



HM TREASURY

Financial Reporting Advisory Board Paper

FRED 37 Intangible Assets & FRED 38 Impairment of Assets

Issue:	Implications of FREDs 37 & 38 for central government
Impact on guidance:	N/A
UK GAAP adaptation?	N/A
IAS/IFRS compliant?	N/A
IPSAS compliant?	N/A
Impact on budgetary regime?	N/A
Recommendation:	The FRAB is invited to give its view on a proposed approach to adapt the FReM in relation to FRED 38's proposed amendment of FRS 15's requirements for impairment loss accounting
Timing:	N/A

DETAIL

Background

1. On 28 July, the ASB published FREDs 37 & 38 setting out proposals for replacing FRS 10 *Goodwill and Intangible Assets*, SSAP13 *Research and Development*, and FRS 11 *Impairment of Fixed Assets* with two IFRS-based standards, as well as making consequential amendments to FRS 15 *Tangible Fixed Assets* and SSAP 4 *Accounting for Government Grants*. The proposals reflect the ASB's convergence agenda and arise from an IASB project on business combinations that will also affect other UK standards as well as IASs/IFRSs. The proposals would have effect from 1 January 2007 and so may be reflected in the FReM for 2007-08.

2. The FREDs include summaries of the main differences between the proposed IAS based new standards and the existing FRSs. These differences include some that might have a significant impact in central government, being:

- The requirement in FRED 37 to capitalise internally generated development expenditure whereas SSAP 13 permits a choice;
- An amendment to FRS 15 (para 15) for the reporting of revaluation gains and losses to eliminate the distinction that a downward revaluation may comprise an impairment loss – where there has been a clear consumption of economic benefit – and other revaluation losses, with the effect that:
 - An impairment loss that is caused by a clear consumption of economic benefits would no longer always be charged in full to the operating cost statement as hitherto, but would be charged initially to the revaluation reserve to the extent of any balance and only then to the operating cost statement. This effect is considered from paragraphs 5 below;
 - It would no longer be possible to charge a revaluation loss to the statement of recognised gains and losses to the extent that the recoverable amount of the asset is greater than its revalued amount, rather than to the operating cost statement. This effect is still being considered and may be the subject of separate consideration by the FRAB in due course.

3. Other differences appear not to be as likely to have such an impact, including:

- The application of different impairment tests for goodwill in FRED 38 from those in FRS 11;
- The extension in FRED 37 of the definition of an intangible asset to include those that may not be separately disposed of and so would not be recognised under FRS 10;
- The classification of website development costs as intangible assets in FRED 37 rather than as tangible assets under UITF Abstract 29;
- An amendment to FRS 15's definition of residual value so as to be based on prices current at the balance sheet date rather than on prices prevailing at the date of acquisition or revaluation;
- An amendment to SSAP 4 to introduce the recognition criteria for assets acquired by way of government grant that are set out in IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*.

4. We have consulted on the FREDs' proposals to help identify any that might need in due course to be adapted or interpreted in the FReM to meet the needs of the public sector, or if the FReM should provide links to practical guidance on the application of the proposals. We have also sought comments on any practical issues that might arise on implementation, including any that may affect its timing, as well as information on any significant financial effects.

5. We have identified one issue on which we invite the FRAB to express its view at this stage. This is that the FRED 38's proposed amendments to FRS 15 for the reporting of revaluation gains and losses will have the effect that the link in this respect between FReM based accounts and the National Accounts would be weakened, and might open up a divergence between accounts and budgets, as the Treasury would probably not want to change the incentives structures in the budgetary framework to fit with this accounting proposal.

6. The current budgetary framework assumes that impairments are charged in full to the operating cost statement as that provides the basis of the budgetary control totals. This treatment is part of the incentive structure that encourages departments to manage their assets more effectively. Where, as a result of management decisions or failure, an asset is consumed more quickly than previously thought then the department will suffer a cost in their budget to reflect that accelerated consumption of economic benefit. This budgetary treatment encourages the correct management incentives and protects the fiscal position as measured in the national accounts.

7. There is also a practical reason for wishing to maintain the current treatment. Currently the Office for National Statistics calculates the measure of depreciation used in the national accounts by using their *Perpetual Inventory Model*. This model includes an assessment of assumed average asset lives, which include not only the assumed normal asset life, but also makes an assumption about the amount of assets that will be used up more quickly than the assumed normal life so as to arrive at the average asset life. However, the ONS is examining the possibility of using depreciation data from the departmental resource accounts directly in the production of the national accounts, in which case it would be necessary to complement that depreciation information with information on impairments. To this end work is being undertaken to examine which types of impairments should score in the production account and in the public sector finance numbers used to measure performance against the Fiscal Rules. Although this review is still under way, it is clear that impairments that represent a clear consumption of economic benefits should be included in the production account and as a cost in the Golden Rule.

8. An alternative approach would be to include an interpretation in the FReM for extra disclosure for impairment losses that brings together those charged to the revaluation reserve where there has been a clear consumption of economic benefits and those charged to the operating cost statement. This would in effect recreate the OCS as per FRS15. However, though this would provide the information to support the National Accounts and budgetary treatment, the links would be weaker and the result more complex to operate.

9. It is difficult to determine whether in practice the impact of FRED 38 would be significant across central government. It may be that not much would be charged to the revaluation reserve under FRED 38 rather than the operating cost statement under FRS 15. This may be because FRS 15 currently recognises that it may be difficult to distinguish in practice between different types of losses and entities commonly follow the requirement in the FRS in these circumstances to charge losses first to the revaluation reserve. It may also be because there are few significant available balances in entities' revaluation reserves.

10. We would need to consult again accordingly, once the work with ONS is completed and before proposals are brought to the FRAB for implementation of the FRED's amendments to the FRSs. Nevertheless, it would be helpful to have the view of the FRAB at this stage on the approach we propose that the FReM should be adapted in respect of FRED 38.

Summary and recommendation

11. FRED 38 includes a proposal for a change to the treatment of impairment losses. The views of the FRAB are invited on the approach we propose that, in principle, the FReM would be adapted to maintain the current support of FReM based accounts to the National Accounts and the budgetary framework.

HM Treasury

September 2005