INSIDE TRACK 36

ACCOUNTING STANDARDS BOARD

In the July 2003 issue

2 Changes in prospect on business combination purchase accounting

4 The IASB's new proposals on the derecognition of financial assets

8 Three draft Abstracts from the UITF

A Question of Timing...

There are now just eighteen months to go before the beginning of 2005 and the mandatory use of International Financial Reporting Standards (IFRSs) in the group accounts of EU listed companies. The International Accounting Standards Board (IASB) last month issued IFRS1, which specifies how companies should effect the transition from current accounting policies to those mandated in IFRS. There are many more new standards to come.

Due for publication in the autumn of 2003 are twelve revised international standards covering topics as diverse as foreign currency translation, stocks, fixed assets, leases and related party transactions. These derive from the 'Improvements' exposure draft published by the IASB in May 2002 and repeated in our FREDs 24 to 29. They are to be closely followed by a new standard on share-based payment, from the material published in the UK as FRED 31.

In the early months of 2004, we can expect eight new international standards. Three will stem from the material in our December 2003 Consultation Paper - on business combinations, impairment and intangible assets. Three will derive from exposure drafts not yet published by the IASB (on insurance contract accounting and asset disposals - both proposals due this month - and on provisions - proposals expected in September).

The other two for publication by early 2004 are the revised versions of IAS 32 and 39, the IASB's standards on the recognition, presentation, measurement and disclosure of financial instruments. The revisions were foreshadowed in our FRED 30, although the IASB has since made tentative decisions to change some aspects of that material and a short exposure draft on limited further amendments may appear this autumn. Perhaps at the same time the IASB will release those parts of IAS 32 and 39 which it has by then finalised.

Later in 2004, the IASB hopes to publish new standards on reporting financial performance, pensions, purchase accounting and government grants, together with further material on the disclosure of financial instruments. None of these standards is intended to be mandatory for 2005. They should, however, be available for early implementation, thus allowing companies which want to ease the burden of substantial change in both 2005 and 2006 to effect one major transition in 2005.

For those UK companies which will not be using the IASB's standards directly, the ASB will this autumn be considering how best to achieve a convergence of UK standards with those of the IASB. More of this in due course.

Meanwhile, it is important to remember that, in Europe, publication of the IASB's standards is not the end of the process. The European Regulation mandates listed companies to apply EU 'adopted' international accounting standards. Adoption involves consideration of the IASB's standards by the Accounting Regulatory Committee (ARC) of member state governments. For obvious reasons, this Committee has yet to consider the many standards not yet published.

It is to be hoped that, once the IASB has concluded its deliberations on each topic, Europe's governments will give swift attention to the adoption process, so that there is no risk that our listed companies will have less than a full and up-to-date set of standards ready for use in 2005.

Business Combinations Phase II

The IASB is now well advanced in its deliberations on Phase II of the Business Combinations project: 'Application of the Purchase Method'. The aim of this project is to introduce requirements to supplement those of ED 3 *Business Combinations*. This is a joint project with the United States standard-setter, the Financial Accounting Standards Board (FASB).

An exposure draft is expected to be published before the end of 2003. Some of its proposals may be controversial. This article focuses on two specific areas: the recognition of goodwill and accounting for transactions that involve minority interests.

Full goodwill method

Under current UK standards, only purchased goodwill (as opposed to internally generated goodwill) may be recognised in the consolidated balance sheet. FRS 10 *Goodwill and Intangible Assets* discusses the nature of goodwill; it reflects the view that it is a bridge between the value of an investment in the entity's own financial statements and the net assets acquired as shown in the group/consolidated financial statements. Therefore, purchased goodwill is initially measured as the difference between the cost of the investment and the group's share of the net assets acquired.

The IASB is considering proposing that the 'full goodwill method' be adopted. This would measure goodwill as the difference between the fair value of the whole of the acquiree and the fair value of the net assets acquired. So where 100% of an entity has been acquired there will be no difference from current practice, if it is assumed that the consideration paid does represent the fair value of the entity (which is a reasonable assumption in most cases).

However, there would be a significant change in those cases where an interest of less than 100% in the acquiree is purchased. In these circumstances, under the 'full goodwill method', both goodwill and the minority interest will be increased by the goodwill that would have arisen had the whole of the acquiree been acquired.

There may be practical problems with this approach. For example, if an 80% interest in an entity has been acquired for 800, it cannot be assumed that a 100% interest would have cost, or have a fair value, of 1,000: it is likely that the consideration paid for the 80% interest included an element of 'control premium' that would not be relevant to an acquisition of the remaining 20% interest, because control has already been acquired. However, it may not be easy to identify the size of the control premium, in order to eliminate it in arriving at a value for the remaining interest. Continuing this example, if the control premium was 100, the 20% interest should be valued on the basis that, without the premium, 80% had a value of 700. This would give a fair value for the 100% interest of 975 (=100 + (700 x 100/80)).

There are also conceptual concerns with the approach. The UK method of accounting for goodwill requires 100% consolidation of controlled subsidiaries—which is consistent with the entity approach espoused by IASB—but then focuses down on the interest of the shareholders in the parent company. These parent shareholders are interested in the assets that they control and, in the context of goodwill, are interested in holding management accountable for any investment it has made. That objective is met by accounting for the goodwill arising in the acquisition transaction, even though no recognition is given to internally generated goodwill. Where there is a minority interest the parent shareholder is not interested in the goodwill that might have arisen on a hypothetical acquisition of the minority because this is irrelevant to the investment made by management.

Under the full goodwill method, by contrast, goodwill is treated as any other asset ('a resource controlled by the enterprise arising from past events and from which future economic benefits are expected to flow to the enterprise'). It is therefore recognised in full with a proportion attributed to the minority interest. The question is whether goodwill truly is a resource or rather merely a difference between the value of the subsidiary acquired and the sum of the fair values of its individual assets and liabilities.

Minority interests

Another feature of the approach being proposed by IASB which would differ from existing UK practice relates to minority interests. The status of this item is at present ambiguous, with some claiming that it is equity (albeit restricted in scope) while others see it as a liability because it is deducted in arriving at shareholders' funds and profit for the year.

The approach being considered for Business Combinations II is founded on the view that the minority represents an equity interest, rather than a liability. However, no consideration appears to have been given to the restricted scope of this equity interest; instead, all shareholders are treated equally whether they own shares in the parent entity or merely in a subsidiary. Under current UK accounting requirements transactions with the minority can give rise to a gain or a loss, for example, if there is a sale of shares in a subsidiary to new investors, whose interest becomes part of the minority interest.

The new approach means that transactions between the group and minority shareholders are characterised as equity transactions and no gain or loss is recognised. Instead, any difference between the change in the carrying value of the minority and the cash transaction is an increase or decrease in equity. Therefore where a parent entity sells part of its stake in a subsidiary, any difference between the carrying amount of the minority interest sold and the consideration received would be recognised in equity.

In a concession to the needs of users, IASB is expected to require that a deduction should continue to be made for minority interests in arriving at net income. The deduction, however, would relate only to the minority's proportion of reported profit. It would not incorporate any gain or loss arising for the parent company on transactions with minorities.

Usefulness of information
These are potentially fundamental changes in financial reporting raising questions such as whether financial statements are primarily addressed to the parent shareholders.

If the interests of the parent company shareholders cease to be the focus of the consolidated financial statements, it will be necessary to develop a new statement showing the total profit attributable to the parent company shareholders from transactions and events of the period.

First-time adoption of IFRS

In June, the IASB published its first International Financial Reporting Standard—IFRS 1. Perhaps appropriately, the standard 'First-time Adoption of International Financial Reporting Standards' sets requirements for those companies that adopt IFRS (including International Accounting Standards developed by the former International Accounting Standards Committee). It will therefore be relevant to the consolidated accounts of listed companies, which are required by an EU Regulation to comply with adopted international accounting standards for accounting periods starting after 1 January 2005, and also any other companies that use adopted international standards.

The standard is based on the proposals set out in an exposure draft which was published in July last year and which was set out in an ASB Consultation Paper. Like the exposure draft, the standard's governing principle is that the accounting policies required by IFRS for the first financial statements are to be applied to all periods presented. There are certain exemptions from this that may be used if an entity so elects and some cases in which retrospective application is prohibited.

An important case in which retrospective application is prohibited is that financial assets and financial liabilities that have been derecognised under the basis of accounting in use before January 2001 are not be recognised in IFRS accounts even if this would normally be required. This reflects the current requirements of IAS 39 'Financial Instruments: Recognition and Measurement'. In its Basis for Conclusions, the IASB has noted that it may amend or delete this exception in the process of completing its improvements to IAS 39. The issue is particularly important as arrangements under which financial assets and liabilities are held off balance sheet can remain in place for many years. The ASB will follow IASB's deliberations closely on this point.

The standard is somewhat different from the proposals in the exposure draft, which envisaged that entities would be required to use either all of the proposed exemptions or none of them. Because it gives greater flexibility over the use of options, the standard does not permit the use of the alternative approach proposed in the exposure draft, under which financial statements would be presented as if the entity had always applied IFRS: this would require consideration of superseded IFRS. There are some other, more detailed, changes from the exposure draft. These include the requirements for business combinations, hedge accounting and cumulative translation differences.

The ASB has welcomed publication of the standard, which will be helpful for companies that are facing the transition to IFRS, and has noted that its requirements are mainly sensible and pragmatic.

IFRS 1 may be obtained from IASCF:

Publications Department
1st Floor
30 Cannon Street
London EC4M 6XH

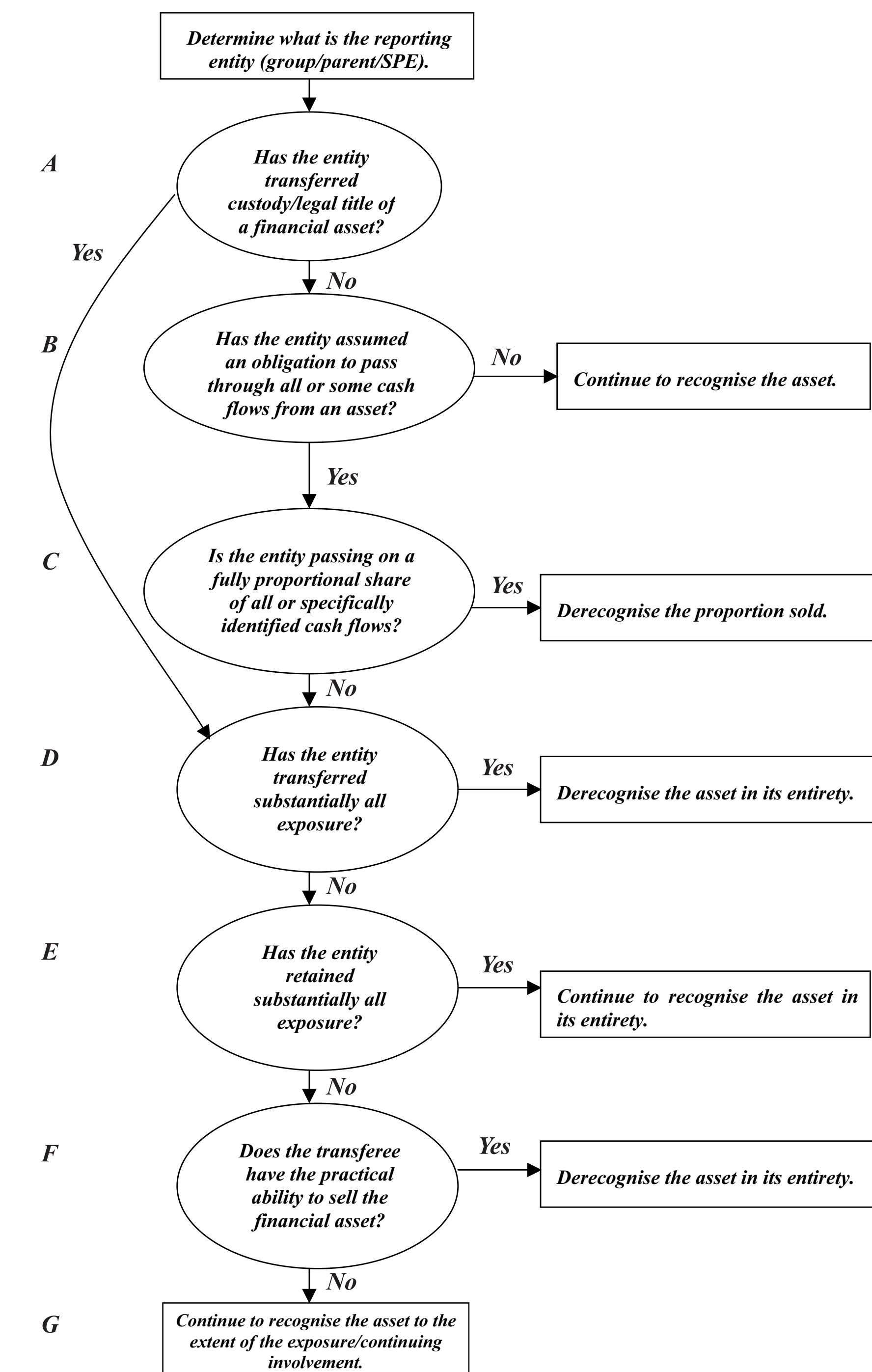
Derecognition and Financial

Mention IAS 39 and most people think of fair value and hedge accounting. However, the standard also deals with another fundamentally important area—accounting for various types of complex financing arrangements. UK companies need to keep abreast of developments in this area if they are not to encounter problems with their balance sheet ratios from 2005.

The existing IAS 39 requirements are difficult to apply because different paragraphs point towards different accounting treatments. The IASB proposed in its 2002 exposure draft to delete those requirements and adopt a 'continuing involvement' approach instead. That proposal has since been abandoned. What the IASB now intends is to impose a structure on the existing requirements. That structure is summarised in the chart to the right and in the paragraphs below.

- The derecognition requirements to be applied depend on whether there has been a transfer of contractual rights to cash flows (Box A). If there has not been, rights will be derecognised (ie treated as sold) if the so-called 'pass-through provisions' are met. Under those provisions, a right to cash flows will be derecognised if the reporting entity has taken on an obligation to pay out cash (Box B), if that obligation exactly offsets either all or a proportion of a right it has to receive cash (Box C), and if certain other criteria are met. Traditional UK loan sub-participations will generally be sales under these provisions.

- Boxes D-G summarise the approach to be adopted if (a) a contractual right to cash flows has been transferred or (b) no actual transfer has taken place, but obligations have been taken on that do not meet the pass-through test. The first tests to be applied are based on the principle that also underlies FRS 5: if the transferor has given up substantially all the exposure to cash flow variability (Box D), the transferred asset has been sold and should be derecognised; and if the transferor has retained substantially all the exposure to cash flow variability (Box E), the transaction should be treated as a borrowing. So, for example, receivables factored with full recourse will remain on the originator's balance sheet, as will receivables factored with partial recourse when the effect of the recourse arrangement is that substantially all the risk remains with the originator. Most repos and stocklending transactions will also be treated as borrowings under these requirements.



- Boxes F and G apply to transactions that fall between

these two extremes; in other words, to transfers that divide up the underlying risk between the parties. Under FRS 5, such transactions are not generally treated as sales (unless what is transferred is a right to a specific cash flow stream, such as an income-only strip, or to a proportionate share of the cash flows), although a linked presentation is sometimes used and results in a display which is similar to treating the transaction as a partial sale. It seems likely that the revised IAS 39 will apply a very different analysis, although the result may often be the same.

- The transferor will derecognise the transferred rights if the transferee has the practical ability to sell the rights to a third party (Box F).

- If the transferee does not have the ability to sell the transferred rights, the transferor will still derecognise the rights unless it is possible that they could be reacquired under the terms of the transfer (Box G). For example, if loan receivables are transferred and the risks underlying those receivables are shared between the parties, the originator will typically be required to recognise only the residual interest (if any) retained and the maximum amount of any portfolio performance guarantees given.

Although this approach will often result in similar accounting to FRS 5, companies should not draw false comfort. IAS 39's approach is different from FRS 5's, particularly in Boxes F and G, so some transactions may be treated differently and this could have significant balance sheet implications. For that reason, companies are urged to start thinking now about the implications of the IASB's requirements for them. 2005 is not far away and, as the IASB will not be issuing any further consultation documents on this aspect of IAS 39, the debate is now over.

Insurance Accounting

On 31 July the ASB is issuing as a Consultation Paper the IASB's proposals on 'Insurance Contracts'. The closing date for comment is 31 October 2003.

This Phase I exposure draft is an interim step towards a radical reshaping of accounting for insurance contracts which will be introduced in Phase II. The IASB has decided that Phase II should develop an accounting standard that will require recognition of the asset or liability directly created by insurance contracts measured at fair value, which will, in the absence of an active market for insurance contracts, usually be calculated using a discounted cash flow model.

Accounting by insurers worldwide is at present inconsistent and fails to conform with the IASB's framework for accounting. The ASB therefore wholly supports the IASB's plans for developing a principled approach to insurance accounting in Phase II and the tentative decisions taken to date.

However, many difficult issues need to be tackled in Phase II, including issues of reliability and the treatment of risk, renewal premiums and surrender values. There is also considerable international opposition among insurers, particularly in North America, to the tentative fair value proposals. Any new Phase II proposals will need field testing and time allocated to amend the systems and build up the databases. It is therefore important to assess the impact of the Phase I proposals properly.

The ASB has concerns about the lack of restrictions on the way that consistency with IFRS can be achieved under the Phase I proposals, which allow many existing accounting policies to be continued. In order to achieve a workable interim solution which avoids imposing major systems changes on entities at this stage, the IASB proposes to exempt insurance contract accounting from complying with the normal qualitative requirements of IFRS (including relevance and reliability) for accounting periods beginning before 1 January 2007. The result may be considerable flexibility in the timing of the recognition and measurement of profits on some insurance contracts. In contrast, changes to accounting policies after initial adoption are much more closely regulated.

In the United Kingdom, the regulation of financial reporting has resulted in some diversity of practice:

- in their statutory financial statements, insurance entities use a deferral and matching approach based on the release of cash flows after meeting regulatory requirements;
- in supplementary financial information, many insurance entities include information about their long-term (life) contracts on a discounted cash flow basis taking into account cash flows released from the regulatory system (embedded value); and
- in the consolidated statutory financial statements of non-insurance entities (such as banks), embedded value amounts are sometimes recognised for long term policies in both the balance sheet and profit and loss account.

The ASB is concerned that diversity of practice may even increase in the UK because of the flexibility permitted by the IASB for existing accounting policies. The ASB has consistently rejected requests to sanction embedded values for the statutory financial statements; such methods usually include future investment margins and management fees thus resulting in the recognition of a profit on the inception of an insurance contract, usually in advance of alternative methods, including those planned for Phase II. The ASB seeks a position for the UK where from 2005 insurance contracts should be accounted for on a comparable basis by all entities which choose to adopt an 'assets and liabilities approach'. The ASB believes this would be achieved if Phase I has the same requirements for continuing with existing accounting policies for insurance contracts as it has for changes to accounting policies.

Updates on

SORPs *Update*

In May, the Investment Management Association (IMA), the new SORP making body for authorised funds (unit trusts and open ended investment companies (OEICs)), issued a draft SORP for comment by 18 August.

The comment period on the draft SORP of the Association of British Insurers (ABI) has closed and it is now considering the issues raised and developing a final SORP.

The Pension Research Accountants Group (PRAG) has been consulting on how to reflect the liabilities for pensions payable in the future in pension scheme accounts and the comment period has recently concluded. The comments received are now being considered with a view to identifying the possibilities for more informative reporting.

The comment period for the exposure draft of a revised SORP for Further and Higher Education Institutions closed on 13 March. Since then the SORP Board has considered the comments received and it is hoped that the SORP will be finalised shortly.

The comment period for the exposure draft of the CIPFA/LASAAC Joint Committee's SORP 2003 for local authorities closed on 29 January, and since then the Joint Committee has been considering the comments received and finalising its SORP. At the end of May the ASB agreed to give a statement on the SORP 2003 and it is expected to be published shortly.

Financial Instruments

In 2002, the IASB issued an exposure draft proposing various changes to its two financial instruments standards (IAS 32 on disclosure and presentation and IAS 39 on recognition and measurement). At the same time, the ASB issued FRED 30, which proposed (a) adoption of the revised IAS 32 in the UK for all entities with effect from 1 January 2004 and (b) that any UK entity choosing to adopt fair value accounting should, from 1 January 2004, be required to comply in full with the revised IAS 39's measurement and hedge accounting provisions.

In the last few months, the IASB has made rapid progress on the comments of respondents and roundtable participants on the proposed revisions.

- For IAS 32, the IASB's discussions appear to be nearly at an end; in the main, the changes proposed in the exposure draft are to be retained. The IASB has also decided tentatively to issue the revised IAS 32 as soon as it is ready, which could mean a final international standard before the end of 2003.
- For IAS 39, the IASB has taken a tentative decision to re-expose revised proposals on one or two issues. As a result, the final version of the revised IAS 39 is not likely to be published until Easter 2004, although an interim version, incorporating the changes agreed on issues not being re-exposed, may be available before the end of 2003.

Later this year, the ASB will consider the implications of this revised IASB timetable for both FRED 30 and FRED 23 'Financial instruments: Hedge accounting'.

Share-based Payment

Last year the IASB proposed, in ED 2 'Share-based Payment', that an expense, measured by reference to fair value, should be recognised in the profit and loss account in respect of all share-based payment transactions. There were to be no exemptions for unlisted entities or for all-employee schemes.

The IASB has now started considering issues raised by respondents. It has reaffirmed its view that share-based payment transactions do give rise to an expense, and that the expense should be measured by reference to fair value and recognised in the profit and loss account. On the other hand, it has also tentatively decided that the final standard should not be based on the unit of service method of allocating the expense that was proposed in ED 2; instead, the standard should adopt the allocation method set out in the US standard, which involves 'truing up' the total expense to reflect the number of options that vest.

The IASB is now considering various valuation issues and, in the autumn, will consider the possible need for exemptions for unlisted entities and/or for some or all all-employee schemes, as well as its proposal that the standard should come into effect from 1 January 2004. The current timetable envisages the publication of a final standard in December 2003.

current projects

The ASB issued the IASB's proposals in FRED 31. That FRED also proposed that the standard should apply to all UK listed and unlisted entities from the IFRS' effective date. The ASB has not yet re-considered this proposal, but will do so in the autumn.

Reporting Financial Performance

An outline of the proposals in this project was included in Inside Track 35 and the topic is also covered in the ASB and IASB websites.

Over the course of the second quarter, consultations were held by project staff and Board members of the IASB and ASB with upwards of sixty companies, user institutions and representative bodies. The results were reported to the June meetings of the Boards and a start was made on reviewing the proposals in the light of comments received. This process continues in July with a view to issuing an exposure draft at the end of this year.

Revenue Recognition

In February, the ASB published a draft Application Note to FRS 5 on revenue recognition. This was an interim step pending the development of a replacement for the international standard on revenue IAS 18, which is currently being reviewed by the IASB as a joint project with the US Financial Accounting Standards Board.

The deadline for responses to the UK exposure draft was 30 May, and the ASB is now considering the comments received.

IASB Project on Short-term Convergence

The aim of this project is to reduce differences between IFRS and US GAAP. The IASB has recently discussed three main areas where it is expected convergence can be achieved:

- government grants;
- disposal of non-current assets and reporting discontinued operations; and
- provisions, contingent liabilities and contingent assets.

On government grants the IASB has signalled its intention to withdraw IAS 20 (which is similar to SSAP 4) and replace it with a new standard. Further work is expected to be undertaken on this in due course.

It is expected that exposure drafts of the IASB's proposals on the other two topics will be issued in July and September respectively.

In particular the proposals on disposal of non-current assets contain differences from current UK GAAP such as the presentation of a separate category of asset that is 'held for sale' (subject to certain criteria being met) and possible changes to the measurement of these assets.

Leases

The ASB presented a plan for a project on leasing to IASB at its meeting in May. The project's objective is to develop a single method of accounting for leases that is consistent with IASB's Framework. The single method would not rely on a distinction between operating and finance leases.

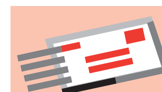
The paper presented to IASB outlined a proposal for commencing the IASB's leasing project, including:

- a summary of the fundamental issues to be addressed in developing a lease accounting model;
- required interaction with other IASB projects; and
- an indicative project timetable.

The IASB expressed interest in undertaking a project on leasing and agreed that it should take account of other IASB projects where similar issues arise including revenue recognition, measurement, derecognition and consolidation.

Public Benefit Entities

In May, the ASB published a Discussion paper on the Interpretation for Public Benefit Entities of the UK Statement of Principles.



Send us Your Views

Responses to the Discussion paper (to prinpubben@asb.org.uk) are due by 1 August 2003.

Urgent Issues Task Force

Treasury Shares

A draft abstract, published on 8 May in Information Sheet 59, addresses the accounting for treasury shares in the light of new legislation - The Companies (Acquisition of Own Shares) (Treasury Shares) Regulations 2003 — which allows companies with 'qualifying' shares to purchase their own shares and hold them in treasury without cancelling them. Shares held in treasury may be sold, used for an employee share scheme or cancelled at a later date. The aim of the draft Abstract is to ensure that the accounting requirements are in place by December 2003 when the new regulations come into effect. The UITF's proposals are consistent with international accounting standards and would require treasury shares to be accounted for as a deduction from shareholders' funds, rather than to be recorded as assets. Comments were requested by 19 June.

Accounting for ESOP Trusts - Proposed Revision to UITF 13

The UITF has also issued proposals (in Information Sheet 60 issued on 8 May) to revise UITF Abstract 13 to require that a company's interest in its own shares that arises through a holding by an ESOP trust should be accounted for in a manner that is consistent with the proposals for accounting for treasury shares. Thus companies would present own shares held by ESOP trusts as a deduction from shareholders' funds rather than as assets.

A small change to Abstract 17 'Employee share schemes' is necessary if, as the UITF proposes, the proposed changes to Abstract 13 should come into effect at the same time as the abstract on treasury shares. The UITF has proposed an amendment to Abstract 17, which will remain in place until it is withdrawn by a new financial reporting standard on share-based payment. The amendment minimises the changes to the existing model for determining the expense that is recognised in respect of awards to employees of shares or share options. Comments on the proposed changes were requested by 19 June.

Emission Rights

A draft abstract on accounting for emission rights was published on 19 May in Information Sheet 61.

The UK and several other governments have been developing schemes to encourage reduced emissions of greenhouse gases. Participants in some schemes accept a cap on their emissions and receive tradable allowances to emit pollutants up to the cap; these allowances may be allocated free of charge, or participants may be required to pay for them. Participants can buy and sell allowances in the market. The UK's Emissions Trading Scheme was launched in 2002; an EU-wide scheme will start in 2005. At present, accounting standards do not provide guidance on the accounting for such schemes.

The proposed abstract is closely aligned to the text of equivalent proposals from the IASB's International Financial Reporting Interpretations Committee (IFRIC). It proposes that a participant should recognise separately an asset (for emissions allowances held), a liability (for the obligation to deliver allowances for emissions that have been made) and a government grant (where allowances are allocated by government for less than fair value). The UITF decided to consult on a modified international text because the relevant international standards and current UK standards produce similar accounting. The intention is that, subject to consideration of comments from respondents, the finally agreed international solution would be introduced into UK accounting. Comments on the proposals were invited by 14 July.

Appointments

Alexis Chapman of The Save the Children Fund has left the Public Sector and Not-for-profit Committee, and **Richard Bray** of Cancer Research UK has joined it.

Further Information

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

Email c.bridge@asb.org.uk

The Board's Publications

Copies of the Board's publications may, except where otherwise stated, be obtained from
ASB Publications
145 London Road
Kingston upon Thames
KT2 6BR

Tel: +44(0) 20 8247 1264
Fax: +44(0) 20 8247 1124

Accounting Standards Board
Holborn Hall
100 Gray's Inn Road
London WC1X 8AL

Tel: +44(0) 20 7611 9700
Fax: +44(0) 20 7404 4497

Website: www.asb.org.uk

ACCOUNTING STANDARDS BOARD

ISSN 1360-1342