INSIDE TRACK 35

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IASB Improvements

The ASB's main comments on the IASB's proposed improvements to certain IASs were summarised in Inside Track 34, January 2003. The IASB has since been deliberating issues raised by respondents.

The ASB welcomes the IASB's decisions on the following important issues.

Materiality. The ASB has argued that the principle that IFRSs need not be applied to immaterial items should be clearly stated. The IASB has agreed to include in IFRSs some additional guidance on materiality.

Fair presentation override. The IASB has confirmed the retention of the override in order to achieve a fair presentation.

Related parties. The IASB has agreed to strengthen the proposed standard by requiring disclosure of the name of the ultimate controlling party.

Exchanges of fixed assets. The IASB has agreed that the standards should clarify that transactions should not be recognised unless they have a commercial substance. This issue is being considered further in the context of the IASB's joint convergence project with the FASB.

Functional currency. The IASB has decided the standard should focus more directly on the importance of the primary economic environment in which the entity operates.

Equity accounting for associates. The IASB has agreed that receivables for which good collateral exists should not be included in the amount to be reduced to nil when an associate incurs losses.

It may also be noted that the IASB has confirmed the exposure draft's proposals regarding

- the retrospective treatment of material errors
- the separation of leases into land and buildings elements (the IASB has yet to consider issues relating to the interaction between IAS 17 Leases and IAS 40 *Investment Property)*
- the recycling of exchange differences on the disposal of a foreign operation.

The IASB has decided that the standards revised in the Improvements project should be mandatory for periods beginning on or after 1 January 2005 (not 2003 as proposed in the exposure draft).

ASB exposure draft on revenue recognition

Turnover - 'the top line' of the profit and loss account - is addressed in a recent exposure draft from the ASB. The draft takes the form of an Application Note 'Revenue Recognition' to FRS 5 'Reporting the Substance of Transactions'. It builds on ASB's recent work, including the Discussion Paper issued in 2001 and its further thinking in the light of the comments received in response to that Paper.

The absence of a specific UK standard on revenue recognition has been a source of muted but continuing criticism for some time. It has led some companies to look to the International Accounting Standard, IAS 18 'Revenue', or to United States accounting standards. There have also been reports of issues arising in practice and, in some cases, the adoption of questionable solutions. The ASB has therefore decided to propose guidance emphasising the principles that underlie good UK practice.

The Application Note will be an interim step, pending the development of a replacement for IAS 18. The Application Note will in general ensure compliance with IAS 18, but will also provide detail on the principles that should be applied in the recognition of turnover. In September 2002 the International Accounting Standards Board and the US Financial Accounting Standards Board agreed to combine their separate researches into a joint project to develop a new accounting standard which will replace IAS 18. The ASB fully supports these efforts.

The draft Application Note is based on the principle that turnover should only be recognised when a seller's performance under a contract with its customers gives rise to either:

- an increase in the seller's assets (such as a debtor); or
- a decrease in its liabilities (usually the release from an obligation arising from payment received in advance).

The draft requires turnover to be measured at the fair value of the gross amount of these increases in assets or decreases in liabilities. The above principles apply generally.

The draft also specifies its application to a number of circumstances. The following summarises some of the main points proposed.

In applying SSAP 9 'Stocks and long term contracts', the recognition of turnover should represent the extent to which the seller has obtained the right to be paid, and therefore should not necessarily follow the pattern of costs incurred.

Contractual arrangements that require the provision of a range of goods or services should give rise to turnover in respect of individual elements only where the elements can be provided to customers separately and a fair value can be derived for each.

Where goods are supplied under 'bill and hold' arrangements, turnover should be recognised only when a number of conditions, including the transfer of the principal benefits and risks to a customer, are met.

Where goods are sold subject to a right of return, the amount recognised as turnover should exclude the sales value of estimated returns.

The draft also addresses the circumstances in which a seller is regarded as acting as a principal and should report gross revenues or, on the other hand, should be seen as an agent and report only commission receivable. Where a seller acts as agent, it is encouraged where practicable to disclose the gross value of sales throughput as additional information.

It is not envisaged that the issue of the Application Note will cause significant change to the approach adopted by the majority of UK entities. However, it will assist in cases where doubts arise about the acceptability of certain reporting practices. The ASB proposes that the amendment to FRS 5 should be finalised to take effect as soon as possible.

Comments on the exposure draft are requested by 30 May 2003.

Interpretation of the Statement of Principles for Public Benefit Entities

In December 1999 the Board published its Statement of Principles for Financial Reporting (the Statement). This sets out the principles that the Board believes should underlie the preparation and presentation of general purpose financial statements, and is primarily intended to be relevant to the financial statements of profit-oriented entities.

The Board believes that a common set of principles should underlie the financial reporting of all entities and the Statement is, broadly speaking, also relevant to the financial statements of public benefit entities. However, some of the principles need to be re-expressed and others need a change of emphasis before they can be applied to these entities.

The project to interpret, or apply, the Statement for public benefit entities has been undertaken under the guidance of the Public Sector and Not-for-profit Committee (PSNC), which reports to the Accounting Standards Board. A Discussion Paper will be issued shortly for public comment.

In tackling the project PSNC identified what appeared to be the main areas where the diferent nature of public benefit entities (when compared to profit-oriented entities) meant that the principles needed revisiting or, more usually, more explanation was required in order to apply the principles. The Discussion Paper considers, chapter by chapter, how the Statement should be interpreted for public benefit entities.

One key consideration in the project was how to define the entities in question. After much discussion the term "public benefit entities" will be proposed in the Discussion Paper, along with a definition. Public benefit entities have a primary objective to provide goods or services for the general or social benefit, rather than a financial objective relating to returns to equity shareholders.

Significant parts of the Statement require no, or very little, additional material to clarify their application to public benefit entities. This illustrates the universality of the underlying principles.

In relation to the elements of financial statements (ie assets, liabilities, gains, losses etc) although, as one would expect, the basics are all common, a significant amount of work has been done in ensuring that elements are well explained in the context of public benefit entities. For example, many, if not most, of the assets held by public benefit entities do not result in inflows of cash to the entity, but are used to provide goods or services for the entity's beneficiaries or customers.

This does not mean, however, that the asset should be reported with a value of zero, providing it is being utilised to provide services for which there is a need or want. Therefore the Discussion Paper proposes additional explanatory material to interpret the definition of an asset and assist in the current value measurement of such assets (where entities adopt a policy of revaluation). One idea that flows through the Discussion Paper is that control includes the ability of an entity to meet its objectives by utilising an item to provide benefits (in the form of goods or services) to its beneficiaries or customers.

Another area of focus for public benefit entities relates to the recognition of liabilities, particularly in relation to constructive obligations. The Discussion Paper identifies a particular type of potential obligation relating to public benefit entities, namely "commitments to provide public benefits". These might include general or policy statements of intention, which would not be expected to create an immediate liability for the reporting entity because they could be altered. Therefore the entity would not have created a valid expectation that its intention would be implemented such that it could not realistically withdraw. This is a difficult area and the Board and PSNC look forward to hearing the views of respondents on the proposed approach.

The Discussion Paper addresses a number of other issues including: the definition of the class of 'users'; their interest in the financial statements of public benefit entities; the boundary of the reporting entity; grants and donations receivable (including conditions and restrictions relating to the receipt or use of the resources, and grants provided for the purpose of acquiring or constructing capital assets); and business combinations.

The Board is confident that the Discussion Paper and the subsequent development of the ideas it contains will contribute to increasing the quality and consistency of financial reporting across the diverse range of organisations that fall within the definition of a public benefit entity.

We look forward to receiving comments on the Discussion Paper in due course from all those interested in the financial statements of public benefit entities, whether preparers, auditors, regulators or other users.

Send us Your Views

Your comments or questions to Jenny Carter, please.
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Reporting Financial Performance

The objective of this joint IASB/ASB project is to categorise and present all income and expenses, gains and losses for a period (referred to below as "income and expenses") in a way that enhances understanding of the financial results and assists users in forming expectations of future income, expenses and profit or loss. The project addresses only issues concerned with presentation; it is assumed that recognition and measurement would follow existing standards, except that gains and losses currently reported in equity would instead appear in the new statement. A separate but parallel project is also in progress at the FASB in the USA.

Although no final decisions have yet been taken, the IASB and ASB have now explored the issues sufficiently to start a series of consultations with selected groups of preparers and users to take soundings on a set of draft proposals. The proposals envisage that all income and expenses should be reported in a single statement of profit or loss stratified into categories as detailed below *and illustrated in the outline format below:*

- A major distinction would be between a Business and a Financing category. The object is to enable users to distinguish the income and expenses generated by the entity's assets from the source of financing of those assets. Financing would include not only interest accruing on debt but also the unwinding of interest on discounted liabilities.
- The Business category would be subdivided into:

  a) an Operating Profit sub-category, which would be the residual within the Business category;
  b) an Other Business sub-category currently expected to include only goodwill impairment, negative goodwill credited to income, currency gain/loss on net investments, investment property fair value changes, revaluations and disposal gains/losses on property, plant and equipment;
  c) a Financial Income sub-category located immediately before Financing.

- Other categories would be for Tax, Discontinuing Activities and Cash Flow Hedges.
- The Business, Financing and Discontinuing Activities categories should be disaggregated (possibly by means of additional columns) into items contributing to Profit before Remeasurement and Remeasurements.
- Remeasurements are revisions of prices or estimates that change the carrying amounts of assets or liabilities. They reflect revised expectations but not events of the period that give rise to initial recognition of assets or liabilities. For example, asset impairments, including stock write downs and bad debts, would be remeasurements but depreciation would not, because it represents the initial recognition of the (planned) consumption of an asset during the period.
- Discontinuing Activities would be presented net after tax, as a single line with disaggregation in the notes.
- The Cash Flow Hedging category would record the income or expense arising on a hedging instrument until such time as the income or expense on the hedged item was reported. At that time, the matching income or expense previously reported on the hedging instrument would be removed from Cash Flow Hedging and reported alongside the income or expense of the hedged item. There would be no effect on reported profit for the period but the effect on the hedged item would be clearly shown.

Reporting Financial Performance

Outline format	Total	Before Remeas.	Remeas-urement
Business			
operating profit	x	x	x
other business	x	x	x
financial income	x	x	x
	xx		
Financing	x	x	x
Tax	x		
Discontinuing activities	x	x	x
Cash flow hedges	x	x	x
Comprehensive income	x	x	x

In the context of the proposed statement, the IASB has provisionally decided to amend IAS 19 Employee Benefits to give immediate recognition, as a remeasurement, to the actuarial gain/loss. Unlike FRS 17, no estimate would be made of the expected long-term return on plan assets; instead, the whole return would contribute to the actuarial gain/loss.

Following the consultations the Boards will reconsider their provisional decisions and discuss them with national standard setters and with IASB's Standards Advisory Council. Once agreement on the draft proposals is reached, it is intended to redesign the cash flow statement to correspond as far as possible with the new statement. It is hoped to issue an exposure draft in the fourth quarter but a final standard is not expected to be mandatory until after 2005.

Financial instruments —
The IASs 32 and 39 roundtables

Of all the standards issued by the IASB, its two financial instrument standards, IASs 32 and 39, seem to be causing the most concern amongst entities preparing to adopt international accounting standards. Last June, the IASB issued an exposure draft setting out amendments it proposed to make to the two standards to ease those concerns. Those proposed amendments have themselves attracted significant comment. Concerned that an important reason for much of the intense debate might be a lack of understanding on both sides, the IASB decided to hold a week of roundtable discussions with commentators. Set out below is a brief summary of the issues that were discussed the most at those roundtables.

Hedge accounting
Inevitably, much of the discussion was about hedge accounting. The IASB made clear that it was keen to find ways of simplifying its requirements in this area—for example: to have just one type of hedge accounting rather than cash flow hedge accounting and fair value hedge accounting; to allow fair value hedge accounting for macro hedges of interest rate risk; and to allow non-derivatives to be used more widely as hedging instruments. However, it also made it clear that any such simplifications must be consistent with the following principles:

- All derivatives should be measured at fair value.
- A hedge will qualify for hedge accounting only if it is: clearly defined, designated and documented; reliably measurable; and effective.
- Gains and losses arising on any ineffective part of a hedging instrument should be identified and taken to the P&L immediately.
- Gains and losses on the effective part should be recognised in the P&L at the same time as the offsetting gains and losses on the hedged item.
- Gains and losses should not be recognised on the balance sheet as assets and liabilities.

Recognition and derecognition
Perceived problems with IAS 39's recognition and derecognition requirements caused the IASB to propose their replacement with the so-called 'continuing involvement approach'. However, respondents to the exposure draft also criticised that approach. The options open to the IASB were discussed at the roundtables and, in the light of those discussions, the IASB has decided to explore two possible ways forward:

- Make relatively minor amendments to the existing IAS 39 approach.
- Make relatively minor amendments to the continuing involvement approach.

Another aspect of the derecognition proposals that was discussed is the 'pass-through provisions'. Those provisions deal with the accounting treatment of rights to receive cash flows when the holder of those rights also has an obligation to pass the cash flows received to another party. Many had assumed that these provisions were an attempt to address a perceived shortcoming in SIC-12 'Consolidation-Special Purpose Entities' which results in many securitisation originators having to consolidate their securitisation SPEs (and thereby bring back onto their consolidated balance sheets the securitised assets transferred to the SPE). However, at the roundtables the IASB explained that the proposals were intended to deal only with entities collecting receivables in an agency capacity (such as servicers of debt portfolios). As that leaves unresolved the alleged difficulties with SIC-12, the IASB has agreed to look at the relationship between SIC-12 and IAS 39.

Loan loss provisioning
The IASB proposed in its exposure draft that the revised IAS 39 should incorporate a significant amount of new material on loan loss provisioning. Unfortunately, it was not clear from the exposure draft whether the IASB intended entities to adopt an incurred loss approach or an expected loss approach. At the roundtables the IASB explained that it had meant to require an incurred loss approach. It intends to clarify this in the final standard.

Another concern raised by many is the prescriptive nature of the proposed loan loss provisioning requirements. The IASB has agreed to consider whether it might be possible to eliminate some of the detail from the requirements.

Equity/liability classification
The principle in IAS 32 is that an instrument should be classified (as either a liability or equity) in accordance with the substance of the contractual arrangement.

Unfortunately, the changes the IASB was proposing to make to the material that supports this principle—including the proposed deletion of the example on economic compulsion—has caused confusion as to what the principle actually means. In the light of what it heard at the roundtables, the IASB has agreed to explore ways of clarifying its intentions. It will also consider whether to re-instate the economic compulsion example.

Recent consultations

Share-based Payment

In November 2002, the IASB issued ED 2 'Share-based Payment'. That ED proposed the implementation from the beginning of 2004 of an accounting standard requiring the recognition of an expense, measured by reference to fair value, in respect of all share-based payment transactions. On the same date, the ASB issued an exposure draft (FRED 31) proposing the implementation in the UK-for all entities and all types of share-based payment, including all employee share-option schemes and SAYE-type schemes-of that international standard on the date it comes into force internationally.

The draft standards also set out proposals on how the fair value expense is to be measured and recognised, and what disclosures should be provided to support the amounts recognised in the primary statements.

The deadline for comments on ED 2 and FRED 31 was 7 March, and both Boards are now considering the comments they received in response to their proposals.

In the USA there is currently a non-mandatory standard that encourages entities to recognise a fair value expense in respect of share-based payments. After ED 2 was issued, FASB issued a consultative document seeking views on the differences between its standard and the draft standard in ED 2. It also sought views as to how it should proceed in this area. In the light of the comments received, FASB has now decided to commence a project that will seek to improve the existing US requirements in this area. Its intention is to issue an exposure draft later this year and have a revised standard in place next year.

Business Combinations

In December 2002 the IASB issued ED 3 Business Combinations and the associated exposure draft of proposed amendments to IAS 36, Impairment of Assets, and IAS 38, Intangible Assets. On the same day the ASB published its consultation paper 'IASB proposals on Business Combinations, Impairment and Intangible Assets'. Comments on both documents were requested by 4 April 2003.
Some of the key issues arising from the proposals were:

- the abolition of merger accounting;
- the non-amortisation of goodwill; and
- the proposed new impairment test for goodwill.

EFRAG has published a draft response to the IASB, on which it has requested views. The following is a summary of key points EFRAG made in its draft response (which the ASB also supports):

- the purchase method of accounting is appropriate for most, but not all, business combinations;
- the IASB should carry out, as a matter of priority, research into the fresh start method of accounting, particularly for those business combinations where it is not possible to identify an acquirer;
- amortisation of goodwill should continue to be permitted;
- the disclosures associated with the calculation of the recoverable amount of goodwill that are proposed in the amended IAS 36 are excessive.

It is too early to summarise the responses received by the ASB, but more detail on some of the ASB's views on the proposals was included in the Preface of the Consultation Paper. In due course, the ASB will be writing to the IASB setting out its views on ED 3 (and the associated proposals for IAS 36 and IAS 38), taking into account the comments received.

Leases

One of the objectives of a new leasing standard would be to ensure that the same principles for recognising assets and liabilities are applied to all leases, regardless of whether or not the lease transfers to the lessee substantially all the risks and rewards that are associated with the property, plant or equipment under lease.

The ASB has been continuing to address issues relating to a single method of accounting for leases. The work is being informed by IASB's ongoing discussions on a number of topics where similar conceptual questions arise. These include questions of how far contracts should be disaggregated into separate (and perhaps offsetting) asset and liability components. The notion of economic substance, including linkage of transactions, is particularly relevant to aspects of leasing. IASB's current project on revenue recognition will inform the thinking on accounting by lessors, where one of the key issues is to determine what changes in assets and liabilities should be recognised at the beginning of a lease.

This project is one of a number of research topics being conducted for IASB by national standard setters. Although IASB is anxious to make progress on this subject, it does not intend to require implementation of a new standard before 2006.

on current projects

Service Concessions

At the request of the IASB, the ASB has been leading an international research team looking at the accounting treatment of service concessions (which are more commonly know as PFI arrangements in the UK).

These arrangements involve a number of difficult accounting questions, which are only partially addressed by existing IASB accounting literature. Which party should recognise as an asset the property used to provide the services? To what extent do the principles behind lease accounting apply to these agreements? How should the income and expenses relating to the agreement be accounted for?

The IASB has asked the research team to report its initial findings at the meeting of the IASB with national standard setters in April.

Business Combinations Phase II

During the period when Phase I of the business combinations project has been out for comment the IASB has been progressing with part of Phase II of the project, dealing with the *Application of the Purchase Method*. This is a joint project between the IASB and FASB.

The IASB and FASB have tentatively agreed a working principle that underlies the remainder of the development of this aspect of the project. The basic premise is that the amount to be recognised by the acquirer should be the fair value of the acquiree. This has led the IASB to consider different methods of determining the fair value of the acquiree, particularly where the acquirer has not obtained a 100% interest in the acquiree.

Some of the potentially more controversial tentative decisions of the IASB are that:

- the costs directly attributable to a business combination are not part of the fair value exchanged and therefore are not part of the consideration paid;
- goodwill should be recognised in full when a controlling interest, less than 100%, is acquired (ie the goodwill that is recognised should include that relating to the minority interest);
- if changes in ownership interests in a subsidiary do not result in a change in control, they should not result in a gain or loss but be treated as equity transactions and accordingly recognised entirely in equity.

The IASB has also considered various issues relating to the recognition and measurement of the net assets acquired, which has included revisiting some of the decisions made in Phase I.

Insurance accounting

The ASB continues to track the IASB's project on accounting for insurance contracts. The project has been split into two parts because a comprehensive standard could not be completed by 2005. Phase I is to set out what insurance companies will need to do to come into line with IASs in 2005. Broadly, the present proposal is to accept existing accounting policies for insurance contracts, subject to eliminating catastrophe and equalisation provisions. The proposal is also to require the immediate recognition of losses on loss making contracts and to separate out some deposit components that are combined with insurance contracts.

While awaiting the Phase II standard, reporting entities are likely to be encouraged to move to more relevant and reliable policies. A key feature is likely to be a definition of insurance contracts requiring the transfer of significant insurance risk. Investment contracts, involving only exposure to financial risk, will be covered by the accounting standards dealing with financial instruments (IASs 32 and 39).

For Phase II of the insurance project, the IASB is working on developing a comprehensive model for insurance contracts, based on identifying the assets and liabilities created and measuring them at fair value.

Consolidation and the treatment of Special Purpose Entities

The ASB continues to monitor the international position on consolidation. In January the FASB issued Interpretation No 46 'Consolidation of Variable Interest Entities' which was designed to meet post-Enron concerns about accounting for Special Purpose Entities. The FASB has now directed the staff to begin work on other aspects of the consolidation project.

Urgent Issues Task Force

Contracts for sales of capacity
On 27 March the ASB issued UITF Abstract 36 'Contracts for sales of capacity'. Entities in some industries (such as telecommunications and electricity) sells rights to use capacity on their networks, sometimes entering into exchange or reciprocal transactions, referred to as 'capacity swaps'. The Abstract addresses three issues.

The first issue is whether a contract for the right to use capacity should be reported as the sale of an asset (or a component of a larger asset), or whether income from the contract should be recognised over its life. The Abstract sets out criteria that need to be met (in accordance with the principles of FRS 5 'Reporting the Substance of Transactions') for transactions to be reported as sales.

The second issue relates to the presentation of transactions in the performance statements. Where the criteria for reporting a transaction as the sale of an asset are met, the Abstract sets out the limited circumstances where the proceeds should be reported as turnover, ie where the transaction is reported in operating results rather than as a fixed asset disposal. The proceeds should be reported as turnover only if the assets were classified as stock when they were acquired or on completion of construction.

The third issue relates to exchanges of capacity. The Abstract sets a high recognition hurdle: turnover or gains should be recognised only in rare circumstances where the assets or services provided or received have a readily ascertainable market value. No accounting recognition should be given to transactions that are artificial or lacking in substance.

Abstract 36 is effective for accounting periods ending on or after 22 June 2003.

Treasury shares
Forthcoming legislation, which is expected to come into effect later this year, will allow certain companies to repurchase their own shares and hold them in treasury without cancelling them. The UITF expects to issue proposals concerning the accounting for treasury shares that would be convergent with IAS, where treasury shares are accounted for as a deduction from shareholders' funds. In addition, the UITF intends to develop proposals to revise UITF Abstract 13 'Accounting for ESOP trusts'.

Emission rights
The International Financial Reporting Interpretations Committee has a current project on emission rights, which is addressing the accounting for schemes, such as the UK's Emissions Trading Scheme, that have been introduced by governments to encourage reduced emissions of greenhouse gases. The UITF is monitoring that project and is considering developing equivalent guidance in the context of UK accounting standards.

Committee on Accounting for Smaller Entities

The Financial Reporting Standard for Smaller Entities (FRSSE) was first issued in November 1997 and has been updated on three occasions since then. The most recent version of the FRSSE was issued in December 2001 (effective June 2002) and takes into account FRSs and UITF Abstracts issued up to June 2001. Since that time, the Board has issued one amendment to the FRSSE (on accounting for retirement benefits) and five new UITF Abstracts (31 - 35). The Board has considered whether the FRSSE should be updated to take into account these UITF Abstracts. It concluded that only UITF Abstract 34, 'Pre-contract Costs' should be included in the FRSSE. However, it did not believe that the impact of the Abstract alone would be sufficiently material for small companies to justify the issue of an Exposure Draft and a revised FRSSE. Therefore, the Board has decided that there will be no update to the FRSSE this year.

Further Information
For further information on any of these topics please contact Charles Bridge at Holborn Hall.

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ACCOUNTING STANDARDS BOARD

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Appointments

Peter Chidgey of BDO Stoy Hayward and **Robert Overend** of Ernst & Young have joined the Urgent Issues Task Force, replacing **Jim Carty** and **Allister Wilson**.

Derek Harris has left the Committee on Accounting for Smaller Entities. **Professor Richard Laughlin** of King's College, London has joined the Public Sector and Not-for-profit Committee.

Staff Changes

Pauline McGee has come to the end of her short-term secondment working mainly on the responses to the May 2002 exposure drafts. She returns to PricewaterhouseCoopers.