KPMG

Financial Reporting Update

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KPMG LLP (UK)

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ASB proposes amendment to FRS 25

The Accounting Standards Board (ASB) has issued an exposure draft proposing identical amendments to FRS 25 *Financial Instruments: Presentation* as those proposed by the International Accounting Standards Board (IASB) to IAS 32 *Financial Instruments: Presentation*. In addition to amendments to FRS 25, the exposure draft proposes changes to Appendix E of FRS 29 *Financial Instruments: Disclosures* that are identical to the IASB's proposed amendments to IAS 1 *Presentation of Financial Statements*.

Under FRS 25, equity classification of a financial instrument depends on strict conditions being met, one of them being that the instrument does not include a contractual obligation to deliver cash or another financial asset to another entity. Any instrument with such an obligation is classified as a financial liability. The above requirement results in instruments that are puttable at fair value being classified as financial liabilities instead of equity. Such a classification has raised concerns with constituents, particularly those from co-operatives, mutual funds, partnerships and private companies, in respect of the presentation impact on the balance sheet and profit and loss account.

Similar issues arise for instruments that create an obligation to deliver a pro rata share of the net assets of an entity on liquidation, for example ordinary shares in a limited life entity or some partnerships that are required to liquidate on the exit of a partner. Such instruments are currently classified as financial liabilities under FRS 25 and the exposure draft also addresses the classification of such instruments.

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The proposals address the issue of classification of the above-mentioned instruments by amending the definition of an equity instrument in FRS 25. The proposals amend what constitutes a 'contractual obligation' for the purposes of the standard. Under the proposals the following instruments would be classified as equity under FRS 25:

- financial instruments that are puttable at fair value
- an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation.

In order to ensure that the revisions apply only to those instruments that are the 'equivalent of ordinary shares' the exposure draft proposes a number of specific criteria that would have to be met in order for a financial instrument to qualify as either a financial instrument puttable at fair value or a financial instrument that entitles the holder to a pro rata share of the net assets of the entity upon its liquidation. In particular, it is important that these instruments are the most subordinated class of financial instrument in the reporting entity.

In respect of FRS 29, consequential amendments are proposed to Appendix E of the standard to require specific disclosures when an entity has reclassified a financial instrument puttable at fair value or an instrument that entitles the holder to a pro rata share of the net assets of the entity, and to require specific disclosure when an entity has financial instruments puttable at fair value classified as equity.

The ASB notes that the IASB's exposure draft is intended to be only a limited scope, short-term solution to the specific concerns relating to financial instruments puttable at fair value and financial instruments that require an entity to deliver a pro rata share of an entity's net assets upon its liquidation. The ASB will continue to monitor progress of the IASB's longer-term project on liabilities and equity.

The ASB's exposure draft is available at

www.frc.org.uk/asb/press/pub1139.html

Lease arrangements under IFRIC 4

IFRIC 4 *Determining whether an Arrangement contains a Lease* was published in December 2004 and provides guidance on determining whether arrangements are, or contain, leases that should be accounted for and disclosed in accordance with IAS 17 *Leases*. IFRIC 4 is effective for annual periods beginning on or after 1 January 2006. Will UK entities reporting under endorsed-IFRSs find leases in unexpected places when they first apply IFRIC 4?

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IFRIC 4 requires that an entity should base its assessment of whether an arrangement is or contains a lease on its substance rather than its legal form. It identifies two criteria for determining whether an arrangement is, or contains, a lease:

- fulfilment of the arrangement is dependent on the use of a specific asset
- the arrangement conveys the right to use that asset.

IFRIC 4 provides guidance on assessing whether an arrangement meets these criteria, drawn largely from US GAAP.

The IFRIC 4 approach differs from that under UK GAAP, where entities would be more likely to apply the separability criteria in FRS 5 to assess whether an arrangement contained a standalone lease or, more generally, account for a lease or a financing arrangement when that best represented the substance of the arrangement.

The criteria can be illustrated by considering a number of examples.

First, consider an arrangement in which an entity enters into a contract with a third party for the supply of electricity. The third party constructs a power plant on-site to provide electricity exclusively for that one entity and receives in return a fixed capacity payment and a variable payment based on the facility's actual energy costs. In this example, there is a specifically identified asset (the power plant) upon which fulfilment of the arrangement is dependent and the entity controls the use of the asset through exclusivity. This arrangement therefore contains a lease that should be accounted for in accordance with IAS 17. Under UK GAAP the entity would have brought this kind of 'take-or-pay' arrangement on the balance sheet as a financing transaction where the fixed charges repaid the supplier's initial investment in the power plant, but will not necessarily have disclosed the arrangement as a lease.

Secondly, consider a manufacturer that enters into a distribution arrangement with a third party (the supplier). The contract specifies that the supplier must construct a new distribution centre on land within the manufacturer's main site. Due to the location of the centre, the manufacturer will exercise certain access controls and it will in any case generally be uneconomic for the supplier to use the centre to fulfil its obligations to other customers. However, the contract contains no separate payment stream relating to the construction or availability of the distribution centre.

In this second case, applying the IFRIC 4 criteria suggests that the arrangement *may* contain a lease between the manufacturer (lessee) and the supplier (lessor). The arrangement depends on a specific asset (the distribution centre), and IFRIC 4 specifically states that a right of use exists where the manufacturer controls physical access and takes more than an insignificant portion of the output

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of the asset. Although the contract contains no separate payment stream in respect of the distribution centre, this does not preclude the arrangement from being a lease under IFRIC 4.

This is in contrast to UK GAAP where it is possible that the manufacturer would have accounted for a lease only if there were separable payments relating to the availability of the distribution centre, and may have accounted for a financing arrangement only if it guaranteed a minimum level of revenue sufficient to repay the costs incurred by the supplier in constructing the distribution centre.

The first example suggests that implementation of IFRIC 4 may result in additional disclosure, the second that IFRIC 4 may result in measurement changes, i.e., if the arrangement does contain a lease then it must be accounted for in accordance with IAS 17. Entities that have entered into 'take-or-pay' type contracts, or are involved in outsourcing arrangements, will need to review there arrangements on a case-by-case basis to assess the full effect.

Auditor fee disclosure

As outlined in an article in the March/April edition of *Update*, the new legal requirements, as set out in Statutory Instrument 2005/2417, for the disclosure by companies of audit and non-audit fees paid to auditors change for periods starting on or after 1 October 2005.

The Institute of Chartered Accountants in England and Wales (ICAEW) issued draft guidance in TECH 04/06 on how to apply the new requirements. Although this guidance still remains in draft at present, the ICAEW expects to finalise this guidance in September 2006, in time for those companies having to apply the requirements first in their accounts for the year ending 30 September 2006.

The new disclosure requirements are complex, particularly for those companies that do not qualify as small or medium-sized, and should be reviewed carefully as they change what falls to be disclosed as audit and non-audit fees. As a brief reminder, companies must disclose any fees receivable by the auditor and its 'associates' for other services provided to the company or its 'associates'. Both uses of the term 'associates' are defined in the legislation and the definition of the auditor's 'associates', which has been changed by the legislation, is very wide-ranging. In addition, non-audit fees must be disclosed within specified categories, which are addressed in the ICAEW's draft guidance with examples of the types of service that may fall within the more difficult categories to interpret.

The ICAEW's draft Technical Release is available at

www.icaew.co.uk/index.cfm?route=135101

The Statutory Instrument and Explanatory Memorandum are available at

www.opsi.gov.uk/si/si200524.htm

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FRC updates Combined Code

In July 2006 the Financial Reporting Council (FRC) published an updated version of the Combined Code on Corporate Governance. The Listing Rules will not formally apply to the revised Combined Code until a separate consultation has been carried out by the Financial Services Authority commencing in September 2006. However early adoption of the updated Code is encouraged on a voluntary basis for reporting years beginning on or after 1 November 2006. Nevertheless, any non-compliance with the requirements of the 2003 Combined Code must still be reported.

The amendment to the Code follows a review into how companies and investors have progressed in implementing the 2003 version of the Code. The review, which started over a year ago, found that overall the Code was bedding down well. However the review also identified that there were some areas which should be updated. These amendments received strong support in a public consultation exercise and have been incorporated into the updated Code as follows:

- an amendment to B.2.1 to enable the company chairman to sit on the remuneration committee if considered independent on appointment (although it is recommended that he or she should not also chair the committee)
- an amendment to D.2.1 to provide shareholders voting by proxy with the option of withholding their vote on a resolution
- an amendment to D.2.2 to encourage companies to publish the details of proxies lodged on resolutions where votes are taken on a show of hands
- an amendment to enable companies to meet the requirement to make the terms of reference of board committees available by placing them on their Web site[1].

The chairman of the FRC is currently engaged in a programme of discussions with the chairmen of listed companies and leading shareholders to obtain a deeper understanding of the impact of the Code.

The FRC's press release is available at

www.frc.org.uk/press/pub1130.html

A copy of the updated Combined Code is available at

www.frc.org.uk/corporate/combinedcode.cfm

1 The FRC specifies that the requirement to make the information available would be met by including the information on a Web site that is maintained by or on behalf of the company.

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Review of pension disclosures

The Financial Reporting Financial Review Panel (FRRP) has published the results of a review it performed of the pension disclosures made by 30 companies – 20 using EU-endorsed IFRS and 10 using UK GAAP. It found a high level of compliance.

The 20 listed companies were following IAS 19 *Employee Benefits* in their December 2005 group accounts. All but two had adopted the revised version of IAS 19 introduced late in 2004 and were recognising actuarial gains and losses immediately in full outside profit or loss in the statement of recognised income and expense; as a result they had to comply with the more extensive disclosures also introduced by that revision. The other two continued to recognise such gains and losses gradually using the 'corridor' method but one gave most of the new disclosures, on a voluntary basis. While the level of disclosure was good, the FRRP concluded that pension reporting under IFRS could have been improved in a number of ways, including:

- fuller disclosure, under IAS 1 paragraphs 116 to 124, of the uncertainties surrounding the estimates inherent in pension accounting and the impact of changes to those estimates
- greater clarity on the nature of the disclosures required – e.g., how to disclose the mortality assumptions used
- a clearer – and less boiler-plate – description of how the expected rate of return on assets had been calculated
- avoidance of unnecessary disclosure of immaterial amounts.

Several of the points raised by the FRRP are reflected in the Accounting Standards Board's recent exposure draft of a non-mandatory Reporting Statement of supplementary pension disclosures (see the May/June *Update*).

The 10 unlisted companies reviewed were following FRS 17 *Retirement Benefits*, mostly in December 2004 accounts with all providing additional disclosures in their notes while still accounting under SSAP 24 *Accounting for Pension Costs*. The most common omission was failing to provide three years' information where required (main financial assumptions; fair value of, and expected rate of return on, assets by category).

The FRRP's press release, and the results of its survey, are available at

www.frc.org.uk/frrp/press/pub1155.html

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WEEE Directive

In July 2006 the Department of Trade and Industry issued a final consultation on revised draft legislation to implement the EU directive on Waste Electrical and Electronic Equipment (WEEE). The directive sets targets for the recycling and environmentally sound disposal of WEEE and requires that the cost of this is borne by producers and commercial users of Electrical and Electronic Equipment (EEE). The comment period closes on 17 October 2006 and final legislation is expected to be laid before parliament in December 2006. On this basis it is likely that legislation will be enacted or substantively enacted by 31 December 2006 and entities should consider its impact when preparing their December 2006 financial statements.

The draft UK legislation distinguishes between WEEE from private households (household WEEE) and other WEEE (commercial WEEE).

In respect of household WEEE, it is likely that a producer's obligations for disposal may arise only as a result of its sales from 1 April 2007 onwards. If this is the case then no provisions in respect of household WEEE will be required at 31 December 2006.

However, in respect of commercial WEEE, a producer's obligations are likely to arise as a result of its sales of EEE from 13 August 2005 onwards. Therefore liabilities may require recognition at 31 December 2006.

Commercial users are likely to be responsible for the disposal of EEE acquired before 13 August 2005, until that EEE is replaced by equivalent EEE on or after that date. Therefore commercial users (i.e., many businesses) may have decommissioning liabilities that require recognition at 31 December 2006.

The draft legislation also permits the producer and commercial user to agree (contractually) that the obligation for disposal will be borne by a specific party. Producers and commercial users should consider the contractual terms of purchases of EEE.

The directive has already been enacted into national legislation in many if not all of the other countries in the EU. Producers and commercial users will need to assess their obligations separately under each national legislation as differences may exist.

The revised draft legislation and the final consultation are available at

www.dti.gov.uk/consultations/page32448.html

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IFRS newsletters

KPMG IFRG Limited has published the following since the May/June 2006 *Update*, which are available on our Web site at www.kpmg.co.uk:

- *IFRS in Brief*, *July 2006* – a summary of the June 2006 meeting of the IASB
- *IFRS in Brief, August 2006* – a summary of the July 2006 meeting of the IASB and the IASB's announcement about adoption of IFRSs and reinforcement of consultation
- *IFRS Briefing Sheet*, Issue 51 – Exposure Draft of Proposed Amendments to IAS 32 and IAS 1 – Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation
- *IFRS Briefing Sheet*, Issue 52 – Discussion Paper on Objectives and Qualitative Characteristics of Financial Reporting
- *IFRS Briefing Sheet*, Issue 53 – IFRIC Interpretation 10 Interim Financial Reporting and Impairment

If you would like further information on any of the matters discussed in this *Update*, please talk to your usual contact at KPMG LLP (UK) or call any of our offices. Earlier *Updates* are available on our Web site, at www.kpmg.co.uk.

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