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BBA Response to ASB Financial Reporting Exposure Draft 23 – Hedge accounting

Issue of principle

The ASB has attempted to tackle a complex area through the introduction of a principles-based standard and has shown that there can be a better starting point than the prescriptive rules-based approach found in IAS 39. We support this initiative and believe that in this respect FRED 23 constitutes an important contribution to the development of a comprehensive international standard on financial instruments.

Implementation issues

The US experience of implementing FAS 133 shows that companies need a certain amount of time to implement the changes required by a fair value based standard, particularly the changes to their risk management practices as well as their accounting systems needed to achieve hedge accounting. In our view, trying to accelerate the 2005 timetable for IAS 39 implementation is simply not possible and it is harmful to try to implement IAS 39 on a piecemeal basis. The proposed transitional arrangements, that the standard would be issued early in 2003 to apply to hedges taken out after a given date and to existing hedges, although without the requirement for pre-designation, are not achievable. Some companies will have started accounting periods to which the standard would apply and will not be given sufficient opportunity to review and, if necessary, change their practices.

Given the complex nature of hedge accounting and the delicate nature of the risk positions that they seek to mitigate, we are very much against piecemeal changes to the accounting rules in this area. This is the case whether those rules are set out in a UK standard or an international standard and for this reason we believe that the objective should be to devise a cohesive set of principles governing hedge accounting and for these to be applied in 2005.

This has the advantage of:

- Allowing companies until 2005 to plan the structural changes to their books that will be necessary following the introduction of IAS 39 even if the main excesses are removed.

- Avoid the risk of commercial loss as a result of hastily introduced procedures aimed at meeting definitions of hedge effectiveness which at present remain unclear.

- Avoiding the potential of companies having to restructure their books to meet the terms of two changes in rules in a relatively short period of time.

Since compliance with FRED 23 will not achieve compliance with IAS 39, we consider that it would be damaging to UK companies that are required to adopt IFRS in 2005 to implement FRED 23. The time and effort taken to achieve documentation and effectiveness testing for hedge procedures that are acceptable under UK GAAP but not under IAS 39 would be wasted unless IAS 39 was significantly amended along the lines of the FRED before 2005.

Environmental issues

We live in an environment where IAS 39 and its implementation guidance have been in place for the last year. IAS 39 has much in common with FAS 133 which has its own set of implementation guidance. FRED 23 uses language imported directly from IAS 39 and it is not clear to what extent the FRED should be interpreted in accordance with IAS 39 or to what extent its approach results in differences from IAS 39. Given that listed companies are expecting to adopt IAS 39 in 2005, many users of the standard will be inclined to interpret it in the same way as IAS 39. Whether or not this is the ASB's intention, we consider that, if a standard is issued, its requirements should be clarified.

The hedge accounting rules

FRED 23 proposes an approach to hedge accounting which is based on three essential tenets:

- Predesignation, with formal documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge;

- Reliable measurement of the effectiveness of a hedge; and

- For forecast transactions, that they are highly probable and involve an exposure to variations in cash flows that could ultimately affect reported net profit or loss.

This, we believe, provides a base more grounded in principle than IAS 39, though there remain issues that require further investigation before a definitive view can be reached on the compatibility of the resulting rules with the objectives of sound risk management.

These are issues that we are actively considering as part of our comprehensive review of IAS 39 and we would expect to be in a position to write to the ASB again on these within the deadline set for comment on FRED 30 and the ED on IAS 32 and 39.

Responses to Specific Questions

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?

No. We are opposed to the phased implementation of IFRS in the UK, particularly in the case of financial instruments where we believe that companies will need until 2005 to implement IAS 39. If the ASB persists in the phased approach, hedges of net investments in foreign operations should be dealt with as part of the revision of SSAP 20 (FRED 24).

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?

We do not agree that the process of bringing UK practice on hedge accounting into line with international practice is helped by the issuance of a standard that does not actually achieve convergence. However, we support the ASB in seeking to develop principles based proposals that may help influence the IASB to make IAS 39 a more principles based standard.

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

We do not believe that other principles should be necessary, although the actual meaning of the proposals is difficult to interpret given that the language of IAS 39 is used.

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?

It is not clear at present what restrictions the ASB intends. The FRED should be explicit about what is and what is not prohibited. If the intention is to preserve current UK practice, this should be clarified.

(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?

Yes.

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)?

We wish to consider this material further and will provide our conclusions shortly.

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?

No. We believe that this halfway stage toward IAS 39 is unhelpful.

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's proposals on:

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

As set out above, we believe that this issue should be dealt with in the revision of SSAP 20.

(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)?

No. We believe that this halfway stage toward IAS 39 is unhelpful.

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

No. We believe that this halfway stage toward IAS 39 is unhelpful.

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?

No. We do not believe it will be possible for companies to reconsider their risk management strategies and change their accounting systems to be able to implement FRED 23 in 2003. If this work then has to be redone in order to implement IAS 39, it would be most unfortunate. Practically, hedge accounting requirements cannot be introduced in the UK before 2005.

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BBA Response to ASB Financial Reporting Exposure Draft 24 - The Effects of Changes in Foreign Exchange Rates/Financial Reporting in Hyperinflationary Economies

Q1. 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?

No.

Q2. Do you agree with the proposal not to include the IAS 21 provisions on the recycling of certain exchange gains and losses?

If the ASB persists with its phased approach and issues a standard before this issue is resolved internationally, we agree with the proposal not to include the IAS 21 provisions on recycling of certain exchange gains and losses. However, this should be re-visited in the event that the IASB decides to retain recycling since, in general, we consider that there should be no significant differences between international standards and UK standards.

Q3. Do you agree with the proposal not to include any transitional arrangements in these UK standards?

Transitional arrangements may need to be considered with respect to the disclosure of net exchange differences recognised in the statement of total recognised gains and losses and treating goodwill as a foreign currency asset where historic records may not be available.

Other comments

- Paragraph 50(b) requires disclosure of net exchange differences recognised in the statement of total recognised gains and losses and a reconciliation of the amount of such exchange differences at the beginning and end of the period. We believe it would be helpful if the ASB provided transitional guidance on the determination of the opening balance for this reconciliation. Companies may have written foreign exchange differences to reserves over a number of years. As the amount of cumulative exchange differences is not required to be disclosed under current UK GAAP, issues arise as to how far back companies should go in order to determine the opening balance without causing undue cost and effort. In its exposure draft, 'First-time Application of International Financial Reporting Standards' at paragraph 23, the IASB has recognised the difficulty of this disclosure for first-time adopters (see also Basis for Conclusions BC51 and 52). We would suggest that a similar approach be taken in FRED 24.

In addition, we believe this disclosure only makes sense if a policy of recycling is in place. The disclosure requirement, therefore, appears inconsistent with the ASB's decision not to include the recycling provisions of IAS 21.

- The FRED in paragraph 6 defines a foreign operation to include a branch. Should "branch" be defined in the way set out in SSAP 20 paragraph 37, i.e. a legally constituted enterprise located overseas or group of assets and liabilities which are accounted for in foreign currencies? Where non-monetary assets are in a foreign currency and also funded by foreign currency borrowings, SSAP 20 permits assets and borrowings to be regarded as a "branch", allowing the non-monetary items to be translated at the closing rate. Exchange differences on the non-monetary assets of the branch can therefore be matched with the exchange differences on the borrowings.

- We note that the hedging provisions have been moved to FRED 23 'Financial instruments: hedge accounting'. SSAP 20, paragraph 51, allowed hedge accounting for foreign currency borrowings used to hedge against foreign equity investments at the individual entity level – subject to satisfaction of certain conditions, exchange differences were taken to reserves. Under the current proposals, there would be no hedge accounting at individual entity level. FRED 23 paragraph 16 (a) (i) states that the gain or loss on the hedging instrument should be taken to reserves. However, there would be no offsetting gain or loss on the equity investment since under FRED 24, an equity investment (for example, an 'other participating interest') would not be a monetary item and would, therefore, remain at the historic exchange rate.

  Also, under paragraph 30 of FRED 24, foreign exchange gains or losses on monetary items which form part of an entity's net investment in a foreign operation would be taken to the profit and loss account at individual entity level, leading to a mismatch if they are hedged with foreign currency borrowings. We are unclear why there should be a different treatment on such items at individual entity level when compared to group level, when they are taken to reserves. The treatment in paragraph 30 could lead to a lack of distributable profits at the individual entity level when the group is profitable.

- The definition of 'spot exchange rate' is 'the exchange rate for immediate delivery' under paragraph 6 of FRED 24. Under market convention in the UK, settlement date is generally two days after the deal date. Would such a contract still meet the definition of a spot exchange rate, in particular the immediate delivery criteria?

- Where a foreign currency transaction is to be settled at a contracted rate, SSAP 20 allows the use of the contracted rate to record the transaction and any resulting asset or liability. FRED 24 does not allow this method; instead it requires the transaction to be measured initially at the spot exchange rate on the date of the transaction. The Preface to FRED 24, paragraph 12, states that a different rate may be used if hedge accounting techniques are used and FRED 23 is applied. We prefer the treatment allowed under SSAP 20. It is simpler and we believe it more accurately reflects the economic substance of the transaction. In addition, we believe the reference to an interaction with FRED 23 is confusing, especially as it is silent on the use of hedge accounting techniques for hedging instruments and hedged items that are not financial instruments.

- Draft standard 'Financial reporting in hyperinflationary economies' - we welcome the additional guidance given on the determination of when hyperinflation is deemed to arise and the method of accounting to be used. However, we have doubts of the usefulness of paragraph 33, which requires that all items in the cash flow statement should be expressed in terms of the measuring unit current at the balance sheet date. This requirement results in a cash flow statement that contains items that are not cash flows and cannot, therefore, be readily understood.

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

Q4. 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.

Q5. 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.

Q6. 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)?

No. In the case of a translation that is made merely for the convenience of readers, we consider that it is preferable to use the closing rate to translate the financial statements. This will not result in the creation of new gains and losses and will maintain ratios.

Q7. Do you agree that the allowed alternative to capitalise certain exchange differences in paragraph 21 of IAS 21 should be removed?

Yes.

Q8. 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 the proposed improvement: goodwill is generated as a result of the acquisition of an entity and therefore relates to the acquired entity. For the same reason, we concur with the improvement regarding fair value adjustments to assets and liabilities.

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BBA Response to ASB Financial Reporting Exposure Draft 25 – Related Party Disclosures

Q1. 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?

No.

Q2. Do you believe that the ASB should consider any transitional arrangements?

No.

Q3. 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?

Inclusion of such information is relevant information for users of financial statements, and the ASB should recommend its inclusion to the IASB. As commented in the response to (i) above, we are not in favour of the issuance of a new UK standard: the content of paragraphs 13A and 13B are included within FRS 8.

Q4. Do you believe that an accounting standard should require disclosure of the names of transacting related parties?

In general, disclosure of related party transactions aggregated by type of related party, as, required by paragraph 15, should be sufficient. However, the standard should require disclosure of the name of the related party where this is relevant to an understanding of the potential effect of the relationship on the financial statements and paragraph 14 should be amended to make this clear.

Q5. Should the definition of related parties specifically refer to shadow directors? Should it also refer to persons acting in concert?

The definition of a related party in paragraph 9 of the new IAS 24 is drawn sufficiently wide not to require shadow directors or persons acting in concert to be specifically referred to.

Q6. 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. Materiality guidance is relevant because transactions that are not material to the reporting entity may be material to the other party to the transaction and therefore may need to be disclosed. The ASB should recommend the inclusion of guidance on materiality to the IASB. In addition, we consider that the standard should include reference to the fact that disclosure cannot be made where this conflicts with the reporting entity's duty of confidentiality arising by operation of law. For example, the standard cannot override bank's obligation to preserve confidentiality of customers' dealings.

Q7. Are there any other aspects of the draft standard that the ASB should request the IASB to review when finalising the revised IAS 24?

The revised IAS 24 exempts wholly owned subsidiaries from disclosing transactions with group entities. We agree with the principal of this exemption as it recognises that those wishing to find more information about the group could do so provided that consolidated financial statements were publicly available. The exemption provided by FRS 8 includes subsidiary undertakings, 90% or more of whose voting rights are controlled within the group. The IASB could consider broadening the disclosure exemption for 90% or more owned subsidiaries on conceptual and practical grounds.

It is further noted that the existence of such an exemption lends support to the inclusion of a requirement to disclose the name of the parent company, and the ultimate holding company, if different, in the notes of the reporting entity (see Q3 , above).

A further area meriting review is the treatment of Employee Share Ownership Plan trusts and similar entities, as they typically hold shares of the reporting company.

The IASB has asked commentators to respond to the following questions on the proposed changes to IAS 24 :

Q8. 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'.

No. The disclosure of management remuneration either in aggregate or for each director by name is useful to users of financial statements of all size companies. While IAS 24 may not be the best place to include such disclosure, which is often subject to legal or other regulatory disclosure requirements, it does not seem appropriate to exclude it.

Q9. 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 support the proposals in paragraph 3 of the draft amendment to IAS 24 'Related Party Disclosure' that: 'The standard does not require disclosure of related party 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.'

As noted above, exemption for subsidiary undertakings should be widened to include those for which 90% of the voting rights are controlled by the group. (By definition, this would be based solely on shares with voting rights.)

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BBA Response to ASB Financial Reporting Exposure Draft 26 – Earnings Per Share

Q1. 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?

No.

Q2. Do you believe that ASB should consider any other transitional arrangements?

As the requirements of FRED 26 are broadly similar to those of FRS 14, no additional transitional arrangements should be necessary.

Q3. Are there any aspects of the draft standard that the ASB should request the IASB to review when finalising the revised IAS 33?

Using an average based on interim periods rather than using a cumulative full year average may produce different values for the components of the dilutive calculation, as potential ordinary shares could be dilutive in one interim period but not in another.

The ASB Statement 'Interim reports' states that the interim period should be treated as an accounting period distinct from the annual cycle; however, certain elements should be presented on an integral basis – i.e. predicting financial information for the full financial year - such as taxation. Whilst we agree that earnings per share should be based on the interim period alone, extrapolating this discrete approach to cover the issuance of options that are based on annual results for the purposes of calculating diluted earnings per share could produce a potentially misleading result. We believe that the dilutive element should be presented on an integral basis rather than using a discrete approach.

The IASB has asked commentators to respond to the following question on the proposed changes to IAS 33:

Q4. 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?

Yes.

Q5. 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).**

No, we do not agree with the approach to deal with the year-to-date calculation of diluted earnings per share. Using an average based on interim periods rather than using a cumulative full year average may produce different values for the components of the dilutive calculation, as potential ordinary shares could be dilutive in one interim period but not in another.

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BBA Response to ASB Financial Reporting Exposure Draft 27 – Events After the Balance Sheet Date

Q1. 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?

No.

Q2. Do you believe that ASB should consider any other transitional arrangements?

No. All matters are adequately covered and convergence will have been achieved.

Q3. Are there any aspects of the draft standard that ASB should request IASB to review when finalising the revised IAS 10?

No. The proposals are in line with the UK Statement of Principles for Financial Reporting.

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BBA Response to ASB Financial Reporting Exposure Draft 28 - Inventories; Construction and service contracts

Q1. 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?

No.

Q2. 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?

We do not agree with the extension of the standard on construction contracts to include service contracts, as this addresses issues that are currently being considered in the current ASB/IASB project on revenue recognition; it would be preferable to await the conclusions of that project rather than implement requirements now that may be changed in the near future.

We also note that the proposed standard does not include the detailed examples given in IAS 18, and in particular the example of loan fees. We believe that the accounting treatment for loan fees set out in the BBA SORP on Advances is consistent with the principles set out in IAS 18 and the proposed ASB standard, in that it distinguishes between the service of arranging a loan and the subsequent collection of interest and repayments on the loan itself; fees properly attributable to the arrangement of the loan should therefore be recognised at the time and not spread over the period of the loan. However, this is inconsistent with the accounting for loan fees set out in the appendix to IAS 18. We believe that further consideration of this issue is necessary before IAS 18 is incorporated into UK standards.

Q3. Do you believe that the ASB should consider any transitional arrangements?

No.

Q4. 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?

None noted.

Q5. Are there any aspects of the standard on construction contracts that the ASB should request the IASB to review in due course?

None noted, other than the accounting for loan arrangement fees referred to above.

The IASB has asked commentators to respond to the following questions on the proposed changes to IAS 2:

Q6. **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.

Q7. **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.

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BBA Response to ASB Financial Reporting Exposure Draft 29 - Property, plant and equipment; Borrowing costs

Q1. 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?

No.

Q2. 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?

In a historical cost model, we consider that the residual value should not be revised to reflect current estimates and so disagree with the proposed international approach. This approach has the unfortunate consequence of increasing the possibility that companies will avoid depreciating certain properties on the grounds that the depreciation is immaterial and would be a retro-grade step for UK GAAP.

Q3. 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?

The standard permits different depreciation methods to be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. It seems unlikely that the annual expenditure required to maintain an infrastructure asset could be deemed to be an allocation of the depreciable amount of the asset. Therefore, we believe that renewals accounting is not within the letter of the standard. We see no particular benefit in allowing UK GAAP to deviate from international practice in this area.

Q4. 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)?

We believe that the value to the business model provides information that is more relevant to users of financial statements than a pure fair value model. The open market value of a property may be higher than the existing use value. While we agree that the higher value should be disclosed, it seems less useful to recognise this in the financial statements since it is not a value that could be obtained by the business if there is no intention or possibility of disposal. This is an example of the difficulties of using pure exit values.

Q5. Are there any other aspects of the differences between the proposed standards and current UK accounting requirements that you wish to comment on?

No.

Q6. 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 uncertainty about how listed insurance groups will report in 2005 is a further reason why we do not support a phased implementation into UK GAAP of international accounting standards before 2005. However, if the ASB intends to continue with this course, we agree that present UK practice should be preserved as a transitional measure.

Q7. 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. For those companies that adopt the new UK standard, we believe that the transitional arrangements in FRS 15 should remain.

Q8. Do you believe that ASB should consider any other transitional arrangements?

No.

Q9. 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?

Paragraph 53A of IAS 16 deals with compensation from third parties for items of property, plant and equipment that are impaired, lost or given up. It states that such compensation should be recognised in the profit and loss account in the period in which it is received. In order to be consistent with the recognition of a contingent asset under IAS 37 'Provisions, contingent liabilities and contingent assets', we suggest that the wording of the paragraph be changed to require that the compensation be recognised when it is virtually certain to be received.

Q10. 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?

Yes. We would support prohibition of capitalisation since, unless there is a clear linkage between a particular borrowing and a qualifying asset, the capitalised interest will be based on theoretical allocations of the total borrowing cost of an enterprise. An enterprise's financial resources support the whole business and we are not in favour of arbitrary allocations being made to capitalise some of a year's finance cost.

Q11. 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 general, we do not support differences from international standards being introduced into UK standards.

Q12. 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 are not in favour of capitalising borrowing costs and this difference in views helps illustrate why we support prohibition. We do, however, prefer the FRS 15 treatment since this shows a more clear linkage between element of the borrowing relating to the qualifying asset and the capitalised borrowing cost.

Q13. Do you have any comments on IAS 23 that you wish the ASB to bring to the IASB's attention?

No.

The IASB has asked commentators to respond to the following questions on the proposed changes to IAS 16:

Q14. 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)?

No. We believe that the issue of whether gains or losses should be recognised on exchanges of similar assets should be addressed in the Revenue Recognition project. Therefore, we do not consider it should be addressed at this time in the improvements project.

Q15. 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?

No, for the reasons set out in the response to Q14.

Q16. 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.

British Bankers' Association
16 September 2002

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BBA Response to ASB Consultation Paper – IASB proposals to amend certain International Accounting Standards

Preface to International Accounting Standards

Each international accounting standard includes a statement that international accounting standards are not intended to apply to immaterial items, and a cross-reference is given to the Board's Preface. However, the cross-referenced paragraph no longer appears in the revised Preface published by the Board in May 2002. We object strongly to this change to the Preface, which was not included in the exposure draft. The absence of this statement has far reaching and serious implications for financial reporting and the phrase should be reinstated at the earliest opportunity. In the meantime, the Board may wish to reinsert this important statement within IAS 1 or IAS 8 as part of their revisions.

IAS 1 – Presentation of financial statements

Q1. 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)?

We strongly support the inclusion in the standard of 'override' provisions, but disagree that these provisions should be made by reference to the regulatory framework of the country in which the financial statements are issued. In our view, if the standards themselves require an override in specific, exceptional circumstances, then there would be no departure from standards where such provisions are used. Therefore, paragraph 15 is unnecessary and the phrase 'if the relevant regulatory framework requires or otherwise does not prohibit such a departure' should be deleted from paragraph 13.

Q2. 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)?

Whilst we support the idea of preventing entities labelling items as "extraordinary", we do not believe that paragraph 78 will be effective in preventing the practice. Entities can just use a different term than "extraordinary". The better way of preventing this practice would be to require items of such size, nature or incidence that their separate disclosure is relevant to an understanding of the entity's performance to be included within the appropriate income statement heading to which they relate. Paragraph 80 should be amended to make this requirement clear and should include the following words at the end: 'under the headings set out in paragraph 76'.

Q3. 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)?

Yes. At the balance sheet date the entity has a current liability

Q4. 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)?

Yes.

(b) If a lender was entitled to demand 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 the 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

Yes. If the breach is rectified within the period of grace, we agree that it is appropriate to classify it as non-current.

(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 paragraph 63 and 64)?

Yes, provided that it is not unlikely that the breach will be rectified.

Q5. 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)?

No. We do not consider that disclosure framed along these lines is necessary or useful. At best, such a requirement will only result in boilerplate disclosures. Indeed, the example given in paragraph 109 with regard to financial assets held-to-maturity can only result in boilerplate disclosure since the categorisation of financial assets is based on the rules in IAS 39 and is not a matter of management judgement. We recommend that these paragraphs be deleted.

However, we consider that disclosure should be required of the methods and assumptions used to measure assets and liabilities where management judgement is needed to determine the appropriate methods and assumptions. The disclosure requirements are best set within the context of a specific accounting standard, for example IAS 32 with regard to measuring the fair value of financial assets and liabilities and IAS 19 with regard to measuring pension assets and liabilities.

Q6. 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 material adjustment to the carrying amounts of assets and liabilities within the next financial year (see proposed paragraphs 110-115)?

We do not agree with the proposals. For most financial businesses, assumptions underlying key measurements of assets and liabilities are likely to be varied and wide-ranging, encompassing economic and commercial trends which are to a greater or lesser extent interrelated. Any meaningful discussion of such assumptions would need to be much more extensive than appropriate to the financial statements. Furthermore, sensitivity of measurement to these assumptions will not always depend on a direct relationship but will itself involve a considerable degree of judgement.

We also consider that the proposal confuses uncertainties relating to the measurement of the item at the accounting date, and changes that might occur over the next period. For example, the value of a traded bond at the balance sheet date is directly available from market price quotations, but its value over the next year is dependent on interest rates, possibly currency rates, and many factors that underlie the issuer's credit rating.

Disclosures of sensitivity to changes in assumptions are also likely to be misinterpreted as meaning that the accounts could be wrong to the extent of the range indicated; such misinterpretation would further undermine the credibility of financial reporting generally. Sensitivity disclosure may also be commercially damaging in some circumstances.

We therefore suggest that such disclosures should focus on the assumptions used, rather than the range of possible outcomes, and should consider only the range of possible assumptions at the measurement date, rather than potential changes in assumptions over the following year.

We also believe that such disclosures are more appropriate to the MD&A or OFR section of the annual report than the financial statements themselves. This places the information in a more appropriate category for audit purposes, and also affords 'safe harbour' treatment. It is also less likely to result in 'boilerplate' discussion.

IAS 8 – Accounting policies, changes in accounting estimates and errors

Q1. 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)?

We agree that voluntary changes in accounting policy and the correction of errors should be accounted for retrospectively. Voluntary changes in accounting policies should be rare and should only be made where the new policy is better than the old policy. Since they are at the discretion of management, it should generally be expected that restatement should not cause undue cost or effort. The wording of paragraph 21 could be improved to make these points clear. We believe it is important for the standard to include a reference to material errors. In the absence of such a reference, IAS 8 could be read as requiring the restatement of comparatives for all errors, however trivial, and entities may be encouraged to use the provision to manage earnings.

Q2. Do you agree with eliminating the distinction between fundamental errors and other material errors (see paragraphs 32 and 33)?

Yes, although as stated in our response to question 1 above, we believe the requirements should apply to material errors.

IAS 17 – Leases

Q1. 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 financing lease by applying the conditions in paragraphs 3-10 of IAS 17.

We have sympathy with the motive for the change, which is to try to ensure that the land element of a lease does not prevent what would otherwise be a finance lease from being accounted for as a finance lease. However, we do not believe it is either appropriate or practical to allocate amounts attributable to the land and buildings separately. Therefore, we do not support this amendment and suggest that it is an area that should be addressed in the wider project on lease accounting.

Q2. 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?

We agree that this choice should be eliminated and agree with the approach taken.

IAS 27 – Consolidated and separate financial statements

Q1. Do you agree that a parent need not prepare consolidated financial statements if all the criteria in paragraph 8 are met?

Yes. We agree for the reasons explained in the basis for conclusions. However we would make following points:

- It seems impractical for an accounting standard to introduce the requirements in 8 (a) with regard to obtaining unanimous agreements from minority interests. How decisions are made by shareholders is a matter for company law and not accounting standards. It would be better for the accounting standard to be less specific in this regard, for example, by merely requiring that minority interests do not object.
- Paragraph 8 (d) should include intermediate parent companies.

- In paragraph 8 (b) what is meant by securities and publicly traded? This should be reworded so that subsidiaries of listed companies which have only issued CDs, commercial paper, etc, should not be required to produce consolidated financial statements if they meet all the other tests.

Q2. 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)?

We do not agree that minority interests should be classified as part of equity. Although the presentation on the balance sheet, as a separately presented element of equity and distinguished from parent shareholders' equity is acceptable, the corollary of this classification is that in the profit and loss account minority interests would not be shown as a deduction in arriving at net profit. We believe that in consolidated accounts the focus must be on the shareholders of the parent, and that from their perspective minority interests are not part of equity. We would also point out that in many cases minority interests represent an obligation of the Group that is more akin to a liability than equity.

Q3. Do you agree that investments in subsidiaries, jointly controlled entities and associates that are consolidated, proportionately consolidated or accounted for under the equity method in the consolidated financial statements should be either carried at cost or accounted for in accordance with IAS 39, in the investor's separate financial statements (paragraph 29)?

Do you agree that if investments in subsidiaries, jointly controlled entities and associates 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)?

Whilst we generally favour deletion of unnecessary options in this case two options are retained and only the third is deleted. That option – to carry these investments under the equity method – is in some ways the most relevant because it usually allows the equity in the financial statements of the investor and in the Group consolidated financial statements to be the same.

In this case therefore we favour retaining all three existing options – cost, equity method and fair value – as the basis for accounting for subsidiaries, jointly controlled companies and associates in the financial statements of the investor.

A holding company may hedge its investment in its subsidiaries by matching their net asset value ('NAV') against foreign borrowings. Under revised IAS 27, the holding company would not be allowed to report the subsidiaries at NAV; suppose it recognises them at historical cost. Then, assuming the holding company can apply hedge accounting to the historical cost of the investment under IAS 39, the holding company accounts will effectively report a foreign exchange position equal to the difference between the subsidiaries' historical cost and NAV. This does not reflect the economics of the situation.

We do agree that if investments in subsidiaries, jointly controlled entities and associates 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.

However, we would note the case where a listed company acts purely as the holding company for a single trading subsidiary. If in this situation IAS 39 were applied then it would result in the listed parent company recognising its own market capitalisation in the balance sheet.

IAS 28 – Accounting for investments in associates

Q1. 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, when such measurement is well established practice in those industries (see paragraph 1)?

Yes. We agree that for venture capital organisations, mutual funds, unit trusts and similar entities IAS 28 and 31 should not apply to investments that otherwise would be associates or joint ventures where these investments are held as part of a portfolio of such investments. We agree that the investments should be accounted for as held for trading in accordance with IAS 39. However, we note that IAS 39 makes an exception to the general rule that trading assets should be carried at fair value in the case of unquoted equity instruments whose fair value cannot be reliably measured. While the requirement that fair value measurement must be a well-established practice in the industries where this exemption will be used should go some way toward ensuring that fair values are generally available, we consider that the standard must acknowledge that there will be some circumstances where reliable fair values cannot be obtained. In such circumstances, the investments should be held at cost less provision for impairment in accordance with IAS 39. This will ensure that all investments that are part of the same portfolios are treated the same way. It would be unacceptable if the standard could be interpreted to mean that an investment in a portfolio of other venture capital investments had to be treated as an associate or joint venture merely because a reliable fair value was not available.

Q2. 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)?

We do not agree with the proposed approach since this might lead to the inappropriate write-down of, for example, long-term receivables when good collateral is in place. We consider that the investor should continue to record changes in the carrying amount for an associate that is incurring losses even if this results in the recognition of net liabilities rather than net assets.

IAS 40 – Investment property

Q1. **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 fair value model set out in IAS 40, paragraphs 27-49?

Yes.

Q2. **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.

Q3. **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. However, as fair values are increasingly used, it will become more untenable for investment property not to be carried at fair value.

British Bankers' Association
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