

# INSIDE TRACK 46



ACCOUNTING  
STANDARDS  
BOARD

## In the December 2005 issue

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- Letter from the Chairman

# Merry Christmas from the ASB



This special edition of *Inside Track* enables us at the ASB to share with you our thoughts on the future direction of financial reporting, as we look forward to 2006. As ever, it will be a busy and exciting time, when proposals will appear that will profoundly affect the future of financial reports-and of course, all that use, prepare and audit financial statements.

One of the main topics seems likely to be the role of Fair Value - Technical Director Andrew Lennard gives an overview of what is happening. In more poetic mode, Andrew also offers - on page 3 - an alternative fair value take on 'The Night Before Christmas'. Closely related to the fair value issue is the joint IASB/FASB project on its conceptual framework - ASB Secretary David Loweth provides a briefing on what has happened so far and what will happen in the next few months. Meanwhile Jennifer Guest looks forward to an expected IASB exposure draft on segmental reporting-see page 7 which will propose moving IFRS more closely in line with US GAAP.

In a more retrospective mode, Ian Mackintosh reflects on his past year as ASB Chairman. We tried to point out that ASB is neither responsible nor to blame for the Australian defeat in the Ashes - but he would mention it anyway. However, it seems that, apart from the dismal Australian sporting performance, it has been a good year.

In a similarly reflective vein, Michelle Crisp reviews the responses to proposals for standards on business combinations, whilst Hans Nailor discusses revenue recognition for service contracts.

On the Operating and Financial Review (OFR), the Chancellor's announcement in late November that the Government will remove the statutory requirement for quoted companies to publish an OFR has implications for the Board's Reporting Standard (RS) 1. While the details of this decision are still being developed by the Government, David Loweth attempts to clarify what companies have to do now under the law and encourages them to carry on preparing and publishing OFRs as an important element of best practice reporting.

ASB's proposals for its future role and the convergence of UK standards with IFRS has been a key talking point, and we are looking forward to the public meeting on 19 January - do join us, as explained in the box.

We are certain that 2006 will see important developments in financial reporting, and (only slightly less confidently) that it will include Christmas. But let us not close without wishing all our readers our very best wishes, for a peaceful and merry Christmas 2005.

## Public meeting on the Board's future role

The ASB is hosting a public meeting in central London on the morning of Thursday 19 January 2006. The meeting will be open to the public. Papers for the meeting will be made available on the ASB's website. For further details, and to apply to attend the meeting, please contact Jennifer Guest at the ASB: e-mail [j.guest@frc-asb.org.uk](mailto:j.guest@frc-asb.org.uk). Sadly, places are limited and will be allocated on a first-come, first-served basis.

# Fair value - let the debate begin!

During 2005, many have sensed an increasing drift towards the use of fair values in accounting-and have strongly welcomed or criticised it. Here Andrew Lennard, the ASB's Technical Director, discusses what the current and future proposals are, and indicates some of the issues that need careful reflection during 2006.

**Q The IASB wants fair value accounting doesn't it?**

A Whilst IASB's exposure draft on amendments to its standard on business combinations was based on a fair value perspective, IASB has not stated that its view is that fair value should be the preferred basis for accounting in general. The truth is that different IASB members probably take different views: some would probably agree that, in any given situation, fair value is the most promising accounting treatment to be considered. But there is no formal proposal that financial reporting should-either in theory or at the standards level-move to a comprehensive fair value system.

**Q But they have just published a paper on Measurement Bases for Financial Accounting which is all for fair value?**

A Well, yes-but the paper is merely a Discussion Paper, intended to contribute to the debate on measurement, and to seek views. It has been written by staff of the Canadian Accounting Standards Board (AcSB) and does not reflect the official views of either IASB or AcSB. The paper is also far from a comprehensive fair value proposal - it deals only with the question of how assets and liabilities should be measured on initial recognition-so it does not say anything about whether those measures should subsequently be adjusted to reflect changes in prices. The responses to the Canadian paper will feed into the IASB/FASB work on the *Conceptual Framework*.

**Q But that's not all, is it?**

A Well, the FASB are expected to publish soon a standard on '**Fair Value Measurements**' - and IASB intends to publish a similar text as an Exposure Draft. It too, is not a proposal for the comprehensive use of fair values in accounting: its aim is merely to describe *how* fair value should be determined in the cases where it is used: the question of *when* fair value should be used is to be left to other standards. IASB is to consider all references to fair value in IFRS and decide in which cases the FASB-based proposals will be appropriate.

**Q So that's all right then?**

A Maybe. The FASB standard will make clear that fair value is to be considered from an exit perspective - that is, that the amount at which an asset is to be stated will reflect what in theory might be raised by the most advantageous sale. That is rather different from the way in which revaluation has been carried out in the UK in the past. Whether that is 'all right' will depend on what you think about exit value accounting; how widespread its use is to be; and whether IASB will be willing to rethink the basis of measurement as part of its project on the *Conceptual Framework*.

**Q But is does mean that the acquisition of any asset that is to be carried at fair value will result in a reported loss?**

A Yes - at least it would appear that that will often be the case.

**Q I can understand fair value accounting where assets are traded on markets and reliable prices are readily available. What about other assets?**

A Both the Canadian and the FASB documents suggest that it would be possible to use estimates of fair value where market values are not available. But it would seem that many assets will continue to be stated at historical cost.

**Q You don't sound wholly enthused?**

A We commented on an exposure draft of the FASB standard and have contributed to the Canadian work. Apart from the FASB's general use of exit values, we also wonder whether it is right to base a theory of measurement simply on the premise of complete and perfect markets. Both documents acknowledge that this may not always be the case - but suggest that in any event fair value should be estimated with the objective of determining what the price would be on such a market, if one existed. If this is seen to be unworkable in many cases, it might have the paradoxical effect of retaining the use of historical cost where sound alternatives could give better financial reporting.

**Q What alternatives are there?**

A Well, current replacement cost, for example, may be more conceptually sound and practical, in some circumstances.

# The Night Before Christmas

*'Twas the night before Christmas, when all through the house  
Not a creature was stirring, not even a mouse.*

*Even Emily slept, so full of mince pie,  
But she stirred when she sensed in the side of her eye...*

*A dark bearded man who calmly  
announced,*

*"I have just acquired Bagpuss, we must  
settle accounts.*

*You paid for him sixpence - that'll settle  
the score!"*

*But Emily cried that her cat was worth  
more:*

*"He's saggy, he's old and made only of  
cloth,*

*and there's just a suspicion he's affected  
by moth,*

*But I love him!" said Emily "How can  
sixpence be fair?*

*To sell him so cheaply I just could not  
bear!"*

*"But most of the things in your shop are  
not sold—*

*They are given away, or so I've been told,"*

*Said the stranger. "Not Bagpuss" said Emily choking back tears,  
"He's my friend, my companion, I have loved him for years."*

*Then all of a sudden another appeared:*

*He was fat, he was old, with a long white beard:*

*"Now Baxter! now Bonbright! now Edwards and Bell!*

*Use your brains, let us see that all is done well!"*

*At that the dark bearded man vanished into thin air  
and Emily slept, sure that all was true and fair.*

*And when Emily woke, 'twas a bright Christmas morn  
With all of the magic of that special dawn.*

*There were pressies: new dresses, some guesses from aunties*

*And things of all kinds for bright Christmas parties.*

*Many and many were Emily's surprises*

*And it wasn't the point that some were the wrong sizes.*

*But the best was her cat, lying safely asleep*

*Thinking thoughts - who knows what? - but thoughts that were deep.*

*But Emily wondered, thinking, had Bagpuss been lost*

*His worth was much more than historical cost.*

*And nor would 'Fair value' be fair recompense*

*Replacing her cat would cost shillings, not pence!*

*And let us not end without wishing each friend*

*The very best wishes we could possibly send:*

*Before hedge accounting drive reason from sight,*

*"Happy Christmas to all, and to all a good night."*

*WITH APOLOGIES TO CLEMENT CLARKE MOORE AND OLIVER POSTGATE  
AND THANKS TO JILL STEVENS AND JO WILLIAMS.*



**Q Doesn't fair value accounting imply less reliability and more volatility in financial statements?**

**A** Let's take these separately. In a sense, historical cost accounting is reliable - there is often little doubt about what the historical cost of an asset is - but it does not necessarily give a depiction of the asset that is any sense relevant. Of course, as they reflect price changes, fair value measures will be more volatile than historical cost measures. But perhaps the main consideration is whether that volatility reflects economic reality, and whether changes in the measurement of assets are reported in a way that clearly distinguishes them from changes in assets resulting from transactions.

**Q What is the ASB doing about it?**

**A** As noted above, we have contributed and shall continue to contribute to all this work. We shall be hosting round tables in the New Year and shall publish a paper before then discussing many of the issues that arise.

**Q How do I stay in touch?**

**A** Register at the ASB website: you will be promptly informed of ASB developments.

# Can you have too much goodwill...?

## Michelle Crisp reviews comments arising from consultation on Business Combinations Financial Reporting Exposure Drafts

In July 2005 the IASB issued Exposure Drafts setting out its proposals from the second phase of the Business Combinations package. As part of its proposed strategy for convergence with International Financial Reporting Standards the ASB issued a "bumper edition" of Financial Reporting Exposure Drafts: FREDs 36 to 39. These FREDs re-packaged the IASB existing IFRSs and its proposals from the second phase of the IASB's Business Combinations project as draft Financial Reporting Standards, and highlighted certain issues that the ASB considered its constituents might like to reflect on.

This article considers what might be in store for the IASB in the New Year when it considers the comment letters to its Exposure Drafts. This article considers what might be in store for the IASB in the New Year when it considers the comment letters to its Exposure Drafts. Of course respondents expressed a variety of views and here we can only give an overview of some of the main themes.

The IASB Exposure Drafts were founded on four fundamental principles:

- (1) The acquirer obtains control of the acquiree at the acquisition date and thereby becomes responsible and accountable for all of the acquiree's assets, liabilities and activities, regardless of the percentage of its ownership in the acquiree;

- (2) The total amount to be recognised for the acquiree should be the fair value of the acquiree as a whole;
- (3) Business combinations generally are exchange transactions in which knowledgeable, unrelated willing parties are presumed to exchange equal values; and
- (4) The identifiable assets acquired and liabilities assumed in a business combination should be recognised at their fair values on the date control is obtained.

These principles were robustly reflected in the IASB's proposals set out in its Exposure Drafts, however early implementation of the proposals does not appear to be on UK respondents' "Christmas lists". UK respondents might relax and enjoy the spirit of Christmas as the IASB has acknowledged that publication of IFRS based on the Exposure Drafts is unlikely to take place in 2006.

The first of the principles results in a gain or loss being recognised when control of a subsidiary is obtained in stages. This is because the proposals require the acquirer to remeasure its non-controlling equity investment at the acquisition date to fair value and recognise any resulting gain or loss in the profit and loss account. The IASB explains that this reflects its conclusion that gaining control of a business is an event that should trigger remeasurement. However, many UK respondents were perturbed by the

recognition of a gain or loss in the profit and loss account and considered that it should be recognised in equity. Additionally, respondents considered that remeasurement of non-controlling equity investments is related to the second principle.

The second principle raised significant debate with respondents raising two particular concerns. The first was that the principle extended the use of fair value measurement without proper conceptual debate as to its appropriateness. The second was a concern about the cost and operational difficulties associated with measuring the fair value of the acquiree. Respondents questioned whether the resulting information provided by applying the principle improved the reliability of financial reporting.

In questioning the ability to reliably measure the fair value of the acquiree, respondents appear to be questioning the third principle, that business combinations generally are exchange transactions in which it is presumed equal values are exchanged. It was noted by one respondent that "when two entities enter into a transaction each will believe that he is getting a good, or at least a worthwhile, deal; it may well be that both sides believe that there is an unequal exchange of values". Most UK respondents agreed with the Alternative Views set out in the Exposure Drafts - that the total value of the acquired business is an extremely subjective measure.

Whilst UK constituents are used to working with the fourth principle they were a little shocked by what might be considered "over indulgence" by the IASB. In applying this principle the IASB reconsidered the recognition of goodwill and whether the information provided by the full goodwill method is relevant. The IASB observed that under the 'Framework' the objective of consolidated financial statements is to provide information about the economic resources controlled by the parent. The IASB concluded that an entity's financial statements provide users with more useful information about the entity's financial position when they include all of the assets under its control regardless of the extent of ownership interest held. Thus the IASB concluded that the full goodwill method is consistent with the concept that control over another entity makes the controlling entity accountable for all of that other entity's assets and liabilities. The first point to note is that this decision relies on the IASB's earlier decision that goodwill is an asset. Some UK respondents noted that even if goodwill is considered to be an asset, it is not like other assets and users of financial statements often disregard it. Giving consideration to this point it becomes questionable what benefits the recognition of full goodwill would bring to financial reporting. It seems that UK respondents consider you can have too much "goodwill".

Some respondents related the recognition of full goodwill to the introduction of the 'economic entity concept', applied in the Exposure Drafts. Until now UK and IFRS have applied the 'parent entity concept' which focuses on reporting to shareholders of the parent entity. Many UK respondents are concerned that the economic entity concept (which treats the group as a single economic unit and non-controlling interests as part of group equity) will result in a loss of focus in financial reporting and undermine the very purpose of financial statements. They consider that group financial statements are prepared from the perspective of the parent company's shareholders not non-controlling interests.

Non-controlling interests were another area where many respondents had problems with the IASB's proposals. In accordance with the economic entity concept no gain or loss, or adjustment to goodwill, is recognised when changes in ownership interest arise after control is obtained. Respondents argued not only against this proposal but also considered that there had been a lack of conceptual debate on how non-controlling interests should be treated.

It is perhaps worth noting that a number of UK respondents questioned the benefits the proposals would bring to financial reporting and therefore why the Exposure Drafts were being published at this point in time. Perhaps as a consequence of being unable to identify what benefits the proposals would bring, some UK respondents questioned whether the IASB had adhered to due process by not issuing the proposals as a Discussion Paper first. Similarly there was a concern expressed about the timing of the Exposure Drafts in relation to other projects being undertaken by the IASB - such as the conceptual framework project and performance reporting.

The IASB set out the four fundamental principles it considered would improve significantly financial reporting for business combinations. They then undertook a conceptually robust approach to their implementation. UK respondents question the practicality of the proposals (despite their conceptual richness), the benefits they bring to financial reporting and whether the resulting financial information improves the reliability of financial statements. At the last count the IASB and FASB had received 257 responses to their proposals - it seems it could be a long and cruel mid-winter that is spent analysing these responses and planning the way forward.

In its response to the IASB the ASB suggested that acquisition accounting may not always be appropriate and suggested research into 'fresh start' accounting. It might be UK constituents would prefer the IASB to take a 'fresh' look at its proposals.

As part of the second phase of the Business Combinations project the IASB also issued proposed amendments to IAS 37 'Provisions, Contingent Assets and Contingent Liabilities' (these proposals were issued as FRED 39 in the UK). The amendments required a different analysis for the recognition of contingent liabilities and proposed contingent assets should be recognised in accordance with IAS 38 'Intangible Assets'. UK respondents were not supportive of these proposals and many considered the proposals lacked practical application.

The amendments to IAS 37 also propose to remove the probability criterion from the recognition of a liability. The absence of a threshold and the increased level of subjectivity means, for example, that a liability would have to be recognised if there was only a 10 per cent risk of an outflow. Many UK respondents support the alternative view of one IASB member that the new analysis fails to provide adequate guidance on when an unconditional obligation should be recognised.

The ASB set out its views on the IASB proposals in its response letter to the IASB. The ASB views are consistent with the views of many respondents. In its response letter the ASB stated "In our view the proposals introduce new concepts and we do not support the conversion of the Exposure Drafts into International Financial Reporting Standards until proper debate on these concepts has been undertaken." The ASB response letter can be found at [www.frc.org.uk/asb/publications/other.cfm](http://www.frc.org.uk/asb/publications/other.cfm)

# Current hot topics

## Where now for the OFR?

On 28 November, the Chancellor of the Exchequer announced in his speech to the CBI Annual Conference that the Government intends to remove the statutory requirement for quoted companies to publish an Operating and Financial Review (OFR) for financial years beginning on or after 1 April 2005. This has implications for the ASB's Reporting Standard 1 (RS1) 'The Operating and Financial Review', which was issued in May under new legal powers to make reporting standards for the statutory OFR and in response to the Government's proposals.

Does this mean that companies should no longer publish an OFR? In our view, the answer is a resounding 'no'. The ASB has long believed that the publication of a narrative explanation of a company's development, performance, position and prospects should be encouraged as an important element of best practice in corporate reporting. The ASB first produced a statement of best practice in 1993 and updated it as recently as 2003. Recent research published by Deloitte ('Hold the Front Pages') showed that 82 per cent of listed companies, in 2004-05, either produced a formal OFR or showed clear recognition of an OFR.

Regardless of whether or not an OFR is a statutory requirement, the ASB's view of best practice remains unchanged. RS1 is the most up-to-date and authoritative good source of best practice guidance for companies to follow.

In any event, companies (and not just quoted companies) and groups will still be required by law to publish an enhanced business review in the directors' report. This requires large and medium-sized (but not small) companies to provide a "balanced and comprehensive analysis of the development and performance of the company's business and of its position, consistent with the size and complexity of the business". The review must also

include a description of the principal risks and uncertainties that a company faces.

A lot of the debate over the statutory OFR focused on the reporting of non-financial aspects. If companies feel that they no longer have to report anything on social and environmental matters, they may need to just pause and think again. The law requires that "to the extent necessary for an understanding of the company's development, performance or position, the analysis shall include both financial and, where appropriate, non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters". Medium-sized companies do not have to provide the non-financial information.

As the Government's detailed plans for removing the statutory requirement for the OFR become clearer, the ASB will consider the implications, consult as appropriate and make further announcements. But the OFR is here to stay.

## UITF Abstract 40 on service contracts

UITF Abstract 40 'Revenue recognition and service contracts' was issued on 10 March and is mandatory for accounting periods ending on or after 22 June 2005. It says, in a nutshell, that revenue from performing services should be recognised as contract activity progresses, rather than on contract completion, when the substance of the contract is that the seller performs its contractual obligations gradually over time.

A number of constituents have been disappointed with the final Abstract and have asked the UITF to reconsider it. A principal concern is that many service providers will have to change previously accepted policies in accounting for short-term service contracts, reporting revenues and therefore profits earlier than before, and that tax will be payable earlier as a result.

The UITF's role, when unsatisfactory or conflicting interpretations of an accounting standard have developed or seem likely to develop, is to reach a consensus as to the accounting treatment that should be adopted. In this case, the UITF had been asked by the CCAB bodies and others that uncertainty and conflicting interpretations surrounded the accounting for service contracts under Application Note G 'Revenue Recognition' to FRS 5 'Reporting the substance of transactions'. The UITF was urged to provide guidance. In reaching a consensus as to the accounting treatment that should be adopted, the UITF does not take a position one way or the other if a particular accounting treatment may have adverse (or indeed favourable) tax consequences for the entities concerned.

The UITF takes the view that Application Note G requires service contracts of any duration to be accounted for in accordance with its general principles and is content that Abstract 40 properly reflects those principles and the interface between Application Note G and SSAP 9 'Stocks and long-term contracts'. The UITF's consensus was ratified by the ASB.

A further question has arisen concerning Abstract 40 and the FRSSSE. The Abstract includes the standard exemption for entities that use the FRSSSE and it has been suggested in some quarters that they can ignore the Abstract. The principles of Application Note G are, however, reflected in the standard section of the FRSSSE 2005 and the ASB has included the consensus paragraphs of Abstract 40 as guidance in an appendix. Its inclusion can only serve to underline that entities using the FRSSSE should have regard to that guidance to determine current practice.

# Update on current projects

## Operating segments

The IASB agreed to consider the case for a project that would seek to achieve convergence between US GAAP and IFRS on the topic of Segmental Reporting. It has been deemed to be a short-term convergence project and the convergence date is 2006, with the IFRS being effective from January 2007. The IASB is planning to publish an exposure draft of its proposals in January.

Currently US GAAP and the International Standards adopt different approaches to segmental reporting. The US standard FAS 131 *Disclosure about Segments of an Enterprise and Related Information* adopts a 'managerial approach', whereas IAS 14 *Segment Reporting* focuses more on disaggregation of consolidated financial statements. These two approaches are fundamentally different and the IASB is likely to propose that it should adopt FAS 131 and make it into an IFRS. The scope of the standard will apply to (a) listed companies and (b) mutuals and unlisted banks.

The main issue of concern with the proposed new IFRS is not the managerial approach, which seems both reasonable and logical in terms of defining segments; but that it allows the information reported for segments not to have to be reconcilable to GAAP.

Under the managerial approach financial information is required to be reported on the basis that it is used internally for evaluating segment performance and deciding how to allocate resources to segments. This may result in differences between the measurements used in operating segment information and those used in the entity's main financial statements. The two bases may be different.

It is possible to allocate an expense to a segment without allocating the related asset. The related assets may be allocated to a different segment, but the standard is explicit in the requirement for a company to disclose

in this case. Asymmetry regarding assets and their related expenses is a proposition which could alarm purists; but does lend weight to the idea that, for segment reporting, relevance is the dominant factor.

## Conceptual framework

The IASB and the US Financial Accounting Standards Board (FASB) are pressing ahead with their joint project to revisit their conceptual frameworks for financial accounting and reporting. The goal of the project is to develop a common conceptual framework that both Boards can use in developing new and revised accounting standards. The Boards have not given the world a Christmas present in the form of a due process document for public comment, but their discussions to date are provoking a lot of debate.

The Boards' discussions to date have focused on the objectives and qualitative characteristics of financial reporting. On objectives, the Boards propose that the converged framework should identify as the primary users of financial reports "present and potential investors and creditors, and their advisers". While most would accept that financial statements are useful to a wide range of users, this goes wider than the ASB's defining class of user (present and potential investors), which in itself is wider than a focus on the current shareholders that many in the UK would like to see. This could impact on the future debate as to whether a proprietary view or an entity view is used to determine the boundary of a reporting entity.

It also impacts on the overriding objective of financial reporting, which the Boards propose should be to provide information to assist users in making economic decisions. But what are economic decisions? Are they simply decisions on whether to sell shares or buy more, or do they include shareholder rights, as owners, to change the direction of the business, or the management? Some ASB constituents believe that the Boards are

placing too much emphasis on buy/sell decisions alone, given their proposal that stewardship should not be included as a specific objective of financial reporting, but that the converged framework should simply acknowledge that financial information may be useful for assessing management's stewardship responsibilities and accountability.

The discussions on qualitative characteristics have also not been without controversy. Relevance, understandability and comparability survive, but the Boards are proposing that reliability should be dropped from the converged framework, as it is a "widely misinterpreted" term. Instead, as the IASB 'Observer Notes' reveal, the Boards are proposing to replace it with "faithful representation", which is described in the box below:

"Representations are faithful - there is correspondence or agreement between the accounting measures or descriptions in financial reports and the economic phenomena they purport to represent - when the measures and descriptions are verifiable and the measuring or describing is done in a neutral manner. Therefore, faithful representation requires completeness, not subordinating substance to form, verifiability, and neutrality".

We hope that's clear to you! If so, please include a simple explanation of what it means in your Christmas card to the ASB.

The Boards have also been developing a process for assessing the qualitative characteristics that would tax even the most dedicated devotees of puzzles. We have not reproduced the process chart here, but those curious enough should take a look at the version in the IASB's 'Observer Notes' for October at [http://www.iasb.org/uploaded\\_files/documents/8\\_1168\\_0510ob08.pdf](http://www.iasb.org/uploaded_files/documents/8_1168_0510ob08.pdf).

Continued ...

# Update on current projects *continued*

Given all the above, it does seem somewhat odd that the Boards are proposing that the first due process document, on objectives and qualitative characteristics, should be an exposure draft, rather than a discussion paper, on the grounds that the proposals involve mostly "refinements" or "clarifications" of the existing frameworks.

And there's more...as well as starting to discuss the reporting entity concept, the Boards are also turning their minds to considering the elements of financial reporting. Early indications are that these discussions could also throw up some interesting and controversial issues. The ASB will continue to monitor closely the project and report developments.

As reported in the last edition of *Inside Track*, the staff at the ASB has submitted some comments on the project to the IASB/FASB team, a copy of which can be accessed on the ASB website at <http://www.frc.org.uk/images/uploaded/documents/FrameworksMemoLetter%20and%20Memo.pdf>

*Other presents we expect to see under the tree include ...*

## Reporting Financial Performance

The IASB is continuing with its project on the format of the income statement, building on the earlier joint project with the ASB. At present debate is focused on whether or not a separate 'financing' category should be disclosed in the income statement, and how such a category should be defined. The ASB's academic panel recently debated a paper on this issue, analysing the more conceptual approaches to a possible definition. Meanwhile, the IASB is finalising an exposure draft of the first stage of this project. The main proposal is expected to be for a single performance statement, reporting all

recognised gains and losses (other than transactions with owners), with the existing net profit figure being a sub-total in the middle of the statement; but allowing a choice of presenting this as two separate statements (similar to the UK profit and loss account and statement of total recognised gains and losses).

## Leases

ASB project director Simon Peerless will be working with IASB on the project into lease accounting, considering how to develop the proposals set out in the G4+1 discussion paper of 1999. Under these proposals the distinction between operating and finance leases would be removed. All leases will be accounted for as the acquisition by the lessee of the right to use the asset for the period of the lease; and this right should be recognised as an asset on the lessee's balance sheet, with a corresponding obligation for lease payments.

## Borrowing costs

The IASB is considering converging IAS 23 'Borrowing Costs', which permits entities to choose whether or not to capitalise borrowing costs relating to the period of construction of a tangible fixed asset, with the US statement SFAS 34, which require capitalisation in all cases. The IASB are considering removing the option in IAS 23; however, other significant differences, such as what interest costs are to be included, and the start and end points of the capitalisation period, would remain. As these are both old standards, neither is viewed as representing a 'high quality' solution in line with modern thinking, and a major project would be required to develop a new standard. The UK standard FRS 15, like IAS 23, permits a choice of capitalisation and non-capitalisation.

## Technical Corrections

The IASB has decided not to proceed with approving a policy for technical corrections to standards, but to use

instead the existing process of amendments, with a short (30-day) exposure period and electronic-only publication of exposure drafts. The first draft technical correction has been confirmed as an amendment to IAS 21 without further exposure. The ASB is issuing an equivalent amendment to FRS 23.

## Consolidations (including Special Purpose Entities)

The IASB has a project on consolidations. The project objectives are:

- to develop a comprehensive definition of control;
- to consider the circumstance in which SPEs should be consolidated based on the concept of control developed; and
- " to address both consolidation policy and procedure.

The IASB have tentatively agreed that control of an entity is *the ability to direct the strategic financing and operating policies of an entity so as to access benefits flowing from the entity and increase, maintain or protect the amount of those benefits.*

Recently the IASB has considered:

- options held of assets versus options over equity instruments;
- the attribution of profits and losses in the context of potential voting rights;
- the nature of an investment in an entity when setting the operating and financing policies of the entity has been put on 'autopilot';
- disclosure required when judgement is required in deciding whether one entity controls another.

The IASB will continue to develop the control model before issuing an Exposure Draft.

In October the IASB issued a statement to highlight its views on de facto control. The statement includes the IASB's view that the control concept in IAS 27 includes de facto control. The statement acknowledges, however, that differences in how IAS 27 is applied might persist until its project on control is completed.

### **EU endorsement update**

The European Commission has issued a statement to make clear that any International Financial Reporting Standard (IFRS) adopted and published in the Official Journal by the date the accounts are signed (rather than the end of the financial year) can be used in the preparation of the accounts for that financial year (as long as the standard does not prohibit early adoption).

A status report on the endorsement of IFRS in the EU is available on the EFRAG website at [www.efrag.org](http://www.efrag.org).

# Accounting for Pensions

It seems that whenever we switch on the radio in the morning or open a newspaper, the pensions crisis is never far from the headlines.

In October's edition of *Inside Track*, we reported on the ASB's announcement that it is undertaking a research project into accounting for pensions.

The Pensions Advisory Panel has now been appointed and held its first meeting this month, at which it discussed the scope and planning of the project and the issues that should be addressed. Details of the membership of the Panel are as follows.

Andrew Lennard - Technical Director, ASB (Chairman)

John Ashcroft - The Pensions Regulator

Nigel Biggs - Unilever UK

David Blackwood - ICI Group

Clive Bouch - Deloitte

Paul Boyle - Financial Reporting Council

Bob Bridges - Capital Cranfield Pension Trustees Ltd

Roger Cobley - Stamford Associates Ltd

Stephen Cooper - UBS Limited

Sarah Deans - J P Morgan

Andrew Evans - PricewaterhouseCoopers LLP

Robert Hails - Watson Wyatt Limited

Gary Hibbard - BP plc

Nicki Mortimer - AstraZeneca plc

Lynn Percy - KPMG LLP

Derek Scott - Chair, NAPF working group on accounting standards

John Smith - BBC Worldwide

Jeremy Stone - N M Rothschild & Sons Ltd

A European working group has been also formed to give the ASB a European viewpoint. The group includes members of the European Financial Reporting Advisory Group (EFRAG) and other European national standard-setters. Details of the membership of the group have been posted on the ASB website.

# ASB issues FRS 29 'Financial instruments: disclosures'

This month, the ASB has issued Financial Reporting Standard (FRS) 29 (IFRS 7) 'Financial Instruments: Disclosures'. The FRS has the effect of implementing in the UK the International Accounting Standards Board's (IASB's) Financial Reporting Standard, IFRS7 'Financial Instruments: Disclosures' which was published in August 2005 and the related amendment to IAS 1 'Presentation of Financial Statements - Capital Disclosures'.

FRS 29 replaces the disclosure requirements of FRS 25 (IAS 32) 'Financial Instruments: Disclosure and Presentation', and applies to those entities applying FRS 26 (IAS 39) 'Financial Instruments: Measurement'. The new standard is mandatory for these entities for accounting periods commencing on or after 1 January 2007, but earlier adoption is allowed to enable entities to move directly to the new requirements on first applying FRS 26, avoiding the need to make two changes in quick succession. The new standard also bases its risk disclosure requirements on the entity's management's internal risk monitoring information, so reducing the burden for additional data collection.

The disclosures required by the Standard include:

- information on the significance of financial instruments for an entity's financial position and performance;
- information about exposure to risks arising from financial instruments. These include, where relevant, certain minimum qualitative disclosures about credit, liquidity and market risks together with descriptions of management's objectives, policies and processes for managing those risks. Quantitative disclosures are also required to provide information about the extent to which the entity

is exposed to risk, based on information provided internally to the entity's key management;

- the entity's objectives, policies and processes for managing capital. This would include quantitative data about what the entity regards as capital, and whether the entity has complied with any capital requirements and if it has not complied, the consequences of such non-compliance.

FRS 29 applies only to entities within the scope of FRS 26—that is, listed entities and entities that use the fair value accounting rules of the Companies Act 1985 to produce their financial statements. Earlier in the year the ASB issued proposals for extending the scope of FRS 26 to all entities (other than those who are able and elect to apply the requirements of Financial Reporting Standard for Smaller Entities). However, the ASB has deferred its decision on implementing this extension of scope for the meantime.

Certain companies have been exempted from the requirements of the Standard. These include subsidiary undertakings where at least 90 percent of the voting rights are held within the group and parent companies in their single-entity financial statements, provided the entity is included in publicly available consolidated financial

statements which include disclosures that comply with this Standard.

# Letter from the Chairman

To say we live in interesting times is an understatement. 2005 has been a pivotal year in more ways than one. Who would have thought that the Australian sporting community would come bearing early Christmas gifts in the form of the Ashes, and of allowing both England and Wales victories in the rugby? I am confident that this is merely a temporary state of affairs and that the natural order of the sporting world will be resumed in the near future.

Change, however, is rather more permanent I hope in the world of financial reporting, with the requirement that, for accounting periods beginning on or after 1 January 2005, listed companies in the UK and Republic of Ireland must use EU-adopted international accounting standards in their group financial statements. This has necessitated a massive exercise across the business community and we look forward to seeing the results of the first year coming through in 2006.

This dramatic change in the environment for accounting standard-setting prompted the Board to consider its own role in this brave new world. In March, we issued a draft Policy Statement which argued that the most significant future role of the ASB will be in seeking to influence the development of high quality international accounting standards by working with the IASB, FASB and other national, European and international bodies involved with standard-setting.

During the exposure period, I met with many constituents to discuss the implications of the changed circumstances in which we now all operate. From those discussions, and the thoughtful responses we had to the exposure draft, it is clear that - while all agree that there is an important future role for the Board (which is a relief!) - two main issues need further consideration, namely: the Board's policy on convergence of UK standards

and IFRS; and how we should relate to and communicate with our constituents and influence European and international matters in the new circumstances. As highlighted on page 1, we are working on proposals in these two areas and I look forward to discussing them at the public meeting in January.

The discussions on the Board's future role have been an important feature of the year, but by no means the only one. We have continued to fly the flag for high quality financial reporting in a number of ways. In working with the IASB, we have been leading a research project on accounting for leases and played an active role in the project team that developed the proposals on management commentary that the IASB issued as discussion paper in October. As part of our influencing role, I have taken on the chairmanship of a group of National Standard-Setters (NSS), which met in London in April and September and will meet again in Canada in March.

The European scene has taken up a great deal of my time during the year. I have continued to attend meetings of the EFRAG Technical Experts Group (TEG) as a non-voting member and I have been pleased to play a part in helping EFRAG develop a more proactive approach in order to improve the input from Europe to the global standard-setting process, under the banner Proactive Accounting Activities in Europe (PAAinE). I look forward to the proactivity bearing some positive results during 2006. To paraphrase European Commissioner Charlie McCreevy in one of his recent speeches - no PAAinE, no gain!

The EU endorsement of IFRS has also required my attention during the year. At the beginning of 2005, it was the controversy over the two 'carve-outs' from the EU-adopted version of the financial instruments standard, IAS 39 (now reduced to one, with the

agreement on the fair value option). The year is ending with concerns about the length of the endorsement process and the fact that a number of IASB pronouncements will not be endorsed for use in the EU until after the end of 2005.

During the year, I have been struck by just how high a profile standard-setting has now assumed. What was once seen as a technical function has regularly hit the headlines. Concerns about the IASB's business combinations proposals, accounting for pensions, the OFR and even UITF 40 have all been reported widely. While I am pleased that the Board and its work has become more visible, it does place on us a responsibility to ensure that our due process and decision-making is clear and transparent.

Looking back over the year, I think that the Board has done some excellent work. We fulfilled our commitment to HM Treasury by issuing a report on financial reporting for life assurance, a complicated subject; we published what I believe is a very good reporting standard on the OFR, even with the removal of its statutory underpinning; and we have kept UK standards on financial instruments up-to-date with IFRS, which is no mean feat.

All this could not have been achieved without the commitment, enthusiasm and knowledge of my fellow Board members, together with all those who serve so willingly on the Board's committees. I am grateful to them all, as I am to the staff, who have managed a heavy workload with skill and dedication.

I am also grateful to you - our constituents - for the interest you show in good quality financial reporting. We cannot manage without your help. So on that note, I would like to wish you all a very Merry Christmas and let's hope for a successful 2006, which I am sure - like 2005 - will be another challenging year.

## Heritage Assets - can accounting do better?

One of the early treats of the New Year will be ASB's proposals on heritage assets. Some museums and galleries report in their balance sheets values for all heritage assets. But most do not; they report values for heritage assets acquired since 2001 as costs are known, but those acquired before then remain unrecognised. The result is inconsistent accounting for similar assets and balance sheet values which whilst seemingly significant represent only a small part of the total number of heritage assets held.

The Board and its Committee on Accounting for Public-benefit Entities is finalising proposals to improve the consistency and transparency of the financial reporting of heritage assets. As well as collections of art, antiquities and books, the proposals will be relevant to heritage assets such as landscape and coastline, historic buildings and archaeological sites.

The Discussion Paper will propose that heritage assets should be reported as assets at values that provide useful and relevant information. This is to be required wherever it is practicable to obtain valuations which, when supplemented with appropriate disclosures, provide useful and relevant information sufficient to assist in an assessment of the value of heritage assets held by an entity. However, where an entity can demonstrate this is not practicable, it should instead adopt a non-capitalisation approach and disclosures should be given to provide useful and relevant information about the heritage assets held.

The Discussion Paper has been developed in collaboration with the International Public Sector Accounting Standards Board. It will issue in 2006 its own Consultation Paper on heritage assets based largely on the ASB's proposals.

## Accounting for public benefit entities

The comment period for the ASB's ED of a proposed interpretation for public benefit entities of its 'Statement of Principles for Financial Reporting' closed on 30 November. The aim of the interpretation is to provide a coherent frame of reference to be used in the development of sector specific guidance for public benefit entities and to assist preparers and auditors faced with new or emerging issues. Over 70 responses have been received to date. The comments are currently being analysed and will be considered in the first instance by CAPE. During the exposure period, the ASB, jointly with the Chartered Institute of Public Finance and Accountancy (CIPFA), hosted a round-table where the proposals gave rise to much constructive discussion.

### Further Information

For further information on any of these topics please contact David Loweth at Aldwych House.

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**ACCOUNTING  
STANDARDS  
BOARD**

ISSN 1360-1342

## Appointments

**Isobel Sharp**, Technical Partner at Deloitte, stands down from the Board at the end of December, having completed two terms of office. An announcement on her replacement is imminent. While leaving the Board, Isobel has, however, agreed to continue as chair of its Committee on Accounting for Smaller Entities (CASE).

Isobel's replacement on the ASB is **Robert Overend**, who is the Technical Partner in Ernst and Young's Financial Reporting Group.