Consultation Response

PROPOSED IMPROVEMENTS TO INTERNATIONAL ACCOUNTING STANDARDS

Comments from the Association of Chartered Certified Accountants

September 2002

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Executive Summary

The Association of Chartered Certified Accountants (ACCA) is please to have this opportunity to respond to the exposure draft of Proposed Improvements to International Accounting Standards issued for comment by the International Accounting Standards Board (IASB).

We are generally supportive of the changes proposed and encourage IASB to put these into place well ahead of the 2005 conversion date for companies in the European Union and Australia. We agree that the existence of optional treatments in standards is inherently undesirable and so are pleased to note that a number of these are being eliminated as part of the improvements. It is also correct to try to reduce the complexities of the overall IAS system and we therefore support the incorporation of a number of the existing interpretations into the revised standards.

We have a few significant reservations about the proposed revised standards, including:

- the exclusion of management compensation from the related party disclosures of IAS24 seems a very retrograde step – management compensation is a very significant form of related party transaction, which is important for understanding accounts and for good corporate governance

- a number of other important extensions which should be made to the disclosures in that standard

  and

- the existing basis for revaluations of property, plant and equipment in IAS16 should have been improved and made more consistent with the valuation model of IAS36 on impairments.

In a number of cases, significant changes have been proposed to the standards, but these changes are neither highlighted in the specific questions raised for comment, nor explained in the basis for conclusions. These cases represent shortfalls in the due process of IASB.

We set out below our responses to the questions raised for comment in respect of each of the standards being revised, together with our other comments on them.

Responses to Specific Questions and Other Comments

IAS1 – PRESENTATION OF FINANCIAL STATEMENTS

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)?

We strongly support the overriding requirement that financial statements should present fairly the results and financial position of an entity, even though this may mean that, in very rare cases, specific requirements of IAS/IFRS may need to be ignored. This 'override' is vital in reinforcing the need for management and auditors to consider the overall presentation given by the financial statements in addition to compliance on a line-by-line basis with the treatment of items in accounting standards. In that sense, the priority for fair presentation is an important supporting element of principles-based standards, which IASB has committed itself to develop.

The override is likely to be much more beneficial in this way, outweighing any detriment from its misuse in practice. UK experience suggests that the use of the equivalent override in standards (as distinct from the override in UK law) is extremely rare, especially where good compliance enforcement mechanisms exist.

We do not think that the overriding requirement for a fair presentation should be restricted by national legal requirements, and so would eliminate the last part of paragraph 13 'if the relevant regulatory framework requires or otherwise does not prohibit such a departure'. Potential conflicts with national requirements, legal or otherwise, should not determine the setting of a single set of high quality accounting standards.

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 agree with prohibiting extraordinary items. We point out, however, that, without the requirement for an overall structure to the income statement, then prohibitions in paragraphs 78 and 79 refer to the particular label 'extraordinary'. There is no prohibition from presenting a profit before unusual or non-recurring items, for example. We suggest that the unusual items required by paragraph 80 should be presented as a component of the rest of the income or expenditure of that type, and not separately. The minimum components of an income statement in paragraph 76 are not a very firm foundation for requiring this. It may be that the project on reporting financial performance will be able to specify a clearer structure for any performance statement.

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)?

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 repayment, 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 disagree with the proposals given in both these questions. In cases where there is agreement in substance to the rescheduling of debts or to dealing with the default conditions at the year end, followed by final agreement before the accounts are issued, the classification of the liabilities should reflect the post balance sheet position.

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)?

The requirement is too wide as currently drafted. A disclosure of the nature of the judgement in applying significant policies would be better than simply a disclosure of the judgements. Examples of the nature of the judgement may be:

- the extent to which past trends are likely to continue into the future

  and

- whether there have been sufficient arm's length transactions to allow fair values to be developed.

Some further examples would aid the illustration of the meaning of the requirement, as the current example may not be very helpful. The decision on the classification of held-to-maturity investments seems to require little judgement, but to reflect management intent.

The meaning of paragraph 108 should be more explicit. It is not clear whether the significance test applies to the judgements or to the accounting policies.

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)?*

We support this additional disclosure requirement in principle.

Additional Comments:

As noted in our answer to Question 2 above, a clear structure of the minimum headings for the income statement would be helpful. This structure should require the display of income and expense items to link turnover with the net profit for the year, with appropriate sub-headings (for example, profit for the year before tax). In particular, the existing requirement to show the operating profit of the enterprise should not be dropped.

IAS currently allows a mixture of measurement bases to be used for assets and liabilities so that the net profit or loss for the period cannot be defined in a meaningful way. There is merit in a benchmark disclosure to allow the effect of the use of different measurement bases to be assessed. The best understood benchmark is historical cost and therefore a disclosure requirement of a net profit based on historical costs should be added to IAS1.

IAS2 - INVENTORIES

Question 1
Do you agree with eliminating the allowed alternative of using the last-in, first-out (LIFO) method for determining the cost of inventories under paragraphs 23 and 24 of IAS 2?

Yes, subject only to the case where it could be demonstrated that LIFO most closely corresponded to the physical consumption of the inventory.

Question 2
IAS 2 requires reversal of write-downs of inventories when the circumstances that previously caused inventories to be written down below cost no longer exist (paragraph 30). IAS 2 also requires the amount of any reversal of any write-down of inventories to be recognised in profit or loss (paragraph 31).
Do you agree with retaining those requirements?

Yes. Reversals of provisions against inventory values should be allowed when these are no longer justified. This would be consistent with IAS36 and impairment provisions against property, plant and equipment and against intangible assets.

IAS8 – ACCOUNTING POLICIES

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. In general, we support the elimination of options as they are inherently undesirable in a set of accounting standards. We see no reason in principle for voluntary and involuntary changes in accounting policies to be treated differently. Comparability of information from one year to the next is very important to most users of accounts for the identification of trends to help project future cash flows. Restating by prior year adjustment is the best way of maintaining this comparability when dealing with changes of accounting policy and 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. We note, however, that the word ‘material’ does not appear in paragraph 32. Immaterial errors would be excluded by the application of the last sentence of the introductory paragraph to the standard which states that IAS are not intended to apply to immaterial items. We also note that the cross-reference to the Preface will no longer work. The specific exclusion of immaterial items is important and should remain either in the introduction to each standard or in the Preface.

IAS10 - EVENTS AFTER THE BALANCE SHEET DATE

We support in principle the proposed change. The wording of paragraph 32, however, needs to be improved to make the principle clearer: that is, that dividends not yet paid should not be recognised as a liability unless there is an unavoidable obligation to pay them existing at the balance sheet date (in line with IAS37). The process for the approval and determination of dividends tends to be a matter which varies from one jurisdiction to another. The meanings of 'proposed' and 'declared' dividends will not be clear in all countries.

IAS15 - ACCOUNTING FOR THE EFFECT OF INFLATION

We agree that this standard should be withdrawn.

IAS16 – PROPERTY PLANT AND EQUIPMENT

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)?

Yes. We recognise, however, real concerns that the quality of the fair values used will directly affect the reliability of the profits recognised. In many countries, the profits recognised in general purpose financial statements are also the basis for the distribution of dividends, and traditionally that has meant restricted to realised profits. It is difficult to see that, where two identical assets are exchanged, any realisation in substance has occurred. The problems, however, of trying to determine whether items are identical or merely similar mean that treating all exchanges at fair value is probably the better answer.

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.)

Yes, in line with our response to Question 1 above.

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)?

Not in every case, as is proposed in the ED. In most cases, there will be a loss of value over time and in these cases depreciation should continue even where the asset is temporarily idle or retired from active use. There are cases where the consumption of value is related entirely to use (for example, the extraction of minerals or the consumption of airspace in a landfill site) and in these instances depreciation should cease when an item is temporarily withdrawn from use.

Other Comments:

We do not agree with the proposed amendments to paragraph 23 of IAS16. In deciding whether subsequent expenditure may be capitalised, the assessment of expected performance should be when the asset was originally acquired or was last improved. As it is worded, it is likely that much repair and maintenance expenditure would qualify for capitalisation.

We do not think that paragraph 29 as it stands is very satisfactory in its simple requirement for fair value (usually to be market value) as the basis of revaluations. This model is not consistent with that for impairments in IAS36, which recognises that either net realisable value or value in use might be appropriate. The IAS36 model seems more realistic than the single measure of fair value. We note that there is a revaluation project under way and hope that the results of that can be incorporated into a revised IAS16.

We do not agree with the change proposed in paragraph 46 to move to a system of re-estimating residual values each year. We would prefer to retain the existing estimation at the time of acquisition (or revaluation) and to leave any adjustment to the time of disposal when the actual residual value will be known. The proposal appears to be creating a mixture of historical cost and revaluation. This is a significant change to the standard, but one which was not highlighted by the questions asked or by the basis for conclusions.

An annual impairment test should be incorporated into IAS16 where there is no depreciation charged on assets other than land, or where it is insignificant because the expected economic life of the asset is very long. Such a test would be comparable to the intended future IAS38 in its treatment of intangible assets with indefinite lives.

IAS16 would benefit from guidance on how to treat donated assets. The revaluation regime should be made more rigorous and should, for example, include:

- the use of external valuers to be required

  and

- the treatment of downward valuations as impairments when there has been a clear consumption of benefits.

IAS17 - LEASES

Question 1

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 agree with this proposal. In principle, leases are of a single item and not of land and a building separately. In practice, the splitting of the lease payments into those for the building and those for the land will be difficult to estimate.

Question 2

Do you agree that when a lessor incurs initial direct costs in negotiating a please, 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 transaction should be capitalised in this way and that they should include those internal costs that are incremental and directly attributable?

While the proposed changes may seem reasonable on their own merit, we consider a fundamental review of lease accounting is needed urgently. Given that we do not support one of the changes and that the other item is largely an elimination of an option, we consider that IAS17 should not be amended at all at this point.

IAS21 – CHANGES IN FOREIGN EXCHANGE RATES

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?

Yes. We agree with the proposed definition of functional currency, except that the term 'economic environment' is not adequate in conveying the meaning that the subsequent paragraphs give to it.

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?

Yes. Entities should be free to choose their reporting currencies. In some countries, financial reporting may have to be in the national currency, which may not the functional currency.

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)?

Yes.

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

Yes. Options in accounting standards are inherently undesirable.

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)?

Yes. It is better to have a clear rule in this case. In some cases, there may be arguments supporting the other possible treatment of goodwill as part of the investment by the parent company in its own currency. In most cases, it is likely, however, that goodwill may represent unrecognised assets of the acquired business and so is best treated in the same way as the other assets.

IAS24 – RELATED PARTY DISCLOSURES

Question 1

Do you agree that the Standard should not require disclosure of management compensation, expense allowances and similar items paid in the ordinary course of an entity's operations (see paragraph 2)? 'Management' and 'compensation' would need to be defined, and measurement requirements for management compensation would need to be developed, if disclosure of these items were to be required. If commentators disagree with the Board's proposal, the Board would welcome suggestions on how to define 'management' and 'compensation'.

No, we strongly disagree with the proposal that management compensation should not be disclosed under IAS24. Management compensation is the most frequent form of related party transaction. Against the background of recent failures of financial reporting, changes to accounting standards should be reinforcing transparency and not reducing it. In developing a single set of high quality accounting standards for use across the world, IASB cannot assume that national regulations will cover the gaps which it has left and, in this case, ensure proper disclosure. Management compensation is a critical item of disclosure from a stewardship and corporate governance viewpoint. It is also vital for other users in understanding financial statements where the ownership and management are essentially the same, because management compensation and dividends may be interchangeable.

The problems of the definition of the terms management and compensation are not reasons for excluding these disclosures; indeed, definitions are only needed because of the exclusions. Paragraph 9(d) already sets out a definition of key management personnel and that would seem to be adequate for the purpose of compensation as well. As for measurement of compensation, IAS19 already addresses this subject and the main missing element will be covered by the future output of the project on share-based payments.

Question 2

Do you agree that the Standard should not require disclosure of related party transactions and outstanding balances in the separate financial statements of a parent or a wholly-owned subsidiary that are made available or published with consolidated financial statements for the group to which that entity belongs (see paragraph 3)? (Note that this proposal is the subject of alternative views of Board members, as set out in Appendix B.)

Yes, but the exclusion should apply to transactions with other group companies only. There may be transactions with other related parties, for example with key management personnel, which should be required even for wholly owned subsidiaries.

Other comments:

There are a number of other very important shortcomings in IAS24 which have not been addressed by these proposals.

- Names of related parties should be disclosed, not just the nature of the relationships.

- Names of controlling parties need to be disclosed, including parent companies and individuals or trusts.

- Materiality needs better definition – in some cases, this should be material to the reporting entity and, in cases of transactions with individuals, it should be material to the other party.

- The definition of significant influence from the UK standard FRS8 would provide a helpful elaboration '…such that the other party might be inhibited from pursuing at all times its own separate interests'. This gets to the heart of why related party disclosures are needed.

IAS27 – CONSOLIDATIONS

Question 1
Do you agree that a parent need not prepare consolidated financial statements if all the criteria in paragraph 8 are met?

Yes. We agree that wholly owned intermediate holding companies need not prepare consolidated accounts.

Question 2
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)?

Yes. We agree that minority interests are not liabilities but a residual interest.

Question 3
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 for in accordance with IAS 39, Financial Instruments: Recognition and Measurement, in the investor's separate financial statements (paragraph 29)?
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)?

Yes to both questions.

For the first question, we note that equity investments in unlisted entities are unlikely to be capable of reliable measurement at fair value under IAS39 and so will be carried at cost. To be carried at anything other than cost, subsidiaries, jointly controlled enterprises and associates would have to be separately listed.

In the second question, we support the consistency of treatment between consolidated and individual company accounts required by paragraph 30.

Other comments:

The effect of acquisitions on turnover and results of the period should be disclosed. We note that the current requirement in paragraph 32(b)(iv) has been deleted without explanation. This seems a vital disclosure for users to understand the results for the year and to be able to compare the results with prior periods.

Balances with non-consolidated subsidiaries should be shown separately. This could be included as a specific requirement in this standard or dealt with in IAS24.

IAS28 – ASSOCIATES

Question 1
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)?

Yes.

Question 2
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)?

No. In principle loans to associates should be written down on the basis of assessments of their recoverability and not automatically on the basis of a share of the losses. The investing company may, for example, hold collateral or other security for its loan which may create special considerations and place it in a different position in comparison to other creditors.

Other comments:
IAS28 would be improved by more disclosures, including:

- rather than relying on the general requirements of IAS24, the names of the associates and jointly controlled enterprises, and balances held with them, should be specific requirements in this standard

  and

- the goodwill element included in the carrying amount should be identified so as to aid comparability with the treatment of subsidiaries.

IAS 33 – EARNINGS PER SHARE

Question 1
*Do you agree that contracts that may be settled either in ordinary shares or
in cash, at the issuer's option, should be included as potential ordinary shares in the calculation of diluted earnings per share based on a rebuttable
presumption that the contracts will be settled in shares?*

Yes.

Question 2
Do you agree with the approach to the year-to-date calculation of diluted earnings per share as illustrated in Appendix B, examples 7 and 12?

Yes.

Other comments:
The restriction on the disclosure of just the standard EPS figure on the face of the income statement in IAS33 (paragraph 65) is not desirable. We support the ability of entities also to show with equal prominence EPS figures on different bases which they believe better portray the result for the period, or which are of equal or greater relevance to users (for instance the headline figures which will have been quoted in newspapers or analyses).

IAS40 – INVESTMENT PROPERTY

Question 1
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?

No.

Question 2
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?

If the change in Question 1 were to come in, the treatment as a finance lease would be right.

Question 3
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?

Yes. The existence, however, of both the fair value treatment and the historical cost treatments as options is not satisfactory in the long run. We agree that the usefulness of the optional treatment to state at depreciated cost should be kept under review.