INSIDE TRACK 39

ACCOUNTING STANDARDS BOARD

In the April 2004 issue

2 Proposals for a ‘one-stop shop’ FRSSE
3 New standard on share-based payment
4 Exposure draft on financial instruments

Convergence of UK and International Accounting Standards

The ASB has set out its plans for the future of UK accounting standards in the light of the move to the mandatory use of International Financial Reporting Standards (‘IFRS’) for the consolidated accounts of EU listed companies.

The issue of the ASB's Discussion Paper 'UK Accounting Standards: A Strategy for Convergence with IFRS' coincides with a Government Consultation Document 'Modernisation of Accounting Directives/IAS Infrastructure'. The effect of the Government's proposals is that many companies will have the choice of using either UK accounting standards or IFRS.

The Discussion Paper takes as its starting point that there can be no case, in the medium term, for the use of two sets of different accounting standards in the UK, and so UK accounting standards should be brought into line with IFRS. The ASB plans to do this whilst minimising the burden of change on those that choose to report under UK accounting standards.

A phased approach is proposed including:

- new standards effective in 2005 and 2006 that will enhance existing UK financial reporting requirements, maintain their position as highly regarded internationally and adapt to changes in the law; and
- thereafter, a series of 'step changes' replacing one or more existing UK accounting standards with standards based on IFRS as prospective IASB projects are completed.

One of the ASB's main objectives is to avoid requiring two changes of accounting policy in respect of the same issue within a short period. For this reason, it proposes the retention of a number of UK standards where the corresponding IFRS may change following completion of current IASB projects.

The Discussion Paper sets out ASB's current intentions for new standards expected to become effective for accounting periods starting in 2005 and 2006, which are:

- Share options: FRS 20, based on IFRS 2 'Share-based Payment', requiring an expense measured at fair value to be recognised in the profit and loss account for all share-based payment transactions. This will be mandatory for listed companies in 2005 and for unlisted companies in 2006 (see page 3).
- Financial instruments: From 2005, standards based on IAS 32 'Financial Instruments: Disclosure and Presentation' and, for listed companies (and on a voluntary basis for other companies), much of IAS 39 'Financial Instruments: Recognition and Measurement' (see page 4).
- Retirement benefits: FRS 17 will replace SSAP 24 in 2005 so that, consistent with IASB proposals for IAS 19 'Employee Benefits', actuarial gains and losses are fully recognised in the statement of total recognised gains and losses in the period in which they arise.

Continued ...

Continued ...

- Post balance sheet events: a standard based on IAS 10 'Events after the Balance Sheet Date', replacing SSAP 17 from 2005.
- Earnings per share: a UK standard (applicable to listed companies only) based on IAS 33 'Earnings per share' and replacing FRS 14 from 2005.
- Related party disclosures: a standard based on IAS 24 'Related Party Disclosures', replacing FRS 8 from 2006.

In addition, the ASB may, after consideration of the responses to its Discussion Paper, issue exposure drafts for:

- a UK standard based on IAS 41 'Agriculture' available for use for accounting periods beginning on or after 1 January 2005; and
- revised disclosures in respect of operating lease commitments, based on those in IAS 17 'Leases'.

The Paper also reviews the implications of the move to IFRS for the Financial Reporting Standard for Smaller Entities (FRSSE) and Statements of Recommended Practice ('SORPs').

Whilst the focus of the paper is on the future of UK accounting standards, it also describes the ASB's plans for its future role, including working with and influencing IASB and other international bodies, maintaining dialogue with its constituents and addressing UK accounting issues.

ASB has requested comments by 30 June 2004.

We would like to apologise to subscribers and customers for the poor print quality of the Discussion Paper, which was not up to our usual standards. Our printers have assured us that this will not happen again.

One stop shop FRSSE

The Accounting Standards Board (ASB) has set out in a recent Discussion Paper a 'one-stop shop' standard for smaller entities.

It proposes to bring together in a single document the contents of the current Financial Reporting Standard for Smaller Entities (FRSSE) and the accounting requirements of companies legislation applicable to smaller companies. The Discussion Paper illustrates the proposal by presenting a full draft of such a 'one-stop shop' FRSSE.

The main purpose of the consultation is to ask whether those preparing the financial statements of smaller entities will benefit from having all the relevant accounting requirements available in the single document.

Comments are invited by 26 May 2004.
The Board, assisted by its Committee on Accounting for Smaller Entities (CASE), will undertake its normal review of the FRSSE and the need for any updating later in 2004.

ASB welcomes new IASB standards for 2005

At the end of March, the IASB published three new standards ('IFRS') and three amended standards.

The new standards are:

- IFRS 3 'Business Combinations';
- IFRS 4 'Insurance Contracts'; and
- IFRS 5 'Non-current Assets Held for Sale and Discontinued Operations'.

The amendments are to: IAS 36 'Impairment of Assets'; IAS 38 'Intangible Assets'; and IAS 39 'Financial Instruments: Recognition and Measurement' (fair value hedge accounting for a portfolio hedge of interest rate risk).

This completes the set of standards with which companies that will use IFRS from 2005 will be required to comply.

The ASB has acknowledged that the IASB has faced an enormous challenge in producing standards to meet the 2005 deadline and has welcomed its achievement in delivering the standards on time. It has also underlined the importance of the European Commission now acting swiftly to ensure these new and amended standards are promptly adopted for use in Europe.

Share-based payment

FRS 20 (IFRS 2) 'Share-based Payment' was issued in April. It reflects the proposal in FRED 31 that the final international standard should be issued as a UK standard.

The Board has long held the view that transactions where employees and others receive shares or share options give rise to an expense and that the expense should be measured at fair value and recognised in the profit and loss account (or included as part of the cost of an asset recognised on the balance sheet). However, although aspects of the arrangements were dealt with in various UITF Abstracts, there had been no standard in the UK or the Republic of Ireland dealing comprehensively with the subject. The introduction of FRS 20 therefore represents a major improvement in UK financial reporting.

The FRS will apply to listed entities from 2005 and unlisted entities from 2006

FRED 31 proposed that the UK standard would come into effect from the effective date of the IFRS - which will be accounting periods beginning on or after 1 January 2005. For listed entities, this proposal is reflected in FRS 20.

The Board concluded, however, that is was reasonable to allow a longer period for implementation by unlisted entities: they are therefore not required to apply the standard until 2006.

The FRS will apply to all share-based payments, including SAYE schemes

The IFRS contains no exemptions. In developing FRS 20, the Board considered whether there were any matters unique to the UK or the Republic of Ireland that justified some exemptions in the FRS, but concluded they were none. As a result, the FRS applies to all share-based payments including all Save-As-You-Earn (SAYE) schemes.

The principles underlying FRS 20

There are two main types of share-based payment: equity-settled share-based payments and cash-settled share-based payments. Equity-settled transactions are when the payment takes the form of equity instruments; cash-settled transactions involve payments in cash (or other assets), the amount of which is calculated by reference to the price of an equity instrument of the payee.

For equity-settled transactions, FRS 20 takes the view that, at the date the transaction was entered into (ie grant date), the entity must have thought the value of the promise it was making (to issue equity instruments if certain criteria are met) was equal to the value of the goods or services it expected, at grant date, to receive in return. The fair value of the goods or services received can therefore be determined either directly (by measuring the fair value of the goods and services received) or indirectly (by using, as a proxy for the fair value of the goods and services received, the grant date fair value of the equity instrument issued).

The FRS sets out the factors that determine whether the direct method or the indirect method is to be used. It also explains how to allocate the amounts calculated to the relevant accounting periods, and how to adjust those amounts in the light of subsequent events.

For cash-settled transactions, FRS 20 requires charges to be made to the profit and loss account to build up a provision equal to the amount that will eventually be paid over the period in which the goods or services are received.

The FRS provides guidance on how to estimate the fair values needed to apply the standard. It recognises that option-pricing models will often have to be used, although it does not require the use of any particular model. It also sets out how to account for reload features and for events such as the repricing, cancellation or replacement of a share option plan.

Financial instruments

The ASB is strongly of the view that standards on the measurement and disclosure of derivatives and other financial instruments are important. Following the release of the revised text of IAS 32 'Financial Instruments: Presentation and Disclosure' and IAS 39 'Financial Instruments: Recognition and Measurement', it has decided to implement both standards in the UK for accounting periods beginning on or after 1 January 2005.

In FRED 30 the ASB proposed that the UK standards based on IAS 39 and the disclosure parts of IAS 32 should apply to certain entities only. Now it is proposing, in a new supplement to FRED 30, two extensions to the scope set out in FRED 30.

The first scope extension proposed is that the measurement and hedge accounting requirements of IAS 39 should apply to all listed entities in addition to those entities using the fair value accounting basis that will be incorporated into the Companies Act from 2005 on implementation of the Fair Value Directive. FRED 30 proposed only that the latter would be required to adopt those requirements.

The intention is that the UK measurement standard will be based on the latest version of IAS 39, which includes the recent changes for macro hedging. The Directive was drafted with an earlier version of IAS 39 in mind and, as a result, the option in the latest version of IAS 39 to designate any financial instrument as fair value through profit or loss will not be available under the Companies Act without recourse to the true and fair override.

The second scope extension proposed in the new Supplement to FRED 30 is that all entities (other than those applying the FRSSE) should be required to provide the IAS 32 disclosures; FRED 30 proposed they should apply only to listed entities and unlisted banks. The ASB has always made clear its intention at some point to extend the requirement for fair value and risk disclosures about financial instruments beyond the limited scope of FRS 13 to all entities other than those adopting the FRSSE. In its view, now is the time to make that change.

These proposals when taken together with those in FRED 30 mean that, for accounting periods beginning on or after 1 January 2005:

- all listed entities and all others choosing to adopt fair value accounting should apply the measurement and hedge accounting requirements of IAS 39; and

- all entities should apply IAS 32's requirements on presentation (which deal mainly with the equity/liability classification) and disclosure.

As indicated in FRED 30, it remains the ASB's intention not to implement in the UK standard the IAS 39 material on recognition and derecognition for the time being.

News from EFRAG

The Technical Expert Group of EFRAG entered a new phase of its life in April. From this month it has a new, full-time Chairman and a turnover of four of its eleven part-time members, two of whom have yet to be appointed. In addition, the chairmen of the German, French and UK standard setting bodies will attend its meetings in an observer capacity.

The changes stem partly from the membership review at the end of initial terms and partly from an internal organisational review begun at the start of 2003 and subsequently encouraged by ECOFIN, which wanted to improve the resources devoted in Europe to assessing and influencing the work of the IASB.

The incoming Chairman, Stig Enevoldsen, is a leading Danish accountant and former Chairman of his own country's standard setting body and of the IASC.

The new team faces a heavy agenda, as the last of the IFRSs intended for use in 2005, including the macro-hedging amendments to IAS 39, come up for review to determine whether EFRAG should recommend to the Commission their adoption for use in the EU.

Despite continuing discussions over some aspects of IAS 39, EFRAG believes that it should discharge its responsibility of reviewing the version of that standard in issue at the end of March. To assist in that process, the ASB written to EFRAG arguing that the wider issues outweigh remaining concerns with the standards themselves. In particular, comprehensive standards addressing financial instruments, derecognition and classification of capital instruments as debt or equity are essential if the accounting regime in Europe is to be regarded as credible. The ASB has therefore urged EFRAG to recommend to the Commission that these IASB standards be adopted for 2005.

ASB Announces Arrangements for Study on Accounting for With-profits Business

The Accounting Standards Board has announced details of how it intends to carry out an urgent study into the accounting for with-profits business by life insurers. This follows the request from HM Treasury in relation to issues raised by Lord Penrose in the report of his inquiry into the affairs of the Equitable Life Assurance Society, published on 8 March.

To assist the Board in its study, the Board has established an Advisory Panel to provide recommendations to the Board and, as relevant, its Urgent Issues Task Force.

The Advisory Panel is chaired by Julian Hance, who stepped down as Group Finance Director of Royal & Sun Alliance Insurance Group plc at the end of March.

Other members are:

Philip Broadley, Group Finance Director, Prudential plc

Andrew Crean, Managing Director Insurance, European Equity Research, Citigroup Smith Barney

Philip Easter, Managing Director Group Finance, Aviva plc

Andrew Lennard, Technical Director, Accounting Standards Board

Peter Needleman, Life Practice Director, Tillinghast

Chris Nunn, member of the Urgent Issues Task Force, former Technical Partner of Andersen

Paul Sharma, Head of Prudential Risks and Accounting, Financial Services Authority (FSA)

Observers from the Department of Trade and Industry and HM Treasury.

The Panel has been tasked with investigating and making recommendations for UK accounting standards relating to with-profits life assurance business that may realistically and feasibly be made for 2004 financial reporting. In this context it is likely to draw on current developments in FSA prudential regulation. The Panel will also consider recommendations to appropriate bodies for accounting changes from 2005.

Julian Hance will attend Board meetings for the next few months to report on the Panel's deliberations and to take the Board's advice.

Reforming Capital

UK and European law links the ability of a company to pay dividends to its statutory accounts. This area of the law has been increasingly seen as in need of reform, for example by the European High Level Group of Company Law Experts.

At the joint initiative of the ASB and the Company Law Centre, an interdisciplinary group has produced a report, which argues that existing law is complex and ineffective. The work was led by Jonathan Rickford, Director of the Company Law Centre, who also edited the report. ASB Chairman Mary Keegan and ASB Technical Director Andrew Lennard participated in the interdisciplinary group.

The report sets out proposals for an approach focussing on maintaining solvency rather than capital. It envisages that there would be no automatic link between the statutory accounts and a company's ability to make a distribution.

A draft of the report was discussed at a conference on 30 January. It will be finalised shortly and transmitted to Government and the European Commission.

Further information is available at www.biicl.org

Updates on current proj

Leases

The ASB is undertaking a research project on leases for the IASB. The project aims to develop a single method of accounting for leases that is consistent with the IASB's Framework. ASB staff has presented introductory papers at recent IASB meetings.

At its November 2003 meeting, the IASB tentatively agreed that recognising the assets and liabilities that arise from all leases would provide more relevant, reliable and comparable financial information than recognising assets and liabilities only in respect of finance leases. It was agreed that the project should explore a conceptual approach that analyses the contractual rights and obligations in leases and identifies the changes to assets and liabilities that arise from them. Under that approach:

a lessor would recognise assets that include:

- its contractual rights to receive cash
- its residual rights in the leased property

a lessee would recognise:

- an asset reflecting its unconditional right to use the leased property (subject to any restrictions in the lease as to how it may be used)
- a liability in respect of its contractual obligations under the lease

At its January 2004 meeting, the IASB discussed cancellation and renewal options in leases. Alternative approaches to a number of examples were considered. These covered lessee options to cancel and lessee options to renew at market and at predetermined rents. Under the first approach, assets and liabilities would be recognised only in respect of unconditional rights and obligations under the lease. This would mean, for example, that a lessee would have assets that include the right of use for the non-cancellable period and the right to renew the lease, and liabilities that include its unconditional obligation to make payments to the lessor. The lessor would have assets that include its unconditional right to receive payments from the lessee.

Under the second approach, the probability of the lessee exercising its options would be considered in recognising assets and liabilities under the lease. This would mean, for example, that if it was considered probable that the lessee would renew the lease, the lessee would have assets and liabilities that include a right of use for the renewal period and the associated obligation to make payments to the lessor. The lessor would have assets that include the estimated lease payments from the lessee.

A further paper has been prepared for consideration at IASB's April meeting which explores these approaches in respect of leases where some or all of the lease payments are contingent (or conditional) on future events. Three types of contingent payments are:

- payments that vary with external factors that are not within the control of the lessee or the lessor, such as price changes (including commercial property leases where the lease payments are varied periodically to open market rents)
- payments that depend on the lessee's usage
- payments that depend on the lessee's profits or other performance (including turnover leases)

A pervasive issue is whether or not the contingent cash inflows are assets of the lessor and the contingent cash outflows are liabilities of the lessee.

Reporting Comprehensive Income

Reports have been given in the January 2004 and earlier issues of Inside Track of the work being done in a joint project between the ASB and IASB to develop a statement of comprehensive income. For ASB, this represented a development at the international level of the proposals it had published in FRED 22 Reporting Financial Performance in 2000. Consultations by the IASB/ASB team over the first half of 2003 revealed a strong desire in numerous countries for the project to be conducted in conjunction with the FASB, which had by then adopted a separate project of its own embracing the balance sheet as well as the performance statements. Accordingly, in the autumn of 2003, staffs of the three boards were asked to develop a joint proposal on how the two projects might be combined and taken forward.

The resulting joint proposal was presented to separate meetings of the three boards in March 2004. It recommended dividing the work into two projects, the first dealing with the form and content of required primary financial statements and the second addressing more difficult issues, including how to present the effects of the "mixed attribute" model and whether there is value in the notion of recycling.

The aim of the first project would be to agree that all three boards should require the same set of primary financial statements. The most significant proposal stemming from this aim would be that there should be a new statement of comprehensive income, which in UK terms would mean that the items currently reported in the statement of total recognised gains and losses would appear immediately following profit for the

ects

period in a single primary statement. No attempt, however, would be made at this stage to agree on what particular items should be recognised below the line of profit for the period nor on whether or not they should be recycled above that line in a subsequent period. Another issue for the project would be agreement on the number of comparative periods to be presented, in the primary statements and in the notes. It should not be assumed that inclusion of this issue implies that a decision will be taken to adopt the two years of comparatives requirement, which is currently applied only by the SEC.

The second project would seek to standardise, both within individual statements and across different statements the content of key totals and sub-totals. Some of this work might be capable of resolution in the first project but definitions of items such as "operating" or "financing", used in both the comprehensive income statement and the cash flow statement, would involve many of the more difficult issues of the later project.

Better disaggregated information, for example on the constituents of revenue, is another goal that some would like to see in the first project but which, for some items at least, might have to await the second.

This joint staff proposal met with varying reactions from members of the three boards. Some agreed with the staff to divide the work into two, while others agreed that the main issues reserved for the second project were too closely related to the first to be ignored at that stage. The structure of the projects will be redebated in April. All boards agree that thorough consultation will be required.

IASB round up

The following provides an overview of current IASB work, other than that referred to elsewhere in this issue of *Inside Track*. It should be noted that some of the decisions referred to below are tentative.

- Revisions to IAS 19 'Employee benefits' are to be proposed that would allow entities to recognise actuarial gains and losses in full in the period in which they occur, outside the profit and loss account. They are to be reported in a 'statement of recognised income and expense'. An important consequence of this is that companies that have elected to comply in full with FRS 17 'Retirement Benefits' will be able to maintain similar accounting when they adopt IFRS.

- Proposals are being prepared on two topics relating to financial instruments. One is to impose restrictions on the fair value option contained in IAS 39 'Financial Instruments: Recognition and Measurement': the other is on financial guarantees and credit insurance.

- IASB is continuing its project on business combinations. An exposure draft on 'Application of the Purchase Method' is at an advanced stage. There is also likely to be an exposure draft of a proposal to extend the scope of IFRS 3 'Business Combinations'.

- The comment period on ED 6 'Exploration for and Evaluation of Mineral Resources' (and on the related ASB Consultation Paper - see *Inside Track* 38) ends on 16 April 2004.

- Ongoing major projects that are not expected to result in publications in the next few months are: insurance contracts (Phase II); revenue recognition (joint with the US Financial Accounting Standards Board); and consolidation.

In addition, the IASB is considering amendments and revisions to a number of other standards. These include IAS 37 'Provisions, Contingent Liabilities and Contingent Assets'; IAS 12 'Income Taxes' and IAS 20 'Accounting for Government Grants and Disclosure of Government Assistance'. Some of these projects stem from IASB's intention to bring about convergence between IFRS and US accounting standards.

Urgent Issues Task Force

IFRIC exposure drafts
The UITF has responded to two draft Interpretations issued in January by the IASB's International Financial Reporting Interpretations Committee (IFRIC).

D3 Determining whether an Arrangement contains a Lease
This IFRIC proposal provides guidance that would require some arrangements that are leases in substance but not in form to be treated as leases under IAS 17 Leases. Outsourcing and take-or-pay contracts are examples of such arrangements that would need to be examined.

There are two important consequences. First, the guidance will ensure that any finance leases contained in such arrangements are identified and reported as such. Secondly, arrangements that are deemed to contain operating leases will be subject to the considerable disclosures about operating lease commitments required by IAS 17.

The UITF does not currently intend to issue IFRIC's proposal as an addition to UK accounting standards because many of the arrangements would be covered by FRS 5, for which there is no equivalent international standard. The UITF has supported IFRIC's proposal in the context of IASB's existing literature.

D4 Decommissioning, Restoration and Environmental Rehabilitation Funds
D4 provides guidance for entities that contribute to funds established to finance future decommissioning liabilities. The proposals include guidance on when an entity should recognise separate assets (for rights to reimbursement from the fund) and liabilities (to pay decommissioning costs).

The UITF believes that UK accounting standards are sufficiently robust in this area and does not consider that it is necessary, at present, to issue an equivalent addition. The UITF has supported IFRIC's proposals, subject to some clarifications of the consensus.

Waste Electrical and Electronic Equipment
The UITF has considered a draft Interpretation issued by the German Accounting Standards Committee (GASC) concerning the recognition of liabilities arising from the EU Directive on Waste Electrical and Electronic Equipment. The Directive, which is expected to be implemented into UK law by the summer of 2004, will make producers of electrical and electronic equipment responsible for most of the costs of end-of-life collection, recycling and environmentally-friendly disposal. The UITF has commented to GASC and welcomed its initiative and its intention to share its work with IFRIC.

The UITF will monitor developments and the forthcoming legislation before deciding whether to issue equivalent proposals and any additional UK-specific guidance that it might wish to include.

Emission Rights
In May 2003 the UITF issued a draft Abstract on accounting for emission rights schemes (Information Sheet 61). It presented the text of a draft Interpretation from IFRIC, together with the changes that the UITF proposed to reflect accounting requirements in the UK where they differed from international accounting standards. The UITF reported its reservations about the lack of symmetry in the proposed accounting model, and these were shared by many respondents. IASB has since announced that it intends to amend IAS 38 Intangible Assets (so that emissions allowances can be measured at fair value with changes in value recognised in profit or loss) and IAS 20 Accounting for Government Grants and Disclosure of Government Assistance; both standards are important references for accounting for an emission rights scheme. IFRIC is expected to issue revised proposals reflecting the proposed changes to those standards. The UITF will consider its next steps in the light of IFRIC's and IASB's decisions.

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

Email d.loweth@frc-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.frc.org.uk/asb

ACCOUNTING STANDARDS BOARD

ISSN 1360-1342

Appointments

Paul Boyle ceased to be a member of the Urgent Issues Task Force on assuming the position of Chief Executive of the Financial Reporting Council. **David Nish**, Finance Director of Scottish Power plc has been appointed to the UITF in his place.

David Loweth has joined the ASB as its Secretary from HM Treasury. He replaces **Charles Bridge** who has completed his secondment and returned to the Department of Trade and Industry.

David's place as HM Treasury observer on the Public Sector and Not-for-profit Committee has been taken by **David Watkins**, Accounting Policies Manager and Secretary to the Financial Reporting Advisory Board.