

30 October 2002

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Dear Mr Stevenson

**IASB PROPOSALS FOR FIRST-TIME APPLICATION OF INTERNATIONAL  
FINANCIAL REPORTING STANDARDS**

I am pleased to enclose the Audit Commission's response to the above Exposure Draft, which is in the form of a Technical Response.

Please feel free to contact me if you would like to discuss any aspect of the Commission's response.

Yours sincerely



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# technical

## **Exposure Draft of Proposed IFRS**

### ***First-time Application of International Financial Reporting Standards***

Audit Commission  
submission to the  
International Accounting  
Standards Board

**Public audit is an essential element in the process of accountability for public money and makes an important contribution to the stewardship of public resources and the corporate governance of public services. The Audit Commission (the Commission) was established in England and Wales as an independent body in 1983 and has statutory responsibilities, amongst other things, for:**

- **appointing auditors to local government and NHS bodies in England and Wales that spend some £120 billion of public money annually;**
- **setting the required standards for its appointed auditors, and regulating the quality of audits;**
- **making arrangements for certifying government grant claims and returns;**
- **undertaking or promoting comparative and other studies to promote the economy, efficiency and effectiveness of local government and NHS services in England and Wales;**
- **defining local government performance indicators;**
- **receiving and, where appropriate, following up information received from 'whistleblowers' in local government and NHS bodies under the Public Interest Disclosure Act 1998; and**
- **carrying out best value inspections of certain local government services and functions in England and Wales.**

**The Commission appoints auditors to local government and NHS bodies from District Audit (the Commission's own arms-length audit agency) and from private firms of auditors. Once appointed, auditors carry out their statutory and other responsibilities, and exercise their professional judgement, independently of the Commission.**

A summary of the key proposals contained in the Exposure Draft of the IFRS can be viewed on the IASB web site ([www.iasb.org.uk](http://www.iasb.org.uk)). Any comments on the issues raised by this response should be addressed to:

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## INTRODUCTION

1. The Audit Commission (the Commission) supports the United Kingdom's Accounting Standards Board's (ASB) strategy of moving towards international standards through its programme of work to align UK accounting standards with International Financial Reporting Standards (IFRSs) and the phased replacement of existing UK standards with new UK standards based on the equivalent IFRSs. It also supports the detailed work which the International Accounting Standards Board (IASB) is undertaking to improve and extend the existing framework of International Accounting Standards.
2. To this end, the Commission has responded to the ASB's series of exposure drafts and discussion papers which relate to international standards. However, in respect of the Exposure Draft *First-time Application of International Accounting Standards* the ASB has issued a consultation paper which asks interested parties to respond to the IASB and to copy their responses to the ASB.
3. The Commission also agrees with the view expressed by the ASB that 'the exposure draft is relevant to UK entities because (i) if they will be required to prepare their financial statements in accordance with IFRSs, they will have to apply the standard on first-time application; and (ii) there are some general exceptions to the principle of retrospective application and it is important that these strike an appropriate balance between avoiding excessive cost and providing high quality financial information.' It is on this basis that the Commission is responding to the IASB.
4. The Commission is responsible for appointing auditors to local authorities, police and fire authorities and NHS bodies in England and Wales. As such, it is primarily concerned with the potential impact of the proposals contained in the Exposure Draft on these public sector entities.
5. Accordingly, this response makes a number of general observations about the proposals in the Exposure Draft where the Commission believes it can add value to the debate. The Commission's responses to the specific issues and questions raised by the IASB in the Preface to the Exposure Draft are contained in Annex A to this response.

## GENERAL OBSERVATIONS: FIRST-TIME ADOPTION OF IFRSs

### *There is a need for orderly transition to International Financial Reporting Standards*

6. The prospective application of IFRSs to the public sector, and those parts that the Commission has a specific interest in, is the responsibility, ultimately, for the UK Government. The accounting framework for NHS bodies is principally the responsibility of the Department of Health (DoH) in conjunction with the Treasury. Local government bodies prepare their accounts in accordance with the relevant Statement of Recommended Practice (SORP) that is prepared by the CIPFA/LASAAC Joint Committee through a process laid down by the ASB. In commenting on the Exposure Draft the Commission recognises that these bodies will determine how the Exposure Draft will be applied to their respective areas of responsibility.
7. The Department of Trade and Industry in the UK is currently consulting on the most appropriate approach to implementing the European Union Directive requiring listing entities to apply International Accounting Standards from 2005 onwards. This exercise also covers non-listed entities, which conceptually would include the public sector. In this context it is unlikely that public sector bodies will be first-time adopters of IFRSs in the manner envisaged by the Exposure Draft.
8. The Commission considers that, on the basis of this Exposure Draft, the current proposals for the first-time application of IFRSs will lead to an orderly and measured transition process. The IASB has taken a pragmatic approach to the requirements placed upon entities adopting IFRSs for the first time.
9. The Commission also notes that the Exposure Draft also includes a 'Basis for Conclusions' and 'Implementation Guidance.' These supporting documents are likely to be of value to both preparers and users of financial statements in the move towards widespread adoption of IFRSs and the Commission welcomes their publication with the Exposure Draft.

### *Full Retrospective Application*

10. The approach taken by the Exposure Draft is to require entities which are first-time adopters of the IFRSs to take one of two options. First, an entity may apply all extant IFRSs at the reporting date retrospectively, taking advantage where necessary of a series of exemptions (discussed below) designed to ease adoption. Alternative, the entity may apply the IFRSs that were effective in each period and may, therefore, have to consider superseded versions of IFRSs if later versions required prospective application.
11. **The approach adopted provides a flexibility which should ease the process of transition**, but also – when the exemptions are taken into account – provides a clear framework within which both preparers and auditors of financial statements can apply judgement and determine the most appropriate approach to the implementation of the specifics of the IFRSs. In particular, the Commission notes that the framework developed by the ASB allows entities which have carried out preparation and developmental work in advance of 'full' first-time adoption (for

example, by providing financial statements which are substantially in accordance with IASB pronouncements) to avoid full restatement on the basis of the extant standards at the reporting date.

12. **The Commission welcomes the clarity of the guidelines on the action required to become a first-time adopter of IFRSs**, as this is an area where there is a need to avoid ambiguity.

*The Exemptions to Full Retrospective Application*

13. The Exposure Draft proposes certain exemptions from the principle of full retrospective application of the IFRSs extant at the reporting date (for those entities who do not apply the IFRSs which were effective in each period). **These exemptions represent a measured attempt to address some of the practical issues which could emerge from the process of first time implementation**, particularly in the one area where difficulties of restatement are most likely to arise – business combinations.
14. The exemptions form three broad categories, as follows.
- (i) Where the IFRS requires a cost-based measurement of assets or liabilities, the entity may use a different basis of measurement as ‘deemed cost’ if to collect cost information would involve ‘undue cost or effort;’
  - (ii) Where the IFRS requires a cost-based measurement of assets or liabilities, the entity may use a different basis of measurement (valuation under previous GAAP) irrespective of considerations of cost or effort if this would improve the relevance to users over and above information on original cost; and
  - (iii) Where an IFRS relies on designation by management, the IFRS prohibits retrospective designation. This is specifically the case for hedge accounting under IAS 39.
15. **Subject to certain issues concerning ‘undue cost or effort,’ the Commission believes that the first category of exemptions is an appropriate and pragmatic one.** The Commission has noted to the ASB that, in certain circumstances, the Exposure Drafts issued by the IASB have used the term ‘undue cost and effort’ in making certain decisions on classification, measurement or disclosure. These Exposure Drafts have perhaps not sufficiently emphasised the importance of considering ‘materiality’ in these decisions. This Exposure Draft also makes reference to ‘undue cost or effort’ in several places in respect of the application of the proposed exemption again without reference to the concept of materiality. **The Commission believes that reference to the concept of materiality should be included in the final IFRS.**
16. However, the Commission is pleased to note that further clarification of the term ‘undue cost or effort’ is provided in two places. At paragraph 3 of the Introduction, the text states that ‘(t)he draft IFRS permits limited exemptions...in specified areas, notably where the cost of complying with this requirement would exceed the benefits to users of financial statements.’

17. At paragraph BC13 of the *Basis for Conclusions*, the Board states that:

‘The Framework recognises that the provision of relevant and reliable information may be constrained by the need for timely reporting and for a balance between the benefits of the information and the cost of providing it. The Board expects that most first-time adopters will begin planning on a timely basis for the transition to IFRSs. Accordingly, in balancing benefits and costs, the Board’s benchmark was an entity that plans the transition well in advance and is able to collect most of the information needed for its opening IFRS balance sheet at, or very soon after, the date of transition to IFRSs. When the Exposure Draft uses the term ‘undue cost or effort,’ it is in this context.’

18. The Commission welcomes this clarification of the concept of ‘undue cost and effort’ and believes that it will be useful for auditors of financial statements in working with preparers to provide assurance on these statements. **However, the Commission would recommend that the Board bring the text of paragraph BC13 within the ambit of the IFRS itself.**
19. The second category of exemptions allows the entity to make a choice on the use of certain amounts determined under previous GAAP based on valuations where these may be more relevant to users. This is an admirable, principles-based approach to the problems arising from different valuation bases for property, plant and equipment and investment property and the opportunities for fair value measurement which arise from events such as a privatisation or an initial public offering. **The Commission believes this to be an appropriate exemption.** However, the Commission notes that there is a marginal risk that audited bodies will utilise this category of exemptions, in conjunction with the relevant national GAAP, to account for business combinations in the most favourable way. However, this is likely to be offset to a degree by the principle of ‘increased relevance to users.’
20. In respect of third category of exemption, previous submissions to the ASB concerning the issue of hedge accounting have indicated that the use of hedging techniques is very limited within the UK public sector. In particular, local government bodies are prohibited by law from entering into hedging transactions. The Commission has noted the proposals within the Exposure Draft to prohibit the full retrospective application of elements of IAS 39 *Financial Instruments: Recognition and Measurement* and believes that **this is an appropriate approach to the potential difficulties arising in respect of hedge accounting on the first-time application of IFRSs.**
21. Finally, the Commission would like to note that, although it welcomes the range of exemptions, **the Board will need to be aware of the risk of a reduction in the comparability of financial statements** where there is a high degree of variation in entity take-up and use of them. However, this is perhaps an inevitable risk arising from the differences between national GAAPs and standard international practice and will, no doubt, reduce in the fullness of time.



*Explaining the Transition*

22. The draft IFRS requires an entity to explain how the transition from previous GAAP to IFRSs affected its reported financial position, financial performance and cash flows.(paragraph 30). The draft IFRS also clarifies that the requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* do not apply to changes in accounting policies which occur when an entity adopts IFRSs as the basis of accounting for this first.
23. The Commission believes that these disclosures are adequate and should lead to the provision of suitably informative information by the reporting entity. There is an argument that the volume of detail to be disclosed could reduce the utility of the financial statements, but the Commission believes that full disclosure of the relevant information can only assist the use of the financial statements in evaluating the impact of the first-time application of the IFRSs. In addition, the Commission welcomes the clarification of the relationship with IAS 8 within the text of the (draft) IFRS.

### ANNEX A: Responses to specific IASB questions in the Exposure Draft

|       | Question  | Comment   |
|-------|---|---|
| (i)   | <p>The proposed IFRS would apply when an entity first adopts International Financial Reporting Standards (IFRSs) as its new basis of accounting, by an explicit and unreserved statement of compliance with all IFRSs (paragraphs 1-5 and paragraphs BC4-BC10 of the Basis for Conclusions).</p> <p>Is this an appropriate description of the circumstances when this proposed IFRS should apply? If not, what changes do you suggest and why?</p>                                | <p>Yes. This approach is a practical, workable one, which should reduce the potential for accounting 'arbitrage' on the adoption of IFRSs.</p> <p>In particular, the approach seems appropriate in the light of the preferences of regulators (such as the European Union and the UK Department for Trade and Industry) for the adoption of IFRSs on a unified basis from 2005.</p> <p>In the light of these developments, the Board's expressed view that the intention is to enhance comparability between first-time adopters of IFRSs, rather than between first-time adopters and current users, is an appropriate one.</p>  |
| (ii)  | <p>The proposed IFRS proposes a requirement that an entity shall prepare its opening IFRS balance sheet using accounting policies which comply with each IFRS effective at the reporting date for its first IFRS financial statements. Paragraphs 13-24 propose limited exemptions from this arrangement.</p> <p>Are all of these exemptions appropriate? Should the board amend any of these exemptions or create any further exemptions (paragraphs BC11-BC89)? If so, why?</p> | <p>The proposed IFRS proposes that this requirement will be modified by the <b>requirement</b> to apply the limited exemptions, <b>except</b> in the situation where the reporting entity chooses to apply the IFRSs which were effective in each period. It is likely that the majority of adopters will choose to adopt the former approach (given the potential utility of the exemptions in terms of cost) and this is likely to lead to a reasonably homogenous approach to the first-time application of IFRSs.</p> <p>The Commission discusses the exemptions in more detail in the main text of this response. However, the Commission has concluded that the exemptions are appropriate.</p> |
| (iii) | <p>Paragraphs 28-37 of the proposed IFRS deal with presentation and disclosure requirements (see also paragraphs BC90-BC97). Are all of these disclosures appropriate? Should the board require any further disclosures or eliminate or amend any of the proposed disclosure requirements? If so, why?</p>  | <p>The paragraphs set out a series of requirements which should ensure unequivocal disclosure by entities adopting IFRSs on the effect of these on reported results. The Commission believes that these disclosures are appropriate and adequate, although the IASB may wish to make it clear that entities are encouraged to provide further information where it would aid the user of the financial statements.</p>  |
| (iv)  | <p>Do you have any other comments on the Exposure Draft?</p>  | <p>No.</p>  |