EFRAG

European Financial Reporting Advisory Group

Improvements to IAS

IASB published an exposure draft on Improvements to twelve existing standards on May 16 with a request for comments by September 16.

EFRAG has considered the proposed changes and developed initial views which are set out in the enclosed paper. Our final response will be considered at the EFRAG meeting of the Technical Expert Group on September 4 and 5. To be considered at the meeting we would like to receive comments on our draft submission no later than August 20th. Our final response will be in the form of a covering letter expressing an overall view (probably generally supportive of the Improvements programme) and highlight matters which are considered particularly important. This will be accompanied by answers to the specific questions raised together with any additional comments.

EFRAG would be grateful if commentators would express the degree of importance attached to matters on which they comment.

EFRAG
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IAS 1

Q1. *Do you agree with the proposed approach regarding departure from a requirement of an IFRS or an IFRIC to achieve a fair presentation?*

A. No we do not agree with the proposed approach. Whilst we strongly support IASB's decision to retain the 'override' provisions, we believe that there should not be alternative treatments according to the regulatory framework of the country where the statements are issued. We sympathise with those countries that have a statutory regulatory prohibition against departures from standards but do not agree that the override provisions should not apply in such a case. Indeed, if IAS 1 itself requires an override when no other means are available to give a true and fair view, then there will be no departure from IFRS taken as a whole. Our view is based on the following considerations:

i. The previous standard stated at paragraph 14 that "the existence of conflicting national requirements is not, in itself, sufficient to justify a departure in financial statements prepared using International Accounting Standards". We agree with that part of the previous statement and regret that it has been removed. The new statement would in our view be in conflict with the original policy. We do not believe IASB is intending to change that original policy despite removing it from the current text. Removal of the text and inserting new paragraphs 13 to 16 creates great uncertainty about the requirements of IFRS where there are conflicts between national regulatory requirements and IFRS.

ii. The previous standard contained an important principle (in paragraphs 12) that "Inappropriate accounting treatments are not rectified either by disclosure of the accounting policies used or by notes or explanatory material." We support that principle and regret that such an important principle is dropped in the new text. Regardless of the decision over applicability of the override when departure from standards is prohibited by the regulatory framework, we believe this principle should be retained. We note that even in countries where the regulatory framework may be thought to prohibit departure from standards the courts (in the Continental Vending case in the US for example) have ruled it unacceptable to fail to depart from a standard if it leads to an unfair presentation.

iii. Financial statements prepared in accordance with IFRS and IFRICs are often used in more than one country (perhaps because the entity has a dual listing). It seems unreasonable that the IFRS compliant financial statements have to be different because the regulatory requirements concerning the use of the true and fair override vary from country to country. In our view the national regulatory framework should not come into consideration when preparing financial statements under International Financial Reporting Standards.

We do accept that departures from IFRS or an IFRIC should be an extremely rare event and 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.

Based on the above we recommend deletion of the words “if the relevant regulatory framework requires or otherwise does not prohibit such a departure” at the end of the new paragraph 13.

Q2. *Do you agree with prohibiting the presentation of items of income and expense as “extraordinary items” in the income statement and the notes (paragraph 78 and 79)?*

A. Paras 78 and 79 suggest that an entity shall not present any items of income and expense as extraordinary items and that no items are to be presented as arising from outside the entity’s ordinary activities. The aim is clearly to abolish what is currently known as an “extraordinary item”. Certainly there has been abuse of extraordinary item treatment and we would support measures to curb that. Therefore we support the prohibition of presentation of income and expense as extraordinary items. However, we believe the present proposals are ineffective because entities will always argue the need to present information so that it is predictively useful. As such “extraordinary items” will be replaced by “non-recurring”, “unusual”, “abnormal” or simply “other items” and the presentation will too often show profit or loss before such items.

In January this year we wrote to you suggesting that steps should be taken to improve the presentation of the income statement to provide more useful and consistent comparisons. We understand that IASB is considering that issue in its “Reporting Financial Performance” project which is accorded high priority on IASB’s timetable.

The treatment of non-recurring, unusual, abnormal and similar items could, in our view, best be dealt with as part of that project. Accordingly we do not support the proposals to eliminate extraordinary items as a “quick fix” at this time when it should in our view more appropriately be dealt with as part of a comprehensive consideration of formats in the Reporting Financial Performance project.

Incidentally, whilst para 79 refers to “the entity’s ordinary activities” we believe that in the absence of further clarification there is room for doubt as to what constitutes ordinary activities.

For the reasons set out above we also believe it is premature to delete the line "operating profit" from the minimum requirements of income statement formats. This is something that should be dealt with in "Reporting Financial Performance" which is in any case a priority project.

Q3. *Do you agree that a long-term financial liability due to be settled within 12 months of the balance sheet date should be classified as a current liability even if an agreement to refinance or to reschedule payments is completed after the balance sheet date and before the financial statements are authorised for issue (paragraph 60).*

A. _Yes_. We do agree. At the balance sheet date the liability was current (due for repayment within next 12 months). If a subsequent refinancing takes place that is an event of the following year and should be accounted for then – it is not an "adjusting event" in the sense of clarifying the situation at the balance sheet date. Nevertheless we would expect a note to the financial statements to refer to the subsequent event if it is important to an understanding of the financial position of the entity.

Q4(a) *Do you agree that 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 authorized for issue, not to demand payment as a consequence of the breach (paragraph 62)?*

Yes. We do agree for the reasons given in answer to the previous question even though the treatment may seem harsh!

(b) (i) *Do you agree that if an entity is in breach of a loan agreement but is given a grace period and rectifies the breach within the grace period the liability should continue to be classified as non-current.*

Yes. We agree with non-current classification if the breach is rectified within the grace period.

(ii) *Do you agree to the same classification if the grace period is given before balance sheet date, the breach has not yet been rectified but has not expired by the date of issue of the financial statements.*

A. _Yes_. We agree provided it is not unlikely that the breach will be rectified. If the breach is a result of a potential going concern problem and it is likely the breach will not be rectified we believe management can only continue to classify the loan as non-current if it can justify the treatment by showing how the breach will be rectified.

Q5. *Do you agree that an entity should disclose the judgement made by management in applying the accounting policies that have the most significant effect on the amounts of items recognised in the financial statements (paragraph 108 and 109).*

No. Although it seems attractive in having management 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 specificity and usefulness of the information likely to be disclosed. We fear that the requirement will only result in boiler plate disclosures.

Q6. *Do you agree that an entity should disclose key assumptions about the future and other sources of measurement uncertainty that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year (paragraphs 110-115).*

Though we support the principle of disclosing key assumptions about the future and other sources of measurement uncertainty we believe the current wording of paragraphs 110-115 combined with the new paragraph 7 is confusing as far as the disclosure requirements regarding risk assessment is concerned. We therefore recommend expanding the current proposal to clarify what is actually expected within the notes to IFRS financial statements as opposed to what should be included in the financial review by management which is outside the financial statements but a key element of financial reporting. It would be helpful to provide examples of such expected disclosures. Finally, we suggest adding to the new text a statement that the actual disclosures in this area will very much depend on an entity's specific situation.

Other comments

1. We believe that the former paragraph 6 stating that the board of directors and/or other governing body of an entity is responsible for the preparation and presentation of its financial statements is very important and that deletion of this paragraph may be interpreted as representing a change of view by IASB. In our opinion it should be re-instated.

2. Similarly we would like to retain the encouragement to present a financial review by management outside the financial statements as set out in old paragraph 8. The new paragraph 7 says that many entities present a financial review by management but no longer expresses encouragement of this practice. We further believe that the new paragraph 9, stating that the reports and statements described in the new paragraphs 7 and 8 are outside the scope of International Financial Reporting Standards, might be misunderstood since the preface to International Financial Reporting Standards says that the IASB promotes the use of IFRSs in general purpose financial statements *and other financial reporting*. The change in name from IAS to IFRS suggests that IASB has an interest in all aspects of Financial Reporting and that would include the financial review by management.

3. We note that for comparative information in respect of the previous period (old paragraph 38, new 33): “numerical information” has been replaced by “amounts” which we believe might be interpreted as currency amounts, a more restrictive term than numerical. We believe, for example, that the number of employees should be disclosed together with comparative figures. Consequently, we do not support this change.

4. The improved standards in several places permit exemptions based on “undue cost or effort” (e.g. paragraph 35: “when the presentation and or classification of items in the financial statements is amended, comparative amounts shall be reclassified unless the reclassification would require *undue cost or effort*“). We believe further guidance should be provided in order to avoid conflicting interpretations which would undermine overall reliability and comparability of IFRS financial statements. Some, for example believe that the expression allows an entity to regard almost any cost as undue whereas the previous test of impracticality was much more stringent.

5. Other disclosures: old paragraph 102 (d) has been deleted which means that there is no longer any disclosure requirement regarding the number of employees. We believe that this change is not an improvement since headcount is considered as key information by users. We therefore do not support this change.

<u>IAS 2</u>

Q1. *Do you agree with eliminating the allowed alternative of using the last-in, first-out (LIFO) method for determining the cost of inventories under paragraphs 23 and 24 of IAS 2?*

A. <u>Yes</u>. We support the proposal to eliminate the LIFO method since this measurement method can and often does result in a distortion of the balance sheet and/or income statement. We further agree that LIFO is generally not a reliable representation of the actual inventory flows and that tax considerations do not provide an adequate conceptual basis to justify the use of LIFO.

Q2. *IAS 2 requires reversal of write-downs of inventories when the circumstances that previously caused inventories to be written down below cost no longer exists (paragraph 30). IAS 2 also requires the amount of any reversal of any write-down of inventories to be recognised in profit or loss (paragraph 31). Do you agree with retaining those requirements?*

A. <u>Yes</u>. If an entity were not to reverse write-downs of inventories when the circumstances that previously caused inventories to be written down below cost no longer exist, inventories would be understated. The fact that the circumstances surrounding inventories no longer exists should be accounted for by the reversal of the write-downs. This reversal should be recognised in the income statement of the period since it reflects an increase in economic benefits and such a treatment is consistent with IAS 8, new paragraph 27, IAS 16, paragraph 37 as well as IAS 38 paragraph 76. In our view the change to paragraph 34(c) requiring disclosure of the amount of any write down of inventories also adds useful information and we therefore support that change.

IAS 8

Q1. *Do you agree that the allowed alternative treatment should be eliminated for voluntarily 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 (paragraph 20, 21, 32 and 33)?*

A. i) Voluntary changes in accounting policies.

We agree with the proposed improvement which requires the use of the previous benchmark treatment whereby such changes are dealt with retrospectively as I if the new accounting policy had always been in use. However, we believe it would be useful if the standard made it clearer that voluntary changes in accounting policy should be made rarely and then only for good reasons. Consistency should not be sacrificed for a desire to show results in a more favourable light.

ii) Correction of errors.

We accept the proposed improvement for correction of errors whereby the comparative amounts of the prior periods in which the error occurred are restated so that the financial statements are presented as if the error had never occurred. This treatment will enable year to year comparisons to be made more effectively.

However, we have some concerns about the 'moral hazard' in this treatment in that entities which have difficulty in meeting current market expectations of earnings may be tempted to search for errors of any magnitude which can be taken back to prior years and thereby assist comparative performance. In the extreme situation, expenses may be deliberately omitted from the current year statements in the knowledge that next year the 'error' will be corrected retrospectively so that the cost never hits current earnings per share.

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

A. We agree with the elimination of the distinction between fundamental errors and other errors because all errors are accounted for in the same way under the improved standard and there is therefore no need to retain any distinction.

Other comments

Paragraph 19 of the improved 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 publication of a new standard yet to be implemented. Previously, paragraph 48 merely encouraged such disclosure. Although we wish to encourage such disclosure it is impractical to require it. For example, a company which approves its financial statements for issue just one day after publication of IAS 39 on financial instruments (or IAS 19 on Retirement benefits) would have to assess its impact in too short a timescale to produce reliable information about the effects or resort to the “undue cost or effort” formula. In practice we believe that this formula will almost always be used because management would otherwise, at a later date, feel obliged to disclose the reasons for any disparity between estimated and actual outcome. Overall therefore we would prefer to retain the former paragraph 48.

If the requirement is to be inserted we believe it should be modified to require disclosure of the effect of the change not just on the entity’s financial position but also on its income. Finally it should be made clear that the estimate of the effect of the change relates to the effect on the current years income and balance sheet rather than on next year’s projected outcome.

IAS 10

No question is put forward for the changes to IAS 10. The principal change to this standard is to prohibit the recognition as a liability at balance sheet date of dividends declared after that date.

We support the proposed changes.

IAS 15

We support the withdrawal of IAS 15.

IAS 16

Q1. *Do you agree that all exchanges of items of property, plant and equipment should be measured at fair value, except when the fair value of neither of the assets exchanged can be determined reliably? (see paragraphs 21 and 21A)?*

A. We do not agree with the proposed change. In our view the old paragraphs 21 and 22 make a sensible distinction between exchanges which are in effect sales of dissimilar items and swaps of similar assets that have a similar use in the same line of business (and have a similar fair value). Old paragraph 22 makes it clear that in the latter case the earnings process is incomplete so no gain or loss should be recognised on the exchange transactions (i.e. the cost of the new asset is the carrying amount of the asset given up). In the basis for conclusions at para A4 further arguments are set out in favour of the original IAS 16 treatment and we believe those arguments remain valid. The counter arguments in A5 are less convincing.

We do understand the difficulty in recognising a dividing line between exchange of similar and dissimilar assets but believe that judgement can be exercised based on how the assets are used to determine the appropriate treatment.

In the basis of conclusions para A5(b) suggests that in some cases it is arbitrary to determine when an earnings process culminates. This points to a need to consider the matter further as part of a separate Revenue Recognition project. Until such time therefore we believe no change should be made to the existing paragraphs 21 and 22.

Q2. *Do you agree that all exchanges of intangible assets should be measured at fair value, except when the fair value of neither of the assets exchanged can be determined reliably (Note that the Board intends to retain the policy in IAS 18, Revenue, prohibiting the recognition of revenue from exchanges or swaps of goods or services of a similar nature and value.)?*

A. We do not support the proposed change for the reasons explained in answer to question 1. There should be no reason to treat intangible assets differently.

Q3. *Do you agree that depreciation of an item of property, plant and equipment should not cease when it becomes temporarily idle or is retired from active use and held for disposal (see paragraph 59)?*

A. <u>Yes</u> we agree. Depreciation should not cease when an asset is retired from active use but the basis of the depreciation may change to reflect a slower rate of wearing out as a result of the reduced usage. However, obsolescence is still a factor and consideration may have to be given to impairment.

<u>Other comments</u>

1. Though we agree in principle with the distinction between incidental income as mentioned in paragraph 17B (to be recognised as income) and net proceeds from selling any items produced when bringing the asset to the necessary location and condition (e.g. samples produced when testing equipment) to be deducted from the cost of the asset according to improved paragraph 15 (b), we believe that in practice such a distinction will be difficult to make and therefore we suggest treating the net proceeds from selling any items produced when bringing the asset to the necessary location and condition in the same way as incidental income. We further suggest presenting such income under a caption called “other income” in the income statement.

2. The new paragraph 60 requires the disclosure of comparative information regarding the reconciliation of carrying amounts at the beginning and the end of the period. Previously comparative information was not required for such a reconciliation. It is not clear why the change has been made. Whilst the additional information simplifies comparisons of additions and disposals of equipment and depreciation charges by class of asset it does make the presentation more complex.

3. Paragraph 46 of the improved standard suggests that residual value is reviewed at each balance sheet date. This implies that not only must potential impairment of residual value be considered but that any change in estimated residual value, up or down, must be reflected. Such an annual reassessment of residual values of all assets (where residual values are not insignificant) represents a major change and imposes an unreasonable burden particularly since residual values are likely to fluctuate according to current economic conditions. We believe the text should be amended to remove the requirement for annual reassessment of residual value where there are no indications of impairment.

IAS 17

Q1. *Do you agree that when classifying a lease of land and buildings, the lease should be split into two elements - a lease of land and a lease of buildings? The land element is generally classified as an operating lease under paragraph 11 of IAS 17, Leases, and the building element is classified as an operating or finance lease by applying the conditions in paragraphs 3 to 10 of IAS 17.*

A. Disaggregation sounds attractive in theory but we do not believe the proposals are practical because lease agreements for property do not split out the amounts attributable to land and to buildings separately. Furthermore, any apportionment is likely to be arbitrary where the property is located in an area that is already fully developed and there are few if any plots of land sold separately that provide a market test of the land element.

We believe that the improvement has been introduced to reflect the relatively short economic life of buildings in Hong Kong. Certainly there is a greater likelihood that the buildings element will be a finance lease in those circumstances but elsewhere most leases are likely to be for a term substantially shorter than the expected economic life of the building. In practice such leases will most likely be operating leases both as regards the land element and the building element so that disaggregation would be a pointless exercise.

For the above reasons we do not support the proposed changes.

Q2. *Do you agree that when a lessor incurs initial direct costs in negotiating a lease, those costs should be capitalised and allocated over the lease term? Do you agree that only incremental costs that are directly attributable to the lease transaction should be capitalised in this way and that they should include those internal costs that are incremental and directly attributable?*

A. We agree that in the interest of greater comparability one of the existing options should be removed. There is room for debate as to which option should be deleted. We believe there are strong arguments in favour of requiring initial direct costs (which are principally selling costs) to be expensed rather than capitalised. After all, selling costs are normally expensed (see IAS 2 para 14(d)). However we can accept that costs that are both incremental and directly attributable to negotiating and arranging a lease are capitalised and spread over the period of the lease in accordance with practice permitted or required by standard setters in major countries for reasons of convergence and comparability.

IAS 21

Q1. *Do you agree with the proposed definition of functional currency as "the currency of the primary economic environment in which the entity operates" and the guidance proposed in paragraphs 7-12 on how to determine what is an entity's functional currency?*

Yes. We agree with the proposed improvements supported by the basis for conclusions.

Q2. *Do you agree that a reporting entity (whether a group or a stand-alone entity) should be permitted to present its financial statements in any currency (or currencies) that it chooses?*

A. Yes. We see no reason why a reporting entity should not be permitted to present its financial statements in any currency it chooses, although we acknowledge that local law in some jurisdictions may require the use of the currency of the parent company. However there are often very good reasons to present financial statements in a different currency – for example, because the group is multinational with shareholders and other users located principally in a different country, or because the parent is located in a small country whose currency is not widely used internationally whilst its main competitors report in one currency (e.g. Euro or US dollar). However, we recommend adding a disclosure requirement under which the reasons for the selection of the reporting currency are summarised if that currency is not that of the country of registration of the parent.

Q3. *Do you agree that all entities should translate their financial statements into the presentation currency (or currencies) using the same method as is required for translating a foreign operation for inclusion in the reporting entity's financial statements (see paragraphs 37 and 40)?*

A. Yes. We support the improvements which we believe increase comparability and reliability of financial statements prepared under IFRS amongst entities.

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

A. Yes. We support the elimination of the option. We believe the option to be unnecessary and the elimination of this option will increase comparability and reliability of IFRS financial statements.

Q5. *Do you agree that:*

(a) goodwill and

(b) fair value adjustments to assets and liabilities

that arise on the acquisition of a foreign operation should be treated as assets and liabilities of the foreign operation and translated at the closing rate (see paragraph 45)?

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

IAS 24

Q1. *Do you agree that the Standard should not require disclosure of management compensation, expense allowances and similar items paid in the ordinary course of an entity's operations (see paragraph 2)?*

'Management' and 'compensation' would need to be defined, and measurement requirements for management compensation would need to be developed, if disclosure of these items were to be required. If commentators disagree with the Board's proposal, the Board would welcome suggestions on how to define 'management' and 'compensation'.

A. No, we do not agree.
We think that shareholders have the right to be informed of top management's remuneration (e.g. those managers for whom remuneration is determined by a remuneration committee of the Board).
'Management' in this context should at least include the Board of Directors in a one tier system, or the Board of Management in a two tier system. Compensation comprises salaries, bonuses and the value of share options, together with other parts of the benefits package (including pension benefits).Even if not exactly quantifiable the contractual agreements regarding compensation between the company and the management should be disclosed.

Q2. *Do you agree that the Standard should not require disclosure of related party transactions and outstanding balances in the separate financial statements of* *a parent or a wholly-owned subsidiary that are made available or published with consolidated financial statements for the group to which that entity belongs?*

A. No, we do not agree. We believe that this information will often be essential to understand the financial position and performance of an entity and should therefore be required for separate financial statements. We recommend a requirement to disclose the intra group amounts included in the balance sheets and income statements. We support the arguments of the six Board members who disagree with the new paragraph 3 as stated in the Appendix B (B4.-B6.).

IAS 27

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

A. Yes. We agree for the reasons explained in the basis for conclusions.

Q2. *Do you agree that minority interests should be presented in the consolidated balance sheet within equity, separately from the parent shareholders' equity (see paragraph 26)?*

A. Yes. We concur with the Board's conclusion 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 (paragraph 49(c)) of equity.

Q3. *Do you agree that investments in subsidiaries, jointly controlled entities and associates that are consolidated, proportionately consolidated or accounted for under the equity method in the consolidated financial statements should be either carried at cost or accounted for in accordance with IAS 39, Financial Instruments: Recognition and Measurement, in the investor's separate financial statements (paragraph 29)?*
Do you agree that if investments in subsidiaries, jointly controlled entities and associates are accounted for in accordance with IAS 39 in the consolidated financial statements, then such investments should be accounted for in the same way in the investor's separate financial statements (paragraph 30)?

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

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

We do agree that if investments in subsidiaries, jointly controlled entities and associates are accounted for in accordance with IAS 39 in the consolidated financial statements then such investments should be accounted for in the same way in the investor's separate financial statements.

IAS 28

Q1. *Do you agree that IAS 28 and IAS 31, Financial Reporting of Interests in Joint Ventures, should not apply to investments that otherwise would be associates or joint ventures held by venture capital organisations, mutual funds, unit trusts and similar entities if these investments are measured at fair value in accordance with IAS 39, Financial Instruments: Recognition and Measurement, when such measurement is well-established practice in those industries (see paragraph 1)?*

A. Yes we agree that for venture capital organisations, mutual funds, unit trusts and similar entities IAS 28 and 31 should not apply to investments that otherwise would be associates or joint ventures if these investments are measured at fair value in accordance with IAS 39, when such measurement is well-established practice in these industries. The fair value measurement will provide the most relevant and useful information.

Q2. *Do you agree that the amount to be reduced to nil when an associate incurs losses should include not only investments in the equity of the associate but also other interests such as long-term receivables (paragraph 22)?*

We do not agree with the proposed approach since this might lead to the inappropriate write-down of, for example, long-term receivables when good collateral is in place.

Other comments

Improved paragraph 18A states that financial statements of the associate as of a different reporting date may be used, provided that the difference is no greater than three months. We believe this requirement will not always be practical since the reporting entity will not necessarily be able to enforce the timely submission of this information and therefore propose that IASB amends para 18A as follows by adding at the end "where this is not possible the most recent available financial statements of the associate are used."

IAS 33

Q1. *Do you agree that contracts that may be settled either in ordinary shares or in cash, at the issuer's option, should be included as potential ordinary shares in the calculation of diluted earnings per share based on a rebuttable presumption that the contracts will be settled in shares?*

A. Yes. The proposed approach is consistent with the definition of dilution and based on an appropriate assessment of the likelihood of actual dilution.

Q2. *Do you agree with the following approach to the year-to-date calculation of diluted earnings per share (as illustrated in Appendix B, examples 7 and 12)?*

(i) 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).

A. A difference between the year-to-date weighted average of the number of potential ordinary shares included in each interim diluted earnings per share calculation compared to a year-to-date weighted average of the number of potential ordinary shares weighted for the period they were outstanding (i.e. without regard of the information reported during the interim periods) will only occur when the weighted average for the interim period is calculated differently compared to the calculation method for the period the potential ordinary shares were outstanding. In example 7 and 12 of Appendix B we noted a difference in the following cases:

- **Retail site contingency**: the year-to-date weighted average of the interim information results in 6,250 while the year-to-date weighted average for the period they were outstanding is actually 5,000. The difference is caused by the fact that under the diluted calculation the contingently issuable shares are included from the beginning of the interim period in which the conditions to issue are satisfied (i.e. opening of a retail store). We do not agree with this approach since the necessary conditions were not satisfied at the beginning of the interim period. The described approach results in the disclosure of diluted earnings per share including contingently issuable ordinary shares for which all necessary conditions have not been satisfied which is incompatible with the new paragraph 47. Consequently, we believe the weighted average shares used to calculate the basic earnings per share (i.e. take the number of issuable shares into account as from the moment the contingent event has occurred, not earlier) should be used.

- **Earnings contingency**: under the example of earnings contingency, the number of contingently issuable shares depends on the net profit in excess of 2,000,000 for the year ended 31 December 20X1. Since the information on the number of potentially issuable shares is most accurate at the end of each period and the contingency becomes an obligation at 31 December 20X1, we do not agree with the illustrated approach and recommend taking the actual information (900,000) into account in calculating the full year diluted earnings per share. This method will best reflect the actual dilution that will occur in the next year and therefore provide the most relevant information.

(ii) *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.*

A. We do not agree with the described approach unless the result of using the average market price during the interim periods reported upon approximates the result that would be obtained when using the average market price during the year-to-date period. We believe that our proposed approach (i.e. using the average market price during the year-to-date period and not the average market price during the interim periods reported upon, unless the outcome of the latter method would approximate the result of the year-to-date period when computing the number of potential ordinary shares) is more consistent with the approach described under IAS 21, new paragraph 20.

(iii) *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).*

A. In our view this question is only relevant to the two cases discussed in the first point above to which we refer for our comments.

IAS 40

Q1. *Do you agree that the definition of investment property should be changed to permit the inclusion of a property interest held under an operating lease provided that:*

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

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

A. Yes, we agree.

Q2. *Do you agree that a lessee that classifies a property interest held under an operating lease as investment property should account for the lease as if it were a finance lease?*

A. Yes, we agree.

Q3. *Do you agree that the Board should not eliminate the choice between the cost model and the fair value model in the Improvements project, but should keep* *the matter under review with a view to reconsidering the option to use the cost model in due course?*

A. Yes, we agree.

For reasons of practicality we support the suggestion that the option not be eliminated in the Improvements project. We agree that this issue should be kept under review with a view to eliminating the option at a later stage.