Comments by the National Audit Office

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

General Comments — FRED 30

The National Audit Office has considered how the proposals may be applied, with particular reference to the central government sector. This consideration does not take account of decisions that will be taken by the Treasury on the application of the standard. Existing accounting requirements for financial instruments, including FRS 4, FRS 13 and UJTF abstracts apply to central government bodies although in a form adapted to circumstances specific to Government. In principle, we see no reason why the standard proposed by FRED 30 should not be adopted in similar way. However, in practice, few central government bodies will need to apply more than the "basic requirements" such as disclosure of financial assets and liabilities including cash, loans, investments and finance leases.

While it is perhaps inevitable that standards on financial instruments are complex, we found that the form of the standard based on IAS's 32 and 39 and the terminology used did not promote clarity in their presentation and thus understandability. In our comments on the IAS's we suggest that the IASB consider whether the standards can be presented in such a way as to make them more usable. Depending on the final form of the international standards, the ASB might consider whether there is need or scope for the presentation of the UK standard to be made clearer.

Specific Comments

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. We agree that implementation of as much as possible of the standards at one time should assist users of financial statements particularly by bringing a greater measure of consistency. While this may place a greater burden on practitioners this approach seems preferable to implementation piecemeal.

In our comments on FRED 23 Financial Instruments: Hedge Accounting we noted that the proposed standard has fewer restrictions than IAS 39. Further convergence on hedge accounting is achieved by the proposals in FRED 30, which bring in many of these restrictions. While FRED 23 is intended to fill a gap in financial reporting in 2003 with the withdrawal of SSAP 20, a delay in implementing the requirements on hedge accounting so that they can be included for the first time in a single statement with the other requirements of IAS 39 may be preferable for the same reasons as it is proposed that IAS 32 and 39 are implemented as a package.

ASB (ii) Implementation in 2004 (Appendix III, paragraphs 1 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 Abs tracts) 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 in principle but see our comments to ASB (iii) to ASB (vi).

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.

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?*

The measurement criteria of IAS 39 will be optional from 2004 and in effect, mandatory from 2005 for listed companies. For unlisted companies, the requirements may remain optional. While implementation in this respect is predicated on changes in companies legislation and the adoption of IFRSs by listed companies, the proposed approach would not seem to promote comparability between financial periods or between otherwise similar entities.

We consider that the Board should consider applying the requirements of IAS 39 for listed companies from when an UK standard based on it is first adopted. Comparability would also be enhanced if similar requirements were adopted for unlisted companies.

(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)*

Yes. We support the ASB's view that fair value gains or losses should not be "recycled" through the Profit and Loss account whereas current proposals for changes to IAS 39 require such treatment. We are also of the view that such gains and losses should be recognised immediately in a statement of performance and that such recognition should not be deferred until the gain or loss is realised. This issue is linked to wider discussion on reporting financial performance and we note that the ASB is undertaking a project with the IASB which (amongst other things) may result in "recycling" being prohibited internationally.

ASB (v) *Hedge accounting—The ASB is proposing a similar approach to IAS 39 hedge accounting requirements as to its measurement requirements. (Appendix ill, paragraphs 57-63, 69 and 70)*

(a) *Do you agree with this approach?*

We have reservations on grounds of comparability similar to those on the proposed standards measurement requirements (ASB (iv) a).

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

Yes.

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

(a) *The FRED proposes that, prior to 2005, entities should be required to comply with MS 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 MS 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 MS 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?*

We have reservations on grounds of comparability. See our comments to ASB (iv) a.

(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?*

Agree. It would seem appropriate that disclosure is required of the widest range of appropriate bodies. Also see our comments to ASB(vi) (b) above.

(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.

General Comments IAS 32 and IAS 39

While it is inevitable that the complexity of financial instruments will make the FRS's requirements inherently complicated, we found that the form of the draft standard and the terminology used significantly affected understandability and thus could make the standard difficult to use. It would seem likely that even experienced practitioners in the field of financial instruments might find the standards hard to interpret and experience difficulty in recognising their requirements. However, with financial instruments becoming more widely available, a wider range of practitioners will need to apply the standards and those with less experience in this area may find the requirements impenetrable.

We suggest that the ASB ask the IASB to consider the form of the standards before they are adopted with a view to simplifying their construction and making them more usable. For instance, the standards would benefit from restructuring and the use of plainer language; including a better sentence structure, shorter sentences, fewer double negatives, better sign-posting/headings, an index, a glossary of terms, and a summary at the start of each section.

Specific Comments

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).

We consider that classification of a financial instrument should be based on the substance of the arrangement. Where the contractual terms are such that an obligation to transfer cash or other financial assets cannot be avoided and there is no right to satisfy the obligation in another way, then the instrument should be classified as a financial liability.

We note that the UK Accounting Standards Board has concerns about IAS 32's material on the equity/liability split and that it is encouraging the IASB to carry out a comprehensive review.

IAS 32 (iii) *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?*

The proposed standard requires that the issuer of a financial instrument shall classify the instruments or its components as a liability or as equity in accordance with the substance of the arrangement. It would seem to follow that the residual amount of a compound financial instrument after deducting any assets and. lia bilities should be classified as equity.

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. Derivatives based on an entity's own equity should be classified as equity if the entity has the right or intends to settle the contract with a fixed number of shares or for a fixed amount of cash or other assets. Otherwise, the derivative is a liability or asset.

IAS 32 (iv) *Consolidation of the text in MS 32 and MS 39 into one comprehensive Standard— Do you believe it would be useful to integrate the text in IAS 32 and MS 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)*

We would support this. There would be advantages in having requirements on financial instruments in a single standard. If this were to be done, consideration would be needed on how the existing standards might be integrated so as to promote clarity of presentation and ease of understanding.

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?*

Yes.

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?*

"Continuing involvement" is a clearly a step forward from the existing requirements of IAS 39. We believe it a reasonable presumption that that an asset or component of an asset in which an entity has no continuing involvement or interest should be derecognised and as such it would seem to be a valid principle on which to base a new standard.

We note that IAS 39 is intended to be an interim standard pending development of a definitive approach. How the principle of continuing involvement is formulated and developed will be a key issue.. We believe that emphasis should be placed on the substance of whether or not there is continuing involvement in an asset. Whereas, undue focus on contractual terms could promote a compliance culture where instruments are devised that meet specified criteria.

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. If the arrangement is such that, together with the pass through arrangement, the transferor no longer has the substance of an asset then there should be derecognition. The conditions in paragraph 41 appear to achieve this.

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?*

On balance, we agree that an entity should be allowed to opt for fair value measurement in this way. In effect, this would apply only in jurisdictions where fair value accounting is allowed but not mandatory.

Inconsistency of treatment could result both within an entity and between entities, in that different measurement approaches might be used for instruments that are similar and essentially used for the same purpose. The Board might require that designation of instruments as held for trading (and thus for which fair value can be used) should be allowed for classes of instruments rather than individual instruments. However, classes of assets may be difficult to determine given the range of instruments available.

IAS 39 (v) *Fair value measurement considerations (paragraphs 95 - 1000D)-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 agree with the requirements..

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?*

Yes.

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?

We are of the view that where an impairment loss has been recognised in the profit and loss account, subsequently reversal of the impairment should also pass through the profit and loss account.

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?

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 MS 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 agree that a financial asset should be recognised if it meets the recognition criteria of the revised IAS 39 irrespective of whether it was de-recognised under the previous requirernents of the standard.