Memorandum of comment submitted to the International Accounting Standards Board in September 2002 concerning the Consultation Paper, 'IASB Proposals to amend certain International Accounting Standards', published in May 2002

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales welcomes the opportunity to respond to the International Accounting Standards Board ('the Board') regarding the Consultation Paper, 'IASB Proposals to amend certain International Accounting Standards', published by the Board for comment in May 2002.

2. We have reviewed the Consultation Paper and set out below a number of comments on the proposed improvements. We deal first with significant general matters of concern before commenting in relation to each standard on major points, the specific issues on which comments are invited and then on points of detail.

KEY CONCERNS

Fair Presentation

3. We strongly support recognition in the proposed improved version of IAS 1 of the principle that departure from the requirements of an International Accounting Standard (IAS) might in some circumstances be necessary to achieve a fair presentation. We believe that the existence of a 'true and fair override' provision in the UK has contributed significantly to the quality of accounting. In our experience, the provision is used rarely (except in order to comply with standards, for example SSAP 19, 'Accounting for Investment Properties') and only in wholly exceptional and appropriate circumstances. For example, in 1996 the UK Financial Reporting Review Panel upheld the decision of the directors of Sutton Harbour Holdings plc to depart from the provisions of SSAP 4 when accounting for government grants in view of the particular circumstances of the company.

4. The existence of effective enforcement mechanisms is an important deterrent to abuse of an 'override' provision. Inconsistent enforcement is likely to undermine the credibility of the Board and its standards and diminish the prospects for global convergence. We believe that the Board has a role to play in encouraging the rapid development of comparable enforcement mechanisms around the globe.

5. We reject the notion that the application of IAS should differ according to the requirements of different regulatory frameworks. International standards should be applied consistently in all jurisdictions; disclosure is no substitute, whether or not the relevant regulatory framework prohibits departures from accounting standards. The concession set out in paragraph 15 and in the last fourteen words of paragraph 13 should therefore be deleted. We also recommend inclusion in the revised standard of the principle that inappropriate accounting cannot be rectified by disclosure (as set out in paragraph 12 of the existing standard).

Materiality

6. It is noted in the introductory paragraph to each of the proposed standards that IAS are not intended to apply to immaterial items, and a cross-reference is provided to paragraph 12 of the Board's draft of the 'Preface to International Accounting Standards'. However, this paragraph does not appear in the revised Preface published by the Board in May 2002. We strongly object to this change, which was not anticipated in the exposure draft. It has profound and unwelcome implications for financial reporting and should be reversed - after appropriate consultation - at the earliest opportunity.

Undue Cost & Effort

7. Several of the draft standards contain exemptions from complying with particular requirements on the basis of the 'undue cost and effort' that might be involved. In our view, use of the phrase 'undue cost and effort' is likely to lead to conflicting interpretations. It also appears to be a less demanding test than 'impracticality', which it replaces. We suggest that each standard in which this concession appears should refer to guidance on its use. We note that such guidance is provided in the Basis of Conclusions to ED 1, 'First-Time Application of International Financial Reporting Standards'.

8. We believe that regular use of these exemptions might undermine the comparability of financial statements and the credibility of IAS. We therefore recommend that the exemptions are either deleted or restricted, as we explain below, case by case. In addition, reporting entities making use of any of the remaining exemptions should disclose why this was appropriate and the effect on the financial statements.

Related Parties

9. As discussed in paragraphs 80 and 81 below, we recommend that IAS 24 should require disclosure of the names of transacting related parties and of the identity of any controlling party and ultimate controlling party.

IAS 1, PRESENTATION OF FINANCIAL STATEMENTS

Responses to Specific Questions

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)?

10. Yes and no. Please see our detailed comments above in paragraphs 3 - 5.

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)?

11. We support the prohibition of extraordinary items, but have concerns regarding the effectiveness of proposed paragraphs 78 and 79 of the exposure draft. It is not useful to prohibit one term without expressly prohibiting all other terms that might convey a similar meaning (for example, 'exceptional' or 'unusual'). As this is not practicable, the proposed prohibition of extraordinary items may not be effective. Paragraph 80 states that all items of an unusual nature, size or incidence should be disclosed separately. We believe that all such items should be included under the appropriate profit and loss account heading. The items should therefore be disclosed separately by way of note, or on the face of the profit and loss account under the appropriate heading if that degree of prominence is necessary to provide a fair presentation.

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)?

12. Yes, we agree, subject to our comments in paragraph 13 below. We recognise that classifying a liability as current or non-current according to the latest information on the probability that it will be paid within twelve months may provide highly relevant information about the entity's financial position. However, we consider that a requirement for presentation to reflect conditions prevailing at the balance sheet date is conceptually superior.

13. Paragraph 57(b) requires a liability to be classified as current if it "is due to be settled within twelve months of the balance sheet date". It should be made clear that this refers to a legal requirement for settlement within twelve months, rather than a less binding agreement or intention. If this is, as we expect, the correct interpretation, the Board should note that application of paragraphs 54 and 57 is likely to produce inconsistent treatment of, for example, intra-group debt in the financial statements of group companies. The classification of liabilities is based on 'due' but the classification of assets is based on 'expected'. We strongly recommend that the Board considers this issue prior to finalisation of the proposed standard.

14. We note that IAS 35 requires disclosure (including optional presentation) of discontinuing operations even where the initial disclosure event is after the balance sheet date. This inconsistency with the proposed presentation of long-term liabilities is unsatisfactory and should be addressed by the Board.

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 payment, 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)?

15. We accept the logic of adopting this approach, subject to our comments in paragraph 13.

Question 5

Do you agree that an entity should disclose the judgements made by management in applying the accounting policies that have the most significant effect on the amounts of items recognised in the financial statements (see proposed paragraphs 108 and 109)?

16. No. In principle, disclosures of this nature should assist users seeking to understand the basis on which financial statements have been prepared. However, we consider that the requirements of paragraph 108 are very unclear and open to differing interpretation regarding the nature and extent of the disclosure required in relation to management ‘judgements’. The example in paragraph 109 regarding financial assets is unhelpful: the decision on whether financial assets are held-to-maturity investments depends on the application of clear rules, not primarily management judgement. The clarity of these requirements should be improved and more meaningful examples provided. We would otherwise prefer these paragraphs to be deleted to avoid uncertainty and inconsistent interpretation.

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)?*

17. In principle, we support greater disclosure of significant risks and uncertainties, including key assumptions about the future. However, implementation of the wide-ranging requirements of paragraphs 110-115 will inevitably involve a high degree of management judgement. We suggest that this is made explicit in the proposed standard by, for example, inserting the words 'in the view of management' before ' have a significant risk of causing a material adjustment'.

18. In our view, it is important that the new requirements result in the disclosure of information that is useful and not excessively detailed. We suggest that the Board consider whether changes to the wording of paragraphs 110-115 might improve the likelihood of this outcome.

Other Points

19. **Other financial reporting** - it is noted in paragraph 9 of the proposed standard that management reviews presented outside the financial statements and additional statements such as environmental reports and value added statements are outside the scope of IAS. We believe that the Board should, in due course, take responsibility for the improvement of all aspects of financial reporting, and welcome the Board's decision to consider development of guidance on the MD&A. We suggest that at an early stage the Board should review the adequacy of its current remit.

20. **Consistency of presentation** - we believe that paragraph 22(a) should not refer to the change demonstrating to management, but to management being able to demonstrate to others. Paragraph 22(a) should therefore be redrafted as follows:

'(a) The entity can demonstrate that, because of a significant change in the nature of the operations…., a change in presentation….'

21. **Disclosure of accounting policies** - this section (paragraphs 103-109) of the proposed standard should emphasise the importance of disclosing clearly in the financial statements:

- the general approach adopted to the selection of accounting policies
- choices made by management when selecting the accounting policies
- most appropriate to the particular circumstances of the reporting entity, and
- the rationale for those choices.

This guidance might be inserted before the existing text in paragraph 105 and might be more useful in practice than the requirements of proposed paragraph 108.

22. **The accruals basis** - the need for caution regarding use of the accruals basis of accounting, highlighted in paragraph 95 of the Framework, should be reflected

in the guidance on accruals accounting in proposed IAS 1. We suggest that the words ‘and only when’ are inserted after ‘when’ in paragraph 21 of the proposed standard.

23. **Annual accounts** - the first sentence of paragraph 47 is misleading, as annual financial statements can be presented for a period longer than one year. We suggest deletion of this sentence and insertion of the word ‘annual’ after the first word of paragraph 48.

24. **Marketable securities** - paragraph 56 explains that a marketable security should be classified as current or non-current by reference to paragraph 54(c), i.e. whether it is expected to be realised within twelve months of the balance sheet date. We consider paragraph 54(b) to be more relevant in this context, i.e. whether the security is held primarily for trading purposes. We suggest that the Board amends paragraph 56 accordingly.

25. **Fixed assets presentation** - paragraph 69 indicates that classes of property, plant and equipment carried at cost or revalued amounts should be presented as separate line items on the face of the balance sheet. The level of detail that this might involve could lead to a lack of clarity. We suggest that guidance on striking the right balance between disclosure and clarity is added to paragraph 68.

26. **Minority interests** - paragraph 76 requires ‘minority interest’ to be shown as a line item on the face of the profit and loss account. The presentation suggested appears to be inconsistent with the change to the accounting treatment of minority interests proposed in draft IAS 27. The Board should ensure that any inconsistencies are eliminated before the improved standards are published.

27. **Drafting** - the cumulative effect of changes in accounting policy and of the correction of errors should be disclosed separately, since they are qualitatively so different. We suggest that the word ‘of ‘ is inserted after ‘and’ in paragraph 91(c) to make this clear.

IAS 2, INVENTORIES

Responses to Specific Questions

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?

28. Yes.

Question 2

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?

29. Yes, we agree with both requirements. We note and agree with the related requirement in paragraph 34 (d) to disclose such reversals.

IAS 8, NET PROFIT OR LOSS FOR THE PERIOD, FUNDAMENTAL ERRORS AND CHANGES IN ACCOUNTING POLICIES

Responses to Specific Questions

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)?

30. Yes, we agree that voluntary changes of accounting policy and errors should be accounted for retrospectively.

Question 2

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

31. Yes. Although we believe that the distinction between fundamental and other material errors has conceptual merit, we support its abolition. The boundary between fundamental and other material errors is not sufficiently clear to avoid uncertainty and inconsistent interpretation.

32. We have referred above to the importance of clarifying the application of IAS to immaterial items. The absence of any reference to materiality in draft IAS 8 would necessitate the restatement of comparative amounts for all errors, however trivial. In our view, paragraph 32 should apply to *material* errors, and guidance on this issue should be added to the draft standard.

Other Points

33. **Fraud** - the effects of fraud are included within the definition of errors in paragraph 3 of the proposed standard. This seems incompatible with the statement in paragraph 3(a) that errors relate to reliable information that was available when the relevant prior period financial statements were prepared. The nature of fraud means that information is unlikely to be reliable or to have been

available at the time of preparation. We suggest that the particular features of fraud-related errors are referred to in paragraph 3.

34. **Selection of accounting policies** - we note that a standard on accounting for insurance contracts is unlikely to be available by 2005. Insurers are likely to have particular difficulty in implementing the guidance on selection of accounting policies in paragraphs 4-6 of draft IAS 8. It would be unfortunate if paragraph 6(c) was interpreted as giving authority to US GAAP; it seems unlikely that the eventual form of the IFRS for insurance contracts will follow US GAAP principles. We suggest that the Board considers the need for transitional arrangements or guidance in IAS 8 for entities that issue insurance contracts.

35. We also recommend insertion of a new paragraph after paragraph 6 of the draft standard cross-referring to the accounting policy disclosure requirements contained in IAS 1.

36. **Changes in accounting policies** - we believe that paragraph 9 should state clearly that management should be able to demonstrate that a change in accounting policy was appropriate. Paragraph 9(b) should therefore be redrafted as follows:

‘(a) *The entity can demonstrate that the change* results in a more relevant …’

37. We do not support the exemption in paragraph 21 from restating comparative information relating to voluntary changes in accounting policies on the grounds of ‘undue cost or effort’. As discussed above, we consider this phrase to be too open to interpretation.

38. We also suggest that a clear statement that voluntary changes in accounting policy are expected to be infrequent should be included in paragraph 19.

39. **Changes in accounting estimates** - disclosure of the ‘nature and amount’ of a change in accounting estimates that has an effect in the current period or is expected to have an effect in subsequent periods is required by paragraph 29. In our view, this requirement is unclear and might prove onerous if interpreted to mean that disclosures are required in respect of each subsequent accounting period. For example, in the case of changes to provisions for bad and doubtful debts, significant changes in estimates can occur from one year to the next for good economic reasons. We suggest that the Board amends paragraph 29 to clarify the level of disclosure anticipated. We consider that the ‘undue cost and effort’ exemption provided in paragraph 30 would then be unnecessary.

40. We would also point out that disclosure of the anticipated effect of voluntary changes in accounting policies in subsequent periods should be required in paragraph 23. We assume that omission of this requirement was unintentional. It should be clear in paragraph 23 that separate disclosures are not required in respect of each subsequent accounting period.

41. **Correction of errors** - clear guidance should be provided in the standard on the adjustments required where:

- an error relates in part to the immediately preceding period and in part to earlier periods and
- allocation between the periods is not possible, perhaps due to fraud.

42. At present, it is unclear in paragraphs 33 and 34 of the proposed standard whether the adjustment would be made to the opening balance of the current period or to the comparative opening balance. In our view, clearer guidance on this issue would obviate the need for an exemption from restating comparative information on the grounds on 'undue cost or effort', as provided in paragraph 33.

IAS 10, EVENTS AFTER THE BALANCE SHEET DATE

Other Points

43. **Examples** - paragraph 8(b) illustrates circumstances in which the receipt of additional information regarding an impairment should be treated as an adjusting event. It would be helpful to illustrate in paragraph 10 the circumstances in which the receipt of such information should be treated as a *non*-adjusting event.

44. Some rationalisation of paragraphs 10 and 21 would be useful, since both provide examples of non-adjusting events. We also suggest that 'window dressing' is included in paragraph 21 as an example of a non-adjusting event that would generally result in disclosure. The corresponding UK standard (SSAP 17) provides guidance on this issue in paragraph 10.

45. **Dividends: disclosure** - paragraph 12 of the proposed standard appears to prohibit disclosure of dividends declared after the balance sheet date on the face of the profit and loss account. We do not support this change. In some circumstances, disclosure on the face of the profit and loss account of additional information is helpful to users seeking to evaluate the performance of the reporting entity, in particular as it relates to income they are to receive. This practice should not be discouraged.

46. **Going concern** - we believe that the guidance in paragraphs 13, 14 and 15 of the proposed standard could be more succinct. In particular, the guidance in paragraph 13 could be replaced by the text preceding paragraph 1 of the exposure draft, and paragraph 15 could be omitted.

IAS 16, PROPERTY, PLANT AND EQUIPMENT

Revaluation of Assets

47. We strongly support the retention in IAS 16 of the option for companies to revalue assets or maintain them at depreciated historical cost. We support the efforts of the UK Accounting Standards Board to ensure that the merits of the 'value to the business' model as a basis for valuing properties are understood and debated at international level.

Residual Values

48. The draft IAS requires use of current prices at each balance sheet date when residual values used in the calculation of depreciable amounts are reviewed. This approach can be viewed as inconsistent with historical cost principles and would involve a significant change to current practice in the UK. One result of the new approach would be the netting of holding gains and depreciation, which is unhelpful to users of the financial statements and conceptually unsatisfactory. It might also lead to non-depreciation on the grounds that any depreciation would be immaterial. We do not support this change. In our view, the Board has not provided a convincing rationale for this change to the existing IAS 16 requirement and should explain more fully the thinking that underlies it.

Responses to Specific Questions

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)?

49. Yes, we agree with this new approach. However, the Board should consider the need for anti-abuse measures: companies might effectively be able to undertake selective revaluations of their assets by arranging mutually-beneficial asset swaps with third parties.

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?

50. Yes, we agree, subject to our response to Question 1 above.

Question 3

Do you agree that depreciation of an item of property, plant and equipment should not cease when it becomes temporarily idle or is retired from active use and held for disposal (see paragraph 59 of the [draft] FRS on property, plant and equipment)?

51. No, we do not agree. Paragraph A11 of the draft IAS explains that the Board concluded that it is inappropriate to cease depreciation as 'the financial

statements would omit the consumption of the asset's service potential that occurs while the asset continues to be held'. We do not find this to be a convincing case for change. It seems more logical to retain the carrying value of the retired or idle asset, subject to impairment tests.

Other Points

52. **Donated Assets** - paragraphs 17 and 18 of the UK standard FRS 15 contain useful guidance on the valuation of tangible fixed assets received by charities as gifts and donations. Although the Board's new Preface recognises that some not-for-profit and public sector entities are likely to use international standards, we accept that the revised IAS should not provide specific guidance for charities. However, the valuation of donated assets has a significant impact on the financial statements of some recipients, and not only in the voluntary sector. The Board should address this issue before finalising the revised text of IAS 16.

53. **Immateriality** - we assume that non-depreciation of assets on the grounds of immateriality will be permitted under IAS 16, although this is not entirely clear in the exposure draft. This should be made clear in the eventual standard.

54. **Consistency with IAS 36** - we note that the approach proposed to revaluations in draft IAS 16 is not consistent with IAS 36, which requires use of the 'value to the business' model in certain circumstances. The Board should consider whether IAS 36 should be amended prior to implementation of revised IAS 16.

55. **Guidance on revaluations** - we consider that the guidance in the proposed IAS on the basis of valuations is inadequate and likely to result in a lack of comparability in valuation practice. This issue should be addressed as part of the Board's convergence project on revaluations announced on 27 June 2002, which we encourage the Board to complete as soon as possible. We suggest that paragraph 32 of the draft standard be amended to encourage periodic use of external valuers. The revised paragraph might refer to revaluation 'every three or five years *by a professionally qualified external valuer*'.

56. **Exchange differences** - we would welcome clarification from the Board on the circumstances in which exchange differences should be regarded as 'an adjustment to interest costs' (paragraph 5(e) of IAS 23). Clear parameters are essential if inconsistent practice is to be avoided.

IAS 17, LEASES

Major Points

The Need for a New Standard

57. We acknowledge the limited scope of the Improvements project and that the Board intends to reconsider in due course the fundamental approach to the accounting for leases established by IAS 17 as a separate project. Nevertheless,

we take this opportunity to emphasise the importance of an early review by the Board of the accounting treatment of leases. IAS 17 is in need of comprehensive improvement before 2005 in the interests of comparability and transparency. The proposed improvements in the exposure draft are, at best, relatively minor improvements to a highly unsatisfactory standard.

<u>Responses to Specific Questions</u>

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.

58. We do not support the proposed treatment of leases of both land and buildings in paragraph 11 *et seq*. We do not accept the assumption that, unless title is expected to pass to the lessee by the end of the lease term, the lease of the land element should be treated as an operating lease, irrespective of the underlying economics. The appropriate accounting treatment of a lease of both land and buildings should be determined in the usual way by applying the conditions in paragraphs 3-10 of IAS 17. We recommend deletion of proposed paragraphs 11A, 11B and 11C and of the second sentence in paragraph 11.

59. We note that the proposed approach converges with requirements in Australia, Canada and the United States. In view of the need to implement substantial changes to lease accounting at an early date, we do not consider that this small and possibly short-lived move towards convergence justifies adoption of a questionable improvement to IAS 17.

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

60. We agree that the choice on how to account for initial direct costs incurred by lessors in negotiating a lease should be eliminated from IAS 17. On balance, we agree that capitalisation and allocation over the lease term is preferable to charging such costs as an expense when incurred. Capitalisation should be restricted to costs that are both incremental and directly attributable to negotiating and arranging a lease, including appropriate internal costs.

<u>IAS 21, THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES</u>

<u>Responses to Specific Questions</u>

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?

61. Yes.

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?

62. Yes.

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)?

63. Yes, this is the simplest approach.

Question 4

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

64. Yes.

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)?

(a) goodwill

65. This treatment will represent a change for those UK companies that treat goodwill as an asset of the parent. We foresee practical difficulties in, for example, dividing goodwill into different currencies and, when the standard is first implemented, in obtaining the information in respect of the prior year. We would look for transitional provisions to deal with the prior year problem if retranslation of goodwill became mandatory. We would also like to see guidance to the effect that the allocation of goodwill to currencies need be done only at a high level (i.e. looking only at the principal functional currency or currencies of the acquired business).

(b) fair value adjustments to assets and liabilities

66. Yes.

Other Points

67. **Recycling** - the proposed revised IAS 21 requires certain exchange differences arising on an entity's net investment in a foreign operation to be recognised in a separate component of equity. On disposal, these exchange differences are recycled to the profit and loss account. We are very much opposed to this treatment. If it is not possible to prohibit this practice as part of the current improvements project, we look to the project on reporting financial performance to do so.

68. **Recognition of exchange differences** - in paragraph 31, third line, we suggest that 'an exchange difference arises' should read 'an exchange difference may arise'.

69. **Change in functional currency** - we understand that the intended effect of paragraph 35 is that comparative figures should be restated based on the exchange rate at the date of change of the functional currency. It would be helpful if this could be made explicit in the standard to avoid any differences of interpretation.

70. **Different reporting dates** - paragraph 44 states that where the assets and liabilities of a foreign operation are consolidated using a balance sheet made up to a different reporting date from that of the group, they should be translated at the exchange rate at the balance sheet date of the foreign operation. However, it goes on to say that 'adjustments are made for significant movements in exchange rates up to the balance sheet date of the reporting entity'. It would be better to replace this with a simple requirement to use the exchange rates at the balance sheet date of the reporting entity because these will always be known by the time that the financial statements of the reporting entity are prepared.

IAS 24, RELATED PARTY DISCLOSURES

Major Points

Exemptions for Subsidiaries

71. Paragraph 3 of the proposed revised standard provides important exemptions relating to the separate financial statements of wholly owned subsidiaries and parents (previously dealt with separately in paragraphs 4 (b) and 4 (c) of IAS 24). We have a number of concerns regarding the exemption for subsidiaries, as detailed below.

72. Paragraph 3, as drafted, appears to provide exemption from disclosure of all related party transactions, not only transactions with other members of the group. This does not appear to be consistent with paragraph 4. We consider that the exemption should only relate to transactions with group members and suggest that paragraph 3 should be redrafted on this basis.

73. If the Board's intention is to provide an exemption applicable to all related party transactions, this will result in a significant and unwelcome change to the existing UK exemption. In our view, it would highlight the importance of providing additional guidance on materiality in the revised standard (discussed below in paragraph 82). Transactions with related parties outside the group that are immaterial to the group as a whole but material to the subsidiary in question would not be disclosed in the financial statements of either the group or the subsidiary. This point is highlighted in paragraph B6 of Appendix B to the exposure draft of proposed improvements to IAS 24.

74. We also consider that the emphasis in paragraph 3 on the availability of the financial statements of the wholly owned subsidiary (rather than just those of the group) is inappropriate. We suggest that the UK requirement in paragraph 3 (c) of FRS 8 *Related party disclosures*, for the consolidated financial statements in which the subsidiary is included to be publicly available, seems more logical. This is particularly the case if the exemption in paragraph 3 does extend to all related party transactions, in which case the subsidiary accounts would not contain any related party information.

75. We believe that the requirement in paragraph 3 for the relevant financial statements to be 'made available or published with the consolidated financial statements' might be interpreted in various ways in different jurisdictions. The requirement might also prove onerous if it continues to be conditional on the availability of the financial statements of subsidiaries (rather than just the group accounts). The clarity of this requirement should be reconsidered.

76. Finally, we recommend that the standard should require, where applicable, disclosure of the fact that advantage has been taken of the exemptions for parents and wholly-owned subsidiaries.

Management Compensation

77. We have a number of concerns regarding proposed exemption in IAS 24 regarding management compensation and similar items. These are set out below.

78. Information regarding the compensation of key management is of legitimate interest to investors and other users of financial statements. We therefore consider that the proposed exemption should only be available where, in a particular jurisdiction, the reporting of management compensation outside of the annual financial statements is a mandatory requirement, as is proposed in the UK. If this is not the case, it is reasonable to require disclosure of aggregated information regarding the compensation of key management personnel in accordance with paragraphs 15 and 18 of draft IAS 24.

79. We also consider that:

- the restriction of the exemption to management compensation 'paid in the ordinary course of an entity's operations' is open to abuse. The words 'paid in the ordinary course of business' should be deleted;

- paragraph 2 should refer, for clarity, to 'the compensation of key management personnel' rather than to 'management compensation';

- the draft standard should require disclosure of employee benefits of key management personnel, as defined in paragraph 8(d) of IAS 19. We believe that this provides a solution to the issue raised by the Board regarding definitions.

<u>Names of Transacting Related Parties</u>

80. We recommend that the standard should include a requirement to disclose the names of transacting related parties. This information can, in some circumstances, improve the transparency of financial statements. The continued absence of a requirement to disclose names would enhance the importance of the requirement in paragraph 14 of the draft IAS to disclose the 'nature of the related party relationship'. However, as presently drafted, paragraph 14 could be misunderstood. It is possible that only the 'minimum disclosures' listed at the end of the paragraph will be disclosed. The paragraph should be redrafted to clarify this point, as follows:

"*If there have been transactions between related parties, an entity shall disclose the nature of the related party relationship. The entity shall also disclose information…. At a minimum, disclosures shall include…"*

<u>Names of Controlling Parties</u>

81. We believe that the standard should require disclosure of the identity of the controlling party and, if different, the ultimate controlling party. UK Financial Reporting Standard 8 requires such disclosure, irrespective of whether transactions have actually taken place. This information can, in some circumstances, be helpful to users of financial statements seeking to appraise the prospects and financial position of a reporting entity.

Materiality

82. We believe that the standard should specify that disclosure is required of material related party transactions and give more guidance on materiality in the context of such transactions. Such guidance is required because of the importance of qualitative aspects of such transactions. The guidance should refer to materiality from the perspective of the related party: the discussion in paragraph 20 of UK FRS 8 *Related party transactions* is a suitable model. The inclusion of guidance is especially important in view of the current uncertainty arising from the exclusion of references to materiality from the Board's revised 'Preface'.

Responses to Specific Questions

Question 1

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

83. Information regarding the compensation of key management is of legitimate interest to investors and other users of financial statements. We therefore consider that the proposed exemption should only be available where, in a particular jurisdiction, the reporting of management compensation outside of the annual financial statements is a mandatory requirement, as is proposed in the UK. If this is not the case, it is reasonable to require disclosure of aggregated information regarding the compensation of key management personnel in accordance with paragraphs 15 and 18 of draft IAS 24.

84. We also consider that:

- the restriction of the exemption to management compensation 'paid in the ordinary course of an entity's operations' is open to abuse. The words 'paid in the ordinary course of business' should be deleted;

- paragraph 2 should refer, for clarity, to 'the compensation of key management personnel' rather than to 'management compensation';

- the draft standard should require disclosure of employee benefits' of key management personnel, as defined in paragraph 8(d) of IAS 19. We believe that this provides a solution to the issue raised by the Board regarding definitions.

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)?

85. No. As set out in paragraphs 71 - 76 above, we have major concerns with the proposed exemptions.

<u>OTHER POINTS</u>

86. **Definitions** - we recommend the following improvements to the definitions set out in paragraph 9 of the revised standard:

- *Related party* (sub-paragraph (a)(ii)) - the reference to 'an interest in the entity' might be misleading and should be deleted. The new wording would therefore be: '(ii) has significant influence over the entity'

- *Close members of the family of an individual* (paragraph (g)) - we are not convinced that the provision of examples is helpful in this instance. Examples might discourage rigorous application of the underlying disclosure principles. If examples are provided in the standard, they should be of a symmetrical nature, referring to both ancestors and descendants.

<u>IAS 27, CONSOLIDATED FINANCIAL STATEMENTS AND ACCOUNTING IN SUBSIDIARIES</u>

<u>Responses to Specific Questions</u>

Question 1

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

87. We welcome the decision of the Board to retain in IAS 27 an exemption for certain subsidiaries from the requirement to prepare consolidated financial statements. Withdrawal of the exemption would impose unnecessary burdens on many companies.

88. We broadly support the modifications proposed to paragraphs 8 to 10 of the existing IAS. Overall, the revised text provides a clearer and more coherent basis for the exemption. However, in our view, the Board should amend sub-paragraph 8(d), which requires publication of consolidated financial statements that comply with IAS by the 'immediate or ultimate parent' of the reporting entity. The exemption should also be available if the reporting entity is included in the published consolidated financial statements of any *intermediate* parent.

89. Paragraph 8(c) prohibits use of the exemption where a parent is ‘in the process of issuing securities in public securities markets’. Clarification of this phrase – including the precise point in time in the process subsequent to which use of the exemption is prohibited - might be necessary to avoid inconsistent interpretation.

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)?

90. We support the proposed requirement for separate presentation of minority interests within equity in the consolidated balance sheet. If the balance sheet classification of minority interests is changed, the Board should also address the income statement classification.

91. We will be giving further consideration to this question in our response to the proposed changes to IAS 32.

Question 3 (a)

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)?

92. We agree that there is insufficient justification for retention of the option to use the equity method in a parent’s separate financial statements.

93. We are uncertain whether the carrying value of an investment in a foreign subsidiary carried at cost may nevertheless be adjusted if it is being hedged in the entity’s own financial statements where the hedge would have to be a fair value hedge, in contrast to the group financial statements where the hedge is a cash flow hedge. We would welcome clarification on this point from the Board.

Question 3 (b)

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)?

94. We accept the logic of adopting the same accounting treatment in the consolidated financial statements and the parent’s separate financial statements for subsidiaries subject only to ‘temporary control’ on the basis that such

subsidiaries are necessarily 'available-for-sale' financial assets, as defined in IAS 39. However, it would be helpful to clarify the circumstances in which these requirements are likely to apply.

Other Points

95. **Coterminous financial statements** - paragraph 19 of the proposed standard sets out conditions for the use of non-coterminous financial statements for subsidiaries. Paragraph 20 provides additional guidance. In our view, the third sentence in paragraph 20 is unhelpful and should be deleted. It repeats some of the requirements of paragraph 19 and notes that management may decide not to produce supplementary financial statements for a subsidiary for consolidation purposes on the grounds of 'undue cost and effort', a phrase that we consider is too open to interpretation, as discussed above. It may also be advisable to state expressly in the standard that 'undue cost and effort' is never justification for excluding from consolidation subsidiaries that are collectively or individually material in the context of the group.

96. **The cost method** - we suggest that descriptions of the cost method in paragraphs 6 and 29B of the draft standard should make it clear that the basis is cost less any impairment.

97. **Other financial statements** - new paragraph 9 states that financial statements prepared by exempt parents under paragraph 8 'are the only financial statements prepared for the entity'. This statement appears to prohibit the preparation of, for example, management accounts and any form of pro forma accounts. We suggest that this paragraph is superfluous and should be deleted.

98. **Paragraph 8 –** we suggest that the word 'entity' is used in place of 'parent'.

99. **Paragraph 29A** - we suggest that the words 'purport to' are superfluous and unhelpful. They should be deleted.

100. **Paragraph 30** - we consider that the requirements set out in paragraph 30 are unclear. In particular, it should be stated more clearly that in the parent's individual financial statements all investments in non-consolidated subsidiaries should be accounted for in accordance with IAS 39.

101. **Paragraph 33(a)** - the requirement for disclosure of 'the reasons why separate financial statements are prepared' in the investor's separate financial statements seems illogical. The requirements of this paragraph should be re-considered by the Board.

IAS 28, ACCOUNTING FOR INVESTMENTS IN ASSOCIATES

Major Points

The Need for Further Improvement

102. The exposure draft addresses only a small number of the potential improvements required to IAS 28. For example, paragraph 3 defines significant influence in terms of the 'power to participate' in key decisions of the investee, whereas the G4+1 group of standard setters emphasises the actual exercise of influence. We encourage the Board to undertake a more comprehensive review of the standard at an early stage.

Losses of Associates

103. We consider that equity accounting should be suspended only when the investee ceases to meet the definition of an associate. The requirement in draft IAS 28 for an investor to discontinue recognising its share of an associate's losses once its share of those losses exceeds its interest in the associate seems inconsistent with the treatment of loss-making subsidiaries. Further, there is a risk of misuse of the requirement, perhaps as part of a scheme designed to avoid recognition of losses. We recommend that the Board deletes this requirement from the draft standard.

Exemptions

104. We consider that an exemption from equity accounting should be provided in paragraph 8 of the proposed standard. The exemption should be comparable with the exemption from presenting consolidated financial statements provided in draft IAS 27 (paragraph 8), except that it should also be available when the reporting entity is included in the published consolidated financial statements of an *intermediate* parent. The requirements for accounting by venturers set out in paragraph 25 of draft IAS 31, 'Financial Reporting of Interests in Joint Ventures', should be modified on a similar basis.

105. At present paragraphs 24A and 24B of IAS 28 seem to be inconsistent with the requirements of paragraph 8. Paragraph 8 should make reference to the different requirements applicable to separate financial statements set out in paragraphs 24A and 24B.

Responses to Specific Questions

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)?

106. We agree that fair value measurement tends to produce more relevant information in these circumstances and that the proposed exemption is appropriate.

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)?

107. Please see paragraph 103 above. If the current approach to accounting for loss-making associates is retained, we would support inclusion of non-equity investments in the amount to be reduced to nil.

OTHER POINTS

108. **Disclosures** - the disclosure requirements set out in paragraph 27 are extensive. It might be appropriate for certain disclosures, for example those set out in paragraph 27(b), to apply only to associates that represent a significant part of the reporting entity's business.

109. **Listed associates** - we suggest that guidance is added to paragraph 18A on the use of information relating to *listed* associates. Information available to the reporting entity may not have been released to the market by the date of publication of the reporting entity's financial statements.

IAS 33, EARNINGS PER SHARE

Disclosure of additional measures of earnings per share

110. We strongly disagree with the requirement in paragraph 65 of the proposed revised IAS 33 that, where a company discloses additional measures of earnings per share, they should be presented in the notes to the financial statements. This carries the implication that presentation on the face of the profit and loss account is prohibited. This would be a very significant change of practice for many UK companies and we see no reason for such a restrictive requirement. In some circumstances, disclosure of additional measures of earnings per share on the face of the profit and loss account is helpful to users in seeking to evaluate the performance of the reporting entity.

111. We note that this requirement is a change to the existing IAS 33 although this fact is not highlighted either in the questions for comment or the summary of main changes proposed by the Board. No justification is provided for the change. We therefore urge the Board to reverse this proposed change to IAS 33.

Responses to Specific Questions

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?

112. Yes, we welcome this proposed change to IAS 33.

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)?*

113. We are not convinced that the approach to the year-to-date calculation of diluted EPS used in the illustrative examples in Appendix B produces useful information, particularly for seasonal businesses. Further, it might involve additional work for preparers of financial statements as well as practical and transitional issues for companies that do not report quarterly or did not report quarterly throughout the period.

114. We suggest that the Board should reconsider the merits of this approach. As a minimum, it should be very clear in the standard that use of the approach illustrated in examples 7 and 12 is not mandatory.

<u>Other Points</u>

115. **Other Disclosures** - net profit or loss for the period is determined after deduction of taxation. We understand that users would welcome disclosure of the taxation charge or credit attributed to each of the separate components of the income statement, including exceptional items. We suggest that the Board should reconsider this issue.

116. **Contracts that May be Settled by Buying Existing Future Shares** - paragraph 51 of the proposed standard contains guidance on contracts that may be settled in ordinary shares or in cash. Differing views exist as to whether contracts should be included in the calculation of diluted EPS when they are expected to be settled by buying, at a future date, existing shares. We suggest that the Board should add a paragraph to the standard clarifying how contracts should be dealt with that may be settled by either issuing new shares or using shares already held in an ESOP trust or buying, in the future, existing shares.

117. **Calculation of Diluted EPS** - profit or loss from continuing operations is not always representative of underlying profitability. For example, a net loss might be reported for a period as a result of an exceptional item. In these circumstances, the prescribed method of calculating diluted EPS may not produce meaningful information, as securities that would have diluted basic EPS might instead have an anti-dilutive effect.

118. Although paragraph 62(c) of the revised standard requires disclosure of securities that could potentially dilute basic EPS, we suggest that the Board should reconsider this issue.

119. **In-substance Share Buybacks** - Where the overall effect of a combination of a special dividend and a share consolidation is a share repurchase at fair value, paragraph 25 of revised IAS 33 would require the transactions to be reflected in the EPS calculation as if a share repurchase at fair value had occurred, rather than in accordance with their legal form.

120. We support the rationale underlying this requirement, but would prefer paragraph 25 to be re-drafted as a clear principle, rather than as a rule. The introduction of the principle that transactions should be reflected in the EPS calculation as a share repurchase at fair value where the overall effect is a share repurchase at fair value would allow other combinations to be reflected in the EPS calculation as a repurchase at fair value. This treatment might, for example, be appropriate when a bonus issue of B shares (which are then redeemed) is combined with a share consolidation of the original shares.

IAS 40, INVESTMENT PROPERTY

Responses to Specific Questions

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:

- *the rest of the definition of investment property is met; and*

- *the lessee uses the fair value model set out in IAS 40, paragraphs 27-49?*

121. We agree with the proposed change. Entities that use the fair value model in IAS 40 should be permitted to use that model for property interests held under an operating lease provided the rest of the definition of investment property is met.

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?

122. We agree with this requirement.

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?

123. Whilst we note that in recent standards, the Board has moved towards a fair value model, we agree that it would not be appropriate at this stage to eliminate the option in IAS 40 of using either the fair value model or a cost model. In due course the Board should address this issue and the convergence implications in close consultation with the liaison standard setters.

Nsj/23 September 2002