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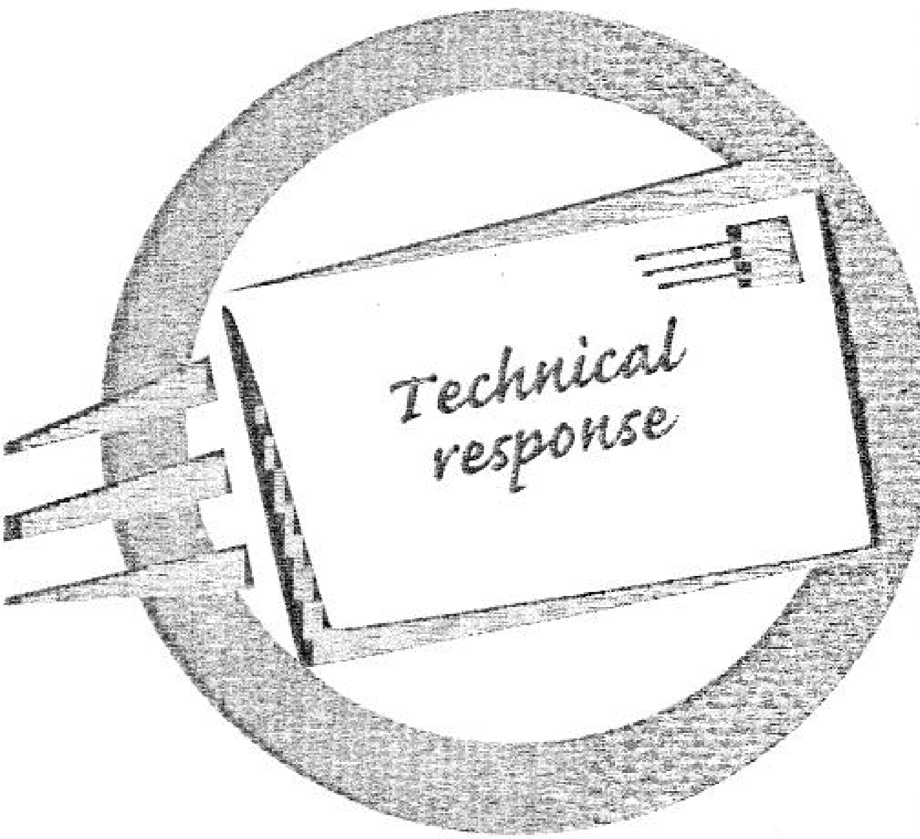

Financial Reporting Exposure Draft 30

Financial Instruments:

Disclosure and Presentation

Recognition and Measurement

Audit Commission
submission to the
Accounting Standards Board

audit commission

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

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

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

A summary of the key proposals contained in FRED 30 can be viewed on the ASB web site www.asb.org.uk. Any comments on the issues raised by this response should be addressed to:

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CONTENTS

INTRODUCTION

1. The adoption and revision of appropriate accounting standards is fundamental to the presentation, within the financial statements, of useful information on an entity's performance and financial position. The Audit Commission (the Commission) supports the ASB's strategy of moving towards international standards through its programme of work to align UK accounting standards with International Financial Reporting Standards (IFRSs) and the phased replacement of existing UK standards with new UK standards based on the equivalent IFRSs. The Commission also welcomes the opportunity to comment on the ASB's implementation of this strategy through the issue of FRED 30 *Financial Instruments: Disclosure and Presentation Recognition and Measurement.*

2. The Commission notes that FRED 30 is based on the IASB's recently published proposals for revisions to IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement.* The Commission also notes that the FRED also contains proposals on the withdrawal of FRS *4 Capital* Instruments, FRS 13 *Derivatives and other Financial Instruments* and related UITF Abstracts.

3. The Commission is responsible for appointing auditors to local authorities, police and fire authorities and NHS bodies in England and Wales. As such, it is primarily concerned with the potential impact of the proposals contained in the FRED on public sector entities. The subject matter of the FRED is clearly relevant to the public sector and those parts of the public sector audited by the Commission' s auditors.

4. Accordingly, this response makes a number of general observations about the proposals in the FRED where the Commission believes it can add value to the debate. The Commission's responses to the specific issues and questions raised by the ASB in the Preface to the FRED are contained in Annex A to this response, and to the questions raised by the IASB in Annex B.

GENERAL **OBSERVATIONS: FRED 30**

5. The prescription of accounting requirements for the public sector in the United Kingdom, including those parts that the Commission has a specific interest in, is a metter for the Government. This will include the prospective application of FRED 30. The accounting framework for NHS bodies is principally the responsibility of the Department of Health (DoH) in conjunction with the Treasury. Local government bodies prepare their accounts in accordance with the statutory requirements applicable to accounts and with the relevant Statement of Recommended Practice (SORP) prepared by the CIPFA/LASAAC Joint Committee through a process laid down by the ASB. In commenting on FRED 30 the Commission recognises that these bodies will determine how the FRED will be applied to their respective areas of responsibility.

6. The FRED sets out (Preface, paragraph 1) two proposed UK accounting standards dealing with financial instruments based on the IASB's published proposals for revisions to IAS 32 and IAS 39. As the ASB has itself concluded, the Commission believes that conceptually it is best to view the requirements in IAS 32 and IAS 39 as a single package, to be implemented in the UK at a single point in time. On this premise, the Commission believes that the logical step is to issue a single accounting standard at that point, rather than two separate ones. The Commission also believes that this should apply to the international accounting standards as well.

7. A single standard (both specifically in the UK and internationally) would of course be necessarily a longer and more complex document than two separate ones. In this context the Commission also believes that the ASB should consider ways in which the FRED might be made more user-friendly. The Commission recognises that the subject matter of financial instruments is inherently complex, but notwithstanding this believes that the presentation, and consequently understandability, of the FRED could be improved. The same point is relevant to the proposed IAS 32 and IAS 39.

8. The FRED also refers to the proposals for hedge accounting in IAS 39, and their reflection (in some respects) in the ASB ' s recent draft of FRED 23 *Financial Instruments: Hedge Accounting.* The Commission responded separately to the ASB on FRED 23, noting that hedge accounting is not a widely-used technique in the UK public sector and that it is, in particular, prohibited for local authorities.

9. On recognition and derecognition, in the absence of a clear path to international convergence, then FRS *5* should continue to provide the basis of UK requirements. The Commission believes that the 'risks and rewards' approach in FRS *5* is generally understood and works well. The Commission also notes the ASB's view that whilst the approach adopted by IAS 39 to recognition and derecognition is likely to result in similar accounting to that resulting from an FRS *5* approach for many common, simple transactions, differences are likely to arise for other types of transaction. The Commission is not convinced that a clear and compelling case for movement towards recognition and derecognition criteria proposed for the revised IAS 39 has been made.

Q	Particular Issue	Comment
ASB (i)	*Treating IASs 32 and 39 as a package (Appendix III, paragraph 15).* The ASB has concluded that it is best to view the requirements in IASs 32 and 39 as a single package of requirements that should, as far as is practicable, be implemented in the UK at a single point in time. Do you share this view?	Yes, It would be helpful for the requirements in IAS 32 and 39 to be viewed as a single package, and ideally as a single standard (both internationally and in the UK specifically).
ASB (ii)	*Implementation in 2004 (Appendix III, paragraphs 17-20).* Notwithstanding the general approach referred to in (i) above, the ASB is proposing to implement, at a single point in time, some parts of the standards in mandatory form, some in non-mandatory form and some not at all for the time being. At the same time, it is proposing to withdraw FRSs 4 and 13 (and related UITF Abstracts) and keep in place most parts of FRS *5*. Do you believe that, in the circumstances, this represents the best possible approach of implementing in the UK the international requirements in this area?	Yes, this is a reasonable approach. But the Commission does have some concerns about the effect on comparability that allowing different entities to adopt varying measurement models for transactions that are of a similar nature
ASB (iii)	*Recognition and derecognition (Appendix III, paragraphs 23-29)* FRED proposes that the proposed new IAS 39 approach to recognition and derecognition should not be implemented in the UK at the present time. Instead, when the direction of international convergence on this subject becomes clearer, a further consultation document will be issued. Do you agree with this approach?	Yes. In the absence of a clear path to international convergence, then FRS *5* should continue to provide the basis of UK requirements on recognition and derecognition of financial instruments
ASB (iv)	*Measurement (Appendix III paragraphs 30-49). The* ASB is proposing that, prior to *2005,* companies should be required to adopt IAS 39's measurement requirements only if they choose to adopt the fair value accounting rules that will be set out in companies legislation. Entities that do not choose to adopt those rules will not initially be required by UK standards to adopt the measurement requirements at all. (a) Do you agree with this approach? (b) Do you agree that the recycling requirements of IAS 39 should not be implemented in the UK pending completion of the project on reporting financial performance and do you agree with the alternative treatment proposed in the FRED? *(Appendix III paragraphs 50-52)*	 a) Yes (although see also response to question ASB (ii). (b) Yes - the Commission agrees with the view that the recycling of gains or losses is not an appropriate accounting technique, and therefore does not support the inclusion of recycling within the proposed revision to IAS 39.

ASB (V)	*Hedge accounting.* The ASB is proposing a similar approach to IAS 39's hedge accounting requirements as to its measurement requirements. *(Appendix III paragraphs 57-63, 69 and 70)* (a) Do you agree with this approach? (b) Do you agree that the approach being proposed in place of recycling? *(Appendix Ill, paragraphs 64-68)*	(a) Yes - although see response to question ASB (ii). (b) Yes. See also the response to question ASB (iv) (b) above - the Commission does not support the use of recycling.
ASB (vi) (a)	The FRED proposes that, prior to 2005, entities should be required to comply with IAS 39's measurement and hedge accounting provisions in certain circumstances only. That will change in 2005 for the consolidated financial statements of listed entities but the FRED suggests, not for other entities or other types of financial statement. Thus, from 2005 listed entities that do not prepare consolidated financial statements and unlisted entities will not be required to adopt IAS 39's measurement and hedge accounting provisions unless they choose to adopt the fair value accounting rules set out in the Companies Act 1985. Similarly, listed entities that prepare consolidated financial statements will not be required to adopt IAS 39's measurement and hedge accounting provisions in their individual financial statements unless they adopt the fair value accounting rules in those financial statements. Do you agree with this approach?	Yes (but see also response to question ASB (ii).
ASB (vi) (b)	FRS 13's disclosure requirements apply only to entities, other than insurance entities, that are listed or have publicly-traded securities and all banks. The ASB is proposing to revise the disclosure requirements on 1 January 2004 and to apply those new requirements to all listed entities, all other entities that have publicly-traded securities and all banks (in other words, the exemption for listed insurance entities will be removed, but otherwise the scope will be unchanged). Do you agree with this approach or do you believe that, from 2004, the requirements should apply to some other entities (for example, unlisted insurance companies) or, alternatively, to a narrower range of entities?	Agee.
ASB (vi) (c)	ERS 13's disclosure requirements apply both to consolidated financial statements and to individual financial statements, except that they do not need to be applied in the individual financial statements of entities that are preparing FRS 13-compliant consolidated financial statements. The FRED proposes to retain a similar exemption. Do you agree with this approach?	Agree.

Q.	Particular Issue	Comment
IAS 32 (i)	*Probabilities of different manners of settlement (paragraphs 19, 22, and 22A).* Do you agree that the classification of a financial instrument as a liability or as equity in accordance with the substance of the contractual arrangements should be made without regard to probabilities of different manners of settlement? The proposed amendments eliminate the notion in paragraph 22 that an instrument that the issuer is economically compelled to redeem because of a contractually accelerating dividend should be classified as a financial liability. In addition, the proposed amendments require a financial instrument that the issuer could be required to settle by delivering cash or other financial assets, depending on the occurrence or non-occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder of the instrument, to be classified as a financial liability, irrespective of the probability of those events or circumstances occurring (paragraph 22A).	The Commission agrees that the substance of a financial instrument should govern its classification on the issuer's balance sheet. The Commission also agrees that in the case of a financial instrument required to be settled in cash or other financial assets it should be classified as a financial liability, irrespective of the probability of the occurrence or non-occurrence of uncertain future events on which the settlement depended. In defining a financial liability the Commission also believes that this would be improved by widening it from simply 'contractual obligations' to also include constructive obligations
IAS 32 (ii)	*Separation of liability and equity elements (paragraphs 28 and 29).* Do you agree that the options in IAS 32 for an issuer to measure the liability element of a compound financial instrument initially either as a residual amount after separating the equity element or based on a relative-fair-value method should be eliminated and, instead, any asset and liability elements should be separated and measured first and then the residual assigned to the equity element?	Yes, the equity element should be the residual element after the separation and measurement of any liability element.
IAS 32 (iii)	*Classification of derivatives that relate to an entity's own shares (paragraphs 29C-29G).* Do you agree with the guidance proposed about the classification of derivatives that relate to an entity's own shares?	Yes.
IAS 32 (iv)	*Consolidation of the text in IAS 32 and IAS 39 into one comprehensive Standard.* Do you believe it would be useful to integrate the text in IAS 32 and IAS 39 into one comprehensive Standard on the accounting for financial instruments? (Although the IASB Board is not proposing such a change in this Exposure Draft, it may consider this possibility in finalising the revised Standards.)	Yes - the Commission believes that it would be valuable to have one single, comprehensive standard on accounting for financial instruments.

IAS 39 (iii)	*Scope: loan commitments (paragraph 1(i)).* **Do you agree** that a loan commitment that cannot be settled net and the entity does not designate as held for trading should be excluded from the scone of IAS 39?	Yes
IAS 39 (ii)	*Derecognition: continuing involvement approach (Appendix L paragraphs 35-57).* Do you agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets under IAS 39? If not, what approach would you propose?	The continuing involvement approach provides a reasonable 'approach for the derecognition of financial assets under IAS 39, although this raises the issue of determining what 'continuing involvement' means. It should be based on criteria that go wider than 'contractual obligations', to include 'constructive obligations', a point covered at question IAS 32 (i) above.
IAS 39 (iii)	*Derecognition: pass-through arrangements (Appendix I, paragraph 41).* Do you agree that assets transferred under pass-through arrangements where the cash flows are passed through from one entity to another (such as from a special purpose entity to an investor) should qualify for derecognition based on the conditions set out in paragraph 41 of the Exposure Draft?	Yes. This treatment accords with the Commission's understanding of the treatment under UK GAAP, which permits derecognition only when substantially all the risks and rewards in an asset have been transferred. This appears similar to the concept of no continuing involvement set out in paragraph 41
IAS39 (iv)	*Measurement: fair value designation (paragraph 10).* Do you agree that an entity should be permitted to designate any financial instrument irrevocably at initial recognition as an instrument that is measured at fair value with changes in fair value recognised in profit or loss?	Yes.
IAS 39 (v)	*Fair value measurement considerations (paragraphs 95-100D).* Do you agree with the requirements about how to determine fair values that have been included in paragraphs 95 - 100D of the Exposure Draft? Additional guidance is included in paragraphs A32 - A42 of Appendix A. Do you have any suggestions for additional requirements or guidance?	The Commission agrees with the requirements about how to determine fair values, and is content with the additional guidance in Appendix A
IAS 39 (vi)	*Collective evaluation of impairment (paragraph 112 and 113(a)-113(d))* **Do** you agree that a loan asset or other financial asset measured at amortised cost that has been individually assessed for impairment and found not to be individually impaired should be included in a group of assets with similar credit risk characteristics that are collectively evaluated for impairment? Do you agree with the methodology for measuring such impairment in	The Commission is not <u>convinced</u> by this proposal, in that the test for impairment should be made at the specific [individual] level and not at the aggregate level. The analogy is with review of

	Paragraphs 113A – 113D)?	debtors that may need to be provided for, which should also be carried out at the level of an individual debtor, rather than a general 'bad debt' provision being established
IAS 39 (vii)	*Impairment of investments in available-for-sale financial assets (paragraphs 117-119).* Do you agree that impairment losses for investments in debt and equity instruments that are classified as available for sale should not be reversed?'	The Commission <u>does not agree</u> with this proposal - if impairments have been recognised in the profit and loss account then any reversal should be recognised in the same way.
IAS 39 (viii)	*Hedges of firm commitments (paragraphs 137 and 140).* Do you agree that a hedge of an unrecognised firm commitment (a fair value exposure) should be accounted for as a fair value hedge instead of a cash flow hedge as it is at present?	Yes.
IAS 39 (ix)	*'Basis adjustments' (paragraph 160).* Do you agree that when a hedged forecast transaction results in an asset or liability, the cumulative gain or loss that had previously been recognised directly in equity should remain in equity and be released from equity consistently with the reporting of gains or losses on the hedged asset or liability?[2]	Yes.
IAS 39 (x)	*Prior derecognition transactions (paragraph 1 71B).* Do you agree that a financial asset that was derecognised under the previous derecognition requirements in IAS 39 should be recognised as a financial asset on transition to the revised Standard if the asset would not have been derecognised under the revised derecognition requirements (ie that prior derecognition transactions should not be grandfathered)? Alternatively, should prior derecognition transactions be grandfathered and disclosure be required of the balances that would have been recognised had the new requirements been applied?[3]	Yes.

1 Note: The FRED proposes that IAS 39, paragraphs 117-119 should be amended for implementation in the UK in 2004 so that no losses on an available-for-sale financial asset will be reversed.

2 Note: The FRED proposes that IAS 39, paragraph 160 should be amended for implementation in the UK in 2004 so that such gains and losses are reported amongst assets and liabilities on the balance sheet rather than in equity.

3 Note: The FRED proposes that IAS 39, paragraph 171B should be deleted for implementation in the UK in 2004.