Smith & Williamson response - Financial Instruments: The Effects of Changes in Foreign Exchange Rates; Financial Reporting in Hyperinflationary Economies (FRED 24)

The following sets out our responses to the questions raised by the ASB and IASB

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?*

Whilst we fully endorse the ASB's approach to convergence, we would refer you to our response to FRED 23. Our concern relates entirely to the effect that replacement of SSAP 21 has on the loss of guidance with respect to hedge accounting and the resultant proposed standard based on FRED 23. Our view is that this guidance should be subsumed into a standard based on FRED 30 and, therefore, the implementation of standards based on FRED 24 should be delayed to coincide with standards based on FRED 30.

ASB (ii) *Do you agree with the proposal not to include the IAS 21 provisions on the recycling of certain exchange gains and losses?*

We agree that the proposal on recycling of gains and losses should be excluded from the UK standard. We are surprised that the IASB has continued to include this proposal in the revision to IAS 21 given comments made by them on recycling in the development of other standards.

ASB (iii) *Do you agree with the proposal not to include any transitional arrangements in these UK standards?*

We do not consider that there are any necessary transitional arrangements.

The IASB has asked commentators to respond to the following questions on the proposed changes to IAS 21:

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?*

We consider that this is sufficient guidance to enable reporting entities to determine functional currency.

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?*

One of the principle aims of the convergence of accounting standards is to create greater comparability between accounts on a global basis. We question, however, whether this is achieved by permitting the use of any currency and would suggest that some restriction be placed upon the currencies in which an entity may prepare its accounts. Restrictions based on the following criteria would appear to be more appropriate.

- Country of incorporation, or
- Functional currency, or
- Currency of the country in which the parent or ultimate parent is incorporated and prepares its accounts.

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)?*

We are in agreement with this approach.

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

We agree with this as it is consistent with the general principles with respect to the recognition of assets and liabilities.

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)?

We agree with this approach in that it produces consistency of accounting treatment.

Smith & Williamson response - Earnings per share (FRED 26)

The following sets out our responses to the questions raised by the ASB and IASB

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?*

We fully support the move towards the international harmonisation of accounting standards and the ASB's intention to 'endorse' new IFRS by issuing revised UK standards at the same time. As the proposals represent only minor amendments to the existing standard, we see no reason for not replacing FRS 14 as soon as the new IAS 33 is approved.

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 the ASB should request the IASB to review when finalising the revised IAS 33?*

No

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?*

This treatment is consistent with requirements elsewhere in existing UK standards, most notably FRS 7 which requires contingent consideration which can be satisfied either by shares or by cash to be accounted for on the basis that the shares will be issued. The approach proposed is therefore appropriate both from the viewpoint of consistency and being one which takes proper account of all potentially dilutive shares.

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

- *The number of potential ordinary shares is a year-to-date weighted average of the number of potential ordinary shares included in each interim diluted earnings per share calculation, rather than a year-to-date weighted average of the number of potential ordinary shares weighted for the period they were outstanding (ie without regard for the diluted earnings per share information reported during the interim periods).*
- *The number of potential ordinary shares is computed using the average market price during the interim periods reported upon, rather than using the average market price during the year-to-date period.*
- *Contingently issuable shares are weighted for the interim periods in which they were included in the computation of diluted earnings per share, rather than being included in the computation of diluted earnings per share (if the*

conditions are satisfied) from the beginning of the year-to-date reporting period (or from the date of the contingent share agreement, if later).

We consider that this approach results in both consistency and the most representative figure for diluted earnings per share at the end of each interim period

Smith & Williamson response . Related parties (FRED 25)

The following sets out our responses to the questions raised by the ASB and IASB

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?*

We fully endorse the ASB's work towards convergence. For the reasons discussed below we do have concerns about the possible dilution of existing requirements with respect to the disclosure of related parties.

ASB *(ii)* *Do you believe that the ASB should consider any transitional arrangements?*

We do not consider that there is any need for transitional provisions.

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 con trolling party? If the new IAS 24 does not require disclosure, do you believe that a new UK standard should require this disclosure as set out in paragraphs 13A and]3B of the [draft] FRS?*

The identity of the controlling party is important information for the users of financial statements and should continue to be included in any accounting standard. Were the new IAS 24 not to require such disclosure, our view is that the UK should continue to include this within the revised FRS.

ASB (iv) *Do you believe that an accounting standard should require disclosure of the names of transacting related parties?*

The omission of the requirement to disclose the names of transacting parties will result in a serious dilution of existing UK standards. The international requirement to make disclose by nature of relationship will not, in our opinion, result in information which will be readily understandable to the readers of the accounts. The current 'post- Enron' environment is not the time to potentially weaken disclosure in such an important area. The use of names provides far more clarity.

ASB (v) *Should the definition of related parties specifically refer to shadow directors? Should it also refer to persons acting in concert?*

We presume that the omission of shadow directors from the IAS is as a result of this being a term specific to UK legislation. It could be argued that such relationships will be picked up through the fairly wide definition of 'key management'. The most appropriate treatment might, therefore, be for the FRS to include specific reference to shadow directors within the definition.

Persons acting in concert should be added to the definition of related parties.

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?*

The failure to include any reference to materiality could result in excessive disclosure which can result in a loss of value of that disclosure. The standard should therefore only require disclosure of material related party transactions.

Whilst it would be helpful to include guidance on materiality, we do not necessarily think that this should be at the same level as within FRS 8. In particular FRS 8 requires disclosure of transactions which are material to *either* party. Whilst we appreciate the reasoning behind this particular requirement, there is a risk that the inclusion of apparently very small transactions dilutes the perceived value of the disclosure.

ASB (vii) *Are there any other aspects of the draft standard that the ASB should request the IASB to review when finalising the revised IAS 24?*

No.

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'.

For UK companies this would have little impact as there is existing disclosure requirements both within legislation and the Listing Rules. There are, however, issues for international comparability going forward. However, we believe that this area is more appropriately addressed through general considerations Of Corporate Governance disclosure.

IASB (ii) *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 (see paragraph 3)?*

We agree and do not think that disclosure of such transactions would add any value to financial statements.

Smith & Williamson response - Events after the balance sheet date (FRED 27)

The following sets out our responses to the questions raised by the ASB and IASB

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?*

We fully support the move towards the international harmonisation of accounting standards and the ASB's intention to 'endorse' new IFRS by issuing revised UK standards at the same time.

The only significant change proposed between FRED 27 and SSAP 17 is that relating to the treatment of dividends proposed after the end of the year. We are in agreement with the proposed change not least because it will introduce greater consistency between the accounting treatment in the UK and that already adopted by a number of other countries.

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.

Smith & Williamson response - Property, plant and equipment; Borrowing costs (FRED **29)**

The following sets out our responses to the questions raised by the ASB and IASB

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 £45 16, unless it becomes clear that further changes to IAS 16 are likely by 2005 as a result of the revaluation project?*

We endorse the ASB's approach to convergence and agree in principle with the adoption of the two IAS covered by FRED 29. We also welcome the fact that the ASB have indicated they will not adopt them should it appear that further changes are likely to happen. We comment below on the proposals with respect to valuation.

ASB (ii) *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?*

We do not think that it is appropriate to review residual balances based on current estimates. Accounting principles do not generally take account of inflation therefore adopting this approach introduces inconsistencies into the reporting of financial performance.

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?*

We have no experience of the use of renewals accounting and do not therefore feel able to comment on this point.

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 17 of the Preface to the FRED)?*

Basis of valuation - Our view is that the ‘value in use’ model of FRS 15 is preferable to the ‘fair value’ model of the IAS. The financial statements of an entity should reflect the circumstances of that entity as they are at the balance sheet date. To include assets at fair value is not compatible with this concept as it takes account of possible events in the future and for many entities events that are unlikely to ever happen in practice.

Frequency of valuations - We prefer the approach of the IAS requiring valuations to be carried out as frequently as necessary to maintain valuations close to carrying value. The five year and three year intervals required by FRS 15 are overly prescriptive and potentially unnecessarily burdensome to some reporting entities.

We do not consider that the valuer need be external to the reporting entity, but do agree that they should have a suitable qualification. Where the valuer is a director or shareholder this fact should be clearly disclosed.

The absence of guidance on the method of valuation is an omission, presumably because there is no international equivalent of the RICS guidelines. Such guidance should be included within the standard to ensure consistency of valuation methods.

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?*

No.

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?*

We support this proposal as we believe that the progress to convergence should be made as simple as possible for companies and this would avoid the risk of introducing two standards in a short period of time.

ASB (viii) *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?*

We consider that this would be an appropriate approach.

ASB (viii) *Do you believe that ASB should consider any other transitional arrangements?*

We cannot i4entify any other transitional provisions that we consider would be appropriate.

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?*

No.

ASB (x) *Do you agree that the capitalisation of borrowing costs should remain optional? If you had to choose between mandatory capitalisation and prohibition of capitalisation, which would you support and why?*

In general we are not in favour of optional treatments in accounting standards. However, we also accept that in the case of borrowing costs there are certain sectors (for example property) where significant borrowing costs are directly incurred in producing an asset and are an integral part of the cost of the asset. However, to have a requirement that all borrowing costs should be capitalised would be overly burdensome on entities in other sectors. An optional approach is, therefore, appropriate in this case.

Were we to have to choose between mandatory capitalisation or prohibition we would favour mandatory capitalisation. The reason for this being that it would result in a fairer reflection of the true cost of an asset. In addition, the alternative of expensing all borrowing costs directly to the profit and loss would penalise those entities who develop their own assets rather than buying them from third parties where the ‘full cost’ of the asset, will be included in the purchase price.

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?*

We agree with this proposal as we do not consider that these are appropriate costs to be capitalised.

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?*

We consider that the approach of FRS 15 is the more correct as it includes the true cost of producing the asset. Given that interest rates on borrowings are higher than on deposits, the approach of the IAS could result in higher amounts being capitalised than under FRS *15.*

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 ofproperty, 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)?*

This appears to be a reasonable basis for recording such assets. Further guidance on the determination of fair value should however be included.

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?*

Whilst this appears reasonable, we again consider that there should be guidance on the determination of fair values.

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)?*

We do not agree with this approach. The more appropriate approach would be to determine whether there has been any impairment in the asset, charge the impairment to the profit and loss account and cease depreciation.