

Country Report for the IFAC PSC

Malaysia

February 2005

Federal Government Accounting System

The Federal Government of Malaysia has been adopting “Modified Cash Basis of Accounting” in the preparation of its annual financial statement. Even though the government adopts cash basis of accounting, assets and liabilities which are not reported in the Balance Sheet are being disclosed in Memorandum Accounts. Financial reporting also encompasses budget reporting whereby comparisons of the actual and budgeted amount for both revenues and expenses are reported in the Statement of Financial Performance.

IPSAS 1 (Financial reporting under the cash basis of accounting)

Effective from financial year 2002, other than preparing the annual Balance Sheet and Statement of Financial Performance to comply with the National Financial Procedure Act, a Statement of Cash Receipts and Cash Payments is prepared so as to be in line with the requirement of the IPSAS 1 (Financial reporting under the cash basis of accounting).

Prospects for the Implementation of Accrual Basis of Accounting

The Accountant General’s Department (AGD) has been taking much initiative in exploring the possibility of moving from cash basis of accounting to accrual basis of accounting in order to enhance accountability, transparency and comparability of the financial statements. Report on the impacts of implementing accrual accounting was prepared and forwarded to the top management for decision making. The decision made was to continue with the cash basis of accounting.

Among the actions that are being carried out are summarized as follow:

- (a) Reengineering of the present accounting system whereby the new accounting system being developed shall be able to capture accounting transactions and prepare financial statements based on accrual basis of accounting if the need arises in the future.
- (b) A committee was set up to explore and evaluate the requirements of the IPSASs (Financial reporting under the accrual basis of accounting) presently in force so as to ensure compliance to these standards if AGD adopts the accrual basis of accounting in the future.
- (c) A committee was also set up to study the implications on the existing laws and regulations which are being in force if AGD implements the accrual basis of accounting.



DATE: 14 February 2005

MEMO TO: MEMBERS OF THE IFAC INTERNATIONAL PUBLIC SECTOR
ACCOUNTING STANDARDS BOARD

FROM: Greg Schollum
NEW ZEALAND REPRESENTATIVE

SUBJECT: **UPDATE ON RECENT DEVELOPMENTS IN NEW ZEALAND**

Introduction

This memorandum updates Members of the IFAC International Public Sector Accounting Standards Board (IPSASB) on recent developments in New Zealand, specifically relating to:

- Generally Accepted Accounting Practice;
- Auditing and Professional Standards;
- Central Government; and
- Local Government.

Generally Accepted Accounting Practice

Adoption of International Standards in New Zealand

In December 2004 the Accounting Standards Review Board (ASRB) announced the establishment of a “stable platform” of New Zealand Equivalents to International Financial Reporting Standards (NZ IFRSs).

All reporting entities, including public sector entities, will be required to comply with the NZ IFRSs from 1 January 2007, but may elect to adopt the new standards from 1 January 2005. NZ IFRSs are based on IFRSs but, where necessary, they have been amended to enable public benefit entities to apply the new standards.

Other issues linked to the adoption of NZ IFRS include:

- a revised differential reporting regime; and
- developing further guidance for public benefit entities (public sector and not-for-profit entities).

Differential Reporting for Entities Applying the New Zealand Equivalents to IFRSs

In December 2004 the Financial Reporting Standards Board (FRSB) issued for comment ED-98 *Framework for Differential Reporting for Entities Applying the New Zealand Equivalents to IFRSs Reporting Regime*. ED-98 takes a similar approach to that in the existing Differential Reporting Framework.



In developing ED-98 the FRSB has sought to identify differential reporting concessions which are equivalent to those in existing NZ financial reporting standards. The FRSB decided to adopt this approach at this time rather than developing new criteria and critically examining the requirements in New Zealand because:

- The existing *Differential Reporting Framework* has provided a sensible way to reduce compliance costs for a large number of entities. There is no evidence that application of the existing *Differential Reporting Framework* has adversely affected users. Although the identification of concessions under the existing *Differential Reporting Framework* involves some subjectivity, it has a sound conceptual basis.
- The FRSB considers that it would be unwise to develop a new approach to differential reporting given that a review of qualifying entities and differential reporting concessions is likely to be required in the short term. The two main projects which will have an impact on differential reporting are outlined below.
 - The IASB project on Accounting for Small and Medium-sized Entities (SMEs)¹.
 - The Ministry of Economic Development (MED) Discussion Documents *Review of the Financial Reporting Act 1993 Part I: The Financial Reporting Structure* (March 2004) and *Review of the Financial Reporting Act 1993 Part II* (November 2004)². The outcome of this review will have an impact on the types of entities required to comply in full with New Zealand equivalents to IFRSs.
- Many entities which currently qualify for differential reporting concessions are subsidiaries with an Australian or European parent and will be adopting New Zealand equivalents to IFRSs for annual accounting periods commencing on or after 1 January 2005. Some of these entities currently qualify for differential reporting concessions. It is therefore important to develop a reporting framework for such entities now.
- New Zealand equivalents to IFRSs require significantly more disclosures than existing New Zealand GAAP. Therefore, any proposed differential reporting regime needs to significantly reduce the disclosures required or compliance costs for current qualifying entities will increase significantly.

¹ Details of the IASB's initial proposals are set out in Discussion Paper, Preliminary Views on Accounting Standards for Small and Medium-sized Entities (June 2004). The Discussion Paper and Comment Letters on the proposals are available from the Current Issues section of the IASB's website <http://www.iasb.org>. IASB Updates provide a summary of the IASB's discussion of current projects.

² The discussion documents are available from the Ministry's website at http://www.med.govt.nz/buslt/bus_pol/bus_law/corporate-governance/financial-reporting/

Similar to the existing Differential Framework, ED-98 proposes that an entity qualifies for differential reporting exemptions (is a qualifying entity) when the entity does not have public accountability, and:

- (i) at balance date, all of its owners are members of the entity's governing body; or
- (ii) the entity is not large.

It has been eight years since the size criteria were reviewed and the FRSB recently considered that an increase in the size criteria was appropriate. The FRSB proposes to amend the size criteria so that an entity qualifies as large if it exceeds any two of the following:

- (a) total income³ of \$20.0 (previously \$5.0) million;
- (b) total assets of \$10.0 (previously \$2.5) million;
- (c) 50 employees (previously 20).

Comments on the proposed Framework are due by 25 February 2005. Copies of ED-98 and the accompanying discussion paper are available on the Institute's web site www.icanz.co.nz.

Application Guidance - Public Benefit Entities

During development of the NZ IFRSs a number of issues were identified where further guidance is required. Many of the issues relate to accounting by public benefit entities (PBE) and include:

- Determining when an entity is a public benefit entity;
- Control;
- Conceptual Framework;
- Non-financial performance reporting; and
- Accounting for associates in the absence of conventional ownership instruments.

The FRSB is considering guidance to assist in determining whether an entity is a public benefit entity. This is important because certain of the NZ IFRSs contain provisions that may only be applied by public benefit entities. NZ IAS 1 requires entities to disclose whether they are public benefit or profit oriented.

The term "public benefit entity" is defined in NZ IAS 1. However, some entities are uncertain as to whether they meet this definition because they have multiple objectives – which include service delivery objectives and objectives in terms of financial targets. The FRSB has developed draft guidance which places a lot of weight on the entity's governing legislation and founding documents to help determine the entity's primary objective.

³ The proposed size criteria refer to "income" rather than "revenue". This is because the definition of income in New Zealand equivalents to IFRSs is equivalent to the definition of revenue in the *Statement of Concepts for General Purpose Financial Reporting*.



The FRSB is also considering the definition of control currently contained in FRS-37. The current definition is being challenged principally by universities not wishing to be seen as 'controlled' by the Crown, and certain amendments are being proposed to improve the definition and its application.

The FRSB is finalising the NZ equivalent to the IASB Framework. The IASB Framework is narrower than the existing Statement of Concepts. The FRSB plans to review the NZ equivalent to the IASB Framework in the second half of 2005. One of the main issues, that the review is likely to consider, is non-financial performance reporting.

Prospective Financial Information

New Zealand currently has on issue FRS-29 *Prospective Financial Information* which was developed in response to a need to regulate the quality of financial reporting within prospectuses of profit oriented entities. The FRSB recently established a Prospective Financial Information Working Group to review FRS-29. Prospective financial information is of particular importance in the local government sector as the Local Government Act 2002 requires local authorities to prepare a Long Term Council Community Plan every three years covering a period of not less than 10 consecutive financial years. Forecast information included in that plan is required to be prepared in accordance with generally accepted accounting practice. In addition, from 2006, such plans are required to contain a report from the local authority's auditor on—

- (a) *the extent to which the local authority has complied with the requirements of the Local Government Act 2002 in respect of the plan; and*
- (b) *the quality of the information and assumptions underlying the forecast information provided in the plan; and*
- (c) *the extent to which the forecast information and performance measures provide an appropriate framework for the meaningful assessment of the actual levels of service provision.*

The Working Group met in January 2005 and will meet next in February 2005 to further develop an exposure draft for consideration by the FRSB.

IASB Projects - Management Commentary

The New Zealand Institute of Chartered Accountants is leading the IASB project on Management Commentary in the research phase, working alongside representatives from fellow Partner Standard Setters Canada, Germany and the UK. The IASB has also allocated staff along with the Board members responsible for liaising with the relevant standard setters.

The IASB Working Group has produced a first draft discussion paper outlining a number of preliminary views on Management Commentary. This paper is to be presented to the IASB in February and then to the IASB Standards Advisory Council.



Auditing and Professional Standards

Auditing Standards

New Zealand has historically developed its own auditing standards using international standards as a base. However, the Professional Practices Board (PPB) is currently exploring the option of adopting International Standards on Auditing (ISAs). Initial consultation has revealed that there is strong support for the adoption of ISAs in New Zealand. However, different views were expressed on how ISAs should be adopted. The PPB's next step is to undertake a broader consultation and set out clearly how it intends to adopt ISAs (i.e. to what extent will changes be made to ISAs and under what circumstances?)

Compilation Engagements

The PPB is currently revising its standards on compilation engagements. A working group is to be established to consider the issues around compilation engagements and to make recommendations to the PPB for the revision of the existing standard and guideline.

Assurance Engagements over Prospective Financial Information

The PPB is also considering a project to develop a standard on providing assurance over prospective financial information. As noted above this is particularly relevant to the local government sector because the Local Government Act 2002 requires local authorities to prepare and have audited a Long Term Council Community Plan. These plans include 10 year financial forecasts.

Central Government

The Public Finance (State Sector Management) Bill has passed through its final stages and came into force on 25 January 2005.

The Bill covered the main pieces of legislation that govern public finances and management of the State sector in New Zealand. This Bill, which amended New Zealand's Public Finance Act, was the culmination of a review of the public management system (the Review of the Centre). The Review of the Centre suggested initiatives to support better integration, greater flexibility, and an increased focus on results, without losing the system's current strengths of transparency, accountability, and financial management.

The Bill aims to strengthen the wider State sector. Taken as a whole, the elements of the Bill work together to—

- achieve service delivery by government agencies that is better integrated and better focussed on people's needs,
- address fragmentation and improve alignment, providing an emphasis on ensuring that the various parts of the State sector work together,
- build a strong State sector, including enhanced capability and strong leadership on values and standards.



The Public Finance Act 1989 provides the basis for effective and efficient use of public financial resources and clear accountability and reporting. The Bill also integrates the Fiscal Responsibility Act 1994 into the Public Finance Act. The amendments—

- enhance responsible fiscal management, including the provision of better information to Parliament,
- allow Ministers to have more flexibility in managing appropriations,
- enhance departmental reporting disclosing a broader range of information about intended and actual performance, and expanding this to cover all departments and also Offices of Parliament and the Reserve Bank,
- make the Controller function of the Auditor-General a more effective check on spending and require Ministers to report to Parliament for serious breaches.

New Zealand's current central government budgeting and financial reporting will continue to be prepared in accordance with generally accepted accounting practice.

The Bill also introduced a new Crown Entities Act. This Act seeks to reform the law relating to Crown entities to provide a consistent framework for the establishment, governance, and operation of Crown entities. Crown entities are part of the wider State sector and are diverse organisations in which the State has a controlling interest. Crown entities form part of the Government reporting entity, but are not part of the Crown itself. The creation of the new Crown Entities Act—

- sets out consistent governance and accountability requirements for Crown entities,
- clarifies relationships between Crown entities, their board members, the Crown, and Parliament, including clear and consistent roles, duties, and procedures for appointment and removal of governing body members,
- tailors the governance and accountability framework to capture major differences between Crown entities according to their relationship with the Crown by providing for different categories of Crown entities (including the degree to which the Crown entity is required to give effect to, or be independent of, government policy),
- clarifies the powers and duties of board members in respect of the governance and operation of Crown entities, including their duty to ensure the financial responsibility of the Crown entity; and
- provides mechanisms for the Government to express and enforce a whole of government approach.

Local Government

2005 will be a challenging year for the Local Government sector in New Zealand. The key issues to be addressed are:



- development of Long Term Council Community Plans incorporating 10 year financial forecasts along with service performance and outcome information, in a state that can be audited;
- restatement of the 30 June 2005 balance sheet of each local authority using NZ IFRS (new set of standards which will replace NZ GAAP);
- a shorter timeframe within which all local authorities need to adopt their 2005 Annual Reports (within 4 months of year end).

If you have any questions about any of these matters please feel free to raise them with me.

Greg Schollum
NEW ZEALAND REPRESENTATIVE+

United States Country Report
Prepared for the IFAC Public Sector Committee
February 2005

Recent Activity of the Federal Accounting Standards Advisory Board (FASAB)

SFFAS 28. In January 2005, the FASAB issued Statement of Federal Financial Accounting Standards (SFFAS) 28, *Deferral of the Effective Date of Reclassification of the Statement of Social Insurance: Amending SFFAS 25 and 26*. This standard defers for one year the effective dates of SFFAS 25, *Reclassification of Stewardship Responsibilities and Eliminating the Current Services Assessment*, as well as SFFAS 26, *Presentation of Significant Assumptions for the Statement of Social Insurance: Amending SFFAS 25*. The requirements of SFFAS 25 and 26 will be effective for periods beginning after September 30, 2005.

SFFAS 27. In December 2004, the FASAB issued SFFAS 27, *Identifying and Reporting Earmarked Funds*. The standard defines earmarked funds and requires, among other things, that component federal entities show nonexchange revenue and other financing sources, including appropriations, and net cost of operations attributable to earmarked funds separately on the Statement of Changes in Net Position. Component federal entities also will show separately the portion of cumulative results of operations attributable to earmarked funds on the Statement of Changes in Net Position and the Balance Sheet. The standards prescribed in SFFAS 27 are effective for periods beginning after September 30, 2005.

SFFAS 26. In November 2004, the FASAB issued SFFAS 26, *Presentation of Significant Assumptions for the Statement of Social Insurance: Amending SFFAS 25*. The amendment reclassifies significant assumptions as basic information rather than as required supplementary information. The standard is effective for periods beginning after September 30, 2004.

National Defense PP&E. The FASAB staff issued Staff Implementation Guidance 23.1, *Guidance for Implementation of SFFAS 23, Eliminating the Category National Defense Property, Plant, and Equipment, Classification of Items Formerly Considered National Defense PP&E* which was effective upon issuance on January 31, 2005.

Recent Activity of the Governmental Accounting Standards Board (GASB)

Statement No. 46. In December 2004, the GASB issued Statement No. 46, *Net Assets Restricted by Enabling Legislation, an amendment of GASB Statement No. 34*. The purpose of Statement 46 is to help governments determine when net assets have been restricted to a particular use by the passage of enabling legislation and to specify how those net assets should be reported in financial statements when there are changes in the circumstances surrounding such legislation. It is effective for periods beginning after June 15, 2005.

OPEB. In December 2004, the GASB staff issued Technical Bulletin (TB) 2004-2, *Recognition of Pension and Other Postemployment Benefit [OPEB] Expenditures/Expense and Liabilities by Cost-Sharing Employers*. The TB clarifies the application of requirements regarding accounting for employers' contractually required contributions to cost-sharing pension and OPEB plans issued in Statement Nos. 27 and 45. It was issued to address questions raised and to foster a comparable application of the recognition requirements of those Statements by cost-sharing employers. The TB is effective for financial statements for periods ending after December 15, 2004, with respect to pension transactions (earlier application is encouraged), and should be applied simultaneously with the implementation of Statement 45 with respect to OPEB transactions.

Termination Benefits. In December 2004, the GASB issued an Exposure Draft (ED) titled, *Accounting for Termination Benefits*. This ED would establish accounting guidance for state and local governmental employers regarding benefits provided to employees who terminate employment. It would establish guidance for benefits, such as early-retirement incentives and severance benefits that are provided as the result of voluntary or involuntary terminations and is intended to enhance comparability of financial statements by requiring governments to account for similar termination benefits in the same manner.

Recent Activity of the Financial Accounting Standards Board (FASB)

Statement 123(R). In December 2004, the FASB published FASB Statement No. 123 (revised 2004), *Share-Based Payment*. Statement 123(R) requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. Statement 123(R) covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. Public entities (other than those filing as small business issuers) will be required to apply Statement 123(R) as of the first interim or annual reporting period that begins after June 15, 2005. Public entities that file as small business issuers will be required to apply Statement 123(R) in the first interim or annual reporting period that begins after December 15, 2005.

Statement No. 153. In December 2004, the FASB issued Statement No. 153, *Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions*. The amendments made by Statement 153 are based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. Further, the amendments eliminate the narrow exception for nonmonetary exchanges of similar productive assets and replace it with a broader exception for exchanges of nonmonetary assets that do not have commercial substance. Previously, Opinion 29 required that the accounting for an exchange of a productive asset for a similar productive asset or an equivalent interest in the same or similar productive asset should be based on the recorded amount of the asset relinquished. The Statement is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005.

Earlier application is permitted for nonmonetary asset exchanges occurring in fiscal periods beginning after the date of issuance. The provisions of this Statement shall be applied prospectively.

Statement No. 152. In December 2004, the FASB issued Statement No. 152, *Accounting for Real Estate Time-Sharing Transactions*. Statement 152 amends FASB Statements No. 66, *Accounting for the Sales of Real Estate*, and No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, in association with the issuance of AICPA Statement of Position (SOP) 04-2, *Accounting for Real Estate Time-Sharing Transactions*. The AICPA's Accounting Standards Executive Committee issued SOP 04-2 (see discussion below) to address the diversity in practice caused by a lack of guidance specific to real estate time-sharing transactions. Statement 152 and SOP 04-2 will improve the accounting and reporting of those transactions. The guidance is effective for financial statements for fiscal years beginning after June 15, 2005, with earlier application encouraged.

Statement No. 151. In November 2004, the FASB issued Statement No. 151, *Inventory Costs, an amendment of ARB No. 43, Chapter 4*. The amendments made by Statement 151 will clarify that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges and by requiring the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. The guidance is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. Earlier application is permitted for inventory costs incurred during fiscal years beginning after November 23, 2004. The provisions of Statement 151 should be applied prospectively.

FASB Staff Positions. The following final staff positions were issued since October 2004 (all are available on the FASB Web site at www.fasb.org):

FSP FAS 109-2. Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004 (December 21, 2004)

FSP FAS 109-1. Application of FASB Statement No. 109, Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004 (December 21, 2004)

Recent Activity of the AICPA Accounting Standards Executive Committee (AcSEC)

SOP 04-2. In December 2004, AcSEC issued SOP 04-2 titled, *Accounting for Real Estate Time-Sharing Transactions*. The SOP was issued to address a diversity in practice caused by a lack of guidance specific to real estate time-sharing transactions. Concurrently, the FASB issued Statement No. 152 (see discussion above).

Deferred Acquisition Costs. On November 29, 2004, AcSEC issued an ED titled, *Accounting by Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements*. The ED provides guidance on accounting by insurance enterprises for deferred acquisition costs (DAC) on internal replacements other than those specifically described in FASB Statement No. 97.

Recent Activity of the AICPA Auditing Standards Board (ASB)

Audit Documentation. The ASB has issued an exposure draft of a proposed Statement on Auditing Standards (SAS) entitled *Audit Documentation*. The proposed Statement will supersede SAS No. 96 of the same name. The proposed SAS establishes standards and provides guidance to an auditor of a nonissuer on audit documentation for audits of financial statements or other financial information being reported on. Among other things, the proposed SAS requires the auditor to consider, when preparing audit documentation, the needs of an “experienced auditor,” having no previous connection with the audit, to understand the procedures performed, the evidence obtained and specific conclusions reached. In addition to the proposed SAS, the exposure draft includes proposed amendments to SAS No. 1, *Codification of Auditing Standards and Procedures* to the section on “Dating of the Independent Auditor’s Report.”

SOP 04-01. In October 2004, the ASB issued an SOP titled, *Auditing the Statement of Social Insurance*, to assist CPAs in auditing this financial statement required by FASAB SFFAS No. 17, *Accounting for Social Insurance*, and No. 25, *Reclassification of Stewardship Responsibilities and Eliminating the Current Services Assessment*. An example of a social insurance program is Social Security for which the statement of social insurance covers a period of 75 years in the future. The effective date for the SOP is for periods beginning after September 30, 2005.

The following auditing interpretations were issued by the ASB since June 2004 and are available on the AICPA web site at: <http://www.aicpa.org/members/div/auditstd/announce/index.htm>.

Attestation Reporting under Government Auditing Standards. In June 2003, the U.S. Government Accountability Office issued a revision to *Government Auditing Standards* (GAS). One change was the addition of a new chapter on attestation engagements that sets forth general, fieldwork, and reporting standards for such engagements performed pursuant to GAS. As a result, in December 2004 the AICPA issued an interpretation to AICPA Statement on Standards for Attestation Engagements (AT sec. 101) in December 2004. Interpretation 6, *Reporting on Attestation Engagements Performed in Accordance With Government Auditing Standards* (AT sec. 9101), explains how an attestation report should be modified when the engagement is performed in accordance with GAS. It also provides an illustrative attestation report.

OCBOA. In January 2005, the ASB revised two auditing interpretations and issued a new auditing interpretation relating to Statement on Auditing Standards (SAS) No. 62, *Special Reports*. Revisions were made for clarity purposes to Interpretation 12, *Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises’ Financial Statements Prepared on a Statutory*

Basis, and to Interpretation 14, *Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting*. Interpretation 15, *Auditor Reports on Regulatory Accounting or Presentation when the Regulated Entity Distributes the Financial Statements to Parties Other Than the Regulatory Agency Either Voluntarily or Upon Specific Request*, provides clarification to paragraph 5(f) of SAS No. 62 regarding the appropriate form of auditor's reporting when the entity plans to distribute its regulatory financial statements to parties other than the related regulatory agencies, either voluntarily or upon specific request.

Recent Activity of the Public Company Accounting Oversight Board (PCAOB)

The PCAOB has issued the following proposals and Final Rules since October 2004. Additional information on these items can be found on the PCAOB web site at www.pcaobus.org.

- *Release No. 2004-015. Proposed Ethics and Independence Rules Concerning Independence, Tax Services and Contingent Fees*
- *Release No. 2004-014. Temporary Transitional Rule Relating to PCAOB Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed In Conjunction with An Audit of Financial Statements*
- *Release No. 2004-013. Proposed Rule on Procedures Relating to Subpoena Requests in Disciplinary Proceedings*

IFAC COUNTRY REPORT: UNITED KINGDOM

FINANCIAL REPORTING COUNCIL

The Financial Reporting Council (FRC), the UK's unified independent regulator, has previously announced that it will carry out a formal assessment of how the Combined Code is being implemented. The Combined Code draws together requirements relating to corporate governance for the UK listed sector. The review will take place in the second half of 2005. In preparation for this review the FRC has carried out an informal assessment of the impact of the revised Combined Code and concluded that encouraging progress had been made since the Code took effect in November 2003.

Accounting Standards Board Developments

Convergence Standards

As part of its strategic objective of ensuring the convergence of UK Generally Accepted Accounting Practice (UK GAAP) and International Financial Reporting Standards (IFRS) the UK Accounting Standards Board (ASB) issued six standards based on IAS equivalents in December 2004. The new standards are:

- FRS 22, *Earnings per Share*
- FRS 23, *The Effects of Changes in Foreign Exchange Rates*
- FRS 24, *Financial Reporting in Hyperinflationary Economies*
- FRS 25, *Financial Instruments: Disclosure and Presentation*
- FRS 26, *Financial Instruments: Recognition and Measurement*

FRS 22, FRS 23 and FRS 24 implement into UK GAAP IAS 33 (revised), *Earnings per Share* IAS 21, *The Effects of Changes in Foreign Exchange Rates* and IAS 29, *Financial Reporting in Hyperinflationary Economies*. FRS 25 and FRS 26 have the effect of implementing IAS 32, *Financial Instruments: Disclosure and Presentation* and the measurement and hedge accounting provisions of IAS 39, *Financial Instruments: Recognition and Measurement* into UK GAAP.

At the same time the ASB issued Amendments to FRS 2, *Accounting for Subsidiary Undertakings*, as a result of statutory changes to the Companies Act regime.

The amendments to FRS 2:

- a. delete references to 'participating interest' in the definition of a subsidiary undertaking and introduce 'the power to exercise or actually exercise, dominant influence and control';
- b. reflect the exemption from the preparation of consolidated accounts for intermediate parent undertakings whose immediate parents are not governed by the law of an European Economic Area (EEA) state; and
- c. remove the requirement for exclusion from consolidation of subsidiaries with dissimilar operations to the parent undertaking.

Provision c. has some resonance in local government, because in developing the modified approach to group accounts for the 2004 Local Government SORP, the CIPFA/LASAAC Joint Committee decided to omit this exclusion.

In December 2004 the ASB issued FRS 27, *Life Assurance*. The standard is the culmination of a process that started in March 2004 when Treasury asked ASB to initiate an urgent study into accounting for with-profits business by life assurers, following an inquiry into failures at Equitable Life, a leading UK life insurer. FRS 27 builds on the new regulatory regime introduced by the Financial Services Authority following the Equitable Life episode. It requires a valuation basis compatible with the FSA's new regime and a number of new disclosures.

The ASB has also issued guidance on the implications for UK entities following the adoption of an "amended" IAS 39 by the European Commission. The differences between "unamended" and "amended" IAS 39 have been referred to in the UK as "carve outs". The guidance covers:

- the hedging "carve-out" where the ASB argues that an accounting policy based on "unamended" IAS 39 upon first adoption will be in compliance with both versions
- the fair value option where the ASB considers that the fair value option "carve out" makes compliance with the "unamended" version more difficult
- commentary and analysis on the EC's legal advice that members states can still require or recommend that liabilities be stated at fair value to the extent that this is allowed by law
- what the definition of "held for trading" encompasses ? Under both versions of IAS 39 financial liabilities that are held for trading are required to be carried at fair value. The Guidance suggests that the definition of "held for trading" might be used more broadly to include some portfolios not formally designated as part of a trading book portfolio
- whether where insurance company liabilities to policyholders are linked to financial assets measured at fair value such liabilities, where repayable on demand, should be deemed to have an amortised cost equating to the fair value of their assets on the grounds that such a fair value is the best representation of the amount payable
- the rationale for using the fair presentation override in cases where the measurement of financial assets at fair value but financial liabilities at amortised cost may give rise to substantial volatility

Operating and Financial Review

In November the Accounting Standards Board (ASB) issued an Exposure Draft of a Reporting Standard (RED 1) on the Operating and Financial Review (OFR). The OFR is broadly the equivalent of Management Decision & Analysis in the USA and Canada.

Under Government proposals, quoted companies will be required to prepare a statutory OFR for the first time for financial years beginning on or after 1 April 2005. The Government has also announced that it intends to specify the ASB in legislation as the body to make the standards for the OFR. Regulations giving legal effect to the proposals are to be laid before Parliament imminently. The proposals in RED 1 build on the requirements of the forthcoming Regulations and the ASB's existing 2003 Statement of Best Practice on the OFR, which is already used by many companies.

The proposals involve a principles-based approach, which, in particular, makes clear that the OFR shall reflect the directors' view of the business. The objective is to assist investors to assess the strategies adopted and the potential for those strategies to succeed. The information in the OFR will be useful to both investors and other users.

The RED reflects the ASB's view that the OFR should have a prospective orientation in order to enhance the ability of investors to assess current and future performance of the reporting entity and the progress towards the achievement of long-term business objectives. Further principles require that the OFR:

- complement as well as supplement the financial statements
- be comprehensible and understandable
- be balanced and neutral; and
- be comparable across time

The principles also provide a basic framework for directors to apply in order to meet the requirements of the Regulations. It is for the directors to consider how best to use this framework to structure the OFR, given the particular circumstances of the entity. Although following a framework approach, the ASB is conscious that some guidance would be useful to directors and it has accordingly prepared some draft Implementation Guidance to accompany the draft Reporting Standard. The Guidance sets out some illustrations and suggestions of specific content and related key performance indicators that might be included in an OFR, especially on the particular matters referred to in the Regulations.

RED 1 has a strongly private sector focus based on the needs of investors. However, it is likely that the issue of the RED will have an impact on narrative reporting in the UK public services. There has been a requirement for an OFR in central government since 2002 and this requirement is being re-examined. In the light of the issue of the RED CIPFA will undertake a project on narrative reporting in the UK public services.

Statements of Recommended Practice (SORPs)

Developments related to the Local Government Statement of Recommended Practice (SORP) are covered in the Local Government section of this report.

Interpretation of Statement of Principles for Public Benefit Sector

It is now expected that a further exposure draft of the proposed *Interpretation of the Statement of Principles for the Public Benefit Sector* will be issued in the second quarter of 2005.

Auditing Practices Board Developments

In January the APB issued for public comment two proposed revised International Standards on Auditing (UK and Ireland):

- ISA (UK and Ireland) 320 (Revised), *Materiality in the Identification and Evaluation of Misstatements*;
- ISA (UK and Ireland) 540 (Revised), *Auditing Accounting Estimates and Related Disclosures (Other Than Those Involving Fair Value Measurements and Disclosures)*.

These exposure drafts are based on the exposure drafts of proposed revised ISA 320 and proposed revised ISA 540 issued by the International Auditing and Assurance Standards Board (IAASB) on 20 December 2004. In accordance with the APB's approach APB additions to the original IAASB text are highlighted with grey shading. This UK approach is known as ISA Plus.

Proposed Revised ISA (UK and Ireland) 320 on Materiality

The exposure draft:

- includes a definition of materiality that makes clear that materiality depends on the size and nature of an item judged in the surrounding circumstances;
- introduces guidance on the use of percentages of benchmarks for the initial determination of materiality (but does not set formulaic rules);
- makes clear that when evaluating identified misstatements, the circumstances related to some of them may cause the auditor to evaluate them as material even if they are of a lower level than the auditor determined to be material when planning the audit;
- indicates that during the audit the auditor is alert for possible bias in management's judgments. When evaluating whether the financial statements as a whole are free of material misstatement, the auditor is required to consider both the uncorrected misstatements and the qualitative aspects of the entity's accounting practices.

Proposed Revised ISA (UK and Ireland) 540 on Accounting Estimates

The exposure draft:

- introduces requirements for greater rigor and scepticism into the audit of accounting estimates, including the auditor's consideration of indicators of possible management bias. It also conforms the approach taken to the audit of accounting estimates with the audit risk and fraud standards
- provides standards and guidance on the auditor's determination and documentation of misstatements and indicators of possible management bias relating to individual accounting estimates. These matters are evaluated in accordance with the standards and guidance in the proposed revised ISA (UK and Ireland) 320

Comments on the proposed revised ISAs (UK and Ireland) are requested by 8 April 2005. The APB will consider the comments received when preparing its response to the exposure drafts issued by the IAASB.

THE IMPACT OF INTERNATIONAL CONVERGENCE ON THE UK PUBLIC SERVICES: A CIPFA BRIEFING PAPER

CIPFA has published a Briefing Paper, *International Convergence and the UK Public Services*. The Paper discusses the background to the convergence of international and UK financial reporting standards and highlights the role of the IASB and the European Commission. It also discusses the IPSASB's Standards Programme, noting the three main components of the second phase of the project. It notes that the work of IPSASB has informed thinking on public sector specific issues in jurisdictions that have been on the full accruals basis for some time and highlights that, in the UK, the Financial Reporting Advisory Board to the Treasury has been particularly keen to follow the emerging approaches to the treatment of tax revenues and the state pension and has highlighted the work of IPSASB on these issues in its last report to Parliament.

Whilst noting that in many areas the requirements of IFRS and UK standards are very similar the paper discusses briefly some technical areas where the incorporation of requirements from IFRS might have significant implications. The areas highlighted are:

- accounting for the Private Finance Initiative in the light of the impending issue of the 3 International Financial Reporting Interpretations Committee interpretations on service concessions.
- the future of renewals accounting, which is relied upon as the method for estimating depreciation for infrastructure assets in the central government sector but is not acknowledged in IAS 16, *Property, Plant and Equipment*
- the future of the "value-in-use concept" which has been a key concept in determining the measurement of property, plant and equipment in the UK, especially in the public services

- the impact of FRS 25 and FRS 26 (see above in Accounting Standards Board Developments) on the UK public services due to their widespread reliance on fair value and their extensive disclosure requirements, which are considerably more onerous than current requirements

The Briefing Paper can be downloaded free of charge from the CIPFA website at www.cipfa.org.

RESOURCE ACCOUNTING AND BUDGETING/WHOLE OF GOVERNMENT ACCOUNTS

Treasury has recently developed approaches to the recognition and measurement of the principal sources of taxation revenue in the UK as part of the shift to an accrual based policy for the treatment of tax. The approaches to recognition and measurement vary between the main categories of tax revenue dependent upon the reliability of measurement. For example the recognition point for inheritance tax will be the initial assessment with amendments to the initial assessment included in the year the amendment is issued. A long-term debtor is recognised where inheritance tax is paid by instalments. For corporation tax for small companies all cash received will be accounted for as income and the movement on debt will be accounted for as income; there will be no attempt to match tax to the period to which it relates. For corporation tax for large companies it is likely that a forecasting model will be used. The approach to income tax will vary dependent upon whether the tax is derived from the Pay-As-You-Earn Scheme, where tax is deducted by employers at source, self-assessed or derived from savings.

Whole of Government Accounts

HM Treasury has highlighted the issue by CIPFA of a Briefing Paper developed in conjunction with the Audit Commission on whole of government accounts and published in November 2004. The Briefing Paper is primarily aimed at the local government sector. It updates readers on the background to, and nature of, Whole of Government Accounts (WGA) noting that the Government Resources and Accounts Act 2000 provides the statutory framework and that, under that Act, WGA statements must conform to UK GAAP subject to necessary adaptations to reflect a public sector context.

The arrangements for the designation of bodies to be included in WGA are outlined, noting that modified arrangements apply in Scotland and Northern Ireland because of the role of the Scottish Executive and Northern Ireland Department of Finance and Personnel. Provisional listings of local authorities and NHS bodies were issued in August 2004 and final lists are expected very soon.

The timetable for the introduction of WGA is highlighted, noting that the first WGA dry-run is for 2004-5 and that the first published and audited WGA statements will be for 2006-7.

The Briefing Paper discusses a number of issues, which both local authorities and National Health Service bodies need to consider now. These include:

- the allocation of responsibilities for meeting WGA requirements in designated bodies
- ensuring that arrangements for accounts closedown and financial statements preparation meet WGA deadlines
- focusing on the identification and elimination of intra-group transactions and balances
- ensuring that there are sound arrangements for the preparation of group accounts

Whilst the key point in the Briefing Paper is that WGA is now part of the financial reporting landscape in the UK and preparations by affected bodies cannot be delayed, the Paper also delivers the message that WGA will not entail large additional burdens for bodies that have efficient arrangements for their financial management. In particular the need to integrate WGA requirements into existing processes, particularly the preparation of the annual accounts, is emphasised.

LOCAL GOVERNMENT

The CIPFA/LASAAC Joint Committee, which is responsible for the development and maintenance of the *Code of Practice on Local Authority Accounting in the United Kingdom (the Local Government Statement of Recommended Practice (SORP))* has issued a consultation exposure draft (ED) of the 2005 edition of the SORP. The ED proposes the following changes to apply to accounting periods commencing on or after 1 April 2005 are to:

- implementing the removal of the Transitional Arrangements for Group Accounts, which the 2004 SORP stated would apply only to 2004/05
- updating sections of the SORP the Pensions Fund section of Chapter 4 following the issue of a revised Pension SORP
- modifying the requirement for a Statement on the System of Internal Financial Control (SIFC), following the introduction of a statutory requirement for English local authorities to include a Statement on Internal Control (SIC) with the financial statements
- updating the SORP to reflect the coming into force of the Business Improvement District scheme in England. The scheme allows businesses to contribute to enhancements to the character of their local communities and is based on similar schemes which have proved successful in the USA
- providing additional clarification of the recognition point for dividend income following the adoption of FRS 21
- updating the SORP to reflect changes to Financial Reporting Standards (FRSs) and new Urgent Issue Task Force (UITF) bulletins

The changes proposed are small in scale in comparison with the major modifications to the requirements for group accounts introduced in the 2004 edition.

Whilst not proposing any change for 2005 the ED invites comments on the approach to capital charges. The current SORP requires a capital charge to be made on all fixed assets used in the provision of services. The capital charge comprise two components, depreciation determined in accordance with UK GAAP, and a capital financing charge, which is designed

to reflect the opportunity cost of capital and is calculated by applying a notional interest rate to the amount at which the fixed asset is carried in the balance sheet. Notional interest rates are determined annually. For 2005/6 the rates are 3.5% for assets carried at current value and 4.95% for assets carried at historical cost.

The use of a notional interest charge was a feature of the introduction of capital accounting in 1994-the last step in the adoption of full accruals accounting in the UK local government sector. The requirement partially reflects the climate of that period when central government was keen to promote a level playing field between the public and private sectors in the market testing and competitive tendering of public service provision. There is a similar use of a notional interest charge in the Resource Accounting Manual in central government, although this is wider and includes current assets and current liabilities, with liabilities attracting a credit.

The development of the ASB's proposed *Interpretation of the Statement of Principles for the Public Benefit Sector* has been a catalyst in the re-evaluation of the approach in local government. In its 2004 Discussion Paper the ASB put forward a view that notional transactions should not be included in general purpose financial statements as they do not represent an outflow of economic benefits. The Joint Committee has previously indicated its intention to consult on the removal of the notional interest component as part of the SORP development process. This will be done in two stages. In this ED the Joint Committee is consulting on the broad options. Following analysis of responses, detailed proposals are to be developed and consulted on as part of the 2006 SORP making process.

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