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NATIONAL AUDIT OFFICE

National Audit Office
157-197 Buckingham Palace Road
Victoria
London SW1W 9SP

GTN 3935
Switchboard 020-7798 7000
Facsimile 020-7

The Technical Director
Accounting Standards Board
Holborn Hall
100 Gray's Inn Road
London
WC1X 8AL

Direct Line 020-7798 7126
Room B352
Reference
Date 13 September 2002

Dear Sir

FRED's 23, 24, 25, 27, 28 and 29

I attach our comments on the exposure drafts above. I hope that you find these comments helpful.

Yours faithfully

P. Morgan

pp. **MIKE SUFFIELD**

Director, Financial Audit Policy and Support

FRED23 - Hedge Accounting General Comments

The National Audit Office has considered how the proposals may be applied, with particular reference to the central government sector. This consideration does not take account of decisions that will be taken by the Treasury on the application of the standard.

The impact on central government will be limited to the small number of bodies that use hedging as part of their risk management strategies.

Specific Comments

Q1 *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 in principle. However, a change to the timetable for implementation may be preferable to issuing a standard if that standard will require amendment to achieve convergence (see comments to question 3b).

Q2 *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 in 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?*

Yes.

(b) *Does the principle need to be supplemented by any other principles?*

The principle appears to be sufficient

Q3 *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 necessary to implement the aforementioned principle*

Yes.

(b) *Do you believe that the FRED should not contain any other restrictions on the use of hedge accounting? If not, what should those other restrictions be?*

The proposed restrictions appear sufficient to implement the principles. However, the proposed standard has fewer restrictions on hedge accounting than IAS 39 and this may have implications for convergence.

Q4 Do you agree with the material in the FRED on measuring hedge effectiveness (see paragraphs 9-15 of the FRED)? 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 in principle.

We agree that the proposed standard should make it clear that an effective hedge need not have the expectation of an exact match between the hedged item and hedged instrument but that there should not be very wide divergence. In this respect, the material on what is regarded as highly effective is useful. However, it might be interpreted that if the fair value of a hedge falls within the range given in paragraph 9 that this is a sufficient requirement for the hedge to be considered effective rather than a minimum requirement.

While the range in paragraph 9 reflects IAS 39, the Board might consider whether there is scope for a difference of emphasis between the UK standard and the international standard in this regard; and whether this would be at odds with convergence. The Board has proposed elsewhere in the exposure draft that the UK standard should be slightly different from IAS 39 while adhering to its principles. It would seem consistent with the Board’s stance (and not inconsistent with convergence) that the UK standard makes it clear that a hedge within the range given in paragraph 9 is not sufficient in itself to be considered highly effective but that other factors (such as those in paragraphs 10 to *15)* should be taken into account.

Q5 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.

Q6 *The ASB has nevertheless decided that the FRED should propose some minimum requirements on the hedge accounting techniques to be used. Do you agree with the FRED 'proposals on:*

(a) the treatment of hedges of net investments in foreign operations (see paragraph 16(a) of the FRED)?

Yes.

(b) the treatment of the ineffective portion of a gain or loss on a hedge that is not a hedge of a net investment in a foreign operation (see paragraph 16(b) of the FRED)?

Yes.

(c) the treatment of hedging instruments that cease to qualify for hedge accounting (see paragraphs 17 and 18 of the FRED)?

Yes.

Q7 *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.

FRED 24 - The Effects of Changes in Foreign Exchange Rates
Financial Reporting in Hyperinflationary Economies

General Comments

The National Audit Office has considered how the proposals may be applied, with particular reference to the central government sector. This consideration does not take account of decisions that will be taken by the Treasury on the application of the standard. However, both SSAP 20 and UITF 9 apply to central government bodies and we see no reason why the standards proposed by FRED 24 should not be adopted.

We support the ASB's view that exchange differences on disposal of foreign operations should not be "recycled" through the Profit and Loss account whereas current proposals for changes to JAS 21 require such treatment. We are also of the view that such gains and losses should be recognised immediately and that recognition should not be deferred until the gain or loss is realised.

This issue is linked to wider discussion on reporting financial performance and we note that the ASB is undertaking a project with the IASB which (amongst other things) may result in "recycling" being prohibited internationally. In order to avoid the possibility that the UK standard will have to be amended further to bring it into line with the international standard, we recommend that the ASB consider whether there is a need to defer implementation until it becomes clear whether or not changes to the international standard are likely in this respect.

Specific Comments - FRED 24

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.

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.

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

Yes.

Specific Comments - 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?

Yes.

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. We believe it a reasonable presumption that an entity will present its financial statements in its functional currency and that in most cases, this will give the most appropriate view of its results and financial position. However, we accept that there may be reasons why presentation in an alternative currency is preferable. In light of this and the disclosure requirements in paragraphs 51 to *55*, we agree with the approach proposed in the exposure draft.

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.

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

Yes.

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 para graph 45)?

Yes.

FRED 25 - Related Party Disclosures General Comments

The National Audit Office has considered how the proposals may be applied, with particular reference to the central government sector. This consideration does not take account of decisions that will be taken by the Treasury on the application of the standard. However, FRS 8 applies to central government bodies although adapted to circumstances specific to Government such as, the relationship between the different elements of government. We see no reason why the standard proposed by FRED 25 should not be adopted in similar way.

Specific Comments - FRED 25

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.

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

Yes. We agree with the Board that an accounting standard should require such disclosure, and if not required by IAS 24, this should be ‘included in the UK standard. The disclosure of the identity as well as the existence of a controlling party is relevant information that could allow users to assess properly the nature of the relationship.

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

Yes. While there may be the presumption of an arms length basis in transactions, this presumption may not be justified when related party relationships exist. There is no explicit requirement in FRS 8 to disclose where transactions are not at fair value (although this might be considered implicit); and as such, disclosure of the names of transacting related parties can assist users in making this assessment. This may be the case particularly where the related parties are directors or major shareholders. Similarly, there is no explicit requirement to disclose where a transaction is not at fair value in FRED 25 (although an assertion that a transaction is at arms length can be made only if this can be substantiated). Thus, the disclosure of names as well as the nature of the relationship and information about the transactions is justified in our view.

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

Yes, the standard should refer to shadow directors and to persons acting in concert. A shadow director is a related party by virtue of the influence that can be brought to bear on the entity directly or on the directors of an entity. Persons acting in concert are related parties as they exert influence by acting together whereas they are not able to do so when acting individually.

It might be argued that the definition of a related party given in FRED 25 encompasses such individuals and groups of individuals. FRED 25 states that a related party is one that has an interest that gives significant influence. In principle, this definition might include either individuals that do not have a formal relationship with an entity or groups of individuals. However, we believe that the revised standard should require a clear statement of the extent to which parties are considered to be related and so make specific reference to shadow directors and to those acting in concert.

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?*

We do not think that it is necessary to specify that disclosure is required of material related party transactions only but additional guidance is needed on how materiality should be applied.

It is implicit that accounting standards need not be applied to items or in circumstance where the impact is not be material. The ASB makes this clear by proposing that the standard say that application is necessary for a true and fair view. FRS 8 provides important guidance on materiality that is not included in FRED *25,* specifically that materiality is to be judged, not only in terms of the significance to the reporting entity, but also in relation to the significance to the other related party. In the absence of specific guidance in this respect, it might not be clear that materiality should be interpreted in its wider sense and thus that it should apply in relation to all related parties.

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.

Specific Comments - IAS 24

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'.*

Yes, although 'management' and 'compensation' might still need to be defined to make it clear what should be excluded from disclosure. The proposed standard says that key management personnel are related parties and thus it would appear unlikely that management personnel who are not key would be related parties. "Key management" is defined in the draft standard already; and the definition of compensation might take account of employee benefits described in IAS 19.

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)? .*

Yes.

NAO Comments by the National Audit Office

FRED 27— Events after the balance sheet date

General Comments

The National Audit Office has considered how the proposals may be applied, with particular reference to the central government sector. This consideration does not take account of decisions that will be taken by the Treasury on the application of the standard. SSAP 17 applies to central government bodies and we see no reason why the standard proposed by FRED 27 should not be adopted in similar way.

Specific Comments

ASB (i) *Do you agree with the proposal to issue a new UK standard on events after the balance sheet date, once the new MS 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.

Comments by the National Audit Office

FRED 28 - Inventories; Construction and service contracts

General Comments

The National Audit Office has considered how the proposals may be applied, with particular reference to the central government sector. This consideration does not take account of decisions that will be taken by the Treasury on the application of the standard. SSAP 9 applies to central government bodies although in a form adapted to circumstances specific to Government and in particular for types of stock for which the accounting treatment may not be covered adequately by SSAP9. In principle, we see no reason why the standard proposed by FRED 28 should not be adopted in similar way.

Specific Comments - FRED 28

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 (iii) *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. It seems appropriate that the draft UK standard maintains the scope of SSAP 9 in this respect.

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. We have not identified further aspects that are in need of review.

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. We have not identified further aspects that are in need of review.

Specific Comments - IAS 2

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 IAS2?*

Yes. This is appropriate and assists convergence.

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 profit or loss (paragraph 31). Do you agree with retaining those requirements?*

Yes, in principle. However, paragraphs 30 and 31 appear to iterate, a similar requirement and it might be better if the requirement is in a single paragraph.

FRED 29 - Property, plant and equipment; Borrowing costs

General Comments

The National Audit Office has considered how the proposals may be applied, with particular reference to the central government sector. This consideration does not take account of decisions that will be taken by the Treasury on the application of the standard. FRS 15 applies to central government bodies although in a form adapted to circumstances specific to Government. In principle, we see no reason why the standard proposed by FRED 29 should not be adopted in similar way.

A standard based on FRED 29 will have a significant impact on the UK public sector not least because a revaluation approach is used widely. In this respect, application of FRS 15 has required interpretation of a deprival value based valuation model in a not for profit environment. How a fair value basis for revaluation will be adopted in the public sector will depend on how fair value is defined and in particular whether it encompasses a valuation of properties based on existing use.

FRED 29's silence on 'renewals accounting' might be taken to imply that renewals accounting cannot be used. If this is the case, there will be implications for bodies in both public and private sectors that have adopted forms of renewals accounting for infrastructure assets.

Specific Comments - FRED 29

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. There would be little benefit in issuing a revised standard that will have a significant impact on the approach to revaluation in the UK if changes to the international standard become likely.

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 disagree with the proposed international approach. The approach outlined in paragraph 46 of the FRED is that, under the historical cost model, the depreciation charge will take account of residual value based on a current estimate whereas the valuation of the asset will not be at a current valuation. This appears inconsistent and in that changes in residual values as a result of a change in price would affect the depreciation charge, whereas the rate at which the asset is consumed (when measured at historical cost) is unchanged.

In our view, the accounting treatment should differ depending on whether a change in residual value is due to price changes or whether it is a consequence of technological change or impairment. In the case of the latter, a change in residual value indicates that the economic benefits of an asset have been consumed (when measured at historical cost). Thus, the residual value should be restated.

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?*

In our view, silence could be interpreted as not allowing renewals accounting. In common with FRS 15, the proposed standard says that depreciation should reflect consumption; and infrastructure assets are consumed even though there may be expenditure to restate the economic benefits or restore the useful life. Paragraph 43 might be interpreted as allowing renewals accounting in that useful life depends in part on wear and tear which in turn depends on the maintenance programme ie life could be very long if the asset is properly maintained. However, paragraph 51 (in common with FRS *15)* implies that a maintenance programme should be reflected in an extension of life rather than as a “built in” assumption of a long life.

We believe that UK entities should be allowed to use renewals accounting in specified circumstances, such as where an asset is deemed to be maintained to a specific level of service. In principle, charging annual maintenance costs that maintain the economic benefits of an asset can provide a better measure of consumption in a current cost environment than an annual depreciation charge. This would be the case particularly for assets where consumption might vary. An example being in the accounting for roads where consumption of the asset can depend on weather conditions and particularly the severity of the winter.

If renewals accounting were to be allowed, the revised standard might also address circumstances when annual maintenance expenditure does not fully maintain the economic benefits of an asset (or goes beyond what is needed to maintain the asset), and thus where the amount charged is less (or greater) than’ consumption. Where differences are material, an adjustment to the amount changed to profit and loss should be made.

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)?*

Revaluation is used widely in the public sector and as such, we agree that it should continue to be an allowed alternative treatment.

A basis of valuation that uses fair value is potentially a significant change from current practice. In principle, fair value if taken as market value for non-specialised assets could lead to more efficient use as it includes a measure of alternative use. However, an objective of financial statements is to reflect the consumption of the economic benefits embodied in an asset and we consider that a deprival value based on the economic benefits forgone may provide a better measure of consumption of an asset in its existing use

While fair value is usually taken to be market value, there would appear to be scope for the proposed standard to provide further interpretation of how fair value may be determined in practice. In particular, there needs to be consideration of whether fair value can be deemed to encompass an existing use value; or whether in practice fair value is sufficiently close to existing use value in most cases. The proposed standard should also provide clearer links to the practices and terminology used by professional valuers, as does FRS *15.* This would enhance understanding between the accountancy and valuation professions of the form of valuation required and how valuations are used.

The proposed standard contains less guidance than FRS 15 on the basis for valuations. In particular, we consider that the standard should specify when an external valuer must be used. In the case of property valuation, the amounts involved could have a significant impact on the financial statements and it is thus particularly important that valuations are seen to be unbiased.

The proposed approach to reporting revaluation gains and losses (set out in paragraph 17 of the Preface) diverts from FRS *15.* In FRS *15,* impairment is always reflected in profit and loss and revaluation losses that are not impairment are reported in the STRGL. In certain circumstances, the proposed approach would result in reductions in value resulting from consumption of economic benefits not being recognised in profit and loss. Thus, we prefer the FRS 15 approach. However, we acknowledge that the IAS treatment is simpler and also that it often reflects how FRS 15 is applied in practice.

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?*

Yes. The proposed approach is consistent with that in other areas where changes to international standards are likely.

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. In practice, historical costs may not be available and without this transitional arrangement there would appear to be no other option than to adopt a revaluation approach.

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?*

As noted above, the proposed international standard does not address renewals accounting. While we understand that there is some opposition to renewals accounting internationally, we suggest that the ASB request the IASB to review its proposals to make it clear that renewals accounting can be used in certain circumstances.

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?*

We agree that capitalisation should remain optional. If we had to choose, we would probably support mandatory capitalisation on grounds of consistency, in that the resulting valuation would match more closely the market price of purchasing a completed asset.

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. In principle, such exchange differences should be treated in a similar way to borrowing costs if there is a presumption that interest rates and exchange rates are linked. However, in practice, it may be difficult to identify reliably the element of exchange differences that relate to changes in interest rates and thus borrowing costs.

ASB (xii) *What are your views on the difference between MS 23 and FRS 15 referred to in paragraph 24 of the Preface to the FRED concerning borrowing costs eligible for capitalisation?*

We believe that the FRS 15 approach is preferable. Borrowing that has yet to be spent on bringing an asset into use cannot be considered to have been embodied in an asset. The interest payable on that borrowing should be treated accordingly.

ASB (xiii) *Do you have any comments on MS 23 that you wish the ASB to bring to the IASB 's attention?*

No.

Specific Comments - IAS 16

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 2iA of the [draft] FRS on property, plant and equipment)?

Yes, in principle.

An objective of financial statements is to show the consumption of the economic benefits embodied in an asset. As such, it seems to us that a deprival value based on the economic benefits forgone will provide a measure of the consumption of an asset in its existing use. While fair value is usually taken to be market value, there would seem to be scope for the proposed standard to provide further interpretation on how fair value may be determined in practice. In particular, there needs to be consideration of whether fair value can be deemed to encompass an existing use value; or whether in practice fair value is sufficiently close to existing use value in most cases.

We note that a joint project is underway seeking to converge the approaches to accounting for revaluations. Should it become clear that further changes to IAS 16 are likely as a result of this project, it would seem preferable to wait until revision was complete before issuing a new international standard rather than to issue a standard that may require subsequent amendment.

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. We presume that this question relates to exchanges of tangible for intangible assets, or vice versa, rather than exchanges of intangible assets only. The accounting treatment in paragraph 21 of the proposed standard is consistent with the equivalent in IAS 38 *Intangible assets.*

MSB (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 for assets that are temporarily idle although there may be a need to consider whether an asset should be re-lifted following a period of being idle. Retired assets should not be depreciated but written down to residual value.

Further comments - renewals accounting

Renewals accounting is allowed in specific circumstances by existing accounting standards in the UK. The proposed international standard does not address renewals accounting and it is not clearly the case that renewals accounting can be used. While we understand that there is some opposition to renewals accounting internationally, we suggest that the IASB review its proposals to clarify that renewals accounting can be used in certain circumstances.