ERNST & YOUNG

5/F Hutchison House
0 Harcourt Road
Central, Hong Kong
Phone: (852) 2846 9888
Fax: (852) 2868 4432
www.ey.com/china

安永會計師事務所
香港中環夏愨道10號
和記大廈15樓
電話：(852) 2846 9888
傳真：(852) 2868 4432

NR/L054/02

30 August 2002

Deputy Director, Accounting
Hong Kong Society of Accountants
4/F Tower Two, Lippo Centre
89 Queensway
Hong Kong

Dear Sir,

**Re: Exposure Draft: Proposed Improvements to International Accounting Standards**

We are pleased to provide our comments on the Exposure Draft arising from the International Accounting Standards Board (the "Board") improvements project for your consideration. In this regard we enclose a copy of our global firm's recent response to the Board which sets out (a) general comments on the project as a whole, together with (b) specific comments on the individual standards with which we would agree except as set out below. In addition to the foregoing, we also believe that there are additional aspects the Exposure Drafts ("EDs") should address and that the Hong Kong Society of Accountants ("HKSA") should also comment on. These too are set out below together with our comments on the specific questions raised by the HKSA in its invitation to comment:

**IAS 27 Consolidated and Separate Financial Statements**

Paragraph 13
We note the proposed requirements concerning the exclusion of subsidiaries acquired where control thereof is intended to be temporary. We believe the scope of this paragraph is too restrictive when contrasted with the current requirements and guidance in Hong Kong SSAP ("HK SSAP") 32 paragraphs 23 to 25. Moreover the ED fails to allow for the real life situations that the HK SSAP contemplates. The HK SSAP provisions were carefully thought out and promulgated by the HKSA. We are not aware of any abuse thereof in practice. Accordingly, since the project is supposed to be an improvements project, we believe that the ED should be revised to incorporate the HKSSAP provisions on this aspect.

**IAS 28 Accounting for Investments in Associates**

Paragraph 8
Our comments above concerning the concept of excluding subsidiaries acquired where control thereof is intended to be temporary, apply equally to the proposed treatment of associates, but with reference to HK SSAP 10 paragraph 9. Accordingly we make the same recommendation in respect thereof mutatis mutandis.

Additional disclosures
We refer to HK SSAP 10 paragraph 37 and the disclosure requirements thereof, which are neither in the current equivalent IAS, nor the ED. We do not believe that Hong Kong is a unique reporting environment in which such disclosures about associates (and joint ventures HK SSAP 21) are necessary to present a true and fair view. The HK SSAP 10 paragraph 37disclosures are, for all the reasons concluded by the HKSA in including such as a

requirement, often essential for the purpose of giving such a view. Accordingly, we believe that the HKSA should recommend that the Board adopt the provisions of HK SSAP 10 paragraph 37. The HKSA might also make the same recommendation in respect of the international standard on joint ventures.

In any event, should the HKSA not persuade the Board as to the merits of its case, we believe that the provisions of HK SSAP 10 in this regard should be retained in any revised HK SSAP.

Our comments on the specific questions asked are as follows:

Yes.

We prefer option b.

No. The HKSA should issue temporary separate guidance on the topic. Changes to the IAS should be minimal.

No. The SSAPs should be aligned to the IAS's. See answer re 5 above.

Yes. The HKSA should also challenge the IASB's proposal.

Q.10 No. The HKSA can issue interpretation guidance in respect of paragraphs 4 and 5 of IAS 8 to deal with the issue.

Yes.

Yes.

Q.14 Yes.

Yes to the principle of providing such guidance. But we believe it can be dealt with within an interpretation.

We appreciate the opportunity to present our comments to the HKSA. If you have any questions concerning the above please do not hesitate to contact our Mr. Nigel Reid.

Yours faithfully,

Ernst & Young

Enclosure: EYG IASB Improvements Project Comment Letter

■ Ernst & Young Global Limited
■ Phone [44] 20 7951 2000
ERNST & YOUNG
Devonshire House
Mayfair Place
London W1J 8AJ
Fax: [44] 20 7951 8888
Web site: http://www.ey.com

22nd August 2002

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

Dear Sir David:

The global organisation of Ernst & Young is pleased to comment on the Exposure Draft, *Improvements to International Accounting Standards.*

We fully support the Board's objectives in the Improvements Project as they are set out in the Invitation to Comment. However, notwithstanding our full support for this project, there are a number of areas in which we have serious reservations with respect to the approach the Board has taken. Our comments below have been grouped under the following headings:

1. Quality of the standard-setting process;
2. General comments; and
3. Comments on individual Standards.

**Quality of the standard-setting process**

*Extensive changes to the Standards*

The stated aim of the Improvements Project is to '… reduce or eliminate alternatives, redundancies and conflicts within existing Standards and to make other improvements to them,' and to '… deal with some convergence issues and to merge any related SIC consensus into the Standard whenever the revision of a Standard presented a suitable opportunity.' This implies that the changes following from the Improvements Project should be relatively limited in their extent and should deal with matters that are widely perceived as being problematic. In many cases, however, we find that changes made to existing Standards are more than just 'improvements' made within the remit of the Improvements Project.

It is, for example, clear that the IASB is proposing substantial changes to IAS 1 that go far beyond what we understand to be the objectives of the improvements project. Some of the changes proposed reflect fundamental shifts in the philosophy and concepts that underlie IFRS financial reporting. For example, paragraph 12 of the existing version of IAS 1 states that 'inappropriate accounting treatments are not rectified either by disclosure of the accounting policies used or by notes or explanatory material'. Although this is a well established principle of IFRS financial reporting with important implications for the application of IFRS generally, the IASB is now proposing to abolish it without, in our view, examining the full implications thereof and without seeking any specific comment thereon. We are therefore concerned that, because commentators have not been asked specifically to comment on changes such as this, and because the IASB has not published a marked-up copy of the proposed changes to IAS 1, commentators may not be aware of all these changes, nor of their full implications. Consequently, there exists a real danger that some fundamental amendments will be made to IAS 1 and other Standards relatively unnoticed and without being subjected to proper due process.

Though we are not opposed to making more extensive changes to Standards, we consider that the process and the way the changes have been brought to the attention of commentators, are not satisfactory in a number of cases:

> IAS 1, IAS 21, IAS 24 and IAS 33 all include the text "This Exposure Draft proposes extensive editorial changes to IAS [xx]. Hence, for ease of reading, it is presented as a 'clean' draft, rather than a 'marked-up' version that marks the changes." We believe that there is a significant risk that many of the, perhaps important, changes made to those Standards may go unnoticed by commentators, which reduces the quality of the standard-setting process and in time will necessitate further changes to Standards or interpretations by IFRIC. In addition, as a practical matter, reviewing 'clean' drafts is significantly more time consuming than reviewing 'marked-up' versions, even when the changes are extensive.
>
> The most important example of a Standard that has been changed significantly without appropriately identifying all of the changes is IAS 33 *Earnings Per Share*. As discussed in more detail in Appendix 12 to this letter, IAS 33 has been extensively revised to incorporate language from SFAS No. 128 (US GAAP). The individual paragraphs of the revised IAS 33 do not appear to be unreasonable, but the lack of field testing of the current proposals leaves the distinct possibility that the new rules will prove to be unworkable upon adoption, or result in earnings per share information that is less relevant than that produced under the existing IAS 33.

As discussed more fully in Appendix 12, we believe that IAS 33 should be withdrawn from the Improvements Project and be made subject of a separate Exposure Draft. In addition, the Board should publish 'marked-up' versions of IAS 1, 21 and 24 to enhance the quality of the exposure process.

*Questions in Invitations to Comment*

In the Appendices to this comment letter we have provided answers to the questions that are included in the Invitations to Comment. In preparing those answers we noted that the questions posed in the Invitations to Comment frequently failed to address some of the most controversial and significant changes proposed in the Exposure Drafts. For example, there is no question on the change of the scope of IAS 2 *Inventories*, despite the fact that this may well be the most significant change to that Standard. This issue is particularly important when coupled with the lack of marked-up drafts in IAS 1, IAS 21, IAS 24 and IAS 33

We consider it an essential characteristic of proper due process that the Board should specifically seek comments on all major changes in the scope and application of Standards. This is an important part of gaining acceptance for the improvements and ensuring the continued high quality of the Standards. By failing to seek specific comments on important changes in the Standards, the Board increases the risk that soon after the revised Standards have been issued interpretations by IFRIC or further amendments will be required.

*Bases for Conclusions*

Our main objections to the Bases for Conclusions as they currently are drafted are as follows:

The Bases for Conclusions in most revised Standards only address some of the changes that are listed in the Summaries of Main Changes and often ignore discussion of items that are not listed in the Summaries of Main Changes (e.g. IAS 24, 27, 28 and 33).

The quality of the arguments used in the Basis for Conclusions also varies greatly. In many cases, the Basis for Conclusions does little more than summarise the changes to the Standard and fails to provide convincing arguments as to:

- Why the change in the Standard was necessary;
- Why the solution chosen by the Board is superior to other possible solutions; and
- Whether or not the change in the Standard is expected to promote greater convergence with other bodies of national GAAP.

The Bases for Conclusions can be important for at least three reasons. Ideally they should illustrate why the solution chosen in the Standard is better than other possible solutions; provide extra help to preparers in grasping the intention underlying a particular requirement; and act in the future as a starting point for IFRIC interpretations and standard-setting by the Board itself. Therefore, we strongly urge the Board to significantly revise the Bases for Conclusions to ensure that each provides a robust discussion of the Board's debate and the reasons for its conclusions. In addition, the Bases for Conclusions in the final Standards should address comments received in the exposure process and the Board's conclusions concerning those comments.

*Convergence between IAS and other bodies of national GAAP*

Although one of the stated aims of the Improvements Project is to '… deal with some convergence issues …', the Board does not appear to have taken a particularly rigorous approach to the matter. In the Basis for Conclusions in some Standards passing reference is made to it; however in general, no systematic approach to convergence is discernable. Neither is there an analysis that states the probable effect upon convergence of the changes being proposed. In fact, in some circumstances, the changes will increase divergence rather than promote convergence. Although we do not advocate convergence for the sake of it, the Board should specifically address whether convergence will be enhanced by a proposed change, and if not, why the Board reached the conclusion it did. We are particularly concerned about situations where proposed amendments cause IAS to diverge from US GAAP. Where IAS and US GAAP are currently converged, that situation should be maintained until such time as the FASB can be persuaded to amend US GAAP in line with proposed changes to IAS.

**General comments**

*Impracticability vs. undue cost and effort*

Throughout the improvements Exposure Draft there are a number of exemptions that are based on the principle of 'undue cost or effort'. We are concerned that, in the absence of further guidance as to how this test should be applied in practice, the concept is virtually meaningless, and entities will apply varying interpretations as to the circumstances under which the exemption may be invoked. At the extreme end of possible interpretation, some might take the view that this criterion would allow an entity to regard almost any cost as undue, whereas the previous test of impracticality was much more stringent. The link between 'undue cost and effort' and materiality is important but has not been addressed.

We believe that, in all the cases where this test is now being used, the Board is effectively introducing a hidden option without definition. In our view, the Board should revert to the former 'impracticable' approach, but should give more guidance about how the impracticability test should be applied in practice.

*Effective date*

The Exposure Draft indicates that the changes to existing Standards will take effect as of 1 January 2003. We have no objection in principle to this effective date, provided that the revised Standards are published prior to this date. It must remain a matter of principle that no new accounting Standard should take effect retrospectively. We are concerned that the Board will not have fully considered the responses to the proposed changes, completed its due process, made the necessary changes to the Exposure Drafts, and published final standards by 31 December 2002. Therefore, if the final Standards are issued during 2003, but retain their proposed 1 January 2003 effective dates, they will require retroactive application. In these circumstances we recommend that the final Standards should apply from a date after their issuance, with earlier adoption encouraged.

*Immaterial items*

The Board has announced its intention to remove the text 'International Accounting Standards are not intended to apply to immaterial items.' from the rubric of each of the Standards. The Preface to International Financial Reporting Standards makes no reference to materiality, instead if refers to the Standards themselves for any guidance on limitations of their scope. Therefore, the only guidance on applying the materiality concept in preparing financial statements that remains in IFRS, is to be found in paragraphs 29 and 30 of the Framework. Given the importance of the materiality concept in the preparation of financial statements, we believe that the reference to materiality should either be retained in the rubric of each Standard or dealt with generically in IAS 8.

**Comments on individual Standards**

Given the length of the Exposure Draft and breadth of subjects covered, our comments on individual Standards have been attached as separate Appendices. Each of the Appendices sets out our comments to the questions presented in the invitation to comment and raises other issues that we believe need to be considered by the Board. Comments on individual Standards can be found in the Appendices as follows:

- Appendix 1 – IAS 1, *Presentation of Financial Statements;*
- Appendix 2 – IAS 2, *Inventories;*
- Appendix 3 – IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors;*
- Appendix 4 – IAS 10, *Events After the Balance Sheet Date;*
- Appendix 5 – IAS 15, *Information Reflecting the Effects of Changing Prices;*
- Appendix 6 – IAS 16, *Property, plant and equipment;*
- Appendix 7 – IAS 17, *Leases;*
- Appendix 8 – IAS 21, *The Effects of Changes in Foreign Exchange Rates;*
- Appendix 9 – IAS 24, *Related Party Disclosures;*
- Appendix 10 – IAS 27, *Consolidated and Separate Financial Statements;*
- Appendix 11 – IAS 28, *Accounting for Investments in Associates;*
- Appendix 12 – IAS 33, *Earnings Per Share;* and
- Appendix 13 – IAS 40, *Investment Property.*

In conclusion, we would like to make the following remark: the Improvements Project Exposure Draft will clearly generate significant comments from many constituents. After considering those comments, the Board may well make significant changes to the Standards that were neither exposed nor highlighted in the invitations to comment. Therefore, to ensure full and open due process, we strongly urge the Board to consider whether re-exposure of any such proposed revisions will be required.

Yours sincerely

Ernst & Young

## Appendix 1 – IAS 1 Presentation of Financial Statements

### General comments

It is clear that the IASB is proposing substantial changes to IAS 1 that go far beyond what we understand to be the objectives of the improvements project. Some of the changes proposed reflect fundamental shifts in the philosophy and concepts that underlie IFRS financial reporting. For example, paragraph 12 of the existing version of IAS 1 states that 'inappropriate accounting treatments are not rectified either by disclosure of the accounting policies used or by notes or explanatory material'. Although this is a well established principle of IFRS financial reporting with important implications for the application of IFRS generally, the IASB is now proposing to abolish it without, in our view, examining the full implications thereof and without seeking any specific comment thereon.

We are therefore concerned that, because commentators have not been asked specifically to comment on changes such as this, and because they do not have access to a marked-up copy of the proposed changes to IAS 1, commentators may not be aware of the full implications of all these changes. Consequently, there exists a real danger that some fundamental amendments will be made to IAS 1 relatively unnoticed and without being subjected to proper due process.

### 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)?*

No, we believe that the proposed approach is fundamentally flawed, for at least three reasons.

We do not believe that IFRS financial reporting should be governed by specific regulatory frameworks that may or may not govern a specific entity. We believe that it is a well-established principle that IFRS should be impervious to legal frameworks and other national influences. For example, a banking regulator might establish its own criteria for the classification of capital instruments as either debt or equity in the regulatory accounts of a bank, or may set specific levels of loan loss provisions; however, neither of these should have any impact on the bank's IFRS financial statements. Similarly, just as Standards such as IAS 12 and IAS 39 ignore national tax systems and rules on realised profits and dividend distributability respectively, so should the application of IFRS be neutral to different national regulatory systems.

We note also that, in concluding that the LIFO method should be eliminated as an option in IAS 2, the Board has stated that 'tax considerations do not provide an adequate conceptual basis for selecting an appropriate accounting treatment and that it is not acceptable to allow an accounting treatment purely because of tax regulations and advantages in particular jurisdictions' (see IAS 2 Basis for Conclusions, paragraph A6). We agree with this position, and similarly believe that 'the relevant regulatory framework' does not provide an adequate conceptual basis for selecting an appropriate accounting treatment.

2. The proposed revision does not address multi-listed companies. The 'relevant regulatory framework' for such a company is unclear. It is also unclear whether such companies (for example, a French SEC registrant company) could prepare two different sets of fully IAS-compliant financial statements for each 'relevant regulatory framework'. The consequence could well be that one multinational group could publish two (or more) sets of consolidated financial statements that are fundamentally different, yet purport to achieve a fair presentation in accordance with IFRS. This would be a wholly undesirable change that would be confusing for users and detrimental to the functioning of the capital markets.

3. Perhaps most importantly, though, the proposed change to the operation of the override is a retrograde step in the effort to achieve high quality financial reporting under IFRS. This is because it abolishes the well-established principle set out in paragraph 12 of the existing version of IAS 1 that 'inappropriate accounting treatments are not rectified either by disclosure of the accounting policies used or by notes or explanatory material.' We believe it to be highly significant that this paragraph of IAS 1 has been deleted, and that the Board is apparently now envisaging, in the proposed new paragraph 15, a system of IFRS financial reporting that allows inappropriate recognition and measurement to be rectified (perhaps only partially) by disclosure. The fact that this is the Board's intention is clearly borne out by paragraph A8(b) of the Basis for Conclusions, which states that 'if the relevant regulatory framework prohibits departure from the requirement, the entity shall, to the maximum extent possible, reduce the perceived misleading aspects of compliance by making the disclosures set out in proposed paragraph 15'.

What this amounts to is that the Board is proposing a 180 degree change to the principle set out is paragraph 14 of the existing IAS 1 that 'the existence of conflicting national requirements is not, in itself, sufficient to justify a departure in financial statements prepared using International Accounting Standards'. Instead, under paragraph 15 of the proposed new Standard, the existence of national (regulatory) requirements could result in companies being forced into producing financial statements that do not provide a fair presentation.

We find this particularly surprising in a post-Enron world of financial reporting, where Harvey Pitt, Chairman of the US Securities and Exchange Commission, has now drawn attention to the well-known Continental Vending case of the 1960s (United States vs. Simon, US Court of Appeals for the Second Circuit). As the Board will be aware, this case established the 'critical test' of fair presentation. This was the test as to whether the financial statements fairly presented the financial condition of the company, and it was held that, whilst proof of compliance with GAAP was persuasive evidence that this was the case, it was not necessarily conclusive. Consequently, even in countries such as the US, where the regulatory framework may be thought to prohibit departure from Standards, the Courts have ruled it unacceptable to fail to depart from a Standard if its application does not result in fair presentation.

We note further that the last sentence of paragraph 10 of IAS 1 has been redrafted in a way that may seem minor to some, but which we believe to be significant. The existing text of IAS 1 states that 'The appropriate application of International Accounting Standards, with additional disclosure when necessary, results, in virtually all circumstances, in financial statements that achieve a fair presentation'. This text has now been substituted with the following: 'The application of International Financial Reporting Standards and Interpretations of those Standards, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.' We believe that this change weakens the concept of 'fair presentation', potentially reducing it to mean mere compliance with the rules.

Whilst we note that the grey lettered paragraph 12 starts with the phrase 'in virtually all circumstances', we believe that the omission of this phrase from the bold paragraph 10 serves to shift the balance of emphasis away from principles-based Standards towards the requirement to apply rules.

In conclusion, we observe that there is no evidence to suggest that there is any abuse in practice of the existing override provisions in the current version of IAS 1. Indeed, we would suggest that these provisions are clearly and tightly drafted, such that a departure from IFRS should be an extremely rare event and will only happen when compliance with the Standard would be so misleading that it would conflict with the objective of financial statements set out in the Framework. Consequently, we believe that paragraphs 10 to 18 of the existing version of IAS 1 should remain unchanged.

**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)?*

No, not in the way proposed in this draft. Because the Board has not addressed the basic issues surrounding performance reporting, there is now even more confusion as to how companies should present their income statements. For example, paragraph 79 of the draft states that 'no items of income and expense are presented as arising from outside the entity's ordinary activities'. Yet the term 'ordinary activities' is not defined in the Exposure Draft, and the definition previously set out in IAS 8 has now been deleted. Consequently, we consider paragraph 78 to be meaningless, as it can only be understood in the context of an adequate definition of ordinary activities.

More importantly, though, we are concerned that, instead of defining the 'results of operating activities', and thereby enhancing the inter-company comparability that could be achieved, the Board has deleted the requirement in paragraph 76 for companies to disclose a sub-total for results from operating activities. The result of this is that there will be nothing to stop companies reporting 'non-core', 'non-recurring', 'non-operating' or 'unusual' items in the income statement, which can be displayed as extraordinary items, without calling them such.

Whilst we appreciate that the Board is probably addressing all these issues in its performance reporting project, that Project is still some way from being converted into a Standard. In the meantime, preparers, auditors and users of financial statements require clarity as to the form and content of the income statement so that consistency, comparability and understandability can be maximised.

**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)?*

No, we believe that paragraphs 63 to 65 of the existing text in IAS 1 should be retained. Whilst we understand the Board's reasoning behind this proposed change, we do not believe that it improves either the usefulness or the coherence of financial statements prepared under IFRS. We believe that in the cases of loan roll-overs and re-financings, it is important to consider the position until the financial statements are authorised for issue. In our view, an important consideration for users is whether or not the reporting entity will be required in the next twelve months to use current assets to repay the loan. For a company to issue financial statements that imply that this is the case when it clearly is not, would reduce the usefulness and coherence of those financial statements.

Importantly also, we note that re-financings, rollovers and re-schedulings are treated as adjusting post-balance sheet events under US GAAP. In fact, US GAAP would also require the re-classification as current a liability that was non-current at the balance sheet if a post-balance sheet event indicated that this was the real position. We therefore do not understand why the Board is now seeking to create a IFRS/US GAAP difference. As noted in our covering letter, we consider that the Basis for Conclusions should address convergence issues, particularly so in this case where the proposed Standard would create a difference where currently none exists.

**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)?*

No, for the same reasons presented in our answer to Question 3.

(b) *if a lender was entitled to demand immediate repayment of a loan because the entity breached a condition of its loan agreement, but agreed by the balance sheet date to provide a period of grace within which the entity can rectify the breach and during that time the lender cannot demand immediate repayment, the liability is classified as non-current if it is due for settlement, without that breach of the loan agreement, at least twelve months after the balance* *sheet date and:*

*(i) the entity rectifies the breach within the period of grace; or*

*(ii) when the financial statements are authorised for issue, the period of grace is incomplete and it is probable that the breach will be rectified (see proposed paragraphs 63 and 64)?*

No, we believe that paragraphs 63 to 65 of the existing text in IAS 1 should be retained. We believe that in the circumstances set out in paragraph 63 the balance sheet classification should be governed by the date on which the grace period ends. In other words, in these circumstances, the date of maturity has been extended to the end of the grace period, with the result that this is the new date at which the loan matures. Consequently, balance sheet classification should be made by reference to the date the grace period ends, subject to consideration of the events that occur after the balance sheet date and before the date that the financial statements are authorised for issue.

**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)?*

No. Whilst it is difficult to disagree with the principle of requiring management to disclose the judgements made in applying the accounting policies that have the most significant effect on the amounts of items recognised in the financial statements, we have strong reservations about the manner in which this disclosure has been proposed. We believe that paragraph 108 is attempting to address a much larger issue that more properly belongs in an MD&A and that, consequently, the proposed requirement as currently phrased will lead only to 'boilerplate' disclosures.

We therefore believe that, until such time as the Board addresses the issue of the MD&A in a separate Standard, these disclosures should be dealt with individually on a Standard-by-Standard basis. This means that specific disclosures should be added to those individual Standards where the Board considers that disclosures about judgments of this nature are required.

**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)?*

No. Again, this is a commendable proposal, but is better suited to the requirements of an MD&A.

In any event, as written, 'significant risk' as used in paragraph 110 is too open-ended and not well enough defined to be implementable. Moreover, it is somewhat unclear as to where the requirements of paragraphs 110 to 115 fit in relation to paragraph 7 – particularly as paragraph 9 states that the matters described in paragraph 7 are outside the scope of IFRS. Consequently, in the absence of a separate requirement detailing the form and content of the MD&A, we believe that the proposals set out in paragraphs 110 to 115 should be addressed on a Standard-by-Standard basis in the relevant disclosures of the relevant Standards. For example, the disclosures contained in IAS 19 about assumptions and the effect of changes in assumptions are clear.

We note also that, during its IAS 36 discussions, the IASC Board discussed whether key assumption disclosures should be required. The conclusion was that they should not, and are therefore not addressed in the IAS 36 disclosure requirements. However, the proposed amendment to IAS 1 would now seem to require that disclosure. We do not agree that it is appropriate for the Board to 'fix' a particular Standard like IAS 36 in this back-door manner.

**Specific issues not covered in questions**

**Financial review: Paragraphs 7 to 9**

Paragraph 8 of the existing IAS 1 states that 'enterprises are encouraged to present, outside the financial statements, a financial review by management which describes and explains the main features of the enterprise's financial performance and financial position and the principal uncertainties it faces'.

This encouragement has now been removed. Instead, there is now the statement to the effect that this is outside the scope of IFRS. We believe that this is a retrograde step that sends the wrong message to preparers of financial statements – particularly in the current financial reporting environment, where the understandability of financial statements is becoming an increasingly important issue. There exists significant public concern that financial reporting has become too focused on the provision of data for the purposes of regulatory compliance, at the expense of the provision of financial information that is reliable, transparent, useful and understandable in order to obtain a full appreciation of a complex business entity. Therefore, we believe that anything done to downgrade the importance of a further discussion of an entity's operations is a step in the wrong direction.

**Accrual accounting: Paragraphs 20 and 21**

Paragraph 20 states that 'an entity shall prepare its financial statements, except for cash flow information, under the accrual basis of accounting'. We consider this to be a somewhat surprising requirement, given the fact that it clearly conflicts with a number of existing IASs. For example, it is unclear how this requirement relates to the application of IASs 39 and 40. In any event, given that IAS 1 is a Standard on the presentation of financial statements, we believe that issues such as this involving measurement more properly belong in IAS 8 or in the Framework.

More importantly, however, we are concerned about the way in which the accrual basis of accounting is described in paragraph 21. We believe that accounting literature generally uses the term 'accrual accounting' to describe the entries recording the earning of revenues and matching of costs (see, for example, R.M. Skinner, *Accounting Principles*, p. 156). Consequently, we believe that paragraph 21 completely mis-defines what is a generally accepted and agreed accounting concept. We presume that the Board's motives for doing this are to ensure that costs and revenues are not deferred if they do not meet the asset/liability definitions; however, if the Board wishes to move away from the traditional approach to accrual accounting, then it should do so by formally acknowledging this and describing its approach using new terms. This 'backdoor' abolition of traditional accrual accounting can be found also in the deletion of paragraph 32 of IAS 2, where the sentence stating that 'the process of recognising as an expense the carrying amount of inventories sold results in the matching of costs and revenues' has now been removed. Again, we believe that the Board should clearly address its move away from accrual accounting by articulating formally the basis of accounting that underpins IFRS.

As an aside, we note that the proposed paragraph 53B(b) of IAS 16 is suggesting that cash, not accrual, accounting should be applied. Presumably, the last word of the sub-paragraph should be 'receivable' not 'received'.

**Number of employees**

We note that paragraph 102(d) of the existing version of IAS 1 has been deleted. We disagree with this change because this disclosure often provides important information to users that is helpful in making comparisons among entities, as well as helping to provide important information about an entity itself.

**Undue cost or effort**

Throughout the improvements Exposure Draft there are a number of exemptions that are based on the principle of 'undue cost or effort'. We are concerned that, in the absence of further guidance as to how this test should be applied in practice, the concept is virtually meaningless, and entities would apply varying interpretations as to the circumstances under which the exemption could be invoked. At the extreme end of possible interpretation, some might take the view that this criterion would allow an entity to regard almost any cost as undue, whereas the previous test of impracticality was much more stringent. The link between 'undue cost and effort' and materiality is important but has not been addressed.

We believe that, in all the cases where this test is now being used, the Board is effectively introducing a hidden option without definition. In our view, the Board should revert to the former 'impracticable' approach, but should give more guidance about how the impracticability test should be applied.

**Minority interest**

We believe that there is substantial inconsistency and confusion surrounding the way in which it is proposed minority interest will be dealt with in IAS 1, and the way in which it inter-relates with IASs 27 and 32.

The confusion starts with the amendment to paragraph 15(c) of IAS 27, which now states that 'minority interests in the net assets of consolidated subsidiaries are identified and presented in the consolidated balance sheet within equity'. This is apparently justified in paragraphs A9 and A10 of the Basis for Conclusions as follows: 'The Board noted that the existence of a minority interest in the net assets of a subsidiary does not give rise to a present obligation of the group, the settlement of which is expected to result in an outflow of economic benefits from the group. Rather, the Board noted that a minority interest represents the residual interest in the net assets of those subsidiaries held by some of the shareholders of the subsidiaries within the group, and therefore meets the Framework's definition of equity'. We disagree with this as a general premise. We believe that the situation often exists that a financial instrument classified as an equity instrument by a subsidiary that constitutes a minority interest in the group balance sheet may well fall to be a liability of the group. An example would be a fixed coupon, redeemable share issued by a subsidiary, with the coupon and redemption guaranteed by the parent.

However, this confusion notwithstanding, the Board's revised view of minority interest results in there being several 'loose ends' to be tied up regarding the way in which minority interest is dealt with in IAS 1:

> Paragraph 65: It is unclear which line items constitute 'equity' as described in IAS 27 paragraph 15(c).
>
> Paragraph 65(o): The application to individual financial statements is unclear. Presumably, the line should read as follows: 'issued capital and reserves (in group financial statements, attributable to owners of the parent)'.
>
> Paragraph 76(h): We consider this to be an inappropriate line item in a group income statement. Presumably, in the case of group financial statements, this should read 'net profit or loss attributable to shareholders of the parent company.' This change may go some way towards dealing with the alternative views of the Board members who voted against the publication of the IAS 1 Exposure Draft.
>
> Paragraph 92(c): there should be clarification as to how minority interest is to be dealt with in this reconciliation.

**Appendix to IAS 1: Illustrative Financial Statement Structure**

We note that the Appendix to the existing IAS 1 has been deleted. We consider this to be a retrograde step. We believe that the Appendix performs a valuable role both in assisting with the application of the Standard and in promoting at least a measure of consistency in the presentation of IFRS financial statements. We therefore believe that the Appendix should be updated as necessary and re-inserted in the Standard

Furthermore, the deletion of the Appendix to IAS 1 seems to us to be inconsistent with the retention of the Appendices to IASs 7 and 14. We therefore believe that the Board should adopt a consistent approach towards the publication of illustrative information in the Appendices to Standards, preferably by updating and re-incorporating the Appendix to IAS 1.

### Historical summaries

We believe that the Board should clarify its position as to the role of historical summaries in IFRS financial statements. Our concern is that historical summaries receive passing reference in a number of Standards, without proper elaboration. For example, paragraph 22 of the proposed amended IAS 8 refers to the restatement of historical summaries. In our view, historical summaries should be presented (and generally are in practice) outside the financial statements. Where this is the case, we do not believe that IFRS are of relevance (although historical summaries should be presented in accordance with IFRS, consistent with the financial statements) and therefore should not refer to them. However, in the unusual event that historical summaries are presented within IFRS financial statements, then it should be made clear in IAS 1 that the full requirement to IFRS should apply to these summaries. Alternatively, the Board needs to address the presentation of historical summaries in a separate project.

### Definition of current assets

It seems that paragraph 54(c) will result in all assets that are to be disposed of in the next 12 months, including property, plant and equipment, being reported as current assets. So, for example, an entity that replaces its fleet of vehicles every five years will be required to reclassify the vehicles as current in the fourth year's balance sheet. We do not believe that this is the intention of the definition, but if it is we strongly disagree with this approach.

In addition, the classification of investments in financial instruments is already covered in IAS 39 as either trading or available for sale. We therefore do not believe that it is appropriate to include the reference to marketable securities in paragraph 56, which is likely to cause confusion rather than provide clarity.

### Disclosure of revenue

Paragraph 76 requires the disclosure of revenue on the face of the income statement. However, it is unclear as to whether this is the total gross revenue of the entity under IAS 18 or only the 'turnover' of the entity. It would seem that the intention is to require the disclosure of turnover, but we believe that this should be made clear.

### Disclosure of dividend per share

Paragraph 90 requires entities to disclose dividend per share (DPS). However, since IAS 33 deals only with EPS, guidance is needed as to how DPS should be calculated. In practice currently, the disclosures vary from DPS based on the number of shares in existence on the date of declaration, to DPS based on the number of shares adjusted for share transactions that do not affect the resources of the enterprise. It is therefore necessary for the Board to clarify what is meant by DPS, perhaps by stating explicitly that the denominator used in the calculation should be the same as that used in the EPS calculation.

## Appendix 2 – IAS 2 Inventories

### Question 1

*Do you agree with eliminating the allowed alternative of using the LIFO method for determining the cost of inventories under paragraphs 23 and 24 of IAS 2?*

We agree with the elimination of the option that allows entities a free choice between LIFO and FIFO. However, the arguments used in the Basis for Conclusions for the elimination of the LIFO method are not comprehensive and compelling because the Board does not discuss the disadvantages of the FIFO method and the effect of the cost formulas on the income statement. Furthermore, we do not believe that the argument in paragraph A5 – that LIFO does not represent physical inventory flows – is relevant, as the same can be said about both the FIFO and weighted average costs methods. Given the conceptual problems that exist with both LIFO and FIFO, we believe that primary arguments for elimination of the LIFO method are (1) the practical difficulties that arise in applying the method and (2) the accounting issues that arise as a result of 'erosion' of LIFO layers (especially in the context of quarterly reporting).

### Question 2

*IAS 2 requires reversal of write-downs of inventories when the circumstances that previously caused inventories to be written down below cost no longer exist. IAS 2 also requires the amount of any reversal of any write-down of inventories to be recognised in profit or loss.*

*Do you agree with retaining those requirements?*

Yes, for the reason that we believe that this approach is entirely consistent with the principle of lower of cost and net realisable value.

### Specific issues not covered in questions

### Paragraph 1(c)

We believe that the change in the wording of paragraph 1(c) may result in a significant change in practice for certain industries. Under the previous wording of paragraph 1(c), only producers of commodities were allowed, under certain circumstances, to value their commodity inventories at net realisable value, whereas under the revised wording any party holding commodity inventories will be allowed to do so.

Though we agree with the change in the scope of the Standard in general, we believe that:

> The wording of the Standard is very lenient, as it does not require all commodity inventories held by an entity to be valued at net realisable value. We think that all commodity traders should value their commodity inventories at net realisable value;

The Board should have specifically invited comments on the proposed change in wording; and

A reference to 'well established practices in certain industries' is an anomaly since the existing IAS 2 would in many cases not have allowed such practice to have emerged, and practice under another GAAP could hardly be relevant for an IFRS-reporting entity.

**Paragraph 32**

In the Basis for Conclusions the Board does not indicate why it is appropriate that paragraph 32, which contains a reference to the process of 'matching of costs and revenues', should be deleted. We believe that this wording is still relevant and believe that the text of paragraph 32 should be retained, particularly in the light of paragraph 20 of the IAS 1 Exposure Draft.

**Paragraph 34(c)**

It is not clear from the proposed revised wording of paragraph 34(c) whether the Standard requires disclosure of the effect of write-downs on the total value of inventories or write-downs recognised in income for the period. The Board should clarify this disclosure requirement in so as to indicate whether it requires disclosure of the income statement effect, balance sheet effect or both.

**Recognition**

IAS 2 only deals with measurement of inventories, but does not provide recognition criteria for inventories. We believe that IAS 2 should either be modified to provide recognition criteria for inventories or refer to the guidance contained in the Framework. In addition, the relationship with paragraph 91 of the Framework, which deals with accounting for equally proportionately unperformed contracts, should be clarified.

## Appendix 3 – IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors

### 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)?*

Yes. However, we note that paragraph 7 states that entities should select and apply 'an appropriate accounting policy …'. We believe that the Standard should be strengthened further by making it clear that, when selecting accounting policies, management should adopt policies that are judged to be the most appropriate to the reporting entity's circumstances for the purpose of fair presentation. Thereafter, the entity's accounting policies should be reviewed regularly to ensure that they remain the most appropriate to its particular circumstances, and a new accounting policy should be implemented only if it is judged to be more appropriate to the entity's particular circumstances than the present accounting policy. We do not believe that, as currently drafted, the Standard is clear as to circumstances under which it would be appropriate for an entity to effect a voluntary change in accounting policy.

In addition, we refer to our general concern expressed in our response to IAS 1 concerning the 'undue cost or effort' exemptions that have been introduced throughout IFRS. In the case of IAS 8, we disagree with paragraph 21, which proposes in the case of voluntary changes in accounting policy, that comparative information presented for a particular prior period need not be restated if restating the information would require undue cost or effort. Given that a voluntary change in policy should be rare and should only be made only if it results in preferable presentation, it seems anomalous that entities should be allowed to avoid the restatement of comparative information by invoking the 'undue cost or effort' let-out. We have similar reservations concerning paragraph 33.

### Question 2

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

Yes, subject to the following issues. We believe that the definition of an 'error' is currently too wide and requires further clarification. In particular, we believe that a distinction should be made between changes in estimates and errors, and it should be made clear that errors exclude changes in estimates. At a minimum, the definition should specifically refer to paragraphs 24 to 26 and thereby formally distinguish between errors and changes in estimates.

In addition, now that the reference to materiality has been deleted from the Preface to IFRS, we believe that the issue of materiality should be dealt with specifically in IAS 8. In so doing, it should be clear that paragraphs 31 to 33 apply only to errors that are material either individually or in aggregate.

**Specific issues not covered in questions**

**Paragraph 2, inter-relationship with IAS 12**

Paragraph 2 of the Exposure Draft states that 'The tax effects of errors and changes in accounting policies are accounted for and disclosed in accordance with IAS 12, Income Taxes.' However, IAS 12 is silent on the tax treatment of accounting policy changes, changes in accounting estimates and errors. We therefore believe that IAS 12 should be reviewed in order to ensure that there is complete clarity on the inter-relationship between IAS 8 and IAS 12.

**Paragraph 5**

We note that paragraph 5 requires the selection of accounting policies to be made by reference to relevance and reliability only. We believe that this requirement should be expanded to deal specifically with understandability and comparability, which are the other two main qualitative characteristics dealt with in the Framework and which, in our view, are of equal importance.

For example, if the Board accepts our position stated above that, in selecting accounting policies, management should adopt policies that are judged to be the most appropriate to the reporting entity's circumstances for the purpose of fair presentation, then inter-company comparability is a very important consideration in this process. If a particular accounting policy is the generally accepted and established policy in a particular industry, then presumably an entity in that industry that is considering adopting a different policy should consider the implication that this would have on comparability.

**Paragraph 19**

Paragraph 19 of the revised text modifies the former paragraph 48 by requiring the disclosure of information about the effects of a future change of accounting policy as a result of the publication of a new Standard yet to be implemented. Previously, paragraph 48 merely encouraged such disclosure. We support this change, but have some observations to make concerning the new requirements:

We believe that these disclosure requirements should be extended to apply in the cases of Interpretations that have yet to be adopted;

We believe that the requirement in 19(d) should be extended to disclose also the effect of the changes on the entity's net profit or loss. We see no sense in requiring only the impact on the balance sheet; and

Consistent with our discussion above, paragraph 19(d)(ii) should be amended to introduce the concept of impracticability rather than 'undue cost and effort'. Also, where this exemption is invoked, companies should be required to provide reasons for not being able to provide the information.

## Appendix 4 – IAS 10 Events After the Balance Sheet Date

We support the changes that the Board intends to make to IAS 10 *Events After the Balance Sheet Date*.

## Appendix 5 – IAS 15 Information Reflecting the Effects of Changing Prices

We support the Board's decision to withdraw IAS 15 *Information Reflecting the Effects of Changing Price*, because the current Standard is considerably out of date and does not give sufficiently clear and meaningful guidance to entities that might wish to reflect the effect of changing prices.

## Appendix 6 – IAS 16 Property, plant and equipment

### 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)?*

### Question 2

*Do you agree that all exchanges of intangible assets should be measured at fair value, except when the fair value of neither of the assets exchanged can be determined reliably? (See the amendments in paragraphs 34-34B of IAS 38, Intangible Assets, proposed as a consequence of the proposal described in Question 1.)*

*(Note that the Board has decided not to amend, at this time, the prohibition in IAS 18, Revenue, on recognising revenue from exchanges or swaps of goods or services of a similar nature and value. The Board will review that policy later in the context of a future project on the Recognition of Revenue.)*

We do not consider that this matter should be dealt with as part of the revision to IAS 16. We believe that the issue of accounting for exchanges of assets would best be addressed by a comprehensive project on accounting for non-monetary transactions in general. This would cover accounting for exchanges of tangible assets, intangible assets, goods and services, as well as provide guidance on both how fair value should be measured in these circumstances and how revenue should be recognised on such exchanges. It would also have to link in with SIC–31.

Consequently, we do not believe it to be appropriate to answer this question in isolation, without considering together all the implications of accounting for barter transactions.

### 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)?*

IAS 16 has never allowed depreciation to cease when an item of property, plant and equipment becomes temporarily idle; the proposed change is to require depreciation to continue to be charged when an asset is held for disposal. We accept that this proposal is more in line with the definition of depreciation and would accept the treatment using the current definition of residual value in IAS 16. However, surely the change is rendered largely superfluous by the proposed change to the measurement of the residual value? In the case of an asset held for resale, the residual value is presumably to be the current estimate of the amount that will be recovered on sale, discounted as appropriate to take account of the time delay until disposal. It is unnecessary to include specific rules to deal with a situation that is perfectly adequately dealt with by the definitions and basic rules within the Standard.

We would not support a rule that allowed the residual value to be revised only at the end of the financial year, which is a possible interpretation of the revised paragraph 46. We are concerned that it would be inconsistent with the requirements in respect of useful life and depreciation method. Both paragraphs 49 and 52 state that a review should be made 'at least each financial year end' and we take this to mean that the review should be performed when events indicate that the life or method may have changed. Obviously a decision to sell could be such an event. Therefore, we recommend that this matter is clarified in the finalised Standard.

There is a further point implicit within the proposals: it appears that a fixed asset is not reclassified as a current asset solely because a decision has been made to sell it. We concur with this view and believe that an explicit statement be made that an asset is not reclassified solely as a result of a decision to sell. However, we refer you to our comments on paragraph 54(c) of IAS 1 under the heading 'Definition of current assets', and request that the Board provides clarity and consistency on the balance sheet classification of fixed assets held for disposal.

Our specific concerns regarding the proposed change to the definition of residual value are addressed in 'Residual value' below.

**Specific issues not covered in questions**

**Scope (paragraph 1(b))**

The wording of paragraph 1(b) of IAS 16 before amendment was identical to the wording of paragraph 1(c) of IAS 38. After the amendment of IAS 16, it appears that items of property, plant and equipment used in 'the exploration for and extraction of minerals' are now within the scope of IAS 16. We believe that the Board should clarify whether this is really what it intended and explain the reasons why such change is required.

**Residual value (paragraphs 6 and 46)**

We are extremely surprised that there is no invitation to comment specifically on the proposed change to the definition of residual value. The implications are of great significance and, in our opinion, have not been fully addressed in the Exposure Draft.

Presumably the intention is that entities will not report gains or losses on sale or retirement of assets as these will have already been taken up into the depreciation charge.

We consider that the proposal to base the residual value on current prices is entirely inappropriate if the assets in question are carried at historical cost. It will introduce into the profit and loss account some of the market value changes that are currently dealt with as movements on equity. Historical cost depreciation should be based on the purchase price and the profit and loss account should not include gains and losses calculated by reference to changes in market value.

The resulting depreciation charge would no longer represent the systematic allocation of cost over the useful life. In some circumstances, the residual value based on current prices may even exceed the assets' written down amount. The draft Standard is entirely silent on how to address this. Is it accepted that in these circumstances there would be a credit to the profit and loss account, i.e. negative depreciation? Is it the intention that residual values would be capped at the brought forward carrying value unless the entity adopts a policy of revaluation? If so, what argument could be used to support this?

We believe that it is consistent and appropriate to restate the residual value at the time that the asset is itself revalued.

In conclusion, we believe that residual value should be defined as before, i.e. it should be based on prices prevailing at the date of acquisition or revaluation and should not take account of expected future price changes.

These points also apply to the proposed changes in paragraphs 7 and 93 of IAS 38. Once again, we consider the proposed change to the treatment of residual values to be inappropriate to assets carried at historical cost.

**Recognition of property, plant and equipment (paragraph 9 and 10)**

In its Basis for Conclusions, the Board does not indicate why it believes paragraphs 9 and 10 should be deleted. In our opinion, the guidance in these paragraphs should be retained as it prevents recognition of an item of property, plant and equipment before its risks and rewards have passed to the entity.

**Components of cost (paragraph 15(b), 17B and 53A)**

We are puzzled by the suggestion that the proceeds of sales of items produced when bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management, be deducted from the carrying value of the asset. Income from sales should never be taken against assets so as to reduce their carrying value, and accordingly all sales proceeds, whether or not in a start up period, should be taken to the profit and loss account. Has this rule been proposed because of a realisation that the purchase price of materials used in the start up period would fall to be capitalised? In principle, if the amounts are material, the appropriate depreciation and cost of the raw material consumed should also be charged to the profit and loss account in the same period as the income is recognised.

A further problem that we believe exists in the guidance provided in paragraph 15(b) is that:

> Paragraph 17B requires that the income generated from activities that are very similar in nature to those referred to in paragraph 15(b) – but which are not necessary to bring the asset to the location and working condition – should be accounted for in an entirely different manner; and
>
> The proposed treatment is incompatible with the requirements in paragraph 53A regarding the treatment of compensation from third parties. (Please note that paragraphs 53A and 53B contain a drafting error as it refers to 'received' rather than 'receivable', thereby inadvertently

requiring cash accounting instead of accrual accounting).

**Subsequent expenditure (paragraph 26)**

This paragraph should refer to immaterial inspection components as well as immaterial replacements and renewals.

**Treatment of revaluation surplus**

We recommend that the Board take the opportunity to remove the ambiguity in paragraph 39 of IAS 16 over the treatment of revaluation surpluses, an ambiguity that is acknowledged in paragraph 64 of IAS 12. We consider this is an important matter that should be treated consistently by entities reporting under IFRSs.

## Appendix 7 – IAS 17 Leases

### Question 1

*Do you agree that when classifying a lease of land and buildings, the lease should be split into two elements—a lease of land and a lease of buildings? The land element is generally classified as an operating lease under paragraph 11 of IAS 17, Leases, and the buildings element is classified as an operating or finance lease by applying the conditions in paragraphs 3-10 of IAS 17.*

We consider that the proposals are essential to allow IAS 17 to be applied properly in jurisdictions such as the UK and Hong Kong where all property leases are leases over land. In the UK there is no separate fair value based on market values for the land and property elements of the lease. Therefore, we support the default position in paragraph 11B that the entire lease be classified as a finance lease unless it is clear that the lease of land and the lease of buildings are both operating leases. However, it must be the case that where the entire lease is deemed to be a finance lease under paragraph 11B the economic life of the leased asset is that of the leased buildings. Paragraph 11C is surely incorrect in implying that this will be the case only when the value of the land is immaterial.

It is unclear how the Board can recognise in paragraph 11B that there may be cases where the split in fair value between land and buildings cannot be made, but also require the entity to assess whether the indicator referred to in paragraph 8(d) applies, as this requires the fair value of each element to be known.

### Question 2

*Do you agree that when a lessor incurs initial direct costs in negotiating a lease, those costs should be capitalised and allocated over the lease term? Do you agree that only incremental costs that are directly attributable to the lease transaction should be capitalised in this way and that they should include those internal costs that are incremental and directly attributable?*

We agree with these proposals, although the Standard should provide examples of directly attributable incremental internal costs.

### Specific issues not covered in questions

#### Multi-element leases

We regret that the Board has only chosen to amend IAS 17 in order to address classification of leases comprising land and buildings. Similar issues also arise in accounting for other multi-element leases, for example those that comprise computer hardware and software. We believe that additional provisions requiring a components approach to other multi-element leases are necessary and would be in line with the amendments to IAS 16.

**Editorial**

We would like to point out that for unknown reasons the proposed amendments to paragraph 12 of IAS 17 are included on page 364 of the Exposure Draft. In respect of this proposed amendment we refer to our general comment on the replacement of 'impracticable' by 'undue cost and effort'.

## Appendix 8 – IAS 21 The Effects of Changes in Foreign Exchange Rates

### 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?*

No. Although we have no comment on the basic definition in paragraph 6, we believe that the factors in paragraphs 7 and 8 should be combined, since the present format gives too much emphasis to the factors in paragraph 7 and it is unclear in what circumstances the factors in paragraph 8 should be taken into account. Is it only when the currencies in 7(a) and 7(b) are different that the factors in paragraph 8 are to be considered or should they also be taken into account if the currencies in 7(a) and 7(b) are the same?

Another factor that should be included is the extent to which the entity uses financial instruments for hedging purposes. Although an entity's sales prices may be mainly influenced by (say) the US dollar, it may be that through the use of forward contracts it hedges its currency risks by selling US dollars forward into another currency, which it may consider to be its functional currency. It is unclear whether the phrase 'and settled' in paragraphs 7(a) and 7(b) would include the effects of such forward contracts. Our reading of the paragraphs is that it does not and therefore we believe that this factor should be addressed specifically.

Since the determination of an entity's functional currency is critical, we believe that the guidance should be supplemented by realistic examples. These should illustrate what might be thought to be the functional currency, where some of the relevant factors are in different currencies.

We have some further drafting comments on these paragraphs and these are set out in 'Specific issues not covered in questions' below.

### 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?*

Yes, provided the currency chosen is one that satisfies the characteristic of 'relevance' under the Framework. The Standard should explain what currencies might fulfil that characteristic. These could be the parent entity's functional currency, the predominant functional currency of the group, the currency of the country of domicile of the entity, or the currency of the country of domicile of the reporting entity's principal shareholders.

### 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)?*

Yes. Although the alternative method suggested in paragraph A14 of the Basis for Conclusions might have some theoretical appeal, the reason for such an approach could equally be said to apply to the translation of foreign operations for the purposes of consolidated financial statements, since this is being done to express the results of the foreign operations in a common currency so that group financial statements may be presented. We therefore agree that 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.

However, it should be noted that the assertion in paragraph A15 of the Basis for Conclusions is incorrect. We agree that it will result in the same amounts for the balance sheet, regardless of whether the translation process is a single or two-stage process. However, it does not necessarily hold true for income and expense items, particularly if an average rate is used, although any difference is likely to be insignificant.

**Question 4**

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

Yes, we agree with the removal of this allowed treatment. For the avoidance of doubt, this should not be taken to mean that exchange differences arising from foreign currency borrowings should no longer be capable of being capitalised as borrowing costs under IAS 23. We suggest that a paragraph to this effect is included after paragraph A20 in the Basis for Conclusions and that paragraph 26 makes specific reference to that treatment.

**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)?*

Yes. We see no reason why 'fair value adjustments' to assets and liabilities of a foreign operation should be treated any differently from the original book value of the assets and liabilities to which they relate. As far as goodwill is concerned, we believe it is more logical to treat it as a currency asset and translate at closing rate, since the value of the foreign operation is likely to be based on the expected future earnings stream expressed in the functional currency of that operation.

**Specific issues not covered in questions**

The reference to the Preface in the first paragraph of the Standard needs to be revised since the Preface no longer contains such a paragraph about 'immaterial items'.

The 'objective' should also contain some reference to the disclosures that are required by the Standard.

**Paragraphs 1 and 2**

Paragraph 1(a) excludes from the scope of this standard 'derivatives transactions and balances that are within the scope of IAS 39'. It is unclear whether the reference to 'balances' are those resulting from the transaction involving the derivatives or whether it is 'all' balances within the scope of IAS 39. We presume it is meant to be the former, in which case we suggest it says 'and any resulting balances'.

**Paragraph 6**

We consider that the definition of 'foreign operation' in paragraph 6 should be expressed in terms of 'functional currency', without making any reference to the country in which it is based. We suggest that the definition is changed to 'an entity that is a subsidiary, associate, joint venture or branch of the reporting entity, the functional currency of which is other than that of the reporting entity.'

We also believe that the definition should be supplemented with a definition of the term 'branch' or further guidance given as to what might constitute a 'branch'.

**Paragraph 7**

We believe paragraph 7(a)(ii) is unnecessary and can be deleted, since such a currency would be that indicated by the final words in parenthesis in paragraph 7(a)(i).

**Paragraph 8**

Paragraph 8(a) should be amended to say 'generated and serviced.'

**Paragraph 9**

The wording in paragraph 9 should be redrafted so as not to use the term 'foreign operation', since the guidance in paragraphs 7 to 14 is intended to enable a reporting entity to determine not only its own functional currency, but also that of its foreign operations. This is because if it is determined that a subsidiary has the same functional currency of the parent, then it is not a foreign operation for the purposes of the Standard. Paragraph 9(a) refers to 'local currency' but this is no longer a term used in the Standard.

**Paragraph 14**

For avoidance of doubt, the examples of monetary items should be expanded to include the obvious ones such as 'trade and other receivables', 'cash and cash equivalents', 'trade and other payables' and 'financial liabilities'. More importantly we consider that the Standard should deal with items that can cause difficulties in practice, such as investments, including investments in bonds and redeemable preference shares, convertible loans, preference shares and equity shares.

**Paragraphs 15 to 17**

Paragraph 16 suggests that the 'reporting entity' is the 'group' rather than the parent of the group and paragraph 52 calls for disclosure of 'a change in the functional currency of ... the reporting entity'. This gives the impression that there can be a group functional currency. We believe that this is not the case. Although paragraph 16 suggests that many groups will comprise a number of entities with different functional currencies, we believe that it should be made clear that there is no such thing as a group functional currency (unless all entities within the group have the same functional currency). The reality is that each separate entity (including the parent entity) has a functional currency. The group itself does not have a functional currency, only a reporting currency. We recommend that paragraph 16 should be redrafted accordingly.

We also consider that it should be emphasised that it is not only in groups where there may be entities with different functional currencies, but that the same could also apply to a single entity that has a branch that is a foreign operation under the Standard.

See also our comments below on paragraph 52.

**Paragraph 20**

Paragraph 20 refers to 'recognition under International Financial Reporting Standards'. This reference to other Standards is inconsistent with the reference in paragraph 22, where it just refers to 'other relevant Standards'.

**Paragraph 21**

We suggest that paragraph (c) is amended to say 'using the spot exchange rates'.

**Paragraphs 25, 26 and 27**

Since paragraph 25 gives an exception to the treatment required by paragraph 26, we suggest that paragraph 26 makes specific reference to this by adding at the end of the paragraph 'or in accordance with IAS 39, Financial Instruments: Recognition and Measurement.' We also think that it would be more logical if the order of these paragraphs were revised so that the present paragraph 25 comes after the present paragraph 27.

As noted in our answer to question 4, we also consider that specific reference should be made to the exception allowed for exchange differences arising from foreign currency borrowings capitalised as borrowing costs under the alternative treatment in IAS 23.

**Paragraphs 30 and 31**

We disagree with the requirement in paragraph 30 that the exchange differences on a monetary item forming part of a reporting entity's net investment in a foreign operation, should be recognised as income or expenses in the separate financial statements of the reporting entity or the foreign operation. We see no reason why such exchange differences should be taken to the income statement. Our understanding of the rationale of why, under the current IAS 21, such exchange differences are taken to equity rather than to the income statement, is that since settlement is neither planned nor likely in the foreseeable future, they do not represent or measure changes in actual cash flows or prospective cash flows of the investing entity. On that basis, the same would hold true for the separate financial statements of the reporting entity. Indeed, since the item is considered to be, in substance, part of the net investment, in our view it would be more appropriate to treat it as such, and therefore consider it to be a 'non-monetary item' under paragraph 21 (b) or 21 (c). Thus, either no exchange differences will be recognised, or they will be reflected in equity. Where the foreign operation is a subsidiary, associate or joint venture, the treatment of this part of the investment should be accounted for in a consistent manner with the treatment of the investment in the separate financial statements adopted under IAS 27.

The rationale for not reflecting the exchange differences in the income statement would also seem to be appropriate for the entity with the 'liability', although we can see that it may be illogical to treat the item as 'non-monetary' or 'equity' for the purposes of IAS 21 but as a liability for the purposes of IAS 39.

We also disagree with the treatment suggested in paragraph 31 where the monetary item is denominated in a currency other than the functional currency of either entity. For both entities any exchange differences do not represent or measure changes in actual cash flows, or prospective cash flows, and as such should not be reflected in the income statement of either entity; nor should they remain in the income statement of the financial statements that include both entities.

We are concerned that this change from the current IAS has not been included in the Summary of Main Changes, nor is there any justification for the proposed treatments within the Basis for Conclusions.

**Paragraph 47**

Since some of the exchange differences could relate to a monetary item that is considered, in substance, to be part of the net investment, we consider that paragraph 47 should refer to the reimbursement, or partial reimbursement of such an item.

**Paragraph 51**

Although we agree with this disclosure requirement, we believe that, since disclosure is only required if the presentation currency is different from that of the functional currency of the parent, it will not always to lead to disclosure in situations where such information would be of relevance. For example, a Swiss parent company whose functional currency is Swiss francs and that presents its financial statements in Swiss francs, would not be required to give any disclosure under this paragraph as presently drafted. However, if the functional currency of the principal operations of the group headed by that parent is the Euro, then we believe that disclosure should be given as to why the financial statements have been presented in Swiss francs rather than the Euro. Accordingly, we believe that disclosure should also be required where the presentation currency is other than the predominant functional currency of the group.

**Paragraph 52**

The wording of this requirement needs to be reconsidered. As noted earlier in relation to paragraph 16, by calling for disclosure of 'a change in the functional currency of ... the reporting entity' this paragraph gives the impression that there can be a group functional currency – which we believe is not the case. Also as presently drafted, this paragraph would require disclosure of a change in the functional currency of a subsidiary, even if consolidated financial statements are not being prepared by the parent. We presume that this is not what was intended, but that disclosure would only be made when there is a change in the functional currency of a significant foreign operation 'within the group'. However, the paragraph also needs to ensure that disclosure is given where there has been a change in the functional currency of a branch included within the financial statements of a single entity.

**Paragraphs 53 to 55**

We fail to see the need for paragraphs 53 and 54. The requirement of paragraph 53 does not appear to add any new requirement from that imposed by paragraph 11 in the proposed revised IAS 1. We suggest that paragraph 53 is deleted and the phrase 'and the requirements of paragraph 53 are not met' is deleted from paragraph 55. Paragraph 54 should then come after paragraph 55 in order to give some explanation of the requirement, but with some consequential changes to the wording as a result of the deletion of paragraph 53.

## Transitional arrangements

We believe that consideration should be given to including transitional arrangements for entities affected by the removal of the allowed alternative to capitalise certain exchange differences in paragraph 21 of the existing Standard, and by the removal of the option to translate goodwill and fair value adjustments at historical rates of exchange. It may be that entities will have practical difficulties in ascertaining the cumulative amount of exchange differences (net of accumulated depreciation) that have been capitalised under paragraph 21 in the past. Similarly, entities may have difficulties ascertaining the exchange adjustments that would have been made in prior years if goodwill and fair value adjustments had been retranslated at each year-end at closing rates, and the consequential adjustments to amortisation or depreciation in each of those years.

## General comments

We broadly support the revisions to IAS 24. However, whilst we understand that convergence is the driving force behind the majority of changes, the Board should not lose the opportunity to ensure that information relevant to users is presented in a 'relevant and comparable' manner. In particular, given the wide disparity of legislative requirements, the Board should ensure that a minimum level of disclosure for management compensation is achieved through this Standard (or if the Board intends to achieve this disclosure through other means, then a statement of intent should be included). If it is the Board's contention that the disclosure of management compensation is a matter of corporate governance rather than financial reporting, then we disagree with this as a reason for not requiring such disclosures. One could argue just as easily that the disclosure of EPS is a matter of financial analysis and not financial reporting, yet there is no suggestion that IAS 33 be withdrawn.

## 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'.*

Paragraph 6 to the Preface sets an objective of the IASB as 'to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting Standards that require high quality, transparent and comparable information in financial statements and other financial reporting ...'. Currently there are significant differences between countries as to the extent and quality of disclosures with regard to executive compensation, with disclosure requirements often being enacted in national legislation. Recent high profile cases in both the US and Europe have indicated that users of financial statements expect transparent disclosure of executive compensation. We believe that, given the current diverse standards of management compensation reporting, in order to achieve the above objective the IASB should prescribe a minimum level of disclosure for executive compensation, with IAS 24 being the logical Standard to do this in.

We note the Board's Basis for Conclusions in paragraph A3 of Appendix A, avoids this issue and lists as reasons three difficulties that any national standard-setter would face. Our response to the three points is as follows:

(a) Whilst some jurisdictions have processes for approving management compensation to ensure an 'arms length' result, it is clear that many jurisdictions do not. To facilitate financial statements being both understandable and comparable, as well as to enable shareholders to assess the reasonableness of management compensation versus performance, minimum disclosure is required;

(b) We do not believe privacy is of significance. In accepting a fiduciary position key management must be transparent in all their dealings with the entity; and

(c) We accept that definitional issues will arise given the legal and structural differences that exist between countries. However, we believe that the proposed definition of 'key management personnel' in paragraph 9(d) of the Exposure Draft (which should be expanded to include shadow directors) captures the group of individuals for whom such disclosures should be made. We believe that the disclosures could be given in aggregate and in 'bands' (without disclosing the names of the individuals concerned), though the amounts attributable to the highest paid director should be disclosed separately. The top band could be defined by reference to the salary of the highest paid individual and lower bands could be based on a percentage (e.g. 10%) of the salary of the highest paid individual. Additionally, the revised Standard should include a description of the types of management compensation to be included within the aggregation (salary, fees and tangible benefits).

We believe costs relating to post-employment benefit plans for key management personnel should be disclosed in aggregate, again with amounts relating to the highest paid director being separately disclosed. Though the Board is working on proposals regarding reporting for Share Based Payments, we believe that in the period before those new rules come into force, disclosure of the nature of such compensation should be required.

**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 wholly-owned subsidiary that are made available or published with consolidated financial statements for the group to which the entity belongs (see paragraph 3)?*

Yes. However, we believe the current wording of paragraph 3 is potentially confusing as it refers to subsidiary financial statements that are 'made available or published with consolidated financial statements of the group'. A literal reading may result in the interpretation that to get the exemption the subsidiary entity accounts must be included as part of the pack containing the group accounts. We believe that the exemption should only apply to 100% subsidiaries consolidated into the financial statements of the group, provided those consolidated financial statements are publicly available, and provided any entity that has taken advantage of the exemption discloses in its individual financial statements the name of the parent company that enabled them to do so and the address from where the consolidated financial statements can be obtained.

**Specific issues not covered in questions**

**General**

We believe the Board should take the opportunity to use this revision to exempt certain transactions from disclosure, where this disclosure distracts the user from those related party transactions that are more worthy of their attention. Particular examples being:

Participation by major shareholders in transactions with shareholders as a whole (e.g., dividends and rights issues); and

Where companies trade with the public (e.g., retailers, certain banks and insurance companies), transactions with key management personnel (and their close families and entity's controlled by them) as members of the public on non-preferential terms. However, transactions with such individuals in a business capacity should, in our view, always be disclosed, whatever the terms.

**Materiality**

There are no specific details on assessment of materiality in the context of related party transactions. We believe that it is appropriate that materiality be assessed in the context of both parties to the transaction, rather than just the reporting entity, and that the revised Standard should state this explicitly.

**Scope**

Paragraph 4(d) of the original text of IAS 24 exempted state-controlled enterprises from having to disclose transactions with other state-controlled enterprises. Though we understand that disclosure of such transactions can be key to understanding the financial position of state-controlled enterprises, a blanket requirement to disclose all transactions with other state-controlled enterprises is quite onerous in many countries. Therefore, we would argue in favour of a solution under which state-controlled enterprises disclose only those transactions with other state-controlled enterprises that take place under terms and conditions that are not available to the general public.

**Paragraph 2**

The wording of paragraph 2 states that no disclosure is required of '... management compensation, expense allowances and similar items paid in the ordinary course of an entity's operations.' One would expect that all compensation to management be paid in the ordinary course of an entity's operations. Without further clarification by the Board, it is unclear under what circumstances disclosure of management compensation and similar items would be expected. In any event, as stated both in our 'General comments' and in our answer to Question 1, we believe that IAS 24 should require unequivocally the disclosure of management compensation and similar items.

**Paragraph 6**

The example given in the third sentence appears to apply to both scenarios and therefore would be better as the ultimate sentence.

**Definition of close family (paragraph 9)**

We agree with the inclusion of a definition of close family. However, the examples given in the definition are restricted to domestic partner and children. Whilst we understand the definition is phrased such that it intends to capture a wider grouping (parents, siblings etc.) we are concerned that having a narrow group of examples may result in preparers limiting themselves to this narrow grouping in their considerations. Further, apart from 'domestic partner' the definition is restricted to family. In the UK, for example, FRS 8 extends the definition to 'members of the same household', and we believe the definition in IAS 24 should be extended similarly so as to enable 'non-family' to be included.

**Disclosures (paragraphs 12 to 19)**

From our reading of paragraphs 12 to 19 it is not entirely clear whether disclosure of the names of related parties is required, our presumption is that it is not. In our view, disclosure of the identity of the related party is necessary to gain a full understanding of the nature and effect of the transaction, and it should be made clear that such disclosure is required by the Standard.

# Appendix 10 – IAS 27 Consolidated and Separate Financial Statements

## Question 1

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

We agree that parent companies that are themselves subsidiaries should be exempt from the requirement to prepare consolidated financial statements (with the consent of minority shareholders when appropriate). However, we disagree with the proposed textual amendments to paragraph 8 and believe that the existing text should be retained, subject to the need to remove the reference to a 'virtually wholly owned' subsidiary.

In our view, the proposed revised wording creates a number of difficulties and anomalies, in part we suggest because it strays into areas that are probably best left to local regulation, as we discuss below.

Sub-paragraph (a) appears to be based on a similar requirement in the EU Seventh Company Law Directive, but (unlike the Directive) without giving any guidance as to how or when such agreement is to be sought.

We suggest that sub-paragraph (b) should be re-worded to 'none of its securities are publicly traded'. This makes it absolutely clear that this refers to listed preference shares or debt as well as equity shares (which we assumes was the intention). A similar change to paragraph (c) may be desirable.

There are two matters of concern in sub-paragraph (d). First, it appears to require the preparation of consolidated financial statements under IFRS by either the immediate or ultimate parent. In other words, a company would not qualify for the exemption in this paragraph if a company which is a parent of the immediate parent, but a subsidiary of the ultimate parent, prepares financial statements under IFRS. We assume that this is simply a drafting error, as we cannot conceive on what basis the IASB can have intended this exemption not to be available when a parent other than the immediate or ultimate parent prepares group accounts.

A further issue is that sub-paragraph (d) does not require the financial statements of the company (hereafter 'H') being relied on by the company claiming the exemption (hereafter 'S') to be audited. In cases where they are not audited, is the auditor of S required to audit H's financial statements in order to ensure that they do indeed comply with IFRS before he can issue an opinion on S's financial statements. If H's financial statements are audited, what are the implications, if any, of an audit qualification for non-compliance with IFRS? As currently drafted, sub-paragraph (d) would apparently prevent S from taking the exemption (since H's financial statements do not in fact comply with IFRS). However, it could well be that the qualification related to a completely different part of the whole group from S's sub-group. It might also be the case that S's sub-group was immaterial to the overall group financial statements. When issues such as this are considered, the absence of any such condition in the original version of IAS 27 becomes clear, suggesting such matters are best left to other regulators.

In addition, we do not support the anomalous situation that this exemption is not available to a company that has associates but no subsidiaries. Please see our more detailed comments on these issues under 'Paragraph 8' below.

**Question 2**

*Do you agree that minority interests should be presented in the consolidated balance sheet within equity, separately from the parent shareholders' equity?*

No. Contrary to what is stated in paragraphs A8 and A9 of the Basis of Conclusions, there are many shares that would be classified as 'minority interests' by IAS 32 as currently drafted that are clearly liabilities under the Framework from the point of view of the group as a whole. For example, we believe that preference shares issued by a subsidiary, in respect of which another member of the group has guaranteed dividend and/or redemption payments in the event that the issuing company is unable to meet them, are, under the Framework, equity instruments of the issuing company but a liability of the group as a whole.

We have commented on this issue in more detail in our response to draft IAS 1.

**Question 3**

*Do you agree that investments in subsidiaries, jointly controlled entities and associates that are consolidated, proportionally consolidated or accounted for under the equity method in the consolidated financial statements should either be carried at cost or accounted for in accordance with IAS 39 ... in the investor's separate financial statements?*

No.

We do not believe that the IASB has justified its proposed abolition of the option of equity accounting for such investments. Paragraph A13 simply asserts, without any evidence, that such information is not relevant whereas fair values are relevant. If anything, we suggest that equity accounting brings greater objectivity, given that, in the case of the unlisted and infrequently traded companies that form the great majority of such investments, 'fair value' is arguably no more than a best guess.

Moreover, such a method is arguably conceptually inappropriate, in the sense that one of the criteria for determining that an investment is a subsidiary, associate or joint venture is that the investment is held for the longer term and not for immediate disposal. To give the fair value of such investments based on the estimated proceeds of an immediate disposal conflicts with this criterion, and the underlying commercial objective of holding such investments.

We also have some concerns with the definition of 'cost method' in paragraph 6 and believe that the words after 'distributions' should be deleted for several reasons. First, it is questionable whether all 'pre-acquisition' dividends should automatically be treated as a return of capital. In our view the better analysis is that they are income, but that they may give rise to a need to adjust the carrying value of the subsidiary concerned.

Second, this definition implicitly assumes that the carrying value of a subsidiary is its fair value at the date of acquisition, which is not necessarily the case. It may already have been reduced by an impairment write-down or (in the case of a subsidiary acquired for an issue of shares) been recorded, in accordance with the requirements of local legislation, at the nominal value, rather than the fair value, of the shares issued.

Third, it is possible that a company could receive a dividend other than from the 'net profits' of the subsidiary (for example in certain jurisdictions from paid in capital). If the capital was paid in by external shareholders, there is no case for applying such a dividend to reduce the cost of investment of the holding company, as would be required under this definition as drafted.

**Specific issues not covered in questions**

**Paragraph 8**

As noted in our response to Question 1 above, we generally support the proposition that subsidiaries should be exempt from preparing group financial statements (with the consent of minority shareholders where applicable) but believe that this aim was better achieved by the original wording of IAS 27, subject to the need to adjust the reference to a 'virtually wholly owned' subsidiary.

Another general issue is that, as drafted, new paragraph 8 gives an exemption from preparing consolidated financial statements only to a 'parent'. In other words, if a wholly-owned subsidiary has an interest in an associate or joint venture, it must (under the proposed amendments to IAS 28) equity account/proportionally consolidate its investment in the associate or joint venture in its own financial statements. In our view there is simply no logical basis for the view that equity accounting/proportional consolidation is required to show a true and fair in the financial statements of a subsidiary without subsidiaries, but not in the financial statements of a subsidiary with subsidiaries. In any event, it would be extremely easy to circumvent such a requirement by purchasing a dormant company with minimal capital, thereby becoming a 'parent' and qualifying for the exemption.

Paragraph 8 cross-refers to paragraph 29 and 30. However, paragraphs 29 and 30 as drafted are not relevant since they apply to the accounting treatment of 'investments in subsidiaries, jointly controlled entities and associates that are consolidated, proportionally consolidated or accounted for under the equity method *in the consolidated financial statements*' (emphasis added). Where consolidated financial statements are not prepared (whether as permitted by paragraph 8 or because the company in question has no subsidiaries), there are no such investments.

**Paragraph 11**

It is not entirely clear how the requirement in this paragraph to consolidate 'all' subsidiaries is intended to interact with the general statement in the rubric following the title that the Standard does not apply to immaterial items. If the intention is that immaterial subsidiaries need not be consolidated, there needs to be clarification (either here or, preferably, in the more general provisions of IAS 8) that any test of materiality must be applied to the aggregate of subsidiaries proposed to be excluded from consolidation on these grounds rather than to each subsidiary individually.

**Paragraph 12A**

Whilst we agree with the broad thrust of this paragraph, we are concerned that it is drafted in too generalised a manner, with the real risk that it could be interpreted as excluding from consolidation investments which we assume the IASB does not intend to exclude. Many jurisdictions provide mechanisms for a company to enter into a 'legal reorganisation' so as to prevent loss of control or significant influence by the investors. We suggest that it would be better to describe the circumstances which the IASB has in mind rather than to use a quasi-legal term that could be understood and interpreted differently in different jurisdictions.

**Paragraphs 12B and 15A**

These amendments purport to incorporate SIC-33 into IAS 27, but in fact they do so only partially, since it is only the 'consensus' paragraphs that have been incorporated, while the Basis for Conclusions and the illustrative appendices of SIC-33 have been omitted. There must be a real risk that, without some of this supporting material, paragraph 12B will not be interpreted as originally intended by the SIC.

However, we believe that there is a good case for not incorporating the substance of the second and subsequent sentences of paragraph 5 of and Appendix B to SIC-33 into a revised IAS 27, as these provisions are somewhat confusing and address derecognition issues that more properly fall within the scope of IAS 39.

**Paragraph 13**

Guidance is required on the accounting treatment to be adopted if a subsidiary is initially excluded from consolidation but is ultimately held for more than one year. It is unclear whether the subsidiary should continue to be accounted for under IAS 39 (which is what is required by this paragraph if read literally), since the criterion is whether or not the investment is held with a view to its disposal in one year, not whether it is in fact disposed of in that time. In other words, the exemption is based on management intent, not on fact.

However, the Board has always tried to avoid having management intent drive the accounting. While introducing (or retaining) it here may be understandable, we think it is necessary for the standard to deal with the situation where the assumption that a subsidiary is held for subsequent disposal within twelve months from acquisition is no longer appropriate. It may help to have a cut-off point (such as the end of the accounting period following that in which the subsidiary was originally acquired), beyond which point control of the subsidiary can no longer be deemed to be temporary, and should be consolidated. In such circumstances, goodwill should be calculated by reference to the net assets at the date of original acquisition, and the prior year should be restated as if full consolidation had been applied from the date of acquisition.

**Paragraphs 17 and 18**

In our view these paragraphs should clarify whether or not eliminations of transactions involving partially-owned subsidiaries should be apportioned between the majority and minority interests.

**Paragraphs 19 and 20**

Neither of these paragraphs clearly states the implied underlying principle that coterminous accounting periods should be used. Paragraph 19 is drafted as if the use of non-coterminous periods is the norm rather than a deviation from it.

**Paragraph 23**

This should be a bold paragraph as it introduces a new point of principle rather than merely amplifying the rule in paragraph 21.

It should also clarify that the profit or loss on disposal should take account of any goodwill arising on acquisition that has not been amortised or subject to a write-down for impairment, including any goodwill that was offset against equity under the transitional arrangements in IAS 22.

Guidance should also be provided on the accounting treatment of deemed disposals or dilution gains and losses (i.e., transactions in which the reporting entity's interest reduces, following further investment by one or more other shareholders). In our view, such gains and losses should be recognised in the income statement.

**Paragraph 29**

The wording of the heading should be amended not by deleting the words 'in Subsidiaries', but by adding immediately after them ', Jointly Controlled Entities and Associates', since this paragraph does not deal with all forms of investment (as would be implied if amended as proposed), many of which fall only within IAS 39.

Please see also our comments under Question 3 and paragraph 8 above.

**Paragraph 29A**

Please see our comments under paragraph 8 above.

**Paragraph 32**

We do not understand why former sub-paragraphs (a) and (b)(iv) of paragraph 32 have been deleted or why the requirement to give the name of a subsidiary in the context of certain other disclosures have been removed. We regard disclosure of the name of a subsidiary and the proportion held as essential and a good deal more 'relevant' to users than the fair value accounting proposed in paragraph 29.

New sub-paragraph (b) seems redundant, given that under the proposals any unconsolidated subsidiary will be shown at fair value.

Sub-paragraph (f) should refer to 'any significant restrictions' (as in new paragraph 12A). The fact that a subsidiary is in a different time zone is a 'restriction' as funds could not be transferred on the same working day, but we do not believe that restrictions of this nature were what the Board contemplated.

**Paragraph 33**

The proposed disclosure in sub-paragraph (a) seems pointless, given that the reason will be satisfaction of the conditions for not preparing consolidated financial statements as fully set out in paragraph 8.

It is not clear what is meant by the requirement in sub-paragraph (b) to provide a 'reference' to the consolidated financial statements.

**Paragraph 34**

We do not understand the purpose of the proposed requirement in the final sentence, since it adds nothing to the general requirements of IFRS with respect to changes in accounting policy. No real information would result, since the proposed requirement is simply that an entity disclose that there is 'an effect', but without giving any description or quantification of it. It is also not clear why an entity should be required to disclose that there is an effect on the financial statements in the case of early adoption, but not otherwise.

## 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, when such measurement is well-established practice in such industries?*

Although we broadly support this change, we do so with a number of major reservations and believe that paragraph 1 must be substantially reworded in order to clarify the conditions that must be met for an entity to claim exemption from applying the Standard.

We have two basic concerns with the current wording:

(a) There are no definitions of 'venture capital organisation', 'mutual funds' or 'unit trusts' in IAS 28, nor are there any generally accepted definitions as a matter of English usage. This is further complicated by the extension of the exemption to 'similar entities'. For example, could a holding company of a diverse group argue that it, or at least some segment of the group, was a 'similar entity'?

(b) As currently drafted the exemption arguably applies to nothing at all, since it refers to investments 'measured at fair value in accordance with IAS 39, Financial Instruments: Recognition and Measurement, when such measurement is well-established practice'. In several countries in the world there is a well-established practice of fair value accounting for investment companies. Very few of those countries, however, currently apply IAS 39. Even where IAS 39 is applied, it is questionable whether its requirements could be described as 'well established' practice, given that IAS 39 has been in issue for less than two years. In addition, would this exemption be available to first-time adopters of IFRS who, by definition would be unable to assert that 'there is a well-established practice'? Accordingly, we suggest deletion of the words 'in accordance with IAS 39, Financial Instruments: Recognition and Measurement'.

In addition, we have a conceptual difficulty with the fact that this exemption applies only to investments in associates and not to investments in subsidiaries, and do not believe that the IASB has provided a reasoned basis for its conclusions on this issue. In our view the reasoning in paragraph A4 of the Appendix for not equity accounting for such investments (essentially that equity accounting does not give relevant information and the market values are readily available) would apply equally to subsidiaries. Conversely, the reasoning given in paragraph A7 for consolidating a subsidiary (that it is 'part of the structure through which the group operates its business') would apply equally to an associate.

A further reason given in paragraph A7 as to why consolidation is appropriate for subsidiaries is that the investor controls them. However, the restrictions typically placed on an investee by a venture capital investor mean that the 'significant influence' exercised over the investee is much closer to control than would typically be the case with strategic investments held by other entities. This means that the move to full control is far from being the watershed implied in paragraph A7, since the impact on the investee of a move from associate to subsidiary status may not be very great.

Moreover, revised IAS 27 will require all subsidiaries where control is intended to be temporary (as is generally the case for portfolio investments held by investment companies) to be carried at fair value.

There appears to be an inconsistency in the way that venture capital organisations are required to account for investments. Under the revised wording of IAS 39 they will be required to account for changes in the fair value of their available-for-sale investments in equity, thus a 15% holding by a venture capital organisation would be accounted for in this manner. However, were that holding to be 25% the proposed revision to IAS 28 would require the changes in the fair value to be accounted for in income for the period. We do not consider this difference in treatment is sensible for this type of organisation and recommend that all changes in the fair value of investments by venture capital organisations are accounted for in equity.

Another issue, not directly addressed, is the treatment of the accounting difference that will arise if an investment previously accounted for in accordance with IAS 39 as described above, is increased such that the investee becomes a subsidiary. Such an accounting difference will typically be a debit, as the share of net assets at fair value is normally lower than market value.

Mechanically speaking the only options appear to be:

(a) the immediate recognition of a loss (when no economic loss has occurred);

(b) the creation of goodwill (which would in effect be internally generated goodwill, contrary to IAS 38); or

(c) a prior year adjustment (when there has been no accounting error or change of policy),

all of which are unsatisfactory for the reasons indicated.

**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?*

We disagree with this proposal as described here. There could well be situations where an associate is incurring losses but remains sufficiently solvent to pay loan finance as it falls due. However, the actual proposed requirement in paragraph 22 of the Exposure Draft is somewhat different from that implied by Question 2. Paragraph 22 states that the write-down should apply to such items that in substance form part of the equity investment (rather to than all long-term debts as implied here).

In our view, there is confusion as to the basis on which an item is considered to be part of the equity investment in an associate. Revised paragraph 22 states that 'an item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension to, or deduction from, the entity's investment in equity.' However, the next sentence states unequivocally that trade payables and receivables do not form part of the equity investment, apparently irrespective of whether 'settlement is neither planned nor likely to occur in the foreseeable future'. This seems to be giving precedence to form over substance contrary to the underlying thrust of the paragraph. A similar contradiction appears in paragraph 13 of the Exposure Draft of the revision to IAS 21.

**Specific issues not covered in questions**

**Paragraph 5A**

This paragraph is intended to incorporate the substance of SIC-33 into IAS 28. However, we are not clear that it does so since it reflects only the requirement of SIC-33 that contingent rights should be taken into account in determining whether or not an investment is an associate. It does not reflect the explicit requirement of SIC-33 that the share of the investment accounted for should be based only on the actual current holding. Whilst this is arguably implicit in paragraph 16A, it is by no means as clear as in SIC-33. We recommend that, for the avoidance of confusion, this point should be made explicitly.

Moreover it is only the 'consensus' paragraphs of SIC-33 that have been (partially) incorporated, whilst the Basis for Conclusions and the illustrative appendices have been omitted. There is a substantial risk that without some of this supporting material, paragraph 5A will not be interpreted as originally intended by the SIC.

However, we believe that there is a good case for not incorporating the substance of the second and subsequent sentences of paragraph 5 of and Appendix B to SIC-33 into a revised IAS 28 as these provisions are somewhat confusing and deal with derecognition issues that more properly fall within the scope of IAS 39.

**Paragraph 5B**

Whilst we agree with the broad thrust of this paragraph, we are concerned that it is drafted in too generalised a manner with a real risk that it could be interpreted as excluding from equity accounting investments that we assume the IASB does not intend to exclude. Many jurisdictions provide mechanisms for a company to enter into a 'legal reorganisation' so as to prevent loss of control or significant influence by the investors. We suggest that it would be better to describe the circumstances the IASB has in mind, rather than to use a quasi-legal term that could be understood and interpreted differently in different jurisdictions.

**Paragraph 6**

We are concerned about the possible effect of the insertion of the words 'The investor's share of the profit or loss of the investee is included in the investor's profit and loss' on the accounting treatment of deemed disposals or dilution gains and losses (that is, transactions in which the reporting entity's interest reduces following further investment by one or more other shareholders).

The newly inserted words may be taken to imply that it is *only* the investor's share of the associate's own profit that goes to the group profit and loss account. If it is read that way, coupled with the fact that the paragraph goes on to say dividends received go to the balance sheet and that other changes in the carrying amount go to equity, the inference drawn might be that profits on deemed disposals (which arise from changes in the carrying value of the associate, other than from an underlying profit of the associate) also go to equity.

We are not clear whether this was the IASB's intention or, if it was, whether it is consistent with the IASB's framework, which, in our view, would require such gains or losses to be included within the profit and loss account.

**Paragraph 8**

Guidance is required on the accounting treatment to be adopted if an associate is initially not equity accounted for, but is ultimately held for more than one year. It is unclear whether the subsidiary should continue to be accounted for under IAS 39, which is what would be required by this paragraph if read literally, since the criterion is whether or not the investment is held with a view to its disposal in one year, not whether it is in fact disposed of in that time. In other words, the exemption is based on management intent, not on fact.

In our view, if such an investment is not sold by the end of the accounting period following that in which it was originally acquired, it should be accounted for under the equity method. Application of the equity method should be based upon the original historical cost and the fair value of net assets at the date of original acquisition, with the prior year restated as if equity accounting had been applied from the date of acquisition.

**Paragraph 8A**

This paragraph raises a number of issues. It appears from the 'Summary of Main Changes' that the IASB intends the revised Standard to 'require the use of the equity method of accounting for an investment in an associate when an investor does not prepare consolidated financial statements because it does not have any subsidiaries'.

However, this does not appear to be the effect of paragraph 8A which states that equity accounting is required 'irrespective of whether the investor also has investments in subsidiaries or whether it describes its financial statements as consolidated financial statements'. As drafted this would apply to an intermediate holding company exempt from preparing group financial statements under paragraph 8 of the revised IAS 27.

There also appears to be a conflict with paragraph 24A of the revised IAS 28 which states that in 'separate financial statements' paragraphs 29, 30 and 33 of the revised IAS 27 apply (which broadly require investments to be carried at cost or market value). It may be that the IASB intended the phrase 'separate financial statements' in paragraph 24A to be construed as defined in paragraph 4 of draft IAS 27. If this is the intention, it should be made explicit.

However, even such clarification would not remove a further problem. The following phrase in paragraph 8A: 'irrespective of whether the investor also has investments in subsidiaries or whether it describes its financial statements as consolidated financial statements' appears to overrule any relaxation that might be offered by paragraph 24A.

We recommend that the IASB clarify both its thinking and its drafting.

**Paragraph 16A**

We broadly support the thrust of this paragraph, but question whether all its ramifications have been fully considered. This possibility can be illustrated as follows:

Reporting entity (A) holds 10% of another entity (B), with the other 90% of B being held by J, a joint venture in which A has a 50% interest. Under IFRS, A will account for 50% of J and therefore (indirectly) 45% of B. However, it could be argued that the effect of paragraph 8A, combined with the '20% presumption' in paragraph 4, is that A cannot equity account for the 10% that it holds directly. This seems an altogether unsatisfactory result, which begs the question of whether voting rights held 'indirectly' through associates and joint ventures should (like contingent rights to shares as addressed in paragraph 5A) be taken into account in determining whether or not significant influence exists. It may be that the IASB takes the view that issues such as this are adequately covered by the fact that the '20% presumption' in paragraph 4 is rebuttable. However, we would not find this a convincing response, since there would be no need for paragraph 5A on this basis, whereas the IASB clearly considers that such a specific clarification is required.

Another issue that may require further consideration is the question of dual-listed companies with two parents. It may well be that there are group management structures or earnings equalisation agreements in place in such entities that make it appropriate for one parent to equity account for investments held through associates or joint ventures, even though the second parent is the only other shareholder in that associate or joint venture.

**Paragraph 16B**

This simply incorporates the requirements of SIC-3. However, experience in the UK with a similar generally-worded requirement suggests that this paragraph will prove insufficiently clear, and have to be addressed by IFRIC in the near future. In the first instance, paragraph 16B gives no guidance as to how the profit is to be eliminated. Is it to be 'parked' in equity pending eventual recycling on the ultimate sale of the asset that is the subject of the transaction? Is a prepayment or accrual to be recognised? Or is the carrying value of other assets or liabilities to be adjusted and, if so, which? It may be that the methodology in paragraph 7 of SIC-13 should be adopted here.

Draft paragraph 16B also fails to address the accounting treatment for the increasingly common situation where two or more entities pool existing businesses into a new entity, which thereby becomes an associate of one or more of them. Again, experience in the US and the UK suggests that guidance is needed to address this method of combining resources.

**Paragraphs 18 and 18A**

In rare cases it may be that compliance with the 'three month' rule would, if the associate is a publicly traded company, result in the publication of price-sensitive information in contravention of the laws or regulations governing the associate. On the basis that, in such cases, the 'three month' rule would have to be ignored, we believe that it would be better to acknowledge this by way of a further exemption, rather than either to ignore the issue; or to force investors to receive a qualified audit opinion for failure to apply IAS 28.

**Paragraph 29**

We do not understand the purpose of the proposed requirement in the final sentence, since it adds nothing to the general requirements of IFRS with respect to changes in accounting policy. No real information would result, since the proposed requirement is simply that an entity disclose that there is 'an effect', but without giving any description or quantification of it. It is also not clear why an entity should be required to disclose that there is an effect on the financial statements in the case of early adoption, but not otherwise.

# Appendix 12 – IAS 33 Earnings Per Share

## General comments

There are numerous proposed changes from the current Standard that are not discussed in the exposure document. We believe that they should be discussed and analysed fully in a revised Exposure Draft.

We are unable to support this draft Standard, at least in its current form. Our main reasons for this are:

First, there are a great many changes proposed, indeed so many that the Board decided it inappropriate to publish the draft in mark-up mode. The vast majority of these proposed changes are not addressed in the Basis for Conclusions, or in the specific questions in the invitation to comment. It is clear that the proposed changes are not restricted to minor issues of drafting. For example, 'contingently issuable shares' is included in the draft as a defined term, but the definition does not reflect the natural meaning of those words. In the absence of either a discussion of the reason for all these changes, or an assessment by the Board of their impact, we do not believe that meaningful consultation can be achieved. Furthermore, the Board is risking adopting a Standard that, like IAS 39, will give rise to a significant number of implementations questions, and will need to be revised yet again shortly after adoption;

Second, the proposed approach of determining the number of shares in the computation by reference to quarterly reported figures is introduced solely by worked examples in Appendix B. The approach is not set out in the text of the Standard itself. In our view, the Basis for Conclusions should explain the reason for this change and, should the new methodology go ahead, any eventual Standard should clearly set out the requirement and specify what the interim periods should be.

## 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?*

Yes.

## 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).*

No. As noted earlier, the text of the proposed Standard as currently drafted does not actually set out the above approach. It is only the appended worked examples that illustrate this requirement, and in them 'interim' as used in the question above is taken to mean quarterly.

In order to support the proposed change we would need to understand the Board's rationale for it. Also, the Standard would need to be amended to actually require such a treatment, and also to set out unequivocally the duration of the interim periods to be used.

**Specific issues not covered in questions**

**General**

We believe the Board should have taken the opportunity to improve the structure of IAS 33, which is not satisfactory as currently drafted. For example, it is only by implication that an entity subject to IAS 33 can understand that it is required to disclose EPS numbers at all. Paragraph 1 is only a scope paragraph; paragraph 2 only states that if EPS numbers are disclosed they should be in accordance with IAS 33; while paragraph 3 is an exemption to a requirement that is not in IAS 33. Paragraph 8 only relates to the measurement of EPS and only deals with the calculation, not the disclosure of EPS numbers; while the disclosure paragraphs do not contain a requirement to disclose EPS numbers.

The proposed new paragraph 8, which falls under the measurement section, seems to combine a measurement issue (how to calculate EPS numbers) with a disclosure issue (that an entity should calculate EPS for both profit or loss from continued operations, and the net profit or loss).

**Parent company-only EPS (old paragraph 2)**

Paragraph 2 of the old version of IAS 33 did not require presentation of EPS based on the parent company-only financial information. This exemption has been deleted in the revised version of IAS 33. In the light of the limitations of EPS figures – as indicated in the Objective to the Standard – we believe that disclosure of two different sets of EPS figures only serves to create confusion, especially as the parent company-only financial statements are generally only included to indicate to what extent the parent company's equity is distributable to shareholders.

**EPS from continuing activities (paragraph 8)**

Under paragraph 8 of the revised IAS 33, entities are now required to disclose EPS based on 'profit or loss from continuing operations' in addition to EPS based on 'profit or loss for the period'. While we agree that it requires relatively little effort on the part of the preparers of the financial statements, we believe that the Board should explain why these additional disclosures are necessary or required.

**Increasing rate preference shares (paragraph 13)**

Paragraph 13 of IAS 33 now includes guidance on how 'increasing rate preference shares' should be taken into account in calculating earnings per share. The guidance in this paragraph appears to be inspired by the SEC's Staff Accounting Bulletin No. 68 (Topic 5Q). Unfortunately, the Basis for Conclusions does not address this change in the Standard and we are left to speculate:

Why the IASB believes this guidance should be included in IAS 33; and

Whether paragraph 13 (which is only seven lines long) is the functional equivalent of the more than two pages of US guidance.

**Repurchase of preference shares (paragraph 14 to 16)**

Paragraphs 14 to 16 of IAS 33 now require an entity, for the purposes of calculating EPS, to adjust its earnings for the period by the amount of 'gains' or 'losses' on the repurchase of preference shares. This change to IAS 33 gives rise to a number of questions:

Why is the IASB introducing a new earnings concept for the purposes of calculating EPS?

Does this lead to convergence or not?

Why does the revised Standard only require earnings to be adjusted for repurchases of preference shares (an undefined term in the context of IAS) and not for the repurchase of other types of shares?

Unfortunately the Basis for Conclusions does not provide answers to any of these questions, nor does it provide an explanation why this approach would increase the relevance of EPS numbers reported.

**Shares issuable after the passage of time (paragraph 21)**

We agree with the clarification made in paragraph 21, which now requires shares to be issued solely after the passage of time to be treated as outstanding for the purposes of calculating basic earnings per share.

**Consolidation of shares (paragraph 25)**

Paragraph 56 of IAS 33 requires that in the case of a 'reverse share split' the earnings per share be adjusted retrospectively. The new wording which can be found in paragraph 25 of IAS 33 seems to be providing an exception to the general rule by requiring 'The weighted average number of ordinary shares outstanding for the period in which the combined transaction takes place is adjusted for the reduction in the number of ordinary shares from the date the special dividend is recognised.'

We believe that there are some significant shortcomings in this aspect of the Exposure Draft:

The Exposure Draft does not explain why this change leads to improved financial reporting;

Though paragraph 25 states that an adjustment should be made when 'a share consolidation is combined with a special dividend and the overall effect is a share repurchase at fair value', it is not clear what is meant by this; and

The Standard does not indicate how preparers should go about 'adjusting for the reduction in the number of ordinary shares'.

**Copying of SFAS 128 (paragraphs 43 to 53)**

A significant amount of text has been copied into IAS 33 from the US Standard SFAS 128. However, instead of copying SFAS 128 in its entirety the Board has opted for the approach of copying guidance from that Standard on a piecemeal basis and, in some cases, to modify the wording of the paragraphs copies. For example:

Paragraph 43 of IAS 33 is based on SFAS 128.18, but the wording has been modified slightly. However, SFAS 128.19 has not been imported into IAS 33, despite the fact that it provides further guidance on the issue addressed in paragraph 43; and

Paragraph 44 of IAS 33 appears to be inspired by SFAS 128.23 and SFAS 128.109, but important differences in the drafting exist.

Similar issues exist regarding paragraph 51 of IAS 33,which is loosely based on SFAS 128.29:

Where SFAS 128.29 requires that it '...shall be presumed that the contract will be settled in common stock and the resulting potential common shares included in diluted EPS ... if the effect is more dilutive'; paragraph 51(a) of IAS 33 requires that the entity '...shall presume that the contract will be settled in ordinary shares, and the resulting potential ordinary shares shall be included in diluted earnings per share if the effect is dilutive';

Paragraph 51(b) and (c) also differ from the guidance in SFAS 128.51; and

Paragraph 52 seems to modify the way paragraph 51 should be interpreted, which raises the question why the guidance in paragraph 52 has not been integrated into paragraph 51.

We do not believe that this approach provides a solid basis for accounting standard-setting. It appears inevitable to us that the implementation of a loosely drafted Standard such as IAS 33 will result in significant practical problems, especially since the IASB has decided not to copy the Basis for Conclusions and all the examples included in SFAS 128.

## Appendix 13 – IAS 40 Investment Property

### Question 1

*Do you agree that the definition of investment property should be changed to permit the inclusion of a property interest held under an operating lease provided that:*

*(a) the rest of the definition of investment property is met; and*

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

We agree with the Board's approach of modifying IAS 40 to address the problem of leasehold property interests, rather than basing the definition of investment properties on interests under finance leases in accordance with IAS 17. It is correctly argued in paragraph A4 that not all leasehold interests would be accounted for as finance leases, even with the new emphasis being given to the classification of leases of land and buildings in the Exposure Draft of revisions to IAS 17. On a point of detail, however, it would be better to use a lease with market rent reviews (i.e. the rent could go down as well as up) as an example of an interest that would still be classified as an operating lease under IAS 17. A lease with upward-only rent reviews could in some circumstances be classified as a finance lease.

We agree also with both proposed conditions. The treatment of property interests held under operating leases is only an issue for those investment property companies that carry all properties at valuation and do not depreciate them.

### 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?*

Although we support the principle of including properties held under operating leases within the definition of investment property, we disagree with the manner in which this principle is being implemented in the Exposure Draft. If operating leases in respect of investment properties are to be accounted for as finance leases, this should apply to all such operating leases, and should not be restricted to entities that have adopted the fair value approach. Furthermore, even in this latter case, entities should not have the freedom to choose whether to treat an operating lease as a finance lease on a property-by-property basis.

The proposed revisions introduce a number of different permutations of options where, by contrast, the Board has a general policy of reducing them. Neither is it clear whether the option to make a choice of treatment on a property-by-property basis is irrevocable or if entities can alter the treatment at will. In summary, therefore, whilst we agree that operating leases of investment properties should be capitalised and accounted for as finance leases, we believe that all such leases should be capitalised whether or not the entity has adopted the fair value model. In this way, the plethora of options implied by the proposed revisions would be eliminated.

In addition, the Board should clarify how the fair value option is applied to investment property held under an operating lease that is reclassified as a finance lease. For example, we presume that it is not the investment property itself that is fair valued, but the right to use that investment property over the remaining life of the lease.

**Question 3**

*Do you agree that the Board should not eliminate the choice between the cost model and the fair value model in the Improvements project, but should keep the matter under review with a view to reconsidering the option to use the cost model in due course?*

We agree that the choice should not be eliminated. However, we do not understand what is meant by keeping "the matter under review". At the present time, we see no pressing need for IAS 40 to be amended further.