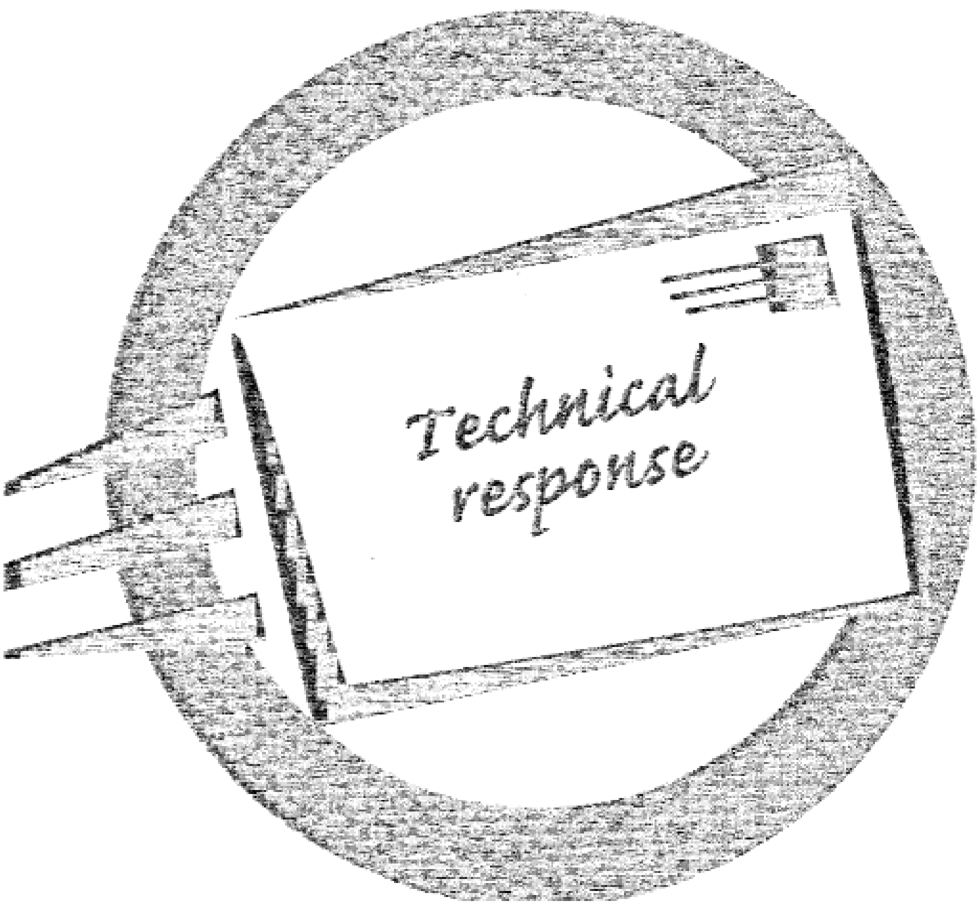
UK 26

technical response



IASB proposals to amend certain International Accounting Standards

Audit Commission
submission to the
Accounting Standards
Board

audit commission

Public audit is an essential element in the process of accountability for public money and makes an important contribution to the stewardship of public resources and the corporate governance of public services. The Audit Commission (the Commission) was established as an independent body in 1983 and has statutory responsibilities, amongst other things, for:

- **appointing auditors to local government and NHS bodies that spend some £120 billion of public money annually;**
- **setting the required standards for its appointed auditors, and regulating the quality of audits;**
- **making arrangements for certifying government grant claims and returns;**
- **undertaking or promoting comparative and other studies to promote the economy, efficiency and effectiveness of local government and NHS services;**
- **defining local government performance indicators;**
- **receiving and, where appropriate, following up information received from 'whistleblowers' in local government and NHS bodies under the Public Interest Disclosure Act 1998; and**
- **carrying out best value inspections of certain local government services and functions.**

The Commission appoints auditors to local government and NHS bodies from District Audit (the Commission's own arms-length audit agency) and from private firms of auditors. Once appointed, auditors carry out their statutory and other responsibilities, and exercise their professional judgement, independently of the Commission.

A summary of the key proposals contained the IASB Consultation Paper can be viewed on the ASB web site (www.asb.org.uk). Any comments on the issues raised by this response should be addressed to:

Paul King
Senior Manager, Accounting and Financial Reporting
Audit Policy and Appointments Directorate
The Audit Commission
1 Vincent Square
London SW1P 2PN

Telephone: 020 7396 1305
Fax: 020 7396 1369
Email: paul-king@audit-commission.gov.uk

CONTENTS

INTRODUCTION

1. The Audit Commission (the Commission) is responsible for appointing auditors to local authorities, police and fire authorities and National Health Service bodies in England and Wales. As such, it is primarily concerned with the potential impact of the proposals contained in the IASs on public sector entities indirectly through the alignment of UK accounting standards with international standards. In this context the Commission supports the UK Accounting Standards Board's strategy of moving towards international standards through its programme of work to align UK accounting standards with International Financial Reporting Standards (IFRPs) and the phased replacement of existing UK standards with new UK standards based on the equivalent WRSs.

2. The ASB issued the Consultation Paper *IASB proposals to amend certain accounting standards* in May 2002 as part of the former's programme of alignment, and which is the subject of this response from the Commission. The ASB has separately published proposals to issue UK standards based on six exposure drafts of revised IASB standards. Accordingly the Commission has separately responded to this proposal.

3. This response makes a number of general observations about the proposals in the IASs where the Commission believes it can add value to the debate. The Commission's responses to the specific issues and questions contained in the Prefaces to the IASs are contained in individual annexes to this response.

GENERAL OBSERVATIONS

IAS 1 PRESENTATION OF FINANCIAL STATEMENTS

4. The proposed amendments to the IAS mainly relate to:

   - limitation of the circumstances in which an entity could depart from a requirement in an]FRS or interpretation of a Standard;
   - elimination of the concept of "extraordinary items" and prohibition of the presentation of items of income or expense as "extraordinary items" in the income statement or notes;
   - limitation on the classification of a long-term financial liabilities in certain circumstances as a non-current liability where circumstances change after the balance sheet date but before the financial statements are authorised for issue; and
   - additional disclosure requirements relating to the judgements made by management and key assumptions about sources of measurement uncertainty.

5. The Commission agrees with the broad thrust of the proposals in the IAS although with some concerns on matters of detail as set out in the responses to the specific questions raised by the IASB in Annex A to this response.

IAS 8 ACCOUNTING POLICIES, CHANGES IN ACCOUNTING EXTIMATES AND ERRORS

6. The proposed amendments to the IAS mainly relate to:

   - removal of the allowed alternative treatments for changes in accounting policies and corrections of errors; and
   - elimination of the distinction between fundamental errors and other material errors.

7. The Commission notes the proposed treatment of errors (paragraphs 31 to 35 of the revised IAS 8) but is concerned that there is no reference at all to the concept of materiality, with the consequent implication that any error should be corrected, no matter how small it might be. It is generally accepted that by their nature financial statements are unlikely to be absolutely correct, in the same way that an audit of those financial statements can normally only provide reasonable assurance and not absolute assurance. The Commission does not believe that the criteria of "undue cost or effort" is an effective alternative to the generally understood concept of materiality.

8. Another issue concerns the proposal to amend paragraph 34 of IAS 8 so that when accounting retrospectively for a correction of an error, the basis for exemption from restating comparative information for a particular prior period changes from "impracticality" to "undue cost or effort". It is not clear whether the new criteria are intended to be more stringent than the old - if this is the intention then the

Commission is not convinced that it will be interpreted as such. There is a risk that entities will be inclined to cite “undue cost and effort” in more instances than is appropriate.

9. The same concern applies to the similar change proposed when there is a voluntary change in accounting policy (paragraph 49 of IAS 8).

10. The Commission also does not support the proposal in paragraph 19 of the IAS to require rather than encourage disclosure of the nature of a future change in an accounting policy when an entity has yet to implement a new Standard that has been issued but not yet come into effect. This seems unnecessary and contradictory to the concept of an effective date within a new standard. In addition, the Commission’s concern expressed above about the concept of “undue cost or effort” extends to the risk that entities will also resort to the exemption provided by the proposed paragraph 19(d)(ii) which states that an estimate does not have to be provided if it cannot be made without undue cost or effort.

11. The Commission would also suggest that the circumstances in which changes to an accounting estimate should be made (paragraph 25) would benefit from being expressed as a bold letter requirement.

IAS 17 LEASES

12. The proposed amendments mainly relate to:

- the inclusion of additional guidance on the treatment of leases of land and buildings; and
- elimination of the choice in IAS 17 on the treatment of initial direct costs i.e. expensing of such costs will no longer be permitted.

13. The Commission agrees with the proposed amendments.

IAS 27 CONSOLIDATED AND SEPARATE FINANCIAL STATEMENTS

14. The proposed amendments mainly relate to:

- extensions to the exemption to prepare consolidated financial statements;
- the requirement to present minority interest as part of equity, but separately from the parent shareholders’ equity; and
- the measurement of investments in subsidiaries, associates and jointly controlled entities in the investor’s separate financial statements.

15. The Commission agrees with the proposed amendments. But in the public sector, both generally and the UK specifically, there are circumstances in which entities can be required (or specifically not required) to prepare consolidated financial statements. These requirements are set out in legislation, or through powers

exercised under legislative provisions and govern the exact financial reporting requirements of an entity, or a group of entities.

IAS 28 ACCOUNTING FOR INVESTMENTS IN ASSOCIATES

16. The proposed amendments mainly relate to:

- the exclusion of investments by venture capital organisations, mutual funds, unit trusts and similar entities from the scopes of IAS 28 and IAS 31 *Financial Reporting of Interest in Joint Ventures* when they are measured at fair value in accordance with IAS 39 *Financial instruments: Recognition and Measurement,* when such measurement is well-established practice in the industries involved; and
- the expansion of the base available for offsetting of an investor's share of losses from an associate to include the carrying amount of an investment in equity shares plus other interests such as long-term receivables.

17. This is not likely to have a significant impact on public sector entities.

IAS 40 INVESTMENT PROPERTY

18. The proposed amendments mainly relate to the expansion of the definition of investment property. The amended definition will allow, but not require, a lessee that has an interest in property under an operating lease to classify that property interest as an investment property (provided the rest of the definition of investment property is met), on a property-by-property basis. This option is limited to entities that use the fair value model in IAS 40.

19. The Commission supports the proposed approach to the IAS.

ANNEX A

IAS 1 PRESENTATION OF FINANCIAL STATEMENTS

RESPONSES TO SPECIFIC QUESTIONS RAISED BY IASB

Q.	Particular Issue	Comment
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)?	Yes, the tightening of such circumstances is supported.
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)?	In principle, yes. But consideration should be given by the IASB as to whether additional disclosure of the circumstances of the items (for example in the notes to the accounts) would provide a more meaningful view of performance of the entity.
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. The classification of the liability as current in such circumstances would be misleading. Although current at the balance sheet date, the agreement to refinance or reschedule is properly viewed as an adjusting Post Balance Sheet Event. It would be useful to consider the disclosure of such items to provide better information to users.
4.	Do you agree that: a. a long-term financial liability that is payable on demand because the entity breached a condition of its loan agreement should be classified as current at the balance sheet date, even if the lender has agreed after the balance sheet date, and before the financial statements are authorised for issue, not to demand payment as a consequence of the breach (see proposed paragraph 62)? b. if a lender was entitled to demand	No to paragraph 62, for the same reasons given in answer to question 3 above. Yes to paragraphs 63 and 64.

	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)?	
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)?	Yes.
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)?	Yes.

ANNEX B

IAS 8 ACCOUNTING POLICIES, CHANGES IN ACCOUNTING EXTIMATES AND ERRORS

RESPONSES TO SPECIFIC QUESTIONS RAISED BY IASB

Q.	Particular Issue	Comment
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.
2.	Do you agree with eliminating the distinction between fundamental errors and other material errors (see paragraphs 32 and 33)?	No – the paragraphs make no distinction between any kind of error, and the concept of materiality is not referred to. The Commission believes that it should be (see observation in the main part of this response)

ANNEX C

IAS 17 LEASES

RESPONSES TO SPECIFIC QUESTIONS RAISED BY IASB

Q.	Particular Issue	Comment
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.	Yes.
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?	Yes, the Commission agrees that the direct costs incurred in negotiating a lease should be capitalised and allocated over the lease term – subject to an impairment test. The Commission also agrees that only the incremental costs, including internal costs, that are directly attributable to the lease transaction should be capitalised as proposed.

ANNEX D

IAS 27 CONSOLIDATED AND SEPARATE FINANCIAL STATEMENTS

RESPONSES TO SPECIFIC QUESTIONS RAISED BY IASB

Q.	Particular Issue	Comment
1.	Do you agree that a parent need not prepare consolidated financial statements if all the criteria in paragraph 8 are met? [paragraph 8: A parent need not present consolidated financial statements to comply with International Financial Reporting Standards if and only if: (a) it is a wholly-owned subsidiary or the owners of the minority interests, including those not otherwise entitled to vote, unanimously agree that the parent need not present consolidated financial Statements; (b) its securities are not publicly traded (c) it is not in the process of issuing securities in public securities market; and (d) the immediate or ultimate parent publishes consolidated financial statements that comply with International Financial Reporting Standards. Such a parent shall prepare financial statements in accordance with the requirements in paragraph 29, 30, and 33 of this Standard for separate financial statements.]	Yes, the proposed amendments are acceptable.
2.	Do you agree that minority interests should be presented in the consolidated balance sheet within equity, separately from the parent shareholders' equity (see paragraph 26)?	Yes. The Commission agrees with the proposed presentation of minority interests.
3.	Do you agree that investments in subsidiaries, jointly controlled entities and associates that are consolidated, proportionately consolidated or accounted for under the equity method	Yes, the proposed amendments are acceptable.

	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 that 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)?	

ANNEX E

IAS 28 ACCOUNTING FOR INVESTMENTS IN ASSOCIATES

RESPONSES TO SPECIFIC QUESTIONS RAISED BY IASB

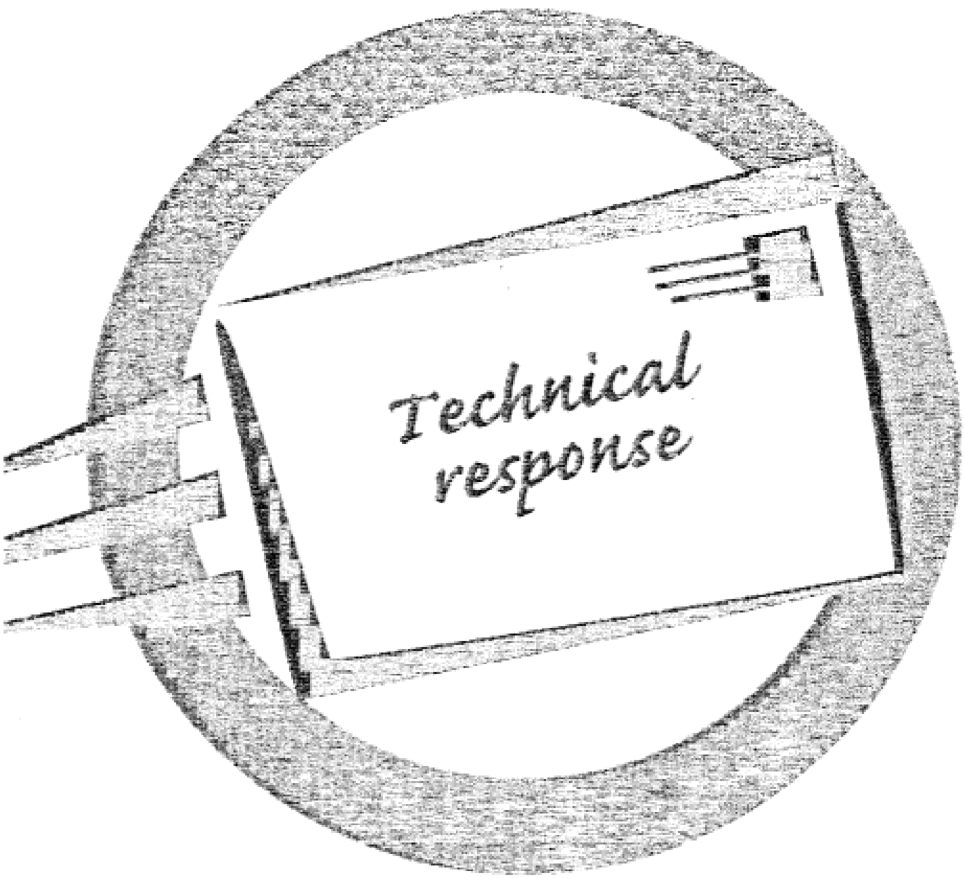
Q.	Particular Issue	Comment
1.	Do you agree that IAS 28 and IAS 31, Financial Reporting of Interests in Joint Ventures, should not apply to investments that otherwise would be associates or joint ventures held by venture capital organisations, mutual funds, unit trusts and similar entities if these investments are measured at fair value in accordance with IAS 39, Financial Instruments: Recognition and Measurement, when such measurement is well-established practice in those industries (see paragraph 1)?	Yes.
2.	Do you agree that the amount to be reduced to nil when an associate incurs losses should include not only investments in the equity of the associate but also other interests such as long-term receivables (paragraph 22)?	Yes.

ANNEX F

IAS 40 INVESTMENT PROPERTY

RESPONSES TO SPECIFIC QUESTIONS RAISED BY IASB

Q.	**Particular Issue**	**Comment**
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?	Yes. The Commission agrees with the proposed amendment to the definition of investment property.
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?	Yes. The Commission agrees with the proposal 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.
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?	Yes. The Commission agrees with the approach proposed.



Financial Reporting Exposure Drafts 23 to 29

Audit Commission submission to the Accounting Standards Board

audit commission

Public audit is an essential element in the process of accountability for public money and makes an important contribution to the stewardship of public resources and the corporate governance of public services. The Audit Commission (the Commission) was established as an independent body in 1983 and has statutory responsibilities, amongst other things, for:

- **appointing auditors to local government and NHS bodies that spend some £120 billion of public money annually;**
- **setting the required standards for its appointed auditors, and regulating the quality of audits;**
- **making arrangements for certifying government grant claims and returns;**
- **undertaking or promoting comparative and other studies to promote the economy, efficiency and effectiveness of local government and NHS services;**
- **defining local government performance indicators;**
- **receiving and, where appropriate, following up information received from 'whistleblowers' in local government and NHS bodies under the Public Interest Disclosure Act 1998; and**
- **carrying out best value inspections of certain local government services and functions.**

The Commission appoints auditors to local government and NHS bodies from District Audit (the Commission's own arms-length audit agency) and from private firms of auditors. Once appointed, auditors carry out their statutory and other responsibilities, and exercise their professional judgement, independently of the Commission.

A summary of the key proposals contained in FREDs 23 to 29 can be viewed on the ASB web site (www.asb.org.uk). Any comments on the issues raised by this response should be addressed to:

Paul King
Senior Manager, Accounting and Financial Reporting
Audit Policy and Appointments Directorate
The Audit Commission
1 Vincent Square
London SW1P 2PN

Telephone: 020 7396 1305
Fax: 020 7396 1369
Email: paul-king@audit-commission.gov.uk

CONTENTS

INTRODUCTION

1. The adoption and revision of appropriate accounting standards is fundamental to the presentation, within the financial statements, of meaningful information on an entity's performance and financial position. The Audit Commission (the Commission) supports the ASB s strategy of moving towards international standards through its programme of work to align UK accounting standards with International Financial Reporting Standards (IFRPs) and the phased replacement of existing UK standards with new UK standards based on the equivalent IFRSs. The Commission also welcomes the opportunity to comment on the ASB's implementation of this strategy through the issue of FREDs 23 to 29.

2. The Commission notes that FREDs 23 to 29 are based on six exposure drafts of revised IASB standards. The ASB has separately issued the Consultation Paper IASB proposals to amend certain accounting standards as part of the former's programme of alignment, containing revised IASs that the ASB does not at this time propose to use as the basis for issuing equivalent UK standards. The Commission has separately responded to the ASB on this proposal.

3. The Commission is responsible for appointing auditors to local authorities, police and fire authorities and NHS bodies in England and Wales. As such, it is primarily concerned with the potential impact of the proposals contained in the FREDs on public sector entities. The subject matter of the FREDs is such that some of them are clearly of more relevance to the public sector and those parts of the public sector audited by the Commission's auditors, whilst others are much less relevant.

4. Accordingly, this response makes a number of general observations about the proposals in the FREDs where the Commission believes it can add value to the debate. The Commission's responses to the specific issues and questions contained in the Prefaces to the FREDs are contained in individual annexes to this response.

GENERAL OBSERVATIONS

FRED 23 FINANCIAL INSTRUMENTS: HEDGE ACCOUNTING

5. The FRED proposes a principles-based approach to restricting hedge accounting, but does not place restrictions on the type of hedge accounting to be used. Essentially, it will only be permitted to hedge account if the 'hedging relationship' and 'hedging-effectiveness' criteria are fulfilled. These are not excessively rigorous requirements and the FRED notes that it is less prescriptive than the IAS equivalent which specifies certain situations where hedge accounting cannot be used.

6. Hedge accounting is not a widely-used technique in the public sector, and in particular local authorities are prohibited from using hedging. Therefore the proposed standard will have little direct relevance to the majority of public sector bodies.

7. Notwithstanding this, the Commission believes that the proposed standard is clear in its requirements and has the virtue of a straightforward, principles-based approach. It also represents a good means of both implementing IAS practice in the UK and allowing the ASB to influence the development of a revised IAS 39.

FRED 24 THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES; FINANCIAL REPORTING IN HYPERINFLATIONARY ECONOM1ES

8. Again, the proposed standard is likely to be of limited direct relevance to most public sector entities, most of whose activities are undertaken within the UK, although some entities with significant overseas activities will be affected.

9. The Commission notes that the FRED is based primarily on the consultation draft of IAS 21 'The Effects of Changes in Foreign Exchange Rates', and that the ASB intend to issue an FRS reflecting the contents of this revised IAS as a replacement for the current SSAP 20. The IASB has also issued an ED based on IAS 29 'Financial Reporting in Hyperinflationary Economies' and the ASB has the same plan in respect of this proposed FRS, replacing the current UTTF 9 and elements of SSAP 20.

10. The Commission notes that the ASB does not agree with the IASB proposals for 'recycling' all foreign exchange gains on disposal of a foreign operation through the P&L (as opposed to being recognised in the STROL). The ASB notes that it is working on a project with the IASB to address this in the longer term.

11. The Commission would also support the change whereby, in the closing rate method of accounting for foreign currency transactions, the closing rate is no longer an option for the translation of P&L items. It is now the rate on the date of transaction or an average.

12. The Commission also supports the proposal in FRED 24 to prevent the deferral of exchange gains or losses on long term monetary items where there is doubt about the convertibility or marketability of the foreign currency.

FRED 25 RELATED PARTY DISCLOSURES

13. The Commission notes that this FRED contains the draft IAS on related party transactions, coupled with ASB discussion of the impacts and proposals for change. There are some significant differences between the IAS and the FRED and, in response, the ASB has raised several potential additions within the UK context. However, the standard is not seen as contentious enough to warrant a delay on implementation.

14. Related party disclosures have a particular significance for the public sector given the greater prominence to issues around propriety and the conduct of public business, and this significance has become more important over recent years. Moreover, the growth of ‘Special Purpose Vehicles’, ‘Arms Length Management Organisations’ and other forms of partnership is likely to increase this prominence further. The Commission believes that this greater significance could usefully be referred to in any new standard.

15. The standard adopts a much simpler approach than FRS 8. Related parties are defined more widely than in FRS S which is useful. This is likely to increase the number of related parties to be disclosed. The disclosure of transactions is slightly narrower than the current FRS and the ASB has suggested an additional UK proposal to report the names of both the controlling party and also the names of transacting parties as it believes the IAS is deficient in this regard. The Commission supports this line.

16. Another key difference is that the IAS defines ‘significant influence’ more narrowly than the FRS (power to participate in the operating and financial policy decisions of the entity rather than the more negative inhibition from pursing interests). This is useful, but arguably too narrow. The Commission is also concerned that the IAS does not specifically address the concept of materiality in considering the need to disclose - which may lead to excessive detail being produced. The Commission also believes that the definition of ‘significant influence’ should be revisited.

FRED 26 EARNINGS PER SHARE

17. Earnings per share is also an issue that will not be applicable to the vast majority of public sector entities, and the FRED notes that the FRS to be produced at the end of the development process will only apply to listed companies.

18. Whilst the issue of earnings per share is not directly relevant to the public sector, the clear specification of performance measures (especially those involving accounting information) is of critical importance. Notwithstanding the fact that

financial commentators use a variety of other ‘home-grown’ measures to assess performance, the earnings per share issue is a key published statistic for listed companies and a vital tool in the evaluation of the other types of entity. Therefore, the Commission supports the requirement in the FRED to publish more earnings per share information (basic and diluted). Similarly, where entities produce additional information on earnings per share then there is merit in the proposals for a reconciliation to be published.

FRED 27 EVENTS AFTER THE BALANCE SHEET DATE

19. This FRED only has a few major differences to extant UK GAAP. The main one is that the SSAP 17 definition of adjusting events includes ‘events which because of statutory or conventional requirements are reflected in financial statements’ is no longer appropriate. This means that dividends are no longer a liability at the year end and this will require a change in the law, which is currently being discussed with DTI.
20. This is not likely to have a significant impact on public sector entities. A similar implication arises with the accounting treatment of dividends declared by subsidiaries in respect of previous periods.

21. The Commission also notes that the draft FRS is more rigid than the current SSAP 17 in that it does not allow for exceptional cases of non-adjusting events becoming adjusting.

22. In the context of the public sector, the reference in paragraph 16 of the FRED to a requirement that an entity should “disclose the date when the financial statements were authorised for issue and who gave that authorisation” will need clarification or interpretation. For example, in the case of NTIS bodies, the financial statements must be adopted (approved) by the Board of Directors, but they are then signed by the chief executive and finance director by order of the Board. In theory, the date of adoption and signature could be different.

FRED 28 INVENTORIES; CONSTRUCTION & SERV1CE CONTRACTS

23. The Commission notes that there are no major changes to UK requirements. The FRED indicates that the IAS-based requirement for ‘reliable estimation’ of contract profits, rather than the SSAP 2 ‘prudently calculated attributable profit’ is closer to the Statement of Principles emphasis on reliability rather than prudence.

24. The draft standard reduces the amount of prescribed guidance on disclosure of contract balances requiring them to be presented as a single line item rather than a collection of elements - ‘gross amounts due from/to customers for contract work.’(SSAP 9 has elements for stock, debtors, creditors, etc.).

25. Finally, the draft standard more explicitly states that the requirements ban be applied to separately identifiable components of a contract or group of contracts if

that would reflect the substance. The ASB comments seem to suggest that this is reasonable if SSAP 9 is interpreted in the light of FRS *5*.

26. This is an important standard for public sector organisations, who are involved in a very wide range of contract arrangements (although not typically as the contractor). The Commission's view is that there are no significant changes to the treatment and the proposals are reasonable. The only issue to raise is that the ASB could perhaps consider the treatment of the outstanding balances at the year-end whether there is a case for retaining the SSAP 9 approach.

FRED 29 PROPERTY, PLANT AND EQUIPMENT

27. The Commission believes that this FRED is likely to have a significant impact on public sector entities. In particular, the following issues are of particular interest in this respect:

28. Whilst the IAS uses the term 'fair value', the definition of the term does not appear to encompass the concept of 'value in use', which is of particular importance to the UK Public Sector.

29. The issue of donated assets is not covered in the IAS. This is also of particular relevance and importance to UK public sector entities, and the Commission's view is that they should be recognised at their fair value by an entity when the asset is donated.

30. There is also no mention of renewals accounting in the FRED. Local Government entities in the UK, in particular, use renewals accounting as an estimate of depreciation in certain circumstances. The Commission supports this approach and its availability as an acceptable accounting treatment within the relevant accounting standards.

31. Further detail on these issues, together with other comments and observations, are contained at Annex G in response to the specific questions raised by the ASB and IASB.

ANNEX A

FRED 23 FINANCIAL INSTRUMENTS: HEDGE ACCOUNTING

Q.	Particular Issue	Comment
1.	Do you agree that a UK standard on hedge accounting is needed at this time to improve UK accounting and to prevent a gap appearing in UK accounting literature on hedges of net investments in foreign operations?	Yes. The possible implications of deferred charges to the profit and loss account are very significant.
2.	The ASB has taken the view that, in order to start the process of bringing UK practice on hedge accounting into line with the practice adopted internationally, the proposed UK standard's restrictions on the use of hedge accounting should be based on the main principle that underlies the hedge accounting restrictions on IAS 39: that hedge accounting should be permitted only if the hedging relationship is pre-designated and meets certain effectiveness criteria. (a) Do you agree that the UK standard should be based on the principles underlying IAS 39 as set out in the FRED? (b) Does the principle need to be supplemented with any other principles?	 Yes. This supports both the convergence process and continues the tradition in the UK of principles-based reporting. At this stage, no.
3.	The ASB has taken the view that the UK standard should contain those detailed restrictions in IAS 39 that appear to it to be necessary to implement the aforementioned principle, but should not at this stage include any other restrictions on the use of hedge accounting. (a) Do you agree that the FRED's proposed restrictions on the use of hedge accounting (see paragraphs 4, 6 and 8 of the FRED) are all	 Yes. These appear to be the bare minimum for the implementation of the standard.

	necessary to implement the aforementioned principle? (b) Do you agree that the FRED should not contain any other restrictions on the use of hedge accounting? If not, what should those other restrictions be?	 Yes. This is particularly important as the purpose of the standard appears to be a 'starting point' for addressing the hedge accounting issues.
4.	Do you agree with the material in the FRED on measuring hedge effectiveness (see paragraphs 9-15)? If you do not, what if any changes would you make to the material (bearing in mind that the material is drawn largely from IAS 39 and that one objective of the FRED is to bring about convergence of accounting practice)?	Yes, the measures appear reasonable. One concern would be the 80-125% range in paragraph 9. Insofar as this 'corridor' appears arbitrary then this may lead to a compliance culture where a figure is this range implies that a hedging arrangement must be one of high effectiveness. Such a 'corridor' also seems to be inconsistent with the statement in paragraph 15 that 'this standard does not specify a single method of assessing hedge effectiveness'. It would be more appropriate to view such a 'corridor' as a minimum requirement of high effectiveness, rather than the sole requirement. Although identical provisions are to be found in IAS 39, as the FRED is to lead to a UK standard with no direct IAS equivalent, such a divergence would not be inappropriate.
5.	The ASB has taken the view that, in the main, the proposed FRS should not prescribe how hedge accounting should be done? Do you agree with this approach?	Yes, for the practical reasons outlined above (i.e. starting to set standards on hedge accounting). However, the ASB should be considering if this will be necessary in the longer term.
6.	The ASB has nevertheless decided that the FRED should contain some minimum requirements on the hedge accounting techniques to be used. Do you agree with the FRED's proposals on: (a) the treatment of hedges of net investments in foreign operations (see paragraph 16 of the FRED)? (b) the treatment of the ineffective portion of a gain or a loss on the hedge that is not a hedge of a net	 Yes. Yes.

	investment in a foreign operation (see paragraph 16 (b) of the FRED)? (c) The treatment of hedging instruments that cease to qualify for hedge accounting (see paragraphs 17 and 18 of the FRED)?	 Yes.
7.	The ASB is proposing that the standard should come into effect for reporting periods ending on or after a date in early 2003, although it is also proposing certain transitional arrangements (see paragraph 20 of the FRED)? Do you agree with this approach?	Yes.

ANNEX B

FRED 24 THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES; FINANCIAL REPORTING IN HYPERINFLATIONARY ECONOMIES

Q.	**Particular Issue**	**Comment**
ASB (i)	Do you agree with the ASB's proposed timetable for the implementation in the UK of standards based on a revised IAS 21 and IAS 29?	Yes. This seems pragmatic.
ASB (ii)	Do you agree with the proposal not to include the IAS 21 provisions on the recycling of certain exchange gains and losses?	Yes. The IAS provisions would make for increased complexity on the disposal of foreign currency operations. In addition, they would conflict with the treatment of revaluation gains on the disposal of fixed assets.
ASB (iii)	Do you agree with the proposal not to include any transitional arrangements in these UK standards?	Yes. The standard is not contentious.
IASB (i)	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. The two new 'notions' appear to be a sensible approach to dealing with the closing rate/temporal method dilemma.
IASB (ii)	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. The alternative would be too difficult to police.
IASB (iii)	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, this seems a sensible suggestion.
IASB (iv)	Do you agree that the allowed alternative to capitalise certain	Yes.

	exchange differences in paragraph 21 of IAS 21 should be removed?	
IASB (v)	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, this seems sensible.

ANNEX C

FRED 25 RELATED PARTY DISCLOSURES

Q.	Particular Issue	Comment
ASB (i)	Do you agree with the proposal to issue a new standard in the UK on related party disclosures, once the new IAS 24 is approved by the IASB?	Yes.
ASB (ii)	Do you believe that the ASB should consider any transitional arrangements?	No, the proposed standard is not onerous.
ASB (iii)	Do you believe that an accounting standard should require disclosure of the name of a controlling party and, if different, that of the ultimate controlling party? If the new IAS does not require disclosure, do you believe that a new UK standard should require the disclosure as set out in paragraphs 13A and 13B of the draft FRS?	Yes, disclosure of the name of the controlling party and the ultimate controlling party if different should be required. In the public sector, the growth of 'arms length' organisations and special purpose vehicles (among others) makes the public availability of this information desirable. From a more principles-based approach, it is hard to see what benefits to users of financial statements might accrue from removing this disclosure requirement. If the IAS did not require disclosure then a new UK standard should require the disclosure set out in paragraphs 13A and 13B of the draft FRS.
ASB (iv)	Do you believe that an accounting standard should require disclosure of the names of the transacting related parties?	Yes, for the reasons set out in answer to ASB (iii) above. In particular, standards of probity in the public sector would be improved through this requirement.
ASB (v)	Should the definition of related parties specifically refer to shadow directors? Should it also refer to persons acting in concert?	Yes, to both questions.
ASB (vi)	Do you believe that an accounting standard should specify that disclosure is required of material related party transactions and give more guidance on materiality in the context of such transactions?	Yes, the concept of materiality is an important one in this concept and guidance would be valuable in interpreting the requirement.

ASB (vii)	Are there are any other aspects of the draft standard that the ASB should request the IASB to review when finalising the revised IAS 24?	Yes. The FRS 8 definition of significant influence, albeit more ambiguous than the IAS definition, is a wide-ranging one. It is therefore arguably closer to the reality of transactions between entities. There is significant scope for transacting entities to arrange their affairs under the draft IAS in such a way that they will avoid reporting related party transactions. Again, there is scope here for the ASB to influence the work of the IASB in a positive way – the highest common denominator approach.
IASB (i)	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'.	The Commission <u>does not agree</u> with the requirement not to disclose management compensation, expense allowances and similar items paid in the ordinary course of an entity's operations. Full and open disclosure of management remuneration in all its forms is a key principle for public sector entities in the UK, and is seen to be an important element in the overall accountability and performance framework. It is also seen as an area of specific interest to readers of the accounts. It is difficult to be prescriptive in seeking to define both 'management' and 'compensation', as both will vary according to the organisational nature and structure of any particular entity. But 'management' would normally include the directors or members of the board or equivalent governing body of the entity, together with others having the authority and responsibility for planning, directing and controlling the activities of the entity. 'Compensation' would include all cash and non-cash benefits derived both directly and indirectly from services provided by 'management' in their capacity as directors, members of the board or equivalent governing body or as employees of the entity.
IASB (ii)	Do you agree that the Standard should not require disclosure of related party	The Commission <u>does not agree</u> with this proposal. The argument for full and open disclosure to satisfy the need for

	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 that entity belongs (see paragraph 3)?	accountability referred to above also means that an appropriate level of disclosure should be made in respect of each individual entity, rather than solely at the group level. In the public sector in the UK, such disclosure is often prescribed in the requirements governing the preparation of financial statements of the entity.

ANNEX D

FRED 26 EARNINGS PER SHARE

Q.	Particular Issue	Comment
ASB (i)	Do you agree with the proposal to issue a new UK standard on earnings per share to replace FRS 14 as soon as the new IAS 33 is approved by the IASB?	Yes. This is in accordance with the convergence programme.
ASB (ii)	Do you believe that the ASB should consider any transitional agreements?	No.
ASB (iii)	Are there any aspects of the draft standard that the ASB should request the IASB to review when finalising the revised IAS 33?	Earnings per share is not a subject that is directly relevant to the Commission's areas of activity, so the Commission is not in a position to respond on this point.
IASB (i)	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?	As above, the Commission is not in a position to respond on this point.
IASB (ii)	Do you agree with the following approach to the year-to-date calculation of diluted earnings per share as illustrated in Appendix II, examples 7 & 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 (i.e.	As above, the Commission is not in a position to respond on this point.

	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).	

ANNEX E

FRED 27 EVENTS AFTER THE BALANCE SHEET DATE

Q.	Particular Issue	Comment
ASB (i)	Do you agree with the proposal to issue a new UK standard on events after the balance sheet date, once the new IAS 10 is approved by the IASB and once the law is amended to permit its application?	Yes.
ASB (ii)	Do you believe that ASB should consider any other transitional arrangements?	No.
ASB (iii)	Are there any aspects of the draft standard that ASB should request IASB to review when finalising the revised IAS 10?	No.

ANNEX F

FRED 28 INVENTORIES; CONSTRUCTION & SERVICE CONTRACTS

Q.	Particular Issue	Comment
ASB (i)	Do you agree with the proposal to issue new UK standards on inventories and construction contracts to replace SSAP 9, once the revised IAS 2 is approved by the IASB?	Yes.
ASB (ii)	Do you agree with the proposal to incorporate part of IAS 18 in the standard on construction contracts so that it may also apply to other contracts for services?	Yes. The Commission believes that the incorporation of part of IAS 18 is useful in providing guidance on an area where it has previously been absent. But once the work of the ASB and other standard setters on revenue recognition is completed then any new guidance arising from that work will need to be reflected in the FRS that emerges from FRED 28.
ASB (iii)	Do you believe that the ASB should consider any transitional arrangements?	No.
ASB (iv)	Are there any aspects of the draft standard on inventories that the ASB should request the IASB to review when finalising the revised IAS 2?	No.
ASB (v)	Are there any aspects of the standard on construction contracts that the ASB should request the IASB to review in due course?	No.
IASB (i)	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?	Yes.
IASB (ii)	IAS 2 requires reversals of write-downs of inventories when the circumstances that previously caused inventories to be written down below cost no longer exist (paragraph 30). IAS 2 also requires the amount of any reversal of any write-down of inventories to be recognised in the profit or loss (paragraph 31). Do you agree with retaining these requirements?	Yes.

ANNEX G

FRED 29 PROPERTY, PLANT AND EQUIPMENT

BORROWING COSTS

Q.	Particular Issue	Comment
ASB (i)	Do you agree with the proposal to issue new UK standards on property, plant and equipment and borrowing costs when the IASB issues the revised IAS 16, unless it becomes clear that further changes to IAS 16 are likely by 2005 as a result of the revaluation project?	Yes. Deferral is also supported if the revaluation project leads to changes before 2005.
ASB (ii)	As explained in paragraph 7 above, the international exposure draft on property, plant and equipment proposes that residual values used in the calculation of depreciable amount should be reviewed at each balance sheet date and revised to reflect current estimates. FRS 15 generally requires prices at the date of acquisition or latest valuation to be used; hence, depreciation expense on a historical cost basis is not reduced by inflation in residual values. Do you agree or disagree with the proposed international approach?	Disagree with the proposed international approach, and support the approach taken by FRS 15.
ASB (iii)	IAS 16 does not address the use of renewals accounting in respect of certain infrastructure assets. Do you believe that the absence of the guidance in FRS 15 would prevent entities from using renewals accounting as a method of estimating depreciation? Should UK entities be permitted to continue to use renewals accounting?	Yes to both elements of the question. UK public sector entities do, in certain circumstances, use renewals accounting as an estimate of depreciation. The Commission supports this approach.
ASB (iv)	What are your views on the differences between the requirements of FRS 15 and IAS 16 concerning revaluations as described in paragraphs 10 to	The Commission supports the approach in the IAS of allowing, as an alternative treatment, the revaluation of property, plant and equipment (at fair value). The definition of fair

	17 above?	value should be broad enough to include the concept of 'value in use' contained in FRS 15.
ASB (v)	Are there any other aspects of the differences between the proposed standards and current UK accounting requirements that you wish to comment on?	The international standard should also cover the issue of donated assets, which are a feature of public sector entities in the UK. The Commission believes that such assets should be recognised by an entity at fair value when they are donated.
ASB (vi)	Do you agree with the ASB's proposal, as a transitional measure (see paragraph 18 above), that the present exemption in FRS 15 in respect of insurance companies should be retained in a new UK standard based on IAS 16 revised pending the outcome of the IASB's projects on insurance and reporting financial performance?	The Commission is not familiar with the insurance industry and therefore is not in a position to make an informed response to this question. But the proposal to maintain the current UK position pending the outcome of IASB work is consistent with the ASB's approach in other areas.
ASB (vii)	The transitional arrangements for the first-time application of FRS 15 allowed an entity that does not adopt a policy of revaluation to retain carrying amounts reflecting previous revaluations instead of restating the carrying amounts to historical cost (see paragraph 19 above). Do you believe that a transitional arrangement should be included in a new UK standard to allow entities that adopted FRS 15's transitional arrangement to continue to recognise the carrying amounts under that arrangement?	Yes, this is supported – in practice historical cost data may not be available.
ASB (viii)	Do you believe that ASB should consider any other transitional arrangements?	No.
ASB (ix)	Are there any other aspects of the draft standard on property, plant and equipment that the ASB should request the IASB to review when finalising the revised IAS 16?	None in addition to the comments made elsewhere.
ASB (x)	Do you agree that the capitalisation of borrowing costs	Yes. If a choice has to be made, the Commission would opt for

	should remain optional? If you had to choose between mandatory capitalisation and prohibition of capitalisation, which would you support and why?	prohibition, on the grounds of prudence.
ASB (xi)	Do you agree that paragraph 5(e) of IAS 23, which allows certain exchange differences to be capitalised, should be deleted in the draft standard on borrowing costs?	Yes.
ASB (xii)	What are your views on the difference between IAS 23 and FRS 15 referred to in paragraph 24 of the Preface to the FRED concerning borrowing costs eligible for capitalisation?	The Commission supports the FRS 15 approach
ASB (xiii)	Do you have any comments on IAS 23 that you wish the ASB to bring to the IASB's attention?	No.
IASB (i)	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 of the [draft] FRS on property, plant and equipment)?	The Commission agrees in principle, subject to the observations above about the definition of fair value being broad enough to incorporate the concept of 'value in use'.
IASB (ii)	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?	Yes.
IASB (iii)	Do you agree that depreciation of an item of property, plant and equipment should not cease when it becomes temporarily idle or is retired from active use and held for disposal (see paragraph 59 of the [draft] FRS on property, plant and equipment)?	Yes in respect of temporary idleness. In respect of 'retired from active use and held for disposal' then if it has not been fully depreciated than the asset should be reviewed for impairment, with a view to being written down to its residual value.