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BBA Response to IASB Exposure Draft – Improvements to International Accounting Standards

Preface to International Accounting Standards

Each international accounting standard includes a statement that international accounting standards are not intended to apply to immaterial items, and a cross-reference is given to the Board's Preface. However, the cross-referenced paragraph no longer appears in the revised Preface published by the Board in May 2002. We object strongly to this change to the Preface, which was not included in the exposure draft. The absence of this statement has far reaching and serious implications for financial reporting and the phrase should be reinstated at the earliest opportunity. In the meantime, the Board may wish to reinsert this important statement within IAS 1 or IAS 8 as part of their revisions.

IAS 1 – Presentation of Financial Statements

Q1. 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 inclusion in the standard of 'override' provisions, but disagree that these provisions should be made by reference to the regulatory framework of the country in which the financial statements are issued. In our view, if the standards themselves require an override in specific, exceptional circumstances, then there would be no departure from standards where such provisions are used. Therefore, paragraph 15 is unnecessary and the phrase 'if the relevant regulatory framework requires or otherwise does not prohibit such a departure' should be deleted from paragraph 13.

Q2. 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)?

Whilst we support the idea of preventing entities labelling items as "extraordinary", we do not believe that paragraph 78 will be effective in preventing the practice. Entities can just use a different term than "extraordinary". The better way of preventing this practice would be to require items of such size, nature or incidence that their separate disclosure is relevant to an understanding of the entity's performance to be included within the appropriate income statement heading to which they relate. Paragraph 80 should be amended to make this requirement clear and should include the following words at the end: 'under the headings set out in paragraph 76'.

Q3. **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. At the balance sheet date the entity has a current liability

Q4. **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)?

Yes.

(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 the 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

Yes. If the breach is rectified within the period of grace, we agree that it is appropriate to classify it as non-current.

(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 paragraph 63 and 64)?

Yes, provided that it is not unlikely that the breach will be rectified.

Q5. **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 that disclosure framed along these lines is necessary or useful. At best, such a requirement will only result in boilerplate disclosures. Indeed, the example given in paragraph 109 with regard to financial assets held-to-maturity can only result in boilerplate disclosure since the categorisation of financial assets is based on the rules in IAS 39 and is not a matter of management judgement. We recommend that these paragraphs be deleted.

However, we consider that disclosure should be required of the methods and assumptions used to measure assets and liabilities where management judgement is needed to determine the appropriate methods and assumptions. The disclosure requirements are best set within the context of a specific accounting standard, for example IAS 32 with regard to measuring the fair value of financial assets and liabilities and IAS 19 with regard to measuring pension assets and liabilities.

Q6. 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 material adjustment to the carrying amounts of assets and liabilities within the next financial year (see proposed paragraphs 110-115)?

We do not agree with the proposals. For most financial businesses, assumptions underlying key measurements of assets and liabilities are likely to be varied and wide-ranging, encompassing economic and commercial trends which are to a greater or lesser extent interrelated. Any meaningful discussion of such assumptions would need to be much more extensive than appropriate to the financial statements. Furthermore, sensitivity of measurement to these assumptions will not always depend on a direct relationship but will itself involve a considerable degree of judgement.

We also consider that the proposal confuses uncertainties relating to the measurement of the item at the accounting date, and changes that might occur over the next period. For example, the value of a traded bond at the balance sheet date is directly available from market price quotations, but its value over the next year is dependent on interest rates, possibly currency rates, and many factors that underlie the issuer's credit rating.

Disclosures of sensitivity to changes in assumptions are also likely to be misinterpreted as meaning that the accounts could be wrong to the extent of the range indicated; such misinterpretation would further undermine the credibility of financial reporting generally. Sensitivity disclosure may also be commercially damaging in some circumstances.

We therefore suggest that such disclosures should focus on the assumptions used, rather than the range of possible outcomes, and should consider only the range of possible assumptions at the measurement date, rather than potential changes in assumptions over the following year.

We also believe that such disclosures are more appropriate to the MD&A or OFR section of the annual report than the financial statements themselves. This places the information in a more appropriate category for audit purposes, and also affords 'safe harbour' treatment. It is also less likely to result in 'boilerplate' discussion.

IAS 2 - Inventories

Q1. 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.

Q2. IAS 2 requires reversals 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.

IAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors

Q1. 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 agree that voluntary changes in accounting policy and the correction of errors should be accounted for retrospectively. Voluntary changes in accounting policies, should be rare and should only be made where the new policy is better than the old policy. Since they are at the discretion of management, it should generally be expected that restatement should not cause undue cost or effort. The wording of paragraph 21 could be improved to make these points clear. We believe it is important for the standard to include a reference to material errors. In the absence of such a reference, IAS 8 could be read as requiring the restatement of comparatives for all errors, however trivial, and entities may be encouraged to use the provision to manage earnings.

Q2. Do you agree with eliminating the distinction between fundamental errors and other material errors (see paragraphs 32 and 33)?

Yes, although as stated in our response to question 1 above, we believe the requirements should apply to material errors.

IAS 16 – Property, Plant and Equipment

Q1. 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 of the [draft] FRS on property, plant and equipment)?

No. We believe that the issue of whether gains or losses should be recognised on exchanges of similar assets should be addressed in the Revenue Recognition project. Therefore, we do not consider it should be addressed at this time in the improvements project.

Q2. 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?

No, for the reasons set out in the response to Q1.

Q3. 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 of the [draft] FRS on property, plant and equipment)?

Yes.

IAS 17 – Leases

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 financing lease by applying the conditions in paragraphs 3-10 of IAS 17.

We have sympathy with the motive for the change, which is to try to ensure that the land element of a lease does not prevent what would otherwise be a finance lease from being accounted for as a finance lease. However, we do not believe it is either appropriate or practical to allocate amounts attributable to the land and buildings separately. Therefore, we do not support this amendment and suggest that it is an area that should be addressed in the wider project on lease accounting.

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

We agree that this choice should be eliminated and agree with the approach taken.

IAS 21 – The Effects of Changes in Foreign Exchange Rates

Q1. 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.

Q2. 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.

Q3. 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)?

No. In the case of a translation that is made merely for the convenience of readers, we consider that it is preferable to use the closing rate to translate the financial statements. This will not result in the creation of new gains and losses and will maintain ratios.

Q4. Do you agree that the allowed alternative to capitalise certain exchange differences in paragraph 21 of IAS 21 should be removed?

Yes.

Q5. 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 agree with the proposed improvement: goodwill is generated as a result of the acquisition of an entity and therefore relates to the acquired entity. For the same reason, we concur with the improvement regarding fair value adjustments to assets and liabilities.

IAS 24 – Related Party Disclosures

Q1. 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. The disclosure of management remuneration either in aggregate or for each director by name is useful to users of financial statements of all size companies. While IAS 24 may not be the best place to include such disclosure, which is often subject to legal or other regulatory disclosure requirements, it does not seem appropriate to exclude it.

Q2. 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 support the proposals in paragraph 3 of the draft amendment to IAS 24 'Related Party Disclosure' that: 'The standard does not require disclosure of related party transactions and outstanding balances in the separate financial statements of a parent or wholly owned subsidiary that are made available or published with consolidated financial statements for the group to which that entity belongs.'

As noted above, exemption for subsidiary undertakings should be widened to include those for which 90% of the voting rights are controlled by the group. (By definition, this would be based solely on shares with voting rights.)

IAS 27 – Consolidated and Separate Financial Statements

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

Yes. We agree for the reasons explained in the basis for conclusions. However we would make following points:

- It seems impractical for an accounting standard to introduce the requirements in 8 (a) with regard to obtaining unanimous agreements from minority interests. How decisions are made by shareholders is a matter for company law and not accounting standards. It would be better for the accounting standard to be less specific in this regard, for example, by merely requiring that minority interests do not object.
- Paragraph 8 (d) should include intermediate parent companies.
- In paragraph 8 (b) what is meant by securities and publicly traded? This should be reworded so that subsidiaries of listed companies which have only issued CDs, commercial paper, etc, should not be required to produce consolidated financial statements if they meet all the other tests.

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)?

We do not agree that minority interests should be classified as part of equity. Although the presentation on the balance sheet, as a separately presented element of equity and distinguished from parent shareholders' equity is acceptable, the corollary of this classification is that in the profit and loss account minority interests would not be shown as a deduction in arriving at net profit. We believe that in consolidated accounts the focus must be on the shareholders of the parent, and that from their perspective minority interests are not part of equity. We would also point out that in many cases minority interests represent an obligation of the Group that is more akin to a liability than equity.

Q3. 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, 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)?

Whilst we generally favour deletion of unnecessary options in this case two options are retained and only the third is deleted. That option – to carry these investments under the equity method – is in some ways the most relevant because it usually allows the equity in the financial statements of the investor and in the Group consolidated financial statements to be the same.

In this case therefore we favour retaining all three existing options – cost, equity method and fair value – as the basis for accounting for subsidiaries, jointly controlled companies and associates in the financial statements of the investor.

A holding company may hedge its investment in its subsidiaries by matching their net asset value ('NAV') against foreign borrowings. Under revised IAS 27, the holding company would not be allowed to report the subsidiaries at NAV; suppose it recognises them at historical cost. Then, assuming the holding company can apply hedge accounting to the historical cost of the investment under IAS 39, the holding company accounts will effectively report a foreign exchange position equal to the difference between the subsidiaries' historical cost and NAV. This does not reflect the economics of the situation.

We do 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.

However, we would note the case where a listed company acts purely as the holding company for a single trading subsidiary. If in this situation IAS 39 were applied then it would result in the listed parent company recognising its own market capitalisation in the balance sheet.

IAS 28 – Accounting for Investments in Associates

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, when such measurement is well established practice in those industries (see paragraph 1)?

Yes. We agree that for venture capital organisations, mutual funds, unit trusts and similar entities IAS 28 and 31 should not apply to investments that otherwise would be associates or joint ventures where these investments are held as part of a portfolio of such investments. We agree that the investments should be accounted for as held for trading in accordance with IAS 39. However, we note that IAS 39 makes an exception to the general rule that trading assets should be carried at fair value in the case of unquoted equity instruments whose fair value cannot be reliably measured. While the requirement that fair value measurement must be a well-established practice in the industries where this exemption will be used should go some way toward ensuring that fair values are generally available, we consider that the standard must acknowledge that there will be some circumstances where reliable fair values cannot be obtained. In such circumstances, the investments should be held at cost less provision for impairment in accordance with IAS 39. This will ensure that all investments that are part of the same portfolios are treated the same way. It would be unacceptable if the standard could be interpreted to mean that an investment in a portfolio of other venture capital investments had to be treated as an associate or joint venture merely because a reliable fair value was not available.

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)?

We do not agree with the proposed approach since this might lead to the inappropriate write-down of, for example, long-term receivables when good collateral is in place. We consider that the investor should continue to record changes in the carrying amount for an associate that is incurring losses even if this results in the recognition of net liabilities rather than net assets.

IAS 33 – Earnings Per Share

Q1. 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.

Q2. 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).**

No, we do not agree with the approach to deal with the year-to-date calculation of diluted earnings per share. Using an average based on interim periods rather than using a cumulative full year average may produce different values for the components of the dilutive calculation, as potential ordinary shares could be dilutive in one interim period but not in another.

IAS 40 – Investment property

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 fair value model set out in IAS 40, paragraphs 27-49?

Yes.

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?

Yes.

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?

Yes. However, as fair values are increasingly used, it will become more untenable for investment property not to be carried at fair value.

British Bankers' Association
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