

INSIDE TRACK 42

In the January 2005 issue

- ASB issues draft OFR standard
- FRS 27 'Life Assurance'
- ASB issue guidance on IAS 39

Welcome to 2005

2005 has arrived. 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.

Of the 36 international accounting standards which are mandatory from 1 January, all but two have now been adopted without amendment for use in Europe. The two exceptions are:

- IAS 39 'Financial Instruments: Recognition and Measurement' - as reported in *Inside Track* 41, the EU has adopted a version of IAS 39 that has been amended by the European Commission from the version published by the International Accounting Standards Board (IASB). The EU-amended IAS 39 has 'carve outs' that affect two parts of IAS 39: the hedge accounting requirements and the so-called 'fair value option'. The ASB has issued guidance on the EU-amended IAS 39 (see page 4). The Commission has also yet to consider the adoption for use in the EU of the amendments to IAS 39 'Transition and Initial Recognition of Financial Assets and Financial Liabilities' which were published by the IASB in December.
- IFRS 2 'Share-based Payment' - at the time of writing, IFRS 2 has yet to be formally adopted by the Commission, but it will do so very

soon. At its meeting in December, the Accounting Regulatory Committee, which advises the Commission on the adoption of international accounting standards in Europe, voted to make IFRS 2 mandatory in the EU. Under the adoption process, the European Parliament has one month to consider the issue before a Commission Regulation on IFRS 2 can be finalised.

In addition, the Commission has yet to consider the adoption in the EU of the amendments to IAS 19 recently published by the IASB (see page 6). Although most of the amendments only become effective for 2006, the one of most importance to the ASB, the immediate recognition of actuarial gains and losses, may be applied for accounting periods ending on or after 16 December 2004.

As well as the standards, there are also 14 interpretations that are mandatory for 2005. Of these, 12 have so far been adopted for use in Europe. The Commission has yet to consider the adoption of two recent IFRIC interpretations: IFRIC 2 'Members' Shares in Co-operative Entities', which is effective from January 2005, and

IFRIC 3 'Emission Rights', which is effective from March 2005. EFRAG has recommended adoption of IFRIC 2. As we went to press, EFRAG was considering its endorsement advice on IFRIC 3.

In the UK, the Government has now passed legislation giving the option for:

- all companies (with defined exceptions) to prepare their individual accounts; and
- non-listed companies to prepare their consolidated accounts

using EU-adopted international accounting standards rather than UK GAAP.

Apology

The ASB moved offices in early December 2004. There were some IT and telecommunications problems during the move and we know that people had difficulty contacting us for a number of days. We apologise for the disruption. As a reminder, our new address and contact details are set out on page 8.

ASB issues draft standard on the OFR

The ASB has issued an Exposure Draft of a Reporting Standard (RED 1) on the Operating and Financial Review (OFR). This follows a Government announcement that, for financial years beginning on or after 1 April 2005, quoted companies in Great Britain will be required to prepare an OFR. The Government has also announced that it intends to specify the ASB in legislation as the body to make the standards for the mandatory OFR.

The proposals in the RED build on the requirements of the OFR Regulations and the ASB's existing 2003 statement of best practice on the OFR, which is already used by many companies. They involve:

- the specification of a number of principles to apply when preparing an OFR; and
- the provision of key elements of a disclosure framework to apply in order to meet the requirements of the Regulations.

Principles

The principles emphasise that the OFR shall reflect the directors' view of the business. The objective is to assist investors to assess the strategies adopted by the entity and the potential for those strategies to succeed. While the OFR shall focus on matters that are relevant to investors, the information in the review will also be useful to other users.

The ASB believes it important that the OFR shall have a forward-looking orientation, identifying those trends and factors relevant to the investors' assessment of the current and future performance of the business and the progress towards the achievement of long-term business objectives.

Further principles require that the OFR shall:

- complement as well as supplement the financial statements;
- be comprehensive and understandable;
- be balanced and neutral; and
- be comparable over time.

Disclosure framework

The key elements of the disclosure framework in RED 1 cover:

- the nature, objectives and strategies of the business;
- the development and performance of the business, both in the period under review and in the future;
- the resources, risks and uncertainties and relationships that may affect the entity's long-term value; and
- the position of the business including a description of the capital structure, treasury policies and objectives and liquidity of the entity, both in the period under review and the future.

It is for directors to consider how best to use this framework to structure the OFR, given the particular circumstances of the entity.

The proposals also cover the provisions in the Regulations that "to the extent necessary" to meet the requirements of the key elements set out above, the OFR shall include information about a range of matters, including employees,

environmental matters, and social and community issues. Again "to the extent necessary", the review shall include analysis using key performance indicators (KPIs). The ASB has not specified any mandatory disclosures in these areas, recognising that it has to be for directors to judge what is required for an understanding of their business. The draft Reporting Standard sets out what disclosures should be made for each KPI included in the OFR, in order that investors can understand and evaluate each one.

Whilst adopting a framework approach, the ASB is conscious that some guidance would be useful to directors and it has accordingly prepared draft Implementation Guidance to accompany the draft Reporting Standard. The Guidance sets out some illustrations and suggestions of specific content and related KPIs that might be included in an OFR.

The text of RED 1 is available on the ASB's website. Comments on it have been requested by 28 February. The ASB aims to finalise the Reporting Standard as soon as possible after the end of the consultation period, but given the need to give due consideration to the views of respondents it may not be possible to do so before 1 April 2005.

ASB issues standard on Life Assurance

In December the ASB issued FRS 27 'Life Assurance'. This represents an important step forward in financial reporting, bringing greater clarity and transparency to the financial statements of entities with life assurance business. It will require disclosure of information that will provide a better understanding of both the liabilities and capital management of life assurers.

The process of developing the standard was started in March 2004 when, following the publication of the Penrose report into Equitable Life, the Financial Secretary to the Treasury wrote to the ASB asking it to initiate an urgent study into accounting for with-profits business by life assurers. The proposals were first set out in an exposure draft, FRED 34, issued in July 2004.

The standard builds on the new regulatory capital regime for with-profits life assurance recently introduced by the Financial Services Authority (FSA) - this introduces the concept of a 'realistic' calculation for policyholder liabilities that recognises constructive obligations to pay future bonuses and uses modelling techniques to value options and guarantees. Under the standard:

- large UK life funds will value their with-profits policyholder liabilities in accordance with the 'realistic' basis of the FSA's new regime; the standard specifies certain adjustments to be made to this amount, and to related assets and liabilities including deferred acquisition costs and deferred tax; and the overall effect on profit and loss is offset by a corresponding transfer to or from the fund for future appropriations;
- if there is a negative balance on the fund for future appropriations the entity must explain why it is appropriate not to have taken action to eliminate it;
- smaller UK funds and overseas life business, which are not covered by

the new FSA requirements, may continue to use their existing accounting policies, but must make additional disclosures in relation to options and guarantees that are not valued at fair value or by using stochastic modeling techniques;

- for bancassurers and other entities that currently recognise the embedded value of life assurance business, the standard imposes a restriction that excludes future investment risk margins from the amount recognised;
- all entities with material life assurance business will make a new disclosure, the capital statement, showing the disposition of shareholders' funds and other components of regulatory capital across the entity. This will be supported by narrative explanation of the regulatory requirements for the various life assurance businesses of the entity, the capital held to meet them, and the extent to which capital in one part of the entity's insurance business is available to meet risks and requirements in other parts of that business;
- further disclosures include narrative discussion of the sensitivity of capital and liabilities to changes in market conditions, and of the assumptions, including those relating to future management actions, made in determining the amounts of these.

In finalising the standard, the ASB took careful note of the concerns expressed by many insurance companies and others in response to the exposure draft. As a consequence, in addition to amending the disclosure requirements to integrate them more fully and placing greater emphasis on the need for narrative analysis, the ASB deferred the implementation date of the standard from December 2004 year ends to December 2005 year ends (and later in the case of a number of the smaller friendly societies).

One consequence of the deferral of the standard is that it would not, unless voluntarily adopted, be applied by those entities adopting international accounting standards (IFRSs) from 2005. The ASB was nevertheless prepared to contemplate this deferral as a result of a very positive response from the major life assurance and bancassurance entities to a proposal for voluntary adoption of the standard within the IFRS framework.

This has culminated in the signing of a Memorandum of Understanding by the ASB and the ABI together with the major life assurers and bancassurers. Under the terms of the Memorandum, the companies will voluntarily comply with the requirements of the standard from 2005. In addition they will disclose, for 2004 year ends, much of the information that will be required by the standard, but in their Operating and Financial Reviews (or elsewhere in their annual reports) rather than in the financial statements themselves. The ABI will encourage wider adoption of this voluntary approach, and will also update its SORP to bring it into line with the standard.

The text of both FRS 27 and the Memorandum are available from the ASB's website.

The ASB will also be making a report to the Treasury on its review of life assurance accounting, in response to the request made in the light of the Penrose report published in March 2004. This will include the ASB's views on a more comprehensive framework for financial reporting for life assurance developed with the intention of helping inform the process the IASB has underway in their insurance project.

ASB issues guidance on IAS 39

In December the ASB issued guidance (available on the ASB's website) on the EU-amended version of IAS 39 adopted by the European Commission (see page 6). The guidance is relevant only to entities in the UK and the Republic of Ireland preparing their financial statements in accordance with EU-adopted IFRSs.

The guidance addresses the parts of IAS 39 that have been affected by the EU's carve outs, taking into account the Commission's explanation that, as a result, certain items in the Companies Act 1985 or equivalent national legislation continue to apply to the relevant entities. The guidance covers four areas.

Hedge accounting

The amended IAS 39 has less onerous restrictions on the use of hedge accounting than the unamended standard. However, if an entity wishes to comply with both the amended standard and the unamended standard, it can do so - by applying the hedge accounting requirements of the unamended standard. The ASB continues to recommend that companies do this.

Fair Valuing of Financial Assets

The Commission's carve outs have no effect on an entity's ability to measure financial assets at fair value through profit or loss.

Fair Valuing of Financial Liabilities

The Commission's carve outs do not affect financial liabilities that are

required to be measured at fair value through profit or loss.

The carve outs do, however, affect which financial liabilities are *permitted* to be fair valued through profit or loss. The unamended standard's permission to measure any financial liability through profit and loss is deleted in the carve out. As a result only those financial liabilities required to be measured at fair value through profit and loss can be so valued under the standard.

This stark situation, however, is complicated by the Commission stating that one effect of the carve out is that certain accounting requirements in national legislation come into play. One major practical effect of this is that an entity that prepared its 2004 accounts in accordance with such national legislation and stated some financial liabilities at fair value through profit or loss can continue, if it wishes, to apply that accounting treatment in following years.

Transitional Arrangements

The Commission has stated that entities applying the carved out version of IAS 39 can regard themselves as first time adopters of IFRSs and thus take advantage of the relief provisions of IFRS 1 'First-time Adoption of International Financial Reporting Standards'. The ASB is unsure of the status of this Commission statement and whether it is in fact correct. It urges entities to avoid this uncertainty by complying from the outset with both the amended and unamended versions of the standard.

Revenue recognition for professional services

A draft UITF Abstract 'Revenue recognition and service contracts' was issued for comment at the end of November (see UITF Information Sheet 70). It seeks to clarify how the relevant accounting standards - FRS 5 Application Note G 'Revenue Recognition' and SSAP 9 'Stocks and long-term contracts' - should be applied in accounting for contracts for services, including services rendered by professional service firms (for example, firms of accountants and solicitors).

Specifically, the draft Abstract addresses the following questions:

- (a) In what circumstances should a contract to provide services be accounted for as a long-term contract?
- (b) How should revenue attributable to a contract for services that is accounted for as a long-term contract be determined?
- (c) How should revenue be recognised on contracts for services that are not accounted for as long-term contracts?

The UITF concluded that revenue should be recognised as the seller's performance takes place, whether or not the contract is long-term. Where, as is often the case, the substance of a contract for services is for the supply of time, this will reflect the time spent on the contract. Comments were requested by 11 January.

Waste electrical and electronic equipment

A draft Abstract 'Liabilities arising from Participating in a Specific Market - Waste Electrical and Electronic Equipment' was issued in November (see Information Sheet 69). It is based on a draft IFRIC Interpretation D10 which clarifies when producers of electrical goods should recognise

and IFRIC Update

certain liabilities relating to waste management costs that arise from market share. The relevant UK and international standards, FRS 12 and IAS 37 'Provisions, Contingent Liabilities and Contingent Assets', are virtually identical.

The issue arises in relation to the EU Directive on Waste Electrical and Electronic Equipment, which will make producers responsible for financing the costs of end-of-life decommissioning of waste equipment from private households.

One model for allocating costs will make current producers responsible (rather than the original producers), in proportion to their market share by type of equipment. The draft proposes that the obligating event that gives rise to a liability is participation in the market in a measurement period, rather than the equipment's manufacture or sale. Comments are requested by 11 February.

Emission rights

The IFRIC issued Interpretation IFRIC 3 'Emission Rights' in December. It specifies the accounting for companies participating in 'cap and trade' schemes aimed at reducing greenhouse gas emissions. The UITF concluded, for the reasons explained in Information Sheet 71, that it will not issue a UITF Abstract at this time.

Co-operative entities

The IFRIC issued IFRIC 2 'Members' Shares in Co-operative Entities and Similar Instruments' in November. It gives guidance on the classification of members' shares in co-operative entities (and other instruments that give the holder the right to request redemption) either as financial liabilities or as equity under IAS 32 'Financial Instruments: Disclosure and Presentation'.

IFRIC 2 is similar to the draft Interpretation D8 issued in June, a version of which was issued as a draft UITF Abstract. It is expected that a final Abstract will be issued shortly now that FRS 25 has been issued implementing IAS 32 for entities subject to UK accounting standards.

Rights to 'call' a pension fund deficit

The UITF considered a question on whether rights of pension fund trustees to 'call' a pension fund deficit should be disclosed in a sponsoring entity's accounts. The UITF noted that there could be situations, including a change in control of the sponsor, in which trustees have contingent rights to require revised contributions from the sponsoring entity. In certain circumstances this might give rise to a greater liability than the amount recorded in the balance sheet calculated in accordance with FRS 17 'Retirement Benefits'.

The UITF noted that FRS 17 requires any agreed contribution rates for future years to be disclosed and FRS 12 requires contingent liabilities to be disclosed, unless the possibility of a transfer of economic benefits is remote. If required by FRS 12, an entity should therefore disclose contingent liabilities arising from retirement benefit schemes. In the light of these requirements the UITF decided not to develop an Abstract.

Service concessions

As reported in previous editions of *Inside Track*, IFRIC has been continuing to develop the appropriate accounting for service concession arrangements. This has significant potential implications for the UK, given the scale of Private Finance Initiative (PFI) contracts. IFRIC has now approved for issue, subject to a number of amendments agreed at its December meeting, three draft interpretations:

- *Determining the Accounting Model;*
- *The Financial Asset Model; and*
- *The Intangible Asset Model.*

These will be issued shortly for public comment. IFRIC is proposing that the interpretations should come into effect for accounting periods beginning on or after 1 January 2006.

IFRIC round-up

In December, the IFRIC issued draft Interpretation D11 'Changes in Contributions to Employee Share Purchase Plans' and final Interpretations IFRIC 4 'Determining whether an Arrangement contains a Lease' and IFRIC 5 'Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds'.

D11 clarifies the accounting under IFRS 2 'Share-based Payment' when an employee ceases to contribute to an employee share purchase plan such as a 'Save-As-You-Earn' (SAYE) scheme and, as a consequence, is no longer able to buy shares in the plan. D11 proposes that the employer should account for this event as a cancellation and, therefore, should recognise immediately the amount that otherwise would have been recognised for services received over the remainder of the vesting period. D11 also addresses the situation where an employee changes from one plan to another.

IFRIC 4 provides guidance on identifying leases in arrangements that in substance convey rights to use assets and, therefore, come within the scope of the leasing standard.

IFRIC 5 provides guidance for entities that contribute to funds established to finance future decommissioning liabilities, which includes the recognition of separate assets and liabilities and the treatment of the right to receive reimbursements.

IASB Update

Amendment to IAS 19 issued

In December, the IASB issued an 'Amendment to IAS 19 Employee Benefits: Actuarial Gains and Losses, Group Plans and Disclosures'. The ASB welcomes this amendment, which modifies three aspects of IAS 19, making it more convergent with the UK standard FRS 17. FRS 17 itself came into full effect from 1 January 2005 for UK entities not subject to IFRSs.

The amendment introduces an option allowing companies to bring the full actuarial gain or loss into their financial statements in the period it arises by recognising it outside profit and loss in a new statement entitled the 'statement of recognised income and expense'. For those using the option, the new statement would operate in exactly the same way and include the same items as the UK's statement of total recognised gains and losses. Previously, IAS 19 required such gains and losses to be recognised within profit and loss, whilst permitting a wide range of options regarding the period in which they had to be brought to account; in consequence, nearly all companies chose to spread the gain or loss rather than swamp their reporting of current trading with potentially large and volatile amounts.

In addition, the amendment requires improved disclosures, including many also required by FRS 17, and slightly eases the methods whereby the amounts recognised in the consolidated financial statements have to be allocated to individual group companies for the purposes of their own reporting under IFRSs.

IAS 39 - transition and initial recognition

In December the IASB issued an amendment to IAS 39 'Financial Instruments: Recognition and Measurement' introducing an additional transitional relief that applies on adoption of one aspect of the revised version of this standard issued in December 2003. Under the standard, the fair value of a financial instrument at the date of its acquisition is taken to be the transaction price unless a different value is available based on observable market prices - so in the absence of such prices, no immediate profit ('day one profit') can arise. The new amendment means that no restatement of earlier transactions is required on first applying this prohibition on recognising day one profits; the date from which transactions are restated can be either 1 January 2004, or 25 October 2002 (the effective date of similar requirements in US GAAP, thus allowing entities who also report under US GAAP to adopt the new requirements consistently).

The ASB will consider a corresponding amendment to FRS 26 (IAS 39) 'Financial Instruments: Measurement'; this was issued for exposure in Part 2 of FRED 30 Third Supplement 'Further amendments to the proposed standards on financial instruments' in July 2004.

IASB standard on Extractive Activities

Also in December, the IASB issued IFRS 6 'Exploration for and Evaluation of Mineral Resources' as the first step

of a project to achieve the convergence of widely varying accounting practices for extractive activities around the world. IFRS 6 exempts from certain requirements of IFRSs and the IASB 'Framework for the Preparation and Presentation of Financial Statements' entities that are engaged in the exploration for and evaluation of mineral resources. Thus, an entity adopting IFRS 6 may continue to use the accounting policies applied immediately before adopting the IFRS. This includes continuing to use recognition and measurement practices that are part of those accounting policies.

IFRS 6 requires entities recognising exploration and evaluation assets to perform an impairment test on those assets when facts and circumstances suggest that the carrying amount of the assets may exceed their recoverable amount. The standard also seeks to improve transparency by requiring improved disclosures for exploration and evaluation assets.

IFRS 6 is effective for annual periods ending on or after 1 January 2006. In the UK, guidance on accounting for exploration and evaluation costs is provided for the oil and gas industry in the SORP 'Accounting for Oil and Gas Exploration, Development, Production and Decommissioning Activities' prepared by the Oil and Gas Accounting Committee (OIAC). UK entities adopting IFRSs in 2005 and using the IASB's exemption election will continue to use the accounting policies recommended by the OIAC SORP.

A 'One-Stop Shop' Standard for Smaller Entities

The ASB published on 23 November 2004 an Exposure Draft of an amendment to the Financial Reporting Standard for Smaller Entities (FRSSE). The Exposure Draft is based on the 'one-stop shop' proposals set out in the March 2004 Discussion Paper, which was widely welcomed by respondents, to reflect the accounting requirements of company law. It also ensures that the FRSSE will be kept up-to-date with existing accounting standards.

The recent changes to the 1985 Companies Act affecting small companies' accounts that come into force from 1 January 2005 have been reflected in the Exposure Draft and this has been a driver for proposing an effective date of accounting periods beginning 1 January 2005. These changes include the requirement to show some preference shares as liabilities in the balance sheet rather than as part of share capital and reserves.

For small companies outside of Great Britain the Exposure Draft gives detailed corresponding references to the legal requirements in Northern Ireland and the Republic of Ireland. The accounting requirements derived from the law are distinguished from those derived from accounting pronouncements to assist entities using the FRSSE that are not bound by companies legislation. In incorporating the legal requirements some restrictions are proposed to the accounting options available under the law. These include:

- Alternative accounting treatments such as the valuation of stock at current costs and the revaluation of intangible fixed assets will not be reflected in the updated FRSSE which is consistent with the accounting requirements of the current FRSSE.
- The recently introduced option to fair value financial instruments and other assets will not be incorporated into the FRSSE at this stage.
- Two of the four formats for the profit and loss account will be available in the FRSSE. However, both formats for the balance sheet are permitted although only Format 1 is shown in full in the Exposure Draft.
- The FRSSE will no longer cover the preparation of consolidated financial statements.

In developing the Exposure Draft, the ASB, assisted by its Committee on Accounting for Smaller Entities, considered all the accounting standards and UITF Abstracts issued, or amended, between October 2004 and June 2001 when the last Exposure Draft of amendments to the FRSSE was published. The proposals to amend the FRSSE are as follows:

- The basic principles of FRS 5 Application Note G 'Revenue recognition' will be incorporated into a new section of the FRSSE on revenue recognition together with

specific guidance on 'bill and hold arrangements' and 'sales with rights of return'.

- The text on post balance sheet events will be updated to reflect that used in FRS 21 'Events after the balance sheet date'. The requirements are essentially the same as the superseded SSAP 17 except that dividends declared after the balance sheet date no longer meet the definition of a liability and should not be recognised in the profit and loss account.
- Of recent UITF Abstracts, only UITF 34 'Pre-contract costs' will be reflected in the FRSSE. It deals with the costs incurred in bidding for and securing contracts to supply goods or services. These are increasingly common transactions in the economy as a whole and sufficiently relevant to smaller entities to justify inclusion of guidance in the FRSSE.

The Exposure Draft proposes, for the time being, not to incorporate any requirements from FRS 20 'Share-based payment' which requires an entity to recognise share-based payment transactions (including those with employees or other parties) and the associated assets, liabilities and expenses.

Comments on the Exposure Draft are invited by 22 February 2005.

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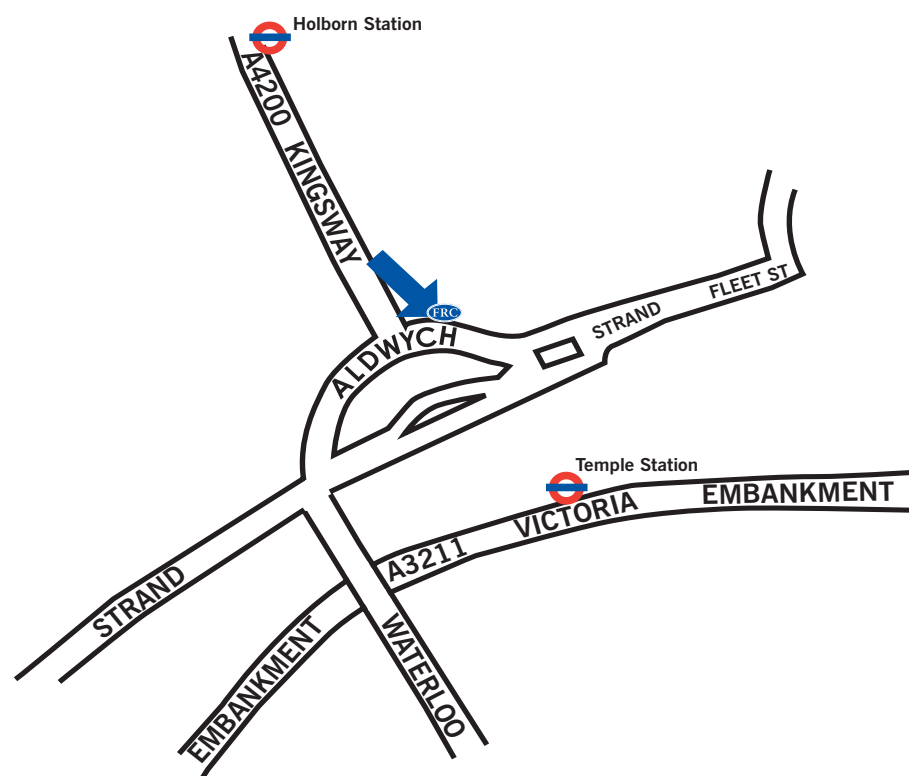
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**ACCOUNTING
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Appointments

John Smith and **Douglas Flint** have stepped down as members of the Board. Their successors have yet to be appointed.

Mike Barnes and **Stephen Burgess** have ceased to be members of the Public Sector and Not-for-Profit Committee. In their place **Steve Warren**, from the Audit Commission, and **Pam Nelson**, Finance Director of London Metropolitan University, have joined the PSNC.