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Exposure Draft of Proposed Improvements to International Accounting Standards

Dear Sir David,

We are pleased that you are offering us the opportunity to comment on the "Exposure Draft of Proposed Improvements to International Accounting Standards". We have selected some questions and rules contained in the exposure draft to comment on. We do not have any comments, or objections, regarding the other questions.

IAS 1

Q 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 recognized in the financial statements (see proposed paragraphs 108 and 109)?

We do not agree with this proposal as, in our opinion, it is not suited to achieve the goal of providing the user of financial statements with information to better understand and compare accounting policies (cf. IAS 1 .A26). The planned provision will rather result in extending the notes by general statements which do not contain any additional information for the user but rather cause an information overload.

Q 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)?

The purpose of this planned provision is to enable the user of financial statements to assess the future development of an entity (cf. IAS I.A29) more reliably. The economic development of an entity is dependent on a great number of positive and negative, company-internal and external factors and, in particular, on their interaction. To inform the user of financial statements about these factors, it is not sufficient to report on future adjustments to individual balance sheet items possibly selected at random. Presentation becomes incomplete if

- the factors which are to be reported on influence facts and circumstances which do not affect the balance sheet (example: major changes in the group of customers);
- certain effects eliminate each other if, in such a case, reporting is only one-sided (example: interest rate changes which result in modified values both on the assets and liabilities side);
- the distinction between “key factors” and “non-key factors” is not clear so that it is up to the accounting person upon which facts and circumstances he will report;
- synergy and follow-up effects are not taken into account (example: price increase of a major raw material which cannot only lead to higher costs of materials but also to lower net sales if demand decreases due to increased sales prices. At the same time, this price increase can result in a write-down of a production plant if the value in use is also falling).

Moreover, the question arises why changes in assumptions which are already expected at the balance sheet date are not yet considered when the corresponding items are recognized and thus directly affect the amounts stated for the items concerned. Thus, for instance, expected changes in assumptions on salary development would have to be considered already in the amounts recognised as a defined benefit liability; a future adjustment would then not be required. If the change is not known at the balance sheet date, it cannot be reported on. That is why the provision would have to be worded more precisely at least in so far as to distinguish between changes which already have to be recognized and changes which are still so vague or improbable that they are not yet recognized.

The goal pursued by the proposed provision can be better achieved by obliging management to disclose in the financial statements a general appreciation of the overall position of the company including an outlook for the future. This, for instance, could be based on the contents of the proposed IAS 1.7 which has not been binding so far.

<u>IAS 2</u>

<u>*Q 1:*</u> *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?*

We do not consent to this proposal. When measuring inventories the actual inventory flow should be considered. There are cases after all where the LIFO method reflects the actual inventory flow (example: coal dumps). The proposed provision should be changed as to allow the continued use of the LIFO method when inventories are actually used in line with this fiction.

<u>IAS 8</u>

<u>*Re IAS 8.19*</u>*: Comments on the effects resulting from the future adoption of an IAS/IFRS that has been issued but not yet come into effect.*

In many cases it will not be possible to adopt this provision as the non-adoption of an IAS/IFRS which has been issued but has not yet come into effect is often due to the lack of corresponding information. This problem occurs in particular when the time span between the issue of the standard and the preparation of the financial statements is very short. If, for this reason, it is not possible to adopt an IAS/IFRS it is not possible to present the effects on the economic situation resulting from the adoption either. That is why the provision should continue to be formulated as a recommendation, not as an obligation.

IAS 16

Q 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 und 21A)?

We do not agree with this proposal. If similar items of property, plant and equipment are exchanged, the transaction is generally not aimed at generating sales or selling the item but at purchasing an asset that has a similar use. According to IAS principles, purchasing transactions are not recognized in net profit or loss, thus excluding that gains are realized at the time of acquisition. The measurement at fair value of the asset which is exchanged for a similar asset would contradict this principle.

In addition, it is possible that the usually contrasting interests between purchaser and seller do not exist when exchanging assets of a similar use and nature so that in such cases fair values could be agreed which would not be realizable upon selling the assets. In particular, if there is no market price for these assets it would be possible to report gains without confirmation by the market (cf. also IAS 16.A4).

For these reasons, the existing provision - with a clear distinction between similar and dissimilar assets - should be retained. This applies both for the exchange of tangible and intangible assets.

Re IAS 16.15(b): The net proceeds from selling items produced when testing equipment are to be deducted from the cost of an asset.

While this rule is correct in theory, it should be very difficult to determine and distinguish these proceeds in practice. That is why it should be allowed to post income immediately (analogously to incidental income) when the expenditure of estimating the proceeds would be too high.

Re IAS 16.22A-22D: Individual components of an item of property, plant and equipment shall be accounted for and depreciated as separate assets.

This rule poses special problems in connection with IAS 36. If, for the purpose of systematic measurement, an item of property, plant and equipment is broken down into separate assets which in turn are recombined into a cash-generating unit to determine any impairment losses, this leads to carrying amounts which can no longer be interpreted. This is especially true because the impairment loss is distributed among these separate assets although it has been determined as a total value for the cash-generating unit.

If for instance the turbines and seats of an aircraft are accounted for as separate assets and are depreciated on a systematic basis over their different useful lives, these separate assets would have to be combined with other aircraft components into a cash-generating unit to determine the impairment loss as turbines and seats do not generate any cash flows on their own. An impairment of the turbines would then possibly lead to a write-down of the seats although the latter's value has not declined while the amount of the turbine write-downs would be too small. Both cases would lead to carrying amounts of little informative value.

This problem could be solved if the aircraft was recognized as an asset as a whole and depreciated and impaired uniformly. A rule would be expedient which distinguishes assets according to their function and use, i.e. all assets which can only be used in an economically reasonable way as an entity would have to be recognized and depreciated as assets.

IAS 28

Q 2: Do you agree that the amount reduced to nil when an associate incurs losses should include not only in vestments in the equity of the associate but also other interests such as long-term receivables (paragraph 22)?

The write-down of long-term receivables for losses incurred by a company accounted for under the equity method is problematic when these receivables have been secured by collateral. In order to avoid inadequate write-downs, each individual asset has to be tested for impairment.

Re IAS 28.18-20: Adjustment of the financial statements of an associate to the balance sheet date and to the accounting policies of the investor.

This rule cannot be accepted as it cannot be implemented in practice for several reasons. The investor has a significant influence on the associate but not a controlling one. Thus, when the reporting dates are the same, it is on the one hand not possible to exercise influence on the date the associate prepares its financial statements so that the investor may possibly not receive the documents needed in time. On the other hand, when the reporting dates are different, the investor cannot force the associate to prepare financial statements as of the same date as the investor nor to prepare interim financial statements. The same applies to the use of uniform accounting policies.

Moreover, the investor generally does not have sufficient internal documents to make the adjustment to the reporting date or to the accounting policies himself. Basically, the investor has no right to claim internal documents so that he has to rely on the annual report published by the associate. Normally, such a report does not contain the detailed information needed by the investor in order to be able to make the appropriate adjustments himself. For instance, to calculate deferred taxes, a tax balance sheet is required which, however, is not published.

Moreover, there are legal reasons against the transfer of internal documents to the investor: On account of the shareholders' right to equal treatment, all shareholders would be entitled to the documents in such a case.

Another problem arises when an associate is accounted for under the equity method by several investors. The investors may prepare their financial statements at different reporting dates and according to different rules (IAS, US GAAP) so that the associate would possibly have to draw up several interim financial statements or make different adjustments. The expenditure involved should be out of proportion to the achievable benefit.

For these reasons, it should be permitted to continue to use the latest financial statements of the associate when applying the equity method. Also, in exceptional cases should it be possible to dispense with adjusting the accounting policies.

Re IAS 28.8A and 24A in connection with IAS 27.29 and 30: Accounting for investments in associates in separate financial statements.

In line with IAS 28.8A, associates shall be accounted for under the equity method "irrespective of whether the investor also has investments in subsidiaries or whether it describes its financial statements as consolidated financial statements". Consequently, the application of the equity method is also obligatory when the investor does not prepare consolidated financial statements, i.e. associates also have to be measured at equity in separate financial statements.

This rule is contradictory to the planned provision of IAS 28.24A which refers to IAS 27.29 and 30. Accordingly, associates which are accounted for under the equity method in consolidated financial statements are either carried at cost or accounted for as described in IAS 39 in the separate financial statements. Accounting using the equity method which has been admissible as a third alternative is to be deleted.

This problem could be solved, for instance, by a similar provision as that in IAS 27.30: Associates which are accounted for using the equity method in consolidated financial statements also have to be accounted for under the equity method in the separate financial statements.

Regarding the effective date of the revised standards:

The amendments proposed in the present exposure draft shall become operative for financial statements covering fiscal years beginning on January 1, 2003. Comments can be submitted by September 16, 2002; consequently, a final version cannot be expected to be published before the end of the year. As the revised provisions will not only have to be applied in the annual financial statements but will also affect interim and quarterly financial statements, we would have to implement them by March 31, 2003. This is not possible on various grounds.

To implement new provisions, an extended lead-time is necessary in large multi-tier groups in particular. New provisions must be analyzed in a first step and then be worked into the group directive. It is especially in multi-tier groups that it takes a certain time for such amendments to reach the company at all levels. In a second step the group internal reporting systems will have to be adapted. This work also requires a certain amount of time; according to our past experience three months at least are needed on technical grounds.

Another problem arises when information which had not been collected before is needed to apply the new rules. In such a case, group-wide queries will have to be started to gain the necessary information. This, again, is not practicable at short notice due to the size (approx. 800-1000 consolidated companies) and the graded structure of our group.

For these reasons we would like to ask you to provide a sufficiently long lead-time for the adoption of new standards as with IAS 39, for instance. In view of the conversion activities required in large groups in particular, the lead-time should not be shorter than one year, starting from the time of the adoption of the final IAS/IFRS.

Yours faithfully

RWE
Aktiengesellschaft

(CFO)

(Head of Group-Accounting)