

In the January 2008 issue

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The Financial Reporting of Pensions

The conclusions of a research project, led by the ASB, into pensions accounting are published as a discussion paper this month. ASB Director of Research Andrew Lennard describes the importance of this work and the main issues arising.

Pensions continue to attract controversy, which is unsurprising given their economic significance and the complexity of pension liabilities. Decades often pass between the right to a pension first arising and the final payment. The amount and timing of the payments is subject to a host of uncertainties. Some of the controversy surrounds how pensions are reported in financial statements. Whilst standard-setters continue to buttress their existing standards by addressing problems as they crop up, it is widely accepted that a fundamental review is necessary.

The Discussion Paper 'The Financial Reporting of Pensions', published in January, is a first step towards just such a review. It seeks to establish principles for future standards, rather than simply attempting to make marginal changes to current practice. A common theme is that the principles that are applied elsewhere in accounting would improve financial reporting if they were applied to pensions.

The ASB led the development of the paper, assisted by its Pensions Advisory Panel which was formed for that purpose. The paper is being published as part of the Proactive Accounting Activities in Europe (PAAinE) initiative, which seeks to provide a European input to financial reporting developments, from a partnership of standard-setters and EFRAG. The views expressed in the paper are the preliminary views of the ASB: other bodies associated with the paper have not taken a view on them. Here it is possible to mention only some of the more radical proposals covered in the paper.

Present accounting standards draw a sharp distinction between defined benefit plans (including final salary plans) and defined contributions plans, and contain separate requirements for these two classes. This can be troublesome, for example, in connection with hybrid plans. The paper does not rely on such a distinction, but proposes that the same principles should be applied to plans of all types.

A particularly difficult issue is whether, as required by present accounting standards, the liability should include the effect of future salary increases. The paper tries to explore the arguments from both points of view, as opinions are strongly held on both sides. It notes, however, that a majority of ASB members believe that the benefits that the employer is currently committed to provide are based on current salaries. An implication of this is that, when a salary increase is awarded, an expense will arise reflecting the increase in the value of pensions that have already been earned.

In many cases a pension liability will be due not from the employer directly, but rather from a plan. In such cases it will often be appropriate for the employer to account for its responsibility (if any) to ensure that the plan is able to pay the benefits as they fall due. However, if application of the normal principles for consolidation requires it, an employer should consolidate the pension plan.

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The financial reporting of pensions

Continued

(This may not often arise in respect of UK plans, *inter alia* because of the duty of the trustees to act in the interests of beneficiaries and not simply that of the employer.)

Consistent with current standards, it is proposed that assets held to pay pensions should be measured at a current value. Liabilities, it is proposed, should be discounted at a risk free rate, rather than the bond rate used under current standards. All changes in assets and liabilities should be reported in the period in which the change takes place. This means that there would be no 'corridor' within which gains or losses may be unrecognised, nor would any gains and losses be spread to future accounting periods.

Under current accounting standards, the expected return on assets is treated as part of the performance of the period, and the difference between the expected and the actual return is treated as an actuarial gain or loss. In contrast, the paper proposes that the actual return on assets should be reported as income. The expected return would, however continue to be disclosed.

The paper addresses financial reporting by pension plans as well as by employers. It notes that the current international standard—IAS 26—contains significant weaknesses and suggests improvements, including that the balance sheet of a pension plan should include the liability to pay benefits in the future, calculated using the same principles as for an employer.

Comments on the paper, which can be downloaded from the website at: <http://www.frc.org.uk/asb/technical/projects/project0065.html>, are requested by 14 July 2008, and a report will then be published setting out the conclusions of a reconsideration of the proposals in the light of the comments received. This report will provide input to the IASB and the FASB for the long-term review of pensions, to which both boards are committed.

Converging standards future role of national

The vision of a single global set of high quality standards is not merely intact, but being realised at a faster rate than many would have predicted a matter of months ago. ASB Chairman Ian Mackintosh explains why there is still a role for the ASB and other national standard setters in this converging world.

Although the headlines often focus on the divergences of opinion, the achievements of the last few years in moving towards a single global set of accounting standards have been remarkable. More than 100 countries on all five continents require or permit the use of IFRS, or are converging with them. Most importantly, this list includes not only Japan but also the US.

However, there are still many hurdles to overcome, with some countries – notably China – still seeking to adopt 'equivalent' rather than 'identical' standards that reflect differences in the commercial environment of that country.

Even the EU, which started at the forefront of the move towards IFRS with its bold adoption of the IAS Regulation in 2002, is now in danger of finding itself out of step and with the laggards with its existing 'carve-out' for financial instruments portfolio hedging and with the potential for greater political involvement delaying the endorsement process for future standards.

What role should the national standard-setters play in this? Should they try to enhance their influence on the IASB by supporting and becoming involved with the convergence process, or should they maintain the right to differ if they do not entirely agree with the proposed standards? Or does the continuing emergence of the IASB as the world's standard-setter mean national standard-setters including the ASB are redundant?

We believe that there is still a leading role for national standard setters. They can exert intellectual influence through thought leadership and as hubs of regional debate, and through their practical experience as interpreters and implementers of standards. Their ability to carry out research, to test theories or proposals on the market and to assist in articulating the impact of standards can provide a highly useful contribution to international standard setting. For instance, the recent research work on pensions, led by the ASB, will be of great use internationally when a full review of the existing standards is undertaken.

Through regional bodies and international groupings, such as EFRAG and its collaborative Proactive Accounting Activities in Europe group (PAAinE), global forums such as the National Standard Setters group and the World Standard Setters annual meeting, and the International Public Sector Accounting Standards Board in the public sector, we can both seek consensus and exert influence all the more effectively.

As well as providing support to the IASB's consultative and decision-making processes, the national standard setters also have a role in building support and acceptance of international standards amongst their constituents. An important part of this is in encouraging the uniform implementation and enforcement of global standards. Without uniformity

Standards and the national standard setters

in these areas, the advantages of global standards would be largely lost. The balance must be struck to ensure consistent application of the principles without underpinning them with a raft of detailed rules and interpretations – and this, in turn, can provide the opportunity to assist the IASB in ensuring that the drafting of the principles-based standards is clear and unambiguous even across a multiplicity of languages and cultures.

Understanding of local needs and conditions is also essential when considering appropriate standards for smaller enterprises. IFRS focuses on, and is most appropriate for, listed and large international private sector companies and may place too high a burden on smaller entities. The exposure draft of the IFRS for SMEs is out for comment and is to be welcomed. But many companies will still fly below its radar. Equally sectors outside the private sector – such as not-for-profit and public benefit entities – also do not always fit easily within the IFRS standards. These are areas where a national or regional approach, taking into account local business practice and needs, is needed and where national standard setters must take the lead.

Within the UK, the ASB's fundamental aim is, as it has always been, to achieve the best financial reporting standards. Central to this is the convergence of UK standards with IFRS. At round-table discussions in London, Edinburgh and Dublin last year, there was a clear message that there is no longer a case for retaining two sets of GAAP. The debate has now moved on to whether there should be a three-tier or two-tier system of reporting.

A three-tier system would see listed companies, and perhaps other large or important entities, applying full IFRS; unlisted companies other than the smallest would apply the IFRS for SMEs; and the smallest layer

would continue to apply the Financial Reporting Standard for Smaller Entities (FRSSE), amended to align it with IFRS. A two-tier system would apply the IFRS for SMEs to both those last categories.

Assuming the final IFRS for SMEs is published by the end of 2008, as projected by the IASB, and effective from mid-2009, a transition period of perhaps two years might be sufficient to allow SMEs to prepare for the changes. This would bring a final transition date from UK standards of 2011. Of course, there are many complex issues to be considered – not least, the cut-off points between the tiers, and the relationship with the EU accounting directives. The ASB will have a major role to play in collating the views of its constituents over this period, and pulling together all the different arguments put forward by preparers, users and advisers.

ASB hosts round table on dividend regime

Under EU law, companies cannot pay dividends to their shareholders unless they are paid out of realised profits. Ascertaining the amount of realised profits is sometimes complex and onerous and establishes a rigid link between an ability to pay dividends and a company's statutory accounts. This may be unsuitable as accounting standards are not primarily framed to ensure that financial statements are suitable for justifying distributions.

Whilst it is clearly necessary that there is protection for the interests of creditors, the current requirements are arguably over complex and may not in any event provide adequate safeguards. There have been a number of calls for reform, which would replace the current regime with a solvency approach which it is sometimes argued would be simpler, more flexible and more effective.

In order to provide an opportunity to learn of progress and to express views the ASB is hosting a public meeting in London on 26 February. The meeting will receive presentations from:

- **Paolo Santella**, a National Expert at the European Commission, DG Internal Market
- **Erich Kandler**, Chairman of the FEE Company Law and Corporate Governance Working Party, and Partner, Deloitte Austria; and
- **Ken Lever**, Chairman of the Financial Reporting Committee of The Hundred Group of Finance Directors.

Further details of the public meeting can be obtained via the ASB website at: http://www.frc.org.uk/asb/registerevent.cfm?event_id=5 **All places are now reserved.**

SEC allows use of IFRS for foreign issuers

As reported in *Inside Track 53*, the US Securities and Exchange Commission last year consulted on a proposal to allow foreign companies to submit financial statements using International Financial Reporting Standards (IFRSs) as issued by the IASB without having to include a reconciliation to US Generally Accepted Accounting Principles (GAAP). On 15 November 2007, the SEC voted to accept this proposal with immediate effect for financial statements for financial years ending after that date. This is a landmark decision which represents an important step towards the development of a single, high quality language for financial reporting that is accepted throughout the world's capital markets. The SEC's rule is available at <http://www.sec.gov/rules/final/2007/33-8879.pdf>.

In the meantime, the SEC is considering the responses to its August 2007 Concept Release on whether it should allow US issuers to file financial statements that comply with IFRS instead of US GAAP.

The SEC has also set up an Advisory Committee on Improvements to Financial Reporting. The Committee's objective is to examine the US financial reporting system to identify ways to improve it. The Committee has produced a 'Draft Decision Memo' setting out its views to date, which can be accessed from the SEC's website. The ASB is monitoring the work of the Committee.

European Developments

Equivalence

On 21 December, the European Commission adopted a Regulation (1569/2007) that sets out the basis on which third-country (ie non EU) GAAPs can be found equivalent to IFRS as adopted by the EU. This affects non-EU issuers that list in EU Member States. In essence, third-country GAAPs may be considered equivalent if investors could make similar assessments of the financial statements drawn up under those GAAPs as those drawn up under IFRS. As a transitional measure, the Commission will be entitled to allow third-country issuers to use their GAAPs in the EU for a transitional period ending in 2011 at the latest, provided those countries are converging with IFRS or the respective third country intends to adopt IFRS.

In determining whether a third country GAAP is equivalent, the Commission has first to consult the Committee of European Securities Regulators (CESR). On that issue, CESR has published, on 18 December, a consultation paper entitled 'CESR's advice on the equivalence of Chinese, Japanese and US GAAP', with a deadline for responses of 25 February. CESR's proposed advice on the 3 GAAPs being considered is to recommend:

- that the Commission finds US GAAP equivalent to IFRS for use on EU markets;
- that, come June 2008, the Commission should consider Japanese GAAP equivalent, unless there is no adequate evidence of the Accounting Standards Board of Japan (ASBJ) making progress under the August 2007 Tokyo Agreement it signed with the IASB to accelerate convergence between Japanese GAAP and IFRS; and
- that the Commission postpones a final decision on Chinese GAAP. CESR notes that the new Chinese standards look substantially similar to IFRS, but there is – as yet – no evidence of their 'concrete' implementation (the first full reporting period under the new standards is for companies with 31 December 2007 year-ends).

The consultation paper can be accessed from the CESR website at: http://www.cesr-eu.org/index.php?page=home_details&id=259.

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European Commission and EU Endorsement of IFRS

The European Commission is at present preparing an evaluation report on how IFRS adoption in the EU has worked in practice, which will be based on the ICAEW's report for the Commission 'EU Implementation of IFRS and the Fair Value Directive' that was published in October 2007 (and reported on in Inside Track 53).

The Commission has also decided that, as part of the process of endorsing IFRS for use in the EU, there needs to be a report on the potential impact of any new IFRS or IFRIC Interpretation (referred to as an 'effects study'), which will be submitted to the Accounting Regulatory Committee (ARC) and the European Parliament (EP). This follows the impact analysis on the adoption of IFRS 8 (referred to in Inside Track 53), which was endorsed for use in the EU in November 2007. The Commission is undertaking effects studies on two IASB pronouncements: IAS 23 Borrowing Costs and IFRIC 12 Service Concession Arrangements and in December 2007 issued questionnaires seeking views on the potential impacts of both. The Commission is planning to submit reports on both to the ARC and the EP in spring 2008.

UITF and IFRIC Update

UITF Draft Abstract 'Hedges of a Net Investment in a Foreign Operation'

The comment period for Information Sheet 84, which set out a draft UITF Abstract 'Hedges of a Net Investment in a Foreign Operation', that is based on draft Interpretation D22 issued by the IFRIC ended, on 9 November 2007. The draft Abstract provides a consensus on what constitutes a hedged risk when hedging the exposure from a net investment in a foreign operation and the location of the hedging instrument within the group. The Information Sheet can be accessed at: <http://www.frc.org.uk/asb/uitf/pub1409.html>. The IFRIC commenced redeliberation of D22 at its meeting in January 2008.

IFRIC Draft Interpretations IFRIC D21 Real Estate Sales

D21 aims to standardise accounting practice among real estate developers for sales of units, such as apartments or houses, 'off plan', ie before construction is complete. The UITF responded to the draft Interpretation in October 2007 a copy of its response can be downloaded from the ASB website.

In summary, while the UITF supports the consensus reached by the IFRIC for the sale of real estate it has two particular concerns. The first relates to the wider implication of the consensus for areas other than real estate sales. The second relates to how the draft Interpretation attempts to identify when a sales agreement meets the definition of a construction contract by setting requirements.

IFRIC D24 – Customer Contributions

This draft Interpretation addresses situations in which an entity receives either an item of property, plant or equipment or cash which must be used to supply services. It would require the entity receiving the contribution to determine whether it has received an asset. Where an asset is to be recognised then an obligation would also be recognised. The obligation would be reduced and revenue recognised as access to the supply of goods or services is provided.

IFRIC D23 – Distributions of Non-cash Assets to Owners

This draft Interpretation addresses unconditional non-reciprocal distributions of assets to shareholders. It proposes guidance on how an entity should measure the dividend payable and how the entity should account, on settlement, for the difference between the carrying amount of the assets and the carrying amount of the dividend payable.

Update on Current

Heritage Assets

The ASB returned to its project on heritage assets at its meeting on 10 January and re-affirmed its conclusions that improved disclosures should be required for holdings of heritage assets. It also noted that heritage assets should conceptually be reported in the balance sheet.

The Board asked for further research on specific aspects and will consider the results of this research at a future meeting.

Business Combinations

In January 2008 the IASB issued revised IFRS 3 'Business Combinations' and IAS 27 'Consolidated and Separate Financial Statements' to complete phase II of the business combinations project.

Significant changes to existing IFRSs are:

- **Partial acquisitions:** In response to concerns with the exposure draft proposals, IFRS 3 now permits the option of measuring non-controlling interests either at their proportionate interest in the net identifiable assets (which is the original IFRS 3 requirement) or at fair value (which is the new requirement in US GAAP).
- **Step acquisitions:** The requirement to measure at fair value every asset and liability at each step for the purposes of calculating a portion of goodwill has been removed. Instead, goodwill is measured as the difference at acquisition date between the fair value of any investment in the business held before the acquisition, the consideration transferred and the net assets acquired.
- **Acquisition-related costs:** Acquisition-related costs are generally recognised as expenses (rather than included in goodwill).

- **Contingent consideration:** Contingent consideration must be recognised and measured at fair value at the acquisition date. Subsequent changes in fair value are recognised in accordance with other IFRSs, usually in profit or loss (rather than by adjusting goodwill).
- **Transactions with non-controlling interests:** Changes in a parent's ownership interest in a subsidiary that do not result in the loss of control are accounted for as equity transactions.

The revised IFRS will become effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 July 2009.

Joint Arrangements

In September 2007 the IASB published for comment a proposal to improve the accounting for joint arrangements - ED 9 'Joint Arrangements'. It is proposed that ED 9 replaces the existing standard IAS 31 'Interests in Joint Ventures'.

In developing its proposals the IASB aimed to address two problems it perceives with regard to IAS 31; these are the choice of accounting that is offered by IAS 31 and the fact that the most significant factor in determining the accounting is based on the form of the arrangement.

The IASB has concluded that proportionate consolidation is not an appropriate method of accounting for jointly controlled entities as it leads to the recognition of assets and liabilities not in accordance with the definitions in the Framework.

The IASB also proposes changing the definition of a joint arrangement and description of a joint venture. A joint arrangement will be accounted for as a joint venture where it is

jointly controlled by the venturers. The venturers do not have rights to individual assets or obligations for expenses of the venture, but to a share of the outcome (eg profit or loss) of the activities of the joint venture. The joint venture controls the assets, incurs liabilities and expenses and earns revenue.

In its comment letter, available on its website, the ASB is supportive of the IASB's proposals.

Share-based payment

In December the IASB issues a limited amendment to IFRS 2 Share-based Payment extending its scope to cover certain transactions where one company in a group received goods or services and another company in the group made a cash payment based on the value of equity shares. Consequential amendments to IFRIC 11 IFRS 2 – Group and Treasury Share Transactions were also proposed. This exposure draft is open for comment until 17 March. The ASB has now issued an exposure draft proposing similar amendments to IFRS 20 and UITF Abstract 44, with a comment deadline of 31 March.

Puttable Financial Instruments

During the first quarter of 2008 the IASB is due to issue a limited scope amendment to IAS 32 'Financial Instruments: Presentation' that would require some financial instruments that currently meet the definition of a financial liability to be classified as equity.

The proposals were originally contained in an Exposure Draft of proposed amendments to IAS 32 and IAS 1 issued in June 2006. Over recent months, the IASB has consulted extensively with constituents on these proposals and as a result the text of the final amendment is likely to be different to that proposed in the ED.

Projects

FRS 25 'Financial Instruments: Presentation' is the UK equivalent to IAS 32 and is a fully converged standard. Once the IASB has issued its final amendment, the ASB will consider whether to make the corresponding changes to the UK standard.

Annual Improvements

In October 2007 the IASB issued an exposure draft of proposed Annual Improvements to International Financial Reporting Standards (IFRS). The ASB, after consultation, has issued a comment letter to the IASB. A copy of the ASB's comment letter can be downloaded from the ASB website (www.frc.org.uk/asb/technical/projects/project0075.html).

The ASB supports the IASB in introducing the annual improvements process as a way of enabling matters of clarification or conflicts between IFRSs to be resolved in a quick and efficient manner.

The IASB is proposing 41 minor amendments to 25 IFRSs. In its comment letter the ASB suggests two of the proposed improvements be removed and be subject to separate due process as, although the proposed amendments to the text of the standard are minor, the potential effect of the amendment could be significant. These are:

- the proposed amendment to IAS 39 'Definition of a derivative', which the ASB considers could have unintended consequences and needs further research into the possible implications; and
- the proposed amendment to IAS 38 'Intangible Assets', where the change could have a significant effect and it is difficult to determine how the Framework is being applied

Revenue Recognition

ASB responds to PAAine Discussion Paper

The ASB has responded formally to the Discussion Paper 'Revenue Recognition—A European Contribution' which published in July 2007. The paper was developed by EFRAG and the German standard-setter (the DRSC) and issued by them and the French standard-setter (CNC). The paper considered two types of approaches to revenue recognition:

- 'critical event' approaches that involve recognising revenue under a contract only when a particular event has taken place or a threshold has been reached (the critical event); and
- 'continuous event' approaches under which revenue is recognised continuously over the course of the contract as it progresses and the entity performs.

In response, the ASB states that it believes that the Discussion Paper makes a valuable contribution in highlighting areas and issues that require further consideration, but does not point clearly to a particular appropriate conceptual basis. The ASB is supportive of further work on the subject, which it suggests would be most fruitful if it addresses what are the appropriate points at which both profit and turnover should be reflected in income and assets and liabilities, and how these might be measured and reported. The ASB response may be downloaded from <http://www.frc.org.uk/images/uploaded/documents/ASBPAAinERevRecResponse.pdf>

Narrative Reporting

The ASB has considered the impact on its Reporting Statement 'The Operating and Financial Review of the business review reporting requirements in section 417 of the Companies Act 2006, which companies have to apply for financial years beginning on or after 1 October 2007.

The ASB believes that the new requirements, detailed in *Inside Track 53*, are already covered by its Reporting Statement on the OFR and that this statement continues to provide applicable best practice guidance for UK companies required to prepare a business review.

In response to requests to make the link between the best practice guidance in its reporting statement and legislative requirement clearer, the ASB has prepared a table to assist UK companies in preparing their business review, linking the Companies Act requirements with the OFR reporting statement. A copy of this table is available on the website at <http://www.frc.org.uk/asb/press/pub1480.html>.

Meanwhile, at its meeting in December 2007, the IASB decided to add a project on management commentary to its active agenda. The work on the project should result in the production of a non-mandatory guidance document based on the Management Commentary discussion paper issued in October 2005. The ASB will continue to keep the area of narrative reporting, and the IASB proposals, under review.

SORPs Update

Local Authorities

The Board approved for publication an Exposure Draft and Invitation to Comment for the 2008 Code of Practice for Local Authority Accounting. Following the major changes introduced in recent SORPs, including group accounts, the presentation of the primary statements and financial instruments, the proposals for the 2008 Code of Practice are less significant. Comments on the Exposure Draft and Invitation to Comment are invited by 30 January 2008.

The SORP Board has decided to prepare the 2008 Code of Practice in accordance with UK GAAP and, in addition, make sure that consolidation information, appropriate for the sector, is available for local government for the 2008-09 Whole of Government Accounts, which are to be prepared on an IFRS basis. The SORP Board is also taking forward work on developing and implementing a new IFRS-based Code of Practice that will allow local authorities to prepare IFRS based accounts from 1 April 2010.

Charities

The Charity SORP Committee issued an Information Sheet in December 2007. This does not amend the SORP, but it does clarify the SORP's requirements in areas such as accounting for grants, the allocation of bank interest and other finance costs and the relevance of the business review. The Information Sheet is available on the Charity Commission website at <http://www.charitycommission.gov.uk/investigations/sorp/infosheet1.asp>

The Charity SORP Committee is taking forward plans for the development of the next SORP, including assessing the impact that convergence with IFRS will have on the accounting framework currently applying to charities. To initiate sector debate, the SORP

Committee has approved proposals for consulting with stakeholders, including a conference in central London in April 2008 and a number of roundtable events later in the year.

Registered Social Landlords

The Board approved an unqualified Statement of Assurance for a Revised SORP for Registered Social Landlords in November 2007. This will apply for accounting periods beginning on or after 1 April 2008 with earlier adoption encouraged. To help with implementing the Revised SORP, particularly the new requirements for accounting for shared ownership sales and mixed tenure development, the National Housing Federation and PwC are to hold conferences in Birmingham and London in February 2008. The aim is to help the sector understand the key changes and practical impact of the new SORP.

Higher and Further Education

An updated version of the SORP, including an unqualified Statement of Assurance, was published by Universities UK in August 2007 and will apply to accounting periods beginning on or after 1 August 2007. Earlier adoption is encouraged. The new SORP provides enhanced guidance in areas such as income recognition, fixed assets and retirement benefits as well as providing more sector specific guidance in areas such as accounting for tuition fees, bursaries and research contracts.

Further Information

For further information on any of these topics please contact Simon Peerless at Aldwych House.

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People

Helen Weir stepped down from the ASB at the end of December, owing to the pressure of other commitments. A replacement is being sought.

Tim Bush, of Hermes Focus Asset Management, has been appointed to the Urgent Issues Task Force (UITF), replacing **Guy Jubb** who stepped down at the end of December.

Lynn Hine and **Pesh Framjee**, partners in Deloitte and PricewaterhouseCoopers respectively, have been reappointed to the Committee on Accounting for Public Benefit Entities (CAPE).

Melanie Kerr has joined the ASB staff as a project director.