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Dear Sir

**FRED 29 'Property, plant and equipment';
'Borrowing costs'**

We are writing with our comments on FRED 29. We agree that the UK standard on fixed assets should be replaced by a new standard that is as close as possible to the international standards on property, plant and equipment and borrowing costs. However, we also agree that, where the UK standard appears to be superior to the existing IAS, the ASB should continue to seek to have IAS changed to adopt the UK approach, for example in the area of valuation bases.

We have considerable reservations about the proposed change to the assessment of residual values in the international (and proposed UK) standard. Our reservations on this matter are set out in more detail in the appendix.

We believe that the existing UK standard sensibly and pragmatically takes account of practical difficulties experienced in certain industries by including guidance on methodology to be adopted to overcome those difficulties in order to secure compliance with the principles of the standard. Examples are the use of renewals accounting in specific circumstances (utilities) and the guidance on donated assets (charities). We consider that the UK standard, whilst remaining consistent with the principles of IAS, should retain this specific guidance.

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Our detailed comments on the questions posed by the ASB in the FRED are contained in Appendix I. Appendix II deals with other matters arising from our review. Our responses to the questions raised by the IASB are set out in our global response to the IASB Exposure Draft, Proposed Improvements to International Accounting Standards'.

Please contact Peter Holgate if you would like to discuss any of the above comments or those in the appendix.

Yours faithfully

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## Appendix 1 Responses to specific ASB questions

**FRED 29 'Property, plant and equipment';**
**'Borrowing *costs*'**

1. **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. We agree that it is appropriate for the UK to harmonise with the international standards on property, plant and equipment and borrowing costs, unless further changes to IAS 16 are likely before 2005.

2. **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?**

We strongly disagree with the proposed international approach to revise the definition of residual values to reflect current estimates for the following reasons:

For assets held at depreciated historical cost the calculation of depreciable amount, being the difference between cost and residual value, will be meaningless as it is not based on like for like values, as one will be on a historical cost basis and the other on a current cost basis. Furthermore, in some cases, the residual value could be greater than the carrying value.

Basing residual values on current prices rather than on prices prevailing at the date of acquisition will reduce the depreciation charge by inflation since acquisition. This will result in a decreasing depreciation profile even when all other factors have remained constant, which is not consistent with the definition of depreciation as it does not result in the 'systematic allocation' of the depreciable amount of an asset over its useful life. Neither does such a basis reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity as required by paragraph 41.

3. **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?**

Renewals accounting is primarily used in the water industry. There are a number of issues and arguments surrounding accounting for infrastructure assets in that industry.

a) The infrastructure has generally been regarded as one asset and is not susceptible to component accounting except where individual assets are clearly identifiable, which generally relates to overground assets. A component approach would be extremely difficult to implement for cost reasons and because components would be very difficult, if not impossible, to identify.

b) The water regulator specifically allows the entity to recover renewals expenditure in computing the required rate of return. This is analogous to a grant from the regulator. For this reason there is an argument that as the recovery is earned generally in the same period as the expenditure is incurred, it would not be appropriate to capitalise the expenditure and amortise it over a period greater than that over which the recovery is allowed. If the renewals expenditure were to be capitalised it would in many cases be necessary to carry out an impairment review and recognise an impairment charge if; for example, the act of capitalising the expenditure took the carrying value significantly above the regulatory asset value on which the regulator bases the return allowed to the entity, that is, under the regulatory approach, the return on the renewals expenditure asset would have been earned fully in the year of expenditure. In effect this could end up having much the same effect as renewals accounting.

c) The useful life of the infrastructure asset may be very long indeed. Unlike other resources, such as gas, water is not a finite resource and it is an essential part of society's needs. Therefore the operating capacity of the infrastructure is required to be maintained indefinitely. This means that the physical life has to be very long indeed. Thus any depreciation is likely to be small and possibly immaterial.

d) The residual value of the asset, because of the maintenance expenditure, is likely to be high at the end of the useful economic life to the entity (as opposed to the end of the physical life, which for the reasons stated above is likely to be very long and possibly indeterminable). Thus again depreciation may be immaterial. This would be even more so if residual values, as proposed, are based on current prices.

Renewals accounting is a pragmatic approach to dealing with the above issues and represents the most practical solution at present. We support keeping renewals accounting until the issues above have been debated and resolved, possibly between the ASB and the IASB. If the Board feels unable to sanction renewals accounting in the context of convergence with IFRS, then we consider that any removal of the specific guidance in FRS 15 should be deferred until years ending December 2005.

**4. 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 above?**

The approach to revaluations in IAS 16 has the advantage of being simpler and easier to apply and therefore we would not disagree with converging with IAS 16 in the UK should IAS 16 maintain the same approach. However, our view and preference is that the FRS 15 approach is conceptually superior and should be adopted internationally, because we believe that the 'value to the business' (i.e. deprival) basis is a more relevant valuation basis than fair value as defined in IAS 16 (i.e. exit values), for property, plant and equipment. Because items of property, plant and equipment are held for the continuing use in the business, rather than for resale, current deprival values are more relevant than realisable values, and consistent with the preparation of the accounts on a going concern basis rather than a break up basis.

**5. Are there any other aspects of the differences between the proposed standards and current UK accounting requirements that you wish to comment on?**

We strongly recommend that the issue of donated assets should be dealt with in the standard along similar lines to the existing paragraph 18 of FRS 15, which refers to the relevant SORP. To remove this guidance would create problems for many charities.

Paragraphs *53A*-*53B* of the FRED require compensation for impairments and related replacements to be included in the profit or loss for the period and disclosed separately on the face of the income statement. This is inconsistent with companies' legislation in those cases where the compensation is not a realised profit (i.e. does not meet the definition of a 'qualifying asset' in Tech 25/00). This would be the case where compensation was in the form of a replacement asset. The FRED should be revised to eliminate this inconsistency.

In addition, the FRED should clarify that, where realised, the net gain or loss on disposal arising under paragraphs *53A* and 53B should be recognised in the profit and loss account in accordance with paragraph 21 of FRS 3.

The treatment of exchanges of assets in paragraph 21 and assets acquired in exchange for shares issued by the entity in paragraph 1 6A is not consistent with existing UK GAAP for intra-group transactions, which are often recognised at book values. The proposed approach is not necessarily appropriate for transactions between entities under common control, which are often not carried out on an arm's length basis. In such cases, similar principles should be used as for other transactions between entities under common control, for example business combinations. Our preference is for transactions between wholly owned entities of the same group to be exempt from these requirements Therefore, we consider that exchanges of assets between entities under common control should be excluded from the scope of paragraphs 21 and 21A of the revised standard.

Paragraph 20 of the FRED states that the carrying amount of an asset may be reduced by applicable government grants in accordance with SSAP 4. However, as noted in paragraph 25 of SSAP 4, this is inconsistent with the Companies Act *1985*. We therefore recommend that paragraph 20 is deleted from the FRED, to avoid confusion with SSAP 4.

**6. 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 performance reporting?**

Yes, although it should be noted that the IASB is unlikely to have finalised its project on insurance contracts before 2005.

## Appendix I Responses to specific ASB questions

**FRED 29 'Property, plant and equipment';**
**'Borrowing costs'**

**7. 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, but only provided that the transitional rule is consistent with the proposed IASB standard on the first time implementation of IFRSs.

**8. Do you believe that ASB should consider any other transitional arrangements?**

The ASB should consider whether specific transitional arrangements are needed in respect of differences in the costs capitalised under FRS 15 and the FRED. Any transitional arrangements should be consistent with the IASB's standard on first time adoption of IFRSs and should not be more onerous.

**9. Are there any other aspects of the draft standard on property, plant and equipment that the ASB should request the IASB to review when fmalising the revised IAS 16?**

There are two aspects that we consider the SB should ask the IASB to review. These are:

**Cost capitalisation**

The definition and guidance relating to the cost of plant, property and equipment in paragraphs 14-18 is similar to that in respect of the cost of inventories in IAS 2. Furthermore, paragraph 18 implies that the same costs would be capitalised under the revised IAS 16 as are capitalised under IAS 2. However, the guidance is not the same, particularly in relation to the treatment of administration and other general overhead costs. None of these costs would be capitalised under paragraph 17 of the revised IAS 16, whereas some such costs would fall to be capitalised in inventory under paragraphs 10-14 of IAS 2.

IAS 16, therefore, should be revised to ensure that it is clear whether the same principles as apply in IAS 2 should also be applied to the capitalisation of property, plant and equipment, or whether there are differences between the two standards. In our opinion IAS 16 should be consistent with IAS 2, whilst clarifying that those items in paragraphs 17(a)-(c) and 17A should be excluded from the cost of property, plant and equipment. This would involve reinstating the first paragraph of paragraph 17 of IAS 16. As well as affecting those assets that are capitalised as property, plant and equipment that are also made for sale in the normal course of business, this issue is also relevant where entities have large capital expenditure departments, devoted solely to the production (or construction) of property, plant and equipment, for example, in the utility and property development industries

## Appendix I - Responses to specific ASB questions

**FRED 29 ‘Property, plant and equipment’;**
**‘Borrowing costs’**

**Comparative information**

We disagree with the proposed removal of the exemption from disclosure of comparative information for the reconciliation of movements in the opening and closing carrying amount of property, plant and equipment in paragraph 60. The key information is in respect of the movements between the opening and closing balance sheet. Giving comparatives is superfluous and will unnecessarily clutter the financial statements.

**10. 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 consider that, where possible, international accounting standards should not contain options and that therefore this option should be withdrawn. Selecting a single treatment is a difficult judgement that may require further consideration and consultation by the IASB.

**11. 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?**

No. In our view there are no grounds for departing from IAS 23, as proposed in FRED 29. Exchange differences that are in substance an adjustment to interest costs should be included in borrowing costs, even though in practice it may be difficult to differentiate between those and other exchange differences.

**12. What are your views on the difference between [AS 23 and FRS 15 referred to in paragraph 24 above concerning borrowing costs eligible for capitalisation?**

The UK should adopt the approach in IAS 23.

**13. Do you have any comments on IAS 23 that you wish the ASB to bring to the IASB’s attention?**

No.

## Appendix II – Other comments

**FRED 29 'Property, plant and equipment';**
**'Borrowing costs'**

Before finalising FRED 29 the ASB should incorporate the principle in SIC 2 'Consistency - Capitalisation of borrowing costs' to require an entity adopting a policy of capitalising borrowing costs to capitalise borrowing costs on all qualifying assets, regardless of whether they are included in stock, investments, intangible assets or property, plant and equipment. As presently drafted FRED 29 could be interpreted as allowing entities to pick and choose which qualifying assets borrowing costs should be capitalised on.