The Institute of
Chartered Accountants
in Australia

13 September 2002

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
LONDON EC4M 6XH UNITED KINGDOM
E Mail: CommentLetters@iasb.org.uk

Dear Sir David

**Exposure Draft of Proposed Improvements to International Accounting Standards**

The Institute of Chartered Accountants in Australia welcomes the opportunity to comment on the Exposure Draft of Proposed Improvements to International Accounting Standards issued May 2002 ('the improvements ED').

As you are undoubtedly aware, our Financial Reporting Council has recently announced its intention that Australia adopts international accounting standards on 1 January 2005. Accordingly, the development of new international standards and improvements to existing international standards are of vital importance to Australia. In our view, it is imperative that financial reporting constituents in this country actively participate in the due processes of the International Accounting Standards Board.

We are generally supportive of the proposals of the improvements ED. However, we urge the Board in its deliberations to promote quality over politics and eliminate any remaining loopholes (i.e. exceptions) and unnecessary options that are contained in the relevant international accounting standards. In particular, we strongly object to the exemption from consolidation accounting based on temporary control.

Our detailed responses to the proposed amendments of international accounting standards affected by the improvements ED are attached.

Yours sincerely,

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# Proposed Improvements to International Accounting Standard IAS 1 Presentation of Financial Statements

**Comments**

We agree with the amendments as summarised on pages 18-20 except as set out below.

We endorse the paragraph 6 description of a complete set of financial statements as including a statement of changes in equity. Australian Standards do not presently require such a statement. However, in our view it is a vital reconciliation for readers of the income statement and balance sheet.

We endorse the paragraph 10 guidance on the meaning of 'present fairly' and its linkage to the application of International Financial Reporting Standards and Interpretations of those Standards.

**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 disagree with the approach at proposed paragraphs 13-15. In our view all entities, as opposed to virtually all entities, that prepare published financial reports must comply with the requirements in International Financial Reporting Standards and Interpretations of those Standards.

In our view, the extremely rare circumstances referred to at paragraph 13 should be handled by the requirement to provide additional information to ensure that a fair presentation is made together with full disclosure of the circumstances that give rise to the need for this additional information. This is the approach adopted by section 295(3) of the Australian Corporations Act, 2001.

We would observe that recent events in the United States make it an imperative for the Board not to mandate an open-ended loophole that can be used to avoid the application of International Financial Reporting Standards and Interpretations of those Standards.

If the Board is determined to keep proposed paragraphs 13-15, then they should expand the commentary at paragraph 16 to include examples of any known extremely rare circumstance that would justify non-compliance with International Financial Reporting Standards and Interpretations of those 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 disagree with the proposal to eliminate extraordinary items. In our view, an extraordinary item is worthy of separate disclosure on the face of the income statement with full disclosure of the nature of the item made in the notes. This is the approach to extraordinary items that is adopted in the Australian Standard AASB 1018 'Statement of Financial Performance' and we commend it to the Board. An important component of the AASB 1018 approach is the limiting effect of paragraphs 5.5.1 and 5.5.3, which make it clear that extraordinary items are extremely rare in practice.

We would observe that IAS 7 'Cash Flow Statements' includes the requirement to separately disclose cash flows associated extraordinary items (paragraph 29). In our view, it would be internally inconsistent to remove extraordinaries from the income statement but retain the cash flow effect of such items in the statement of cash flows.

We would also observe that analysts and educated users of the financial statements typically seek an earnings number that is before extraordinary or non-recurring items. The Board should seek to accommodate rather than muddy the waters for these users.

**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)?**

We disagree with the proposed approach on the basis that the reporting period prior to re-financing would have the potential to mislead users with regard to the long-term debt and gearing level of the entity.

We prefer the approach adopted in the Australian Standard AASB 1040 'Statement of Financial Position' and we commend it to the Board. Paragraph 4.5 of AASB 1040 states as follows:

> 'Where current liabilities and non-current liabilities are presented separately in accordance with paragraph 4.1, long-term interest-bearing liabilities must continue to be categorised as non-current, even when they are due to be settled within twelve months of the reporting date, when all of the following conditions apply:
> (a) the original term was for a period of more than twelve months
> (b) the entity is committed to an agreement to refinance, or to reschedule payments, prior to the *time of completion* of the financial report.'

In our view, the agreement to re-finance is an event that provides additional information about conditions that exist at reporting date and as such the event is relevant to the classification of the liability at reporting date.

**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 proposed approach at (a) on the basis that it has the potential to mislead users with regard to the long-term debt and gearing level of the entity.

We prefer the approach adopted in the Australian Standard AASB 1040 'Statement of Financial Position' and we commend it to the Board. Paragraph 4.6 of AASB 1040 states as follows:

> 'Where current liabilities and non-current liabilities are presented separately in accordance with paragraph 4.1 and an undertaking, including a covenant included in a borrowing

agreement, is breached such that the liability becomes payable on demand, the liability must be categorised as current unless all of the following conditions apply:

(a) the lender has agreed, prior to the time of completion of the financial report, not to demand payment as a consequence of the breach

(b) it is not probable that further breaches will occur within twelve months of the reporting date

(c) in the absence of the breach, the liability would not have been due for settlement within twelve months of the reporting date.'

In our view, the lender's agreement subsequent to reporting date provides additional information about conditions that exist at reporting date and as such the event is relevant to the classification of the liability at reporting date. In other words, at reporting date it was probable or likely that the breach would not result in the borrowings becoming payable on demand.

**Question 5**
**Do you agree that an entity should disclose the judgments 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)?**

We agree with this proposal. In our view, the directors should highlight for the users of their financial reports which accounting policies involve significant management judgment with regard to estimates and assumptions.

**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 agree with this proposal but only on the grounds that it will educate users of the inherent measurement uncertainty in the carrying amounts of certain classes of assets and liabilities.

We are not convinced that the notes to the financial statements should include multiple possible values for assets and liabilities that differ from those recognised on the face of the statements. If an asset is measured at fair value, then the focus of the financial report must be to provide the best possible estimate of fair value rather than a range of possible values contingent on future events.

# Proposed Improvements to International Accounting Standard IAS 2 Inventories

**Comments**

We agree with the amendments as summarised on page 69. We heartily endorse the elimination of the LIFO basis of assigning costs to inventory and urge the Board to take this step in the interests of the comparability of financial information.

**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?**

We agree with this proposal and note that it will bring IAS 2 into line with the Australian Standard AASB 1019 'Inventories' (paragraph7.2).

**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?**

We agree with this proposal and note that it will bring IAS 2 into line with the Australian Standard AASB 1019 'Inventories' (paragraph9.3).

# Proposed Improvements to International Accounting Standard IAS 8 Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies

**Comments**

We agree with the amendments as summarised on pages 89-91 except as set out below.

We disagree with open-ended exemptions based on ‘undue cost or effort’. In the extreme, it could be argued that the requirement at paragraph 33 to change the comparatives always involves undue cost and effort. In our view, further explanation of what constitutes undue cost or effort is required. As a minimum we would expect commentary to effect that the circumstances of undue cost or effort are very rare indeed.

**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)?**

We disagree with this proposal. The problem we perceive with retrospective adjustment is that it provides an incentive to make errors so that items of revenue and expense are never brought to account in the income statement.

Our preference is for voluntary changes in accounting policies and corrections of errors to be accounted for retroactively such that the cumulative financial effect up to the end of the preceding financial year must be recognised as revenue or expense in the income statement. It should be noted that this is the approach adopted by Australian Standard AASB 1001 ‘Accounting Policies’ (paragraph6.3) and AASB 1018 ‘Statement of Financial Performance’ (paragraph7.1).

Irrespective of our preference for the retroactive approach, we agree that it is an imperative for the Board to support a single method and eliminate allowed alternatives in this area.

**Question 2**
**Do you agree with eliminating the distinction between fundamental errors and other material errors (see paragraphs 32 and 33)?**

We agree with this proposal. In a literal sense, a material error is always fundamental to the presentation of the financial report.

# Proposed Improvements to International Accounting Standard IAS 10 Events After the Balance Sheet Date

**Comments**

We agree with the main change that dividends declared after balance date should not be recognised as a liability at that balance date. It should be noted that this approach has already been adopted by Australian Standard AASB 1044 ‘Provisions, Contingent Liabilities and Contingent Assets’ (paragraph13.1).

We also agree with the changes proposed to paragraph 8 that clarify that a court case settled before the financial report is authorised for issue should be treated as an adjusting event, such that, the entity must adjust the amounts recognised in the financial statements

# Proposed Withdrawal of International Accounting Standard IAS 15 Information Reflecting the Effects of Changing Prices

**Comments**

We agree with the withdrawal of IAS 15 on the basis that the Standard has not passed the test of user demand and therefore usefulness.

# Proposed Improvements to International Accounting Standard IAS 16 Property, Plant and Equipment

**Comments**

We agree with the proposed amendments as summarised on pages 125-128 except as set out below.

We disagree with the proposal to review residual value at each reporting date (paragraph 46) as this may be used as a means of avoiding depreciation. We prefer the approach adopted by AASB 1021 whereby residual value is only updated if the asset is subsequently revalued (paragraph 5.6).

**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)?**

We agree with the principle that the cost of acquisition of an item of property, plant and equipment that has been acquired in exchange for another item is measured as the fair value of that other item given up. It should be noted that this approach is consistent with the Australian Standard AASB 1015 'Acquisitions of Assets' (paragraph 6.1).

We agree that the book value of the item of property, plant and equipment that is exchanged should be used to measure cost only where fair values cannot be determined reliably.

**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.)**

We agree and note that this proposal is consistent with the treatment of exchanges of property, plant and equipment.

**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)?**

We agree that an item of property, plant and equipment that has become temporarily idle should continue to be depreciated. In our view the 'useful life' of a depreciable asset is continuous notwithstanding any downtime that the asset may have where it is held awaiting further use.

We disagree that an item of property, plant and equipment that is held for disposal should continue to be depreciated. In our view, such an item has the character of a current asset. In this case, the remaining future economic benefits of the asset are expected to be realised through imminent sale not use during one or more reporting periods. In our view, depreciation of a current asset is inappropriate. However, we agree that the asset should continue to be subject to an impairment test.

# Proposed Improvements to International Accounting Standard IAS 17 Leases

**Comments**

We agree with the Board's limited amendments to accounting for leases at this time. We encourage the Board to progress with a wider project on leases and specifically address whether all non-cancellable leases should be capitalised.

**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 agree with this approach, which is consistent with the Australian Standard AASB 1008 'Leases' (paragraphs 5.3.11 to 5.3.13)

**Question 2**
**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 transaction should be capitalised in this way and that they should include those internal costs that are incremental and directly attributable?**

We agree.

# Proposed Improvements to International Accounting Standard IAS 21 The Effects of Change in Foreign Exchange Rates

**Comments**

We agree with the proposed amendments as summarised on pages 179-182 except as set out below.

We note that the proposed changes to IAS 21 amount to the abolition of the 'temporal method' of translation for integrated foreign operations. Our preference is to retain the existing framework of IAS 21 whereby the translation of a foreign operation depends on its operating and/or operating inter-dependence with the entity. This is the model used by the Australian Standard AASB 1012 'Foreign Currency Translation'. Nonetheless, we are willing to accept the argument that the abolition of the temporal method will simplify accounting for foreign operations and improve the consistency and comparability of consolidated financial statements.

**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?**

We agree.

**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?**

We agree with the principle that an entity should be allowed to present their financial statements in the currency that provides the most relevant and reliable information for their stakeholders.

However, we disagree with an open-ended provision that would allow the choice of a currency that is remote or has no intrinsic connection with the entity. For example, if a company in the United Kingdom has only European assets and operations is there a valid reason why it should be allowed to present its financial statements in Vietnamese Dong.

In our view, there needs to be some overriding requirement that the choice of presentation currency is made in such a manner to ensure that the resulting financial statements are comparable and understandable while satisfying the qualitative characteristics of relevance and reliability.

**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)?**

We agree.

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

We agree.

**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)?**

We disagree that, of itself, a fair value adjustment is an asset or liability.  This statement seems to confuse recognition of a financial statement item with its measurement.  Of course, the application of the 'current rate method' will result in the identifiable assets and liabilities of a foreign operation being restated using the closing exchange rates.  However, the fair value of these assets and liabilities for the purpose of measuring goodwill and their translated carrying amounts at later reporting dates should not be confused.

We disagree that goodwill must be restated to the closing rate at the end of each reporting period.  Goodwill is measured as the difference between cost of acquisition and the identifiable net assets acquired at fair value.  By definition, the initial and subsequent measurement of goodwill requires the application of the historic exchange rate applicable at the date of acquisition.

# Proposed Improvements to International Accounting Standard IAS 24 Related Party Disclosures

**Comments**

We agree with the proposed amendments as summarised on pages 213-214 except as set out below.

**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)?**

We disagree with non-disclosure of management compensation. In our view, the notes to the financial statements should include full and specific disclosure of all the remuneration of directors and executives including the components of such remuneration.

We commend to the Board the proposed Australian approach set out in ED 106 'Director, Executive and Related Party Disclosures' (May 2002). This approach involves the establishment of two separate Standards, one dealing with disclosures for directors and executives and the second with disclosures for other related parties.

**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)?**

We agree.

# Proposed Improvements to International Accounting Standard IAS 27 Consolidated Financial Statements and Accounting for Investments in Subsidiaries

**Comments**

We agree with the amendments as summarised on pages 233-234 except as set out below.

We strongly disagree with any exemption from consolidation based on temporary control (paragraph 13). We ask the Board, 'Why retain a loophole that can be used to conceal group losses and debts?'

We strongly encourage the Board to provide no exceptions whatsoever to the consolidation of subsidiaries, which is the approach of the Australian Standard AASB 1024 'Consolidated Accounts'.

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

We agree.

**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)?**

We agree with this approach, which is consistent with Australian Standard AASB 1024 'Consolidated Accounts' (paragraph 32).

**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)?**

We agree.

**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)?**

We agree.

# Proposed Improvements to International Accounting Standard IAS 28 Accounting for Investments in Associates

**Comments**

We agree with the amendments as summarised on pages 257-258 except as set out below.

We disagree with the statement at paragraph 16 that many of the procedures appropriate for the application of the equity method are similar to consolidation procedures. In our view, the commentary here should highlight how each method is distinct from the other rather than indicate that they are like methods. For example, the equity method involves a proportional consolidation of post-acquisition profits and losses into the one-line investment account whereas the full consolidation method involves a line-by-line aggregation that combines the accounts of the parent entity and each of its subsidiaries.

**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)?**

We agree but would prefer the exclusion to be based on measurement at fair value as required by another International Accounting Standard rather than reliance on industry practice.

**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)?**

We agree.

# Proposed Improvements to International Accounting Standard IAS 33 Earnings Per Share

**Comments**

In our view the calculation of EPS can be done in numerous ways and it is arguable whether one method is any better than another. Therefore, we encourage the Board consult with the analyst community on the proposed rule changes to ensure that the methodology of IAS 33 is widely accepted by the main user group for this financial information.

**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?**

We agree.

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

- **The number of potential ordinary shares is a year-to-date weighted average of the number of potential ordinary shares included in each interim diluted earnings per share calculation, rather than a year-to-date weighted average of the number of potential ordinary shares weighted for the period they were outstanding (ie without regard for the diluted earnings per share information reported during the interim periods).**
- **The number of potential ordinary shares is computed using the average market price during the interim periods reported upon, rather than using the average market price during the year-to-date period.**
- **Contingently issuable shares are weighted for the interim periods in which they were included in the computation of diluted earnings per share, rather than being included in the computation of diluted earnings per share (if the conditions are satisfied) from the beginning of the year-to-date reporting period (or from the date of the contingent share agreement, if later).**

We agree.

# Proposed Improvements to International Accounting Standard IAS 40 Investment Property

**Comments**

We disagree with IAS 40's approach of allowed alternatives for the subsequent measurement of investment property. In our view, this approach detracts from the quality of International Accounting Standards.

**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?**

We agree.

**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?**

We agree.

**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?**

We disagree.

We note that the international exposure draft leading to the issue of IAS 40 (i.e. E 64) did not promote options for subsequent measurement. Rather, E 64 proposed a comprehensive fair value model for the subsequent measurement of investment property. We supported this fair value model when making comment on E 64 to the (then) International Accounting Standards Committee. The basis for our support of fair value model is that it provides the most relevant information on financial position and financial performance for those entities that are engaged in property investment.

In our view, the Board made an error when it took a 'U turn' from the original proposals of E 64. The Board should take the present opportunity offered by the Improvements project to correct its error and eliminate the cost model immediately.

# Proposed Consequential Amendments to International Accounting Standards and SIC Interpretations

**Comments**

We agree with the proposed consequential amendments to International Accounting Standards and SIC Interpretations to the extent that they are consistent with our comments above.