Memo

Philips International B.V.

To: International Accounting Standards Board	F.a.o. Sir David Tweedie	

From:

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5600 MD EINDHOVEN		Date: 2002-09-16

Subject: Improvements to IAS

Dear Sir,

On behalf of Royal Philips Electronics N.V., I am pleased to respond to the invitation the International Accounting Standards Board, to comment the *Exposure draft on Improvements to IAS (in the remainder referred to as the exposure draft).* We will first present a number of general comments and observations and subsequently address the questions for respondents.

1. General Comments

As an organization we endeavor to find the appropriate balance between providing relevant and meaningful information to our stakeholders and limiting the costs involved in creating and collecting this information, a cost that is ultimately borne by our shareholders. In addition we are conscious of the, in itself deplorable, fact that accounting standards across the world are not harmonized. This may result in distortions in the level playing field for international companies when new standards are introduced in a certain jurisdiction that are fundamentally different from those applicable in other jurisdictions. Not only does this reduce comparability; it potentially can create a competitive disadvantage for companies that are forced to disclose more or different information than their competitors reporting under a different GAAP. In the improvements project we notice that a number of possible convergence issues with US GAAP, although implicitly addressed, are not resolved. In our view that is highly undesirable that this opportunity is not used.

We also have to raise a general concern with regard to the intended development of new standards in a number of area's and the work plan for the coming years. It is of vital importance for the change over to IAS in Europe that the number of new standards to be issued between 2003 and 2005 is limited and that conceptually new items like the performance statement are not introduced in that period. Not only would such actions by

the Board result in unacceptable expenses for reporting organizations, they would also seriously create the risk of miscommunication with the users of financial statements.
In addition we would like to make the following general observations:

1. Some changes will increase the complexity and costs of IAS without resulting in additional material information (e.g. fair valuation of all investment properties in IAS 40, Investment Properties, if the alternative cost treatment were dropped; allocation of goodwill and fair value adjustments to currency of the acquired entity(ies) in IAS 21, Effects of Changes in Foreign Exchange Rates).

2. The number of changes proposed in a document with more than 400 pages will lead to substantial efforts in all units that are consolidated. The adjustment of internal guidelines, training and IT-systems will take time. Therefore, it would increase the quality of compliance if preparers had more time. It would definitely be helpful if all the drafted changes would become effective on or after 1.1.2004 with encouragement of earlier application, especially bearing in mind that issue of the changes is foreseen only in the first quarter of 2003.

3. A principle-based IAS can lead to situations where required information is not fully defined or the applied methods not fully described. However, a lack of detailed and formalized definitions or methods should not be the reason to abolish well established practices as seems to be the case in various proposed changes (eg. number of employees). In addition this can lead to various country specific interpretations which are undesirable in view of the needed global convergence

4. The improvement project introduces several new rules which will detract from a true and fair presentation and from best business practice, i.e.
   a) The 12 month time threshold for the non-consolidation of business units held for sale (IAS 27).
   b) The deletion of the requirement to disclose the number of employees.
   c) The deletion of the requirement to show “the results of operating activities”.

2. Answers to specific Questions

IAS 1 - Presentation of Financial Statements

Question 1 : Proposed Departure from an IFRS or from an IFRS Interpretation

We agree with the clarification between a departure that is justified under the Framework (IAS 1 rev. §§ 13-14) and a departure that is prohibited under the Framework (IAS 1 rev § 15).

Question 2 : Prohibition of extraordinary items

While we agree with the prohibition of extraordinary items, we consider that § 79 which says that “no items of income and expense are presented as arising from outside the entity’s ordinary activities” is misleading since it could be interpreted as forbidding any disclosure of such amounts or separate disclosure of other exceptional gains/losses. We propose to reword § 79 as follows: “The prohibition of extraordinary items does not prevent an entity from disclosing gains/losses such as losses related to events such as natural disasters or expropriation in accordance with paragraph 82, as long as such gains and losses and other exceptional items are clearly disclosed as part of the ordinary activities”.

Question 3 : Agreement to refinance or to reschedule payments completed after the balance sheet date

No. We disagree that a liability that is due to be settled within twelve months from the balance sheet date should be classified as a current liability when an agreement to refinance has been completed after the balance sheet date but before the financial statements are authorised for issue.

IAS 10 § 2 defines adjusting events as "those that provide evidence of conditions that existed at the balance sheet date". In the case under review, the entity has a long-term loan at the balance sheet date and this is evidenced by the terms and condition of the loan but the company has to classify the loan as current when it is due to mature within 12 months. However, an agreement to extend the maturity for an additional long term period that is entered into after the balance sheet date but before the financial statements are authorised for issue is indeed an adjusting event because according to IAS 10 it provides evidence that the company will not incur a cash outflow within 12 months from the balance sheet date. We also consider that requiring that there is an agreement to refinance (i.e. some legal documentation) at the balance sheet date also contradicts § 35 of the Framework that requires that transactions are "presented in accordance with their substance and economic reality and not merely with their legal form".

Question 4 a : Agreement not to Demand Payment After the Breach of Loan Conditions

No. We disagree that a long-term loan be classified as current after the breach of the loan terms and conditions 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. Our arguments are similar as those of question 3: we consider that the agreement not to demand payment is an adjusting event in accordance with IAS 10.

Question 4 b : Period of Grace After the Breach of the Loan Conditions

No. We disagree that the period of grace be granted by the balance sheet date. We consider that such a period should be granted by the date the financial statements are authorised for issue for the same reasons as those stated under questions 3 and 4 b. Nevertheless we agree with the conditions of items (i) and (ii) of question 4 (b) concerning the rectification of the breach.

Question 5 : Judgements made by Management in Applying Accounting Policies

No. We consider that such kind of general information should be part of a future IFRS on Management Discussion and Analysis. For the time being, we consider that the Board should stick to what is already specifically requested in other IASs or implement new specific requirements in various IASs and IFRSs if really necessary. In addition the concept is not clearly defined or explained in the exposure draft, which makes it difficult to determine what a meaningful discussion would entail. Therefore we propose to delete paragraphs 108 and 109.

Question 6 : Key Measurement Assumptions

No for the same reasons as under question 5 above. Again the proposed paragraphs also lack in clarity, which makes their introduction undesirable. Therefore we propose to delete paragraphs 110 to 115.

Other points

Elimination of "the results of operating activities"

We disagree with the deletion of the requirement to show "the results of operating activities" in § 76. Whilst we accept that "operating activities" is not yet a defined term under IAS we nevertheless recommend retaining this disclosure requirement for the following reasons:

a) In many industries operating income or a similar term is one of the key performance measures along with revenue and net income used by investors or analysts for assessing an entity's results.

b) IAS 14 contains the requirement to report a "segment result". Although IAS 14 allows several alternatives to define "segment result", the example in IAS 14 appendix B appears to make a preferred definition of "operating profit" clear. We consider that this total before financial items and taxes is totally appropriate for manufacturing companies and should be retained. Suitable wording should also be introduced to cover financial and non-manufacturing entities.

c) We are aware that the Reporting Financial Performance project may introduce refinements to any definition of "the results of operating activities", however, we do not consider that this justifies elimination of this concept, certainly as a alternative concepts are not available.

Elimination of requirement to disclose number of employees

While we appreciate that the proposed change does not forbid this disclosure, it appears to us desirable to continue to require it as it generally gives a useful concrete indication of the substance and real resources of an entity, which is not available from the pure financial figures. It is considered as good business practice to disclose information regarding the workforce e.g. as stated in the OECD Guidelines for Multinational Enterprises, Chapter 3 on Disclosure (revised 2000). Eliminating the guidance on the topic is likely to result in divergent practices between various countries which in not in the interest of the users of financial statements and may be detrimental to global convergence.

<u>IAS 2 - Inventories</u>

Question 1 : Elimination of LIFO

We disagree with this proposal. Although the LIFO method may have some theoretical drawbacks it is applied in certain industries and regarded as best practice for these industries. Simply abolishing it is too easy. Before taking such a step the Board should seriously consider whether industry differences necessitate the introduction of industry specific standards. The establishment of high quality standard requires that such a principal question is addressed first before an accepted option is eliminated.

Question 2 : Reversal and disclosure of inventory write-downs

Concerning the general topic of reversals of write-downs, however, we note the absence of a clearly defined and consistent criterion in IAS for determining in the various standards which types of downward value adjustments may be reversed and which not. The proposal on inventories favours permitting reversal, while the proposal in IAS 39 would not permit reversal of impairments of available-for-sale financial assets. Differing criteria apply to reversals of impairments under IAS 38 depending on type of asset. Transparent, high-quality standards should be based on transparent, high-quality criteria for deciding which types of reversal to allow and which not. In addition the topic is full of convergence issues in view of the prohibition of many reversals under US GAAP. We recommend that the Board gives high priority to resolving these differences in its convergence projects and postpones any new guidance until the convergence issue is resolved.

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

Question 1&2: Elimination of allowed alternative

We recommend retaining the distinction between fundamental and other material errors. Fundamental errors need to be corrected retrospectively other material errors should be only corrected prospectively. In addition the suggested requirement (para. 19 (d)) to disclose the effect of future changes in accounting policies as a result of the introduction of new standards is impractical or even virtually impossible to honour. That requirement can not be justified.

IAS 10 – Events after the balance sheet date

We agree that dividends declared after the balance sheet date should not be recognised as a liability at the balance sheet date.

IAS 16 - Property, Plant and Equipment

Question 1&2 : Exchanges of Items of Property, Plant and Equipment and intangibles

We disagree with the proposed changes. The distinction between exchanges that represent a sales transaction and swaps of similar assets that is incorporated in the current standard is in accordance with economic reality and should be maintained.

Question 2 : Exchanges of Intangibles Assets

Yes, we agree in principle because this issue is similar to that of question 1.

Question 3 : Items of Property, Plant and Equipment that Become Temporarily Idle or that are Retired from Use

Yes, we agree subject to the addition of the following sentence at the end of paragraph 59:

"If an item of property, plant and equipment that becomes temporarily idle or that is retired from use has been impaired and its recoverable amount has been determined on the basis of the net selling price, then such item ceases to be amortised."
We consider that our proposed addition is justified because the value based on the net selling price in accordance with IAS 36 is the best evidence of the future economic benefits embodied in the items of PP&E. Furthermore any additional depreciation in this circumstance would be a double counting with the impairment loss. In addition we recommend to align the guidance with US GAAP in this respect to reduce reconciliation's.

IAS 17 - Leases

Question 1 : Classification of Land and Building Lease

While we agree that the classification of land and building leases be clarified, we do not agree with the general requirement of allocating a lease value to the land and building elements and that the classification of the entire lease as either finance or operating is allowed only "if the lease payments cannot be allocated reliably between these two elements".

We consider that the way the requirements are presented does not reflect the economic substance of real estate lease agreements since enterprises enter into such agreements to obtain the use of both the land and the building. The relevant fact is that the enterprises enjoy (or do not enjoy) the risks and rewards of the whole property. If the present value of the lease payments of the whole real estate lease annuities amounts to substantially all of the fair value of the leased assets (§ 8 d) or if the assets are of a specialised nature (§ 8 e) we do not see why the whole lease would not be entirely classified as a finance one. Requiring to split the land and building elements gives a primacy to the criterion of § 8 (c), i.e., the major part of the economic life, just because the land has an indefinite life. We consider that this would be form over substance.

Question 2 : Lessors' Initial Costs

Yes we agree that lessors' initial costs incurred in negotiating a lease be capitalised over the lease term and that only incremental direct costs are eligible for capitalisation. We recommend to review convergence with other GAAP's in this area and have to ask for further clarification of the concept of "incremental directly attributable (internal) costs. The Board should realize that we have to instruct more than 1.000 reporting entities with regard to the proper application of its standards. Introducing theoretical distinctions that are far removed from economic reality makes application of standards a practical impossibility.

Other points

Even with the improvements of 1999 and 2002, IAS 17 on leases is still not satisfactory since it allows some possibilities of arbitrage between finance and operating leases. We consider that the Board should rapidly elaborate an exposure draft based on the G4+1 discussion papers of 1996 and 2000 and review IAS 17 in order to achieve accounting treatments that converge with other important accounting standards.

IAS 21 – The effects of changes in foreign exchange rates

Question 1 : Proposed definition of functional currency

We agree with the definition of functional currency because of its emphasis on the currency of the "economic environment in which the entity operates". We see that this takes over word-for-word the FAS 52 definition. We support convergence to US GAAP in this area.

Question 2 : Financial statements may be presented in currency of choice

We agree with this concept.

Question 3 : Translation into presentation currency uses same method as translation of a foreign operation

We agree with this approach.

Question 4 : Elimination of allowed alternative to capitalize certain exchange differences

Yes – we agree to this elimination.

Question 5 : Goodwill and fair value adjustments should be allocated to the foreign operation

We believe that your proposal to require goodwill and fair value adjustments to be accounted for in the currency of the acquired entity raises several issues, which should be explicitly dealt with in any revised standard. We therefore recommend that the proposed change should be removed from this exposure draft. We recommend that any change is included together with the proposed exposure draft on business combinations, as a consequential amendment to IAS 21 at that time, so that the full implications can be considered. In our view, the issues to be considered include the following:

a) fair value adjustments may be made to assets, for example intangible assets related to intellectual property, which are owned by the acquired entity at the acquisition date, but are subsequently transferred to another entity within the combined group which has a different functional currency from the acquired entity. We believe that the currency in which fair value adjustments are deemed to be denominated should reflect any such subsequent transfers prospectively from the date of transfer, since not to do so would result in accounting inconsistent with the accounting for any other balance sheet item held by the entity to which the fair valued asset has been transferred;
b) if a group of several companies has been acquired and not all of those companies have the same functional currency, your proposal would require that goodwill be allocated on a legal entity basis to each of the functional currencies involved. We believe that any such allocation would be arbitrary, and would not necessarily reflect the substance of the business combination. We believe that goodwill, as a residual, relates to the acquired group of companies as a whole, and should be held at that level as a single amount for foreign currency translation purposes. The currency chosen should be the currency which best reflects the substance of the acquisition transaction; this may be the currency in which acquisition consideration was paid or valued. We also believe that, if goodwill were to be required to be allocated, it would be desirable for the allocation basis to be consistent with the basis of allocation for impairment testing purposes, which in turn should be convergent with US GAAP requirements. A legal entity basis will not necessarily be convergent with the allocation basis in FAS 142;

Other points

Issues with IAS 29 – Reporting in hyperinflationary economies

The following remarks regarding IAS 29 are important, but they are not relevant for all preparers. New IAS 21 places yet more emphasis on the very old and inadequately conceived IAS 29.

IAS 29 may be acceptable for an entity reporting and presenting its financial statements at a leisurely pace in a hyperinflationary country. It does not adequately address key issues important for major multi-nationals reporting very quickly in non-hyperinflationary economies due to the following:

a) It assumes that reliable and appropriate inflation indices are available when the reporting to Group headquarters occurs. Normally such indices are unavailable when the reporting within 1 or 2 days after month end is required.

b) IAS 29 provides almost no guidance on the appropriate income statement translation approach e.g. Where the sales invoice includes an assumption about future inflation until settlement this “implicit interest” is incorrectly included in sales revenue and not shown as a financing item. This results in disclosure of inappropriate sales revenue in the consolidated financial statements.

c) Operationally we expect considerable difficulty in correctly allocating the monetary correction to the appropriate lines in the income statement and to the business segments.

d) In cases of very high-inflation the whole business environment usually thinks and manages its business on a hard-currency basis. If this is the reality for the business world then it makes sense to also use this in the financial reporting. Depending on the specific circumstances of the individual entity, local and HQ management often find local-currency financial information unusable for managing the business and rely on data, which is expressed in a reliable unit of measurement.

The IAS 29 concept is fundamentally different to the FAS 52 concept, which uses discounting by applying forward exchange rates for translation instead of price indices. We consider that forward foreign exchange rates are more reliable than price indices. The IAS 29 approach in fact doubly reduces the reliability of financial data: where indexing of local-currency values is performed, official indices in such countries are notoriously, often wilfully, inaccurate, rendering re-valued data highly dubious; and exchange rates, necessary for the translation of those local-currency values into “real money”, are also frequently massively managed and barely reflect economic reality.

We consider that it is unacceptable that IAS and US GAAP use fundamentally different approaches (even if the SEC does not require restatement for this difference) as it reduces comparability of consolidated financial statements. We suggest that the IASB urgently reviews the fundamental issues involved in accounting for activities in hyperinflationary economies with a view to converging the accounting frameworks in this area.

IAS 24 – Related Party Disclosures

Question 1 : Elimination of requirement to disclose “management compensation”

No we fundamentally disagree. This is information that is important to our shareholders and uniform definitions should be established in IAS, preferably in line with other GAAP’s to avoid that practices across countries become more disparate. .

Question 2 : Reduction in disclosures for parent or wholly-owned subsidiary

We disagree with the Board’s majority view and agree with the minority view. Where there is a statutory or other requirement to produce separate financial statements of the parent or a wholly-owned subsidiary that comply with IAS then disclosures of related party transactions, including those with the rest the Group, should be made.

IAS 27 - Consolidated and Separate Financial Statements

Question 1 : Consolidated Financial Statements

We agree with the conditions for the exemption of consolidation.

Question 2 : Minority Interests

Yes. The inclusion of minority interests as a separate component of equity is justified since minority shareholders also have an equity interest but one that is distinct from that of the Group's shareholders.

Question 3 : Investments in subsidiaries, Jointly Controlled Entities and Associates

We see that there is merit in continuing the three options that are currently available: cost, equity method and fair value.

Other points

Non-consolidation when an investee has severe long-term restrictions on its ability to transfer funds to the investor (§ 12c)

We disagree that severe long-term restrictions on an investee's ability to transfer funds to the investor should be assumed to result in non-consolidation. Such an exemption may lead to legal structures which prohibit funds flow to the sponsoring entity (eg. trusts or foundations) being contemplated which will result in non-consolidation of certain entities even though these entities are clearly controlled by the Group and are performing activities which are for the benefit of the Group.

We consider that where there are severe long-term transfer restrictions this will result in valuation and impairment issues requiring disclosure but that consolidation is still necessary. "The power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities" is sufficient as a criterion here.

12 month limit for non-consolidation

We disagree with the 12-months threshold for allowing to exclude from the consolidation a **subsidiary that is held for re-sale** (paragraph 13). Very often a group of companies has to re-sell subsidiaries after an acquisition because it has been required to do so by anti-trust authorities. If such authorities allow a limit that exceeds 12 months, we consider that such limit should be accepted by the Board. The same remark also applies to the proposed change of IAS 28 paragraph 8.

Disclosures about non-consolidated subsidiaries

We also disagree with paragraph 32 (b) that requires to **disclose summarised financial information of subsidiaries that are not consolidated**. As subsidiaries that are held for re-sale are recognised at their expected net selling price, we consider that such value, which represents the future cash flows out of the subsidiary, is more informative than the selected financial information.

IAS 28 - Accounting for Investments in Associates

Question 1 : Scope exclusions

Yes. We agree that investments held by venture capital organisations, mutual funds, unit trusts and similar entities and that are measured at fair value in accordance with IAS 39 shall not be included in the scope of IAS 28 and of IAS 31.

Question 2 : Losses of associates

No. We do not agree that the amount to be reduced to nil when an associate incurs losses should also include investments such as long-term receivables. Certain assets may be secured by collateral that is not affected by the losses that are incurred and may therefore retain their value.

IAS 33 – Earnings per share

Question 1: Contracts settled either in cash or in shares at the issuer's option

We agree that such contracts should be included as potential shares in the calculation of diluted EPS based on a rebuttable assumption of settlement in shares.

Question 2: Year-to-date calculation of diluted EPS

We have no clear preference for either of the approaches as long as it is possible to explain the logic behind it and the outcome of the calculation to investors..

Other points

We note, without any mention in the "summary of main changes" on page 281, that there are significant increases in disclosure requirements on EPS proposed in para. 58 (continuing operations), 60 (discountinuing operations) and 62 (points (c) and (d)). We doubt whether the addition of such statistics make a significant contribution to users' understanding of the financial statements - especially those in para. 60 and 62 (c) and (d).

IAS 40 - Investment Property

Question 1 : Operating leases

Yes. We agree that operating leases should be included in investment property if the rest of the definition of investment property is met and if the lessee uses the fair value model.

Question 2 : Accounting of operating leases

Yes. We agree that a lessee that classifies a property held under an operating leases as an investment property should account for the lease as if it were a finance lease because such method is the best estimate of the fair value of the lease.

Question 3 : Removal of cost method for investment properties

Yes we agree that the removal of the option to use the cost method for investment properties needs to be kept under review for elimination at a later stage.

We hope that you find our comments of interest and we look forward to being involved in future discussions on the subject. In case you require any further clarification or exchange of thought feel free to contact me.

Yours sincerely,

Peter Sampers
Manager Policies & Directives