THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

16 January 2009

Our ref: ICAEW Rep 02/09

Your ref:

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

By email: commentletters@iasb.org

Dear David

DISCONTINUED OPERATIONS - PROPOSED AMENDMENTS TO IFRS 5

The Institute of Chartered Accountants in England and Wales (the Institute) is pleased to respond to your request for comments on the exposure draft *Discontinued Operations - Proposed Amendments to IFRS 5*, published in September 2008.

Please contact me if you would like to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REPRESENTATION

ICAEW REP 02/09

DISCONTINUED OPERATIONS - PROPOSED AMENDMENTS TO IFRS 5

Memorandum of comment submitted in January 2009 by The Institute of Chartered Accountants in England and Wales, in response to the exposure draft *Discontinued Operations - Proposed Amendments to IFRS 5*, published in September 2008.

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to comment on the International Accounting Standards Board Exposure Draft *Discontinued Operations - Proposed Amendments to IFRS 5*, published in September 2008.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 130,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

4. Our members occupy a wide range of roles throughout the economy. This response was developed by the Financial Reporting Committee of the Institute, which includes preparers, analysts, standard-setters and academics as well as senior members of accounting firms.

MAJOR POINTS

5. We do not agree with the proposals in the exposure draft. We understand the IASB's desire to improve IFRS 5, which is a fundamentally flawed standard (see paragraphs 10 - 14 below), but the proposed 'improvements' would in our view actually only serve to make a bad standard worse. We do not support basing the definition of a discontinued operation on an *operating segment* as defined in IFRS 8, because this definition will not be one that captures all – or only – strategic shifts.

6. The Introduction to the ED notes that the objective of the proposals is to achieve convergence with US GAAP in the definition of discontinued operations and disclosure of all terminated components. While this is a praiseworthy objective, we have stated many times that it is important to converge only when the fundamental objective of improved financial reporting is thereby met - or at least that the converged standard is no worse than the one it is replacing. In our view this is not the case here, despite our views on the existing IFRS 5. The proposals smack of a compromise that leads to inferior accounting under IFRS and yet leaves both sides of the debate dissatisfied.

7. The exposure draft does not articulate a clear principle for IFRS 5. We suggest that the underlying principle, which should be stated overtly, should be that a discontinued operation represents a 'strategic shift' in the entity's operations. We accept that there are elements of subjectivity in this approach, but we do not believe that this causes problems in practice and we believe that users' needs are generally well-served by such an approach. In any case, subjectivity is an inherent part of financial reporting in a world where many decisions cannot be made on a 'black and white' basis.

8 Paragraph BC7 sets out the three reasons behind the boards' decision to use an operating segment as the criterion for determining whether a component that has been disposed of or is held for sale should be presented in discontinued operations. However, we do not agree that the changes proposed successfully address the concerns set out in that paragraph.

(a) Paragraph BC7(a) - disposal of an operating segment would not adequately capture strategic shifts in an entity's operations (see paragraph 15 below).

(b) Paragraph BC7(b) - any subjectivity in the terms 'major line of business' and 'geographical area' has not caused problems in practice (see paragraph 18 below).

(c) Paragraph BC7(c) - using operating segments as the criterion might make it simpler to identify a discontinued operation, but it would not make it any easier to ascertain the numbers (see paragraph 18 below).

9. We also do not support the additional disclosure requirements relating to those components that have been disposed of or are held for sale that do not meet the criteria for treatment as discontinued operations. Too many small disposals will require to be disclosed in the notes. Disclosure should only be required for key items that are necessary to an understanding of the entity's activities. If 'discontinued operations' is an appropriate level of separate recognition, then there is no need for additional disclosure. If it is not an appropriate level of recognition, then the defect cannot be rectified by disclosure (see also our comments in paragraph 24 below). The hybrid proposed by the Board merely serves to blur the distinction between discontinued operations and the consequences of other management decisions.

10. We take this opportunity to reiterate some of our fundamental concerns with IFRS 5, given that an exposure draft should be an opportunity to introduce improvements. The standard requires discontinued operations to be disclosed as a single amount in comprehensive income, turning it into a quasi-extraordinary item when extraordinary items have rightly been banned under IFRS. This was a retrograde step which provides the opportunity to any entities so inclined to present a less reliable measure of pre-tax profit by pushing as much as possible into the 'discontinued' category. Moreover, users are then not able to make straighforward use of the comparatives, because the previous year's numbers are presented on a different basis to those declared in the current year.

11. We think the opportunity should be taken either here or in the project on Financial Statement Presentation, to reconsider the approach. In particular, the IFRS 5 approach to presentation of discontinued operations downplays the stewardship aspect of financial reporting, where management should be held accountable for *all* the gains and losses arising in the period. We prefer a presentation approach that is similar to that in the UK standard FRS 3 *Reporting Financial Performance*, where discontinued operations are shown separately on a columnar basis, but disaggregated across each relevant line item. This presentation was generally used under IAS 35, and the IASB's decision to abandon it in favour of the quasi-extraordinary item treatment available under US GAAP was not a move towards higher quality reporting.

12. The proposed FASB Staff Position FSP FAS 144-d *Accounting for the Impairment or Disposal of Long-Lived Assets* suggests that there is now similar concern in the US about the level of abuse arising from pushing too many items into the 'discontinued'

category further down the income statement. For example, ‘Certain preparers of financial statements have argued that the definition of a discontinued operation in Statement 144 results in too many activities being classified as discontinued operations in the income statement’ (FSP FAS 144-d.A2.c). See also,‘ … this additional requirement [limiting which businesses may be classified as held for sale on acquisition] would provide discipline over what components are classified as discontinued operations in the income statement and thus would avoid abuse.’ (FSP FAS 144-d.A3.c).

13. As an alternative to an FRS 3 approach, some kind of shadow disclosure for business disposals that matches shadow disclosure required for acquisitions would probably be closer to what interests users. It is rare, though not unheard of, for management to make a strategic decision to sell a well-performing operation, but what the IFRS 5 presentation is really permitting preparers to say to users is that they should forget about the company's past failings and concentrate on the continuing healthy operations left for the future.

14. Our other major issue with IFRS 5 relates to the use of management intent as a determinant of when a discontinued operation is identified. We suggest that the approach in IAS 35 *Discontinuing operations* is superior, so that discontinued operation classification is triggered when:

    - the company has entered into an agreement to sell substantially all of the assets of the discontinuing operation; or

    - its board of directors or other similar governing body has both approved and announced the planned discontinuance.

    The IAS 35 approach relies on ideas of commitment and obligation, and is consistent with other IASB literature - for example, IAS 37.

SPECIFIC QUESTIONS

Question 1 – Definition of discontinued operations

IFRS 5 defines a discontinued operation as a component of an entity that either has been disposed of or is classified as held for sale and

(a) represents a separate major line of business or geographical area of operations,

(b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations or

(c) is a subsidiary acquired exclusively with a view to resale.

This exposure draft proposes changing the definition so that a discontinued operation is a component of an entity that

(a) is an *operating segment* (as that term is defined in IFRS 8) and either has been disposed of or is classified as held for sale or

(b) is a *business* (as that term is defined in IFRS 3 *Business Combinations* (as revised in 2008)) that meets the criteria to be classified as held for sale on acquisition.

The exposure draft proposes that an entity should determine whether the component of an entity meets the definition of an operating segment regardless of whether it is required to apply IFRS 8.

Question 1(a) **Do you agree with the proposed definition? Why or why not? If not, what definition would you propose, and why?**

15. We do not agree with the proposed definition. As noted in the exposure draft, IFRS 5 currently requires, inter alia, that a discontinued operation must represent 'a separate major line of business or geographical area of operations' or 'is part of a single co-ordinated plan' to dispose of the same. These elements are encompassed in the idea of a 'strategic shift' in the company's operations, which we regard as a useful criterion. However, although paragraph BC7(a) suggests that disposal of an operating segment (as defined in IFRS 8) would 'most likely' indicate a strategic shift in an entity's operations, we do not believe that this would invariably be the case, nor that the entirety of such a shift would invariably be reported.

16. For example, an entity might discontinue a significant part of an operating segment as part of a larger strategic shift in its operations (for example, in discontinuing a manufacturing line it might also significantly cut back on the manufacture of parts that are also supplied to other customers), but the partial discontinuance would not fall to be disclosed, despite the importance of the information to users. Or an entity might sell an entire operating segment together with part of a second one, yet only the 'whole' segment would qualify to be reported as a discontinued operation. At the other extreme, entities might start reporting to their Chief Operating Decision Maker components that previously had not been so reported, perhaps in order to enable the decision to be made whether or not to dispose of that component: this would result in a component being reported ultimately as discontinued that had not been an operating segment on an ongoing basis.

17. The economic environment we are facing is likely to result in a substantial increase in the number of companies restructuring operations, and it may be helpful to focus on this when considering changes to the current standard. If businesses are retrenching geographically this may, for example, cut out 20% of three out of four business segments, which users would want to see separately disclosed as much as if the fourth segment, which is only 25% of the whole group's business, was also being sold on. We expect to see more by way of geographic retrenchment over the next couple of years, so this is the wrong time to be dropping this reporting from IFRS. Geography is probably more important to strategy for companies outside the US in general: it would be less common for a US GAAP reporter to have most of its business outside its domestic market than for an IFRS reporter, so this is something IFRS should be leading on rather than following US GAAP.

18. Nor do we find the other arguments in paragraph BC7 convincing. While it may be true to say, in paragraph BC7(b), that the terms 'major line of business' and 'geographical area' could be subjective, we do not believe they have caused significant problems in practice. Furthermore, the argument in paragraph BC7(c) that 'using operating segments as the criterion would simplify the determination of what should be presented in discontinued operations' does not stand up to scrutiny. Using operating segments may make it simpler to *identify* a discontinued operation, but it does not make it any easier to ascertain the numbers to be reported, since they must – rightly – be determined on an IFRS basis, irrespective of the basis used for segmental reporting.

19. Overall, we do not believe that the proposal to use an operating segment as the basis for determining a discontinued operation is sound. The proposed change in approach appears to move away from what users would regard as useful information to what (a subset of) preparers might find easier to provide. We think that the underlying principle that a discontinued operation represents a 'strategic shift' in the entity's operation is the correct one. We do not believe that the proposals in the exposure draft accurately reflect this principle.

20. Despite our views on the main change proposed to the definition, we do agree that using the term 'business' rather than 'subsidiary' in the second (previously third) part of the definition is an improvement, as it allows for disposal of a business that is not held in the legal form of a subsidiary.

Question 1(b) **If an entity is not required to apply IFRS 8, is it feasible for the entity to determine whether the component of an entity meets the definition of an operating segment? Why or why not? If not, what definition would you propose for an entity that is not required to apply IFRS 8, and why?**

21. Since we support using a definition that is not referenced into IFRS 8, we believe that the same non-IFRS 8 definition could be applied by all entities.

22. While it would be feasible in many or most cases for an entity not within the scope of IFRS 8 to determine whether a component meets the definition of an operating segment, we believe it is wrong in principle to apply the rules of a standard that entities are scoped out of to the very entities that are scoped out. A standard that is not required to be applied by all should not be introduced, by cross-reference, to one that is universally effective. In particular in this case, such an approach creates complexity, and will be onerous for entities affected.

Question 2 – Amounts presented for discontinued operations

Under IFRS 8, amounts disclosed for operating segments are the amounts reported to the chief operating decision maker. Nevertheless, although the proposed definition of a discontinued operation refers to operating segments, this exposure draft proposes that the amounts presented for discontinued operations should be based on the amounts presented in the statement of comprehensive income, even if segment information disclosed to comply with IFRS 8 includes different amounts that are reported to the chief operating decision maker.

Question 2 **Do you agree that the amounts presented for discontinued operations should be based on the amounts presented in the statement of comprehensive income? Why or why not? If not, what amounts should be presented, and why?**

23. Clearly, any analysis of the statement of comprehensive income should be based on the amounts actually presented in the statement of comprehensive income. Hence we agree with this approach to measurement whatever the definition of discontinued operations that, ultimately, is included in the revised standard.

Question 3 – Disclosures for all components of an entity that have been disposed of or are classified as held for sale

The exposure draft proposes disclosures for all components of an entity that have been disposed of or are classified as held for sale, except for *businesses* that meet the criteria to be classified as held for sale on acquisition.

***Question 3(a)* Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes would you propose, and why?**

24. We disagree with the proposed disclosure requirements. BC9 explains that the additional disclosure requirements are proposed in order to provide useful information to users. However, such disclosure is essentially rules-based and sits uneasily in a purportedly principles-based standard. The Framework (paragraph 82) is perfectly clear that any failure to recognise items cannot be rectified by additional disclosure. Therefore, if a 'component' that has been disposed of is sufficiently material to require to be disclosed, it is sufficiently material to require to be accounted for properly – ie, as a discontinued operation, assuming it meets the relevant definition. Similarly, if a component is not sufficiently material to qualify as a discontinued operation, it is not sufficiently material to require disclosure.

25. We believe that the IASB should be assessing all proposals for additional disclosure in the light of an overriding principle of reducing unnecessary complexity and clutter in financial statements, and that this proposal falls down on that basis. While users may be *interested* in this additional information, as they are in virtually any additional information they can obtain about an entity, we do not believe it will be relevant to their decision-making needs (Framework 26) when the component in question is insufficiently material to qualify as a discontinued operation. The definition of discontinued operations needs to be fit for purpose and should stand on its own, without relying on the prop of additional disclosures for items falling outside that definition.

***Question 3(b)* Do you agree with the disclosure exemptions for *businesses* that meet the criteria to be classified as held for sale on acquisition? Why or why not? If not, what changes would you propose, and why?**

26. We agree with and support this change.

Question 4 – Effective date and transition Entities would be required to apply the proposed changes prospectively, from a date to be determined by the IASB after exposure, with one exception: the amounts in the statement of comprehensive income (or in the separate income statement) should be reclassified on the basis of the revised definition of discontinued operations for all periods presented. Earlier application would be permitted.

***Question 4* Are the transitional provisions appropriate? Why or why not? If not, what would you propose, and why?**

27. We agree that if the proposals are adopted as currently drafted, then the proposed transitional relief is appropriate. However, as explained above we oppose the introduction of the additional disclosures to which the relief would be relevant; in their absence, we can see no reason why the new rules should not be applied retrospectively.

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