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Dear Marie-Christine

Exposure Draft of Proposed Improvements to International Accounting Standards

As you are aware, the ASB published the text of the above IASB exposure draft in a series of FREDs and a Consultation Paper. We have forwarded to you separately the comments we have received and the Board's comments on IAS 24, 'Related Party Disclosures' were set out in my letter to Sir David Tweedie dated 4 October.

This letter sets out the views of the ASB, having taken account of the comments we have received, on the following standards:

- IAS 1 Presentation of Financial Statements
- IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors
- IAS 16 Property, Plant and Equipment
- IAS 17 Leases
- IAS 28 Accounting for Investments
- IAS 33 Earnings Per Share
- IAS 40 Investment Property

The Board will be discussing the responses relevant to IAS 21, The Effect of Changes in Foreign Exchange Rates at the same time as those relating to IAS 32 and IAS 39.

Our comments are confined to major points, which the ASB believes require consideration by IASB.

Materiality

The final version of the IASB's *Preface to International Financial Reporting Standards* does not include the statement that was in the exposure draft that 'IFRS need not be applied to immaterial items'. As a result, there is no clear authority in IASB literature for that proposition, despite the references to materiality in the IASB Framework and in IAS 1. While the exposure draft of IAS 1 refers to materiality and aggregation at paragraphs 24-27, those paragraphs apply only to presentation and disclosure and not the application of standards.

The ASB believes it is imperative that IASB literature clearly states that standards need not be applied to immaterial items. This would most appropriately be dealt with in an overarching context such as the Preface or the rubric to each standard. However, if that cannot now be achieved, an acceptable solution would be for the matter to be dealt with in IAS 1 or IAS 8.

IAS 1 - Presentation of Financial Statements

Departures from IFRS to achieve a fair presentation (Question 1)

The concept of a true and fair view is at the heart of the British and European tradition of financial reporting. The ASB therefore welcomes the retention of the override in order to achieve a fair presentation in the revised draft of IAS 1.

The importance of an override provision should not be judged by how frequently or rarely it is invoked. Its primary importance is to place an unambiguous responsibility on management to ensure the accounts meet the reasonable expectations of users, and to make clear that it cannot be assumed that this has been discharged simply because the accounts comply with current standards.

IASB may wish to consider whether, given the rapid pace of change in business practices, it wishes to retain the claim in paragraph 12 that 'In virtually all circumstances, a fair presentation is achieved by compliance with applicable International Financial Reporting Standards and Interpretations of those Standards'. The paragraph goes on to note that disclosure beyond that required by Standards is necessary in some circumstances, and that accounting policies should be selected to provide relevant information. Nonetheless, taken as a whole, the paragraph could be read as implying that mere compliance with Standards is in many or most cases sufficient.

The Board is concerned about the proposal that the availability of the override should be dependent on whether or not the override is permitted in the relevant regulatory framework. The Board believes that International Standards should be applied consistently in all jurisdictions. There is a risk that inconsistent application will lead to a lack of comparability and undermine the harmonisation process. Our Board urges the IASB to consider the retention of the guidance in the current IAS 1, paragraphs 12 and 13.

Classification of a long-term financial liability (Questions 3 and 4)

The Board welcomes the thrust of the proposed changes in respect of the classification of long-term liabilities when they become current and when they become immediately payable as a result of a breach of conditions. The Board believes, however, that the requirements should be made more rigorous.

For example, paragraph 61 permits a liability that falls due within twelve months of the balance sheet date to be shown as non-current when an entity expects to refinance the obligation for at least another twelve months after the balance sheet date under an existing loan facility. This would include a case where an agreement to refinance has been entered into with a party other than the current lender and on different terms. The terms of the refinancing may indeed be such that there is a little chance that the entity will actually use the refinancing facility.

The Board believes that only an agreement to refinance with the same lender and on substantially the same terms – which is in substance similar to an agreement to extend a borrowing – should result in a short-term liability being reported other than as non-current.

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

Elimination of the distinction between fundamental and other material errors (Question 2)

Although a conceptual case can be made that all errors should be dealt with retrospectively, the ASB does not agree that an accounting standard should require this treatment. The distinction between changes in estimates and errors is often highly subjective, and the proposed requirement creates the risk of a large number of restatements, and also of manipulation.

Whilst we recognise the difficulties in defining “fundamental”, the ASB is of the view that the existing distinction between fundamental and other errors is likely to give rise to fewer problems than the IASB’s current proposal.

IAS 16 - Property, Plant and Equipment

Exchanges of items of property, plant and equipment (Questions 1 and 2)

The exposure draft proposes 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. The ASB is very concerned that the standard should make clear that it would not be appropriate to recognise gains or losses in those cases where due to the artificiality or lack of substance of the transaction this cannot be justified.

Revision of residual values to reflect current estimates

The ASB believes the IASB should reconsider the proposal that residual values used in the calculation of depreciable amount should be revised regularly to reflect *current* estimates of residual values. For assets carried at historical cost, the depreciable amount and annual depreciation expense will be understated on a historical cost basis where residual values are increased by inflation since acquisition—the depreciation expense is in effect a mixture of historical and current cost. The ASB believes that for assets carried at historical cost, revisions to estimates of residual values and depreciable amounts should be based on prices at the date of acquisition.

Revaluation

The improvements exposure draft did not propose changes, nor seek for comments on the basis to be used for revaluation. The ASB remains of the view that existing use value is, in general, an appropriate basis for the valuation of property, plant and equipment that is held for continuing use in the business rather than for resale. It believes that the revaluation debate should be a priority for the IASB and should be concluded before the revised standard is issued.

IAS - 17 Leases

The ASB and the IASB agree that current standards on leases are unsatisfactory and that progress towards an alternative model should be a high priority. In this context, the changes proposed to IAS 17, particularly in respect of leases of land and buildings are, in ASB's view, inappropriate. It seems unlikely that the requirement to separate the land and buildings elements will result in many more leases being capitalised, but it will add a considerable burden, especially in countries such as the UK where very many properties are held on leases. It will also tend to reinforce the distinction between operating and finance leases, which seems unlikely to be retained in a new leasing standard.

Leases of land and buildings (Question 1)

As indicated below, the ASB believes there are likely to be problems with the approach proposed in the exposure draft. A more practical solution to the treatment of leases of land and buildings would be to remove the requirement that prevents leases of land from being treated as finance leases unless title is expected to transfer to the lessee by the end of the lease.

The exposure draft proposes that, in the case of a lease of land and buildings, the minimum lease payments should be allocated between the land and building elements in proportion to their relative fair values at the inception of the lease. It is not clear whether this is intended to refer to the fair value of the interest held (ie. the right to occupy for the term of the lease) or the fair value of outright ownership.

It would appear that such an allocation will not necessarily result in an allocation that reflects economic reality. In any lease where the residual value accrues to the benefit of the lessor, the pricing of the lease would be expected to be affected by other factors as well as the fair value of the asset that is let, especially the anticipated loss of value of the asset during the term of the lease. The lessor of an asset requires reimbursement for both interest and the depreciation of the asset over the term of the lease. As land will generally hold its value to a greater extent than buildings, it is to be expected that a higher proportion of the lease payments would relate to the building than to the land.

IAS 28 - Accounting for Investments in Associates

Amount to be reduced to nil when an associate incurs losses (Question 2)

The Board does not agree that in applying the equity method the investor's interest should include items such as long-term receivables. Whilst the equity method can be seen as representing the effect of profits or losses on an equity stake, it cannot plausibly be argued to do so in the case of an interest in the associate's debt. If, for example, the debt is secured on high-quality assets the debt may retain its value even if the associate is loss-making.

The ASB believes that where debt is impaired it should be written down to reflect economic circumstances prevailing at the balance sheet date; this is not generally achieved by the arithmetic exercise of deducting the investor's share of the associate's losses for the period.

IAS 33 - Earnings Per Share

In view of the recently announced convergence project with the FASB aimed at eliminating differences between IASB and FASB standards, the ASB believes that 'Earnings Per Share' should be a top candidate for achieving complete convergence of standards (i.e. in terms of the wording). The following comments on the exposure draft are made subject to this overriding view.

Year-to-date calculation of diluted earnings per share

The ASB does not agree that, for the year-to-date calculation of diluted earnings per share, both the number of potential ordinary shares to be included and the fair value to be applied should be an average of those used in each interim period rather than the average for the year-to-date period. This principle is not expounded in the standard but is reflected in examples 7 and 12 of Appendix II (which does not form part of the standard and is included only for illustrative purposes.)

The ASB believes that the calculation should be based on figures for the year-to-date period, consistent with a fundamental principle underlying IAS 34, 'Interim Financial Reporting'. IAS 34 paragraph 28 states that 'the frequency of an enterprise's reporting (annual, half-yearly, or quarterly) should not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes should be made on a year-to-date basis'.

The ASB agrees that it is not desirable that the number of reporting periods in an entity's financial year should determine any measurements, including earnings per share. The proposed approach does not encourage comparability as entities with the same earnings and average number of shares and potential ordinary shares will, in their annual financial statements, report different per share amounts depending on whether they prepare quarterly or six monthly or, in some jurisdictions, only annual reports. This lack of comparability would be accentuated in the reporting of entities whose business is seasonal.

Diluted earnings per share

The ASB notes a lack of clarity regarding the manner in which diluted earnings per share is to be calculated, specifically in respect of loss-making entities. It also suggests that the IASB may have diverged from the US standard (FAS 128) in this area.

Revised IAS 33 defines dilution as a 'reduction in earnings per share or an increase in loss per share', resulting from an assumption that potential ordinary shares are converted, exchanged or issued as ordinary shares. Paragraph 39 of the standard is consistent with this definition in that potential ordinary shares are deemed anti-dilutive when their conversion would increase earnings per share from continuing operations or decrease loss per share from continuing operations.

Paragraph 37, however, states that potential shares are only to be treated as dilutive when their conversion would decrease earnings per share from continuing operations. There is no reference to the impact on conversion of a loss from continuing operations. Some have suggested that paragraph 37 could be amended to state that potential shares are to be treated as dilutive when conversion would increase loss per share. However, if paragraph 37 were amended in this way, 'out of the money' options, for example, would be treated as dilutive for loss-making entities. This however would be contrary to paragraph 43, which states that only 'in the money' options are dilutive, as illustrated in example 12 of Appendix II.

The ASB suggests that the detailed requirements in this area are reconsidered, with a view to ensuring that they are both clear and consistent and, if appropriate, compliant with the principles underlying FAS 128.

Other issues

The IASB proposes extensive changes to the text of IAS 33, few of which are explained in the Summary of Main Changes. Several respondents to the ASB's exposure draft have pointed out a number of areas where further clarity or guidance is needed to address inconsistencies in the present draft and to encourage uniformity of application. The Board asks that IASB give full consideration to these points. In particular, the Board encourages IASB to ensure that the examples included within the appendices are, in all respects, consistent with the requirements of the standard.

IAS 40 - Investment Property

Property interests held under an operating lease (Questions 1 and 2)

The ASB strongly supports the recognition that an interest in a property that is held under an operating lease may qualify as an investment property. It believes that without this change IAS 40 would not provide credible financial information in a jurisdiction such as the UK where a large proportion of properties, including investment properties, are held under operating leases.

The conditions proposed for an interest in a property that is held under an operating lease to be accounted for as an investment property are:

- (i) the lessee uses the fair value model; and
- (ii) the lease is accounted for as a finance lease.

The ASB that the second condition requires some clarification in respect of property leases that commonly arise in practice, particularly leases where the rental payable is variable. In the UK, for example, leases frequently provide for 'upwards only rent reviews', which provide that the rental is to be increased to a market rental at intervals of, say five years; the rent is not reduced in the event that market rentals have fallen. It would be necessary to clarify how the finance lease model could be applied in cases where the rents are contingent.

Eliminating the choice between cost and fair value models (Question 3)

The ASB is strongly of the view that a fair value approach provides superior financial information on investment properties than a cost-based approach. It understands that IASB could not eliminate the cost model as part of its improvements project, but nonetheless hopes that IASB will find an early opportunity to do so, no later than 2004.

Naturally we would be pleased to enlarge on any of these comments if that would be helpful to IASB.

Yours sincerely

Mary Keegan
Chairman