CONTENTS

International Accounting Standards

IAS 1 Presentation of Financial Statements (excluding paragraphs 13 to 35)

1. The current version of IAS 1 was issued in December 2004, replacing the 1997 version of the standard and is applicable to all periods beginning on or after 1 January 2005. This paper excludes from its scope paragraphs 13 to 35 of IAS 1 as these paragraphs will be presented to the Board within the completed Chapter 2 of the IFRS-based FReM. Paragraphs 13 to 35 provide guidance on the overall considerations (materiality, going concern etc) in preparing financial statements.

Objective of IAS 1

2. The objective of IAS 1 is to prescribe the basis for presentation of general purpose financial statements to ensure comparability with the entity's financial statements of previous periods and with the financial statements of other entities.

3. General purpose financial statements are those intended to meet the needs of users who are not in a position to demand reports tailored to their particular information needs.

Main Features of IAS 1

4. A complete set of financial statements comprises:

- a balance sheet;
- an income statement;
- a statement of changes in equity showing either:
    - all changes in equity, or
    - changes in equity other than those arising from transactions with equity holders acting in their capacity as equity holders;
- a cash flow statement; and
- notes, comprising a summary of significant accounting policies and other explanatory notes.

Comparative Information

5. Except when a Standard or an Interpretation permits or requires otherwise, comparative information shall be disclosed in respect of the previous period for all amounts reported in the financial statements. Comparative information shall be included for narrative and descriptive information when it is relevant to an understanding of the current period's financial statements.

6. When the presentation or classification of items in the financial statements is amended, comparative amounts shall be reclassified unless the reclassification is impracticable. When comparative amounts are reclassified, an entity shall disclose:

- the nature of the reclassification;
- the amount of each item or class of items that is reclassified; and
- the reason for the reclassification.

7. When it is impracticable to reclassify comparative amounts, an entity shall disclose:

- the reason for not reclassifying the amounts; and
- the nature of the adjustments that would have been made if the amounts had been reclassified.

Identification of the financial statements

8. The financial statements shall be identified clearly and distinguished from the other information in the same published documents.

9. Each component of the financial statements shall be identified clearly. In addition, the following information shall be displayed prominently, and repeated when it is necessary for a proper understanding of the information presented:

- the name of the reporting entity or other means of identification, and any change in the information from the preceding balance sheet;
- whether the financial statements cover the individual entity or a group of entities;
- the balance sheet date or the period covered by the financial statements, whichever is appropriate to the components of the financial statements;
- the presentation currency, as defined in IAS 21 *The Effects of Changes in Foreign Exchange Rates*; and
- the level of rounding used in presenting amounts in the financial statements.

Reporting Period

10. Financial statements shall be presented at least annually. When an entity's balance sheet date changes and the annual financial statements are presented for a period longer or shorter than one year, an entity shall disclose, in addition to the period covered by the financial statements:

- the reason for using a longer or shorter period; and
- the fact that comparative amounts for the income statement, statement of changes in equity, cash flows statement and related notes are not entirely comparable.

Balance sheet

Current/non-current distinction

11. An entity shall present current and non-current assets, and current and non-current liabilities, as separate classifications on the face of its balance sheet in accordance with IAS 1 except when a presentation based on liquidity provides information that is reliable and is more relevant. When the exception applies, all assets and liabilities shall be presented broadly in order of liquidity.

12. Whichever method of presentation is adopted, for each asset and liability line items that combine amounts expected to be recovered or settled (a) no more than twelve months after the balance sheet date and (b) more than twelve months after the balance sheet date, an entity shall disclose the amount expected to be recovered or settled after more than twelve months.

Current assets

13. An asset shall be classified as current when it satisfies any of the following critera:

- it is expected to be realised in, or is intended for sale or consumption in, the entity's normal operating cycle;
- it is held primarily for the purpose of being traded;
- it is expected to be realised within twelve months after the balance sheet date; or
- it is cash or a cash equivalent (as defined in IAS 7 *Cash Flow Statements*) unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the balance sheet date.

All other assets shall be classified as non current.

Current Liabilities

14. A liability shall be classified as current when it satisfies any of the following criteria:

- it is expected to be settled in the entity's normal operating cycle;
- it is held primarily for the purpose of being traded;
- it is due to be settled within twelve months after the balance sheet date; or
- the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the balance sheet date

All other liabilities shall be classified as non-current.

15. The face of the balance sheet shall include line items that present the following amounts:

- the total assets classified as held for sale and assets included in disposal groups classified as held for sale, in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*; and

- liabilities included in disposal groups classified as held for sale in accordance with IFRS 5.

Annex B provides details of the minimum presentation required by IAS 1 on the face of the balance sheet.

16. Additional line items, headings and subtotals shall be presented on the face of balance sheet when such presentation is relevant to an understanding of the entity's financial position.

Information to be presented either on the face of the balance sheet or in the notes

17. An entity shall disclose, either on the face of the balance sheet or in the notes, a further sub-classification of the lines presented, classified in a manner appropriate to the entity's operations.

Income Statement

18. All items of income and expense recognised in a period shall be included in profit and loss unless a Standard or an Interpretation requires otherwise. Annex C provides details of the minimum presentation required by IAS 1 on the face of the income statement.

19. Additional items, headings and subtotals shall be presented on the face of the income statement when such presentation is relevant to an understanding of the entity's financial performance.

20. An entity shall not present any items of income and expense as extraordinary items, either on the face of the income statement or in the notes.

21. When items of income and expense are material, their nature and amount shall be disclosed separately.

22. An entity shall present an analysis of expenses using a classification based on either the nature of the expense or their function within the entity, whichever provides the information that is reliable and more relevant.

Statement of changes in equity

23. An entity shall present a statement of changes in equity, showing on the face of the statement:

- profit or loss for the period

- each item of income and expense for the period that, as required by other Standards or by Interpretations, is to be recognised directly in equity, and the total of these items;

- total income and expense for the period showing separately the total amounts attributable to equity holders of the parent and to minority interest; and

- for each component of equity, the effects of changes in accounting policies and corrections of errors recognised in accordance with IAS 8.

A statement of changes in equity that comprises only these items shall be titled a statement of recognised income and expense.

24. An entity shall also present, either on the face of the statement of changes in equity or in the notes:

- the amount of transactions with equity holders acting in their capacity as equity holders, showing separately distributions to equity holders;

- the balance of retained earnings (i.e. accumulated profit or loss) at the beginning of the period and at the balance sheet date, and the changes during the period; and

- a reconciliation between the carrying amount of each class of contributed equity and each reserve at the beginning and end of the period, separately disclosing each change.

Notes

25. The notes shall:

- present information about the basis of preparation of the financial statements and the specific accounting policies in this standard;

- disclose the information required by IFRSs that is not presented on the face of the balance sheet, income statement, statement of changes in equity or cash flow statement;

- provide additional information that is not presented on the face of the balance sheet, income statement, statement of changes in equity or cash flow statement, but is relevant to an understanding of any of them; and

- disclose information that enables users of financial statements to evaluate the reporting entity's objectives, policies and processes for managing capital.

26. Notes shall, as far as practicable, be presented in a systematic manner. Each item on the face of the balance sheet, income statement, statement of changes in equity and cash flow statement shall be cross-referenced to any related information in the notes.

Disclosure of Accounting Policies

27. An entity shall disclose in the summary of significant accounting policies:

- the measurement basis (or bases) used in preparing the financial statements; and

- the other accounting policies used that are relevant to an understanding of the financial statements.

28. An entity shall disclose, in the summary of significant accounting policies or other notes, the judgements, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

Key Sources of Estimation Uncertainty

29. An entity shall disclose in the notes information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing a material adjustment to the carrying amounts of the assets and liabilities within the next financial year. In respect of those assets and liabilities the notes shall include details of:

- their name; and

- their carrying amount as at the balance sheet date.

Capital

30. A number of disclosures are required, including of:

- Qualitative information about objectives, policies and processes for managing capital, including (but not limited to) a description of:

    - what the entity manages as capital; and

    - any externally imposed capital requirements and now they are incorporated into the management of capital;

- Summary quantitative data about what the entity manages as capital; and

- Whether the entity has complied with any externally imposed capital requirements to which the entity is subject.

Comparison with UK GAAP

31. The subject matter in IAS 1 (excluding paragraphs 13 to 35) is covered by the following sources in the UK; guidance on the format and contents of financial statements is provided by the Companies Act 1985 and FRS 3, guidance on Corresponding Amounts is provided by FRS 28 *Corresponding Amounts*.

32. The components of financial statements are broadly the same under UK GAAP (Companies Act and FRS 3) as they are under IAS 1. A minor difference exists in that movements in reserves (equity) could be included as part of the statement of changes in equity under IAS 1 and therefore as part of the main statement whereas under UK GAAP (FRS 3) this information would be provided in a note to the Statement of Total Recognised Gain and Losses.

Format of Financial Statements

33. The contents of the Balance Sheet and Income Statement as required by IAS 1 are similar to that required by the Companies Act 1985 (there are some differences due to differing terminology and recognition requirements e.g. under IAS 41 *Agriculture* biological assets are separately recognised on the face of the balance sheet). The Companies Act 2006 will supersede the Companies Act 1985 (probably in 2008). Schedule 4 of the 1985 act provides formats for the Balance Sheet and Profit and Loss Account. These formats are not provided in the 2006 Act but will be given in separate regulations. At the time of writing such regulations had not been issued by the Secretary of State, however we understand that these regulations will largely replicate the formats in the 1985 Act for entities using UK GAAP while those using International GAAP will be referred to IAS 1. Therefore references to the Companies Act in this paper refer to the 1985 act, unless otherwise stated.

Balance Sheet

34. IAS 1 is less prescriptive as to the format of the balance sheet than is the Companies Act. IAS 1 only requires that current and non-current assets are separately classified on the face of the balance sheet and even this requirement is waved where a presentation based on liquidity is used on the grounds that it provides information that is reliable and more relevant (than a presentation that is not based on liquidity). IAS 1 does not prescribe the order of items to be presented in the balance sheet, the standard only requiring that aggregation and presentation is such that the information within the balance sheet provides an understanding of the entity's financial position.

Income Statements

35. IAS 1 is also less prescriptive than is the Companies Act as to the format and content of the income statement. IAS 1 provides details of the minimum presentation; the descriptions and ordering can be amended when necessary to explain the elements of financial performance.

36. Like FRS 3, IAS 1 effectively outlaws extraordinary items while allowing entities to present exceptional items (although IAS 1 doesn't use the term exceptional) on the face of the income statement.

Statement of Changes in Equity

37. The statement of changes in equity required by IAS 1 provides the same information as that provided in the Statement of Total Recognised Gains and Losses (STRGL). However, the example in the Implementation Guidance accompanying IAS 1 shows the movement for each component of equity on the face the statement, this differs to the example given in FRS 3 where the movements on components of equity are shown in the notes.

38. IAS 1 provides some flexibility as to the presentation of the statement that is not provided in FRS 3. Entities can provide a single combined statement (combining changes in equity with recognised gains and losses) entitled a Statement of Changes in Equity or they can provide a Statement of Recognised Income and Expense which provides the same detail as the STRGL with details of changes in equity (reserves) shown in the notes.

Notes

39. IAS 1 is less prescriptive than is the Companies Act. The Companies Act details the specific notes required for the balance sheet and profit and loss account. In contrast IAS 1 states that notes are provided, where required, by specific IFRS or to provide additional information not present on the face of the balance sheet or income statement.

Capital

40. FRS 29 incorporates IAS 1's capital disclosure requirements into UK GAAP and is applied by entities subject to the requirements of FRSs 25, 26 and 29.

Comparative Amounts

41. In UK GAAP, FRS 28 *Corresponding Amounts* provides guidance on comparative information. FRS 28 provides much the same guidance as provided in the relevant sections of IAS 1 but with some minor differences.

42. IAS 1 applies to all amounts in the financial statements except where a Standard or Interpretation permits otherwise and includes narrative and descriptive information when this is relevant to the understanding of the financial statements. In contrast FRS 28 outlines those specific components of the financial statements for which corresponding amounts need not be provided and contains no requirements to provide comparative information relating to descriptive items.

43. Where it is necessary to reclassify comparative amounts but impractical to do so IAS 1 provides entities with the option not to reclassify. No such option is provided in FRS 28.

Reporting Period

44. Guidance on reporting periods is contained in the Companies Act. The requirements are broadly the same as those in IAS 1.

Impact of IAS 1 on Public Sector Accounts

45. In the current version of the FReM, Chapter 7 deals with the financial statement presentation and corresponding amounts.

Presentation of Financial Statements

46. In the public sector NDPBs and Trading Funds prepare income statements (income and expenditure or profit and loss account) in accordance with either format 1 or 2 of the Companies Act. Government departments and executive agencies are required to prepare an Operating Cost Statement, which is an adaptation of the Companies Act format.

47. It is proposed that NDPBs and Trading Funds will apply the income statement requirements of IAS 1 in full.

48. The operating cost statement format recognises the lack of a profit motive in the public sector. It is proposed that this adaptation be retained but given the greater flexibility within IAS 1 (as compared to the Companies Act). It should be reflected as an interpretation in the IFRS-based FReM.

49. The FReM requires all entities to apply Companies Act balance sheet format 1 but that capital and reserves should reflect the circumstances of the individual entity.

50. It is proposed that the requirements of IAS 1 be interpreted for the public sector so as to remove the flexibility to prepare a balance sheet in any format or to show assets and liabilities in order of liquidity and that the requirement that capital should reflect the circumstances of the individual entity be retained. For reasons of comparability across the public sector, the FReM should provide a definitive format that will present assets and liabilities in the appropriate current or non-current categories.

51. This proposal was put to public sector bodies as part of the RABIG consultation for this FRAB paper. Three balance sheet format options were provided all of which were within the spirit of IAS 1. The vast majority of respondents preferred the option based on the existing format and it is this format, which is therefore proposed in this paper.

52. For the majority of public sector bodies, presentation based on liquidity will not provide more relevant information. Where departments believe that an alternative balance sheet format should be employed, which may or may not be one based on liquidity, they will need to discuss the reason why they believe this to be the case with the relevant authority.

53. The FReM interprets FRS 3 for those entities that do not have a financial objective of full cost recovery (i.e. their activities are financed by Vote). These entities should not include such voted expenditure in the STRGL and the statement should itself be entitled a Statement of Recognised Gains and Losses (SRGL). The FReM requires that movements in the donated asset and government grant reserve should be taken to the STRGL (or SRGL).

54. The FReM also contains an interpretation in relation to profits on disposal of an asset. Such a profit can be accounted for as negative expenditure to the extent that it represents a final adjustment of depreciation. Where this is not the case profits should be accounted for as income. This interpretation would seem to relate to the OCS rather than the STRGL.

55. It is proposed to interpret the IAS 1 Statement of Changes in Equity (Reserves) requirements. All entities will present a Statement of Changes in Equity. The option of providing a Statement of Recognised Income and Expenses with details of reserve movements in the notes is withdrawn. Entities that are supply financed will in future include supply financing and net operating cost in the Statement of Changes in Equity (reserves) within the section of the statement showing transactions with equity holders.

56. Draft 'Department Yellow' style financial statements are provided at Annexes A, D and E of FRAB (86)03.

Identification of Financial Statement and Reporting Period

57. It is proposed that the requirements of IAS 1 are adopted in full.

Comparative Information

58. The FReM interprets FRS 28; the decision as to whether corresponding information should be disclosed in respect of amounts specific to government departments (e.g.

information on the Statement of Parliamentary Supply) will be taken on a case by case basis and will be shown in the pro-forma Department Yellow.

59. It is proposed to retain the existing interpretation but otherwise to apply the IAS 1 comparative information requirements in full. This will extend the existing requirement so as to provide comparative information for relevant narrative information while also allowing entities to not adjust comparatives where it is impractical to do so.

Impact on disclosures in resource and other accounts

60. IAS 1 requires an entity to disclose information that enables users of its financial statements to evaluate the entity's objectives, policies and processes for managing capital. 'Capital' is an undefined term in IFRS. Indeed, an entity is required to disclose what it means by the term 'capital'. The examples provided in IAS 1 indicate that 'capital' is primarily an entity's equity resources or the buffer that is available to absorb losses before creditors are exposed to such risk.

61. The financing of entities covered by the FReM generally is ultimately tax-based and an IAS 1 based notion of capital does not apply to most of them. It is proposed that capital disclosures should be given only with the agreement of the relevant authority.

62. There is no further impact on resource or other accounts.

IAS 2 Inventories

63. IAS 2 *Inventories* was issued so as to be effective for all periods beginning on or after 1 January 2005 replacing the 1993 version (revised) of the standard.

Objective of IAS 2

64. The objective of the standard is to prescribe the accounting treatment for inventories. IAS 2 provides guidance on the determination of cost and its subsequent recognition as an expense, including any write-down to net realisable value. It also provides guidance on the formulas that are used to assign costs to inventories.

Main features of IAS 2

65. The Main features of IAS 2 are:

a) Inventories shall be measured at the lower of cost and net realisable value.

b) Cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

66. IAS 2 does **not** apply to the following inventory assets which are covered by other standards:

- work in progress under construction contracts.
- financial instruments.
- biological assets related to agricultural activity and agricultural produce at the point of harvest.

67. IAS 2 does also **not** apply to the measurement of inventories held by:

- producers of agricultural and forestry products, agricultural produce after harvest and minerals and mineral products, to the extent that they are measured at net realisable value in accordance with well-established practices in those industries.
- commodity broker-traders who measure their inventories at fair value less cost to sell.

Comparison with requirements of UK GAAP

68. IAS 23 *Borrowing Costs* allows for borrowing costs to be included in the cost of inventories in certain circumstances. SSAP 9 *Stocks and Long-term Contracts* is silent on the issue of borrowing and finance costs. IAS 23 will be the subject of a separate FRAB paper.

69. IAS 2 is more prescriptive than is SSAP 9 of the formulas entities can employ to arrive at the cost value for high volume interchangeable items. IAS 2 only allows for use of the first-in, first–out (FIFO) and the weighted average cost methods. No such restrictions exist in SSAP 9, although the use of last-in, first-out (LIFO) is not encouraged.

70. IAS 2 addresses the reversal of write-downs of inventory to net realisable value. IAS 2 requires that such reversals should be recognised as a reduction in the inventory expense (cost of sales) during the period. SSAP 9 is silent on this issue.

71. SSAP 9 includes long-term contract balances as a category of stock. IAS 2 excludes long-term contracts from its scope as IAS 11 *Construction Contracts* deals with the balance sheet treatment of construction costs, while IAS 18 *Revenue* covers long-term service contracts.

Impact of IAS 2 on the public sector

72. The accounting treatment of inventories under IAS 2 is virtually the same as that under SSAP 9. As such the application of IAS 2 will not result in a material change in the method of accounting for inventories in the public sector.

Impact on disclosures in resource and other accounts

73. The disclosure requirements in IAS 2 are far more detailed than those in SSAP 9. SSAP 9 only requires that the sub categories of stock are shown in the balance sheet (or the notes) and that narrative of the accounting policies and the method of valuation is provided. IAS 9 additionally requires disclosure of:

- the carrying amount of inventories carried at fair value less cost to sell.
- the amount of inventories recognised as an expense during the period.
- the amount of any write-down recognised as an expense in the period.
- the amount of any reversals of such write-downs.
- the circumstances or events that led to the reversal of the write-down.
- the carrying amount of inventories pledged as security for liabilities

IAS 7 Cash Flow Statements

74. IAS 7 was originally issued in 1977 but subject to amendment in 1993, the amended text being effective for all periods beginning on or after 1 January 1994. The standard was subject to further minor amendment in 2005 to incorporate changes made to the standard as a result of the IASB's 'improvements' project.

Objective of IAS 7

75. The objective of the standard is to require the provision of information about the historical change in cash and cash equivalents of an entity by means of a cash flow statement that classifies cash flows during the period from operating, investing and financing activities.

76. Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value.

Main Features of IAS 7

77. The main features of IAS 7 are:

- an entity shall prepare a cash flow statement in accordance with the requirements of the standard and shall present it as an integral part of its financial statements for each period for which financial statements are presented; and

- the cash flow statement shall report cash flows during the period classified by operating, investing and financing activities.

Operating Activities

78. Operating activities are the principal revenue producing activities of the entity.

79. Cash flows from operating activities shall be reported on either a direct or indirect basis. Under the direct method the major classes of gross cash receipts and payments are disclosed, whereas under the indirect method the profit or loss for the period is adjusted for transactions of a non-cash nature or income or expenditure associated with investing or financing cash flows.

Investing Activities

80. Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

81. All major classes of gross investing receipts and payments shall be disclosed separately.

Financing Activities

82. Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

83. All major classes of gross financing receipts and payments shall be disclosed separately.

Net Basis

84. The following cash flows may be reported on a net basis;

- cash receipts and payments on behalf of customers where the cash flows reflect the activities of the customer (e.g. funds held for customers by an investment entity); and

- cash receipts and payments for items in which the turnover is quick, the amounts are large and the maturities are short (e.g. the purchase and sale of investments).

Foreign Currency Cash Flows

85. Cash flows in foreign currency shall be reported in the functional currency using the exchange rate at the date of cash flow in line with IAS 21 *The Effect of Changes in Foreign Exchange Rates*.

86. Cash flows of a foreign subsidiary shall be translated using the exchange rate at the date of the cash flow again in line with IAS 21.

Interest and Dividends

87. Cash flows from interest and dividends received and paid shall be disclosed separately and consistently classified from one period to another as either operating, investing or financing.

Taxes on Income

88. Cash flows arising from taxes on income shall be separately disclosed and classified to operating activities, unless they can be identified specifically with financing or investing activities.

Acquisitions and Disposals of Subsidiary Undertakings or Other Business Units

89. The aggregate cash flows from acquisitions and disposals of subsidiaries or other business units shall be presented separately and classified as investing activities.

90. The following disclosures should be made in respect of both acquisitions and disposals;

- the total purchase or disposal consideration;

- the portion of the purchase or disposal consideration discharged by cash and cash equivalents;
- the amount of cash and cash equivalents in the subsidiary or business unit acquired or disposed of; and
- the amount of the assets and liabilities other than cash or cash equivalents in the subsidiary or business unit acquired or disposed of, summarised by each major category.

Non-cash transactions

91. Investing or financing transactions that do not require the use of cash or cash equivalent shall be excluded from the cash flow statement but shall be fully disclosed elsewhere in the financial statements.

Components of Cash and Cash Equivalents

92. An entity shall disclose the components of cash and cash equivalents and shall present a reconciliation of the amounts in its cash flow statement with the equivalent items in the balance sheet.

Additional Disclosures

93. An entity shall disclose, with suitable commentary, the amount of significant cash and cash equivalent balances held but not available for use by the group.

Comparison with UK GAAP

94. In the UK coverage is provided in FRS 1 *Cash Flow Statements*. There are several differences in approach between IAS 7 and FRS 1, the most notable of which being that IAS 7 seeks to show the generation and utilisation of cash and cash equivalents whereas FRS 1 concentrates on cash only.

95. Under IAS 7 entities classify cash flows to the relatively wide categories of operating, investing and financing activities. FRS 1 requires cash flows to be classified to one of the following nine categories;

- Operating activities
- Dividends from joint ventures and associates
- Return on investment and serving of finance
- Taxation
- Capital expenditure and financial investment
- Acquisitions and disposals
- Equity dividends paid

- Management of liquid resources
- Financing

96. There are similarities between the FRS 1 definition of 'management of liquid resources' and the IAS 7 definition 'cash equivalents'. However, the two standards treat investments that can be quickly converted into cash very differently. FRS 1 treats such items as one of the categories explaining how cash has been used within the entity while IAS 7 treat such items as analogous to cash.

97. FRS 1 excludes from its scope certain entities (e.g. mutual life assurance companies, pension funds, small entities as defined by the companies act), IAS 7 contains no similar exemptions.

98. The rules pertaining to netting differ. Both IAS 7 and FRS 1 allow cash flows to be reported on a net basis where they relate to quick turnover transactions where the amounts are large and the maturities short. IAS 7 additionally allows net cash flows to be reported where receipts and payments on behalf of customers reflect the activities of the customer rather than the entity. FRS 1 allows net cash flows to be reported for single financial transactions that fulfil the capital instrument requirements of FRS 4 (although much of FRS 4 has recently been withdrawn and replaced with FRS 25 *Financial Instruments: Disclosure and Presentation* and FRS 26 *Financial Instruments: Measurement*).

99. FRS 1 requires hedging transactions to be reported within the same category as the hedged transaction. IAS 7 contains no similar requirement suggesting that hedging transactions should be disaggregated from for the hedged transaction where the cash flows would fall within different categories on the face of the Cash Flow Statement.

100. There are minor presentational differences between the two standards: under IAS 7 it is expected that material components within each category will be presented on the face of the Cash Flow Statement, whereas under FRS 1 the material components are detailed in the notes to the cash flow and only exceptional items are reported on the face of the statement.

101. FRS 1 requires entities to provide a reconciliation of the movement of cash to the movement in net debt. There is no similar requirement in IAS 7.

Impact of IAS 7 on public sector accounts

102. The FReM adapts FRS 1 for departments covering the whole of the UK and departments covering England and Northern Ireland requiring cash flows to be categorised in the following headings;

a) Net cash flows from operating activities

b) Capital expenditure and financial investment

c) Receipts due to the consolidated fund which are outside the scope of the department's activities

d) Payments of amounts due to the consolidated fund

e) Financing

103. This adaptation requires such departments to produce a cash flow statement similar to that required by IAS 7 with additional line items to capture transactions with the consolidated fund. Items a), b) and e) above being similar to the IAS 7 categories of operating, investing and financing. All other bodies, not having such consolidated fund transactions, are required to apply FRS 1 in full.

104. The current FReM also contains three further adaptations requiring departments to adjust the cash flow statements for debtors and creditors. Of the three only the first really merits adaptation status and then only inasmuch as it remind entities to exclude balances with the Consolidated Fund and Notional Loans Fund from the reconciliation of operating costs to operating cash flows. All the remaining adaptations concern adjustments that would be required to any cash flow statements and are as such downgraded to ‘other relevant information’.

105. There is one final adaptation in the current FReM that removes the FRS 1 requirement to reconcile net cash flow to net debt. As detailed above IAS 7 contains no similar requirement.

Proposed Treatment of IAS 7 for the public sector

106. As part of the RABIG consultation on this FRAB paper entities were asked to provide their view on two cash flow statement format, the first following the IAS 7 format and is thus similar to that required by the current FReM, the second which rather than reconciling net cash flows to bank reconciled net operating costs to the net cash requirement. The purpose of the second format being to show the linkage between these two important figures in the resource accounts and to provide information that was most relevant to the sector. The vast majority of respondents to the RABIG paper favoured the IAS 7 format and it is this format that is presented in this paper.

107. So that the cash flow statement better follows the IAS 7 format the consolidated fund adjustments as required for department covering the whole of the UK and departments covering England and Northern Ireland have been moved to the end of the statement.

Impact on disclosures in resource and other accounts

108. There is no further impact on disclosures than as already detailed in this paper.

<u>IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors</u>

Objective of IAS 8

109. The objective of the Standard is to prescribe the criteria for selecting and changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting treatment and correction of errors.

Main features of IAS 8

110. The Standard has three main sections: Accounting Policies, Changes in Accounting Estimates, and Errors. The main features of each are considered in turn.

Accounting Policies

111. Where a transaction, event or condition falls within a Standard or Interpretation issued by the IASB the accounting policy or policies applied to that item shall be determined by applying the Standard or Interpretation and considering any relevant Implementation Guidance.

112. In the absence of a Standard or Interpretation that specifically applies to a transaction, event or condition judgement should be used to develop an accounting policy that is relevant and reliable.

113. In making the judgement necessary to develop an accounting policy that is relevant and reliable consideration should be given to the requirements and guidance in Standards and Interpretations dealing with similar and related issues; and the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the IASB's *Framework for the Preparation and Presentation of Financial Statements*.

114. In making the judgement described above consideration may also be given to the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to that of the IASB to develop accounting standards.

115. Entities shall select and apply accounting policies consistently.

116. Entities shall change accounting policies only if the change is required by a Standard or Interpretation or results in financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

117. The application of an accounting policy for transactions that differ in substance from previous transactions or the application of a new accounting policy for transactions that have not previously occurred (or were not previously material) are not changes in accounting policy.

118. Where a change in accounting policy results from the initial application of a Standard or Interpretation the change should be accounted for using the specific transitional provisions in the Standard or Interpretation. Where a Standard or

Interpretation includes no transitional provisions or a change is made voluntarily it shall be applied retrospectively.

119. A change in accounting policy is applied retrospectively by adjusting the opening balance of each affected component of equity (reserves) for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied.

120. A change in accounting policy should be applied retrospectively except where it is impracticable to determine the period specific events or the cumulative effect of the change. Where it is impracticable to determine period specific events or the cumulative effect the new accounting policy should be applied as at the beginning of the earliest practicable accounting period, which may be the existing period. Where it is not practicable to effect the new accounting policy retrospectively it should be applied prospectively from the earliest date practicable.

Changes in Accounting Estimates

121. A change in an accounting estimate shall be recognised prospectively by including it in the profit or loss in the period of the change and future periods, as appropriate, or to the extent that a change in estimates gives rise to a change in assets, liabilities or equity it should be recognised by adjusting the relevant carrying amount.

Errors

122. Entities shall correct all material prior period errors retrospectively except where it is impracticable to determine the period specific events or the cumulative effect of the change (the rules on impracticability being the same as those relating to the retrospective application of changes in accounting policy).

Comparison with requirements of UK GAAP

123. The guidance contained in IAS 8 is provided across 2 UK standards, FRS 18 *Accounting Policies* and FRS 3 *Reporting Financial Performance*, which, amongst other things, provides guidance on prior period adjustments. The requirements of IAS 8 are similar to those of the relevant extracts of FRS 18 and FRS 3 but with the following differences:

124. IAS 8 provides detailed guidance on the circumstances under which retrospective application of changes in accounting policies or the correction of errors is impracticable (which the Standard refers to as the 'impracticability criterion'). Similar guidance is not provided in FRS 3.

125. FRS 3 requires that prior period adjustments are only made for accounting policy changes and fundamental errors. The requirements of IAS 8 are similar in respect of accounting policy changes but in relation to errors the requirement is that all material errors are retrospectively corrected. FRS 3 defines a fundamental error as being of such significance as to destroy the true and fair view of the financial statements. IAS 8 states errors are material if they could individually or collectively influence the economic decisions of users. IAS 8 would therefore appear to set a lower threshold for the correction of prior period errors than does FRS 3.

126. The process for determining accounting policies in IAS 8 is broadly the same as in FRS 18. However, FRS 18 provides greater guidance on the objectives against which the appropriateness of accounting policies should be judged than that given in IAS 8. FRS 18 additionally requires that comparability and understandability are taken into account, however both concepts are key components of the Qualitative Characteristics of Financial Statements section of the IASB's Framework for the Preparation and Presentation of Financial Statements.

127. FRS 18 states that 'going concern' and 'accruals' have a pervasive role in financial statements and hence the selection of accounting policies. This direct linkage of these concepts with accounting policies does not form part of IAS 8. The IASB cover these concepts in IAS 1 *Presentation of Financial Statements* as part of its discussion of the 'overall considerations' when preparing financial statements.

128. In the absence of a Standard or Interpretation that specifically applies to a transaction, event or condition, in addition to considering the requirements and guidance given in Standards and Interpretations dealing with similar and related issues, IAS 8 allows entities to consider the pronouncements of other standard setters where these do not conflict with International Standards or Interpretations. There is no similar allowance in FRS 18.

129. IAS 8 states than when it is difficult to distinguish a change in accounting policy from a change in accounting estimate, it is treated as a change in an accounting estimate. FRS 18 makes no similar statement.

Impact of IAS 8 on public sector accounts

130. The differences between IAS 8 and the relevant parts of FRS 3 and FRS 18 are not great and have little practical effect on the underlying accounting.

131. The FReM requires (at 7.4.18) that where entities need to make prior period adjustments they should contact the relevant authority to ensure that the budgeting implications have been properly considered. As IAS may result in an increase in prior period adjustments due to the lower threshold set by IAS 8 for such adjustments when compared to FRS 3 (material rather than fundamental errors), this requirement should be retained.

Impact on disclosures in resource and other accounts

132. The disclosure requirements of IAS 8 are similar to the relevant disclosure requirements of FRS 3 and FRS 18. However, IAS 8 requires the disclosure of impending changes in accounting policy with an estimate of the impact of the change. IAS 8 also requires detailed disclosure of the result of changes in accounting policy and corrections of errors on financial statement line items.

IAS 10 Events after the balance sheet date

133. IAS 10 was adopted into UK GAAP by FRS 21, and there are no differences to discuss.

IAS 11: Construction Contracts

134. IAS 11 *Construction Contracts* was issued so as to be effective for all periods beginning on or after 1 January 1995. It was subject to minor revision in May 1999 to incorporate changes stemming from the revision of IAS 10 *Events After the Balance Sheets Date*.

Objective of IAS 11

135. The objective of the standard is to prescribe the accounting treatment of revenue and costs associated with constructions contracts as such contracts tend to have start and finish dates that fall in different accounting periods.

Main features of IAS 11

136. The main features of IAS 11 are:

a. Contract revenues comprise the initial amount of revenue agreed in the contract, variations in contract work and claims and incentives to the extent that it is probable that they will result in revenue and are capable of being reliably measured.

b. Contract costs comprise those costs that relate directly to the specific contract, costs that are attributable to the contract activity and can be allocated to the contract and such other costs as are specifically chargeable to the customer under the terms of the contract.

c. When the outcome of the construction contract can be estimated reliably contract revenue and contract costs associated with the construction contract shall be recognised as revenue and expense respectively by reference to the stage of completion of the contract activity at the balance sheet date. An expected loss on the construction contract shall be recognised as an expense immediately.

d. When the outcome of a construction contract cannot be estimated reliably revenue shall be recognised only to the extent of the contract costs incurred that it is probable will be recoverable. Contract costs shall be recognised as an expense in the period in which they are incurred.

Comparison with requirements of UK GAAP

137. IAS 11 does not cover the accounting treatment of long–term service contracts whereas SSAP 9 *Stocks and Long-term Contracts* does cover such contracts. IAS 18 *Revenue* deals with the accounting treatment of long-term service contracts. IAS 18 will be the subject of a separate FRAB paper.

Impact of IAS 11 on public sector accounts

138. The accounting treatment of construction contracts under IAS 11 is virtually the same as that under SSAP 9 (augmented by Application Note G of FRS 5 *Substance of*

Transactions). As such the application of IAS 11 will not result in any change in the method of accounting for such contracts in the public sector.

139. There is a minor consequently change in the application of the modified historical cost accounting convention to construction costs. Under SSAP 9 work in progress balances are recognised as stocks. The existing FReM 2.1.5 *Accounting Conventions* requires that stocks are held at current values. Under IAS 11 no work in progress is recognised, IAS 11 instead recognises the gross amount owed to or from the customer in the appropriate asset or liability category. Within the existing FReM there is no requirement to hold such balances at current value.

Impact on disclosures in resource and other accounts

140. The balance sheet presentation requirements of IAS 11 differ to those of SSAP 9. IAS 11 requires those items which have yet to pass through the operating statement to be shown in the balance sheet as:

- Advances, amounts received in excess of that billed.
- Due from customers, the aggregate of all contracts where amounts are owed by customers (excluding advances).
- Due to customers, the aggregate of all contracts where amounts are owed to customers (excluding advances).

Whereas SSAP 9 requires that the following items are shown in the balance sheet:

- Debtors, amounts included in turnover but not billed.
- Creditors, payments on account in excess of turnover less WIP.
- WIP, the amount by which costs incurred exceeds those taken to cost of sales and not off set against creditors.
- Provisions for foreseeable losses.

IAS 12: Income Taxes

141. IAS 12 *Income Taxes* prescribes the accounting treatment for income taxes and is applicable for periods beginning on or after 1 January 1998. The Standing Interpretation Committee (SIC) of the International Accounting Standards Board (IASB) has issued two Interpretations relating to IAS 12, SIC-21 *Income Taxes – Recovery of Revalued Non-Depreciable Assets* and SIC 25 *Income Taxes – Changes in the tax status of an entity or its shareholders.* Both are effective from 15 July 2000. Income taxes are also the subject of a short-term project currently under way by the IASB and the US Financial Accounting Standards Board (FASB), aimed at reducing the differences between IFRS and US Statements of Financial Accounting Standards (SFAS). IAS 12 achieves significant convergence with the requirements of SFAS 144; however, differences arise because both Standards have numerous exceptions to the basic principle. The IASB's approach to convergence is not to reconsider the underlying approach, but rather to eliminate exceptions to the basic principle. A joint exposure draft was expected in early 2006, but a presentation to the ASB on 20 April 2006 confirmed that the timetable has slipped and a draft is unlikely to appear until later this year.

142. Current UK GAAP is enshrined in Financial Reporting Standard (FRS) 16 *Current Tax,* effective for accounting periods ending on or after 23 March 2000 and FRS 19 *Deferred Tax,* effective for accounting periods ending on or after 23 January 2002.

The main features of IAS 12

143. IAS 12 prescribes the accounting treatment for income taxes, that is, taxes that are based on taxable profit. Income taxes include all domestic and foreign income taxes including foreign withholding taxes payable by a subsidiary, associate or joint venture on distributions to the reporting entity. Therefore, the standard applies to UK corporation tax that is assessed on an entity's profits. IAS 12 deals with:

a. Current tax consequences of transactions and other events that give rise to current tax assets and liabilities, and

b. Future tax consequences of transactions and other events that give rise to deferred tax assets and liabilities.

144. Current tax for the current and prior periods should, to the extent unpaid, be recognised as a liability. It should be recognised as an asset to the extent that the amounts already paid exceed the amount due. The benefit of a tax loss, which can be carried back to recover current tax of a prior period, should be recognised as an asset. Current tax assets and liabilities for the present and prior periods should be measured at the amount expected to be paid to, or recovered from, the taxation authorities, at the tax rates applying at the balance sheet date.

145. Deferred tax liabilities should be recognised in full for all taxable temporary differences, except for liabilities arising from:

a. The initial recognition of goodwill;

b. A transaction which

i. is not a business combination, and

ii. at the time of the transaction, affects neither accounting profit nor taxable profit;

c. Temporary differences arising on investments in subsidiaries, branches and joint ventures if the entity is able to control the timing of the reversal of the difference, and it is probable that the temporary difference will not reverse in the future.

146. A deferred tax asset is recognised only to the extent that it is probable that a tax benefit will be realised in the future. If it is probable that a tax benefit will be realised, a deferred tax asset is recognised on unused tax losses and unused tax credits.

The main features of SIC 21 – Recovery of Revalued Non-Depreciable Assets

147. IAS 12.20 notes that the revaluation of an asset does not always affect taxable profit in the period of the revaluation and that the tax base of an asset may not be adjusted as a result of the revaluation. If the future recovery of the carrying amount is taxable, any difference between the carrying amount of the revalued asset and its tax base is a temporary difference and gives rise to a deferred tax liability or asset. SIC 21 addresses the issue of how the term "recovery" is interpreted in relation to an asset that is not depreciated and is revalued in accordance with IAS 16 *Property, Plant and Equipment.* SIC 21 also applies to investment properties that are revalued under IAS 40 *Investment Property* but would be considered non-depreciable if IAS 16 were applied (e.g. land).

148. The consensus is that as the asset is not depreciated, recovery of the carrying amount will be through sale rather than through use.

The main features of SIC 25 – Changes in the Tax Status of an Entity or its Shareholders

149. SIC 25 addresses the issue of how an entity accounts for the tax consequences of a change in its tax status or that of its shareholders. The consensus is that a change in the tax status of an entity or its shareholders does not give rise to increases or decreases in amounts recognised directly in equity and the current and deferred tax consequences of a change in tax status are included in profit or loss for the period.

Comparison with requirements under UK GAAP

150. IAS 12 deals with both current and deferred taxes. The rules in respect of current taxes are similar to those of FRS 16, although there are presentational differences. IAS 12 requires current tax to be presented on the face of the balance sheet (there is no such requirement in FRS 16) Other presentational differences include:

a) IAS 12 requires current tax to be charged directly to equity if it relates to items that are also charged or credited directly to equity;

b) FRS 16 requires all current tax to be included in the statements of performance (that is, profit and loss account or STRGL).

151. In respect of deferred tax, IAS 12 is conceptually different from FRS 19. Instead of accounting for timing differences (the basis used in FRS 19), it uses a balance sheet

concept of temporary differences – differences between the carrying amount of assets, liabilities, income and expenditure and their tax base (the amount attributed to them for tax purposes). Temporary differences include not only timing differences, but other differences between the accounting and tax bases of assets, liabilities, income and expenditure that are not timing differences, for example, revaluation of assets for which no equivalent adjustment is made for tax purposes. Other differences include:

a) IAS 12 prohibits the discounting of deferred tax. FRS 19 permits, but does not require, discounting deferred tax;

b) IAS 12 requires a reconciliation of the total (current and deferred) tax charge to the tax charge that would result from applying the standard rate of tax to the profit on ordinary activities before tax. FRS 19 requires the reconciliation to be carried out for the current tax charge only.

152. The current IFRS/US convergence project on IAS 12 is likely to also include a review of SIC 21 and SIC 25. Depending on the results of this work, proposals for a UK standard to replace FRS 16 and FRS 19 will be issued by the ASB concurrently with the issue of proposals from the IASB.

Impact of IAS 12 on public sector accounts

153. Entities covered by the requirements of the FReM are usually exempt from the tax regime and therefore unlikely to apply IAS 12 in practice. However, where, exceptionally, an entity does have to account for income tax IAS 12 should apply in full to entities covered by the shadow FReM. RABIG members have been consulted and concur with this view.

154. The presentation and disclosure requirements of IAS 12 will be taken into account in developing the format of resource and other accounts in the light of the move to EU-adopted IFRS and other initiatives.

IAS 16 Property, Plant and Equipment

155. IAS 16 *Property, Plant and Equipment* was issued in 2003 to be applied for annual periods beginning on or after 1 January 2005 replacing the 1998 version (revised) of the standard.

Objective of IAS 16

156. The principal objective of the Standard is to prescribe accounting treatment such that users of the financial statements can determine an entity's investment in its Property, Plant and Equipment (PPE) and the changes in such investment.

157. The principal issues for consideration within the Standard are therefore identified as: recognition of assets, determination of carrying amounts, and the depreciation charges and impairment losses recognised in relation to them.

Scope

158. The Standard does not apply to:

a. Investment properties (IAS 40);

b. PPE classified as held for sale (IFRS 5);

c. Biological assets related to agricultural activity (IAS 41);

d. The recognition and measurement of exploration and evaluation assets (IFRS 6); or

e. Mineral rights and mineral reserves.

159. In addition, other standards (such as IAS 17, *Leases*) may require different recognition criteria for assets; however the ongoing treatment of these assets will fall under IAS 16.

Definition

160. Property, plant and equipment are tangible items that:

a. Are held for use in the production or supply of goods and services, for rental to others, or for administrative purposes; and

b. Are expected to be used during more than one period.

Initial recognition and measurement

161. The cost of an item of property, plant and equipment should be recognised as an asset if, and only if:

a. it is probable that future economic benefits associated with the item will flow to the entity; and

b. the cost of the item can be measured reliably.

162. An item of property, plant and equipment that qualifies for recognition as an asset should be measured at its cost. This will comprise:

a. its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

b. any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

c. the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

163. Examples of directly attributable costs are:

a. costs of employee benefits (as defined in IAS 19 *Employee Benefits*) arising directly from the construction or acquisition of the item of property, plant and equipment;

b. costs of site preparation;

c. initial delivery and handling costs;

d. installation and assembly costs;

e. costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and

f. professional fees.

164. IAS 23 *Borrowing costs* establishes criteria for the capitalisation of interest.

Subsequent measurement

165. IAS 16 permits an entity to use either the cost model or the revaluation model as its accounting policy. The policy chosen must be applied consistently to an entire class of property, plant and equipment:

a. <u>Cost model.</u> After recognition as an asset, an item of property, plant and equipment should be carried at its cost less any accumulated depreciation and any accumulated impairment losses.

b. <u>Revaluation model.</u> After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably should be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations should be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date.

166. If an asset's carrying amount is increased as a result of a revaluation, the increase should be credited directly to equity under the heading of revaluation surplus. However, the increase should be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss.

167. If an asset's carrying amount is decreased as a result of a revaluation, the decrease should be recognised in profit or loss. However, the decrease should be debited directly to equity under the heading of revaluation surplus to the extent of any credit balance existing in the revaluation surplus in respect of that asset.

Depreciation

168. IAS 16 requires that each part of an item of property, plant and equipment that has a cost that is significant in relation to the total cost of the item should be depreciated separately.

169. The residual value, useful life and depreciation method applied to an asset should be reviewed at least at each financial year-end and, if expectations differ from previous estimates, should be accounted for as a change in an accounting estimate in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Impairment

170. To determine whether an item of property, plant and equipment is impaired, an entity applies IAS 36 *Impairment of Assets*.

Derecognition

171. The carrying amount of an item of property, plant and equipment should be derecognised:

a. on disposal; or

b. when no future economic benefits are expected from its use or disposal.

172. The gain or loss arising from the derecognition of an item of property, plant and equipment should be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the item.

Main differences from UK GAAP (FRS 15, Tangible Fixed Assets)

Subsequent expenditure

173. IAS 16 capitalises subsequent expenditure on an asset in the same way as the initial spend, i.e. where it is probable that future economic benefits will flow to the entity and the cost can be measured reliably; any parts of the asset that are replaced should be derecognised. FRS 15 requires capitalisation where the condition of the asset is improved

beyond previously assessed standards of performance, where a separately depreciated component of an asset has been replaced or restored, or where there has been a major inspection or overhaul. Following consultation with the relevant entities little, if any, change to accounting under FRS 15 is expected.

Non-monetary exchange

174. Where an asset is acquired for non-monetary consideration, IAS 16 states that it should be measured at the fair value of the consideration (unless the transaction lacks commercial substance, or the fair value of the asset given up is not reliably measurable; in these cases the carrying value of the asset given up should be used). There is no equivalent rule in FRS 15.

Revaluation model

175. Where a policy of revaluation is adopted, IAS 16 requires this to be at fair value (usually market value). FRS 15 is more prescriptive and uses a ‘value to the business’ model, which defines ‘current value’ as the lower of replacement cost and recoverable amount and specifies certain valuation bases that should be used for different types of property.

Revaluation losses

176. Under IAS 16 revaluation losses are always charged firstly against any existing revaluation surplus, with any remaining charge expensed; impairment is dealt with in IAS 36 Impairment of Assets. FRS 15 requires losses due to a clear consumption of economic benefits to be charged directly to the profit and loss account.

Residual values

177. IAS 16 requires residual values to be based on prices current at the balance sheet date; FRS 15 bases these on prices at the date of acquisition (or revaluation). Therefore, for assets carried at historical cost this could make a significant difference to depreciation charged.

Non-depreciation

178. IAS 16 contains no requirement to carry out impairment reviews of assets that are not depreciated (i.e. where depreciation is immaterial or asset life is greater than 50 years). However, IAS 36 Impairment of Assets does require that an annual assessment of any indicators of impairment is made.

Renewals Accounting

179. IAS 16 contains no reference to renewals accounting for infrastructure assets.

Donated assets

180. IAS 16 contains no reference to donated assets.

Impact of IAS 16 on the public sector

181. The current FReM adapts, interprets and provides additional guidance on FRS 15 to deal with items of specific relevance to government accounting. The treatment of some, although not all, of these items will also need to be explained under IAS 16 requirements.

182. Areas considered to be of specific interest in the public sector are:

a. The impact of gains and losses on revaluations;

b. Valuation methodology and disclosure;

c. Infrastructure assets;

d. Non-reciprocal transfers (Donated assets and other asset transfers); and

e. Heritage assets.

183. These items are considered further in paragraph 31 and onwards below.

Impact on disclosures in resource and other accounts

184. Broadly the disclosure requirements of IAS 16 are similar to current requirements. However, IAS 16 requires comparatives for all disclosures, including the disclosure of movements in carrying amount by asset class; this will increase the volume of disclosure required.

IAS/IFRS compliance

Gains and losses on revaluations

185. An ***adaptation*** of IAS 16 is proposed to ensure that gains on revaluation of fixed assets are credited to the relevant reserve as follows:

a. Assets financed by grants in aid - the revaluation reserve

b. Donated assets – the donated asset reserve

c. Assets financed by grants, including any from the EU – the government grant reserve

186. A further ***adaptation*** is proposed to require an annual transfer from the donated asset reserve to the operating cost statement equal to the depreciation charge on the asset plus any impairment.

187. The creation and treatment of the government grant reserve has already been approved by the Board via paper (82)06 *IAS 20 Accounting for Government Grants*. Similarly, in its consideration of the IPSASB Exposure draft on Non-Exchange Revenues (FRAB (80)02) the board confirmed its view that the current treatment of donated assets was appropriate.

188. The purpose of these adaptations is to maintain the split of reserves such that the donated asset and government grants reserves reflect the net book value of donated assets and those financed by government grants respectively.

Valuation methodology and disclosure

189. The following ***interpretations*** of IAS 16 are proposed:

a. To require use of the revaluation model. This removes the cost model option available to entities, is consistent with the current FReM and will prevent entities reverting to a cost model;

b. To exempt entities from disclosing carrying amounts on a historical cost basis. This is consistent with the current FReM as much of this detail will be unavailable for existing assets;

c. Entities should not capitalise any finance costs that are directly attributable to the construction of tangible fixed assets. This is consistent with the agreed interpretation of IAS 23 *Borrowing costs*.

190. IAS 16 states that fair value is usually determined from market-based evidence. Where such evidence is not available because of the specialised nature of the asset IAS 16 recognises that fair value may need to be estimated using an income or depreciated replacement cost approach.

191. In the context of the public sector, an 'exit' value as determined by market-based evidence is frequently not appropriate because of the lack of a market and the specialised nature of certain assets, particularly property. Some form of 'entry' valuation is therefore usually more appropriate.

192. FRS 15 uses a 'value to the business' model, which values an asset at the lower of replacement cost and recoverable amount, the latter being the higher of value in use and net realisable value. Within the public sector this usually manifests itself as depreciated replacement cost.

193. Although IAS 16 does not define any such model, it does recognise that there may not be market-based evidence from which to determine fair value. In such cases IAS 16 states that an entity may need to estimate fair value using an income or depreciated replacement cost approach.

194. An income approach will not usually be appropriate in the public sector. Therefore, as is currently the case, under IAS 16 specialised property assets will be held at depreciated replacement cost.

195. In line with updates proposed to the current FReM considered by the FRAB via previous papers on Asset valuation, additional ***guidance*** on valuation is proposed (refer to Annex B), this includes confirmation that non-property assets may use depreciated historical cost basis as a proxy for fair value for assets where the difference is immaterial.

Infrastructure assets

196. Key infrastructure assets held by entities falling under the jurisdiction of the FReM are road (UK) and water (NI) networks.

197. The accounting for infrastructure assets is discussed in detail in Annex A. In summary, renewals accounting is not available under IAS 16; therefore, if the standard is fully adopted, such assets must be accounted for in line with other property, plant and equipment. However, this will cause significant practical difficulties for a number of entities as current systems do not hold, or capture, data on a component basis. Further consultation, including a cost/benefit analysis is therefore proposed.

Non-reciprocal transfers

198. Within government non-reciprocal transfers can be split into two categories – donated assets and other asset transfers.

199. IFRSs do not provide any conceptual guidance on non-reciprocal transfers (e.g. assets received for no consideration), however IPSAS 17 does include guidance, as does the draft Statement of Principles for Financial Reporting, proposed interpretation for public benefit entities ("SOP"). In addition, in early 2000, the G4+1 group of standard setters (since disbanded) published a Discussion Paper *Accounting by Recipients for Non-Reciprocal Transfers, Excluding Contributions by Owners: Their Definition, Recognition and Measurement*. The IASC sought comments on this paper but no further guidance has been issued.

Donated assets

200. The existing FReM requires donated assets to be capitalised at current value on receipt, which is consistent with the SOP. IPSAS 17 and the G4+1 paper state that capitalisation should be at fair value. This treatment is consistent with the rest of IAS 16 and therefore it is proposed that this treatment is adopted.

201. The current FReM requires the amount capitalised to be taken directly to a donated asset reserve. However, the SOP and G4+1 paper propose that, rather than taking the amount capitalised straight to reserves, it should be recognised as revenue because it results in an increase in equity/assets. IPSAS 17 does not give explicit guidance, but does confirm that the measurement on recognition of a donated asset does not constitute a revaluation.

202. As discussed in paragraphs 31 to 34 above, under current government accounting a donated assets reserve is maintained so that the value of government assets financed by donations is separately identifiable. This distinction will be lost if donated assets are accounted for through the operating cost statement and the board has previously confirmed its approval of this treatment. It is therefore proposed that the ***guidance*** on donated assets in the current FReM is retained in the IFRS-based FReM, as modified to reflect the fair value requirements of IAS 16.

Other assets transfers

203. On occasion, entities may receive assets from another part of the public sector for no consideration. Assets acquired in this way are not donated assets and should not be accounted for via the donated asset reserve.

204. From the guidance discussed above, it is clear that asset transfers should be capitalised at fair value. The question of whether such a transfer gives rise to revenue is considered in the following paragraph.

205. It is an established principle that a transfer of functions from the responsibility of one part of the public sector to another (commonly known as Machinery of Government changes) will be accounted for using merger accounting. Non-reciprocal asset transfers that arise from a transfer of functions such as this do not, therefore, give rise to revenue; rather, any increase in capital is taken directly to reserves.

206. This conclusion holds intuitively – an asset transfer within the public sector is a redistribution of government assets and should not give rise to revenue in any entity. Any other type of non-reciprocal transfer of assets is likely to be rare; therefore ***guidance*** is included directing entities to consult the relevant authorities in such cases.

IAS 17 Leases

Objective of IAS 17 Leases

207. The objective of the standard is to prescribe the accounting treatment for leases and the related disclosure requirements.

Scope

208. The standard does not apply to:

(a) leases to explore for or use minerals, oil, natural gas and similar non-regenerative `resources; and

(b) licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

The standard does not apply to the following as the basis for measurement:

(a) property held by lessees that is accounted for a investment property (see IAS 40);

(b) investment property provided by lessors under operating leases (see IAS 40);

(c) biological assets held by lessees under finance leases (see IAS 41, Agriculture); or

(d) biological assets provided by lessors under operating leases (see IAS 41).

Definitions

209. 4. A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

210. A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.

An **operating lease** is a lease other than a finance lease.

A **non-cancellable lease** is a lease that is cancellable only;

upon the occurrence of some remote contingency;

with the permission of the lessor;

if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or

upon payment by the lessee of such an additional amount that, at the inception of the lease, continuation of the lease is reasonably certain.

The **inception** of the lease is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease.

As at this date:

a lease is classified as either an operating or a finance lease; and

in the case of a finance lease, the amounts to be recognised at the commencement of the lease term are determined.

The commencement of the lease term is the date from which the lessee is entitled to exercise its right to use the leased asset. It is the date of initial recognition of the lease.

The lease term is the non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease, it is reasonably certain that the lessee will exercise the option.

Minimum lease payments are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by an reimbursed to the lessor, together with:

(a) for a lessee, any amounts guaranteed by the lessee or by a party related to the lessee; or

(b) for a lessor, any residual value guaranteed to the lessor by:

the lessee;

a party related to the lessee; or

a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

Fair Value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Economic life is either:

the period over which an asset is expected to be economically usable by one or more users; or the number of production or similar units expected to be obtained from the asset by one or more users.

Useful life is the estimated remaining period, from the commencement of the lease term, without limitation by the lease term, over which the economic benefits embodied in the asset are expected to be consumed by the entity.

Guaranteed residual value is:

for a lessee, that part of the residual value that is guaranteed by the lessee or by a party related to the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and

for a lessor, that part of the residual value that is guaranteed by the lessee or by a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

Unguaranteed residual value is that portion of the residual value of the leased asset, the realisation of which by the lessor is not assured or is guranteed soley by a party related to the lessor.

Initial direct costs are incremental costs that are directly attributable to negotiating and arranging a lease, except for such costs incurred by manufacturer or dealer lessors.

Gross investment in the lease is the difference between:

the minimum lease payments receivable by the lessor under a finance lease, and

any unguarantted residual value accruing to the lessor.

Net investment in the lease is the gross investment in the lease discounted at the interest rate implicit in the lease.

Unearned finance income is the difference between:

the gross investment in the lease, and

the net investment in the lease

The interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of (a) minimum lease payments and (b) the unguaranteed residual value to be equal to the sum of (i) the fair value of the leased asset and (ii) any initial direct costs of the lessor.

The lessee's incremental borrowing rate of interest is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the fund s necessary to purchase the asset.

Contingent rent is that portion of the lease payments that is not fixed in amount but is based on the future amount of a factor that changes other than with the passage of time(eg percentage of future sales, amount of future use, future price indices, future market rates of interest).

Related Interpretations

IFRIC 4 Determining whether an Arrangement contains a lease

SIC 15 Operating Leases - Incentives

SIC 27 Evaluating the Substance of Transactions in the Legal Form of a Lease

211. IFRIC 4 – Determining whether an Arrangement contains a lease. In December 2004 the International Accounting Standards Board issued IFRIC 4. This interpretation explains that the requirements of IAS 17 leases have wider applicability than just those agreements described as leases.

212. SIC 15 – Operating Leases incentives was issued in July 1999 and it clarifies the recognition of incentives related to operating leases by both the lessee and lessor. The interpretation indicates that lease incentives (such as rent-free periods or contributions by the lessor to the lessee's relocation) should be considered an integral part of the consideration for the use of the leased asset.

213. SIC 27 – Evaluating the Substance of Transactions involving legal form of leases was issued in December 2001 and addresses issues issues that may arise when an arrangement between an enterprise and an investor involves the legal form of a lease. The provisions of SIC 27include

214. Accounting for arrangements between an enterprise and an investor should reflect the substance of the arrangement. All aspects of the arrangement should be evaluated to determine its substance, with weight given to those aspects and implications that have an economic effect. In this respect, SIC 27 includes a list of indicators that individually demonstrate that an arrangement may not, in substance, involve a lease under IAS 17, Leases.

215. If an arrangement does not meet the definition of a lease, SIC 27 addresses whether a separate investment account and lease payment obligation that might exist represent assets and liabilities of the enterprise; how the enterprise should account for other obligations resulting from the arrangement; and how the enterprise should account for a fee it might receive from an Investor. SIC 27 includes a list of indicators that collectively demonstrate that, in substance, a separate investment account and lease payment obligations do not meet the definitions of an asset and a liability and should not be recognised by the enterprise.

216. A series of transactions that involve the legal form of a lease is linked, and therefore should be accounted for as one transaction, when the overall economic effect cannot be understood without reference to the series of transactions as a whole.

Main differences from UK GAAP (SSAP 21- Accounting for Leases and hire purchase contracts)

217. The broad approach of the international and the UK standard is similar. Both IAS 17 and SSAP 21 require leases to be classed as a finance lease or an operating lease. The definition of a finance lease is the same in both standards. IAS 17 does not provide a quantitative test of whether a lease is a finance lease (90% test required under SSAP21), but instead provides additional guidance on when a lease should be classified as a finance lease.

218. IAS 17 requires that a lease of land and buildings should be split at the inception of the lease into a separate lease of land and a lease of buildings. Unless title is expected to pass to the lessee at the end of the lease term, leases of land should normally be treated as

operating leases. Income recognition by lessors for finance leases is different under the two standards. SSAP21 requires the use of the net cash investment method (after tax) whilst IAS 17 requires the net investment method (before tax)

219. IAS 17 requires more extensive disclosures for both lessees and lessors. In particular lessees should disclose the total of future minimum lease payments; SSAP 21requires only disclosure of next years lease payments.

220. Impact on disclosures in resource and other accounts

221. The introduction of IAS 17 is likely to bring some leases proposals on to the public sector balance sheet.

222. As part of the research behind these proposals, information was sought from government departments with the largest operating leases about the likely effect of the implementation of IAS 17. The result of that consultation is in annex B. From this analysis it appears that there is going to be some impact but overall this is going to be immaterial. Out of the six departments contacted, only the Department for International Development (DfID) said that some of their operating leases could turn to finance leases under IAS 17. However, without an in-depth analysis, it was difficult to state precisely the amount involved but a rough estimate indicates that the worst case scenario is about £55 million of which around £25 million relates to overseas properties. It is unlikely that the final figures will be anywhere near as much as £50 million because the assumption made here is that all the overseas leases are going to become finance leases, which is clearly not going to be the case.

IAS 18: Revenue

223. IAS 18 *Revenue* sets out the accounting treatment of revenue arising from certain types of transactions and events and is applicable for periods beginning on or after 1 January 1995. Revenue arises in the course of an entity's ordinary activities and is referred to by a variety of different names including sales, turnover, fees, interest, dividends, royalties and rents. IAS 18 identifies the primary issue as determining when to recognise revenue and sets out the criteria that should be used for determining whether or not revenue should be recognised.

224. In July 2001 the ASB issued a discussion paper, 'Revenue recognition', that made proposals with the aim of establishing a framework within which to address consistently revenue issues arising in different contexts. In December 2002 the IASB and the US Financial Accounting Standards Board (FASB) agreed to combine their separate researches into a joint project to develop a new accounting standard, which will replace IAS 18. The ASB discussion paper will not now proceed to become a UK standard, but will be used to help establish the UK position so that the ASB may work with the IASB/FASB in their development of a new international financial reporting standard. The IASB/FASB have developed tentative concepts for revenue recognition but do not plan to have preliminary views available until the second quarter of 2007.

225. In the meantime, in November 2003, the ASB issued 'Amendment to FRS 5, 'Reporting the substance of transactions': Revenue recognition' (Application Note G). This is intended as an interim step to provide guidance in the UK until a new Standard is developed internationally, and is effective from 23 December 2003. ASB staff are also participating in a European Financial Reporting Advisory Group (EFRAG) working party on this subject. The International Financial Reporting Interpretations Committee also receives frequent requests for guidance on the application of IAS 18. However, so far the Committee has issued only one Interpretation relating to IAS 18, SIC-31 *Revenue – Barter transactions involving advertising services*, effective from 31 December 2001.

The main features of IAS 18

226. IAS 18 prescribes the accounting treatment for revenue arising from:

- The sale of goods;
- The rendering of services; and
- The use by others of entity assets yielding interest, royalties and dividends.

It *does not* deal with revenue arising from transactions covered by other Standards, such as:

- Construction contracts (IAS 11);
- Lease agreements (IAS 17);
- Dividends from equity-accounted investments (IAS 28);

- Insurance contracts (IFRS 4);
- Property, Plant and Equipment (IAS 16);
- Changes in the fair value of financial assets and liabilities (IAS 39); and
- Changes in the fair value of biological assets relating to agricultural activity (IAS 41).

227. In IAS 18 revenue is defined as the gross inflow of economic benefit during the period arising in the course of the ordinary activities of an entity, when those inflows result in increases in equity, other than increases relating to contributions from equity participants. Revenue includes only inflows of economic benefits that belong to the entity and it, therefore, excludes amounts collected on behalf of and paid or payable to others, such as value added tax or amounts collected on behalf of a principal by the entity as agent. In the latter case, revenue attributable to the entity would be the commission it is entitled to keep rather than the gross receipts it must pay to the principal.

228. Revenue is measured at the fair value of the consideration received or receivable. The consideration is usually cash. If the inflow of cash is significantly deferred, and there is no interest or a below-market rate of interest, the fair value of the consideration is determined by discounting expected future receipts. If dissimilar goods or services are exchanged (as in barter transactions), revenue is the fair value of the goods or services received or, if this is not reliably measurable, the fair value of the goods or services given up.

229. Revenue from the sale of goods is recognised when:

- Significant risks and rewards of ownership are transferred to the buyer;
- The seller has no continuing managerial involvement or control over the goods;
- The amount of revenue can be measured reliably;
- It is probable that economic benefits will flow to the seller; and
- The costs of the transaction (including future costs) can be measured reliably.

230. Revenue from rendering services is recognised by reference to the stage of completion if the following conditions are met:

- The amount of revenue can be measured reliably;
- It is probable that economic benefits will flow to the service provider;
- The stage of completion of the transaction can be measured reliably; and the costs of the transaction (including future costs) can be measured reliably.

231. If the outcome cannot be measured reliably, revenue is recognised only to the extent of the expenses recognised that are recoverable.

232. Interest revenue is recognised on a time-proportion basis using the effective interest method. Royalties are recognised on an accruals basis in accordance with the

substance of the relevant agreement. Dividend revenue is recognised when the shareholder's right to receive the dividends is established (i.e. dividends receivable are recognised when declared, and no longer at the discretion of entity paying the dividend).

The main features of SIC 31 – Barter Transactions Involving Advertising Services

233. SIC 31 was issued in May 2001 to deal with particular issues around revenue recognition in the 'dotcom' boom of the late nineties. Entities usually trade for cash or the right to receive cash. Sometimes, however, transactions are undertaken that involve the swapping of goods or services, these are known as barter transactions. The standard gives the examples of oil and milk, where suppliers exchange stock in different locations to meet local demands. IAS 18 does not permit revenue to be recognised in an exchange or barter of similar goods or services, therefore SIC 31 applies to the exchange of 'dissimilar' services; specifically advertising by each party for the other on the internet, on poster sites, on television or radio, published in magazines or journals or through some other medium.

234. IAS 18 requires revenue to be measured at the fair value of the consideration received or receivable. The consensus is that revenue from an exchange involving advertising services cannot be reliably measured by reference to the fair value of the services received. This is because reliable information is not available to the seller to support such measurement. However, a seller can reliably measure revenue at fair value of the advertising service it provides in a barter transaction, by reference to non-barter transactions that meet certain criteria specified in SIC 31.

Comparison with requirements under UK GAAP

235. Prior to the issue of Application Note G by the ASB in November 2003, IAS 18 has been used widely, together with US GAAP, by UK entities for guidance on revenue recognition. Application Note G sets out the basic principles of revenue recognition and is intended to codify existing best practice. However, there is a change in emphasis as Application Note G guidance is based on an assets and liabilities approach. This means that an entity should measure revenue according to either an increase in assets (such as a debtor) or a decrease in liabilities (for example, the release of a liability initially set up when a customer pays in advance). The application note also includes specific guidance for five types of transaction that give rise to turnover that have been subject to differing interpretations in practice. These are:

- Long-term contractual performance;
- Separation and linking of contractual arrangements;
- Bill and hold arrangements;
- Sales with right of return; and
- The presentation of turnover by principals and agents.

236. Several Urgent Issues Task Force (UITF) Abstracts also deal with, or touch on, issues relating to revenue recognition and the related matter of cost recognition. These include:

- UITF 24, 'Accounting for start-up costs', issued on 22 March 2000;

- UITF 26, ‘Barter transactions for advertising’, issued on 9 November 2000;
- UITF 28, ‘Operating lease incentives’, issued on 22 February 2001;
- UITF 34, ‘Pre-contract costs’, issued on 21 May 2002;
- UITF 36, ‘Contracts for sales of capacity’, issued on 27 March 2003; and
- UITF 40, ‘Revenue recognition and service contracts’, issued on 10 March 2005.

237. IAS 18 does not permit the previous UK practice (pre-2005) of recognising dividends receivable on equity shares at the time they are proposed. Instead, as noted in paragraph 9 to this paper, dividends receivable are recognised when declared rather than proposed. From 1st January 2005 UK law has been changed to enable the IFRS treatment to be adopted in the UK.

238. The Companies Act 1985 is more restrictive than IAS 18 in terms of profits that may be included in the profit and loss account. Schedule 4 paragraph 12(a) states, “…only profits realised at the balance sheet date shall be included in the profit and loss account”. IAS 18 contains no such restriction and, therefore, there could be instances where revenue that represents an unrealised profit might be included in the profit and loss account under IFRS, which provisions of Schedule 4 to the Act would not permit to be included. A practical example of such a difference is the accounting for revaluation gains, such as those on investment properties that are covered by IAS 40. Other examples include movement in the fair value of held-for-trading financial assets under FRS 26 and biological assets under IAS 41.

239. The work being undertaken by the IASB and FASB to develop a new general Standard on revenue recognition involves an accounting model in which a reporting entity would recognise revenue on the basis of changes in assets and liabilities arising from contracts with customers, without consideration of additional criteria, such as earning or realisation. This is more consistent with Application Note G in the UK rather than IAS 18 but in practice would mean little change for those entities already adopting IAS 18 in the public sector.

Impact of IAS 18 on public sector accounts

240. Entities covered by the requirements of the FReM are already applying UK GAAP (more specifically, Application Note G and UITF Abstract 40) in full and a move to IAS 18 is unlikely to have any practical impact.

241. In the public sector the parliamentary process, as well as accounting standards, determine how income is presented. In public sector accounts income from the following sources is accounted for as financing through the General Fund rather than shown as income:

- Supply;
- Grants and grants-in-aid;
- Grants from the Department of Constitutional Affairs to the National Assembly of Wales;

- Amounts from the National Insurance Fund in respect of welfare benefits;
- The Consolidated Fund in respect of standing services; and
- Advances from the Contingencies Fund.

IAS 19 – Employee Benefits

242. IAS 19 *Employee benefits* prescribes the accounting and disclosure by employers for employee benefits (ie all forms of consideration given by an entity in exchange for service rendered by an employee.) Such consideration will include wages and salaries and other forms of remuneration as well as pension benefits, and termination benefits.

243. Although IAS 19 applies to the accounts of employing entities, we intend to apply its requirements in respect of pension and termination benefits to the resource accounts prepared by the major pension schemes in central government (as we currently do with FRS 17).

244. Like FRS17, IAS19 contains simplified arrangements for accounting by employers where they are members of a multi-employer pension schemes, and, as far as accounting for pension costs is concerned, it is not expected that the application of IAS 19 will have significant implications for the entities and other funds, accounts and flows covered by the requirements of the IFRS-based Government Financial Reporting Manual.

245. The major difference between IAS19 (as amended in December 2004) and FRS17 as regards pension costs is in the treatment of actuarial gains and losses. IAS19 allows alternative treatments, ie recognition through reserves, or partial recognition in the performance statement. The amendments to the FreM will clarify that actuarial gains and losses are to be recognised through reserves.

Impact on disclosures in resource and other accounts

246. Amendments to the disclosure requirements of the current FRS17 are proposed in an Exposure Draft issued in June 2006. As these will align the disclosure requirements of IAS19 and FRS17, the implementation of IAS19 will potentially have no impact on the disclosures in resource and other accounts. If approved, the amended disclosures will be implemented for the 2006-07 accounts. However, the Exposure Draft includes a controversial suggestion, which is not included in IAS19, that the buy-out obligation (ie the amount that would be paid to another party in exchange for his taking on the liability) should be disclosed. Were this suggestion to be adopted, we would need to consider the implications for resource accounts as it is not clear what relevance such information would be in a public sector context.

IAS 20: Accounting for Government Grants and Disclosure of Government Assistance

247. IAS 20 is long established and became operative for financial statements covering periods beginning on or after 1 January 1984. It provides guidance on the accounting treatment of government grants (which is very similar to that in the equivalent standard in the United Kingdom - SSAP 4) and on the disclosure requirements for government grants and other forms of government assistance. A programme to amend IAS 20 was considered but has been deferred pending completion of other related projects, although an exposure draft is expected in the second half of 2007.

248. IAS 20 (paragraph 2(c)) does not apply to "government participation in the ownership of the entity" and hence will apply only to those grants and (less likely) grants-in-aid that are given in exchange for goods or services. As previously agreed, grants-in-aid (whether for capital or revenue purposes) should be treated as contributions from controlling parties and credited to reserves as they are given to support the general revenue or capital expenditure of the entity.

249. IAS 20's definitions of "government assistance", "government grants", and "grants related to assets" are given in Annex A attached. IAS 20 does not distinguish between "grant" and "grant-in-aid" and, as the treatment of each type of assistance may be different, the proposed wording for the IFRS-based FReM draws the necessary distinctions.

Impact on disclosures in resource and other accounts

250. IAS 20 requires the disclosure of information about the accounting policies adopted and methods of presentation in respect of government grants; the nature and extent of government grants recognised; and details of any unfulfilled conditions and other contingencies attaching to government assistance. It is not expected that these requirements will result in any disclosures additional to those provided at present.

IAS/IFRS compliance

251. IAS 20 requires government grants in respect of revenue expenditure to be credited to income, and those in respect of capital expenditure either to be credited to deferred income or deducted from the cost of the asset. As previously agreed in connection with the application of SSAP 4, the option of deducting grants or grants-in-aid from the cost of the asset is not permitted.

252. In order to conform to the treatment in Estimates, grants-in-aid should be recognised on a cash basis, notwithstanding the requirements in IAS 20 (and IAS 1) that the accruals basis should be adopted. Grants may be accounted for on an accruals basis so long as the conditions in *Government Accounting* are satisfied.

IAS 21 The effects of changes in foreign exchange rates and SIC 7: Introduction of the Euro

Applicability

253. IAS 21 and SIC 7 apply in full.

Objective of IAS 21

254. The objective of IAS 21 is to prescribe how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency.

255. An entity may carry on foreign activities in two ways. It may have transactions in foreign currencies or it may have foreign operations. The principal issues are which exchange rate(s) to use and how to report the effects of changes in exchange rates in financial statements.

Interpretation of IAS 21 for the public sector context

256. The presentational currency will be the same as the functional currency (i.e. pounds sterling).

SIC 7 Consensus

257. The requirements of IAS 21 regarding the translation of foreign currency transactions and financial statements of foreign operations should be strictly applied to the changeover to the Euro.

IAS 23 Borrowing Costs

258. IAS 23 *Borrowing Costs* sets out the accounting treatment for borrowing costs and is applicable for periods beginning on or after 1st January 1995.

259. The Standard generally requires the immediate expensing of borrowing costs. However, the Standard permits, as an allowed alternative treatment, the capitalization of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset.

Definitions

260. Borrowing costs are interest and other costs incurred by an entity in connection with the borrowing of funds.

261. A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Benchmark treatment

262. The benchmark treatment for borrowing costs is that they shall be capitalised where they are directly attributable to the acquisition, construction or production of a qualifying asset. However, where qualifying assets are held at fair value, borrowing costs should be expensed.

IAS 24 – Related Party Disclosures

263. The current version of IAS 24 Related Party Disclosures was issued in December 2003, and became effective for financial periods ending on or after 1 January 2005. It is similar to FRS 8 in requiring an entity to disclose transactions with related parties. The main differences are:

a. Whereas FRS 8 requires the disclosure of transactions only when they are material (as defined), IAS 24 has no similar exemptions. However, IAS 1 *Presentation of Financial Statements* addresses the question of materiality and we consider that, in practice, the concept of materiality as defined in FRS 8 will apply to disclosures under IAS 24 (see paragraph 3 below);

b. FRS 8 does not require the disclosure in an entity's own accounts of transactions between that entity and its related parties where these are eliminated on consolidation, and where the consolidated accounts are publicly available. No such exemption applies in IAS 24;

c. IAS 24 requires the disclosure of the remuneration paid to senior managers. FRS 8 does not require the disclosure of emoluments in respect of services as an employee, although this information is provided in the remuneration report of departments etc.

264. 2. As there has long been a question over the application of FRS 8 to ministers (including members of their close families), departmental resource accounts and accounts prepared by other entities have never disclosed transactions between entities and their relevant ministers. This paper proposes a continuation of this arrangement pending the outcome of consultation with Australia and New Zealand (which are considering similar issues relating to the implementation of IAS 24) and, if necessary, with ministers.

Impact on disclosures in resource and other accounts

265. 3. The requirements of IAS 24 are different only in detail from those in FRS 8 and, as currently proposed, there should be little impact on the disclosures in resource and other accounts. Although there is no explicit reference to materiality in IAS 24, it (as with other standards) applies only to material items. Materiality is defined in IAS 1 Presentation of Financial Statements as "omissions or misstatements of items are material if they could, individually or collectively influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances [emphasis added]. The size or nature of the item, or a combination of both could be the determining factor.". It does not seem unreasonable to interpret "surrounding circumstances" to mean that materiality should be judged from the viewpoint of both the entity and the individual – which is consistent with the definition of materiality in FRS 8. In other words, it seems likely that materiality will be judged against the same criteria as are currently used.

IAS/IFRS compliance

266. The proposals are an interpretation of IAS 24 to the extent that,

- Disclosures of transactions with related parties other than individuals may be restricted to the name of the entity's parent department (if any) and a note of the main entities within government with which the entity has had dealings (that is, no information about those transactions need be given). Full details of transactions with individuals will, however, be given. This approach is that currently applied to FRS 8, and addresses the practical problem that because, in principle, the list of related party transactions could be excessively large, restricting the information simply to the names of the main entities with which the department or body has had dealings enables the disclosures to be kept to manageable proportions;

- Charitable non-departmental public bodies shall follow the disclosure requirements for related party transactions given in the Charities SORP;

- The requirement to disclose the compensation paid to management, expense allowances and similar items paid in the ordinary course of an entity's operations will be satisfied by the disclosures made in the Remuneration Report;

- Pending the outcome of further discussions, a department's ministers (including members of their close family) are not to be regarded as being related parties of that department or its sponsored bodies;

- Although not strictly an interpretation of IAS 24, the IFRS-based FReM will note that the definition of "materiality" in IAS 1 means that the effect of a related party transaction should be judged from the viewpoint of both the entity and of the individual.

IAS 26 – Accounting And Reporting By Retirement Benefit Plans

267. IAS 26 *Accounting and Reporting by Retirement Benefit Plans* applies to the financial statements of retirement benefit plans and thus has limited application to the entities, funds, accounts and flows covered by the IFRS FReM. It will be of relevance to the resource accounts prepared by the major schemes within central government[1]. Guidance on the form of pension scheme accounts is currently given in the SORP *Financial Reports of Pension Schemes* (July 1996).

268. As nothing in IAS 26 would require any changes to the current format of the pension scheme accounts, implementation of IAS 26 should be straightforward. For the avoidance of doubt, the amendments to the FreM clarify that the pension scheme accounts should include a report of the scheme's managers, and a report of the scheme's actuaries as well as the normal primary statements and supporting documents; IAS26 does not address the preparation of these statements.

269. There are, however, a few areas where IAS 26 provides options, and the proposed wording for the FreM will limit those options to ensure consistency with current practices. These areas are:

a. The scope of IAS 26 is restricted to retirement benefits. As some of the pension schemes accounts also reflect transactions relating to benefits payable under early departure terms, the FreM will make it clear that such transactions should continue to be reflected in the pension scheme accounts. Although the treatment of "termination benefits" is covered in IAS19, its requirements relate to the accounts of employers, whereas this section of the FReM will apply to the accounts of the pension schemes themselves;

b. IAS 26 permits the use of both the current salary method and the projected salary method to determine the actuarial present value of promised retirement benefits. Current practice is to use the projected salary method (described in FRS 17 as projected unit method) and the FreM will make it clear that the use of the current salary method is not allowed;

c. IAS 26 allows the financial statements to include information about the actuarial present value of promised retirement benefits in (a) a statement of net assets, (b) as a note to the accounts or (c) in a separate actuarial report. Pension scheme accounts currently show the pension provision as a liability on the balance sheet and the FreM will clarify that options (b) and (c) are not permitted.

Impact on disclosures in resource and other accounts

270. There should be no change to the disclosures required in pension scheme accounts.

[1] The major schemes within central government are: Armed Forces Pension Scheme, Judicial Pension Scheme; NHS Superannuation Scheme, Overseas Superannuation Scheme (Department for International Development); Principal Civil Service Pension Scheme; Research Councils' Pension Scheme; the Teachers' Superannuation Scheme and the United Kingdom Atomic Energy Authority Superannuation Schemes.

IAS 27, IAS 28 and IAS 31 – Subsidiaries, Associates and Joint Ventures and related interpretations

271. IAS 27 *Consolidated and Separate Financial Statements,* IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures* were revised as part of the IASB's Improvements to International Accounting Standards project. The current versions of IASs 27, 28 and 31 are effective from all periods beginning on or after 1 January 2005. SIC 12 *Consolidation – Special Purpose Entities* was amended in November 2004, while SIC 13 *Jointly Controlled Entities – Non-Monetary Contributions by Venturers* was amended in December of 2004.

272. IAS 27 provides guidance on the preparation and presentation of consolidated financial statements for a group of entities under the control of a parent. The standard also provides guidance on the presentation of investments in subsidiaries, jointly controlled entities and associates in separate financial statements.

273. IAS 28 provides guidance on accounting for investments in associates.

274. IAS 31 provides guidance on accounting for interests in joint ventures.

275. SIC 12 provides guidance on accounting for special purposes entities (SPE) where control is not achieved through an equity holding.

276. SIC 13 provides guidance for venturers on the accounting for gains and losses on non-monetary assets provided to joint ventures (JV) as consideration for an equity share in the JV.

Main Features of IAS 27, IAS 28 and IAS 31

277. A parent, unless exempted from doing so, shall present consolidated financial statements in which it consolidates its investment in subsidiaries and incorporate its investments in associates on an equity basis and its investments in JVs on a proportionate or equity basis.

278. An entity, whether as parent, investor or venturer is exempted from preparing consolidated financial statements and equity accounting for interests in associates and proportionately consolidating (or, as an allowable alternative, equity accounting) for interests in JVs if;

The investment in the subsidiary, associate or JV is temporary being classified as held for sale in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, or;

- the entity is itself a wholly-owned subsidiary, or is a partly-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;

- the entities debt or equity instruments are not traded in a public market (a domestic of foreign stock exchange or an over-the-counter market, including local and regional markets);

- the entity did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instrument in a public market; and

- the ultimate or any intermediate parent of the entity produces consolidated financial statements available for public use that comply with International Financial Reporting Standards.

279. Consolidated financial statements shall include all subsidiaries of the parent.

280. On consolidation of subsidiaries all intragroup balances, transactions, income and expenses shall be eliminated in full.

281. The financial statements of the parent and its subsidiaries, associates and JVs used in the preparation of the consolidated financial statements shall, where practicable, be prepared as of the same reporting date. When it is deemed impractical to prepare financial statements to the same date the results of the subsidiary, associate or JV should be suitably adjusted, regardless there should be no more than a three month difference between the reporting date of the parent and the subsidiary, associate or JV

282. Consolidated financial statements shall be prepared using uniform accounting policies.

283. An investment in an entity shall be accounted for as a financial instrument (IAS 39 Financial Instruments: Recognition and Measurement) from the date it ceases to be a subsidiary, provided it does not fall to be accounted for as an associate or jointly controlled entity.

284. Minority interests shall be presented in the consolidated balance sheet within equity separate from the parent shareholders' equity. Minority interests in the profit and loss of the group shall be separately disclosed.

285. In the separate financial statements of the parent investments in subsidiaries, associates and jointly controlled entities not classified as 'held for sale' shall be accounted for either at cost or as a financial instrument in accordance with IAS 39.

Joint Ventures – Specific Guidance

286. Jointly controlled operations and jointly controlled assets are not necessarily JVs. JVs are contractual arrangements whereby two or more parties undertake an economic activity that is subject to joint control.

287. A venturer should recognise its share of assets, liabilities, expenses and income in relation to jointly controlled operations and jointly owned assets.

288. A joint venture should be accounted for using proportionate consolidation (IAS 31 provides two presentation options for proportionate consolidation). However, as an

alternative to proportionate consolidation IAS 31 also allows a venturer to recognise its interest in JVs using the equity method.

Main Features of SIC12

289. SPEs are often created to take forward narrow and well-defined objectives. The sponsor's equity interest in the SPE and its method of control over the SPE may be structured in such a way that the SPE would not be accounted for as a subsidiary undertaking as required by IAS 27.

290. SIC 12 requires that, regardless of the equity holding and control structure, where in substance the SPE is controlled by the sponsor it should be consolidated by the sponsor.

Main Features of SIC13

Where venturers make non-monetary contributions in exchange for an equity share in the JV the venturer recognises in profit and loss the element of any gain or loss that is attributable to the equity interests of the other venturers.

Comparison with UK GAAP for IAS 27, IAS 28 and IAS 31

291. In the UK guidance on accounting for subsidiaries is contained in FRS 2 *Subsidiary Undertakings*, while guidance on accounting for associates and joint venture is contained in FRS 9 *Associates and Joint Ventures*.

292. The requirements of IAS 27, 28 and 31 are very close to those of UK GAAP. Differences in approach are limited to:

293. FRS 2 has provision for subsidiary undertakings to be excluded from consolidation where:

- severe long-term restrictions substantially hinder the rights of the parent undertaking;
- the interest in the subsidiary is held exclusively with a view to subsequent re-sale; or
- the subsidiary undertaking's activities are so different from that of the parent that consolidation would be incompatible with the obligation to present a true and fair view.

294. These exclusions are derived from Companies Act requirements and as such no similar exclusions are contained in IAS 27. IAS 27 only allows for subsidiaries to be excluded from consolidation where the parent intends to sell the interest within 12 months and is therefore classified as available for sale.

295. In the Explanation to FRS 2 the expectation of the ASB is that exclusions due to long term restrictions and different activities will be rare. The Explanation also states that where long term restrictions exist subsidiaries should continue to be consolidated until control is lost making consolidation inappropriate and that differences in activities are better dealt with through segmental reporting rather than non-consolidation. Therefore, the exclusions under FRS 2 are much closer to the requirements of IAS 27 than first they appear.

296. FRS 2 exempts certain parents from preparing consolidated financial statements. These exemptions are the same as those detailed in IAS 27 with the exception of those stemming from Companies Act requirements. Specifically, FRS 2 exempts certain small and medium sized companies where no similar exemption exists in IAS 27.

297. There are differences in the criteria under which an entity would be regarded as a subsidiary. While these differences are small it is noticeable that IAS 27 does not contain reference to 'dominant influence', which is a key element of the FRS 2 definition.

298. IAS 27 requires minority interests to be presented within equity. Under UK GAAP minority interests are generally presented below liabilities, but before shareholders' interests.

299. Under IAS 31 the primary method for accounting for JVs is by proportional consolidation. FRS 9 requires JVs be accounted for in the consolidated financial statements using the equity method. However, the equity method is a permitted alternative under IAS 31.

Comparison with UK GAAP for SIC 12

300. The requirements of SIC 12 are the same as the quasi-subsidiary requirements of FRS 5 *Substance of Transactions*; SPEs that would not fall to be consolidated through legal form should be consolidated where the benefits that arise for the reporting entity are no different in substance to those that would arise were the SPE a subsidiary.

Comparison with UK GAAP for SIC 13

301. Similar guidance to that contained in SIC 13 is contained in UITF 31 *Exchanges of Business or other Non-monetary Assets for an Interest in a Subsidiary, Joint Venture or Associate*. UITF 31 is wider in scope than SIC 13 as it covers similar transactions in relation to subsidiaries.

302. UITF 31 requires that goodwill (in-line with FRS 10) be recognised where the fair value of the assets acquired differs from the fair value of the consideration. There is no such requirement in SIC 13.

Comparison of Disclosure Requirements

303. The disclosure requirements of IAS 27, IAS 28, IAS 31, SIC 12 and SIC 13 are similar to those of UK GAAP. Differences are limited to;

304. IAS 27 requires more detailed disclosure in financial statements where subsidiaries are not consolidated than does FRS 2.

305. FRS 9 requires an investors share of its associates' operating results be brought into the consolidated profit and loss immediately after group operating profit. IAS 28 requires only that the investors consolidated profit and loss reflect the share of the results of its investee.

306. Where the aggregate of the investors share in all its associates exceeds 15% of the value of the total group FRS 9 requires additional disclosure of the aggregate of the share in investees turnover (if not already provided), fixed assets, current assets, liabilities due

within one year and liabilities due after one year. Additionally where the share of associates exceeds 25% of the group total the investor should also disclose the aggregate of the share of investees profit before tax, taxation and profit after tax. These requirements do not feature in IAS 28.

307. The only material differences in disclosure for JVs is that where the aggregate of the venturer's share in all its JVs exceeds 15% of the value of the total group FRS 9 requires additional disclosure of the aggregate of the venture's share in its JVs' fixed assets, current assets, liabilities due within one year and liabilities due after one year. Additionally where the share in JVs exceeds 25% of the group total the venturer should disclose the aggregate of its share of JVs' profit before tax, taxation and profit after tax. IAS 31 contains no such requirements.

Impact of IAS 27, IAS 28, IAS 31, SIC 12 and SIC13 on the Public Sector

308. In the current version of the FReM the departmental consolidation boundary as set by FRS 2 is subject to an adaptation, only those entities over which the department exercise in-year budgetary control are deemed to fall within the boundary. Under FRS 2 the consolidation boundary is determined by strategic control. The effect of this adaptation is that departments will generally only consolidate supply-financed agencies, non-executive NDPBs, advisory NDPBs and tribunal NDPBs. Executive NDPB, trading funds and public corporations are not consolidated.

309. The adaptation applied to FRS 2 is extended to FRS 9 and the quasi subsidiary requirements of FRS 5. As such, entities will only equity account for those associates and JV and will only consolidate those quasi subsidiaries over which they exercise in-year budgetary control.

310. Executive NDPBs, trading funds and public corporations apply UK GAAP without adaptation or interpretation when establishing their own consolidation boundary.

Aligning Accounts Budgets and Estimates

311. The intention of the FReM adaptation is to align the accounting and Estimates boundaries. However, in respect of executive NDPBs only the adaptation does not fully align accounts with budgets. Executive NDPB are fully consolidated in budgets but are not consolidated in accounts. The cause of this difference in treatment lies in the differing foci of accounts and budgets. The accounting boundary is primarily set so as to align with the Estimate, as such accounts show how the funds voted by parliament have been used. Budgets are set so as to score expenditure against the golden rule, which is measured through the National Accounts prepared by the Office for National Statistics. The National Accounts are prepared following the guidance in the European System of Accounts (ESA 95) not GAAP. There are well documented differences between GAAP and ESA 95.

312. Aligning accounts, budgets and Estimates is a major piece of work not least because it encompasses how parliament votes funding to the public sector. The Treasury has started a *Clear Line of Sight* project, to examine how accounts, budgets and Estimates might be aligned and how the process of funding departments and scoring the use of that funding might be simplified.

313. The Clear Line of Sight team have made a number of proposals to Ministers as to how alignment might be achieved. Central to these proposals is the alignment of the budgeting and Estimates treatment of executive NDPBs and the consolidation of such bodies in the accounts of the parent department, which will achieve the objective of simplification and alignment of budgets, accounts and Estimates. Any changes in the treatment of NDPBs in Estimates will have to be agreed with parliament.

314. Given the need to consult widely and to discuss any changes to Estimate treatment with parliament it is unlike that ministerial approval will be granted prior to the proposed publication of the IFRS-based FReM in late 2007. As such, it is proposed that the existing adaptations in respect of the consolidation boundary are retained for IAS 27, IAS 28 and IAS 31 pending completion of the work on *Clear of Line Sight*.

Impact on disclosures in resource and other accounts

315. There is no additional impact on disclosures other than already detailed in this paper.

<u>IAS 29 Financial Reporting in hyperinflationary economies</u>

Interpreting IAS 29

316. IAS 29 will be interpreted in the same way as FRS 24 – in that as all entities covered by this Manual have a functional currency of pounds sterling, HM Treasury will notify classification of hyperinflationary economy if appropriate.

IAS 32 Financial Instruments: Presentation

317. Previous FRAB papers, including FRAB (75) 04 and (71) 02, have summarised FRS 25 and FRS 26 and their potential impact in government. IFRS 7 replaces IAS 32's disclosure requirements. IFRS 7's requirements are differently phrased and are less prescriptive in some respects. It also has some new requirements. Examples are the disclosure of exposure to credit risks and capital disclosures. Its overall impact on disclosures in accounts covered by the FReM appears to be similar to that of FRS 25 and its international equivalent, IAS 32. Neither IFRIC Interpretation is likely to be significant for those accounts.

318. There does not appear to be any significant impact of IAS 32 on entities covered by the FReM.

IAS 32 – an interpretation

319. The Board has approved (FRAB 75(04) the treatment of PDC as a form of financing in the bottom half of eg a trading fund's accounts, and the inclusion of dividends in its income and expenditure account and as liabilities, where appropriate, in its balance sheet.

Overview of IAS 32

320. IAS 32 Financial Instruments: Disclosure and Presentation, was issued in December 2004. It has the effect of implementing IAS 32 for entities not preparing their accounts in accordance with IASs as adopted in Europe. It sets out requirements for the presentation of, and disclosures relating to, financial instruments. Its presentation requirements apply to all entities for accounting periods beginning on or after 1 January 2005, and largely replace those of FRS 4, Capital instruments. Its disclosure requirements apply to entities that apply IAS 39.

321. IAS 32's objective is to enhance users of financial statements' understanding of the significance of financial instruments to an entity's financial position, performance and cash flows. Its presentation requirements cover the classification of issued debt and equity financial instruments and the implications of that classification for dividends and interest expense. Its disclosure requirements require a range of mainly risk-based qualitative and quantitative disclosures to be given about financial instruments held or issued, but are superseded by those in IFRS 7, Financial instruments: Disclosures from 1 January 2007.

322. IAS 32's definitions of financial instruments, assets and liabilities, and of equity instruments, underlie FRSs 26 and 29 as well, and do not differ significantly from those of FRS 13. IAS 32 classifies financial instruments, from the perspective of the issuer's balance sheet, as financial assets, financial liabilities and equity instruments:

- A financial instrument is a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity;

- A financial asset is, mainly, an asset that is either cash, or an equity instrument of another entity, or a contractual right to receive cash or another financial asset from another entity;

- A financial liability is a liability that is, mainly, a contractual obligation to deliver cash to another entity or to exchange financial assets or liabilities on unfavourable terms. Investments, loans, debtors, creditors, provisions that are subject to contracts, and cash are all examples of financial instruments;

- An equity instrument is a contract evidencing a residual interest in the assets of an entity after deducting all of its liabilities, and fair value as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

323. IAS 32 also covers compound financial instruments, which may contain both a liability and an equity component. And it allows offset of assets and liabilities only where there is a legally enforceable right to set off and an intention to settle on a net basis.

324. Its presentation requirements arise from its classifications of liabilities and equity and include that interest, dividends, losses and gains relating to financial liabilities are presented as income or expense in profit or loss whereas distributions to holders of equity instruments are debited directly to equity.

Changes from existing standards – IAS 32's presentation requirements

325. IAS 32's presentation requirements differ from those of FRS 4 in taking a substance approach and in not being bound by Companies Act definitions of shares. Under IAS 32, a financial instrument is an equity instrument only if there is no contractual obligation or economic compulsion to deliver cash or another financial asset to the holder of the instrument. Preference shares that would be classified under FRS 4 as shares and presented in non-equity shareholders' funds may be required by IAS 32 to be presented as financial liabilities, and related dividends would be presented as interest payments.

326. In addition, currently under the Companies Act, dividends on equity instruments are debited to the profit and loss account. However, under IAS 32, such dividends will be required to be debited directly to equity.

327. Lastly, IAS 32's rules on the offset of financial assets and liabilities, where these are brought together as a single net payable or receivable, differ from those in FRS 5. For example, it may be enough under FRS 5 to have a master netting agreement to show net positions, but, under IAS 32, there would also need to be an intention to offset.

Implementation of IAS 32's presentational requirements in the FReM

328. The FReM does not adapt or interpret FRS 4, and it is not proposed that the FReM should do so for IAS 32 other than, as agreed with the FRAB, to give the following interpretations for the PDC of trading funds and NHS Trusts, that

- PDC is classified and presented as a form of financing in the bottom half of the balance sheet along with the accumulated reserves; and

- Dividends on PDC are presented in the income and expenditure account and are accounted for where appropriate as liabilities in the balance sheet.

IAS 36 Impairment of Assets

329. The objective of IAS 36 Impairment of Assets is to ensure that assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and the Standard requires the recognition of an impairment loss.

330. The Standard shall be applied in accounting for the impairment of all assets, other than:

a. Inventories (IAS 2);

b. Assets arising from construction contracts (IAS 11);

c. Deferred tax assets (IAS 12);

d. Assets arising from employee benefits (IAS 19);

e. Financial assets within the scope of IAS 39;

f. Investment property carried at fair value (IAS 40);

g. Biological assets (IAS 41);

h. Assets arising under insurance contracts (IFRS 4);

i. Assets held for sale in accordance with IFRS 5.

331. Therefore, IAS 36 applies to (among other assets) land, buildings, machinery and equipment, investment property carried at cost, intangible assets, and assets carried at revalued amounts under IAS 16 and IAS 38.

Definitions

332. Carrying amount is the amount at which an asset is recognized in the balance sheet after deducting accumulated depreciation and accumulated impairment losses.

333. Fair value is the amount obtainable from the sale of an asset in an arm’s length transaction between knowledgeable, willing parties.

334. Value in use is the present value of the future cash flows expected to be derived from an asset (but please see interpretation for the public sector context in Annex A).

335. Recoverable amount is the higher of an asset’s fair value less costs to sell and its value in use.

336. An asset is impaired when its carrying amount exceeds its recoverable amount.

Identifying an asset that may be impaired

337. At each balance sheet date an entity shall review all assets to look for any indication that an asset may be impaired. If there is an indication that an asset may be impaired, the entity shall estimate the recoverable amount of the asset.

338. The recoverable amounts of the following types of intangible assets should be measured annually whether or not there is any indication that it may be impaired:

a. An intangible asset with an indefinite useful life;

b. An intangible asset not yet available for use;

c. Goodwill acquired in a business combination.

Indications of impairment

339. In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following external and internal indications. The list is not exhaustive:

a. Market value declines;

b. Negative changes in technology, markets, economy or laws;

c. Increases in market interest rates;

d. Company stock price is below book value;

e. Obsolescence or physical damage;

f. Asset is part of a restructuring or held for disposal;

g. Economic performance of an asset is worse than expected.

340. In addition, an indication that an asset may be impaired may indicate that the asset's remaining useful life, depreciation method, or residual value may need to be reviewed and adjusted, even if no impairment loss is recognized for the asset.

Measurement

341. Recoverable amount is the higher of an asset's fair value less costs to sell and its value in use.

342. The best evidence of an asset's fair value less costs to sell is a price in an arm's length binding sale agreement. If there is no binding sale agreement but an asset is traded in an active market, the market price less costs of disposal is used. Market price means current bid price if available, otherwise it is the price in the most recent transaction. If there is no active market, the best estimate of the asset's selling price less costs of disposal is used.

343. The calculation of value in use should reflect the following elements:

a. An estimate of the future cash flows the entity expects to derive from the asset in an arm's length transaction;

b. Expectations about possible variations in the amount or timing of those future cash flows;

c. The time value of money, represented by the current market risk-free rate of interest;

d. The price for bearing the uncertainty inherent in the asset; and

e. Other factors, such as liquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

344. Cash flow projections should be based on reasonable and supportable assumptions, the most recent budgets and forecasts, and extrapolated for periods beyond budgeted projections. Cash flow projections should also relate to the asset in its current condition – future restructurings to which the entity is not committed and expenditures to improve or enhance the asset's performance should not be anticipated.

345. In measuring value in use, the discount rate used should be the rate that reflects current market assessments of the time value of money and the risks specific to the asset. If a market-determined asset-specific rate is not available, a surrogate must be used that reflects the time value of money over the asset's life as well as country risk, currency risk, price risk, and cash flow risk. The entity's own weighted average cost of capital is one such surrogate that would be considered.

Recognition

346. An impairment loss should be recognized whenever recoverable amount falls below carrying amount.

347. The impairment loss shall be recognized as an expense in profit or loss, unless it relates to a revalued asset when it shall be recognized against any revaluation surplus for the asset to the extent that the impairment loss does not exceed the amount in the revaluation surplus for that same asset.

348. After the recognition of an impairment loss, the depreciation charge for the asset shall be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

Cash-generating units

349. If there is any indication that an asset may be impaired, recoverable amount shall be estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, an entity shall determine the recoverable amount of the cash-generating unit to which the asset belongs. Cash-generating units are the smallest identifiable group of assets that generate cash inflows and are largely independent of the cash inflows from other assets or groups of assets. Cash-generating assets are those that are held to generate a commercial return. The recoverable amount of an individual asset cannot be determined if the asset does not generate cash inflows that are largely independent of those from other assets. The implication is that the entity will be engaged

in income-generating activity (through the provision of goods or services to external parties) to hold assets/units that are cash-generating. Entities should apply IAS 36 without adaptation to any income-generating activities.

Reversing an impairment loss

350. An entity shall assess at each reporting date whether there is any indication that an impairment loss recognized in prior periods may no longer exist or may have decreased. If any such indication exists, the entity shall estimate the recoverable amount of that asset. Indications of a potential decrease in an impairment loss mirror the indications of a potential impairment loss in paragraph 11 above.

351. A reversal of an impairment loss shall be recognized immediately in profit and loss. The increased carrying amount due to reversal should be no more than the depreciated historical cost of an asset would have been if the impairment had not been recognized. A reversal of an impairment loss on a revalued asset is credited directly to equity under the heading revaluation surplus. However, to the extent that an impairment loss on the same revalued asset was previously recognized in profit or loss, a reversal of that impairment loss is also recognized in profit or loss.

352. After a reversal of an impairment loss is recognized, the depreciation charge for the asset shall be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

Comparison with requirements under UK GAAP

353. The coverage of IAS 36 'Impairment of Assets' and FRS 11 'Impairment of Fixed Assets and Goodwill' is very similar, but there is an important difference between the two standards in the treatment of losses on revalued fixed assets.

354. Current accounting practice under FRS 11 requires losses (impairment) on revalued fixed assets to be charged to the profit and loss account if they are caused by a clear consumption of economic benefits. Other impairments of revalued fixed assets (i.e. those not caused by a consumption of economic benefits) should be recognized against any revaluation reserve for that asset until the carrying amount of the asset reaches its depreciated historical cost and thereafter in the profit and loss account. IAS 36 allows all losses to be set against previous revaluation gains before recognizing the loss in the income statement.

Disclosures in resource and other accounts

355. An entity shall disclose the following for each class of assets:

a. Impairment losses recognized in profit or loss;

b. Impairment losses reversed in profit or loss;

c. The line item(s) of the profit or loss in which the impairment losses are recognized/reversed.

356. If an individual impairment loss/reversal is material disclose:

a. Events and circumstances resulting in the impairment;

b. Amount of the loss.

IAS 37 Provisions, contingent liabilities and contingent assets

357. IAS 37 does not differ significantly from FRS 12 and is not discussed further.

IAS 38 Intangible Assets

358. IAS 38 *Intangible Assets* was issued in March 2004 and is applied to the accounting for intangible assets acquired in business combinations after 31 March 2004, and to all other intangible assets for annual periods beginning on or after 31 March 2004.

Objective of IAS 38

359. The objective of IAS 38 is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Standard. This Standard requires an entity to recognise an intangible asset if, and only if, specific criteria are met. The Standard also specifies how to measure the carrying amount of intangible assets and requires specified disclosures about intangible assets.

Scope of IAS 38

360. IAS 38 applies to all intangible assets **except** for:

a. Intangible assets that are within the scope of another Standard, e.g. intangibles held for sale (IAS 2 *Inventories* and IAS 11 *Construction Contracts*), deferred tax assets (IAS 12 *Income Taxes*), lease assets (IAS 17 *Leases*), assets arising from employee benefits (IAS 19 *Employee benefits)* and goodwill (IFRS 3 *Business Combinations*);

b. Financial assets;

c. Mineral rights and expenditure on exploration for, or development and extraction of non-regenerative resources;

d. Intangible assets arising from insurance contracts issued by insurance companies.

Definition, initial recognition and measurement

361. An intangible asset is an identifiable non-monetary asset without physical substance.

362. An intangible asset, whether acquired externally or generated internally, is initially recognised at **cost** if all of the following criteria are met:

a. The asset meets the definition of an intangible asset, i.e. it is identifiable and controlled by the entity;

b. It is probable that future economic benefits that are attributable to the asset will flow to the entity (which may include cost savings or other benefits resulting from the use of the asset by the entity rather than revenue from sales); and

c. The cost of the asset can be reliably measured.

363. IAS 38 includes additional recognition criteria for internally generated intangible assets where it is sometimes difficult to assess whether the assets meet the above

recognition criteria. To assess whether an internally generated intangible asset meets the criteria for recognition, an entity classifies the generation of the asset into:

a. a research phase; and

b. a development phase.

No intangible asset arising from research (or from the research phase of an internal project) is capitalised, but is expensed as it is incurred.

364. IAS 38.57 requires that an intangible asset arising from development is capitalised if, and only if, the entity can demonstrate all of the following:

a. the technical feasibility of completing the intangible asset so that it will be available for use or sale;

b. its intention to complete the intangible asset and use or sell it;

c. its ability to use or sell the intangible asset;

d. how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself, or if it is to be used internally, the usefulness of the intangible asset;

e. the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset;

f. its ability to measure reliably the expenditure attributable to the intangible asset during its development.

365. If an intangible asset does not meet the criteria for recognition as an asset, the expenditure is recognised as an expense when incurred. Expenditure that was initially recognised as an expense is not included in the cost of an intangible asset at a later date.

366. IAS 38.63 specifically prohibits the recognition as intangible assets of brands, mastheads, publishing titles, customer lists and items similar in substance that are internally generated, in that they are not separable, i.e. that they cannot be distinguished from the cost of developing the business as a whole.

Subsequent measurement

367. IAS 38 permits the use of either the cost model or the revaluation model for each class of intangible asset:

a. Cost model. After initial recognition the benchmark treatment is that intangible assets should be carried at cost less any amortisation and losses;

b. Revaluation model. After initial recognition intangible assets may be carried at a revalued amount (based on fair value, i.e. open market value) less any subsequent accumulated amortisation and any accumulated impairment losses, but only if there is an active market for the asset.

Under the revaluation model, revaluation increases are credited directly to equity as revaluation surplus, i.e. to a revaluation reserve in the public sector context, except to the extent that it reverses a revaluation decrease previously recognised.

368. For the public sector context, in which modified historical cost accounting applies, it is proposed that the IAS 38 option of subsequent measurement at cost be withdrawn. Following initial recognition, intangible assets should be carried at valuation at the balance sheet date.

Classification of intangible assets based on useful life

369. An entity assesses whether the useful life of an intangible asset is finite or indefinite. The useful life is indefinite if there is no foreseeable limit to the period over which the asset is expected to generate net cash flows. An intangible asset with an indefinite useful life is not amortised, but it is tested for impairment at least annually. For an intangible asset with a finite life, the depreciable amount is amortised on a systematic basis over its useful life.

Disclosure

370. For each class of intangible assets entities are required to disclose:

a. The useful life or amortisation rate;

b. Amortisation methods for finite assets;

c. Gross carrying amount and any accumulated amortisation and impairment losses;

d. Line items in the income statement in which amortisation is included;

e. A reconciliation of the carrying amount at the beginning and end of the period showing:

   i. Additions (business combinations separately);

   ii. Assets classed as held for sale;

   iii. Revaluations;

   iv. Impairments;

   v. Reversals of impairments;

   vi. Amortisation;

   vii. Foreign exchange differences.

Comparison with requirements under UK GAAP

371. FRS 10 *Goodwill and Intangible Assets* requires that an intangible asset purchased separately from a business should be capitalised at cost. It further requires that an intangible asset acquired as part of the acquisition of a business should be capitalised separately from goodwill if its value can be measured reliably on initial recognition. IAS 38 applies specific recognition criteria on the initial recognition of intangible assets (para 5).

372. FRS 10 has a rebuttable presumption that the useful economic lives of intangible assets are limited to periods of 20 years or less, unless otherwise justified and the asset is capable of continued measurement. IAS 38 requires that amortisation of an asset with a finite life be amortised on a systematic basis over its useful life, and provides examples of useful life for different types of intangible assets.

373. FRS 10 requires that internally developed intangible assets should be capitalised only where they have a readily ascertainable market value. IAS 38 applies additional specific recognition criteria for internally developed intangible assets (para 7), and does not recognise internally generated brands or other items similar in substance as intangible assets.

374. SSAP 13 *Research and Development* requires that expenditure on pure and applied research (other than the cost of fixed assets acquired or constructed in order to provide facilities for research and development activities over a number of accounting periods) should be expensed as incurred.

375. SSAP 13 permits but does not require, the capitalisation of development costs when the recognition criteria are met. IAS 38 requires capitalisation when the recognition criteria are met.

376. SSAP 13, as currently adapted in the FReM, requires that development expenditure be capitalised where there is a clearly defined project for which expenditure can be separately identified and which an entity expects to complete with the result that an asset will be brought into **use** or in the case of entities engaged in profit making activities, where the project is commercially viable. A further SSAP 13 adaptation in the FReM is that internal costs, including the cost of capital charge, should not be capitalised if they relate to activities that can only be carried out by the in-house staff.

Impact of IAS 38 on public sector accounts

377. Entities covered by the requirements of the FReM may from time to time have intangible assets. The IAS 38 recognition criteria for intangible assets is more prescriptive than under existing UK GAAP adapted standards. Nevertheless, it is proposed that in principle, IAS 38 should apply in full, as interpreted, to entities covered by the shadow FReM. This means that some entities previously not capitalising internally generated intangible assets, may be required to do so if the relevant recognition criteria are met. For such entities, the full application of IAS 38, as interpreted, raises two issues of practicality on adoption and subsequent application of the Standard. These relate to:

a. <u>Initial recognition on a cost basis</u>. Where intangible assets have been generated over a lengthy time period, it is likely that some entities will not have a reliable historical record of costs to enable initial recognition at cost in the balance sheet. In such cases, capitalisation is likely to be prospective from adoption of the Standard, and not retrospective.

b. Subsequent revaluation. It is likely in practice that some entities may not be able to apply the revaluation model, based on fair value, due to the absence of an active market for the asset. When market values are not available it is proposed that amortised replacement cost is used.

378. The full application of the Standard, as interpreted, also means that where the IAS 38 recognition criteria are met, the current FReM exemption from capitalising internal costs where they relate to activities that can only be carried out by in-house staff, will no longer apply, i.e. all such costs will be required to be capitalised.

Impact on disclosures in resource and other accounts

379. The presentation and disclosure requirements of IAS 38 will be taken into account in developing the format of resource and other accounts in the light of the move to EU-adopted IFRS and other initiatives.

IAS 39 Financial Instruments: Measurement

Summary of the potential impact of IAS 39

380. IAS 39 is the first comprehensive UK accounting standard on the measurement of financial instruments. To evaluate its impact, it is necessary to apply its detailed requirements to each of its separate categories of financial instruments as held by government entities, as currently reflected on balance sheet and in some cases off-balance sheet, and compare the results with those under current policies and practices.

381. The values of many financial assets and liabilities may not change under IAS 39 because they will continue to be based on the transaction amount, effectively on cost, or because they are already discounted to reflect the time value of money. This will be the case with cash and most short-term debtors and creditors. It may also apply to some provisions that will now need to be accounted for under IAS 39 as financial instruments rather than under FRS 12 as hitherto.

382. However, significant changes may need to be made to the carrying values of some long-term debtors and creditors, particularly those that may be required to be discounted for the first time. Financial instruments such as financial guarantees may also appear on balance sheet for the first time, and some provisions may be measured differently, when accounted for as liabilities under IAS 39 rather than accounted for under FRS 12. Lastly, balance sheet recognition will need to be given newly to derivatives, including all hedging instruments and some derivatives that are embedded in other contracts.

Overview of IAS 39

383. IAS 39 (IAS 39) Financial Instruments: Measurement was issued in December 2004. It has the effect of implementing IAS 39 for entities not preparing their accounts in accordance with IASs as adopted in Europe. It sets out requirements for the classification, recognition and measurement of financial instruments.

384. It applies to listed entities still following UK standards for accounting periods beginning on or after 1 January 2005, and to entities preparing accounts in accordance with the fair value accounting rules set out in the Companies Act 1985 for accounting periods beginning on or after 1 January 2006 but such entities may voluntarily apply it for accounting periods beginning or after 1 January 2005.

385. IAS 39's objective is to establish principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial ones. It requires:

- initial recognition of a financial instrument to be on a specific measurement basis;
- subsequent measurement of specified categories of financial instruments using specified measurement bases;
- hedge accounting to be used only when certain criteria are met;

- embedded derivatives to be identified and, where the effect is material, accounted for separately; and

- liabilities formerly accounted for under FRS 12 which relate to financial instruments, including financial guarantee contracts, to be brought within its scope.

Initial recognition - measurement

386. IAS 39 requires financial assets and liabilities to be measured initially at fair value. It defines fair value as the amount for which an asset settled, or a liability extinguished, between knowledgeable, parties in an arm's length transaction. In very many cases, this is effectively the transaction value, but it need no be so. For example, a fair value may need to reflect discounting for the time value of money and so a subsidised loan would be recorded initially at a lower amount and an charge is made accordingly to the operating cost statement which is unwound in subsequent periods.

Subsequent measurement

387. Subsequent measurement depends on how the financial instrument is categorised, and is normally at fair value or at amortised cost using the effective interest method, where:

- the amortised cost of a financial asset of a financial liability as the amount at which the financial asset or financial liability is recognised at initial recognition minus principal repayments, plus the cumulative amortisation using the effective interest rate method of that initial amount and the maturity amount; and

- the effective interest method calculates the amortised cost of a financial asset or liability and allocates the interest income or expense over the relevant period. The effective interest rate is the rate that exactly discounts the estimated future cash flows over the life of the instrument to its net carrying amount.

Categorisation of financial instruments

388. The FRS's main categories of financial instruments are:

- Financial assets or liabilities at fair value through profit or loss, those either held for trading (including hedging instruments other than those subject to hedge accounting requirements) or as designated;

- Held-to-maturity investment assets, where, eg, the entity has the ability and the intention to hold to maturity (but which cannot be equities);

- Loans and receivable assets, with fixed or determinable payments, and not quoted in an active market;

- Available-for-sale assets (as designated); and

- Other liabilities (ie other than at fair value though profit or loss).

Designation as fair value through profit and loss

389. IAS 39 (as amended in 2005) allows the designation of financial assets and liabilities other than derivatives as at fair value through profit and loss only in specified circumstances. These are mainly where doing so results in more relevant information because:

- It eliminates or significantly reduces a measurement or recognition inconsistency; or

- A group of financial assets, liabilities or both is managed and its performance evaluated on a fair value basis, in accordance with a documented risk management strategy and information about the group is provided internally on that basis to the entity's key management personnel.

Subsequent measurement

390. Financial assets, including derivatives that are assets (other than those that are accounted for as hedges), are measured subsequently at fair value through profit or loss except for held-to-maturity investments, and loans and receivables, both of which are measured at amortised cost using the effective interest method unless they are designated either as fair value through profit and loss or as available for sale.

391. Changes in the fair value of assets held at fair value through profit and loss are taken through profit and loss in their entirety. This practice is new to entities other than those, such as banks, who have accounted on a trading book basis.

392. Changes in the fair value of available-for-sale assets are taken to the STRGL, except for impairment losses and foreign exchange gains and losses which are taken to profit or loss, until disposal or sale at which time the cumulative changes previously taken to the STRGL are then recognised in profit or loss. Such recycling though profit or loss of unrealised gains and losses previously recognised in the STRGL is new to UK GAAP.

393. The amortisation of held-to-maturity investments, and of loans and receivables, is taken to profit and loss, as are impairments.

394. Financial liabilities are measured subsequently at amortised cost using the effective interest method except mainly those that are designated as fair value through profit or loss. Amortisation and fair value changes are reflected in profit and loss.

Hedges

395. IAS 39 addresses hedges in some detail and has the effect of bringing many hedges on to balance sheets for the first time. Financial assets and liabilities that are classified as hedged items are subject to hedge accounting requirements:

- Fair value hedges hedge the possibility of changes in fair values. Related fair value movements in both the hedging instrument and the hedged item are recognised in profit or loss.

- Cash flow hedges hedge the possibility of changes in future cash flows. Related fair value movements in the hedging instrument are recognised in the STRGL until such time as the hedged item affects profit or loss.

Embedded derivatives

396. Embedded derivatives are derivatives that are embedded in non-derivative contracts. They are newly required to be accounted for separately, through profit or loss, unless the economics of the derivative are closely related to those of the host contract (and so the effect of separate accounting would not be material).

397. An embedded derivative is one or more implicit or explicit terms in a contract that affects the cash flows of the contract in a manner similar to a stand-alone derivative instrument. The derivative element of such contracts may be based on a specified interest rate, security price, commodity price, foreign exchange rate, index of prices, or other variable.

398. IAS 39 does not provide a description or definition of what are closely related economic characteristics and risks, and where the economics may differ significantly, but provides examples of each. What is necessary is to understand the economic characteristics of the host contract and the embedded derivative and their cash flows, and to compare the cash flows of the contract as a whole with those of the host contract alone.

399. IAS 39's aim is to ensure that mark-to-market through profit or loss cannot be avoided by including, or embedding, a derivative in another contract that is not marked to market through profit or loss. Separate accounting may be required, for example, for inflation-, equity- or commodity-linked features embedded in a debt instrument. However, it would not be required, for example, for a contract that is to be settled in a foreign currency where the contract is in the currency of either party to the contract or the foreign currency is the only one in which contracts for a particular commodity is priced (such as US$ for crude oil contracts).

400. The host contract may be itself be a financial instrument that intuitively would normally be likely to be considered under a financial instrument standard, such as a debt or equity instrument. But the host contract may also be an instrument that might not so clearly be identified, such as an insurance contract or a sale or purchase contract, or a lease.

401. Because IAS 39 applies to all financial instruments, FRS 12 is amended to exclude these from its scope. The effect is that liabilities will newly be recognised where they would not have been under FRS 12 because it is less than probable that there will be an outflow of economic benefits.

Implementation of IAS 39 in the FReM

402. The FReM currently sets out requirements for the measurement of a number of categories of financial assets and liabilities, all of which have to be considered separately against IAS 39's requirements. It is not proposed that the FReM should adapt any of IAS 39's requirements. However, proposals for interpretations of IAS 39 to be set out in the FReM are included in the analysis of IAS 39's requirements below.

403. IAS 39 allows a degree of freedom to designate assets and liabilities as between its categories (paragraphs 20 & 21 above). We propose that the FReM should include an interpretation that, generally, the designation options in IAS 39 for the classification of assets and liabilities may be exercised only with the consent of the relevant authorities. Further, consultation with the relevant authorities would also be required for re-classifications of assets and liabilities. This is to ensure consistency of approach and

treatment because of the potential effects on entities' budgets and on the National Accounts.

404. The main categories under the FReM currently are:

a. Investments in public bodies

b. Other investments

c. Debtors

d. Creditors and accruals

e. Provisions

Investments in public bodies

405. The FReM currently requires departments to hold investments in public bodies outside the departmental boundary (PDC, other equity, loans) to be held at historical cost. It is proposed that IAS 39 should be interpreted so as to continue this treatment for the same reasons as before.

Other investments

406. The FReM currently requires other investments to be reported at market value, or, this cannot be readily ascertained, on a basis determined by the entity, in agreement with the relevant authority, to be relevant in the circumstances. Allocation of these investments to IAS 39's categories will be required. It is proposed that the FreM include an interpretation requiring the agreement of the relevant authority to a basis of measurement at fair value other than at market value.

Debtors, creditors and accruals

407. The FReM currently requires debtors, including loans, and creditors and accruals, to be held on a cost basis. IAS 39 requires them to be recognised initially at fair value and subsequently on an amortised cost basis other than where traded or where designated as at fair value through profit and loss. It is proposed that the FReM include an interpretation requiring the agreement of the relevant authority to a basis of subsequent measurement other than at amortised cost.

408. The effect of initial recognition at fair value and subsequent measurement at amortised cost is that, for example:

- subsidised loans are initially recognised at lower then their nominal amount and this reflected in an initial charge to the operating cost statement. In subsequent periods, the amortisation (or unwinding of the discount) is then added to the loan and credited to the operating cost statement, though this is offset by the cost of capital charge on the loans); and

- long term liabilities that do not carry current rates of interest also reflect the time value of money through their initial measurement at a fair value that is lower than their nominal amount. In subsequent periods he amortisation (or unwinding of the discount) then increases the liability and is charged to the operating cost statement, though this is offset by the cost of capital credit on the liability.

409. All long term debtors, creditors and accruals will need to be reviewed to establish whether they will be accounted for under IAS 39 and, if so, whether they are carried on an amortised cost basis. Where the basis would change to amortised cost, the financial effects of this change will need to be identified.

Provisions

410. The FReM requires provisions to be accounted for on the basis of FRS 12. IAS 39 amends FRS 12 to exclude from it all provisions arising under financial instrument contracts, including financial guarantee contracts, and requires them to be measured instead as financial liabilities under IAS 39.

411. IAS 39 requires these liabilities to be recognised initially at fair value and subsequently on an amortised cost basis other than where traded or where designated as at fair value through profit and loss. It is proposed that the FReM include an interpretation requiring the agreement of the relevant authority to a basis of subsequent measurement other than at amortised cost.

412. Whilst FRS 12's recognition criteria include an assessment of probability, IAS 39's do not. Under IAS 39, an assessment of probability is included instead in the measurement of a liability. Hence a liability may be required to be recognised under IAS 39 that would not have been recognised under FRS 12 because the probability level is less than 50%. The effect here will be to bring on balance sheet some liabilities hitherto only disclosed as contingent liabilities. All contingent liabilities need to be reviewed to establish whether they will accounted for under IAS 39 instead of FRS 12 and, if so, the financial effects of this change will need to be identified.

413. In addition, current accounting practice under FRS 12 may not give the different values to provisions with varying levels of probability of 50% and above that are given on their recognition as liabilities under IAS 39. All provisions need to be reviewed to establish whether they will be accounted for under IAS 39 instead of FRS 12 and, if so, the financial effects of this change will need to be identified.

Hedges

414. Currently under the FReM, in the absence of specific requirements in UK accounting standards, not all hedges might appear on balance sheet, and those that do would likely to be treated on an amortised cost basis to match the accounting treatment of the hedged item. Under IAS 39, all derivatives must be measured at fair value, whether used for hedging or trading purposes.

415. IAS 39 permits special hedge accounting, allowing the recognition of gains and losses on the hedged item in some circumstances. But it imposes strict requirements for hedge designation and effectiveness testing of the hedge relationship. Hedging relationships that satisfy these requirements are likely to be rare in government. It is proposed that the FReM include an interpretation requiring the agreement of the relevant authority to the use of IAS 39 based hedge accounting, for which the financial effects should be identified for the purpose of this RABIG consultation.

Embedded derivatives

416. The FReM does not currently require embedded derivatives to be accounted for separately. All entities need to consider whether they have any contracts in which there may be embedded derivatives that IAS 39 would require to be accounted for separately where the result of so doing is material. If so, the financial effects of this change will need to be identified.

IAS 40 Investment property

417. IAS 40 *Investment property was* revised in 2003 to be applied for annual periods beginning on or after 1 January 2005, replacing the 2000 version of the standard.

Objective of IAS 40

418. The objective of the Standard is to prescribe the accounting treatment for investment property and related disclosure requirements.

419. The principal issues for consideration within the Standard are therefore identified as recognition, measurement and disclosure of investment properties.

Scope

420. The Standard *does not* apply to:

a. Biological assets related to agricultural activity (IAS 41 *Agriculture*);

b. Mineral rights and reserves such as oil, natural gas and similar non-regenerative resources.

421. The Standard *does* apply to the following specific items in relation to leasing:

a. The measurement in a lessee's financial statements of investment property interests held under a finance lease; and

b. The measurement in a lessor's financial statements of investment property provided to a lessee under an operating lease.

Other Standards (such as IAS 17 *Leases* and IAS 18 *Revenue*) deal with the recognition, measurement and disclosure of other lease arrangements.

Definition

422. Investment property is property (land or a building – or part of a building – or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation, or both.

423. The following are *not* investment property, and are therefore outside the scope of IAS 40:

a. Property intended for sale in the ordinary course of business or in the process of construction or development for such sale (IAS 2 *Inventories*);

b. Property being constructed or developed on behalf of third parties (IAS 11 *Construction Contracts*);

c. Owner-occupied property (IAS 16 *Property, Plant and Equipment*);

d. Property being constructed or developed for future use as investment property (IAS 16 *Property, Plant and Equipment*); and

e. Property that is leased to another entity under a finance lease (IAS 17 *Leases*).

Initial recognition and measurement

424. Investment property is recognised as an asset when, and only when:

a. it is probable that the future economic benefits that are associated with the investment property will flow to the entity; and

b. the cost of the investment property can be measured reliably.

425. Investment property is measured initially at cost. Transaction costs are included in the initial measurement. Such costs should not include:

a. start-up costs (unless they are necessary to bring the property to the condition necessary for it to be capable of operating in the manner intended by management);

b. operating losses incurred before the investment property achieved the planned level of occupancy; or

c. abnormal amounts of wasted material, labour or other resources incurred in constructing or developing the property.

Subsequent measurement

426. IAS 40 permits an entity to use either the fair value model or the cost model for the subsequent measurement of investment property. The policy chosen should then be applied to all its investment property:

a. <u>Fair value model</u>: The fair value of investment property is the price at which the property could be exchanged between knowledgeable, willing parties in an arm's length transaction. A gain or loss arising from a change in the fair value of the investment property must be included in net profit or loss for the period in which it arises;

b. <u>Cost model</u>: After initial recognition, investment property is accounted for in accordance with IAS 16 *Property, Plant and Equipment* (i.e. at cost less accumulated depreciation and impairment losses), unless it is classified as held for sale, in which case it should be measured in accordance with IFRS 5.

Disposal

427. An investment property should be derecognised on disposal or when the investment property is permanently withdrawn from use and no future economic benefits are expected from its disposal.

428. Gains or losses arising from the retirement or disposal of investment property are calculated as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised in net profit or loss in the period of the retirement or disposal.

Generic Disclosure requirements

429. For both the fair value model and the cost model an entity is required to disclose:

a. whether it applies the fair value model or the cost model;

b. if applying the fair value model, whether property interests held under operating leases are classified and accounted for as investment property;

c. when classification is difficult, the criteria it uses to distinguish investment property from owner-occupied property and from property held for sale in the ordinary course of business;

d. the methods and significant assumptions applied in determining the fair value of investment property;

e. the extent to which the fair value of investment property is based on a valuation by a qualified independent valuer. If there has been no such valuation, that fact must be disclosed;

f. the amounts recognised in profit or loss for:

   i. rental income from investment property;

   ii. direct operating expenses (including repairs and maintenance) arising from investment property that generated rental income during the period;

   iii. direct operating expenses (including repairs and maintenance) arising from investment property that did not generate rental income during the period;

g. the existence and amounts of restrictions on the realisability of investment property or the remittance of income and proceeds of disposal;

h. contractual obligations to purchase, construct, or develop investment property or for repairs, maintenance or enhancements.

Additional disclosures for the fair value model

430. In addition to the generic disclosures above, an entity applying the fair value model shall disclose:

a. a reconciliation between the carrying amounts of investment property at the beginning and the end of the period, showing additions, disposals, fair value adjustments, net foreign exchange differences, transfers to and from inventories and owner-occupied property, and any other changes;

b. any significant adjustments to a valuation obtained to arrive at the valuation included in the financial statements;

c. if an entity that otherwise uses the fair cost model measures an item of investment property using the cost model, specific additional disclosures are required.

Additional disclosures for the cost model

431. In addition to the generic disclosures, an entity applying the cost model shall disclose:

a. the depreciation methods used;

b. the useful lives or the depreciation rates used;

c. the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period;

d. a reconciliation of the carrying amounts of investment property at the beginning and end of the period, showing additions, disposals, depreciation, impairment recognised and reversed, net foreign exchange differences, transfers to and from inventories and owner-occupied properties, and any other changes.

Main differences from UK GAAP (SSAP 19 Accounting for Investment Properties)

432. Measurement bases that may be used

Under IAS 40 an entity may choose to apply either the fair value model or depreciated cost model to all of its investment property (with some specified exceptions). SSAP 19 requires investment properties to be held at open market value.

433. Recognition of gains and losses on revaluation

IAS 40 states that gains or losses arising from changes in fair value should be recognised in the income statement. Under SSAP 19 such gains and losses are recognised in the Statement of Total Recognised Gains and Losses (STRGL), unless it is a permanent deficit (or its reversal), in which case the charge (or credit) is taken to the profit and loss account.

Impact of IAS 40 on the public sector

434. IAS 40 is likely to impact on only a small number of entities covered by the requirements of the FReM. Subject to the adaptation and interpretation proposed in paragraph 20 and Annex A, there will be little change to current accounting.

Impact on disclosures in resource and other accounts

435. Although the disclosure requirements of IAS 40 are more extensive than SSAP 19 they are not considered to be onerous.

436. The presentation and disclosure requirements of IAS 40 will be taken into account in developing the format of resource and other accounts in light of the move to EU-adopted IFRS and other initiatives.

IAS/IFRS compliance

437. An ***interpretation*** of IAS 40 is proposed to require use of the fair value model, i.e. for the public sector context, it is proposed that the IAS 40 option of subsequent measurement at cost be withdrawn. This is in line with the interpretation of FRS 15 in the current FReM.

IAS 41: Agriculture

438. IAS 41: *Agriculture* was issued in December 2000 and became effective from 1 January 2003.

Objective of IAS 41

439. The objective of IAS 41 is to prescribe the accounting treatment, financial statement presentation and disclosures related to agricultural activity. Agricultural activity is the management by an entity of the biological transformation of biological assets for sale, into agricultural produce, or into additional biological assets.

Scope of IAS 41

440. IAS 41 is applied to account for the following when they relate to agricultural activity;

a. Biological assets;

b. Agricultural produce at the point of harvest; and

c. Government grants related to biological assets.

441. IAS 41 does **not** apply to:

a. Land related to agricultural activity (IAS 16 *Property, Plant and Equipment* and IAS 40 *Investment Property*);

b. Intangible assets related to agricultural activity, e.g. milk quotas (IAS 38 *Intangible Assets*).

Definitions, Initial recognition and measurement

442. A Biological Asset is a living animal or plant. Agricultural produce is the harvested product of the entity's biological assets.

443. An entity will recognise a biological asset or agricultural produce when, and only when:

a. the entity controls the asset as the result of past events;

b. it is probable that future economic benefits associated with the asset will flow to the entity; and

c. the fair value or cost of the asset can be measured reliably.

444. A biological asset is required to be measured on initial recognition and at each balance sheet date at its fair value less estimated point-of-sale costs, except only on initial recognition, and only if market-determined prices or values are not available, in which

case the biological asset is measured at cost less any accumulated depreciation and any accumulated impairment losses.

445. Agricultural produce harvested from an entity's biological assets are measured at its fair value less estimated point-of-sale costs at the point of harvest. Fair value measurement stops at harvest, from which point IAS 2 *Inventories* applies.

446. Point-of-sale costs include commissions to brokers and dealers, levies by regulatory agencies and commodity exchanges, and transfer taxes and duties. Point-of-sale costs exclude transport and other costs necessary to get assets to a market.

Guidance on measurement of fair value

447. IAS 41 provides guidance on the measurement of fair value as follows:

a. contract prices to sell at a future date are not necessarily relevant in determining the fair value of a biological asset or agricultural produce, because fair value reflects the current market rate in which a willing buyer and seller would enter into a transaction;

b. if an active market exists for a biological asset or agricultural produce then the quoted market price represents the most reliable basis for determining the fair value of the asset. If an active market does not exist then IAS 41 provides alternatives;

c. in some circumstances, market-determined prices or values may not be available for a biological asset in its present condition. In these circumstances the present value of expected net cash flows should be used, discounted at a current market-determined pre-tax rate;

d. cost may sometimes approximate fair value when little biological transformation has taken place since initial cost occurrence, or, the impact of the biological transformation on price is not expected to be material.

Gains and losses

448. A gain or loss on initial recognition of biological assets at fair value, and changes in fair value of biological assets during a period are reported in net profit or loss.

449. A gain or loss arising on initial recognition of agricultural produce at fair value (as a result of harvesting) should be included in net profit or loss for the period in which they occur.

Government grants

450. Unconditional government grants related to a biological asset measured at fair value are reported as income when the grant becomes receivable.

451. Conditional government grants related to a biological asset measured at fair value (including where the grant requires an entity not to engage in certain agricultural activity) are recognised as income only when the conditions have been met.

Other issues

452. Whilst agricultural land is accounted for under IAS 16 *Property, Plant and Equipment*, biological assets that are physically attached to land are measured as biological assets separate from the land, e.g. an entity can use information regarding the combined assets to determine fair value for the biological assets.

453. The fair value less estimated point-of-sale costs of a biological asset can change due to both physical changes and price changes in the market. Separate disclosure of physical and price changes is encouraged, but not required.

Disclosure

454. Disclosure requirements include:

a. the aggregate gain or loss in the period on initial recognition of biological assets and agricultural produce, and change of fair value in the period;

b. a description of each group of biological assets (narrative or quantified description);

c. a description of the nature of the entity's activities involving each group of biological assets, and, non-financial measures or estimates of the physical quantities of each biological group of assets at the end of the period, and of physical quantities of output;

d. the methods and assumptions applied for determining fair value;

e. information on the existence and carrying amounts of biological assets whose title is restricted, and the carrying amounts of biological assets pledged as security for liabilities,

f. the amount of commitments for the development or acquisition of biological assets;

g. financial risk management strategies related to agricultural activity;

h. a reconciliation of changes in the carrying amount of biological assets, showing separately changes in value, increases due to purchases, decreases attributable to sales, decreases due to harvesting, increases from business combinations and foreign exchange differences.

455. Disclosure of a quantified description of each group of biological assets, distinguishing between consumable and bearer biological assets, or between mature and immature assets, is encouraged but not required.

456. If fair value cannot be measured reliably, and an entity measures biological assets at cost less any accumulated depreciation and any accumulated impairment losses at the end of the period, then additional required disclosures include:

a. a description of the biological assets;

b. an explanation of why fair value cannot be measured reliably;

c. if possible, the range of estimates within which fair value is highly likely to lie;

d. the depreciation method used;

e. the useful lives of the depreciation rates used; and

f. the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period.

457. If the fair value of biological assets previously measured at cost now becomes available, certain additional disclosures are required (IAS 41.56).

458. Disclosures relating to government grants include the nature and extent of the grants, unfulfilled conditions and other contingencies, and significant decreases expected in the level of government grants.

Comparison with requirements under UK GAAP

459. There is no equivalent Standard in UK GAAP for the accounting treatment related to agricultural activity, as defined in IAS 41.

460. As an example of existing practice, presently, the Forestry Commission does not separately account for biological assets (trees). Such biological assets are included within Land values (Forest Estate category), which includes bare land, any trees growing on it and roads, and valued under an Existing Use basis. It should be noted that not all forest owned by a body such as the Forestry Commission is for agricultural activity. Forest held for recreational purposes would fall within IAS 16 *Property, Plant and Equipment*

Impact of IAS 41 on public sector accounts

461. IAS 41 is likely to impact on a small number of entities covered by the requirements of the FReM. IAS 41 does require the separate accounting for agricultural activity as defined by the Standard, where currently entities may not separately account for such items. The Standard also requires the use of fair value measurement, however, this is unlikely to produce materially different results from where an Existing Use basis valuation is used, e.g. in trees harvested for timber.

462. IAS 41 also has significant disclosure requirements, detailed in paragraphs 17-21, which will be a new requirement.

Impact on disclosures in resource and other accounts

463. The presentation and disclosure requirements of IAS 41 will be taken into account in developing the format of resource and other accounts in the light of the move to EU-adopted IFRS and other initiatives.

IFRS 1 First Time Adoption of IFRS

464. IFRS 1 deals with the first time adoption of international accounting standards. It describes in some detail how the first IFRS-based financial statements are to be determined; the key feature is whether those statements contain an explicit and unreserved statement of compliance with IFRSs. Accounts prepared in accordance with the FReM will thus need to include such a statement. In general, IFRS 1 requires an entity to comply with each IFRS effective at the reporting date for its first IFRS-based financial statements.

465. It will be necessary for the entity to prepare an opening balance sheet at the date of transition to IFRSs which will form the starting point for its accounting under IFRSs. This balance sheet need not be presented in the first IFRS-based financial statements. Thus, if a move to IFRS-based accounts is planned for (say) 2008-09, it will be necessary to prepare an IFRS-based balance sheet at 1 April 2008 that may differ from the UK GAAP-based balance sheet at 31 March 2008.

466. Subject to some limited exemptions in specified areas on cost/benefit grounds, the opening IFRS balance sheet will:

- Recognise all assets and liabilities whose recognition is required by IFRSs;
- Not recognise items as assets and liabilities if IFRSs do not permit such recognition;
- Reclassify items that were recognised under previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity under IFRSs; and
- Apply IFRSs in measuring all recognised assets and liabilities.

467. Where the adoption of IFRSs results in differences between the closing balance sheet and the opening balance sheet, those differences shall be recognised directly in retained earnings (eg the General Fund) at the date of transition to IFRSs.

468. However, the standard provides for two categories of exceptions to the principle that an entity's opening IFRS balance sheet shall comply with each IFRS:

a. Exemptions from some requirements of other IFRSs;

b. Prohibition of retrospective application of some requirements of other IFRSs.

469. This paper does not comment on all the examples quoted in the IFRS 2, but the following are considered to be most relevant in a public sector context:

(i) Fair value or revaluation as deemed cost

470. The opening IFRS balance sheet should record property, plant and equipment at their fair values. However, it is possible to use a previous valuation if that revaluation was broadly comparable to (a) fair value or (b) cost or depreciated cost under IFRSs adjusted to reflect changes in a general or specific index.

471. It is considered likely that the valuation methods adopted by central government entities will satisfy one or other of the above criteria and, on the face of it, there seems little need for a separate assessment of fair values on the adoption of IFRSs.

(ii) Employee benefits

472. IAS 19 Employee Benefits allows an entity to use the option of using a "corridor" approach in recognising actuarial gains and losses, and IFRS 1 provides guidance on the implications of the initial adoption of IAS 19. However, central government bodies are not permitted to use the corridor approach, and the dispensations allowed by IFRS 1 will not be relevant.

473. IFRS 1 requires the first set of IFRS-based accounts to include comparative figures for the balance sheet, income statement, cash flow statement and notes based on IFRSs. However, to avoid complications with reconciling these figures with those used in previous Estimates and accounts, the proposal is to allow the first IFRS-based accounts to include comparative figures from the previous UK-GAAP based accounts, unless there are material differences between figures determined on a UK-GAAP and IFRS basis.

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[2] The exemptions listed in IFRS 1 cover business combinations; fair value or revaluation as deemed costs; employee benefits; cumulative translation differences; compound financial instruments; assets and liabilities of subsidiaries, associates and joint ventures; designation of previously recognised financial instruments; share-based payment transactions; insurance contracts; decommissioning liabilities included in the cost of property, plant, and equipment; leases; and fair value measurement of financial assets or financial liabilities at initial recognition.

IFRS 2 Share Based Payments

474. At its meeting on the 29 September 2004 (FRAB (69) 03), the Board was asked to note the issue of FRS 20 *Share-based payments* which was compliant with IFRS 2, being identical to IFRS 2 apart from implementation dates and reference to the FRSSE.

475. At that time the Board were asked to note that both Standards (IFRS 2 and FRS 20) had no relevance to public sector accounting and that the then RAM, NDPB and Trading Fund accounting guidance would be amended to reflect this.

IFRS based FReM

476. This paper re-confirms that IFRS 2 has no relevance to public sector accounting and that the IFRS based FReM will include a reference to this effect.

IFRS 3 Business Combinations

Main Features of IFRS 3

477. The main features of IFRS 3 are set out below.

478. All business combinations within the scope of IFRS 3 are to be accounted for by applying the purchase method (commonly referred to as the acquisition method in the UK).

479. IFRS 3 excludes from its scope;

- business combinations in which separate entities or businesses are brought together to form a joint venture;

- business combinations involving entities or businesses under common control;

- business combinations involving two or more mutual entities;

- business combinations in which separate entities or businesses are brought together to form a reporting entity by contract alone without the obtaining of an ownership interest (for example, combinations in which the separate entities are brought together by contract alone to form a dual listed corporation).

480. An acquirer is identified for every business combination within the scope of IFRS 3. The acquirer being the combining entity that obtains control of the other combining entity.

481. The acquirer measures the cost of a business combination as the aggregate of: the fair values, at the date of exchange of the assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree, plus any costs directly attributable to the business combination.

482. The acquirer recognises separately at the date of acquisition the acquiree's identifiable assets, liabilities and contingent liabilities that satisfy the following recognition criteria at that date, regardless of whether they had been previously recognised in the acquiree's financial statements:

- in the case of an asset other than an intangible asset, it is probable that any associated future economic benefit will flow to the acquirer, and its fair value can be measured reliably;

- in the case of a liability other than a contingent liability, it is probable that an outflow of resources embodying economic benefit will be required to settle the obligation, and its fair value can be measured reliably;

- in the case of an intangible asset or a contingent liability, its fair value can be measured reliably.

483. The identifiable assets, liabilities and contingent liabilities that satisfy the above recognition criteria are to be measured initially by the acquirer at their fair values at the acquisition date, irrespective of the extent of any minority interest.

484. Goodwill acquired in a business combination is recognised by the acquirer as an asset from the acquisition date, initially measured as the excess of the cost of the business combination over the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities recognised as above.

485. IFRS 3 prohibits the amortisation of goodwill acquired in a business combination and instead requires goodwill to be tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired, in accordance with IAS 36 *Impairment of Assets*.

486. IFRS 3 requires the acquirer to reassess the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the business combination if the acquirer's interest in the net fair value of the items recognised as detailed above exceeds the cost of the combination (what FRS 10 refers to as '*negative goodwill*'). Any excess remaining after the reassessment must be recognised by the acquirer immediately in profit or loss.

Comparison with the requirements of UK GAAP

487. The overriding difference between IFRS 3 and UK GAAP is that IFRS 3 effectively outlaws the use of merger accounting. In the UK FRS 6 allows for the use of merger accounting where strict criteria are met. In all other cases acquisition accounting is used.

488. FRS 6 specifically allows the use of merger accounting for group reconstructions even though such combinations might not meet strict merger accounting criteria. Group reconstructions can be accounted for as mergers where: '*companies legislation does not prohibit its use, the ultimate shareholders remain the same as do their rights in relation to other shareholders and no minority interests in the group are altered*'.

489. IFRS 3 provides guidance (in its *Application Supplement – Allocating the cost of a business combination*) on the fair value measures to be applied to assets and liabilities acquired. In the UK guidance on fair values is provided by FRS 7 *Fair Values in Acquisition Accounting*. There is little difference between the fair value measures in IFRS 3 and FRS 7.

490. IFRS 3 also provides guidance on accounting for goodwill. In the UK FRS 10 provides guidance. The method of calculating goodwill contained in the draft IFRS 3 exposed by the IASB was very different to that in FRS 10. However, the method of calculating goodwill in the issued standard is in-line with that in FRS 10.

491. IFRS 3 prohibits the amortisation of goodwill. Goodwill should instead be subject to an annual impairment review, or more frequent review if events or changes in circumstances suggest that goodwill might be impaired (as per IAS 36). FRS 10 contains a rebutable assumption that goodwill and intangibles have a useful economic life of less than 20 years and should be amortised accordingly. Where goodwill is assessed as having a life of greater than 20 years the asset should be subject to an annual impairment review.

Regardless, goodwill and intangibles should be subject to impairment reviews where, like IAS 36, events or changes in circumstances suggest that it might be impaired.

492. IFRS 3 requires that *negative goodwill* is immediately taken to profit and loss. FRS10 requires negative goodwill up to the value of the non-monetary assets acquired to be recognised in the period that the assets are recovered, whether through depreciation or sale. Any excess is released to the P&L over the period that will benefit from the negative goodwill.

493. There is a minor difference in the re-measurement window in IFRS 3 as compared to FRS 6. IFRS 3 allows a 12 month period of re-measurement during which time the value assigned to acquired assets and liabilities can be amended and goodwill adjusted accordingly. FRS 6 allows for adjustment up to the end of the second reporting period after the combination.

Impact of IFRS 3 on the Public Sector

494. The existing FReM interprets the requirements of FRS 6: '*the merger of two or more entities into one new entity, or the transfer of functions from the responsibility of one departmental group to another (commonly known as Machinery of Government changes), will be accounted for using merger accounting'*. The basis of this interpretation is that bodies covered by the FReM are deemed to be under common control and therefore such changes are viewed as group reconstructions (FRS 6, 13 refers).

495. Machinery of government changes are those stemming from the streamlining of the public sector where for reasons of improved service delivery functions are moved from one part of the public sector to another. This can be as wide as two large departments being brought together to form a new entity or as narrow as a small function moving from one department to another.

Applying IFRS 3

496. Public sector bodies are deemed to be under common control and therefore business combinations involving such bodies are outside the scope of IFRS 3.

497. It is proposed that the UK public sector continues to use merger accounting for transfers of functions and machinery of government changes within the sector. This proposal will be re-considered once IASB have finalised Phase II of its Business Combinations project.

498. Combinations involving an entity or entities within the public sector with an entity outside the sector will follow the requirements of IFRS 3.

499. Transfers of assets within the public sector, which do not represent a transfer of functions or a machinery of government change, will be accounted for using the fair values measures in IFRS 3.

IFRS 4 Insurance Contracts

500. IFRS 4 *Insurance contracts was* revised in 2003 to be applied for annual periods beginning on or after 1 January 2005, replacing the 2000 version of the standard. It represents the conclusion of Phase 1 of the IASB's project on insurance contracts and was issued because the IASB saw an urgent need for improved disclosures for insurance contracts, and modest improvements to recognition and measurement practices, in time for the adoption of IFRS by listed companies throughout Europe and elsewhere in 2005. The improvements to recognition and measurement are ones that will not likely have to be reversed when the IASB completes the second phase of the project.

501. IFRS 4 applies to most insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds. It does not apply to other assets and liabilities of an insurer, such as financial assets and financial liabilities within the scope of IAS 39 Financial Instruments: Recognition and Measurement. Nor does it cover accounting by policyholders. It defines an insurance contract as a "contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder."

Improved disclosures

502. The IFRS requires extensive disclosures of information that helps users understand the assets, liabilities, income, expense, and cash flows in the insurer's financial statements that arise from insurance contracts, including the accounting policies and estimation techniques used. Further information is required on the amount, timing and uncertainty of future cash flows from insurance contracts, including on risk management objectives and policies, the terms and conditions of insurance contracts, insurance risk, (with sensitivity analysis), and interest rate risk and credit risk.

Improvements to recognition and measurement practices

503. The IFRS does not prescribe the use of specific accounting policies. Instead it aims to prohibit some. For example, it prohibits those involving the use of provisions for possible claims under contracts that are not in existence at the reporting date (such as catastrophe and equalisation provisions), and accounting policies that de-recognise insurance liabilities before they are discharged or cancelled, or expire. And it requires a test for the adequacy of recognised insurance liabilities and an impairment test for reinsurance assets.

504. It also limits changes to accounting policies to those that produce better information. For example, an accounting policy that measures insurance liabilities on an undiscounted basis can be continued under IFRS 4 but may not be introduced as a new policy.

Main differences from UK GAAP

505. There is no direct equivalent in UK GAAP to IFRS 4. Entities in the UK that carry out insurance business apply the Association of British Insurer's Statement of

Recommended Practice on Accounting for Insurance (SORP), whereas the IFRS is wider in its scope in applying to all insurance contracts issued by any reporting entity. Insurance contracts as defined in IFRS 4 that are issued by entities in the UK that do not undertake insurance business apply the UK accounting standards that underlie the SORP, eg FRS 5, 12 (other than as issued by an insurance entity) and 13. Application of either these accounting standards or the SORP would be unlikely to lead to significant inconsistency with the IFRS for recognition and measurement, though the IFRS based disclosures would be more extensive.

Impact of IFRS 4 on the public sector

506. IFRS 4 is likely to have little significant impact on the recognition and measurement practices for insurance contracts undertaken by entities covered by the requirements of the FReM.

507. It may affect disclosures in the accounts of the ECGD, but elsewhere there may be few changes as government does not issue significant insurance contracts widely otherwise.

IFRS 5 Non-Current Assets Held for Resale and Discontinued Operations

508. IFRS 5 *Non-current assets held for sale and discontinued operations* was issued as one of the outputs of a short-term project being undertaken by the IASB and the US Financial Accounting Standards Board (FASB), aimed at reducing the differences between IFRS and US Statements of Financial Accounting Standards (SFAS). IFRS 5 achieves significant convergence with the requirements of SFAS 144 *Accounting for the impairment or disposal of long-lived assets* in accounting for assets held for sale, the timing of the recognition of discontinued operations and the presentation of those operations.

The main features of IFRS 5

509. The introduction to IFRS 5 lists its main features as:

a. adopting the classification of assets held for sale, using the defined terms set out in Appendix A to the IFRS;

b. introducing the concept of a disposal group, which is a group of assets that will be disposed of (by sale or otherwise as a group in a single transaction) together with the associated liabilities;

c. requiring assets or disposal groups that are classified as held for sale to be measured at the lower of carrying amount and the fair value less costs of sale;

d. specifying that assets classified as held for sale, or included within disposal groups classified as held for sale, should not be depreciated;

e. specifying that assets classified as held for sale, and the assets and liabilities included within disposal groups classified as held for sale, should be presented separately on the face of the balance sheet;

f. classifying an operation as discontinued at the date the operation meets the criteria to be classified as held for sale or when the entity has disposed of the operation;

g. requiring the results of discontinued operations to be presented separately on the face of the income statement; and

h. prohibiting the retrospective classification of an operation as discontinued, when the classification criteria are not met until after the balance sheet date.

510. IFRS 5 does **not** apply to the following assets, which are covered by other standards:

a) deferred tax assets (IAS 12 *Income taxes*);

b) assets arising from employee benefits (IAS 19 *Employee benefits*);

c) financial assets within the scope of IAS 39 *Financial instruments: recognition and measurement*;

d) non-current assets held at fair value under IAS 40 *Investment properties*;

e) non-current assets measured at fair value under IAS 41 *Agriculture*; and

f) contractual rights under insurance contracts as defined in IFRS 4 *Insurance contracts*.

Comparison with requirements under UK GAAP

511. Under both FRS 3 and IFRS 5, the activities that are ending must be significant to be classed as discontinued operations. FRS 3 requires that they must have a material effect on the nature and focus of the reporting entity's operations and a material reduction in its operating facilities, whereas IFRS 5 states that the activities must represent a separate, major line of business or geographical area of operations.

512. The classification criteria for a discontinued operation under IFRS 5 precludes recognising an operation as discontinued where those criteria were not met at the balance sheet date. The criteria, which are the same as those for recognising any other asset as held for sale, include:

c) the asset or disposal group is available for immediate sale;

d) an active plan, supported by management, should be in place, and active steps being taken to find a buyer and conclude the sale;

e) the asset (or disposal group) should be marketed for sale at a price that is reasonable relative to its fair value, and the sale is expected to be concluded within one year at that price, although a period of more than one year does not preclude carrying the asset as available for sale provided that the events that cause the extension are outside the entity's control; and

f) if changes in circumstances mean that the classification criteria are no longer met, the entity should immediately cease to classify the asset (or disposal group) as available for sale.

513. Under UK GAAP (FRS 3 *Reporting Financial Performance*) operations could be recognised as discontinued if the sale or termination had been completed after the balance sheet date, but no later than three months of the balance sheet date or the date on which the financial statements were approved, whichever was the earlier. This need not be the case under IFRS 5, where the sale needs to be completed normally within one year of the asset or disposal group becoming available for resale.

514. FRS 3 requires full information to be given about discontinued operations (for example, turnover, costs of sales and net operating expenses) in the profit and loss account. IFRS 5 requires only the profit from discontinued operations to be shown on the face of the income statement (after profit from continuing operations), with appropriate analysis given in the notes.

515. There are no specific requirements in UK GAAP (FRS 15 *Tangible fixed assets*, for example) to disclose separately on the balance sheet assets held for sale, although some argue that they should be disclosed as a separate category within fixed assets. Others consider that assets no longer held for use should be reclassified as current assets or as current asset investments. If the former, the asset will be carried at the lower of cost or net realisable and if the latter, can be carried at valuation.

516. IFRS 5 requires the assets and liabilities to be disclosed separately: as additional lines after sub-totals of other current assets and current liabilities. Additionally, if any amounts relating to the assets have been taken direct to equity, then a separate line needs to be shown in the equity section of the balance sheet disclosing that amount.

IFRS 6 Exploration for and Evaluation of Mineral Resources

517. The introduction to IFRS 6 lists the main features as:

a) permitting entities to develop accounting policies for exploration and evaluation assets without specifically considering the requirements of paragraphs 11 and 12 of IAS 8. As such, an entity may continue to use those policies applied immediately prior to the adoption of IFRS 6. This includes continuing to use the recognition and measurement practices that are part of those accounting policies.

b) requiring entities recognising exploration and evaluation assets to perform an impairment test on those assets when the facts and circumstances suggest that the carrying amount of the assets may exceed their recoverable amount.

c) varying the recognition of impairments from that in IAS 36 *Impairment of Assets* but measureing the impairment in accordance with IAS 36 once the impairment is identified.

Impact of IFRS 6 on the public sector accounts

518. The Treasury knows of no entity covered by the FReM that is engaged in extractive activities or likely to become engaged in extractive activities in the future. As such, while IFRS 6 will apply to the public sector no specific accounting guidance will be provided in the shadow FReM. The shadow FReM, or its associated guidance, will contain a statement to this effect (e.g. standing alongside the current FReM is a list of those standards applied by the public sector with the relevant FReM chapter).

IFRS 7 Financial Instruments - Disclosures

519. IFRS 7's objective is to require disclosures that enable users to evaluate the significance of finance instruments for an entity's financial position and performance, and on risks relating to those financial instruments. Due to the largely non-trading nature of their activities and the way in which they are financed, many entities in Government are not exposed to the degree of financial risk faced by business entities. Moreover, financial instruments play a much more limited role in creating or changing risk than would be typical of the listed companies to which the IASs mainly apply. Generally, financial assets and liabilities are generated by day-to-day operational activities and are not held to manage the risks facing the entity in undertaking its activities.

520. Accordingly few entities' financial instruments are likely to give rise to risks significant enough for detailed closure to be necessary for the entity's overall financial position, performance or cash flows to be understood. It is proposed that disclosure be limited to what is necessary for that understanding.

Overview of IFRS 7

521. IFRS 7 Financial instruments: Disclosures was issued in December 2004. It has the effect of implementing IFRS 7 for entities not preparing their accounts in accordance with IASs as adopted in Europe. It sets out requirements for disclosures relating to, financial instruments. It applies to all entities for accounting periods beginning on or after 1 January 2007, and replaces the disclosure requirements of IAS 32, Capital instruments.

522. IFRS 7's objective is to enhance financial statements users' understanding of the significance of financial instruments to an entity's financial instruments, performance and cash flows.

523. The disclosures required by IFRS 7 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.

Changes from existing standards

524. A further new requirement of IFRS 7 is for capital disclosures. Capital is not defined in IFRS 7. Indeed, one of its disclosure requirements is of what a reporting entity means by that term. But private sector commentators on the related requirements in IAS 1

consider that capital would seem to be primarily an entity's equity resources or the buffer that is available to absorb losses before creditors are exposed to such risk.

Implementation of IFRS 7 in the FReM

525. The FReM does not adapt FRS 13's disclosure requirements, and it is not proposed that the FReM should adapt those of IAS 32.

526. The FReM, para 7.4.45, gives a number of interpretations of FRS 13 for the public sector context. It is proposed that these interpretations should continue to be included for IFRS 7.

527. Further, many departments, NDPBs and trading funds are likely to have few dealings in financial instruments that give rise to risks for which IFRS 7 would require extensive disclosure because of their significance to an understanding of the entity's overall financial position, performance or cash flows. Accordingly, it is proposed that the FReM include an interpretation of IFRS 7 that draws attention to the need to disclose only what is necessary for that understanding.

528. Lastly, in the FRS's capital disclosure requirements the notion of capital as a buffer for risk to creditors does not arise in the same way for public sector entities. This is because of the nature of the, ultimately taxed based, financing of the public sector. So it is proposed here that IFRS 7 is interpreted as giving rise only rarely to any capital disclosures for which prior consultation will be required with the relevant authorities.

IFRS 8 Operating Segments

Comprehensive Spending Review (CSR) 07

529. Under the CSR 07 departments are required to establish a set of strategic objectives. These objectives should cover the full range of the department's business and form the 'top line' of the department's business plan. Public Service Agreements (PSAs) will be supported by strategic objectives, however not all strategic objectives will relate to PSAs. PSAs represent a priority subset of government business for the spending period, stemming from all overarching goals of government and responding to long-term challenges facing the UK.

530. CSR 07 requires departments to manage their activities in line with their departmental strategic objectives (DSOs). The Treasury proposes that DSOs should form the IFRS 8 reportable segments and that any links between the DSOs and a department's PSAs be disclosed.

Differences in focus between the Statement of Net Operating Cost by Aim and Objectives and IFRS 8

531. The purpose of IFRS 8 is to provide users of financial statements with information about the entities revenue earning segments. Whereas, the purpose of the *Statement of Net Operating Costs by aims and Objectives* is to provide users of the financial statements with information about the resources used by the entity in meetings its objectives, which are in turn linked to the delivery of government policy.

532. Strictly applied it is questionable that departments would provide any information under IFRS 8, given that it requires entities to report revenue earning segments whose results are regularly reviewed by the Chief Operating Decision Maker.

533. IFRS 8 (13) provides guidance on the quantitative thresholds for sales, reported profit and assets above which a segment should be separately reported. IFRS 8 (13) goes on to say; *operating segments that do not meet any of the quantitative thresholds may be considered reportable, and separately disclosed, if management believes that information about the segment would be useful to users of the financial statements*.

Segmental information required by IFRS 8

534. IFRS 8 only requires that a measure of profit or loss and total assets for each segment are reported. While the standard also requires that liabilities, revenues, interest revenue, interest expense, depreciation and a range of further items are reported for each segment it caveats this requirement with the statement; if provided to/reviewed by the Chief Operating Decision Maker.

535. IFRS 8 also requires that the entity reconcile reported segmental revenue, profit or loss, assets, liabilities and all material reported items to the total figure in the financial statements. This is because IFRS 8 does not require full allocation of the above items to reportable segments, it only requires that at least 75% of external revenue is reported by operating segments, the remainder being reported within an 'other' segment. Further,

IFRS 8 accepts that corporate support activities are not operating segments as they do not generate revenue.

536. It could be argued that the *Statement of Net Operating Costs by Aims and Objectives* meets the reporting requirements of IFRS 8 albeit interpreted to disclose on an expenditure, rather than an income, basis.

Proposed Application of IFRS 8 for Departments

537. The requirement to prepare a *Statement* of *Net Operating Costs by Aims and Objectives* is to be withdrawn and replaced with a *Statement of Net Operating Cost by Departmental Strategic Objectives* based on IFRS 8 disclosures.

538. Executive Agencies (that are not whole departments), NDPBs, Trading Funds are to apply IFRS 8 in full.

539. Departments (and all other bodies required to prepare a *Statement* of *Net Operating Costs by Aims and Objectives*) will apply IFRS 8 as interpreted, with the department's strategic objectives agreed under the CSR 07 settlement as its reportable segments. Departments will disclose the gross expenditure, income, net expenditure and total property, plant and machinery for each operating segment on a full allocation basis.

540. The reporting required under IFRS 8 is similar to that required in the *Statement of Net Operating Costs by Aim and Objectives* except for the requirement to disclose property, plant and machinery for each segment, which is new. The actual IFRS 8 requirement is to report total assets by segment. It will be difficult for some Department's to prepare materially correct segmental information for property, plant and machinery but not impossible – they are already allocating out depreciation in the *Statement of Net Operating Costs by Aim and Objectives,* so it should be possible to impute such asset values. It will be much more difficult to allocate other asset values to operating segments so as to arrive at total assets as required by the standard. However, for the majority of departments, these assets are unlikely to be material in the context of their financial statements and, where they are material, any such allocation is unlikely to be reliable or meaningful (e.g. allocating large cash balances to segments).

541. It is proposed that for each segment departments also disclose, on a full allocation basis, any further information required by IFRS 8 which is routinely reviewed by the Department's Chief Operating Decision Maker.

542. As departments are fully allocating expenditure, income and property, plant and equipment to segments formal reconciliation to the OCS and the balance sheet as required by IFRS 8 will not be necessary.

Fees and Charges Disclosures

543. Managing Public Money contains an additional disclosure requirement for all services for which income exceeds £1m (or is material in the context of the financial statements). These disclosures are part of the general accountability requirements that Accounting Officers must adhere to.

544. Fees and charges disclosure requirements should be followed in full, however, where fees and charges reporting requirements are already met through IFRS 8 disclosures, entities need not duplicate disclosure.

Impact on disclosures in resource and other accounts

545. There are no further disclosure requirements than those detailed above.