FINANCIAL REPORTING FACULTY

BY ALL ACCOUNTS

THE JOURNAL FOR FINANCIAL REPORTING FACULTY MEMBERS

ISSUE 2 | JULY 2010

IFRS & BEYOND

We speak to the IASB's Sir David Tweedie, Ken Beeton at HM Treasury, and UK smaller practitioner Peter Nicol.

PLUS...

Expert commentary on IFRS and UK GAAP developments.

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FROM THE CHAIRMAN

I'm delighted to welcome you to the second issue of the faculty's journal, *By All Accounts*. A tremendous amount of work has gone into maintaining the high standard set by the first issue and to expand the range of technical content to try to meet the diverse interests of our members. This is reflected in the inclusion in the journal of interviews providing excellent insights on financial reporting from three very different perspectives: with Sir David Tweedie, Chairman of the IASB; with Ken Beeton, Director of Financial Management & Reporting at HM Treasury; and with UK smaller practitioner Peter Nicol.

We continue to build the member offering of the faculty in line with your feedback. In the first half of 2010 we published several of our acclaimed online factsheets, designed to provide members with practical commentary on recent changes in accounting requirements. In response to your comments we are aiming to provide more information on what new factsheets are in the pipeline. Our blogging platform attracts a broad range of content from our highly-respected community of financial reporting professionals, and our first events roadshow commenced in June. After your positive feedback, we hope to produce two issues of *By All Accounts* this year, together with one or more supplements to cater for special interests.

The excellent work of the faculty staff is in many respects underpinned by the work of volunteers, and I would like to take this opportunity to express my sincere thanks to the many individuals who have contributed to the faculty's strategy and output over the past 18 months. This edition of *By All Accounts* profiles the members of the editorial board, who work tirelessly to ensure that the faculty's publications meet the very highest standards.

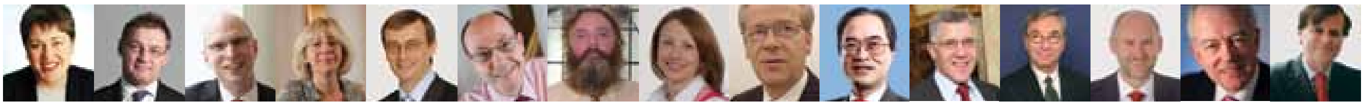
As your Chair – and an elected member of the Board since the April 2010 AGM – I look forward to the further enhancement of the faculty's offering during the remainder of the year.

FROM THE FACULTY HEAD

For everyone closely involved with financial reporting, 2009 was a difficult year. Not only did we have to deal with the challenges presented by the global economic crisis, we also had to prepare for key changes in IFRS and UK GAAP reporting for 2010 and pay attention to a raft of proposals for further reform at UK, European and global levels. It therefore seems timely that the faculty was launched at the end of 2008. Since then it has attracted a substantial number of members from the UK and overseas and has established itself internationally as a trusted voice on financial reporting issues.

Historic events are often only identified in hindsight. History may record that the early years of the faculty coincided with transformational changes in financial reporting, both internationally and in the UK. These include the worldwide IFRS revolution, spectacular in many respects but still vulnerable and incomplete at present, not least due to hesitation in the US and discontent in Europe over IASB governance; the impact of the financial crisis, with debate still continuing both on the need for reform of financial instruments accounting, and on whether the focus of financial reporting should be on transparency or financial stability; in the EU, controversy over whether small companies should be required to produce GAAP accounts at all; the debate about withdrawing UK GAAP as we know it and the ongoing shift in the basis of public sector accounting in the UK. Accountants of a certain age may look back with some nostalgia to a rather more manageable pace of change in the 1980s and 90s.

This edition of the faculty journal explores many of the current challenges facing faculty members. We hope that you find it interesting. Ideas for the next edition are very welcome.



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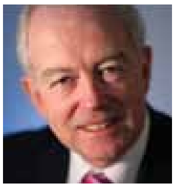
PROACTIVE, RESPONSIVE AND ACCOUNTABLE? AN INTERVIEW WITH SIR DAVID TWEEDIE

In an exclusive interview for the Financial Reporting Faculty, Sir David Tweedie, Chairman of the IASB, speaks to Robert Bruce, veteran financial journalist, about past successes and current and future challenges.



The zest is undiminished. A lifetime spent battling to bring about better standards of financial reporting, first in the UK and then around the world, has not blunted the enthusiasm of Sir David Tweedie. He has spent the last 10 years as Chairman of the International Accounting Standards Board (IASB), and the 10 years before that as Chairman of the UK's Accounting Standards Board, (ASB). By the middle of next year he will be stepping down as Chairman of the IASB, though it is likely, after a brief pause for breath, that he will become President of the Institute of Chartered Accountants of Scotland in April 2012. It seemed like good timing for the Financial Reporting Faculty to ask some questions.

The first and most obvious one was what Sir David considered his greatest achievement as a standard setter. He had no doubt. 'It was the time spent with my colleagues from the ASB turning back the years of the creeping crumple in the UK in the late 1980s, banning outrageous practices through the Urgent Issues Task Force, and introducing more principles-based standards into the UK', he said. And if he had his time over again would there be anything he would do differently? 'Much as I would have liked to have spent most of our time at the IASB re-writing many of the standards we inherited, the main objective of the Board I chaired was to get

'I hate, loathe and detest the income tax standard.'

countries to buy in to the vision of one single set of high quality global standards', he said. 'The fact that at present 117 countries allow these standards and many more major economies are adopting IFRS in the next few years is a reward in itself'.

He is a forthright critic and it is no surprise that asking him what were his favourite and least favourite standards, and why, produced an immediate reaction. 'I hate loathe and detest the income tax standard', he said. 'I believe that it shows liabilities that simply don't exist and I am sorry that in my time, under my chairmanship, there was no time to amend this standard. Similarly, I think other standards are too complicated. Specifically, the standard dealing with share-based payments and others, notably dealing with associates, have no rationale whatsoever. Associate accounting was satisfactory when there was no accounting for off balance sheet subsidiaries. That problem has been addressed and we now still have ridiculous accounting showing the share of profits in an associate when in fact, there is no way these profits can be obtained by the investor'.

As for his favourite standards, well there is a bit of a bias towards the UK here. 'My favourite standards are probably those from the UK, namely standards improving acquisition accounting, which was probably the biggest scam in British accounting in the latter part of the last century, the impairment method of dealing with goodwill and showing the full effect of changes in the pension fund, FRS 17. And all of these proposals have been adopted internationally'.

On the old imponderable of how far the investor and preparer communities feel they are involved in the standard-setting process he is upbeat. 'Overall I'd hope that they feel engaged in the process', he said, 'but there is of course always more that we can do. We have dramatically improved our engagement with stakeholders during the last few years. Our due process is rigorous and transparent, and we now routinely undertake a dizzying amount of outreach activities to supplement the formal due process consultation, such as roundtable discussions, webcasts, podcasts, blogs, snapshots, conferences, and so on'. And there is more to come. 'We receive high levels of input from preparers, but it is more difficult to encourage investors to get involved. We have recently launched an initiative to encourage greater investor participation in the standard-setting process, and the early signs are encouraging'.

How far, we asked, has the financial crisis been a risk, a threat, or an opportunity for the IASB and has the G20 timetable meant that you have taken on too much work in too short a time? His answer was swift. 'Yes, yes, yes and yes', he said. 'The crisis has provided the greatest real-world stress-test of financial reporting in a generation. In general the standards stood up pretty well to an intense battering and it would be surprising if there were no improvements to be made. In response to the crisis we have provided additional guidance on how to apply fair value measurement in illiquid markets, improved the accounting for off balance sheet activities and, of course, begun the process of reforming financial instruments accounting'.

And there are opportunities within the crisis. 'I'm also a firm believer in the old adage of "never waste a good crisis"', he said. 'We've been able to get things done in record time, to a very high standard. The crisis has certainly focused the minds of many people, not just at the IASB but also others who have a stake in high quality financial reporting. And that has helped us to engage a broad range of interested parties in the development of new standards'.

He expanded on the theme. 'For example, we had to complete the first part of financial instruments reform in less than six months', he said. 'That meant we have to proactively seek input before, during and after the formal consultation period. We had to bring people with us, show that we were listening, and then once we'd decided which way to go, close the feedback loop.

'We explained what we'd heard, how we were responding, as well as the rationale for the decisions we had taken. That's enough for most reasonable people. Of course', he smiled, 'not all people are reasonable…'

And the overall effect has been good. 'The crisis has changed standard-setting forever, but in a good way', he said. 'It is no longer acceptable to take more than a decade to develop a new standard, or to simply drop proposals onto our constituents and wait for the replies. Proactive, responsive and accountable – these are the attributes of modern-day standard-setting'.

Next we turned to the issue of the barriers to the full adoption of international standards and how those barriers could be removed. 'Well', he said, 'the logic of global standards remains compelling. Recent events, be they the financial crisis, Lehman's Repo 105 or Greek debt, shows the interconnected nature of capital markets around the world. It just doesn't make sense to account differently for the same transaction based on where it may have occurred.

'The markets want global standards, investors want global standards, the G20 wants global standards and the profession wants global standards', he said. 'So, whilst the current challenges to getting there may seem daunting I remain confident that these challenges will be overcome'.

And one of the perceived obstacles is US GAAP. How would he describe it – good, bad, or ugly? 'US GAAP has stood the test of time pretty well', he said. 'Despite what you may hear, US GAAP is principles based. It's just that over the years layer upon layer of guidance have been added, resulting in the burdensome US GAAP that you see today'.

'Our convergence work will result in significant improvements to both IFRSs and US GAAP', he said, 'but the ultimate goal has to be a single, principles-based and high quality set of financial reporting standards that take the best ideas from IFRSs and US GAAP'.

One of the issues up ahead is how far do local circumstances, or cultural differences, or how accountants are trained, for example, make a big difference to how international standards are applied in practice? 'It's a good question', he said. 'It does make a big difference, but one that we work hard to overcome. The benefit of having so many nationalities represented around the board table is that we cannot ignore regional or indeed cultural issues. What may be considered normal practice in Europe may not be acceptable in Asia', he said. 'We also work with national standard setters around the world and seek input on a global basis as part of our due process. And Wayne Upton, our Director of International Activities, also spends a considerable amount of time around the world in order to better understand regional issues and assist with local implementation'.

Looking back, you can argue that UK standards written in the 1990s are some of the best principles-based standards around. Does he look back with pride at those and perhaps look forward with regret? 'I am proud of what we achieved during my time at the ASB', he said. 'Setting standards for a single country was also a much easier task. The number of stakeholders was far less, and we were able to drive through change in a way that is more difficult with so many countries now using IFRSs.

'But the UK, from a financial perspective, is not an island. Global standards are the future, and I am immensely proud of what the members and staff of the IASB have achieved in the last nine years', he said. 'Sure, not all of the standards are as I would have liked. The job of my successor will be to address these deficiencies. However, the benefits of getting to a single set of high quality standards outweighs the odd standard that needs patching up'.

And where does he think IFRS will be in 10 years' time? He has, as you might expect, a clear view. 'I hope and expect that IFRSs will be used by all capital markets around the world, applied on a consistent basis, and will have been further improved under the guidance of the new chairman'.

'I hope and expect that IFRSs will be used by all capital markets around the world.'

And what tips would he give that person? 'My successor will have to deal with the standards that I had no time to reconsider', he said, 'and he'll also have to deal with the implementation difficulties experienced by many large economies switching to IFRS in the next few years. My advice would be to visit as many of these economies as possible, to hear first hand the issues rather than simple looking at written communications from them. Purple faces and knotted veins give you a better impression of how important an issue is deemed to be rather than simply looking at the written word. When someone says something along the lines that a standard does not make economic sense, a chairman has always got to listen to determine whether in fact the situation was not appreciated by the standard setter, which', he smiled, 'does happen, or whether in fact vested interest is involved'.

He paid tribute to his colleagues. 'I have been blessed with outstanding Board members who have become personal friends', he said, 'though some observers may not think it with the ferocity of the arguments that occur in the boardroom. Bringing on new Board members and using them as ambassadors and leaders is critical for any chairman'.

Finally, of course, Tweedie is famed for the many jokes which pepper his speeches and presentations. So we asked which one out of the vast repertoire was his personal favourite. He was on the verge of an annual holiday in the far northwest of Scotland when we spoke. 'So it is not surprising my favourite joke', he said, 'is the one about two partners from the London office of a large accounting firm arriving in the Hebrides to do an investigation, going into a newsagent and, mindful of the need of keeping up to date, asking for a copy of the *Financial Times*. They were taken aback when the old lady behind the counter asked them which they wanted – today's paper or yesterday's paper? Being Londoners and feeling under pressure to keep up to date they of course asked for today's paper. And were promptly told: "Ach weel you'll have to come back tomorrow".'

MATERIALLY DIFFERENT

John Boulton, Faculty Manager, reviews IFRS changes effective for 2010 year-ends.

Changes to IFRS that are mandatory for reporting periods ending in 2010 have the potential to materially impact financial statements. This article highlights some of the main points to be aware of.

ACQUIRERS AND SELLERS BEWARE

Those acquiring and selling businesses need to be aware of the revisions to IFRS 3 *Business Combinations* and IAS 27 *Consolidated and Separate Financial Statements*, which apply to accounting periods beginning on or after 1 July 2009. These will involve major changes to existing practice and may have a material impact on the amounts recognised on an acquisition.

IDENTIFIABLE INTANGIBLE ASSETS

Following the revision to IFRS 3 there is likely to be greater scrutiny of the identifiable intangible assets arising on acquisition. The provision in old IFRS 3 that such assets should only be recognised where they were reliably measurable has been removed. As a result, recognition is now required for all identifiable intangibles.

TRANSACTION COSTS

Under old IFRS 3, if costs were incurred that were directly attributable to an acquisition, such as due diligence or legal costs, these were treated as part of the consideration for the transaction. Consequently, such costs were effectively capitalised within the recognised goodwill balance.

Under new IFRS 3, this is no longer permitted. Such costs are now required to be charged to profit or loss either pre- or post-acquisition, depending on when the cost is incurred and the services received.

CONTINGENT CONSIDERATION

Under old IFRS 3, the measurement of purchase consideration was not finalised until the resolution of any contingency affecting its amount. By contrast, new IFRS 3 requires that the fair value of the contingent consideration payable must be determined to reflect conditions as at the acquisition date and finalised during the measurement period without the possibility of later revision to reflect any updated estimates of conditions existing at acquisition date. The measurement period runs up to one year from the acquisition date.

If contingent consideration classified as a liability is ultimately settled for an amount different from the acquisition date fair value as finalised during the measurement period, subsequent adjustments are made through profit or loss and do not affect goodwill.

PARTIAL ACQUISITIONS

One of the most significant changes introduced by new IFRS 3 is the option to measure the minority interest (now the 'non-controlling interest') initially at fair value ie, to include its share of goodwill. The alternative is to measure the non-controlling interest initially at its proportionate share of the acquiree's identifiable net assets ie, to exclude its share of goodwill. As a result of this and the changes to step acquisitions described below, the approach to measurement of goodwill under new IFRS 3 may differ substantially from that found in old IFRS 3.

STEP ACQUISITIONS AND PARTIAL DISPOSALS

Where business combinations are achieved in stages, old IFRS 3 required goodwill to be calculated incrementally at each step. Under new IFRS 3, the only step that is relevant for the purpose of measuring goodwill is the one in which control is acquired. The acquisition fair value exercise is performed at that step only.

Effectively, new IFRS 3 requires that the acquirer builds up a total value/amount for the subsidiary comprising the part that it has just purchased, any part that it held prior to the purchase and any part that it did not purchase. From this is deducted the net sum of the recognised 'fair values' of 100% of the assets acquired and liabilities and contingent liabilities assumed ie, not just the proportionate stake acquired.

New IAS 27 also introduces changes in measurement and presentation when an entity sells part of a business, either while retaining control or otherwise.

A faculty factsheet is available on this topic, *IFRS 3 Revised*. It examines all of the key changes to IFRS 3 and IAS 27 and considers the practicalities of applying the new requirements. If you want a printed copy let us know at frfac@icaew.com

IFRS 2 AND GROUP COMPANIES

An amendment has been published to IFRS 2 *Share-based Payment,* clarifying the treatment where an entity receives goods or services and the liability arising is settled by or with shares in another group company.

The amendment requires the receiving entity to account for the goods or services received regardless of whether it will actually be recharged for the liability. Whether the transaction is accounted for as an equity-settled or cash-settled share-based payment will depend upon the nature of the awards granted and the entity's own rights and obligations.

BEFORE YOU DO ANYTHING ELSE...

IFRS GAAP continues to evolve and, as well as the changes outlined above, there have also been amendments to a number of other standards, many as a result of the 'annual improvements' process. For example, companies may need to reassess the classification of any long leases of land, which following 'improvements' to IAS 17 may be classified as finance leases even where title does not transfer. There are also new IFRIC interpretations addressing non-cash distributions and transfers of assets from customers.

Members involved in 2010 IFRS reporting should consult the list of relevant IFRS changes provided on page 29 and the new faculty factsheet on 2010 changes, *2010 IFRS Accounts*. If you want a printed copy let us know at frfac@icaew.com

FINANCIAL REPORTING UPDATE: CHANGES AND CHALLENGES IN 2010

The Financial Reporting Faculty's first roadshow will bring you up to date on major changes coming into effect in 2010, and the significant areas of change expected in the near future.

WHY SHOULD YOU ATTEND?

Our presenters are technical experts in their fields with a wealth of experience of applying new regulations in practice. These events are highly recommended for both members in business and in practice looking to plan ahead and keep abreast of important developments in the complex financial reporting environment.

This half-day roadshow event will cover:

- Key changes in UK GAAP reporting for 2010
- Key changes in IFRS reporting for 2010
- A look ahead to changes in IFRS
- An overview of the new IFRS for SMEs
- Any key legislative changes and proposals.

Technical presentations will be followed by a panel Q&A session.

DATES, TIMES AND VENUES IN THE SECOND HALF OF 2010

Tuesday 6 July 2010
9:30–12:30
Birmingham Botanical Gardens, Westbourne Road, Edgbaston, Birmingham, B15 3TR

Tuesday 14 September 2010
14.00–17.00
Cedar Court Hotel, Denby Dale Road, Calder Grove, Wakefield, WF4 3QZ

Monday 20 September 2010
14:00–17:00
Chartered Accountants' Hall, Moorgate Place, London, EC2R 6EA
*****FULLY BOOKED*****

Monday 4 October 2010
9:30–12:30
Chartered Accountants' Hall, Moorgate Place, London, EC2R 6EA

SPEAKERS

Each event will feature at least three of the following speakers:

Stephanie Henshaw, Technical Partner at Francis Clark LLP and member of the Faculty Board.
Yvonne Lang, National Technical Director at Smith & Williamson Ltd, and a member of the ICAEW Financial Reporting Committee.
Brian Shearer, National Director of Financial Reporting at Grant Thornton, member of the Faculty Board, the ICAEW Financial Reporting Committee, and the UITF.
Andy Simmonds, Partner at Deloitte, member of the ASB and EFRAG, and Faculty Chairman.
Kathryn Cearns, Consultant Accountant at Herbert Smith LLP, Chair of the Financial Reporting Committee and member of the Faculty Board.

COSTS

Financial Reporting Faculty Member
£70.50

Member of other ICAEW Faculty*
£88.13

Other
£99.88

*Audit and Assurance Faculty, Corporate Finance Faculty, Finance and Management Faculty, Financial Services Faculty, Information Technology Faculty, Tax Faculty.

Book now
Call: +44 (0)1908 248 159
(Mon–Fri, 09:00–17:00)
or online at icaew.com/index.cfm/route/170601

DIVIDENDS, PROFITS AND THE LAW

A new faculty factsheet provides practical guidance for UK directors on the determination of distributable profits and the risks of unlawful distributions. Nigel Sleigh-Johnson, Faculty Head, highlights some of the key messages.

Those unfamiliar with UK law on distributions might assume that the decision by a board to pay a dividend depends on the need to retain cash to develop the business and to ensure that the claims of creditors can be met as they fall due. These factors are important, but are only part of the story. Dividends – or distributions to use the legal term – can be made only out of 'profits available for distribution' as shown in the 'relevant accounts' drawn up in accordance with the applicable UK law and accounting standards. A dividend cannot, therefore, be paid in the absence of sufficient distributable profits regardless of the extent of surplus cash balances or unused borrowing facilities.

If, at the time of the distribution, a member knows or has reasonable grounds for believing that the distribution is made in contravention of the Companies Act 2006, he or she is liable to repay it (or the part of it that was in contravention). Directors may, in some circumstances, be personally liable if they authorise an unlawful distribution which cannot be recovered. The factors to be considered in determining whether a distribution is permitted are many and varied and consequently great care should be taken to avoid contravention of the law.

A key point to note is the wide variety of transactions that could qualify as distributions. A distribution is defined in law (subject to some specific exemptions) as every type of distribution of a company's assets to its members, whether in cash or otherwise. The *Aveling Barford* case established that a transfer of an asset to a member (or a company owned by a member) at an undervalue is a distribution, and this principle was codified in the 2006 Act. Thus, transfers of assets other than cash may count as distributions.

Directors also need to bear in mind that certain aspects of UK common law apply to distributions. The most important rule here is that a company cannot lawfully make a distribution out of capital. Directors must also consider whether the company will still be solvent following the proposed distribution.

Further complexity surrounds the determination of realised profits, particularly in more complex transactions. One issue is that whether a transaction results in a realised profit will depend on whether the consideration received is 'qualifying consideration'.

ICAEW FINANCIAL REPORTING FACULTY

UK DISTRIBUTABLE PROFITS
IFRS and UK GAAP Factsheet

Published 29 April 2010
Last updated 29 April 2010

PRACTICAL HELP IN A COMPLEX WORLD

Section 1
Introduction

The factsheet provides advice on these legal issues, as well as on determining which set of financial statements should be used in making the calculation of distributable reserves and on the incremental rules for plcs (whether listed or not), which must pass a further balance sheet test. It also looks at some of the common situations where questions on the effect on distributable profits arise, such as employee share schemes and also dividends receivable from another group company.

The faculty factsheet *UK Distributable Profits* can be downloaded from icaew.com/frfifrsfactsheets.
If you want a printed copy let us know at frfac@icaew.com. The full ICAEW guidance on this topic, summarised in the factsheet, is available in Tech 01/09 *Guidance on the determination of realised profits and losses in the context of distributions under the Companies Act 2006* available at icaew.com/index.cfm/route/166387

PROVISIONS AND CONTINGENCIES: RADICAL CHANGE AFOOT?

Kathryn Cearns, Consultant Accountant at Herbert Smith LLP and Chair of the ICAEW Financial Reporting Committee, explains the practical implications of controversial proposals to amend international accounting for liabilities.

INTRODUCTION

Almost every business has liabilities. Goods ordered on credit and many accruals are regular, transaction-driven events and easy to deal with in financial statements. For others, judgement is required to decide whether there is a liability at all; if there is, how much should be provided; and what disclosures should be made in relation to it. These are dealt with in IAS 37 (which mirrors the UK's FRS 12).

The original driver to amend the standard was the IASB's work on business combinations accounting. Under IFRS 3, when companies account for acquisitions of other businesses, they must fair value all contingencies they take on. The IASB decided that all accounting for provisions and contingencies ought to be the same, whether relating to an acquisition or not.

EXISTING IAS 37

Under IAS 37 as it stands at the moment, a provision can only be made when:

1. an entity has a present obligation, legal or constructive, as a result of a past event; and
2. it is probable (which means more likely than not) that an outflow of resources (cash, other assets or delivery of services) will be required to settle the obligation; and
3. a reliable estimate can be made of the amount of the obligation (although it is emphasised that it will be a rare circumstance when a reliable estimate cannot be made).

In situations of uncertainty, for example a law suit, all evidence must be assessed and a provision recognised when it is more likely than not that a present obligation exists. When measuring a provision, the best estimate of what the entity would rationally pay to settle the obligation should be assessed. If a company does not have a liability, it may nevertheless need to disclose a contingent liability (a possible obligation, or an obligation where an outflow is unlikely, or where the amount of the obligation cannot be measured reliably).

It is worth bearing in mind that one of the reasons IAS 37 was developed was to stop companies **over-providing** (allowing excessive provisions to be released back into profit and smooth results in future periods), not just (or even primarily) to deal with companies that **under-provided.**

PROPOSED CHANGES

The first change is that the existence of a present obligation must be assessed separately from the likelihood of any outflow of resources. In other words, criterion (2) above is dropped for the purposes of determining whether a liability exists. The IASB view is that you either have a liability or not, irrespective of whether you will have to pay anything to settle it. Contingent liabilities would cease to exist as a category.

Secondly, the rules on measurement of a provision are to be tightened. The basic premise – the amount that would rationally be paid to settle at the balance sheet date – is the same. But the IASB is concerned that current practice has been inconsistent.

'Contingent liabilities would cease to exist as a category.'

For portfolios of homogeneous items, companies have assessed probability-weighted averages, which equate to expected values, for example in relation to warranties. But single liabilities are often measured on the basis of most likely outcome. The IASB would now require all provisions to be measured by assessing all likely outcomes, assigning probabilities to them, and working out an expected value.

EXAMPLE: EXPECTED VALUE

A company has had a legal claim made against it and has assessed the evidence, such that it believes it does have a liability. The company assesses the likely outcomes and probabilities as follows:

AMOUNT	PROBABILITY	PROBABILITY-WEIGHTED PAYMENT
£0	30%	£0
£100,000	40%	£40,000
£200,000	20%	£40,000
£1,000,000	10%	£100,000
Expected value		£180,000

Thus the expectations as to payment are built into the measurement of the provision. The IASB will also require inclusion of a risk margin to reflect possible variability of outcome.

Where a company will settle an obligation by performing a service, the amount calculated for that service should be assessed by what an outside contractor would have to be paid, which will include a profit margin.

OBJECTIONS TO THE PROPOSALS

The IASB has been working on this project for a long time. Following an Exposure Draft (ED) in 2005 and consideration of responses, there is at the time of writing (May 2010) a current ED dealing just with measurement. There have been concerns over due process on this project but, leaving those aside for the moment, commentators (including the Financial Reporting Faculty) are objecting to the proposals on some or all of the following grounds:

- In conditions of uncertainty, likelihood of outflow is a relevant consideration which should be retained as a criterion for recognition.
- Companies will find it difficult to assess probabilities of outcomes for large, one-off liabilities and the whole exercise will be very subjective.
- Including a risk margin is conceptually valid but will add complexity for little benefit outside the insurance sector.
- A profit margin for delivery of service will lead to overstatement of provisions when companies would rationally carry out the work themselves at a lower cost, and to the reporting of a gain when the work is performed.
- By abandoning contingent liabilities, the IASB will be requiring disclosure of everything that isn't a provision, unless it is remote. Retaining the category makes more sense.
- It is not clear what problem the IASB is trying to fix. Acquisition accounting has a different objective, but this heralds an upheaval of the whole accounting for provisions when there have been no complaints from users.

'It is not clear what problem the IASB is trying to fix.'

Undoubtedly, however, the outcome of the project will depend on what users think is useful information for large, one-off liabilities. In the example above, the amount of the provision of £180,000 is not a possible outcome, and in fact a payment of under £100,000 is most likely. Which is the most useful figure: £180,000 or £100,000? Answers on a postcard please!

THE CALM BEFORE THE STORM? IFRS BEYOND 2010

Nigel Sleigh-Johnson provides a brief overview of forthcoming changes to IFRS, with observations by Faculty Chair, Andy Simmonds.

Looking forward to financial years ending in 2011, there are fewer changes to IFRS to take stock of than in recent years and these are confined to relatively narrow circumstances. However, beyond these already published amendments, the IASB is working on a high number of far-reaching projects likely to have a very significant impact on IFRS financial reporting. Although most of these are not expected to be mandatory for 2011 financial statements, early adoption may be permitted and some awareness of what's in the standards pipeline is advisable.

2011 YEAR-ENDS: NEW REQUIREMENTS

RELATED PARTY TRANSACTIONS

Revisions have been made to IAS 24 *Related Party Disclosures* to provide greater clarity on the definition of a related party. In addition, new provisions have been added to exempt entities under government control or significant influence from disclosing transactions with other government-controlled entities. The exemption will apply to all transactions except those individually or collectively significant.

Effective for accounting periods beginning on or after 1 January 2011.

CHAIRMAN'S VIEW

This amendment allows countries such as China, with significant government interests, to avoid disclosing excessive detail.

RIGHTS ISSUES NOT DENOMINATED IN FUNCTIONAL CURRENCY

This amendment to IAS 32 *Financial Instruments: Presentation* applies to entities issuing rights, options or warrants denominated in a currency other than the entity's functional currency. These were previously treated as derivative liabilities, but now, provided certain conditions are met, they will be recognised as equity.

Effective for accounting periods beginning on or after 1 February 2010.

CHAIRMAN'S VIEW

This amendment was relevant to a number of banks who committed to make rights issues just ahead of a movement in currencies.

COMPARATIVE DISCLOSURE EXEMPTION ON FIRST TIME ADOPTION

A further amendment has been made to IFRS 1 *First-time Application of IFRSs* to allow first time adopters an exemption from the requirement to provide certain comparatives to IFRS 7 disclosures.

Effective for accounting periods beginning on or after 1 July 2010.

CHAIRMAN'S VIEW

Amendments to IFRS 1 tend to be at the request of, and relevant to, countries who are in the process of changing to IFRS.

DEFINED BENEFIT PENSION SCHEMES – MINIMUM FUNDING REQUIREMENT

An amendment has been made to IFRIC 14 *IAS 19 – the Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*. Previously, where entities made advance payments in connection with a minimum funding requirement, they were prevented from recognising this as a prepayment. The amendment allows recognition of such a prepayment.

Effective for accounting periods beginning on or after 1 January 2011.

CHAIRMAN'S VIEW

The key message of IFRIC 14 is to restrict pension assets to those controlled by an entity. Unhelpfully, it has been read in a more rule-based way, with the result that IASB has needed to clarify the words rather than simply emphasise its principle.

DEBT FOR EQUITY SWAPS

A new IFRIC interpretation has been issued to provide guidance on debt for equity swaps. IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments* clarifies the accounting for situations where a creditor accepts equity in full or partial settlement of a financial liability.

Effective for accounting periods beginning on or after 1 July 2010.

CHAIRMAN'S VIEW

The treatment under IFRIC 19 is likely to be no different from the treatment most companies have adopted anyway – so no change in practice, and it's not clear why this needed an interpretation.

FURTHER DEVELOPMENTS

FINANCIAL INSTRUMENTS: IFRS 9

IFRS 9 *Financial Instruments* is the result of the first stage of the IASB project to replace IAS 39 *Financial Instruments*: *Recognition and Measurement* and sets out new requirements for the classification and measurement of financial instruments. Deliberations continue on stage 2 of the financial instruments project, on impairment, and stage 3, on hedge accounting.

IFRS 9 is effective for accounting periods beginning on or after 1 January 2013; early adoption by EU companies is not currently permitted.

> **CHAIRMAN'S VIEW**
> This is just the first phase in simplifying IAS 39. There is no chance of the EU endorsing this standard until others in the series have been issued by IASB.

OTHER 'FINANCIAL CRISIS PROJECTS'

During 2010 the IASB is scheduled to issue a replacement to IAS 27 *Consolidated and Separate Financial Statements*, as well as a standard requiring disclosure of qualifying unconsolidated special purpose or structured entities. The criteria determining when a financial asset or liability should be derecognised are due to be addressed in an exposure draft, with a standard expected by the first quarter of 2011. A new standard providing guidance on fair value measurement is also expected.

> **CHAIRMAN'S VIEW**
> Neither IAS 27 nor the derecognition requirements of IAS 39 are causing major problems, so it is not clear why IASB feel the need to change them. The IASB drafts produced so far are less clear than the originals.

FINANCE AND OPERATING LEASE DISTINCTION

Shortly, an exposure draft is due to be issued with a view to publication of a revised lease accounting standard in 2011. In the earlier discussion paper, the IASB proposed that the distinction between operating and finance leases be removed and that all leases be recognised on-balance sheet. Lessees would recognise both an asset to represent their usage rights and a liability for their obligation to pay rentals; lessors would adopt the reverse treatment.

In the consultation following the discussion paper, a number of respondents felt that the scope of the proposed standard should be reduced to exclude certain types of leases. It was also felt that the proposals were not a panacea and that there was a danger of new 'bright line' distinctions forming between arrangements caught by the requirements and those not.

The exposure draft, unlike the discussion paper, is expected to address lessor accounting, as well as the lessee side.

> **CHAIRMAN'S VIEW**
> Many observers accept the logic of moving all leases on-balance sheet. However, IASB thinking on lessors is causing concern, as is their assertion that they do not need to amend their definition of a liability.

ACCOUNTING FOR REVENUE RECOGNITION

A project is in progress to radically alter the requirements in IFRS relating to revenue recognition. The current requirements are mainly contained in IAS 18 *Revenue* and IAS 11 *Construction Contracts*, each containing quite different revenue recognition principles. These would be replaced with a single new standard.

Concern was expressed during the discussion paper stage, now completed, over the ability of a single standard to deal with complex contracts. The IASB is currently considering the results of the consultation and an exposure draft is due to be issued shortly.

> **CHAIRMAN'S VIEW**
> This project is part of the agenda to converge with US GAAP. In this area, US GAAP is in need of major reform. However, IAS 18 works reasonably well. While it needs updating, for example to cover bundled transactions, it does not need any change to its principles. Early IASB drafts do not look like an improvement.

OTHER PROPOSALS

The IASB has a huge programme of work over the next few years, and the commentary above has only highlighted some of the key projects. Among other things, the programme for 2010 also includes major projects on financial statement presentation, income taxes, joint ventures and post employment benefits. There are also well-advanced proposals to issue amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and to publish non-binding guidance on management commentary.

WHERE'S THE BEEF?

People are still blaming financial reporting for the financial crisis. Brian Singleton-Green, Faculty Manager, looks at the evidence.

Almost as soon as the global financial crisis dawned, some critics blamed it on fair value accounting. The gist of the argument was that banks' profits were inflated during the boom years by massive fair value gains. Their accounts, it has been said, were 'misleading to the point of treachery' and – it is alleged – they paid out in cash 'colossal accounting profits that [were] largely imaginary'. When the market turned, these imaginary gains were reversed and the banks collapsed. If only they had used historical cost, these problems could have been avoided.

This argument has not gone away. But further on into the crisis a more sophisticated critique appeared. This focused on the banks' historical cost accounting. It was claimed that the 'incurred loss model' that the banks were required to use to calculate loan impairments understated their losses in the good times. They should have used an 'expected loss model' instead. Some critics drew a different conclusion. If only the banks had used fair value, they said, these problems could have been avoided.

So perhaps it's really quite simple. We should have used fair value wherever we used historical cost and historical cost wherever we used fair value.

As the financial crisis – or at least its first phase – is now past, it's reasonable to assume that those who place the blame on financial reporting will by now have some evidence to support their claims. If they have, so far they've kept it to themselves.

It's quite possible that the evidence will emerge, and I certainly don't intend to stick my neck out and say that it will never be found. The theoretical models that explain how accounting caused the crisis, or made it significantly worse, are elegant and even persuasive. It's just that I haven't seen the evidence for them yet.

Those who have studied the facts in some depth conclude that fair value did not play a significant role. In a lengthy report published at the end of 2008, the US Securities and Exchange Commission found that bank failures in the US were not attributable to fair value accounting, but were 'the result of growing probable credit losses, concerns about asset quality, and…eroding lender and investor confidence'. It reached a similar conclusion for US investment banks.

An important study in the *Journal of Economic Perspectives* by eminent academics Christian Laux and Christian Leuz finds the same. In 'Did fair-value accounting contribute to the financial crisis?' they conclude that, 'based on existing evidence, we have little reason to believe that fair value accounting contributed to banks' problems in the financial crisis'.

Another useful empirical study is *Fair Value Accounting: Villain or Innocent Victim* by Sanders Shaffer of the Federal Reserve Bank of Boston. This concludes that, for the sample of banks reviewed, fair value accounting had 'a minimal impact' on their capital. Instead, 'capital destruction was due to deterioration in loan portfolios and [capital] was further depleted by… proprietary trading losses and…dividends'.

As for the incurred loss versus expected loss argument, I have seen no research at all on this.

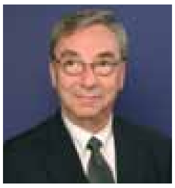
Even the March 2010 Valukas report into Lehman Brothers' failure, which appears to identify clear deficiencies in its accounting, does not attribute its collapse to these defects.

The crisis was, surely, caused by imprudent property-based lending, and securitisations based on that lending, which assumed that property prices would carry on rising. They didn't. When property prices fell back, the lenders and those who held the related securities faced massive losses. You can elaborate on that explanation in various ways, but accounting, if it had a role at all, was just a bit player.

Back in the 1980s there was a TV ad in the US for 'Wendy's hamburgers'. It was aimed at rivals' products – all bun and no beef. In the ad, an elderly lady peered at an open burger and asked, 'Where's the beef?' The phrase passed into the language. When we look at the criticisms of financial reporting and its alleged role in the crisis, we may also ask, 'Where's the beef?'

IFRS FOR SMES: AN UPDATE

As the UK and jurisdictions around the world assess the merits of adopting the new international standard for SMEs, Paul Pacter, IASB Director of Standards for SMEs and IASB Board member Designate, updates faculty members on progress in implementation.



In late 2003, the IASB embarked on a project to develop a separate standard for small and medium-sized entities. Six years and 44 Board meetings of deliberations later, the IFRS for SMEs was issued in July 2009.

To the best of our knowledge, in the 10 months following publication, 61 jurisdictions either have already adopted the IFRS for SMEs or have publicly stated an intention to do so. Here are some examples, region by region:

- South America: Argentina (proposal), Brazil, Venezuela.
- Caribbean: Bahamas, Barbados, Dominican Republic, Eastern Caribbean, Guyana, Trinidad and Tobago.
- Central America: Belize, Costa Rica, El Salvador, Panama, Nicaragua.
- Africa: Botswana, Egypt, Ethiopia, Namibia, Sierra Leone, South Africa, Tanzania, Uganda.
- Asia: Cambodia, Hong Kong, Philippines. Malaysia and Singapore are studying.
- Europe: United Kingdom (proposed), Ireland (proposed), Turkey. The European Commission is currently consulting on the IFRS for SMEs.
- Available for use without any action: United States, Australia, Canada (but Canada has also adopted its own SME standard, and Australia is considering a disclosure-exemptions-only local standard).

The IFRS Foundation (formerly the IASC Foundation) is forming an SME Implementation Group (SMEIG) to support the implementation of the standard. The SMEIG will develop non-mandatory guidance for applying the IFRS for SMEs in the form of questions and answers (Q&As) that will be made publicly available on a timely basis, and make recommendations to the IASB regarding the need to amend the IFRS for SMEs. The Foundation invited nominations for membership on the SMEIG, and selection by the Trustees is currently underway as of May 2010. All members will serve on a voluntary basis, and I will act as Chairman. The terms of reference and operating procedures for the SMEIG are available on the IASB's website at www.iasb.org/IFRS+for+SMEs/SME+Implementation+Group

I understand that ICAEW is developing online training materials and holding events on the new standard for its members and others, and that is very welcome. The IFRS Foundation is developing 35 stand-alone training modules – one for each section of the IFRS for SMEs. The training materials are available on IASB's website for free download at go.iasb.org/smetraining

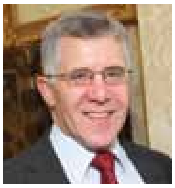
The Foundation is also holding three day 'train the trainers' workshops on a regional basis, in co-operation with regional professional associations and the world's development agencies, to build capacity for the implementation of the IFRS for SMEs, particularly in developing and emerging economies. So far, we have conducted workshops in Kuala Lumpur, Malaysia, Hyderabad, India and Dar es Salaam, Tanzania. Similar workshops are scheduled in Cairo, Egypt, and Panama City, Panama. The complete PowerPoint presentations used in the training sessions are available on IASB's website at www.iasb.org/Conferences+and+Workshops/IFRS+for+SMEs+Train+the+trainer+workshops.htm

Finally, starting in March 2010, the IASB began publishing a monthly newsletter called *IFRS for SMEs Update*. It is a staff summary of news relating to the IFRS for SMEs. Each issue includes an update on translations of the IFRS for SMEs, newly posted training materials, upcoming workshops, and national adoptions. Once the SMEIG starts its work, the newsletter will include information about proposed Q&As and final Q&As. You can subscribe for free at www.iasb.org/IASB+Registration.htm

The IASB believes that the IFRS for SMEs will result in better quality reporting, tailored for the capabilities of small companies and the needs of lenders and creditors, and understandable across borders. I look forward to a UK decision on which entities should use the standard, and to continuing to work with ICAEW to help ensure a smooth UK transition from existing GAAP.

FINANCIAL REPORTING AND FINANCIAL MANAGEMENT: THE UK PUBLIC SECTOR AT A CROSSROADS?

On the following two pages we highlight the content of the first public sector supplement to *By All Accounts,* starting with an extract from our interview with Ken Beeton, Director, Financial Management and Reporting at HM Treasury.



The faculty is now working closely with partner organisations to increase its profile in public sector financial reporting, to both influence the policy debate and to provide professionals working in the public sector with useful, relevant and practical information. In the July 2010 public sector supplement available with this issue of *By All Accounts*, we reflect on some of the key messages around the implementation of IFRS within the public sector highlighted at the annual public sector conferences held jointly with CIPFA earlier this year under the banner *IFRS and beyond*.

A REVOLUTION AT THE HEART OF GOVERNMENT

In an exclusive and wide-ranging interview for the faculty the day after the UK General Election, Ken Beeton, Director of Financial Management & Reporting at HM Treasury and a member of the faculty, speaks to Robert Bruce. Extracts from the interview are set out below, together with synopses of the other articles included in the supplement.

Robert Bruce: How well placed are government finance teams to deliver IFRS-based financial and budget reporting?

Ken Beeton: We have implemented IFRS in central government from 1 April 2009. We'll find out very shortly just how well this has gone because departments are currently preparing their first IFRS-based resource accounts. However, early signs are very encouraging. I am very grateful to the National Audit Office which collaborated appropriately with us on a trigger point strategy to help departments and arm's-length bodies evidence their progress in stages. For example, all 2008–09 comparatives have been restated on an IFRS basis and reviewed by the NAO. There are now very few problems with those numbers and, although there will inevitably be some new issues in 2009–10, we are well placed for a successful implementation.

Moving onto the Alignment Project then, there has been debate during the election campaign about efficiency savings and the project is supposed to streamline government financial reporting. What is the level of efficiency saving envisaged and how will this be tracked to ensure it is realised?

The Alignment Project is about better financial reporting and the main benefit will come in enabling better financial scrutiny by Parliament and others. Currently, departments keep three sets of books: budget numbers, which are based on the national economic accounts supported by statistical standards, but also including some elements of IFRS; estimates, which are the basis upon which Parliament authorises spending; and resource accounts, which are based on IFRS. These frameworks have many different rules and the boundaries are drawn differently.

The Alignment Project will move us to a single framework from 1 April 2011. It will provide a clear line of sight through budgets, parliamentary authority and accounting for spending, with one version of the truth, as in the private sector. This will be much simpler and more efficient for departments in the way that they manage their business. For example, lining up the Treasury's and Parliament's controls over spending will reduce burdens. It will also enable departments to focus on delivery against a single set of limits, rather than on several. It will move the emphasis away from compliance to adding value across departmental families and will get rid of some perverse and unhelpful incentives. So this is a very important project that will have lasting benefits in terms of improving transparency and accountability and in promoting greater effectiveness and value for money.

It is quite widely assumed that the first set of published Whole of Government Accounts (WGAs) will be qualified. Does this undermine the exercise? What will you and HM Treasury do to eliminate the problems?

WGA are a consolidation covering around 1,500 public sector bodies, including central government departments and arm's-length bodies, devolved and local government and the NHS. There is no holding company, as such. Historically, different accounting policies have been used across the public sector and one of the benefits of WGA is to bring consistency. However, this will not be achieved fully from day one. For example, central government moved to an IFRS-based framework for 2009–10 but this will not be achieved fully for local government until 2010–11.

In the early years, there will inevitably therefore be some qualification of WGA by the NAO but this should be transitional as we improve and align processes and frameworks. Rather than undermining the exercise, as you suggest, this improvement and alignment process reinforces the need for WGA and for the consistent and transparent reporting that these consolidated accounts will bring.

Given the threat of spending cuts, what is HM Treasury going to do to try to ensure that finance teams are not reduced to unacceptable levels and that their professional and technical development continues?

Finance functions are not protected from the ongoing need to deliver with improved efficiency. They should lead by example. We have developed some benchmarks to help show where improvements are possible. That said, if we want to deliver cost reductions, we need a strong finance profession to bring together the information and challenge that will help Ministers make the tough choices that fiscal consolidation will require. We shall continue to develop the capacity and capability of the Government Finance Profession, ensuring that finance is the right size and works in the right way to deliver what is needed.

Finally, what do you think the faculty can contribute to the public sector?

I chaired the *IFRS and beyond* events held in London and Leeds earlier this year, organised jointly with CIPFA. The commitment of the faculty to support professionals in the public sector, given the many financial reporting challenges we all face, is very welcome. As a member of the faculty I think that this journal supplement is an important step forward.

OTHER ARTICLES

EMBEDDING IFRS

Faculty members Christina Earls (UK Department for Works and Pensions) and Elizabeth Dobson (UK Department for Transport) explain the dangers of regarding IFRS as just a technical accounting issue. They note that to embed new ways of working following the transition to IFRS reporting into 'business as usual', it is necessary to examine people issues, systems and processes, as well as ensuring that all technical accounting issues have been resolved.

FINANCE IN AN AGE OF AUSTERITY

Mark Williams (Deloitte) uses the example of complex accounting for partnerships and joint financing arrangements to highlight the unique challenges faced by senior finance professionals in the UK public sector. He argues that in an age of austerity, these challenges will increase, and finance professionals will become central to the decision-making process taking place in public bodies under the new Conservative/Liberal Democrat administration.

IMPLEMENTING IFRS-BASED STANDARDS FOR THE AUSTRALIAN GOVERNMENT

Peter Gibson and Brett Kaufmann (Australian Government Department of Finance and Deregulation) reflect on the experience of first implementing the Australian equivalents of International Financial Reporting Standards. They note that although there were distinctive factors that influenced the Australian experience, their account may resonate with faculty members in the UK public sector who have recently completed their first year of IFRS accounts and provide some lessons and insights for other members still dealing with the challenges of IFRS transition.

HOW ESA 95 IS WORKING IN PRACTICE

Chris Hughes and Peter Dymoke (PwC) look at some of the challenges involved in accounting for PFI in the UK public sector. They explain the relevance of European Community rules that dictate how member states should prepare their national accounts and compare experience of applying IFRIC 12 in local authorities and the National Health Service.

FINANCIAL MANAGEMENT AT THE HEART OF PUBLIC SERVICE DELIVERY

Nick Jackson (HM Treasury) and Sumita Shah (ICAEW) discuss the importance of financial management in the public sector. They explain that strong financial management is essential if government is to succeed in its policymaking, planning and delivery of key objectives, and examine the importance of leadership and culture; integration; communication and engagement; standards and quality; and last but not least, professional qualifications and development.

FIVE STAR FCO?

Keith Luck (UK Foreign and Commonwealth Office) explains the journey of the department from financial management straggler to 4★ and counting. He discusses what lay behind this transformation and the main lessons of the innovative FCO programme.

The July 2010 public sector supplement is available to members on request from frfac@icaew.com

FROM IAS 39 TO IFRS 9: MORE THAN JUST A NAME CHANGE

Stephen Chan, Partner and Head of Technical & Training, BDO Hong Kong, explains the background to a new IFRS and the key changes.

BACKGROUND

IAS 39 *Financial Instruments: Recognition and Measurement* establishes the principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. It also deals with the classification of financial instruments, their ongoing measurement (including when impairment is required), when financial instruments should be recognised and derecognised, and hedge accounting requirements. At the G20 summits in 2009, world leaders declared that improvements were needed to financial reporting. As IAS 39 is widely considered to be one of the most 'unfriendly' IFRSs due to its complexities and internal inconsistencies, the IASB has significantly accelerated its project to replace the standard.

However, replacing IAS 39 is no easy task. The IASB therefore divided the project into various chunks. IFRS 9 *Financial Instruments* (issued 12 November 2009) is the first milestone but is also only part of the 'solution', because it covers only the classification and measurement of financial assets. The IASB has an ambitious target of completing this replacement project during 2010 as set out below:

PLANNED PUBLICATIONS

- Improved derecognition requirements of financial assets (and liabilities), covered by the exposure draft (ED) issued by the IASB in April 2009.
- Revised impairment methodology, covered by the IASB's November 2009 ED, which was out for consultation until 30 June 2010.
- Enhanced guidance on hedge accounting; an ED was expected to be published in the first quarter of 2010 (unfortunately delayed).
- New requirements for classification and measurement of financial liabilities, covered by the IASB's July 2009 ED, but not yet finalised pending re-consideration.

IFRS 9 applies to annual accounting periods commencing on or after 1 January 2013, with earlier application permitted (subject to local laws and regulations). If it is applied for a period beginning before 1 January 2013, disclosure is required of that early adoption and the extensive consequential amendments to other IFRSs also need to be applied.

The new standard is required to be applied on a fully retrospective basis, subject to extensive transitional provisions. However application of IFRS 9 to financial assets in comparative periods where those financial assets have already been derecognised at the date of initial application is prohibited.

A number of jurisdictions including Hong Kong have adopted IFRS 9 with the same effective date. However, the European Union (EU) has announced its decision to delay its adoption in the EU pending further consideration.

KEY CHANGES

The following is a very brief outline for some of the more important changes introduced by IFRS 9.

NEW SINGLE MODEL FOR CLASSIFICATION OF FINANCIAL ASSETS

IFRS 9 eliminates 'the held to maturity' category and the related 'tainting' rules, and also the 'available for sale' and 'loans and receivables' categories by requiring that on initial recognition, all financial assets are classified into one of just two measurement categories – amortised cost or fair value (FV).

NEW CRITERIA FOR AMORTISED COST MEASUREMENT

A financial asset is measured at amortised cost only if it meets two conditions: the objective of an entity's business model is to hold the financial asset in order to collect contractual cash flows; and the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

NO EXEMPTION FROM FV MEASUREMENT FOR UNQUOTED EQUITY INVESTMENTS

Investments in equity instruments do not meet the conditions to be measured at amortised cost because they do not contain contractual terms that give rise to cash flows on specified dates that are solely payments of principal and interest on the principal amount outstanding. Consequently investments in equity instruments are measured at FV. IFRS 9 has no exemption from FV measurement for those instruments for which FV cannot be reliably measured.

NEW FV MEASUREMENT CATEGORY: THROUGH OCI

For investments in equity instruments which are not held for trading (eg, those held for strategic purposes), IFRS 9 allows an entity, on initial recognition, to make an irrevocable election (on an instrument-by-instrument basis) to recognise all changes in FV in other comprehensive income (OCI). There are no transfers from OCI to profit or loss (that is, no recycling) and hence no impairment requirements. Dividends from such designated equity instruments are recognised in profit or loss when the right to receive payment of the dividend has been established.

STRICTER RESTRICTION ON APPLYING FV OPTION

IFRS 9 includes an election, similar to that of IAS 39, which permits an entity, on an optional basis, to classify a financial instrument or group of instruments at FV where that financial instrument would otherwise be measured at amortised cost.

In a change from IAS 39, this option is only available if the designation results in the elimination of, or significant reduction in, a measurement or recognition inconsistency.

STRICTER RESTRICTION ON RECLASSIFICATION

The classification of financial assets is made on initial recognition. Reclassification after initial recognition is prohibited, unless an entity fundamentally changes its business model for managing its financial assets, in which case reclassification is required. The circumstances in which reclassification is required are extremely restrictive.

DIFFERENT ACCOUNTING FOR CONTRACTS CONTAINING EMBEDDED FEATURES

The terms of a financial asset may include cash flow characteristics which contain certain embedded features, such as interest rate floors and caps, early repayment features and extension provisions. Provided the host contract is within the scope of IFRS 9 and all of the conditions in IFRS 9 are met, these financial assets are measured at amortised cost and the embedded features are not bifurcated and accounted for separately. Where the host contract is not within the scope of IFRS 9, the current guidance in IAS 39 continues to apply to the analysis and accounting treatment of embedded derivatives.

In a forthcoming second article for the faculty I hope to spell out some of the practical implications of IFRS 9 for corporate entities.

IFRS: ROOM FOR IMPROVEMENT?

Bill Hicks, Group Financial Controller at Tate & Lyle plc, presents an alternative view on where IFRS are heading.

Since its evolution from the IASC (a few things to a few men) 10 years ago, not only has the International Accounting Standard Board (IASB) become one of the two most prominent standard setters, it has raised the awareness of accounting issues and promulgated genuine improvements in financial reporting. Significant credit for this must go to Sir David Tweedie, who has been an articulate and persuasive advocate of the work of the Board, despite his terrible and oft-repeated jokes. So, everything's alright then is it? Er, no, not really.

There is not a particular moment that I can point to where the wheels came off the bus and the Board began to lose the confidence of many of the group of preparer constituents to which I belong, although there were clear signs around the time of the original issue of IFRS 3 on business combinations.

So where are we now? It seems to me that the problems we face from the IASB and its direction of travel can be summarised under three broad headings:

- The accounting model is too academic, leading to financial reporting that fails to meet one of its principal objectives, that of communication.
- The Board is too dogmatic in its approach and seems unwilling or unable to respond to criticism or suggestions.
- The agenda is too crowded and the Board's goals are inappropriate.

All these issues are linked, but I will address each individually, identifying some of the roots and effects of each.

The refrain that the numbers in the financial statements bear no relationship to the results of the business is a familiar one and the recent increase in the use of non-GAAP measures by companies simply reinforces this perception (or, indeed, reality). This seems odd considering the Board's aspiration to move to a presentation of the financial information 'through the eyes of management', but a glance at the proposed conceptual framework soon clears up this apparent contradiction. In the basis for conclusions for those proposals, there is an assertion that companies prepare their results by valuing a balance sheet and deducting the previous period end balance sheet; this is so at odds with the reality of transaction-based bookkeeping and accounting that is sometimes renders one speechless in response. I suppose that the ensuing academic model would have its charm in a Sudoku sort of way, but it would be little use in understanding and communicating the performance of a business. So alternative measures have to be found.

As for dogmatism, I am afraid I am going to have to resort to using a c-word – contingent liabilities. The hell or high water determination of the Board to push through a much derided replacement to IAS 37 still draws gasps of admiration. Or, possibly, to quote Bridget Jones, the cry of 'why, why?' After all, the current standard has a few faults (what standard doesn't?), but seems to work perfectly satisfactorily, as evidenced by the absence of requests for interpretations from the IFRIC. (I'm afraid my suggestion that this lack of requests is due to constituents knowing the standard was subject to revision has more than a whiff of New Speak about it.) Perhaps, by the time this article is published, the Board will have pulled back from the brink, but it doesn't detract from my main point – the Board could have quietly dropped the project several years ago when all the flaws in and problems with their proposals were articulated clearly and convincingly. Instead we have seen further wasting of the Board's and their constituents' precious resources.

And while the current agenda certainly does not lack for ambition, given those precious resources, there have to be considerable doubts as to the achievability of satisfactory standards in the next 18 months. I suspect that the Board's overriding ambition is not so much a single set of high-quality global accounting standards (think of the proposed replacement to IAS 37!) or convergence with US GAAP, but more acceptance of IFRS by the SEC. Would the momentum be maintained if the SEC said 'yes' tomorrow?

So is it all a litany of despair? I'm an eternal optimist (I support Norwich City, after all) and, despite my protestations here, remain a firm supporter of the Board. We have seen some real signs of the Board being more receptive (the process behind the development of IFRS 9 has been encouraging) and I think there may be an opportunity for a change of focus with the retirement of Sir David. The resultant recruitment process has been characterised as finding a replacement for Sir David, but I would prefer it to be seen as a chance to re-define the role of the Chairman (or woman) as one which concentrates on standard setting, leaving the advocacy work largely to, say, the Trustees. And it would recognise the brutal fact that Sir David, like his jokes, is simply irreplaceable.

Perhaps I should add before I sign-off that these views are not those of the ICAEW and not those of Tate & Lyle. But I am fairly confidant that they are shared by more than a few colleagues in the UK business community! I would in any case be very interested in any feedback on my views from faculty members.

SUMMARY FINANCIAL STATEMENTS

Marinanne Mau, Faculty Manager, introduces a new faculty factsheet.

All UK companies that have their accounts audited can, if they wish, offer their shareholders and other 'entitled persons' the option of receiving Summary Financial Statements (SFS) instead of the full annual report and accounts (ARA). This facility used to be available for listed companies only, but for several years it has also been an option for unlisted companies.

For larger companies there may well be a considerable cost-saving in printing and despatching printed copies of SFS instead of the full ARA. But the other main driver of the legislation is to provide shareholders with information in a shorter and more straightforward form, easier to read and understand.

The new faculty factsheet *Summary Financial Statements* explains the requirements and the pros and cons of taking advantage of the option. It can be downloaded from icaew.com/frfifrsfactsheets If you want a printed copy, please let us know at frfac@icaew.com

THE TEAM BEHIND THE FACTSHEETS

We profile the editorial board.

To date the Financial Reporting Faculty has published some 17 factsheets, introducing changes coming into force and highlighting how they might affect faculty members. They are designed to help members make sense of new reporting requirements by providing a clear synopsis of the key facts and then signposting to where further detail can be found. Feedback to date has been highly encouraging. Helping faculty staff ensure that the factsheets are relevant, reliable and hopefully understandable is the Financial Reporting Faculty's Editorial Board, a superb team of expert volunteers chaired by Phil Barden of Deloitte. Bringing with them a wealth of experience from a variety of backgrounds ensures that the factsheets combine technical accuracy and practical tips designed to ease the burden of keeping pace with an ever-changing and complex financial reporting environment.

PHIL BARDEN, DELOITTE
Phil is an Associate Partner in Deloitte's UK technical department, where he is the leader of the writing team for *iGAAP 2010: IFRS Reporting in the UK* and one of the principal authors of *ukGAAP2010: Financial reporting for UK unlisted entities.*

YVONNE LANG, SMITH AND WILLIAMSON
Yvonne is National Technical Director at Smith and Williamson, where she is responsible for all aspects of technical compliance for the assurance and business service departments.

MATT BLAKE, HMRC
As the Commissioner's Advisory Accountant at HMRC, Matt is responsible for all accountancy advice given to HMRC's policy officers, both when they are considering accountancy practice in relation to existing tax law, and when they are discussing and formulating future policy and tax law and guidance.

BRIAN CREIGHTON, BDO
Brian is a Director in BDO's Accounting and Reporting Advisory Unit. He is the chair of the LSCA Technical committee and a member of the ICAEW Company Law sub-committee and the ICAEW/ICAS Distributable Profits Working Party.

LYNN PEARCY, KPMG
Lynn is a UK Technical Partner at KPMG. She is also a member of the UK ASB's Financial Sector and Other Special Industries Committee (FSOSIC).

KEN RIGELSFORD, DELOITTE
Ken is a Director in Deloitte's UK technical department and a major contributor to Deloitte publications including *ukGAAP 2010 Financial reporting for UK unlisted entities* and *iGAAP 2010 IFRS Reporting in the UK.*

MARTIN CAVEY, SOLE PRACTITIONER
Martin provides general accounting services for his clients.

STUART PARKINSON, BAKER TILLY
Stuart is a Senior Manager at Baker Tilly.

ROBERT CARROLL, GRANT THORNTON
Robert is a Senior Manager in National Assurance Services at Grant Thornton UK.

Matt, Martin, Yvonne, Lynn and Ken are also members of the ICAEW's Financial Reporting Committee.

KEEPING IT SIMPLE

Faculty Board member Peter Nicol is a Partner at Manchester-based firm Horsfield & Smith, part of the Kreston network. His contribution – based on his work with specialist and regional clients – gives an essential voice to preparers of accounts for smaller entities. But the need to keep financial reports simple and comprehensible is important for organisations of every size, as he explained to us after the faculty's recent AGM.

Financial Reporting Faculty: You come a long way to attend FRF meetings. What tempted you to get involved?
Peter Nicol: I realised that with audit thresholds increasing, the proportion of specialist audits we do would rise – and that having some influence over financial reporting was going to be of more relevance to us. Almost 50% of our audits are specialist of one sort or another – pension funds, charities, industrial and provident societies – which still have much lower thresholds. I still deal with plenty of local or family-owned firms that also require an audit – so hopefully I can use that experience to influence the debate.

So you can speak for preparers and users that are out of the spotlight?
Up to a point. Their voice is regrettably limited because the profession is increasingly driven by international standards. Too many people complain about irrelevant accounting standards, but aren't prepared to put something into getting them changed. It is still possible, through the Institute, to have an impact on the debate.

What are the challenges for you as a practitioner?
Taking my charity clients as an example, the vast majority of charities are mostly concerned that their accounts are accurate, timely and will not give rise to questions from the Charity Commission. And they are usually anxious to comply with the rules. Of course, the vagaries of the SORP don't always help! They also rely on us quite heavily for the actual detail of the financial reporting. You get into that internal debate about whether you're providing accounting or auditing services – so one side of the firm does that, while a completely separate individual on the other side handles the audit.

But presumably the financial reporting itself also throws up issues?
Absolutely. For example, we're dealing with one client's executive final salary scheme that according to the actuaries had a surplus of just over £1.5m. The client decided to close the scheme. In order to get the same benefits to the members, it cost them an extra £1m. So that's a difference of £2.5m on a scheme with 10 members. It perhaps puts the problems faced by BA or M&S into some perspective.

Pensions reporting has always been contentious…
Personally, I have some major reservations about current standards. There are so many assumptions in there – so much is subjective, based on the work that actuaries do, that it cannot give a 'correct' answer. Everyone seems to take pension numbers as gospel at the moment, but the assumptions in there could still be too bullish.

Do you think that's a problem more generally?
I have severe reservations about any accounting standard that introduces choice. I would far rather they set out 'the way it should be done'. OK, not all businesses are the same and there may be exceptions. But having a single version ought to be the starting point. It's broadly the way standard-setters have gone with IFRS for SMEs – and that's something I would support. It's going to mean that some people gain and some people lose – 'twas ever thus and it always will be. But if you have too much choice in accounting standards, you can't know what you're comparing.

Are you a cheerleader for the work of the IASB, then?
I confess, I'm not a huge supporter of fair value (FV) accounting at least outside major financial institutions. I hear arguments that analysts need fair value because historic cost accounting means they're putting through so many adjustments to get estimates for future cash flows. But it's the assumptions and estimates you have to use in FV that worry me. At least with historic cost accounting, you're working from a hard number.

That seems a little remote for the kind of clients you deal with.
What the analysts need from a multinational quoted company is quite different from what a small client turning over £5m in the north of England needs. You can suggest discounting the mortgage he's got on his factory – tell him, 'the liability shown on the balance sheet will be less than you actually owe the bank.' He knows what he owes – he just thinks you're on another planet. What a typical owner-manager wants is financial reports that tally with what they're getting in their management accounts.

It's a cost-benefit issue. You have very complex standards on financial instruments, for example, that are intended to cover multinationals. They're couched in terms that mean they pick up redeemable preference shares in a private company. In fact, no one really cares about that at a smaller business. But if those accounts were subject to audit or if the ICAEW's Quality Assurance Directorate found you'd got it wrong – you're left exposed.

Did the FRSSE help?

In theory, everything got more relaxed when FRSSE came in. But if you have just one client who doesn't use it, you still have to know all of the standards. And because all our people have been trained on the full standards anyway, we went the other way and said, forget about the FRSSE. That's changing now. And with IFRS for SMEs, I can see a lot of firms saying we're not going to go to the lengths of learning full IFRS. The thought of trawling through 2,500 pages of accounting standards is horrific.

I think we'll get to a situation where we're reporting either under IFRS or IFRS for SMEs – albeit the UK GAAP version of the latter. The reality is that we are in a global economy and the sooner we have everyone using the same set of standards, the better.

And you see ICAEW as a positive force in that progression?

One of the fundamentals of the Institute is that it's there for the public benefit. It never lobbies for the direct interest of its members – it's doing it for the wider good. It's not about whether it costs our members money, it's about whether a standard will work. The Heritage Assets exposure draft published by the Accounting Standards Board was a good example. It was a fine document, and someone had spent a lot of time working it up. But at the end of the day, it didn't add anything to the sum of human knowledge.

So the role of the Institute and of the faculty is very important. You do these things because you want to put something back in without necessarily getting something out of it for yourself. And I'm proud of what we've achieved to date through the new faculty.

MIND THE (UK) GAAP

John Boulton examines the latest developments in UK GAAP and considers what the future may hold for UK financial reporting.

The UK standard-setting arena remains quiet while deliberations continue on the future of UK GAAP. Changes to UK standards are mainly limited to reflecting equivalent changes in IFRS, which has also resulted in a long-awaited revision of the LLP SORP. In this article we provide a round-up of the latest developments.

FRC GUIDANCE ON GOING CONCERN

Against the backdrop of the recent turmoil in the global economy, going concern naturally remains an important issue in financial reporting. For UK companies, the various requirements of company law, accounting standards and the listing rules are brought together in the Financial Reporting Council guidance *Going concern and liquidity risk: guidance for directors of UK companies 2009.* The guidance is relevant to all UK companies, including those applying IFRS, for years ending on or after 31 December 2009.

The paper centres around three principles which cover the process directors should follow when assessing going concern, the period covered by the assessment and the disclosures to be considered. The importance of balanced, proportionate and clear disclosures about going concern is emphasised.

IFRS-RELATED AMENDMENTS

The majority of changes to UK standards effective for 2009/10 financial statements bring in to UK GAAP amendments made to the equivalent international standards.

The amendments include: FRS 26 (IAS 39) *Eligible Hedged Items,* FRS 20 (IFRS 2) *Group Cash-settled Share-based Transactions* and FRS 25 (IAS 32) *Puttable Instruments and Obligations Arising on Liquidation* and *Classification of Rights Issues.*

HERITAGE ASSETS

The ASB published one new standard in 2009: FRS 30 *Heritage Assets*, effective for accounting periods beginning on or after 1 April 2010. Its main impact is to require more disclosure without changing the items that are brought on-balance sheet or their measurement.

REVISED SORP FOR LIMITED LIABILITY PARTNERSHIPS

An updated version of the SORP for LLPs was published on 31 March 2010. The revisions update the SORP for the amendment to FRS 25 *Puttable Instruments and Obligations Arising on Liquidation*. This will have important implications for some LLPs as certain liabilities to partners currently shown within creditors may need to be reclassified into equity.

The revised SORP is effective for accounting periods beginning on or after 1 January 2010.

THE FUTURE OF UK GAAP

The ASB continues to deliberate on the future of UK GAAP following the closure of the period for comment on its recent consultation paper, which attracted a record number of submissions.

Three tiers were identified in the proposal. Publically accountable entities would form tier 1 and would adopt IFRS in full, including in their separate entity accounts. Small companies would form tier 3 and could continue to apply the FRSSE. Those companies in-between would form tier 2 and would apply the new IFRS for SMEs. Entities could always opt to move into a higher tier.

Particular concern at the proposals has been expressed by groups applying IFRS in their consolidated accounts. At present British subsidiaries in these groups commonly apply UK GAAP and many feel that moving to the IFRS for SMEs would involve significant costs for little benefit. Specifically, the measurement requirements in the IFRS for SMEs differ from full IFRS in a number of respects and therefore adjustments would still be necessary at consolidation level. One solution suggested is a fourth tier, full IFRS with reduced disclosures, for subsidiaries.

An ASB exposure draft setting out the Board's final recommendations is due to be issued after the summer. However, the final outcome may be affected by developments in Brussels. Proposals are currently before the EU Council of Ministers to exempt micro-entities from the requirements of the 4th Directive. Already approved by the European Parliament, the new requirements, on adoption in the UK, could in due course result in the exemption of micro-entities from the requirement to prepare statutory financial statements.

WHAT IS A MICRO-COMPANY?

Companies with:

- fewer than 10 employees
- a balance sheet total (ie, total assets) below €500,000
- annual turnover below €1 million.

Two out of the three criteria would have to be satisfied.

We will watch with interest as these key proposals develop and keep faculty members informed of the implications.

Further details on all of these developments can be found on the faculty website icaew.com/frf

UK GAAP ISSUES

Robert Carroll, Senior Manager, National Assurance Services at Grant Thornton, highlights two current areas of concern for UK GAAP reporters.

RELATED PARTIES – HAVE YOU CAUGHT UP WITH THE CHANGES?

FRS 8 *Related Party Disclosures* was amended for periods commencing on or after 6 April 2008. A key change, easily overlooked, is the narrowing of exemptions.

One key change was the removal of the previous blanket exemption from disclosure in a parent's individual accounts where presented with consolidated financial statements. Another important change for parents and subsidiaries was to restrict exemption from disclosure of transactions in individual company accounts to those where any subsidiary that is a party to the transaction is wholly owned by a member of the group. Previously, a wider exemption was available to subsidiaries from disclosing transactions with other group entities and investees of the group, if 90% or more of their voting rights were controlled within the group.

If your accounts state:

- the parent company has taken advantage of the exemption from disclosure of related party transactions in its individual financial statements; or
- the company has taken advantage of the exemption from disclosing related party transactions with other group entities and investees of the group on the grounds that 90% or more of voting rights in the company are controlled within the group…

…then think again, as those exemptions no longer apply!

DO ACCOUNTING REQUIREMENTS FOR CAPITAL INSTRUMENTS HAVE MUCH IMPACT ON FRSSE COMPANIES?

Well, they might do.

Many FRSSE companies have issued shares carrying particular rights, possibly to protect family interests or because of venture capital involvement. Such rights may make those shares either financial liabilities or compound instruments, thus giving rise to accounting challenges.

For example, a venture capitalist may hold convertible preference shares giving rights to non-discretionary cumulative preference dividends and an option for the holder to convert to ordinary shares. The right to a cumulative preference dividend creates a financial liability. However, the option to convert to ordinary shares may meet the definition of an equity instrument in the FRSSE.

To do this, the options must evidence a residual interest in the company's assets after deducting all of its liabilities. Typically, this will be met if each preference share converts to a fixed number of ordinary shares. Such instruments will be compound ie, contain both liability and equity features.

FRSSE (2008) paragraph 2.2 requires the directors to have regard to substance in determining how amounts are presented in the profit and loss account and balance sheet. Paragraph 12.1 requires a financial instrument or its component parts to be classified as a financial liability, financial asset or equity instrument in accordance with the substance of the contractual arrangements rather than its legal form. Hence, the preference shares in the above example will need to be split between a liability component, representing the obligation to pay contractual dividends, and an equity component, presented within capital and reserves. Contractual dividends would be accrued even if not paid (for example due to lack of distributable profits) and presented along with interest in the profit and loss account.

The FRSSE does not elaborate on how the initial split should be made but FRS 25 *Financial Instruments: Presentation* may be a useful source of guidance. FRS 25 paragraph 31 states that the initial allocation is carried out by assigning the residual to equity after the amount determined for the liability component has been deducted from the fair value of the instrument as a whole.

A good starting point is to review all shares and debt instruments in issue to ensure their component parts are identified, then estimate the liability components, and treat the residual amount as equity. Do not simply assume that because an instrument is legally a share, it will be presented in capital and reserves by a FRSSE company.

DIRECTORS' ACCOUNTING DISCLOSURES REVISITED

Stephanie Henshaw, Technical Partner at Francis Clark LLP, and Andrew Güntert, Lecturer with Mercia Group Ltd, contribute some further thoughts on directors' accounting disclosures by UK companies.

In the January 2010 edition of *By All Accounts*, the directors' disclosure requirements in section 413 of the UK Companies Act 2006 (CA 2006) were compared with the equivalent requirements of the Companies Act 1985 (CA 1985). The article ended 'and there continues to be uncertainty about the new requirements'!

Certainly it has come as a surprise that the new disclosures appear to have complicated, rather than simplified, the position. The most 'difficult' issues raised were:

- The term 'advances and credits' is not defined in CA 2006 (which leads to difficulties in deciding exactly what it means and so what needs to be disclosed eg, does it cover only loans or should other advances such as quasi loans be included?); and
- Section 413 of CA 2006 is worded in such a way that it appears to require separate disclosure of each individual advance made to a director. For owner-managed businesses with frequent minor transactions, this could result in an extensive but largely pointless note to the accounts.

To date, a wide range of disclosures has been made in published accounts, from details of every single advance or credit and every repayment set against them (plus mandatory information on interest rates/conditions etc), through summaries by category, to opening and closing balances and maximum amount during the year (ie, no perceptible change from CA 1985). Inevitably, the debate as to what the accounts should show has continued and a widespread feeling has developed that some common-sense should be applied.

We should remember that the statutory disclosure applies to advances granted **to** directors. Where a director's current or loan account remains in credit, it is likely that the company is not making advances; the director is merely drawing against what the company owes him. Therefore the disclosure requirements of CA 2006 become significant when a director has an 'overdrawn' current account. It is worth reminding directors that the company's money is not their own and that there is a formal approval process for loans, and for plcs and members of plc groups this also extends to quasi loans and credit transactions. Fewer advances mean less disclosure.

One of the big accountancy firms has recently published an analysis of section 413, with the comment:

'A common sense interpretation of the requirement is that it will be adequate to give summarised details such as the total amounts drawn down and repaid during the period, together with the balance at the year end and the maximum outstanding during the period'.

The firm also noted that the EU Directive from which section 413 is derived does not require every individual movement on a loan account to be disclosed.

We recognise that this interpretation is not completely consistent with the exact wording in section 413. There are risks, too, with summarising directors' advances in this way. For example, if only aggregate amounts advanced and repaid are shown it may not be apparent that a director's loan exceeded £10,000 in aggregate and so shareholder approval should have been sought. Directors must also bear in mind the need for the accounts to give a true and fair view. There is no stated materiality to the disclosures, so any measure of materiality applied in practice is likely to be much lower than for other items in the accounts simply because of the directors' involvement.

However, we think that this interpretation has considerable merit, bearing in mind that the Government's intention in section 413 was to reduce the burden on UK companies by reducing the statutory disclosures to the minimum required by EU law.

It provides perhaps the 'common sense' approach many practitioners have called for.

An earlier and more extensive version of this article was published in the May 2010 edition of *Audit and Beyond*, the newsletter of the AAF. This topic will be covered at each of the 2010 Financial Reporting Faculty roadshow events and the faculty will continue to monitor the need for further updates and practical guidance.

SUBSTANCE ABUSE!

Guy Loveday, Lecturer and faculty member, provides a personal view on a darker side of UK GAAP.

Are you a substance abuser? If you don't know, there is a simple test to help you to find out.

When faced with a choice, why do you account for something in the way that you do? Is it because it results in a good matching of costs and benefits? If so then you may well be a substance abuser! The correct answer is of course because it best reflects the substance of the transaction involved.

This is not a new answer. It has been the correct answer in the UK for the last 10 years at least (since the replacement of SSAP 2 with FRS 18 on accounting policies). The truth is that, even now, it is not always the answer given to HMRC Inspectors when queries are raised about the appropriateness of particular UK GAAP accounting policies.

So let's say that you do give the right answer. Are you ready for the follow up question from HMRC? It is this: why do you believe that that policy best reflects the substance of the transaction? I am told that many answer that it results in a good matching of costs and benefits! For these people substance seems just a word. Substance should, on the contrary, be a mindset for accountants working with UK GAAP (or indeed with IFRS).

So how do we establish the accounting that will best reflect the substance of the transaction? By following the principles laid down in FRS 5 *Reporting the Substance of Transactions* – issued in 1994, a mere 16 years ago. Legal form is a good place to start as in most cases the legal form and the substance will be closely aligned. But we then need to confirm that accounting on the basis of the legal form produces an answer which is consistent with the substance.

FRS 5 gives a list of areas where legal form and substance might differ – and indicates where additional work needs to be done to check out alignment with substance. We establish the substance by first gathering information about all the aspects and implications of the transaction. Then we use our judgement to give greater weight to those aspects and implications that have more commercial effect in practice. Let's look at an example.

A company receives a consignment of stock on a sale or return basis. Should it recognise an asset (stock) and a related liability, or not? It depends on the terms and conditions associated with the arrangement and the weighting given to them. There is a right to return the stock, but what are the consequences of so doing, and is it likely to happen? If there is a significant financial penalty involved then perhaps commercially returning the stock is unlikely, and we should give less weight to this aspect of the transaction. We might then conclude that we have substantially all of the risks and rewards normally associated with owning stock and should account for it as if we do – and not let a little thing like absence of legal title prevent us from doing so!

On the other hand, there might be no significant penalty associated with the return of the stock. Historically there may have been occasions when consignments have indeed been returned. We might conclude that this is an important aspect of the transaction, one that prevents us from having substantially all the risks and rewards normally associated with ownership, as we do not appear to be bearing the obsolescence risk. We then end up not recognising the stock as an asset at the time of its receipt. We are not saying that we won't recognise the stock because we don't own it of course, because that is old-fashioned thinking.

'Substance should be a mindset for accountants working with UK GAAP.'

Another way of looking at a problem like this is to determine whether or not the consignment stock on receipt meets the definition of an asset. This is effectively another test for substance abuse. Do you know the definition of an asset under UK GAAP? If your answer is, 'well no, not off the top of my head, but I know where to look', then you may well be a substance abuser! These definitions are the basic building blocks of accounting nowadays in the way that prudence and matching were once in the dim and distant past. Needless to say, the definition of an asset does not emphasise legal title, but rather rights or other access to future benefits.

It would be wrong to assert that UK GAAP in 2010 is totally substance driven. There are vestiges of the old thinking still to be found in the SSAPs that are still extant. SSAP 9 on stocks and long-term contracts, for example, is positively drenched in prudence. Can we be confident that all items currently recognised as prepayments (or accruals) meet the definition of assets (or liabilities) – or are they there as a last vestige of the matching tradition?

Here is a recent example of continuing confusion in this area.

In answer to a question raised by ICAEW CEO Michael Izza concerning contingent fee arrangements, the ASB replied:

'The ASB also noted that its attention had been drawn to the evolution of two approaches, in practice, to the accounting for the cost of work performed under contracts with contingent fee arrangements that were incomplete at the period end; either expensing the cost of work performed as incurred; or recognising the costs of work performed as work in progress at the period end.

The ASB agreed that UK financial reporting standards currently permit either of these approaches to the recognition and measurement at the period end of the cost of work performed under contingent fee arrangements. Thus where the amounts involved are material, those responsible for the financial statements should apply their professional judgement to select the accounting policies most appropriate to the particular circumstances in accordance with FRS 18 *Accounting Policies*, paragraph 17.'

Many have misinterpreted this statement as meaning that they have a straight choice and can write off such costs if they want to as a tax efficient treatment. It is as if they haven't read – or more likely appreciated the meaning of – the final sentence. FRS 18 states that the objectives against which an entity should judge the appropriateness of accounting policies to its particular circumstances are relevance, reliability, comparability and understandability. These are qualitative characteristics drawn from the UK *Statement of Principles* and also used in the international conceptual framework. FRS 18 informs us that financial information is reliable only if it reflects the substance of the transactions and other events that have taken place.

Should the cost of work in progress under contingent fee arrangements be recognised in the balance sheet or the profit and loss account? It depends on the particular circumstances and whether or not the expenditure meets the definition of an asset (which it almost certainly would); and if it does, whether or not there is sufficient evidence concerning its recoverability. When the work is incomplete at the period end, this is inevitably a judgement call which needs to be made, once again, by gathering information about aspects and implications and weighting them accordingly. It is not a straight choice. Decisions must be justified as best reflecting the substance of the transaction.

'If the accounting treatment doesn't get you then the disclosure will!'

It should be recognised that judgements made by different businesses about appropriate treatments for very similar transactions will not necessarily be the same. FRS 5 caters for this by the disclosure requirements to be found in paragraphs 30 and 31. It is fair to say that, if we are talking about material amounts, if the accounting treatment doesn't get you then the disclosure will!

Substance abuse is not likely to disappear any time soon. But hopefully some of the pointers above, based on many frank discussions with UK GAAP practitioners around the country, will help fellow faculty members avoid some of the pitfalls that await the unwary!

NEW AND AMENDED IASB AND UK STANDARDS – EFFECTIVE DATES

IFRS

Annual periods BEGINNING on or after 1 January 2009

Amendments to IFRS 1 and IAS 27 *Cost of Investment in a Subsidiary, Jointly Controlled Entity or Associate.*
Amendment to IFRS 2 *Vesting Conditions and Cancellations.*
Amendment to IFRS 7 *Financial Instruments: Disclosures.*
IFRS 8 *Operating Segments.*
IAS 1 *Presentation of Financial Statements (revised).*
IAS 23 *Borrowing Costs (revised).*
Amendment to IAS 32 *Puttable Instruments and Obligations Arising on Liquidation.*
IFRIC 15 *Agreements for the construction of real estate.**

Annual periods BEGINNING on or after 1 July 2009

IFRS 1 *First-time Adoption of International Financial Reporting Standards (revised).*
IFRS 3 *Business Combinations (revised).*
IAS 27 *Consolidated and Separate Financial Statements (revised).*
Amendment to IAS 39 *Eligible Hedged Items.*
IFRIC 17 *Distributions of Non-cash Assets to Owners.**
IFRIC 18 *Transfers of Assets from Customers.**

Annual periods BEGINNING on or after 1 January 2010

Amendment to IFRS 1 *Additional Exemptions for First-time Adopters.*
Amendment to IFRS 2 Group *Cash-settled Share-based Payment Transactions.*

Annual periods BEGINNING on or after 1 February 2010

Amendment to IAS 32 *Classification of Rights Issues.*

Annual periods BEGINNING on or after 1 July 2010

Amendment to IFRS 1 *Limited Exemption from Comparative IFRS 7 Disclosures for First-time Adopters.*
IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments.***

Annual Improvements

Annual Improvements for 2008, 2009 and 2010 affect a number of standards and have multiple effective dates. For full details see faculty factsheets *2009 IFRS Accounts* and *2010 IFRS Accounts.*

The EU must endorse all international standards before they can become mandatory for EU preparers. The latest version of the Endorsement Status Report is available on the website of the European Financial Reporting Advisory Group (EFRAG) at www.efrag.org The principles of unendorsed standards and interpretations may be adopted early if they do not conflict with the requirements of any endorsed standards or interpretations.

For regularly updated information on all new IASB standards, EU endorsement and effective dates visit the faculty webpage 'Mandatory dates for IFRS standards' icaew.com/ifrsdates

UK GAAP

Annual periods BEGINNING on or after 1 January 2009

Amendment to FRS 20 *Vesting Conditions and Cancellations.*
Amendment to FRS 29 *Financial Instruments: Disclosures.*

Periods ENDING on or after 31 December 2009

Amendment to UITF 42 and FRS 26 *Embedded Derivatives.*

Annual periods BEGINNING on or after 1 July 2009

Amendment to FRS 26 *Eligible Hedged Items.*

Annual periods BEGINNING on or after 1 January 2010

Amendment to FRS 20 *Group Cash-settled Share-based Payment Transactions.*
Amendment to FRS 25 *Puttable Instruments and Obligations Arising on Liquidation.*

Annual periods BEGINNING on or after 1 February 2010

Amendment to FRS 25 *Classification of Rights Issues.*

Annual periods BEGINNING on or after 1 April 2010

FRS 30 *Heritage Assets.*

For regularly updated information on all new UK standards and effective dates visit the faculty webpage 'Mandatory dates for UK standards', icaew.com/ukgaapdates

*The applicable dates in the EU for IFRIC 12 *Service Concession Arrangements*, IFRIC 15 *Agreements for the Construction of Real Estate*, IFRIC 16 *Hedges of a Net Investment in a Foreign Operation*, IFRIC 17 *Distributions of Non-cash Assets to Owners* and IFRIC 18 *Transfers of Assets from Customers* are later than in the original interpretation.
**Not EU endorsed at the time of writing (24 June 2010).

AND FINALLY…

We reproduce an article from the summer 1983 issue of Arthur Young McClelland Moores & Co's *Arthur Young Business View* which lampoons a depressingly familiar lack of clarity.

WHAT ARE REALISED PROFITS? ONLY THE JUDGES CAN SAY

The Companies Act 1981 contains the apparently innocuous requirement that only realised profits can be included in a company's profit and loss account. The lucidity of this rule is marred only by the fact that no one has a clue what 'realised profits' means and, when the Bill was being debated, the accounting profession wisely persuaded the Government to include the following explanation in the Act:

'…for the avoidance of doubt, references in this schedule to realised profits, in relation to a company's accounts, are reference to such profits of the company as fall to be treated as realised profits for the purposes of those accounts in accordance with principles generally accepted with respect to the determination for accounting purposes of realised profits…'.

This is excellent and would have been of great value but for the fact that no one has a clue what this means either. Accordingly, the accounting profession last year issued a definitive document on the topic which was a masterpiece of ambiguity and in which the only unequivocal words read: 'Ultimately the interpretation of the law will rest with the Courts'.

Happily, the law has now been clarified in the recent case of *R v The Fly-By-Night Broomstick Company*, where the Crown secured a conviction based on a breach of the realised profits rule. The following extracts from their Lordships' judgment reveal the simple but inexorable logic of the law.

Lord Erudite: 'This is a case where the company has wantonly included in its profit and loss account those profits derived from sales of goods made on credit terms, without waiting until the customer remitted payment for the goods. Expert evidence has been submitted to the effect that this is a practice not uncommon among trading companies but, if this is so, it is nonetheless to be deplored. It is quite clear to me that no realisation of profits has occurred – the company has merely exchanged an item of stock for a debtor. It has no more money than when it started and is still exposed to the risk that the customer will prove unable or unwilling to meet its obligations. It is precisely this sort of abuse that the statute was designed to prevent – the reckless reporting of profits from transactions of a speculative nature whose ultimate out-come must remain a matter of conjecture until the cash is safely in the bank.'

Lord Literal: 'I concur with my learned friend Lord Erudite, except that I would go further. It would not be sufficient that the debt had been paid into the bank, for that merely exchanges one debt for another and the company would still run the risk that the bank would be unable to pay the amount when requested. Clearly the profit cannot be regarded as realised until the company holds the requisite number of banknotes in its own safe.'

Lord Reductio: 'I also concur with the conviction, but I would not take such a liberal view of the realised profits rule. Bank notes simply represent a promise to pay the bearer the sum started on the note and the company still must run the risk that the Bank of England will default on this promise. In my view the law is clear. The finance director cannot report a profit on any transaction until he has the proceeds of the sale in gold sovereigns in an old sock underneath his bed.'

Lord Avant-Garde: 'With the greatest respect to my colleagues, I dissent from their judgment. It is clear to me that the common law permits companies to report profits whenever the directors have decided on a plan that will earn them. The wording of the Act is quite plain. Whenever the directors realise that an opportunity to make profits exists, that profit is a realised profit and can thus be included in the accounts.'

Notwithstanding this minority opinion, the directors were found guilty and were sentenced to be hanged by the neck until they said they were sorry. It is understood that prosecutions against half a million other companies are now pending.

Have you any favourite spoofs of financial reporting requirements, or do you want to write one? Contact us at frfac@icaew.com