. We believe that having the examples throughout the standard is more helpful than relegating them to an appendix.

If there are any matters arising from this letter you would like to discuss, please do not hesitate to contact Danielle Stewart on 020 7731 6163.

Yours faithfully

Danielle Stewart
Chairman, LSCA Technical Committee

13 September 2002

Marie-Christine Batt
International Accounting Standards Board
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EC4M 6XH

Dear Madam

**LSCA TECHNICAL COMMITTEE RESPONSE TO EXPOSURE DRAFT OF PROPOSED IMPORVEMENTS TO INTERNATIONAL ACCOUNTING STANDARDS, SPECIFICALLY RE: IAS 8 'NET PROFIT OR LOSS FOR THE PERIOD, FUNDAMENTAL ERRORS AND CHANGES IN ACCOUNTING POLICIES'**

With a membership of 30,000, the London Society of Chartered Accountants (LSCA) is the largest of the regional bodies which form the Institute of Chartered Accountants in England & Wales. London members, like those of the Institute as a whole, work in practice or in business. The London Society operates a wide range of specialist committees including Technical (accounting and auditing), Tax, Regulation and Ethics Review and Financial Services and Insolvency, which scrutinise and make representations to issuing bodies such as yourselves. The LSCA Technical Committee welcomes the opportunity to respond to the International Accounting Standards Board ('the Board') regarding the revision to International Accounting Standard IAS 8, 'Net Profit Or Loss For The Period, Fundamental Errors And Changes In Accounting Policies', published by the Board for comment in May 2002.

We have reviewed the exposure draft (ED) and set out below a number of comments. We comment first on major points of concern, then on the specific issues raised in the exposure draft and finally other points of detail. Note that we have expressed our views on specific UK issues in a separate letter to the UK Accounting Standards Board; however, as the ASB has stated that it is seeking to converge with international standards to the greatest extent possible, the views in this letter should be taken as our primary input into the process of developing and improving standards that will apply directly in the UK.

**MAJOR POINTS**

## Materiality

The issue of materiality needs to be addressed in this standard, particularly in relation to the correction of errors (see our answer to your Question 2 below).
We have highlighted, in a separate letter to the Board, the importance of clarifying the application of IFRSs to immaterial items because of the late change to remove the relevant paragraph from the Board’s Preface. One (presumably unintended)

consequence of the absence of any reference to materiality in draft IAS 8 would be the need to restate comparative amounts for all errors, however trivial. In our view paragraph 32 should refer to *material* errors, and guidance on this issue should be added to the final standard.

**RESPONSES TO SPECIFIC QUESTIONS**

**Question 1**

*Do you agree that the allowed alternative treatment should be eliminated for voluntary changes in accounting policies and corrections of errors, meaning that those changes and corrections should be accounted for retrospectively as if the new accounting policy had always been in use or the error had never occurred (see paragraphs 20, 21, 32 and 33)?*

**Yes. As well as eliminating an option, we believe that this is the correct conceptual approach. However, the final standard should make it clear that it is only** material **changes arising from changes in accounting policies and the correction of errors.**

**Question 2**

Do you agree with eliminating the distinction between fundamental errors and other material errors (see paragraphs 32 and 33)?

**Yes. Although we believe that the distinction between fundamental and other material errors has conceptual merit, we support its abolition. The boundary between fundamental and other material errors is not sufficiently clear to avoid uncertainty and inconsistent interpretation. See our comments above on materiality.**

**<u>OTHER POINTS</u>**

**Selection of accounting policies**
We note that a standard on accounting for insurance contracts is unlikely to be available by 2005. Insurers are likely to have particular difficulty in implementing the guidance on selection of accounting policies in paragraphs 4-6 of draft IAS 8. We suggest that the Board considers the need for transitional arrangements or guidance in IAS 8 for entities that issue insurance contracts.

For the avoidance of doubt, we suggest that the wording of Paragraph 4 is altered to read ‘When a pronouncement or publication of the International Accounting Standards Board applies to an item in the financial statements, …’ and in Paragraph 5 ‘In the absence of a pronouncement or publication by the International Accounting Standards Board that …’

We suggest that this section of the draft standard should cross-refer to the accounting policy disclosure requirements set out in IAS 1.

**Changes in accounting policies**

**We do not support the exemption in paragraph 21 from restating comparative information relating to voluntary changes in accounting policies. It is not the grounds given for the exemption to which we object – that of 'undue cost or effort' – but rather that we consider it unlikely that the management of a company would be able to come decide on whether a change of policy is appropriate without knowing what the impact of such a change would have been on at least some aspects of the previous year's results. Obtaining information for one comparative period would, in our view, never be so onerous as to allow an exemption for no changes at all to be made to the comparative information. We suggest that the Board should redraft paragraph 21 to state that comparative information need not be restated** to the extent **that it would require undue cost and effort, thereby requiring entities to restate as much as possible, even if they cannot do so completely.**

**We also suggest that paragraph 22 should indicate that changes in accounting policy are likely to be infrequent.**

**Changes in accounting estimates**

The requirements of Paragraph 29 are unclear and would be onerous if interpreted to mean that disclosures are required in respect of each subsequent accounting period. We suggest that the Board amends paragraph 29 to make it clear that this level of disclosure is not required by adding "shall be disclosed in the period that the accounting estimate has changed". The 'undue cost and effort' exemption in paragraph 30 would then be neither necessary nor appropriate.

For the sake of consistency, Paragraph 23 should also require disclosure of the estimated effect of voluntary changes in accounting policies in subsequent periods, but again clarify that the disclosure is only required in the period of change.

**Correction of errors**

As with changes in accounting policies, we do not support the exemption given in Paragraph 33 from restating comparative information relating to errors on the grounds on 'undue cost or effort'. As for Paragraph 21 discussed above, we would prefer the text to read 'need not be restated to the extent that it would require undue cost and effort.

In addition, there should be clear guidance on the approach to be adopted if an error relates in part to the immediately preceding period and in part to earlier periods and allocation between the periods is not possible (perhaps due to fraud). In the current drafting in paragraphs 33 and 34 it is unclear whether the adjustment would be made to the opening balance of the current period or to the comparative opening balance.

Paragraph 33 also needs to use a similar approach as that in Paragraph 21 to draw in the restatement of assets and liabilities as well as retained earnings, perhaps along the lines of "When comparative information for a particular prior period is not restated, the opening balance of retained earnings for the next period <u>and the corresponding balances of assets and liabilities as at the beginning of </u>the next period shall be restated .." or similar.

If there are any matters arising from this letter you would like to discuss, please do not hesitate to contact Danielle Stewart on 020 7731 6163.

Yours faithfully

Danielle Stewart
Chairman, LSCA Technical Committee

13 September 2002

Marie-Christine Batt
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Dear Madam

**LSCA TECHNICAL COMMITTEE RESPONSE TO EXPOSURE DRAFT OF PROPOSED IMPROVEMENTS TO INTERNATIONAL ACCOUNTING STANDARDS, SPECIFICALLY RE: IAS 24 "RELATED PARTY DISCLOSURES"**

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We have reviewed the exposure draft (ED) and set out below a number of comments. We comment first on major points of concern, then on the specific issues raised in the exposure draft and finally other points of detail. Note that we have expressed our views on specific UK issues in a separate letter to the UK Accounting Standards Board; however, as the ASB has stated that it is seeking to converge with international standards to the greatest extent possible, the views in this letter should be taken as our primary input into the process of developing and improving standards that will apply directly in the UK.

## MAJOR POINTS AND ANSWERS TO QUESTIONS

### Materiality

21. In view of the importance of the qualitative aspects of such transactions, we believe that related parties is an area where materiality is especially important, and it therefore needs to be addressed in the standard. This is because, in the context of related party transactions, at least for related party transactions with key management personnel and their immediate families, materiality of a transaction to the relevant related parties should be considered, not just materiality to the financial statements as a whole. Such information will always be available to the reporting entity simply because of the inherent closeness of the relationship between the entity and its related parties. The inclusion of guidance is of particular timely importance given the current uncertainty arising from the exclusion of references to materiality from IASB's revised Preface (on which we have commented in a separate letter to the Board).

## Exemptions for Subsidiaries

22. Paragraphs 3, 4 and 19 of the draft standard deal with group situations, and due to lack of clarity, their combined effect is to confuse the reader. We have a number of concerns regarding the drafting of the exemption for subsidiaries, as detailed below.

23. Paragraph 3 provides an important exemption relating to the separate financial statements of wholly owned subsidiaries and parents (previously dealt with separately in paragraphs 4 (b) and 4 (c) of the original IAS 24). As drafted, this paragraph appears to provide exemption from disclosure of **all** related party transactions, not merely those related party transactions with other members of the same group. This does not appear to be consistent with paragraph 4 of the ED. We believe that the exemption should relate only to transactions with group members and strongly recommend that paragraph 3 should be redrafted to clarify this point.

24. However, IASB's intention appears to be to exempt, in the context of 100% subsidiaries, the disclosure of **all** their related party transactions, since this is implied in the dissenting view given in paragraph B6 of Appendix B to the ED. In our view this move would be unwelcome. It also highlights the importance of providing additional guidance on materiality in the revised standard (discussed above in paragraph 1). Transactions with related parties outside the group that are immaterial to the group as a whole, but material to the subsidiary in question, would not be disclosed in the financial statements of either the group or the subsidiary. This is exactly the point made in paragraph B6 of Appendix B as referred to above and we support the reasoning therein.

25. Another fundamental point in relation to the exemption is the fact that it applies for wholly owned subsidiaries. Limiting the exemption to only 100% owned subsidiaries is, in our view, likely to hit some obvious practical difficulties.

For example, in the UK it is often the situation that employees own shares (representing a small fraction of the total share capital) that the company cannot buy out, so achieving 100% ownership is impossible. We suggest therefore that the requirement be reduced to 90% ownership, since our experience in the UK suggests that this limit has worked well and has not been abused. Also it should be made clear that it is ownership of ordinary or common shares that is key, rather than preference or any other class of share that may be held.

26. We consider that the emphasis in paragraph 3 of the draft standard on the availability of the financial statements of the exempted subsidiary (rather than just those of the group) is inappropriate. A more logical requirement would be for the consolidated financial statements in which the subsidiary is included to be made publicly available as a requirement of the exemption. This is particularly the case if the exemption in paragraph 3 **does** extend to **all** related party transactions, not just intra-group transactions, in which case the subsidiary accounts would not contain **any** related party information.

27. In any case, we believe that the requirement in paragraph 3 for the relevant financial statements to be 'made available', or 'published' with the consolidated financial statements will be interpreted in differing ways in different jurisdictions (e.g. through electronic means that may not be accessible to all shareholders). The requirement is likely to prove onerous if it continues to be conditional on the availability of the financial statements of subsidiaries (rather than just the group accounts). In addition to this problem, is the issue of subsidiaries that have different year-ends, and therefore different accounts publication dates, to the parent entity. The clarity of this requirement should be reconsidered.

28. Paragraph 4 indicates that intra-group related party transactions and outstanding balances are eliminated in group accounts, but it is unclear whether any disclosure is expected in the group accounts. This should be clarified, since paragraph 19 does require disclosure in the group accounts of related party transactions with associates and joint ventures.

29. Paragraphs 4-10 above are intended to answer your **second question** regarding exemption from disclosure of related party transactions in group situations.

## Management Compensation

30. We have a number of concerns regarding Paragraph 2 of the ED and the proposed exemption for disclosure of management compensation and similar items.

31. We consider the revision to IAS 24 in this regard an improvement on the previous standard and therefore offer it limited support. However, this is because the UK, in relation at least to directors, is well served by company law and listing requirements in this area, as is the case in a number of other jurisdictions, but not in all. Information regarding the compensation of key management is clearly of legitimate interest to investors and other stakeholders. We therefore consider that the proposed exemption should only be available where, in a particular jurisdiction, the reporting of management compensation outside of the annual financial statements is a mandatory requirement, as in the UK. If this is not the

case in the jurisdiction in question, it is reasonable to require disclosure of aggregated information regarding the compensation of key management personnel in accordance with paragraphs 15 and 18 of the ED.

32. In order to achieve this, we recommend the following changes to the draft standard.

- "Key management personnel" should be a stand-alone definition, extracted from the current proposed related parties definition in paragraph 9(d). Also the definition needs to be amended so that it reads: "responsibility for planning, directing OR controlling the activities of the entity". This is in order that all directors are captured, including "shadow" directors and non-executive directors.

- The restriction of the exemption to management compensation "paid in the ordinary course of an entity's operations" is open to abuse and seems to us to serve no useful purpose; the words should be deleted.

- Paragraph 2 should refer, for consistency, to "the compensation of key management personnel" rather than to "management compensation".

- The draft standard should require disclosure of "the employee benefits, as defined in IAS 19, of key management personnel, as defined (at present) in paragraph 9(d)".

33. Paragraphs 10-12 above provide our answer to your **first question** regarding disclosure of management compensation, and in particular the last two bullet points above are designed to address the concerns you have expressed about the need to define 'management' and 'compensation'.

## Names of Transacting Related Parties

34. The absence of a requirement in the ED to disclose the names of transacting related parties is an issue of fundamental concern to us. Recent corporate scandals, particularly those in the USA such as Tyco, Enron and Adelphia, have invariably involved transactions with related parties that appear to have been inadequately disclosed. This would seem an ideal opportunity to tackle one of the issues raised in these cases by strengthening disclosure requirements. (In this context, please note that any confidentiality issues can generally be dealt with in a satisfactory manner; the UK standard tackles the issue of banking confidentiality rules by allowing exemption on statutory but not contractual grounds.)

35. We believe that it is **always** of fundamental importance for the user of the accounts to have knowledge of the name of the transacting related party; without it, disclosure of the relationship and the transactions is meaningless. Further, if the transacting party is a corporate entity, we believe that the name of any director who has an interest in the transacting related party should also be disclosed. This should be clarified by adding the requirement for names as detailed above, within the list of "information" in paragraph 14 of the ED

36. As currently drafted, paragraph 14 of the ED, containing the requirement to disclose the "nature of the related party relationship", could be misinterpreted. It is possible that only the "minimum disclosures" listed at the end of the paragraph will be disclosed. The paragraph should be redrafted to clarify this point, as follows:

"If there have been transactions between related parties, an entity shall disclose the nature of the related party relationship. The entity shall also disclose information about the transactions and outstanding balances necessary for an understanding of the potential effect of the relationship on the financial statements. Such information shall include [(a) – (d) *(plus names – see paragraphs 14-15 above)*] and any other information needed to fully understand the nature of the related party transaction."

## Controlling Parties

37. We consider it to be of great importance that disclosure should be made of the identity of the controlling party and ultimate controlling party of the reporting entity. This information is relevant to investors and other stakeholders seeking to appraise the prospects and financial position of a reporting entity. It will be particularly vital information should the IASB decide not to accept our recommendation, detailed above, to require the names of transacting related parties to be given. Recent European and international anti-money-laundering initiatives, which require the identification of those that control a corporate entity as part of the "know your client" procedures, would also be aided significantly by such disclosures.

38. We note that in the original IAS 24, paragraph 19 required disclosure of details of the "relationship with the controlling party", implying a need to disclose the name of that party. We believe that the requirement of paragraph 13 of the proposed standard is meaningless if the entity does not give the **name** of the controlling party, and hence the ultimate controlling party. Therefore clarification of the fact that the name of the controlling and the ultimate controlling party is required should be provided in paragraph 13 of the exposure draft. This would then represent an improvement to the old IAS 24 in line with the aims of the improvements project.

39. Further, it should be made clearer that the controlling party can be an individual, as well as a corporate entity.

### Horizontal groups and parties acting in concert

40. We consider that the definition of related parties should be extended to include persons acting in concert because of the risks associated with identifying related parties within so-called 'horizontal groups'. It is often difficult to pin down the dominant party that is causing entities to enter into transactions with related parties. This is a particular issue in those countries where "family conglomerates"

are common, and indeed a similar issue arose with business empires in the UK when the empire of the late Robert Maxwell unwound after his death.

## OTHER ISSUES

41. We recommend the following improvements to the definitions set out in paragraph 9 of the revised standard:

**Related party**

- sub-paragraph (a)(ii) - the reference to 'an interest in the entity' might be misleading and should be deleted. The new wording would therefore be: "(ii) has significant influence over the entity"
- sub-paragraph (g) - the reference to "post-*employment* benefit plan" should be amended to read "post-*retirement* benefit plan"

**Close members of the family of an individual**

- We are not convinced that the provision of examples is helpful in this instance. Examples might discourage rigorous application of the underlying disclosure principles. If examples are provided in the standard, they should be of a symmetrical nature, referring to both antecedents and descendants.

22. Paragraph 11 (c) (i) needs to be amended to indicate that parents or individuals funding a subsidiary are not intended to fall within the definition of a provider of finance.

23. In paragraph 18, we suggest a rewording as follows: "Items of a similar nature may be disclosed in aggregate *for each separate category* except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the entity."

If there are any matters arising from this letter you would like to discuss, please do not hesitate to contact Danielle Stewart on 020 7731 6163.

Yours faithfully

Danielle Stewart
Chairman, LSCA Technical Committee

16 September 2002

Marie-Christine Batt
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Dear Madam

**LSCA TECHNICAL COMMITTEE RESPONSE TO EXPOSURE DRAFT OF PROPOSED IMPORVEMENTS TO INTERNATIONAL ACCOUNTING STANDARDS, SPECIFICALLY RE: IAS 17 'LEASES' & IAS 40 'INVESTMENT PROPERTY'**

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We have reviewed the exposure draft (ED) and set out below a number of comments. We comment first on major points of concern, then on the specific issues raised in the exposure draft. Note that we have expressed our views on specific UK issues in a separate letter to the UK Accounting Standards Board; however, as the ASB has stated that it is seeking to converge with international standards to the greatest extent possible, the views in this letter should be taken as our primary input into the process of developing and improving standards that will apply directly in the UK.

## Exposure draft of IAS 17 Leases

### MAJOR POINTS

1. We have combined our responses to IAS 17 and IAS 40 as there are some areas of overlap between the proposals.

2. We recognise the limited scope of the Improvements project and that the IASB intends to reconsider in due course the fundamental approach to the accounting for leases established by IAS 17 as a separate project. However, we are concerned that some of the changes being proposed are designed as “fixes”, which lack logic and only demonstrate the urgent need for a complete review of the treatment of leases. The proposed improvements in the IASB exposure draft are, at best, relatively minor improvements to a highly unsatisfactory standard. In our view the Board should, at this juncture, isolate the conceptual issues for consideration in the more major, longer-term project and

concentrate here on dealing with acknowledged practical difficulties and failings in the standard that can be dealt with quickly, but that leave the main conceptual thrust of the standard intact. We believe that this proposed amendment to IAS 17 fails on both these fronts.

3. In the UK we face particular issues in converging to this leasing standard. Our existing standard permits an alternative approach to finance income recognition by lessors (the net cash investment method) that many believe to be conceptually superior to that in IAS 17. Our view is that only a comprehensive project on leasing can hope to tackle such issues. In addition, the UK standard contains several disclosure requirements that we believe are beneficial, more so in the current climate where failure to disclose off balance sheet items, of whatever nature, is likely to be penalised by the market. We are concerned that this 'improved' standard has not attempted to focus on more comprehensive disclosure as an interim measure until the Board has completed its work on derecognition in general and leasing in particular.

## RESPONSES TO SPECIFIC QUESTIONS

Q1 Do you agree that when classifying a lease of land and buildings, the lease should be split into two elements - a lease of land and a lease of buildings? The land element is generally classified as an operating lease under paragraph 11 of IAS 17, Leases, and the buildings element is classified as an operating or finance lease by applying the conditions in paragraphs 3-10 of IAS 17.

We do not support the proposed treatment of leases of land and buildings in paragraph 11 *et seq*. We do not accept the assumption that, unless title is expected to pass to the lessee by the end of the lease term, the lease of the land element should be treated as an operating lease, regardless of the substance of the transaction. We do not agree that either commercially or conceptually the leasehold interest in a building and the land on which it rests (i.e. the "property") can or should be separated into a lease of two different assets. In addition we can foresee many practical problems with the proposed split based on valuations, for example when a leasehold site is acquired for development purposes. We appreciate the motivation for the change, i.e. that a land element should not prevent a lease that would otherwise be a finance lease from being treated as a finance lease and we also concur with the Board's rejection of the alternative approach of classifying a lease of land and buildings as an operating lease in its entirety. However, we do not believe that the proposed approach is correct conceptually and should be dealt with in the wider major project elsewhere on the Board's agenda.

We therefore do not support the inclusion of the new paragraphs 11A, 11B and 11C; further, we believe that the second sentence of paragraph 11 should be deleted.

Q2 Do you agree that when a lessor incurs initial direct costs in negotiating a lease, those costs should be capitalised and allocated over the lease term? Do you agree that only incremental costs that are directly attributable to the lease should be capitalised in this way and that they should include those internal costs that are incremental and directly attributable?

We agree that the choice on how to account for initial direct costs incurred by lessors in negotiating a lease should be eliminated from IAS 17. On balance, we agree that capitalisation and allocation over the lease term is preferable to charging such costs as an expense when incurred. Capitalisation should be restricted to costs that are both incremental and directly attributable to negotiating and arranging a lease, including appropriate internal costs. We wonder whether the Board should also tackle the issue of initial costs incurred by lessees. Should there be parallel requirements in the standard? This seems to be an omission that could also be dealt with in the improvements project.

## IAS 40 - Investment Property

### RESPONSES TO SPECIFIC QUESTIONS

*Q1 Do you agree that the definition of investment property should be changed to permit the inclusion of a property interest held under an operating lease provided that:*

*a) the rest of the definition of investment property is met; and*

b) *the lessee uses the fair value model set out in IAS 40, paragraphs 27-49?*

Although we agree with the outcome of the proposed change, we do not believe that the classification of an asset as an investment property should be determined by the accounting treatment that is adopted for that asset (and see our answer to Question 3 below). Leasehold assets that meet the rest of the definition of an investment property should be treated as such. Accordingly, the proposed words "if and only if, in addition to the above condition being met, the lessee uses the fair value cost model set out in paragraphs 27-49 of this Standard" should be deleted. The proposed treatment demonstrates again the urgent need for a complete review of the leasing standard.

*Q2 Do you agree that a lessee that classifies a property interest held under an operating lease as investment property should account for the lease as if it were a finance lease?*

We are not sure what the practical consequences of this will be as, based on our experience in the UK, we believe that the vast majority of leasehold investment properties are long leaseholds with an immaterial ongoing rent commitment. We are also concerned that this represents a piecemeal introduction of a new treatment for leased assets which, aligned with our comments above in relation to IAS 17, should properly be left to the introduction of a new leasing standard.

*Q3 Do you agree that the Board should not eliminate the choice between the cost model and the fair value model in the Improvements project, but should keep the matter under review with a view to reconsidering the option to use the cost model in due course?*

We do not agree. One of the main reasons for the Board instituting a fast-track improvements project was the elimination of options wherever possible. The Basis for Conclusions in the original IAS 40 indicates very clearly that the favoured approach of many at the old IASC was to move to fair value, but that it was not then felt possible to do so (it was a politically difficult time, given that it was known that the existing IASC was soon to be restructured and replaced by a new Board and there was a push to get the standard out before the old Board was disbanded).

In any case, we believe that the case for removing the historical cost option in IAS 40 is quite a straightforward one to make. Property investment companies use and are judged on the basis of fair values of their properties; the accounting standard is thus lagging behind the market by not requiring relevant information to be given. The question of reliability should be in no doubt: fair value measurement is well-established in the property world and there are international rules on valuation. We see the current work of the 'revaluation group' as being unaffected by this issue when its remit is to consider the treatment of operational assets that have to be depreciated. Nor do we believe that it is necessary to await resolution of the issue of how gains and losses are to be reported in the major project on reporting financial performance; investment property fair value gains and losses should be treated as already required by IAS 40, i.e. in the income statement. Exactly where in a single performance statement that would be can be determined once the reporting financial performance project reaches its conclusions.

The Board should take the opportunity to remove an acknowledged poorer option in this case.

If there are any matters arising from this letter you would like to discuss, please do not hesitate to contact Danielle Stewart on 020 7731 6163.

Yours faithfully

Danielle Stewart
Chairman, LSCA Technical Committee

20 September 2002

Marie-Christine Batt
International Accounting Standards Board
30 Cannon Street,
London
EC4M 6XH

Dear Sirs,

**LSCA TECHNICAL COMMITTEE RESPONSE TO EXPOSURE DRAFT OF PROPOSED IMPROVEMENTS TO INTERNATIONAL ACCOUNTING STANDARDS, SPECIFICALLY RE: IAS 27 "CONSOLIDATED AND SEPARATE FINANCIAL STATEMENTS"**

With a membership of 30,000, the London Society of Chartered Accountants (LSCA) is the largest of the regional bodies which form the Institute of Chartered Accountants in England & Wales. London members, like those of the Institute as a whole, work in practice or in business. The London Society operates a wide range of specialist committees including Technical (accounting and auditing), Tax, Regulation and Ethics Review and Financial Services and Insolvency, which scrutinise and make representations to issuing bodies such as yourselves. The LSCA Technical Committee welcomes the opportunity to respond to the International Accounting Standards Board ('the Board') regarding the revision to International Accounting Standard IAS 27, 'Consolidated and Separate Financial Statements', published by the Board for comment in May 2002.

We have reviewed the exposure draft (ED) and set out below a number of comments. We comment first on the specific issues raised in the exposure draft and then on other points of detail.

**RESPONSES TO SPECIFIC QUESTIONS**

**Q1. Do you agree that a parent need not prepare consolidated financial statements if all the criteria in paragraph 8 are met?**

The Committee are strongly in favour of having exemption criteria in IAS 27 relating to the preparation of consolidated accounts for certain subsidiaries. Without this exemption subsidiaries would in many cases be forced to produce consolidated accounts unnecessarily.

The Committee broadly agrees with the revised criteria in para. 8 but have the following additional comments:

The Committee believes that para. 8 (a) should not refer to unanimous agreement from minority interests but instead the requisite consent required by law from minority interests.

The Committee considers that para. 8 (c) referring to "in the process of issuing securities in public securities markets" is rather ambiguous and needs to be made clearer.

The Committee believes paragraph 8 (d) needs to be made clearer by stating "any parent in which it is included publishes consolidated financial statements that comply with International Financial Reporting Standards" since at an intermediate parent level financial statements complying with International Financial Reporting Standards may not be prepared.

**Q2. Do you agree that minority interests should be presented in the consolidated balance sheet within equity, separately from the parent shareholders' equity (see paragraph 26)?**

The Committee agrees with the proposals to present minority interests within equity, separately from the parent shareholder's equity. This presentation is considered by the Committee to most fairly reflect the total assets controlled by the group but still give due prominence to any minority interest in the consolidated balance sheet.

However, the Committee believe that if the IASB are to look at the presentation of minority interests in the balance sheet then they must at the same time look at presentation in the income statement. Looking at the balance sheet presentation alone is considered wholly inappropriate.

**Q3 (a) Do you agree that investments in subsidiaries, jointly controlled entities and associates that are consolidated, proportionately consolidated or accounted for under the equity method in the consolidated financial statements should be either carried at cost or accounted in accordance with IAS 39, Financial Instruments: Recognition and Measurement, in the investor's separate financial statements (paragraph 29)?**

The Committee agrees with the elimination of the equity method as an option, in the investor's separate financial statements.

Also, the Committee considers IAS 27.30 should be redrafted to be clearer that the investment in any non-consolidated subsidiary, for whatever reason, should be accounted for in accordance with IAS 39.

In addition the Committee would like to point out that the choice in IAS 27.29 may lead unusual results. For instance, in a situation such as where a listed parent with one trading subsidiary, the market value of the trading subsidiary is the market value of the listed parent. This would therefore mean that if the listed parent could follow IAS 39 in the solus accounts it would record its investment in the trading subsidiary at its own market value and take the gain to its own profit and loss account (assuming legal issues are resolved to permit IAS 39).

The Committee also disagrees with the last sentence of para 29B by requiring distributions received in excess of profits post acquisition should be accounted for as a reduction in the investment value. The Committee believes that all distributions should go to the income statement.

**Q3 (b) Do you agree that if investments in subsidiaries, jointly controlled entities and associates are accounted for in accordance with IAS 39 in the consolidated financial statements, then such investments should be accounted for in the same way in the investor's separate financial statements (paragraph 30)?**

The Committee concurs that when an entity applies IAS 39 in its consolidated financial statements when accounting for investments in subsidiaries, associates or joint ventures when either (a) acquired and held exclusively with a view to subsequent disposal in the near future; or (b) operating under severe long term restrictions that significantly impair its ability to transfer funds to the entity, that the same method should be applied for the investor's separate financial statements. The Committee considers that a consistent treatment in both the consolidated and investor's own financial statements under these circumstances would be the only common sense option.

**OTHER COMMENTS**

**Para. 9 - Only financial statements** – The Committee believes that this paragraph appears only to confuse rather than aid and thus should be deleted.

**Criteria for exclusion from the scope of consolidation –** The Committee agree that it is helpful to be more specific by stating "within twelve months" in para. 13 when control is intended to be temporary rather than using vague statements like "in the near future".

**Long term restrictions** – The Committee agrees that consideration of severe long term restrictions are better dealt with when considering control (para. 12A) as opposed to requiring a separate exclusion category for consolidation where long term restrictions exist.

**Minority interests** – The Committee believe that losses applicable to the minority (para. 27) should not be limited.

**Disclosures –** The Committee considers that certain of the suggested disclosures are unnecessary and would therefore favour deletion of paras. 32 (c) and 32 (e).

**Para. 33. – Disclosures in investors own financial statements** – As currently drafted this implies that separate financial statements are “stand-alones” (i.e. Not combined with consolidated accounts) which may not be the case and the Committee would thus favour a distinction being made.

**Effective date** – The Committee believe that the last sentence of para. 34 by stating “if early adoption affects the financial statements, an entity shall disclose the fact” that it does not make it clear if this is irrespective of whether or not it is adopted early.

If there are any matters arising from this letter that you would like to discuss, please do not hesitate to contact Steven Brice (Chairman of the working party – 0207 220 3231) or Danielle Stewart (020 7731 6163).

Yours faithfully,

Danielle Stewart
Chairman, LSCA Technical Committee

20 September 2002

Marie-Christine Batt
International Accounting Standards Board
30 Cannon Street,
London
EC4M 6XH

Dear Sirs

**LSCA TECHNICAL COMMITTEE RESPONSE TO EXPOSURE DRAFT OF PROPOSED IMPROVEMENTS TO INTERNATIONAL ACCOUNTING STANDARDS, SPECIFICALLY RE: IAS 28 'ACCOUNTING FOR INVESTMENTS IN ASSOCIATES'**

With a membership of 30,000, the London Society of Chartered Accountants (LSCA) is the largest of the regional bodies which form the Institute of Chartered Accountants in England & Wales. London members, like those of the Institute as a whole, work in practice or in business. The London Society operates a wide range of specialist committees including Technical (accounting and auditing), Tax, Regulation and Ethics Review and Financial Services and Insolvency, which scrutinise and make representations to issuing bodies such as yourselves. The LSCA Technical Committee welcomes the opportunity to respond to the International Accounting Standards Board ('the Board') regarding the revision to International Accounting Standard IAS 28, 'Accounting for Investments in Associates', published by the Board for comment in May 2002.

We have reviewed the exposure draft (ED) and set out below a number of comments. We comment first on the specific issues raised in the exposure draft and then on other points of detail.

**RESPONSES TO SPECIFIC QUESTIONS**

**Q1. Do you agree that IAS 28 and IAS 31, Financial Reporting of Interests in Joint Ventures, should not apply to investments that otherwise would be associates or joint ventures held by venture capital organisations, mutual funds, unit trusts and similar entities if these investments are measured at fair value in accordance with IAS 39, Financial Instruments: Recognition and Measurement, when such measurement is well-established practice in those industries (see paragraph 1)?**

The Committee agrees that for investments which would ordinarily meet the definition of either an associate and/or a joint venture should not apply the accounting requirements in IAS 28 and/or IAS 31 when the investment is held by either venture capital organisations, mutual funds, unit trusts or similar entities which apply IAS 39 fair value measurement rules to that strategic investment.

The Committee considers that for these types of industry well established fair value accounting practices provide the most meaningful measure for strategic investment values. The Committee therefore considers that by inclusion of this scope exemption that meaningful information, under IAS 39, can still be produced when neither the equity method nor proportionate consolidation are deemed appropriate.

**Q2. Do you agree that the amount to be reduced to nil when an associate incurs losses should include not only investments in the equity of the associate but also other interests such as long-term receivables (paragraph 22)?**

The Committee considers that an investor should provide for its share of the losses in full, even where this results in the investor showing a share of net liabilities as opposed to net assets. The Committee believes that a "nil position" does not provide the fairest reflection of the position of the investor's investment in equity of the associate even with the proposed widening of the definition of "interest in an associate" to include other interests such as long-term receivables. Any negative resulting position is best reflected as a provision in the investor's financial statements.

**OTHER COMMENTS**

**Impairment losses –** By also including the "proceeds on the ultimate disposal of the investment" in para 23 (a) this appears to be double counting.

**Use of equity accounting** – The Committee considers that if the investing company does not prepare consolidated financial statements because it has no subsidiaries that it should still be permitted to use a cost option as long as additional information on the relevant amounts for its joint ventures and associates using equity accounting is disclosed in its own individual financial statements.

**Disclosures –** The Committee considers that certain of the suggested disclosures are unnecessary and would therefore favour deletion of paras. 27 (b) (c) and (d).

**Effective date** – The Committee believe that the last sentence of para. 29 by stating "if early adoption affects the financial statements, an entity shall disclose the fact" that it does not make it clear if this is irrespective of whether or not it is adopted early.

If there are any matters arising from this letter that you would like to discuss, please do not hesitate to contact Steven Brice (Chairman of the working party – 0207 220 3231) or Danielle Stewart (020 7731 6163).

Yours faithfully,

Danielle Stewart
Chairman, LSCA Technical Committee

20 September 2002

Marie-Christine Batt
International Accounting Standards Board
30 Cannon Street
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EC4M 6XH

Dear Madam

**LSCA TECHNICAL COMMITTEE RESPONSE TO EXPOSURE DRAFT OF PROPOSED IMPROVEMENTS TO INTERNATIONAL ACCOUNTING STANDARDS, SPECIFICALLY RE: IAS 1 'PRESENTATION OF FINANCIAL STATEMENTS'**

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We have reviewed the exposure draft (ED) and set out below a number of comments. We comment first on major points of concern, then on the specific issues raised in the exposure draft and finally other points of detail.

## IAS 1 PRESENTATION OF FINANCIAL STATEMENTS

We welcome the proposed improvements to IAS 1, subject to our comments below, and believe that it is worth introducing these improvements even though the Board has a wider project on reporting financial performance on its agenda. The difficulties facing that project are such that many of these proposed improvements might otherwise have been delayed considerably.

However, we believe that leaving only minimal requirements for the line items required to be disclosed on the face of the primary statements, particularly the income statement, means that the scope for improvements to the standard have been limited.

## MAJOR POINTS

### *Fair Presentation*

42. We strongly support recognition in the proposed standard of the principle that departure from the requirements of an IAS might in some circumstances be necessary to achieve a fair presentation. Our experience in the UK suggests that the existence of a statutory requirement to show a "true and fair view", including the existence of an override, has contributed significantly to the quality of financial reporting. For those who fear abuse of such a provision, in our experience the override itself is rarely used.

    The UK's detailed requirements relating to the preparation of financial statements are split between statute (specifically Company Law) and accounting standards which are issued by a body independent of the government. The requirements which are contained in statute are typically detailed and specific; many of them are detailed rules rather than high level principles. The requirement to show a true and fair view, including the override, is also set out in Company Law and is repeated in our accounting standards. Because it is difficult to change legislation, particularly when it has been set at a European level, the true and fair override has tended to be used where accounting practice has developed to the extent that some of the more detailed rules within the law have become out of date. In other words, the override is predominantly used as a mechanism to overcome anachronistic rules.

    Otherwise, the override in standards has been used only in wholly exceptional and appropriate circumstances, which are too rare to be anticipated in a principles-based standard. Hence, the downside of possible abuse of the override has been far outweighed by the benefits achieved from the overall requirement to show a true and fair view, beyond the application of existing standards and rules, as it focuses the minds of preparers and auditors to achieve this end.

43. Nevertheless, we regard the existence of an effective enforcement mechanism as an important deterrent of abuse of an 'override' provision. Inconsistent enforcement of international standards is likely to undermine the credibility of the Board and its standards and diminish the prospects for global convergence. We believe that the Board has a role to play in encouraging the rapid development of comparable enforcement mechanisms on a worldwide basis and we direct the Board's attention to the UK Financial Reporting Review Panel, which the Fédération des Experts Comptables Européens (FEE) has recently suggested as a model for the rest of Europe. The UK has shown that it is possible to have an effective 'policeman' and yet resist the temptation to 'interpret' standards when passing judgement on specific cases, which would have the double danger of undermining both the IASB as standard setter and the

proper exercise of accountants' professional judgement when applying principles-based standards in practice.

44. We do not support the proposal that the application of IFRS should differ according to the requirements of different regulatory frameworks. The principle of 'fair presentation' is, in our view, closely associated with and underpinned by the provision of principles-based standards rather than detailed rules for financial reporting. By including this proposal, the revised standard at once undermines this approach to accounting standards and financial reporting. The Board should not concern itself with legal or regulatory rules in particular countries that would prevent the proper application of this approach; such issues are for national authorities to deal with. We realise that this may represent a significant change in approach and even philosophy by some regulators, but such a move will be necessary if principles-based standards promulgated by the Board are to become a reality on a world-wide basis.

45. International standards should be applied consistently in all jurisdictions: disclosure is no substitute, whether or not the relevant regulatory framework prohibits departures from accounting standards. The concession set out in paragraph 15 and in the last fourteen words of paragraph 13 should therefore be deleted. If the IASB persists in retaining these parts of the standard, it should be made clear that failure to override because of local jurisdictional rules, even where additional disclosure is given as required by paragraph 15, means that an entity will not be able to claim that the financial statements "present fairly". There is a danger of this happening, given the phrase "with additional disclosure where necessary" in paragraph 10. We would therefore also recommend inclusion in the revised standard of the principle that inappropriate accounting cannot be rectified by disclosure, as set out in paragraph 12 of the existing standard, but now deleted (a decision we deplore and for which we see no justification).

## RESPONSES TO SPECIFIC QUESTIONS

### Question 1

Do you agree with the proposed approach regarding departure from a requirement of an International Financial Reporting Standard or an Interpretation of an International Financial Reporting Standard to achieve a fair presentation (see proposed paragraphs 13-16)?

Please see our comments above in paragraphs 1-4.

### Question 2

Do you agree with prohibiting the presentation of items of income and expense as 'extraordinary items' in the income statement and the notes (see proposed paragraphs 78 and 79)?

We support a prohibition on entities showing, as a separate post-tax category or line item on the face of the performance statement, items that have been segregated purely because they are judged by management to be in some way unusual or abnormal. We therefore have some concerns regarding the effectiveness of proposed paragraphs 78 and 79 of the exposure draft, which simply prohibit one term without specifically prohibiting other possible terms (for example, 'exceptional' or 'unusual'). Instead, the standard should make it a positive requirement that all items of an unusual nature should be included under the appropriate income statement heading to which they relate, as well as removing the extraordinary item line from the income statement, as has been done in paragraph 76. The text, probably in grey letter, can then encourage entities to disclose unusual items separately by way of note, or disaggregated on the face of the income statement if that degree of prominence is necessary to provide a fair presentation (as long as the item remains within the relevant line).

Alternatively, if this is considered inappropriate for the improvements project, it could be addressed instead in the Board's current project on reporting financial performance. As noted in our introductory remarks, the failure of the standard to require line items to be disclosed between revenue and profit before tax in the income statement, such as cost of sales, may make our suggestion impractical for the scope of this revision to IAS 1.

**Question 3**

Do you agree that a long-term financial liability due to be settled within twelve months of the balance sheet date should be classified as a current liability, even if an agreement to refinance, or to reschedule payments, on a long-term basis is completed after the balance sheet date and before the financial statements are authorised for issue (see proposed paragraph 60)?

Yes, we agree, subject to our comments in the following paragraphs. We recognise that classifying a liability as current or non-current according to the latest information on the probability that it will be paid within twelve months may provide highly relevant information about the entity's financial position. However, we consider that a requirement for presentation to reflect conditions prevailing at the balance sheet date is conceptually superior (and presumably companies will always choose to disclose the supplementary information on refinancing as it will be in their best interests to do so). We suggest the inclusion in this part of the standard of a cross-reference to paragraph 18, highlighting that a breach of covenants of this nature will mean that management will need to consider whether the entity is a going concern.

Paragraph 57(b) requires a liability to be classified as current if it "is due to be settled within twelve months of the balance sheet date". It should be made clear that this refers to a legal requirement for settlement within twelve months, rather than a less binding agreement or intention. If this is, as we expect, the correct interpretation, then application of paragraphs 54 and 57 is likely to produce mutually inconsistent treatment in the accounts of entities involved in the same transaction, because the classification of liabilities is based on 'due' but the classification of assets is based on 'expected'. The most obvious example is probably intra-group debt assets and liabilities in the financial statements of transacting group companies. The Board may wish to consider this issue prior to finalisation of the proposed standard.

**We note that IAS 35 requires disclosure (including optional presentation) of discontinuing operations even where the initial disclosure event is after the balance sheet date. This conceptual inconsistency with the proposed presentation of long-term liabilities is unsatisfactory and should also be addressed by the Board.**

**Question 4**

Do you agree that:

(a) *a long-term financial liability that is payable on demand because the entity breached a condition of its loan agreement should be classified as current at the balance sheet date, even if the lender has agreed after the balance sheet date, and before the financial statements are authorised for issue, not to demand payment as a consequence of the breach (see proposed paragraph 62)?*

(b) *if a lender was entitled to demand immediate repayment of a loan because the entity breached a condition of its loan agreement, but agreed by the balance sheet date to provide a period of grace within which the entity can rectify the breach and during that time the lender cannot demand immediate payment, the liability is classified as non-current if it is due for settlement, without that breach of the loan agreement, at least twelve months after the balance sheet date and:*

  (i) *the entity rectifies the breach within the period of grace; or*
  (ii) *when the financial statements are authorised for issue, the period of grace is incomplete and it is probable that the breach will be rectified (see proposed paragraphs 63 and 64)?*

**We accept the logic of adopting this approach, subject to our comments in answer to question 3.**

**Question 5**

Do you agree that an entity should disclose the judgements made by management in applying the accounting policies that have the most significant effect on the amounts of items recognised in the financial statements (see proposed paragraphs 108 and 109)?

**No. We do not consider it necessary or appropriate to make management justify their decisions in this way; a statement of fair presentation should be sufficient. Where measurement variables exist that give scope for management judgement to be applied to accounting treatments, disclosure of those variables should simply be required in the relevant standard; for example, disclosure of the discount rate applied to pension liabilities, or the example given in paragraph 109 that relates to IAS 27. Moreover, the other example in paragraph 109 regarding financial assets is unhelpful: the decision on whether financial assets are held-to-maturity investments depends on the application of specific rules**

**within current accounting standards, not management judgement. Paragraphs 108 and 109 should be deleted to avoid uncertainty and inconsistent interpretation.**

**Question 6**

Do you agree that an entity should disclose key assumptions about the future, and other sources of measurement uncertainty, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year (see proposed paragraphs 110-115)?

**In principle, we support greater disclosure of significant risks and uncertainties, including key assumptions about the future. However, implementation of the wide-ranging requirements of paragraphs 110-115 will inevitably involve a high degree of management judgement (as paragraph 111 itself makes clear). We suggest that this is made explicit in the proposed standard by inserting the words 'in the view of management' before 'have a significant risk of causing a material adjustment' in the bold letter text in paragraph 110.**

**OTHER POINTS**

**Other financial reporting**
**It is noted in paragraph 9 of the proposed standard that management reviews presented outside the financial statements and additional statements such as environmental reports and value added statements are outside the scope of IFRS. We believe that the Board should, in due course, take responsibility for the improvement of all aspects of financial reporting, and welcome the Board's decision to consider development of guidance on the MD&A, as recently highlighted in the Board's published work programme and agenda. We suggest that at an early stage the Board should review the adequacy of its current remit and revise or delete this paragraph.**

**Consistency of presentation**
We believe that paragraph 22(a) should not refer to the change demonstrating to management, but to management being able to demonstrate to others: a more rigorous test that would be less open to abuse. Paragraph 22(a) would then read:

> '(a) The entity can demonstrate that, because of a significant change in the nature of the operations…., a change in presentation….'

**Disclosure of accounting policies**
This section (paragraphs 103-109) of the proposed standard should emphasise the importance of disclosing clearly in the financial statements:

- the general approach adopted to the selection of accounting policies;
- choices made by management when selecting the accounting policies most appropriate to the particular circumstances of the reporting entity, and
- the rationale for those choices.

**This guidance might be inserted before the existing text in paragraph 105 and might be more useful in practice than the requirements of proposed paragraph 108 (and see our comments above on paragraphs 108 and 109).**

**The accruals basis**

The need for caution regarding use of the accruals basis of accounting, highlighted in paragraph 95 of the Framework, should be reflected in the guidance on accruals accounting in proposed IAS 1. We suggest that the words 'and only when' are inserted after 'when' in paragraph 21 of the proposed standard.

**'Annual' accounts**

The first sentence of paragraph 47 is misleading, as annual financial statements can be presented for a period longer than one year. We suggest this sentence is deleted; instead insert 'annual' after the first word of paragraph 48.

**Marketable securities**

Paragraph 56 explains that a marketable security should be classified as current or non-current by reference to paragraph 54(c), i.e. whether it is expected to be realised within twelve months of the balance sheet date. However, on the basis of the current IASs on financial instruments, we consider paragraph 54(b) to be more relevant in this context, i.e. whether the security is held primarily for trading purposes and we suggest that the Board amends paragraph 56 accordingly.

**The balance between disclosure and clarity**

The level of detail that might be involved depending on the level of disaggregation on the face of the primary financial statements could lead to the statements becoming unreadable due to overload of information. We suggest that guidance on striking the right balance between disclosure and clarity is added to paragraph 68; the notes can always be used to provide additional breakdown of line items.

**Minority interests**

**Paragraphs 65 and 76 require a 'minority interest' to be shown as a line item on the face of the balance sheet and income statement respectively. The presentations suggested appear to be inconsistent with the changes to the accounting treatment of minority interests proposed in draft IAS 27. The Board should ensure that any inconsistencies are eliminated before the improved standards are published (as noted in paragraph A18 of the Basis for Conclusions).**

**Disaggregation in the statement of changes in equity**

The cumulative effect of changes in accounting policy and of the correction of errors should be disclosed separately in this statement. It may be sufficient to insert 'of' after 'and' in paragraph 91(c) to make this clear.

**Removal of some disclosure requirements**

**We are not sure why the Board has decided to remove the requirements to disclose the number of an entity's employees and an entity's country of incorporation and its registered address. While the IASB may believe that such**

**disclosures are not part of the financial reporting information over which it claims a remit, these are pieces of useful information which will affect the user's assessment of the financial position and performance of the entity. As such, they can be argued to fall within the broad frame of relevant financial information.**

*If there are any matters arising from this letter you would like to discuss, please do not hesitate to contact Danielle Stewart on 020 7731 6163.*

*Yours faithfully*

*Danielle Stewart*
Chairman, LSCA Technical Committee

1 October 2002

Marie-Christine Batt
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

Dear Madam

**LSCA TECHNICAL COMMITTEE RESPONSE TO EXPOSURE DRAFT OF PROPOSED IMPROVEMENTS TO INTERNATIONAL ACCOUNTING STANDARDS, SPECIFICALLY RE: IAS 16 PROPERTY, PLANT AND EQUIPMENT'**

With a membership of 30,000, the London Society of Chartered Accountants (LSCA) is the largest of the regional bodies which form the Institute of Chartered Accountants in England & Wales. London members, like those of the Institute as a whole, work in practice or in business. The London Society operates a wide range of specialist committees including Technical (accounting and auditing), Tax, Regulation and Ethics Review and Financial Services and Insolvency, which scrutinise and make representations to issuing bodies such as yourselves. The LSCA Technical Committee welcomes the opportunity to respond to the International Accounting Standards Board ('the Board') regarding the revision to International Accounting Standard IAS 16, 'Property, Plant and Equipment', published by the Board for comment in May 2002.

We have reviewed the exposure draft (ED) and set out below a number of comments. First we give our major points, then we comment on the specific issues raised in the exposure draft and finally on other points of detail.

## MAJOR POINTS

*Residual values*: We strongly disagree with the proposed change to paragraph 46 (and the definition of residual value) to require the current residual value, assessed as at the balance sheet date, to be used. We believe that this proposal is inconsistent with the benchmark treatment, since it effectively introduces a partial revaluation into the calculation of the depreciable amount of the asset.

We consider that the proposed change is a significant matter and should have been highlighted in the IASB's consultation and specific questions for comment.

**<u>RESPONSES TO SPECIFIC QUESTIONS</u>**

**Question 1**

*Do you agree that all exchanges of items of property, plant and equipment should be measured at fair value, except when the fair value of neither of the assets exchanged can be determined reliably (see paragraphs 21 and 21A)?*

No. We believe that the treatment of exchanges of property, plant and equipment should focus on whether there has been a change in the *substance* of the entity's assets, rather than on whether there has been a mere legal exchange. Where there has been no such change in substance, the cost of the acquired asset should be measured as the carrying value of the asset given up in exchange. If the focus is instead on legal exchange, this would seem to present a method by which entities could, with the cooperation of a third party, effectively revalue its assets on a piecemeal basis. We acknowledge, however, that guidance would be required on how to determine whether the substance of the entity's assets had in fact changed.

**Question 2**

*Do you agree that all exchanges of intangible assets should be measured at fair value, except when the fair value of neither of the assets exchanged can be determined reliably? (See the amendments in paragraphs 34-34B of IAS 38, Intangible Assets, proposed as a consequence of the proposal described in Question 1.)*

*(Note that the Board has decided not to amend, at this time, the prohibition in IAS 18 Revenue, on recognising revenue from exchanges or swaps of goods or services of a similar nature and value. The Board will review that policy later in the context of a future project on the Recognition of Revenue.)*

See response to Question 1.

**Question 3**

*Do you agree that depreciation of an item of property, plant and equipment should not cease when it becomes temporarily idle or is retired from active use and held for disposal (see paragraph 59)?*

No, we strongly disagree that this should be a general requirement.

Depreciation is defined as "the systematic allocation of the depreciable amount of an asset over its useful life" and useful life is defined as "either (a) the period of time over which an asset is expected to be used by the entity; or (b) the number of production or similar units expected to be obtained from the asset by the entity."

In respect of assets retired from active use and held for disposal, since it is no longer being used by the entity its useful life would appear to have come to an end (even if it was previously expected to last longer). We therefore agree with the argument set out in the final sentence of paragraph A10 of the Appendix to the exposure draft that accounting for such assets should become a process of valuation rather than of cost allocation.

If the value of the asset continues to decline, because its useful life had fallen within part (a) of the definition, in our view that decline would form part of the (provision for) loss on sale.

In respect of assets that are temporarily idle, for assets whose useful life falls within part (b) of the definition we disagree with the statement in paragraph A11 of the Appendix that "the financial statements would omit the consumption of the asset's service potential". If there is no current production, or if none of the other factors set out in paragraph 43 of the draft standard have led to a reduction in the service potential of the asset, we do not understand what consumption of service potential is taking place that is being omitted from the financial statements. We agree with the proposed change in respect of assets that are temporarily idle and whose service potential is consumed by the mere elapse of time.

**OTHER POINTS**

*Impairment testing*: We note that IASB are likely to continue to require an annual impairment test for intangible assets with indefinite lives and for goodwill. In order to foster a consistent approach to the application of impairment testing, we suggest that the standard might include a requirement to test annually for impairment any property, plant or equipment that is either not being depreciated or being depreciated over a very long life (the standard specifying what period this should be).

*Valuation:* Again to foster consistency, we suggest that the standard should at least encourage, if not require, the involvement of an external professionally qualified valuer at a specified minimum interval.

*Donated assets:* We note that assets received by government grant are recognised in the accounts at a deemed cost. We wonder whether assets donated by other parties should also be recognised at a deemed cost (being their fair value at donation).

If there are any matters arising from this letter that you would like to discuss, please do not hesitate to contact Danielle Stewart on 020 7731 6163.

Yours faithfully,

Danielle Stewart
Chairman, LSCA Technical Committee

1 October 2002

Marie-Christine Batt
International Accounting Standards Board
30 Cannon Street,
London
EC4M 6XH

Dear Madam

**LSCA TECHNICAL COMMITTEE RESPONSE TO EXPOSURE DRAFT OF PROPOSED IMPROVEMENTS TO INTERNATIONAL ACCOUNTING STANDARDS, SPECIFICALLY RE: IAS 21 'THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES'**

With a membership of 30,000, the London Society of Chartered Accountants (LSCA) is the largest of the regional bodies which form the Institute of Chartered Accountants in England & Wales. London members, like those of the Institute as a whole, work in practice or in business. The London Society operates a wide range of specialist committees including Technical (accounting and auditing), Tax, Regulation and Ethics Review and Financial Services and Insolvency, which scrutinise and make representations to issuing bodies such as yourselves. The LSCA Technical Committee welcomes the opportunity to respond to the International Accounting Standards Board ('the Board') regarding the revision to International Accounting Standard IAS 21, 'The Effects of Changes in Foreign Exchange Rates', published by the Board for comment in May 2002.

We have reviewed the exposure draft (ED) and set out below a number of comments. We comment first on the specific issues raised in the exposure draft and then on other points of detail.

**<u>Consolidated accounts and presentational currency</u>**

1. As noted at 5 below we prefer the method discussed in A14 of the Board's Basis of Conclusions to translate financial statements into a presentational currency. Where consolidated financial statements are to be presented in a presentation currency it would first be necessary to prepare the consolidated financial statements in the group's functional currency in accordance with paragraph 30 of the ED.

**<u>Invitation to Comment</u>**

2. Paragraphs 3 to 7 below address the specific questions raised by the Board in the invitation to comment on the ED.

*Question 1 Do you agree with the proposed definition of functional currency as "the currency of the primary economic environment in which the entity operates" and the guidance proposed in paragraphs 7-12 on how to determine what is an entity's functional currency?*

3. Yes. We particularly welcome paragraph 10, which highlights that it is not just a matter of rules but requires the entity's management to exercise judgement.

*Question 2 Do you agree that a reporting entity (whether a group or a stand-alone entity) should be permitted to present its financial statements in any currency (or currencies) that it chooses?*

4. Yes, provided such convenience translations are in addition to preparing financial statements in an entity's functional currency and identify both the functional and presentation currency and the exchange rate.

*Question 3 Do you agree that all entities should translate their financial statements into the presentation currency (or currencies) using the same method as is required for translating a foreign operation for inclusion in the reporting entity's financial statements (see paragraphs 37 and 40)?*

5. No. We prefer the use of the closing rate at the latest balance sheet date so as to preserve comparability year on year. As noted in A14 of the Basis for Conclusions such an approach does not generate any new gains or losses and does not change ratios from those that would have been calculated in the functional currency.

*Question 4 Do you agree that the allowed alternative to capitalise certain exchange differences in paragraph 21 of IAS 21 should be removed?*

6. Yes. We note that this does not prohibit the capitalisation of exchange differences under IAS 23 *Borrowing costs*.

*Question 5 Do you agree that (a) goodwill and (b) fair value adjustments to assets and liabilities that arise on the acquisition of a foreign operation should be treated as assets and liabilities of the foreign operation and translated at the closing rate (see paragraph 45)?*

7. Yes. However there may be practical difficulties where historically entities have translated goodwill at the historic rate as currently permitted by IAS 21. For example, dividing goodwill into different currencies and, when the revised standard is first implemented, in obtaining the information in respect of the prior years. We would look for transitional provisions to deal with the prior year problem if retranslation of goodwill became mandatory. Such transitional provisions should be capable of being applied under the standard addressing first time application of IFRS.

8. Problems could arise when an entity acquires a group as to whether the goodwill is in the functional currency of the acquired group or whether it needs to be attributed to the underlying entities in that group which may have different functional currencies. We note the statement in paragraph A27 of the Basis for

Conclusions which states that the Board will keep this matter under review in the context of the proposals for impairment testing of goodwill.

**<u>Different reporting dates</u>**

9. Paragraph 44 states that where the assets and liabilities of a foreign operation are consolidated using a balance sheet made up to a different reporting date from that of the group, they should be translated at the exchange rate at the balance sheet date of the foreign operation. However, it then requires that "adjustments are made for significant movements in exchange rates up to the balance sheet date of the reporting entity". This should be replaced with a simple requirement to use the exchange rates at the balance sheet date of the reporting entity. These rates will always be known by the time that the financial statements of the reporting entity are prepared and more clearly reflects what is actually required by paragraph 44.

**If there are any matters arising from this letter you would like to discuss, please do not hesitate to contact Danielle Stewart on 020 7731 6163.**

**Yours faithfully**

**Danielle Stewart**
**Chairman, LSCA Technical Committee**