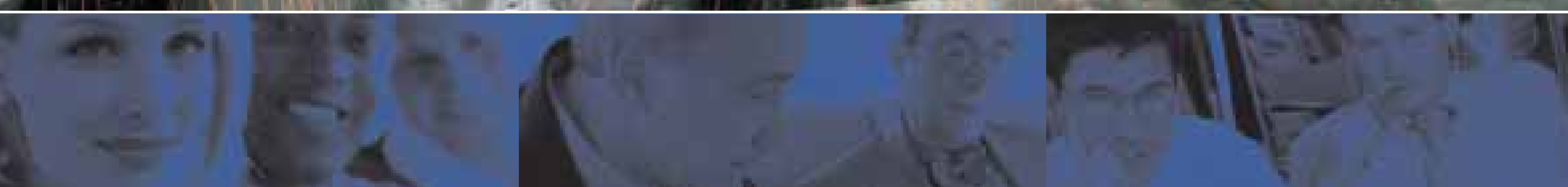
IAS PLUS

Deloitte & Touche

Manufacturing

The future for UK automotive & aerospace industries under IAS

by **Michelle Fisher**



Contents

Introduction

The purpose of this publication is to give users and preparers of financial statements an idea of the impact of International Accounting Standards (IAS) on the accounts of UK manufacturing companies, in order that they can prepare themselves for the changes ahead. The booklet focuses on component and system manufacturers in the automotive and aerospace industries but will be extremely useful for all UK manufacturers.

The publication doesn't cover all areas of the financial statements which will be affected by IAS as it focuses on the main issues which concern the industries covered. Other areas such as tax liabilities, deferred taxation and employee benefit schemes will also be affected by IAS and must be included in the company's preparations. Companies will need to plan for the effect of implementation on their tax liabilities. Clearly changes in accounting policy which impact the accounting profit will potentially impact the tax liability of a company as the starting point for taxing UK companies is the accounting profit. Where tax does not follow the accounting treatment then collating the information to prepare the tax return and the deferred tax implications could give rise to substantial compliance burdens.

Major changes under IAS

All entities with securities listed in the European Union must prepare consolidated accounts in accordance with International Accounting Standards (IAS) for periods beginning on or after 1 January 2005.

The Department of Trade and Industry will confirm later this year whether IAS will apply to unlisted company and individual company accounts. In practise, this decision may have little impact as the UK's Accounting Standards Board (ASB) has commenced a programme of new UK Standards based on IAS. In most cases, this will affect all companies outside the Financial Reporting Standards (FRS) for Smaller Entities (FRSSE) regime.

All affected entities will need to apply IAS in 2004 in order to report comparative figures. However, companies will need to run systems in parallel in 2003 in order to report under UK General Accepted Accounting Principles (GAAP) in 2003, to be sure that the systems are ready for reporting under IAS in 2004 and to appreciate the changes to the figures arising under IAS.

Convergence program

As indicated above, the ASB is developing UK standards based on IAS. Since May 2002, the ASB has published nine exposure drafts (FRED 23 – 30) as part of its effort to achieve convergence between UK GAAP and IAS. Many of these are expected to become standards in 2003. The International Accounting Standards Board (IASB) published an exposure draft in May 2003 called "Improvements to IAS". This proposes revisions to twelve IAS.

As the IASB change existing standards, the ASB is proposing that these are incorporated into UK GAAP. As any new standards will apply to all companies in the UK, the impact of IAS will affect non-listed companies regardless of the Department of Trade and Industry (DTI) consensus. The result of the convergence program may mean that UK GAAP will equal IAS by 2005.

Impact of IAS

This booklet looks at the changes to the main areas of the financial statements that will affect UK manufacturers with a focus on component/system manufacturers within the automotive and aerospace industries. The areas covered are:

- Foreign exchange;
- Research and Development;
- Stock and long term contracts;
- Revenue;
- Segmental Reporting; and
- Plant and machinery.

In addition, there is a chapter on business combinations. Although this area is less specific to the industries covered by this booklet, as the changes are expected to have a great impact on the accounts due to the sizes of the balances involved, the main changes have been reviewed.

Timetable for companies

2002 Plan

- Implementation of IAS;
- The training of staff; and
- The impact on IT systems.

2003 Implement

- The training of staff; and
- Parallel run and test of systems.

2004 Comparatives

- Produce comparative information required for 2005 accounts.

2005 Deadline

- First report in IAS.

Executive summary

IAS will have a significant impact on your business. There will be significant changes to profits and net assets. A few of the changes covered in the booklet are highlighted below:

Foreign exchange

- Stricter hedging criteria;
- Derivatives to be held at fair value; and
- Enhanced volatility in profits and equity.

Research and Development

- Development costs meeting the criteria must be capitalised and amortised, affecting net assets and profits.

Stock and Revenue

- Extra rules and guidance over long term contracts and revenue may affect recognition of profits and revenue.

Segmental analysis

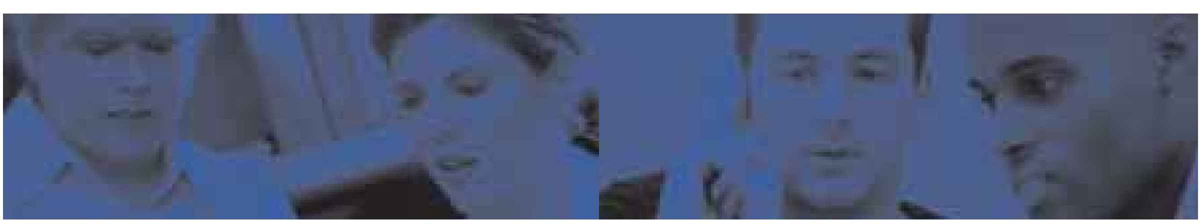
- More extensive disclosures.

Plant and Machinery

- Various differences in the treatment of revaluations; and
- Different calculation of interest eligible for capitalisation.

Business Combinations

- Mergers will be prohibited; and
- Goodwill will be subject to impairment testing only, as amortisation will no longer be applied, leading to further volatility in earnings.



Foreign exchange and hedging

Overview

Large UK manufacturers usually have a significant global presence and they are exposed to exchange rate movements on many transactions and on the translation of the net assets and profits of foreign subsidiaries. To minimise this exposure, companies often have hedging policies which involve the use of financial instruments, generally forward contracts.

Under IAS, there are extremely complex rules and guidance on accounting for financial instruments and hedging. This chapter only gives a brief summary of the key changes expected to foreign exchange transactions and hedging of foreign currency risk under IAS.

Foreign transactions

Initial recognition of transactions

IAS and UK GAAP treat the following foreign currency transactions by a single entity in the same way:

- Transactions are translated at the exchange rate on the transaction date (or at an average rate for a period as an approximation if rates do not fluctuate significantly);
- Monetary assets/liabilities are translated at closing rate (rate at the balance sheet date);
- Non–monetary assets/liabilities are translated at the exchange rate at the date of the transaction (i.e. there are no further retranslations); and
- Non-monetary items that are valued at fair value are translated at the exchange rate at the date when the latest fair value was determined.

There is one difference between IAS and UK GAAP. In the UK, where the transaction is to be settled at a contracted rate, that rate is used. In addition, where a transaction is covered by forward contract, the rate of exchange specified in that contract may be used. IAS prohibits the use of contracted or forward rates.

The above prohibition leads to two different treatments. In the UK, the current treatment for contracts settled at a forward or contract rate is to use that rate to record the initial transaction and liability and then continue to use that rate at each balance sheet date.

Under IAS, the transaction and liability must be recorded at the exchange rate on the transaction date and any forward contract must be recorded at cost (likely to be negligible initially). Subsequently, the liability must be recorded at the closing rate at each balance sheet date and the transaction left at the historic rate. Forward contracts must be remeasured to fair value at each balance sheet date and any hedge accounting used only where the hedging rules are met (see below).

Foreign Operations

Temporal method

UK GAAP and IAS both require the financial statements of foreign operations, which are integral to the operations of the reporting enterprise, to be translated as if the transactions are those of the reporting entity (see transactions of a single entity).

Net Investment method

Where foreign entities operate independently from the reporting enterprise, both IAS and UK GAAP require amounts in the balance sheet amounts to be translated at the closing rate.

Under IAS, the income statement must be translated at an average rate for the period (approximation to the rate at transaction date) and exchange differences should be taken to equity. UK GAAP allows the closing rate to be used as an alternative to the average rate and requires exchange differences to be taken to the statement of recognised gains and losses (STRGL) and shareholders funds. (There is no STRGL under IAS).

Under IAS, on disposal of the entity, the exchange gains and losses are recycled to the income statement. On a partial disposal, the relevant portion is taken to income. Under UK GAAP, recycling to the income statement of gains and losses on disposal is prohibited. The cumulative exchange differences are not included in the calculation of profit or loss on sale and they remain in equity.

Under IAS, goodwill and fair value adjustments may be treated as part of the foreign entity and translated at closing rate, or they can be treated as part of the reporting enterprise and never retranslated. UK GAAP does not really address the treatment of goodwill and fair value adjustments, however the retranslation method is generally used.

Recent IAS developments

The following changes are proposed to current IAS in an exposure draft, “Improvements to IAS” (A new IAS is expected on this in 2003):

- There will no longer be a different accounting treatment for integral foreign operations. This means that the IAS version of the temporal method will be abolished; and
- Goodwill and fair value adjustments to assets and liabilities must be treated as part of the assets and liabilities of the foreign entity and translated at a closing rate (as in the UK).

Impact of IAS

Net Investment method – In practice, most companies in the UK use the average rate to translate the income statement so the restriction under IAS to the closing rate is unlikely to have a strong impact on current accounting treatments.

Temporal method – If the proposals in the exposure draft are accepted then the temporal method will no longer be used for integral foreign operations. This will have the effect that, for these operations, the non-monetary assets and liabilities will be translated at closing rate rather than the historic rate or the date of determination of fair value.

Financial instruments and hedging

Accounting for forward foreign exchange contracts

In the UK, there is no specific guidance on accounting for derivatives, although detailed disclosures are required. Under IAS, derivatives (which include forward foreign exchange contracts, futures, currency swaps and options) will initially be measured at cost. Derivatives, if not designated as hedging instruments, are classified as ‘held for trading’ financial instruments under IAS 39, Financial Instruments Recognition and Measurement. This means they will be subsequently measured at fair value and gains or losses will be taken to the income statement.

Hedging criteria

Under IAS, a hedging relationship qualifies for special hedge accounting if and only if specific criteria are met. In the UK, there is no comprehensive guidance on hedging, so there are few restrictions on its use.

IAS 39 allows hedge accounting if the following conditions are met (see text box at the end of this chapter for more detail):

- Formal documentation of the hedging relationship at inception of the hedge;
- Expectation of high effectiveness (normally if actual results are within 80 to 125% range);
- High probability of occurrence of a forecasted transaction (not based solely on the intent of management);
- Effectiveness of the hedge can be measured reliably; and
- Ongoing review of the relationship to ensure the hedge is highly effective throughout the reporting period.

Types of hedging accounting

Under IAS, there are three types of hedge accounting:

- Fair value hedge;
- Cash flow hedge; and
- Hedge of a net investment in a foreign entity.

Fair value hedges

Definition

A hedge of the exposure to changes in the fair value of a recognised asset or liability, or an identified portion of such an asset or liability, that is attributable to a particular risk and that will affect reported net income.

(IAS 39 para (137a))

If the strict hedging criteria are met, financial instruments, which are used to hedge foreign currency risk on a recognised asset or liability, can be accounted for as fair value hedges. For example a fair value hedge can be use to hedge exposure to changes in exchange rates on fixed rate debt.

Hedges of future transactions cannot be accounted for as fair value hedges (see cash flow hedging).

Hedging a foreign currency loan payable with a foreign exchange forward contract can be accounted for as either a fair value or a cash flow hedge.

Accounting treatment

1) *The gain or loss from remeasuring the hedging instrument at fair value should be recognised immediately in net profit or loss; and*

2) *The gain or loss on the hedged item attributable to the hedged risk should adjust the carrying amount of the hedged item and be recognised immediately in net profit or loss. This applies even if a hedged item is otherwise measured at fair value with changes in fair value recognised directly in equity. It also applies if the hedged item is otherwise measured at cost.*

(IAS 39, para (153))

In summary, a fair value hedge involves remeasuring both the hedging and the hedged item to fair value through the income statement.

Accounting for cash flow hedges

Definition

A hedge of the exposure to variability in cash flows that

i) *is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a forecasted transaction (such as an anticipated purchase or sale); and that*

ii) *will affect reported net profit or loss.*

(IAS 39, para (137b))

If the criteria are met, financial instruments, which are used to hedge future foreign currency risk of cash flows on recognised assets or liabilities or forecasted transactions, can be accounted for as cash flow hedges. For example a cash flow hedge can be used to hedge exposure to changes in exchange rates on floating rate debt.

A forecasted transaction must be a single transaction with a group of similar transactions, be probable to occur and be with a third party.

Accounting treatment

1) *The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge should be recognised directly in equity through the statement of changes in equity; and*

2) *The ineffective portion should be reported:*

   i) *Immediately in net profit or loss if the hedging instrument is a derivative; or*

   ii) *In the limited circumstances in which the hedging instrument is not a derivative, in accordance with the policy on reporting changes in fair values of that type of financial asset or liability.*

3) *If the hedged firm commitment or forecasted transaction results in the recognition of an asset or a liability, then at the time the asset or liability is recognised the associated gains or losses that were recognised directly in equity should be removed from equity and should enter into the initial measurement of the carrying amount of the asset or liability.*

(IAS 39, para (158,160))

In summary, a cash flow hedge involves remeasuring only the hedging item to fair value through retained earnings (just the effective portion of the hedge).

Hedge of a net investment in a foreign entity

Under IAS, where hedging criteria is met, the hedging instrument is measured at fair value and to the extent that the hedge is effective, gains and losses are deferred in equity together with the exchange differences arising on the entity's investment in the foreign entity. On disposal of the entity, these gains and losses are recycled to the income statement. Provided the hedging instrument is not a derivative (e.g. a loan), the full gain and loss can be deferred in equity (even the ineffective part). If the hedging instrument is a derivative, the ineffective portion must be taken to the income statement.

Under UK GAAP, hedge ineffectiveness is always taken to income. As explained earlier, recycling of gains and losses on disposal are not allowed so the cumulative exchange differences are not included in the calculation of profit or loss on sale.

Recent IAS developments

The following changes are proposed to current IAS in the exposure draft, Improvements to IAS (A new IAS is expected on this in 2003):

- Hedges of firm commitments are treated as fair value hedges rather than cash flow hedges; and
- When a hedged forecast transaction occurs and results in an asset or liability, the gain or loss deferred in equity does not adjust the initial carrying amount of the asset or liability (basis adjustment). It remains in equity and is reported in net profit or loss in a manner that is consistent with the reporting of gains or losses on the asset or liability.

Impact of IAS

There will be much stricter rules on hedge accounting under IAS so many hedges will no longer be allowed (e.g. simpler hedge strategies may not be effective). The terms of derivatives will need to be considered carefully to ensure they will make effective hedging items and pricing agreements will need to be structured so they fit with the derivatives which are available for hedging. Businesses will need to develop a thorough hedging and risk management strategy to ensure the hedging criteria are met.

Proposals to remove the basis adjustment under IAS will mean that keeping track of the effective part of the hedge on particular assets will be difficult. Information systems must be adapted to do this and address other issues such as testing of effectiveness of a hedge.

In general, accounting for derivatives and hedges under IAS is likely to lead to enhanced volatility in profits and equity.

Recent UK developments

FRED 23 and 24 have been issued to bring the UK treatment in line with current IAS treatment of foreign exchange transactions and hedging.

There will still be one significant difference between IAS and UK GAAP if the new FREDs and IAS exposure drafts are accepted. IAS 21 requires all the exchange differences, which are taken to equity, to be recognised in the profit and loss account for the period. The new FREDs do not permit such 'recycling' of exchange gains and losses. The ASB and IASB have a joint project on reporting financial performance, the result of which may mean that this practice will be prohibited internationally.

The hedging requirements in FRED 23 are less rigorous than those under IAS 39. Compliance with IAS 39 will result in compliance with FRED 23 (except in the area of recycling), however the reverse is not true.

Hedging Criteria

Under this Standard, a hedging relationship qualifies for special hedge accounting if, and only if, all of the following conditions are met:

a) At the inception of the hedge there is formal documentation of the hedging relationship and the enterprise's risk management objective and strategy for undertaking the hedge. That documentation should include identification of the hedging instrument, the related hedged item or transaction, the nature of the risk being hedged, and how the enterprise will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or the hedged transaction's cash flows that is attributable to the hedged risk;

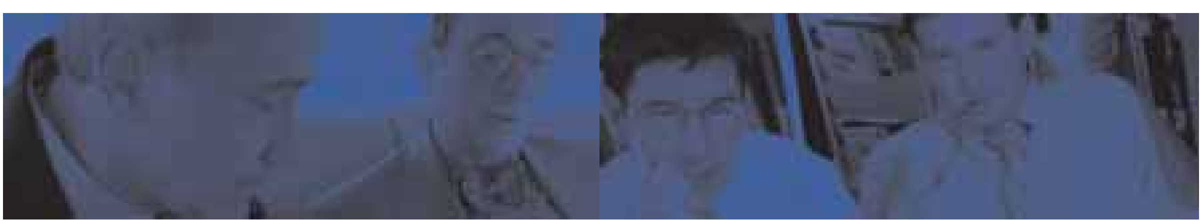
b) The hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistent with the originally documented risk management strategy for that particular hedging relationship;

c) For cash flow hedges, a forecasted transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect reported net profit or loss;

d) The effectiveness of the hedge can be reliably measured, that is, the fair value or cash flows of the hedged item and the fair value of the hedging instrument can be reliably measured; and

e) The hedge was assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting period.

(IAS 39, para (142))



Research and Development

Overview

A substantial investment in research and development is vital in order for manufacturers to remain competitive, due to the rapid technological advancement in the automotive and aerospace industries. For example, major research is required to improve product performance, energy efficiency and to ensure that safety regulations are met.

Initial recognition

Both UK GAAP and IAS require any research expenditure to be expensed during the year.

> *Under IAS 38, an intangible asset arising from development (or from the development phase of an internal project) should be recognised if, and only if, an enterprise can demonstrate all of the following:*
>
> *a) The technical feasibility of completing the intangible asset so that it will be available for use or sale;*
>
> *b) Its intention to complete the intangible asset and use or sell it;*
>
> *c) Its ability to use or sell the intangible asset;*
>
> *d) How the intangible asset will generate probable future economic benefits (including the existence of a market for the output of the intangible asset or the intangible asset itself or the usefulness of the intangible asset if used internally);*
>
> *e) The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and*
>
> *f) Its ability to measure the expenditure attributable to the intangible asset during its development reliably.*
>
> **(IAS 38, Intangible Assets para (45))**

The treatment of development expenditure differs between UK GAAP and IAS. Under IAS, entities must capitalise any expenditure that meets the criteria for recognising an intangible asset. In the UK, companies can choose whether they capitalise expenditure that satisfies the criteria in SSAP 13. The only constraint in the UK is, if an accounting policy of deferral of development expenditure is adopted, it must be applied consistently to all development projects.

The criteria for capitalising development costs under IAS is similar but slightly stricter than criteria under UK GAAP. IAS specifies the need to demonstrate how the asset will generate future economic benefit. SSAP 13 criteria require only a reasonable expectation of economic benefit.

Currently, UK practise varies with some companies capitalising development costs, which meet the criteria and others writing off all development expenditure as it is incurred.

Past development costs

SSAP13 allows entities to capitalise development expenditure, which was written off in a previous year as it did not meet the criteria, if it meets the conditions for deferral in a subsequent year. IAS 38, Intangible assets, does not have this option and development expenditure that was initially recognised as an expense, must not be recognised as part of the cost of an intangible asset at a later date.

Amortising deferred development costs

IAS 38 adopts a similar treatment to SSAP 13, as it requires the depreciable amount of the development costs to be allocated on a systematic basis over the best estimate of its useful life. Amortisation should begin when the asset is available for use (e.g. when production of a product commences).

As under SSAP 13, IAS 38 requires the amortisation period and method to be reviewed annually.

There is a rebuttable presumption in IAS 38 that the useful life of an intangible asset will not exceed twenty years. No similar assumption is given in UK GAAP, however it is rare in the UK for companies to have a period of amortisation over 20 years, as it is difficult to have a reasonable certainty of recovery over a long period.

Overall, changes under IAS are unlikely to affect the length of useful economic lives determined under current UK practice.

Impact of IAS

Compulsory capitalisation of specific development costs may increase the net assets of those entities who would normally expense such costs. The income statement will be affected over a number of years by amortisation rather than in the year of expense. Extra staff time will be required in order to review expenditure against the criteria under IAS and to review any impairment and amortisation of the costs carried forward.

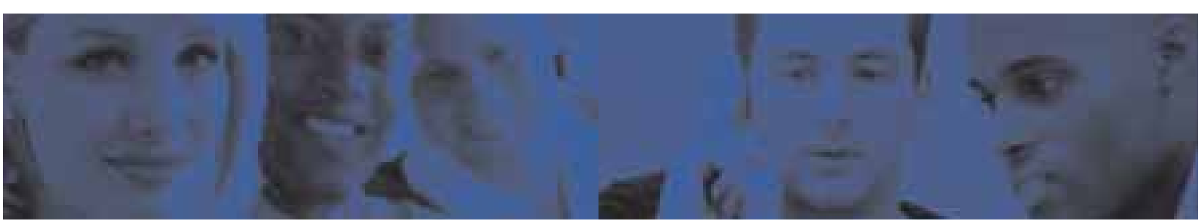
For those companies who already capitalise such cost, the stricter IAS criteria will have to be met or the cost will need to be expensed. All companies will need to expense any prior year costs that have been reinstated.

Future Development of IAS

The IASB may add a research project on intangible assets to its agenda. There is a lot of support for the approach in IAS 38, but there is concern that the guidance is not sufficiently robust. The project may result in an amendment or replacement of IAS 38.

The project would seek to develop a consistent approach for recognition and measurement of intangible assets, including purchased and internally generated intangible assets (excluding those acquired via business combinations).

Company	Accounts	Accounting policy for development costs	Total research and development costs during year
GKN plc	Year end 31 Dec 2001	Written off as incurred.	£105 million in continuing subsidiaries (£7 million refunded by 3rd parties) and £115m share in joint ventures (£103 funded by 3rd parties) (4% of turnover).
Smiths Group plc	Year end 31 July 2001	Written off in the year in which it is incurred.	£110 million (2% of turnover).
Tomkins plc	Year end 30 April 2001	Written off in the year in which it is incurred.	£24.4m (1% of turnover).
Rolls-Royce plc	Year end 31 Dec 2001	Charged to profit and loss account in the year, excluding known recoverable costs on contracts, contributions to shared engineering programs and application engineering.	£358 million (net) (£20m application engineering costs capitalised) (5% of turnover).
Meggitt plc	Year end 31 Dec 2001	Written off as incurred.	£26 million (6% of turnover).



Stock and Long Term Contracts

Overview

Products are highly engineered and they require complex and expensive manufacturing. Therefore, companies within the industry will often carry a high value of stock on the balance sheet.

Measurement of stock

IAS and UK treatment of stock are similar in most respects. The definitions and guidance surrounding the inclusion of amounts within stock are very similar. UK GAAP has more extensive guidance on allocation of costs (e.g. on allocation of the costs of general management).

UK GAAP requires that the methods used in allocating costs to stock should give the fairest approximation to cost. This includes the choice between using First In First Out (FIFO) or weighted average cost. IAS is less restrictive than UK GAAP and allows an open option of using the benchmark methods FIFO or weighted average, and gives Last In First Out (LIFO) as an allowed alternative treatment for stock valuation. LIFO is generally not appropriate in the UK.

IAS gives selling costs as an example of expenditure to exclude from the carrying value of stock. Under UK GAAP, when a firm sales contract covers the provision of goods to customer’s specification, overheads from marketing and selling costs, which were incurred before manufacture may be included in cost.

Foreign exchange gains and losses in stock

The benchmark treatment under IAS for exchange differences arising on the settlement of creditors for stock purchases, is to recognise them as income or expenses in the period in which they arise. This is also the appropriate treatment in the UK.

However, IAS allow an alternative treatment which can be used in rare cases. Exchange differences that result from a severe devaluation or depreciation of a currency, against which there is no practical means of hedging can be included in the carrying amount of stock. This is unlikely to arise in the UK, but it could affect foreign subsidiaries and hence the consolidated accounts.

Measurement of long term contracts

UK rules for recognition of revenue on long-term contract work in progress comply with IAS except IAS has more extensive guidance on types of contract and the measurement of revenue.

The two main differences between UK GAAP and IAS on the measurement of long term contracts balances are noted below.

The first difference is SSAP 9 places more emphasis on prudence when calculating profit. IAS focuses more on reliability.

The second difference is that in certain situations, IAS requires combination or segmentation of contracts. IAS states that, in some circumstances, it is necessary to apply the Standard to the separately identifiable components of a single contract or to a group of contracts together in order to reflect the substance of a contract or a group of contracts.

'When a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:

a) Separate proposals have been submitted for each asset;

b) Each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and

c) The costs and revenues of each asset can be identified.

A group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:

a) The group of contracts is negotiated as a single package;

b) The contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and

c) The contracts are performed concurrently or in a continuous sequence.'

(IAS 11 para (8,9))

SSAP 9 generally requires accounting on a contract by contract basis. Consequently, there may be timing differences between the recognition of profits and revenues.

Disclosure of contracts

UK GAAP and IAS have different detailed requirements in respect of presentation and disclosure.

Under IAS, amounts received from the customer before the related work is performed are recognised as a separate liability ('advances'). However, there are no requirements on the analysis of the remaining amount in the balance sheet. IAS requires it to be presented as a single asset or liability, the 'gross amount due to/from customers for contract work'. This is calculated as the total revenue receivable plus any costs, net of any progress payments incurred in respect of revenue which has not yet been taken.

In the UK, separate disclosure is required of 'amounts recoverable on contracts' (a debtor), 'payments on account' (a creditor), 'long-term contract balances' (stock) and foreseeable losses (a provision or creditor).

Recent IAS developments

The IASB exposure draft, "Improvements to IAS" proposes to remove the allowed treatment of LIFO and the alternative treatment for foreign exchange gains or losses. This would remove the main discrepancies between IAS and UK GAAP so only small differences will remain in this area. A new IAS is expected in 2003.

Recent UK developments

FRED 28 has been released based on IAS 11 'Construction Contracts', IAS 2 'Inventories' (including proposed changes to LIFO and exchange differences) and some of IAS 18, 'Revenue'. A standard is expected at the beginning of 2003 which will replace SSAP 9.

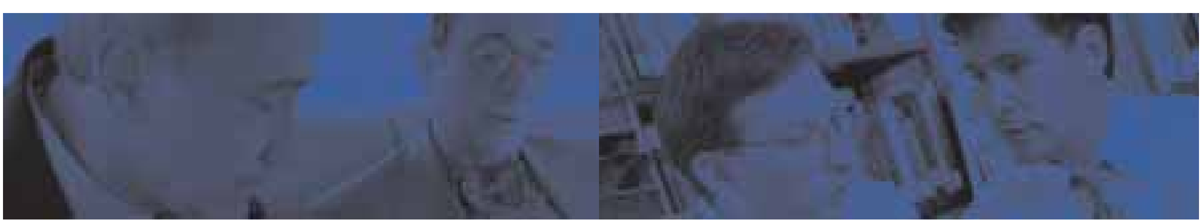
Impact of IAS

There will be little change in the treatment of stock under IAS.

The main difference will be within long-term contracts. Companies will need to consider the combination or segregation of contracts. In addition, some requirements over presentation and disclosures will change under IAS, however, it is unclear how significant the differences will be in the future.

Future IAS developments

The IASB is considering a comprehensive project on derecognition of all types of assets and liabilities. Currently, IAS has no equivalent standard to FRS 5, "Reporting the Substance of Transactions". This project may affect when to recognise stock in the future.



Revenue Recognition

Overview

Revenue is usually the largest balance in the accounts of manufacturers. Sales and market share are two of the most common statistics used in financial highlights given by companies.

Guidance

Currently, UK GAAP has no general revenue recognition criteria. The guidance followed in the UK is within the ASBs Statement of Principles and FRS 5. An ASB discussion paper on Revenue Recognition was published in July 2001, as a first step towards an accounting standard.

IAS 18 'Revenue' is a specific IAS on revenue recognition. Under IAS, revenue recognition criteria is given for three types of transactions:

- The sale of goods;
- The rendering of services; and
- Interest, royalties and dividend revenue.

FRS 5 and the statement of principles in UK GAAP does not specifically cover the above three transactions like IAS so there is less guidance in these areas. However, FRS 5 has more guidance on sale and purchase agreements and consignment stock than IAS.

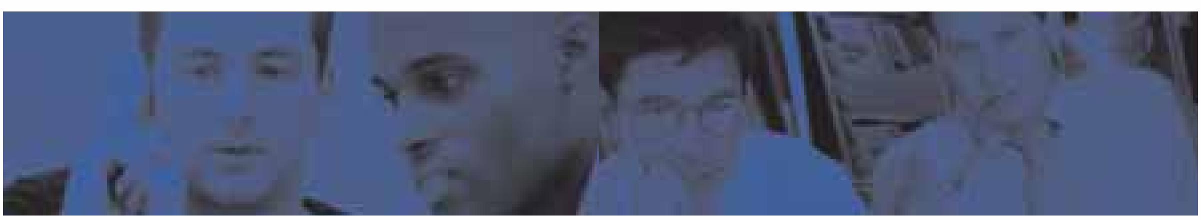
In general, the criteria in the ASB statement of principles on recognition of an asset or liability are similar to the criteria in the IASB framework. As IAS 18 is based on this framework, revenue recognition in the UK and under IAS is similar. Small differences may arise as FRS 5 and the ASB statement focus on changes to assets/liabilities whereas IAS 18 is more income statement focused.

Impact of IAS

There will be little difference in revenue recognition, however IAS deals with some transactions in more detail and this will need to be followed.

Future IAS developments

There is a project on the IASB agenda, which is based on the ASB Revenue Recognition paper. This may lead to an amendment or replacement of IAS 18. In the future, there could be significant changes to the guidance on how and when revenue should be recognised.



Segmental Reporting

Overview

Large manufacturers usually have a significant global presence and carry out many types of business. Segments will have significantly different profitability rates, opportunity for growth and degrees of risk.

Sometimes, the disclosure of segmental information can be prejudicial. For example, where a company operates in countries in which competitors are not required to provide segmental analysis, they will be providing the competitors with useful one way information about their results and returns in different markets.

Scope

In the UK, the standard has requirements which apply to all entities and additional requirements for public limited companies, those with a public limited company as a subsidiary and entities which exceed specific size criteria (unless its parent provides segmental information).

Under IAS, the requirements only apply to entities whose equity or debt securities are publicly traded or who are in the process of going public. There are no requirements, which apply to all entities. In group accounts, segment information only needs to be given based on the consolidated financial statements, as in the UK.

Both IAS and UK encourage all entities to apply the provisions of the accounting standards. However IAS, unlike UK GAAP, states that if an entity chooses to disclose segment information voluntarily in its financial statements, it must comply with the requirements in the standard in full. This is likely to be off-putting to some entities due to the extensive disclosures required. However, it prevents entities from only showing selective information.

The UK standard allows an exemption from giving disclosures where, in the opinion of the directors, the disclosure of any information required would be seriously prejudicial to the interests of the reporting entity. Under IAS, there is no similar exemption clause.

Approach

Under UK GAAP, reportable segments are determined by different returns, risks, rates of growth and future development potential.

IAS adopts a slightly different approach and requires an entity to identify segments using its internal reporting structure. The basis for this is that risks and returns affect how companies are organised and managed.

Both IAS and UK GAAP require business and geographical segments to be disclosed. IAS requires one of these to be reported in primary format and the other secondary format depending on which segments have the biggest impact on risks and returns.

- Business segments should be reported in primary format if the risks and rates of return are affected predominantly by differences in the products and services produced.
- Geographical segments should be reported in primary format if the risks and rates of return are affected predominantly by operations in different countries or other geographical areas.

UK GAAP does not distinguish between primary and secondary reporting formats.

Disclosure

Currently, under UK GAAP, all entities must disclose business and geographical segmental analysis for external and inter-segmental revenue.

In the UK, certain entities (see scope) are required to show segmental analysis for:

- Result; and
- Net assets.

Under IAS, an enterprise must show the following segmental analysis for its primary segments:

- Sales revenue distinguishing between external and intersegment (as under UK GAAP);
- Result (as UK);
- Assets (UK – net assets);
- The basis of intersegment pricing;
- Iiabilities;
- Capital additions;
- Depreciation; and
- Non-cash expenses other than depreciation.

The following analysis is required secondary segments:

- Revenue;
- Assets; and
- Capital additions.

Other differences:

- UK GAAP requires disclosure of information for segments which account for 10% or more of total third party revenue, results or net assets. IAS has the same requirement except disclosure is only required for segments which earn the majority of their turnover from external customers.
- Under IAS, if revenue of reported segments is below 75% of total revenue, additional segments must be reported until the 75% threshold is met. This is not required under UK GAAP.
- UK GAAP does not have such detailed definitions as IAS for the segments requiring disclosure.
- Under UK GAAP, if an acquisition, a sale or a termination has a material impact on a major business segment, this impact should be disclosed and explained. IAS does not require this.
- Under UK GAAP, disclosure is required of the aggregate share of net profit or loss of associated undertakings if they account for at least 20% of the reporting entity's total result or 20% of it's net assets. IAS requires disclosure of the aggregate share even if the 20% levels are not met.

Impact of IAS

IAS disclosures are more extensive and prescriptive than UK GAAP disclosures so they will take more time to prepare.

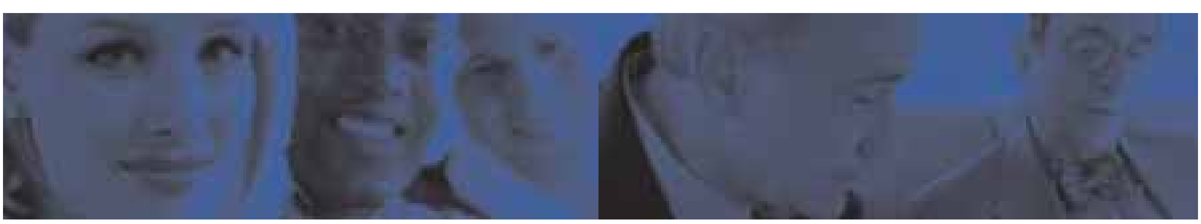
Competitors and other readers of the accounts will have access to more information about the company.

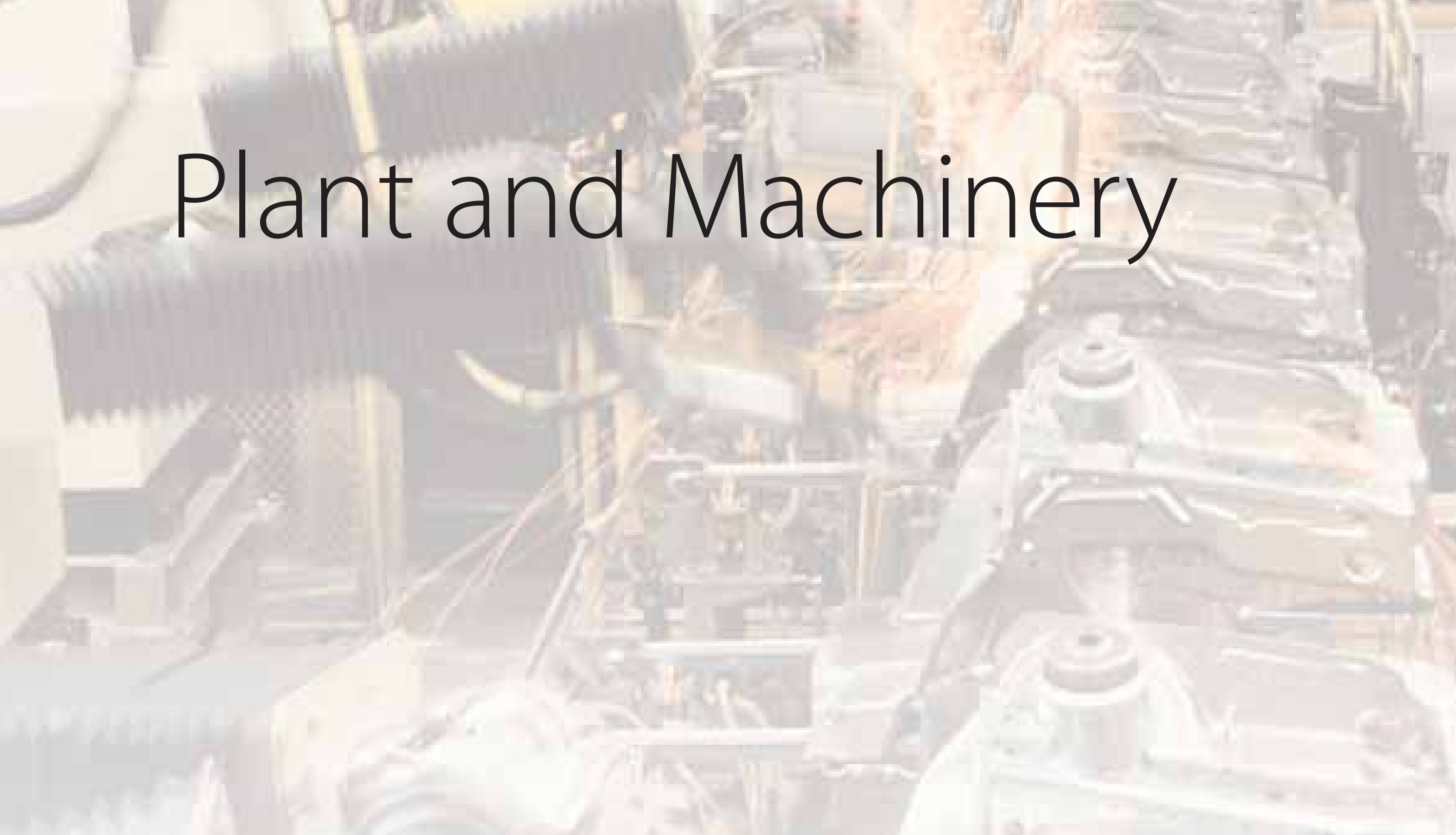
Entities, which take the exemption from preparing the information, will now have to show the detailed disclosures even if they are considered detrimental to the entity.

Non listed entities will now have more regulation over the information they produce. Entities will need to comply with the standard in full or not at all.

Future developments of IAS

A project on segmental reporting is being considered by the IASB.





Plant and Machinery

Overview

Large manufacturing companies within the aerospace and automotive industries make substantial investments in expensive and specialised plant and machinery in order to support the complex manufacturing processes involved in the production of their advanced technological products. In addition, due to the high cost of purchasing the necessary equipment, many companies have a significant number of assets under finance or operating leases.

This is a large area to cover so only the most significant changes are summarised in a table below. The accounting treatment by lessors is not reviewed here.

Recent IAS developments

The second column in the table below gives the key current differences between UK GAAP and IAS. The third column gives the main proposals to change accounting in this area in the new exposure draft, Improvements to International Accounting Standards.

Future IAS developments

The IASB has a list of research projects, which they are considering adding to their agenda. The projects may lead to amendments to IAS in the future and are as follows:

Impairment of assets

This project would examine some impairment issues within the existing standards in various jurisdictions and look to develop a common solution. Issues could include: use of impairment triggers, definition of impairment, and reversals of impairment losses.

Revaluations of certain assets

This project would aim to converge the accounting treatments for revaluations of assets under different jurisdictions. It would be a specific project to ensure that if revaluations are permitted, they are measured and reported consistently and in a comparable way.

Leases

This project would seek to improve the accounting for leases by developing an approach that is more consistent with the definitions of assets and liabilities in the conceptual framework. This will build on an earlier G4+1 Study. The G4+1 is an association of the accounting standard-setting bodies including the ASB. The IASB participate in the work of the G4+1 as an observer.

Proposals from G 4+1 study

For lessees, the objective should be to record, at the beginning of the lease term, the fair value of the rights and obligations that are conveyed by the lease.

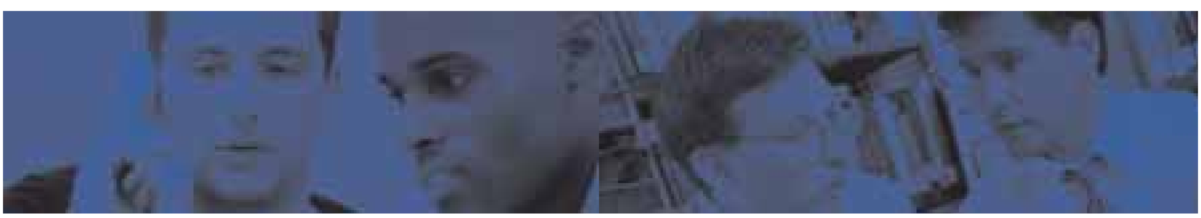
Leases that are presently characterised as operating leases (and not on the lessee's balance sheet) would give rise to assets and liabilities, but only to the extent of the fair values of the rights and obligations that are conveyed by the lease. Thus, if a lease were for a small part of an asset's economic life, only that part would be reflected in the lessee's balance sheet.

The fair value of the rights obtained by a lessee would in general be measured as the present value of the minimum payments required by the lease, plus any other liabilities incurred.

The amounts reported as financial assets by lessors would, in general, be the converse of the amounts reported as liabilities by lessees.

Recent UK developments

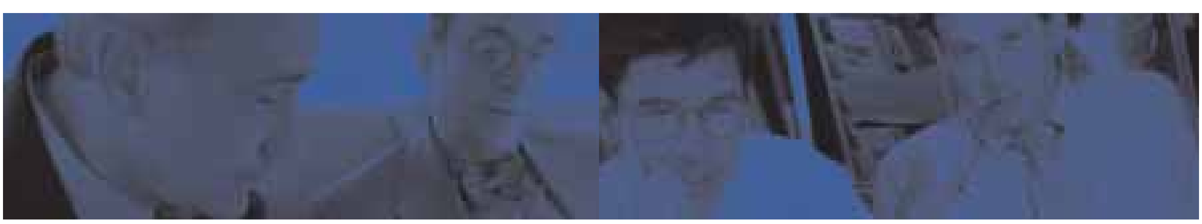
FRED 29, one of the new ASB exposure drafts, is based on IAS 16 'Property Plant and Equipment' and IAS 23 'Borrowing Costs'. It also includes the changes proposed in the new IASB exposure draft. A new UK standard is expected in 2003.



Subject	Current differences	Proposed changes to IAS in the exposure drafts
Initial measurement of tangible fixed assets (TFA)	• Determining the initial cost of assets that are purchased or constructed is similar under IAS and UK GAAP. • UK GAAP has no specific requirements over TFA acquired through exchange of other TFA. Current practice varies and in general, gains are rarely recognised unless exchanged items are clearly dissimilar. • IAS contains specific requirements. No gain/loss is recognised when similar items are exchanged and the acquired asset is measured at the carrying value of the asset disposed of. A gain/loss may be recognised if dissimilar items are exchanged and the asset received is measured at fair value (i.e. the fair value of the asset given up, adjusted for any payments made). • Under IAS, government grants for fixed assets can be deducted from the carrying value of the asset, reducing depreciation, or held separately as deferred income and amortised over the life of the asset. UK GAAP only allows the later option.	• More guidance is given on directly attributable costs to include in initial measurement. • All exchanges of items (regardless of whether they are similar) are measured at fair value unless the value cannot be determined reliably. In addition, more guidance is given on the use of fair values when assets are exchanged.
Subsequent expenditure on TFA	• Both IAS and UK GAAP allow capitalisation only if it increases the standard of performance of the existing asset. • IAS allows an exception for subsequent expenditure on safety and environmental assets, if the new asset enables the entity to derive greater future economic benefits from an existing asset.	
Revaluations of TFA	• IAS and UK GAAP both allow revaluation of TFA to current values and the increase to be held as a revaluation surplus in equity (IAS) /reserves (UK). • IAS states that current value is generally the fair value, usually market value determined by assessment. UK GAAP defines current value as the lower of replacement cost and recoverable amount, where recoverable amount is the higher of net realisable value and value in use. • Under IAS, revaluations of properties should be at market value. Under UK GAAP, the valuation basis depends on the nature of the property and may be at existing use, depreciated replacement cost or open market value. • UK GAAP is more detailed than IAS on the frequency and basis of revaluations.	
Impairment of TFA held at cost	• Both UK and IAS state that an asset is impaired if its carrying value exceeds the higher of value in use or net realisable value. An asset will be written down to the higher of the two. • Both IAS and UK GAAP require impairments to be recognised in the income statement.	• Compensation from third parties for TFAs impaired/lost is taken to the income statement in that period.

Subject	Current differences	Proposed changes to IAS in the exposure drafts
Impairment of revalued TFA	• Where revaluation losses are due to a consumption of benefits, UK GAAP requires them to be taken to the income statement in full. IAS allows the losses to first be debited against any related revaluation surplus of that asset and then requires the remainder to be taken to income. • Where revaluation losses are not due to a clear consumption of benefits the IAS treatment is the same as above. Under UK GAAP, the losses are debited against the revaluation surplus of that asset (and shown in the statement of recognised gains and losses (STRGL)), to the extent that carrying amount exceeds depreciated historic cost. • UK GAAP requires losses, to the extent the recoverable amount of the asset exceeds its current value, to be taken to the STRGL. Treatment under IAS is as above.	
Depreciation of TFA	• UK and IAS have similar requirements over calculation and recognition of depreciation. • Under UK GAAP, the useful economic life (UEL) of a TFA and its residual value (where material), should be reviewed at the end of each reporting period. Residual values are calculated using prices at the date of acquisition or latest valuation. Under IAS if TFA are not revalued, residual values are never revised. IAS only requires residual values to be revised at the time of any revaluation. IAS only requires periodic review of asset lives. • UK GAAP requires an annual impairment on an asset where depreciation is not charged due to materiality or a long UEL. IAS has no similar requirements or guidance.	• Residual values, if material, and UEL will be reviewed at the year end for all assets. Residual values should be revised using current prices for assets with similar ages and conditions as the estimated asset. • Assets that are disused and held for disposal or temporarily idle must be depreciated.
Capitalisation of borrowing costs	• Both UK GAAP and IAS allow interest to be expensed or capitalised when funds are borrowed specifically for obtaining a qualifying asset. IAS contains more detail on what constitutes borrowing costs. • Under IAS, exchange differences may be capitalised if they are regarded as adjustments to interest cost. UK GAAP gives no guidance and in general, costs are not capitalised. • Under IAS, the amount of interest eligible for capitalisation should be determined as the actual interest incurred on that borrowing during the period less any investment income on the temporary investment of part of the loan. UK GAAP requires that interest is limited to the actual costs incurred on the borrowings during the period in respect of the expenditure on the TFA and that interest paid or received on the unused/reinvested part must be taken to the income statement.	

Subject	Current differences	Proposed changes to IAS in the exposure drafts
Classification of leases (lessee only)	● IAS and UK GAAP are similar and both follow substance rather than legal form. IAS has more guidance on the classification between a finance lease and an operating lease than UK GAAP. However, IAS has no equivalent standard to FRS 5 to support the classification. ● IAS does not have a rebuttal presumption, like UK GAAP, that if the minimum lease payments are greater than 90% of the fair value of the asset then the lease is a finance lease. ● IAS and UK GAAP have similar requirements for accounting and presentation of leases and lease incentives.	● Clarification that when a lease of both land and buildings is classified the lease should be split into a lease of land and a lease of buildings.



Business Combinations

Overview

Acquisitions and mergers occur in the aerospace and automotive industries in order to achieve growth and market share targets, enter new markets and obtain synergies. Consolidation may become more regular as companies act to improve efficiencies in their supply chain in response to the current market conditions.

Impact of IAS

This is not an area that is typical to the automotive and aerospace industries. However, there will be a considerable impact on larger groups due to the amount of goodwill and frequency of acquisitive activity. For example, on introduction of IAS, impairment testing of goodwill and the recognising more intangibles on the balance sheet could initially cause significant amounts of goodwill to be written off. This reaction was seen in the US when companies had to adopt a similar accounting treatment to that under IAS.

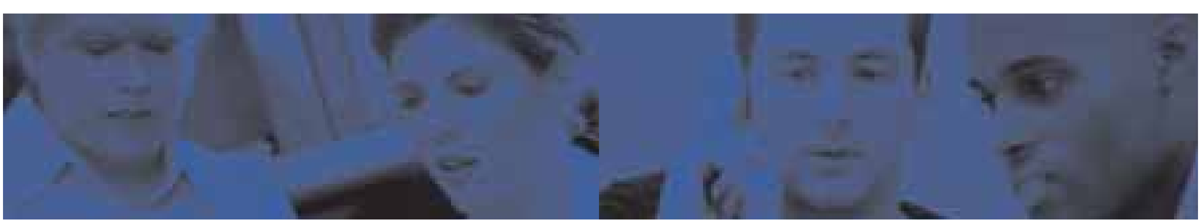
Recent and future developments of IAS

The IASB has two projects, business combinations phase I and phase II. The board completed its discussions on phase I in April 2002 and published an exposure draft in December 2002. A new standard is expected in 2003. The timetable for phase II has not been finalised and its main features are still under discussion at IASB meetings.

The second column in the table below shows the key current differences between UK GAAP and IAS. The third column gives the main decisions made on changes to current IAS in phase I and notes the areas under consideration in phase II.

Subject	Current differences between UK GAAP and IAS	Proposed changes to date on IAS in phase I and phase II
Goodwill – general	• The amount of goodwill may be different as UK GAAP and IAS may give different measurements of the fair value of the assets acquired and the consideration paid. • Both GAAP and IAS have a rebuttal assumption that the useful economic life (UEL) of goodwill will not exceed 20 years. IAS does not permit an indefinite UEL like UK GAAP. • IAS only requires an impairment review at the end of the first full financial year if the UEL is greater than 20 years or there are impairment indicators. UK GAAP requires a first year review in all cases.	• All goodwill will be subject to impairment testing. Goodwill will no longer be amortised. Amortisation of any existing goodwill will stop. • There will be an annual impairment test but a detailed calculation of recoverable amount will only be required when there is evidence of impairment. • The two proposals above will result in a very different amount of goodwill on the balance sheet and greater volatility of profits.
Intangible assets acquired in business combination	• Both IAS and UK GAAP require intangible assets to be included in goodwill unless they meet specific criteria for separate presentation. • The definition and recognition criteria of intangibles are similar between UK GAAP and IAS. The main difference is UK GAAP requires an intangible asset to be separable (i.e. it can be disposed of separately from the business). IAS does not require separability as long as the asset is identifiable, it is probable that it will generate future economic benefits and its cost can be measured reliably.	• An illustrative list of potential acquired intangibles will be included in the new standard (similar to that in US standard Financial Accounting Standards Board (FASB) 141). • Initial measurement will not be limited to an amount that will not create or increase negative goodwill. • Intangible assets are recognised separately from goodwill if they arise from contractual or legal rights or are separable from the business. • Purchased research costs can be recognised separately, even if they would not be capitalised had they been generated internally. • More intangibles will be recognised separately on the balance sheet. Goodwill balances will be lower. Intangibles, excluding goodwill, will still be subject to amortisation.
Negative goodwill	• Both UK GAAP and IAS require negative goodwill to be presented as a negative asset. • IAS allocates negative goodwill to income, first to match any costs in the acquirer's plans for the acquisition and then to match depreciation or sale of the non-monetary assets acquired. Any balance is taken to income immediately. • UK GAAP assigns an amount up to the fair value of the acquired non-monetary assets to income as they are depreciated or sold. Any balance is matched to the periods expected to benefit.	• If negative goodwill arises, a reassessment of the identification/ measurement of the net assets acquired should be done. Any remaining negative goodwill is recognised immediately as a gain and shown in the income statement. • Any negative goodwill existing at the adoption of the new standards must be credited to opening retained earnings.

Subject	Current differences between UK GAAP and IAS	Proposed changes to date on IAS in phase I and phase II
Measurement of assets and liabilities on acquisition	• Both IAS and UK GAAP permit changes to fair values recognised at acquisition if they are made before the first annual accounting period end. They are recognised as changes to goodwill. • In calculating the fair value of deferred tax assets and liabilities on acquisition differences may occur due to discrepancies between IAS and UK GAAP in this area.	• After an acquisition has been initially accounted for, adjustments to the values (and hence goodwill) should only be made where they are corrections of errors. • Deferred income tax and pension obligations will not be measured at fair values. Pension obligations will be valued using the assumptions of the acquirer if they differ from the acquiree's assessment of future events. • Some measurement issues on the identifiable assets acquired are still under discussion in phase II.
Restructuring provisions at acquisition	• Under IAS, when certain criteria are met the acquirer must recognise a liability for terminating or reducing activities of the acquiree, which was not a liability of the acquiree at that date. UK GAAP does not permit provisions arising from the acquirers intentions	• IAS is following UK GAAP – The acquirer should recognise a provision only if the acquiree has, at the date of acquisition, an existing liability for restructuring costs recognised under IAS 37 (which is similar to FRS 12).
Cost of acquisition	• Under IAS, contingent consideration in the form of shares may be shown as a liability. Under UK GAAP, shares to be issued must be shown in shareholders funds. • UK GAAP contains more guidance on discounting of deferred consideration than IAS. • Items, which are not acquisition costs under UK GAAP, may qualify under IAS. For example the issue costs of shares or other securities. • Under UK GAAP, before increasing a stake in a subsidiary, the identifiable assets and liabilities are revalued to fair value if this differs materially to the carrying value. This is optional under IAS.	• Issues related to the measurement of consideration are still under discussion in phase II. So far, the board has decided that costs directly attributable to a business combination are not part of the fair value of the exchange transaction and should be excluded from the cost of a business combination. • Treatment of business combinations achieved through successive share purchases will be reviewed in phase II.



Subject	Current differences between UK GAAP and IAS	Proposed changes to date on IAS in phase I and phase II
Minority Interests	• The benchmark treatment under IAS is showing the minority interest at its share of the pre-acquisition carrying values of net assets. An allowed alternative is stating the minority interest at its share of the fair value of net assets. UK GAAP requires the alternative treatment. • Under IAS, losses in a subsidiary may create a debit balance on minority interests only if the minority has an obligation to finance the losses. Under UK GAAP, a debit balance is always required unless the group has a commercial obligation to provide finance that may not be recoverable in respect of the accumulated losses attributable to the minority.	• The benchmark treatment will be prohibited meaning IAS will come in line with current UK GAAP. • Included in the scope of phase II is whether a minority interests' share of goodwill should be recognised and whether the purchase of a minority interest should be treated as the purchase of equity.
Uniting of Interests (mergers)	• The criteria under IAS and UK GAAP are similar and both focus on substance. IAS gives less guidance on size criteria. • Accounting under IAS and UK GAAP are similar. • IAS does not address group reconstructions, whereas UK GAAP has special rules in this area.	• An acquirer must be identified. Uniting of interests will be prohibited. • Group reconstructions will be covered in phase II. Changes could mean that some group structures would no longer achieve the desired accounting treatment.
Subsidiaries excluded from consolidation	• IAS and UK GAAP require subsidiaries under temporary control to be excluded from consolidation. UK GAAP is more prescriptive than IAS. • The exclusions for long-term restrictions are broader under IAS and would include restrictions on the amount of currency leaving the country. • IAS requires excluded companies to be shown as investments and held at fair value. They are not accounted for as associates. UK GAAP requires them to be shown as associates when significant influence is present, or fixed asset investments. In the UK, if they are held for resale, they are shown in current assets and valued at the lower of cost and net realisable value.	• No changes currently expected.

Who to contact

UK Manufacturing Group Leader

Philip Johnson	**+44 (0) 161 455 6202**	**prjohnson@deloitte.co.uk**

National Assurance and Advisory

Andy Simmonds	**+44 (0) 20 7438 2485**	**asimmonds@deloitte.co.uk**

Assurance and Advisory

Michelle Fisher	**+44 (0) 20 7438 2343**	**mifisher@deloitte.co.uk**

Deloitte & Touche would be pleased to advise on specific application of the principles set out in this publication. Professional advice should be obtained as this general publication cannot be relied upon to cover specific situations; application will depend upon the particular circumstances involved.

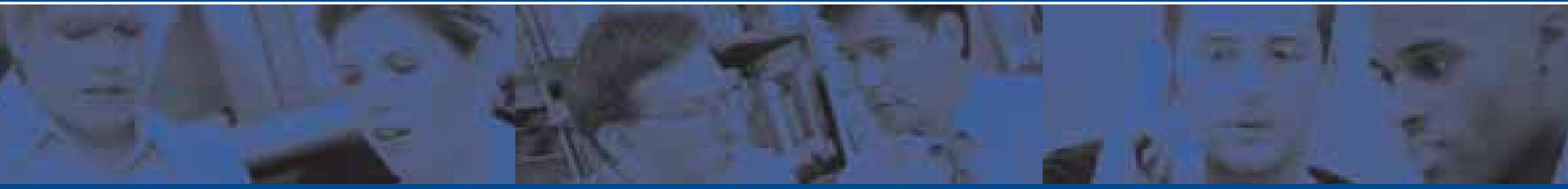
For more information on Deloitte & Touche please access our website at **www.deloitte.co.uk**

Deloitte & Touche is the UK's fastest growing major professional services firm in 23 locations, with over 10,000 staff nationwide and fee income of £713.6 million in 2001/2002. It is the UK practice of Deloitte Touche Tohmatsu, a global leader in professional services with around 100,000 people in 140 countries and fee income of $12.5 billion for the year ended 31 May 2002.

Deloitte & Touche is authorised by the Financial Services Authority in respect of regulated activities.

Deloitte & Touche, Stonecutter Court, 1 Stonecutter Street, London EC4A 4TR, United Kingdom.
Tel: +44 (0) 20 7936 3000. Fax: +44 (0) 20 7583 1198.

Designed and produced by The Deloitte & Touche Studio, London. *6119B*



Deloitte
Touche
Tohmatsu