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Mr P Ebling
Accounting Standards Board
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Dear Mr Ebling,

Comments on FRED 30

We welcome this opportunity to comment on FRED 30. Our responses to the specific questions asked by the ASB, including those raised by the IASB, are given in the attached appendix.

While we appreciate that many of the FRED's proposals which are new to UK companies have been requirements under IAS for some time, and that comments are not specifically sought on these areas, we would like to make some general points:

- The rules-based nature of IAS 32 and IAS 39, and consequently of FRED 30 as well, can lead to results which are difficult to comprehend. Examples are:

  > A floating rate borrowing is reported at amortised cost. A fixed rate borrowing swapped into floating rate has exactly the same economic effect, but the accounting treatment (unless hedge accounting is obtained) is very different: ie the borrowing is accounted for at amortised cost and the swap is marked-to-market with the gain or loss recognised in the income statement;

  > Hedge accounting is not available for non-derivative instruments intended to hedge interest rate risks; nor of the cash flow risk associated with interest receipts on a variable-rate held-to-maturity investment;

  > The definition of hedges of unrecognised firm commitments as cash flow hedges or fair value hedges is debatable, and entails significant differences in accounting. The fact that the proposed new IAS 39 changes the required treatment from the former to the latter is indicative of the problems in interpreting the rules.

  We would prefer standards which provide a framework of principles and concepts and which allow entities to account for assets and liabilities and transactions in ways which reflect their real nature and purpose. We believe that such an approach is less open to abuse, and unlikely to lead to the peculiar accounting effects which can occur when detailed rules are laid down. Commentary on the recent accounting scandals in the US has frequently cited the rules-based approach to US standard-setting as a contributory factor, so it is regrettable that UK GAAP will become more rules-based as a result of convergence with international accounting standards.

- The FRED's requirements on hedge accounting will entail increased paperwork and administrative workload in corporate treasury departments to ensure that hedge designation and testing criteria are met. While much of this is undeniably good treasury practice, the rules linking documentation and accounting treatment mean that an administrative oversight/ could result in failure to achieve hedge accounting regardless of the purpose of the transaction and its economic effect. The new rules may be useful in preventing bad practice in some entities, but they also have the unfortunate consequence of imposing administrative workload and risk of unexpected volatility in their financial statements on those entities which already account for hedges in a responsible manner.

- The recognition of unrealised gains proposed in the FRED has potentially major consequences for UK tax legislation and company law. For over 100 years, the overriding principle of prudence in measuring accounting profits has enabled these profits to be used as the basis for taxable profits. The move to recognising unrealised profits means that UK tax legislation will need to redefine the measure of taxable profits in order to ensure that only realised profits are taxed. Similarly, there could be major consequences for the definition of distributable reserves in company law. In view of these potentially significant changes, we believe that the move to basing UK standards very closely on international accounting standards should be deferred until 2005 - the date when reporting of group results under IAS will be mandated for some entities to allow time for the necessary changes to law to be debated and made.

Finally, I would like to remind you of the comments I made to Mary Keegan in my letter dated 10th July 2002, which outlined several reasons, in addition to the point regarding legislation above, why we do not believe that a piecemeal approach to convergence between UK OMP and international financial reporting standards is helpful. We feel strongly that the ASB should reconsider its preference for a piecemeal approach, and hope that it will agree to delay the effective date for a FRS based on FRED 30 until 2005.

Yours sincerely,

Mr PF Blackburn
Corporate Financial Controller
GlaxoSmithKline plc

Financial Instruments:
Disclosure and Presentation & Recognition and Measurement
(FRED 30)

ASB QUESTIONS

ASB (i) *Treating lASs 32 and 39 as a package (Appendix Ill, 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. Many of the disclosure requirements in IAS 32 presuppose IAS 39's measurement and hedging requirements. Equally, it would be difficult for users of financial statements to understand some of the impacts of implementation of IAS 39 without the associated disclosures specified in IAS 32.

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 requirement in this area?

As we stated in our letter to Mary Keegan dated 10 July 2002 on the subject of the ABS'S approach to conversion to International Financial Reporting Standards, we do not agree that the changes proposed under the ASB's current programme to converge UK GAAP with lAS should become effective until 2005. Listed companies which prepare consolidated accounts, such as GlaxoSmithKilne (GSK), are faced with a heavy workload in order to successfully manage the transition to lAS in 2005 as mandated by the recent EU regulation. We believe that the most efficient use of resources would be to implement all the changes together. Piecemeal implementation prior to 2005 dictates a company's transition programme and sets an agenda which may not be the most suitable for its circumstances. The distraction from the overall objective caused by piecemeal implementation is increased where the UK

requirements differ in certain respects from IAS ones, as is the case with FRED 30.

Those companies required to adopt IAS in their 2005 group accounts will need to provide comparative figures for 2004 and, in the case of SEC registrants such as GSK, for 2003 as well. We would rather focus on preparing in advance IAS-based figures for these periods, in parallel with the figures reported under existing UK GAAP, than have to implement early slightly different requirements in the reported figures, only to change them again for the comparatives reported in 2005.

That said, given the currently proposed implementation date for FRED 30 of 2004, we do agree that it makes sense to exclude some parts of the standards where there is a prospect of further significant change in the IAS requirements prior to 2005 (see also our answer to (Hi) below).

Our views on making adoption of the measurement and hedging requirements in Part ll of the FRED non-mandatory are given under (iv)(a) and (v)(a) below. In brief, we believe that adoption should be mandatory to protect comparability between UK companies' financial statements.

ASB (iii) *Recognition and derecognition (Appendix III paragraphs 23-29)—The* **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. It would be unhelpful to implement IAS 39's detailed requirements on recognition and derecognition, if there is a possibility that they may change in the not-too-distant future.

ASB (iv) *Measurement (Appendix Ill, 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?

As stated above under question (ii), we would propose deferring implementation! of FRED 3D's requirements until 2005.

Post 2005, we do not believe that it makes sense for companies reporting under UK GAAP to be exempted from the measurement requirements in Part Il of FRED 30. Although the expected revisions to the 1985 Companies Act will permit but not require fair value accounting, we believe the ASB should take the opportunity in the FRS drawn up from FRED 30 to mandate this approach for financial instruments. This would necessarily impose a burden of transition on all companies, as the changes in accounting treatment are fundamental and extensive. However, for this very reason, comparabllity between UK companies will be significantly reduced if the changes are not applied across the board.

(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)*

While we generally would prefer complete convergence, we do support delaying implementation of requirements on a particular topic if it appears possible, as in this case, that the requirements may change before listed companies are obliged to adopt IAS for their group accounts in 2005.

The IASB's current project on reporting financial performance may identify principles and formats of reporting which would make alternative treatment unnecessary, particularly as we understand that the ASB is a joint partner with the IASB on the project The opportunity to await the project group's findings, and so potentially to avoid differences between UK GAAP and IAS on the issue of recycling by amending the FRED'S requirements in fight of those findings, provides another reason for deferring implementation of the FRED until 2005.

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?

We do not agree with making the hedging requirements non-mandatory. We see no reason why any company which enters into hedging arrangements should not be required to comply with the process and accounting requirements in FRED 30. The accounting treatment presupposes that a fair value measurement basis is being applied, but, as noted above at (iv) (a), we also support making this a mandatory requirement

(b) Do you agree with the approach being proposed in place of recycling? (Appendix Ill, paragraphs 64-68)

We believe that it would be preferable to await the outcome of the project on reporting financial performance, and, hopefully, a resolution of the recycling problem, before implementing a FRS.

ASB (vi) *Unlisted entities and individual financial statements*

(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?

No. Please see the responses to questions (iv)(a) and (v)(a) above.

(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?

We agree that the disclosure requirements should apply only to entities in which a member of the public may hold a stake as a shareholder or holder of a traded security, and to banks and listed insurance entities. The disclosure requirements are extensive and the effort involved in producing them for the financial statements of other entities is probably not justified by the value of the additional information provided.

(c) FRS 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?

Yes.

IASB QUESTIONS

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).

Yes. This approach avoids the need for repeated assessments of probabilities, which could alter from period to period resulting in frequent transfers between liabilities and equity and damaging comparability between periods.

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. This approach conforms with the definition in paragraph 5 of an equity instrument as evidencing a residual interest in the assets of an entity after deducting all its liabilities.

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?

We agree with the guidance proposed.

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. Such a standard would be very long, but it would enable all key requirements regarding financial instruments to be accessed in one place. Also, placing the disclosure requirements of IAS 32 more clearly in the context of, for example, the measurement requirements of IAS 39 would make the purpose behind the disclosures more readily understandable.

IAS 39 (i) *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 scope of IAS 39?

As GSK does not generally have such commitments, we do not hold strong views on this topic.

IAS 39 (ii)) *Derecognition: continuing involvement approach (Appendix I, 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?

We would comment that the "risks and rewards" approach applied in the UK under FRS 5 appears to be well accepted by UK companies and we are not aware of any significant problems with it. As this is a more conceptual approach, it may give less scope for financial engineering designed to work around rules to achieve results which are not in accordance with the substance of the transaction.

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?

Based on the continuing involvement approach described in the Exposure Draft, we agree that such pass-through arrangements should qualify for derecognition.

IAS 39 (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?

This option provides flexibility and facilitates the use of natural hedges, should an entity wish to use them. We support it for these reasons.

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?

We have no suggestions for additional requirements or guidance.

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 paragraphs 113A-113D?

We agree that an asset with no evidence of individual impairment may be included in a group of assets with similar characteristics for collective evaluation. This approach makes sense if losses are to be recognised based on proportions experienced in the past or on estimated probabilities.

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?

No, we do not see why these assets should be treated differently from assets carried at amortised cost.

Furthermore, banning reversal of impairment losses may deter entities from recognising such losses until the last possible moment – a problem that may be aggravated by the fine distinction that sometimes exists between a loss recognised as a fair value adjustment and a loss recognised as impairment. Retention of IAS 39's current accounting treatment would avoid creating an incentive to interpret the rules to avoid recognition of impairment losses.

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?

Conceptually, we do not believe that a portion of a commitment should be recognised on the Balance Sheet just because it has been hedged and the value of the hedging instrument has changed. Although hedge accounting means that the net impact on both the balance sheet and the income

statement is nil, this grossing up of the balance sheet adds complexity to the financial statements.

On the other hand, we note that the proposal to change the accounting for hedges of unrecognised firm commitments would bring IAS 39 into line with US GAAP (SFAS 133). Such convergence is a desirable objective and, for companies such as GSK which is SEC-registered, would simplify the reconciliation process from IAS to US GAAP.

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?

No. A basis adjustment reflects the economic effect of the entity's hedging activity. Use of basis adjustments also <u>ensures</u> that the hedging gain or loss is transferred to the income statement pro rata with other impacts to the income statement, eg depreciation, arising from the asset or liability concerned. Although paragraph 160 requires transfers from equity to achieve the same effect, the need to track movements in hedged items over several years in order to release matching amounts from equity will be an onerous task with potential for oversight.

IAS 39 (x) *Prior derecognition transactions (paragraph 171B)*—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?

We are concerned that both of these options will entail restating previous transactions, either for inclusion in the accounts or in disclosures. It may not be practical to do so, and we believe that the option to retain the prior treatment, with no additional disclosure, for previously transferred assets should be considered where restatement would not warrant the time and effort involved.