CIPFA RESPONSE TO EXPOSURE DRAFT OF PROPOSED IMPROVEMENT TO INTERNATIONAL ACCOUNTING STANDARDS

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CIPFA

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1 INTRODUCTION

CIPFA welcomes the opportunity to comment on the proposed improvements to International Accounting Standards. CIPFA supports the IASB objective of eliminating alternatives and conflicts in existing standards.

CIPFA's approach in responding to this exposure draft is to focus primarily on those standards which have a significant public-sector impact and where change is proposed by the UK Accounting Standards Board to UK Generally Accepted Accounting Practice. CIPFA also comments on proposed revisions to International Accounting Standards, where although there is no immediate proposal to incorporate the change into UK GAAP, there is a significant issue of principle.

CIPFA notes that the scope of the IASB's standards does not include either the public sector or the not-for-profit sector. However, CIPFA notes that at both national and international level the approach of public sector standard setters is heavily informed by international GAAP. The first phase of the IFAC Standards Project has produced a set of core-standards based on international standards extant as at August 1997. CIPFA welcomes the use of some terminology which can be also used in the public and not-for-profit sectors such as the use of the term entity rather than enterprise.

COMMENTS ON SPECIFIC STANDARDS

IAS 1 – PRESENTATION OF FINANCIAL STATEMENTS

Q1 *Do you agree with the proposed approach regarding departure from a requirement of an International Financial Reporting Standard or an Interpretation of an International Financial Reporting Standard to achieve fair presentation?*

A Although the proposed change in wording to paragraphs 13-16 of the current IAS1 is superficially minor, it can be construed as a narrowing of the requirement to present fairly / give a true and fair view. This is particularly the case because what is encapsulated in one black letter paragraph in the current IAS 1 is now in three black letter paragraphs in the revision. In particular paragraph 16 of extant IAS 1 contains a specific acknowledgement that "in extremely rare circumstances, application of a specific requirement in an International Accounting Standards might result in a misleading financial statements". This has been replaced by the opening sentence of black letter paragraph 15 in the proposed revision with an emphasis on "management concludes".

Although this is a relatively minor textual change it could be interpreted as a significant move towards a 'compliance' approach to fair presentation. It is likely to diminish the extent to which management pro-actively considers the most appropriate treatments for individual entities. Recent events have highlighted the weakness of 'the compliance culture'. The wisdom of a further move in this direction seems questionable. We therefore have strong reservations about these proposed amendments.

Q2 – Q6 No comments

IAS 2 – INVENTORIES

Q1 *Do you agree with eliminating the allowed alternative of using the last-in first-out method for determining the cost of inventories under paragraphs 23 and 24 of IAS 2?*

A CIPFA strongly supports the elimination of the alternative of utilising LIFO.

Q2 *IAS 2 requires reversals of write-downs of inventories when the circumstances that previously caused inventories to be written down below cost no longer exist (paragraph 30). IAS 2 also requires the amount of any reversal of any write-down of inventories to be recognised in profit or loss (paragraph 31).*

Do you agree with retaining those requirements?

A Agree. However paragraphs 30 and 31 appear to duplicate a similar requirement. For clarity the requirements should be in a single paragraph.

IAS 8 – ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

No specific comments.

IAS 10 – EVENTS AFTER THE BALANCE SHEET DATE

No specific comments.

IAS 15 – INFORMATION REFLECTING THE EFFECTS OF CHANGING PRICES

No specific comments.

IAS 16 – PROPERTY PLANT & EQUIPMENT

General Comments

These relate principally to the basis of valuation, the issue of renewals accounting and the issue of donated assets.

Basis of Valuation – CIPFA notes that IAS 16 permits, as an allowed alternative treatment, the revaluation of property, plant and equipment and that, when this option is selected, revaluation should be at fair value. CIPFA supports strongly the retention of such an option. CIPFA considers that the definition of fair value should be broadened to embrace the value in use concept that informs the definition of current value in UK FRS 15, *Tangible Fixed Assets*.

Depending upon the circumstances CIPFA considers that the failure to incorporate value in use in the definition of fair value may lead to unrealistically high or misleadingly low carrying values. CIPFA does not consider it appropriate for open market value (OMV) to be used for valuing an operational asset unless there is clear evidence that the asset is to be sold or used for an alternative purpose. Conversely, an asset that has been adapted by its current owner may be valued at a considerably lower figure than its existing use value.

It is acknowledged that paragraph 31 of the exposure draft recognises that the specialised nature of certain items of plant and equipment means that there is no evidence of market value because such items are rarely sold. In such cases valuation is at depreciated replacement cost. However, it is unclear what level of market evidence is required in order for a market value to be reliable. This is a particular issue in the public sector where a high proportion of assets are specialised and where a reliance on OMV may lead to misleadingly low carrying values.

It is also considered that the failure to embrace the concept of value in use in IAS 16 makes the standard inconsistent with IAS 36, *Impairment of Assets*. The requirements of IAS 36 are underpinned by the concept of recoverable amount, in the measurement of which value in use is a key concept. We therefore have reservations whether IAS 16 and IAS 36 articulate.

CIPFA supports the view put forward by the International Federation of Accountants Public Sector Committee that, in the context of the components approach to the recognition of property, plant and equipment, there is a risk that entities may account for components at a level where the costs of doing so may exceed the benefits. CIPFA therefore proposes that paragraph 12 be amended so that it is clear that the components approach applies only to material components.

Renewals Accounting – Unlike the equivalent UK standard FRS 15, *Tangible Fixed Assets*, IAS 16 does not address the issue of renewals accounting. It is our view that under certain conditions renewals accounting is an appropriate method of estimating depreciation. These conditions are:

- the infrastructure asset is a system or network that as a whole is maintained at a specified level of service potential by the continuing replacement and refurbishment of its components
- the level of annual expenditure required to maintain the operating capacity (or service capability) of the infrastructure asset is calculated from an asset

management plan that is certified by a person who is appropriately qualified and independent
- the system or network is in a mature or steady state.

Donated Assets – The treatment of donated assets is a further area on which IAS 16 is silent. UK FRS 15 includes a requirement that tangible fixed assets received as gifts and donations by charities should be recognised at their current value at the date of receipt. The approach to recognition of such assets is particularly significant in, but not limited to, the not-for-profit sector and the issue could be addressed straightforwardly by including a requirement for donated assets to be recognised at fair value at the date of receipt.

Answers to Specific Questions

Q1 *Do you agree that all exchanges of items of property, plant and equipment should be measured at fair value, except when the fair value of neither of the assets exchanged can be determined reliably?*

A Agree in principle, subject to the points on the definition of fair value made above. However, we find paragraph 21 contradictory and suggest that the drafting of the last two sentences is reconsidered. As currently drafted it makes an assertion that is partially refuted by the next sentence. Our view is that the fair value of the asset received is a more appropriate measurement than the fair value of the asset given up. Similar considerations apply to the revisions to paragraphs 26 and 34 of IAS 38 (see below).

Q2 *Do you agree that all exchanges of intangible assets should be measured at fair value, except when the fair value of neither of the assets exchanged can be determined reliably?*

A Agree subject to points above**.**

Q3 *Do you agree that depreciation of an item of property, plant and equipment should not cease when it becomes temporarily idle or is retired from active use and held for disposal?*

A Partially agree. Normally temporary idleness should not be a sufficient rationale for non-depreciation. We therefore agree with the statement in paragraph 43 that other factors such as technical or commercial obsolescence and wear and tear are applicable while an asset remains idle. There may be a special case where a temporary idle period has been anticipated and reflected in the life of the asset and the depreciation method adopted.

Where an asset has been retired from active use before it has reached the end of its estimated useful life and therefore has not been fully depreciated it should be reviewed for impairment in accordance with the indicator in paragraph 9(f) of IAS 36. Nevertheless we agree that depreciation should not cease.

IAS 17 – LEASES

No specific comments.

IAS 21 – THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

General Comments

CIPFA welcomes the proposed improvements to IAS 21. However CIPFA does not support the treatment derived from the existing IAS 21 (paragraph 30 of the draft standard) in consolidated statements of the gains and losses on exchange differences related to monetary items forming part of a net investment in a foreign operation.

CIPFA is of the view that gains and losses that, in accordance with the Board's *Framework for the Preparation and Presentation of Financial Statements*, are properly included within income or expense should be included within income or expense on recognition, regardless of whether they have been realised. Items that are capital maintenance adjustments should not be included in profit and loss. Subsequent realisation should not lead to capital maintenance adjustments being 'recycled' into profit and loss. Thus it is CIPFA's view that these exchange differences should, in principle, be included in profit and loss on recognition.

A comprehensive measure of financial performance would make these concerns redundant. CIPFA therefore recognises that this issue is a part of wider questions about the reporting of financial performance. It is understood that this is being considered within the project on reporting performance being conducted in conjunction with the UK Accounting Standards Board. We note that the most recent project summary issued by the IASB suggests that recycling of these gains and losses would be prohibited. We welcome this and accordingly suggest that it would be undesirable for IAS 21 to be amended twice in rapid succession. We therefore recommend that consideration be given to delaying adoption of a new revised IAS 21 until this issue is further advanced.

Answers to Specific Questions

Q1 *Do you agree with the proposed definition of functional currency as "the currency of the primary economic environment in which the entity operates" and the guidance proposed in paragraphs 7-12 on how to determine what is an entity's functional currency?*

A Agree

Q2 *Do you agree that a reporting entity (whether a group or a stand-alone entity) should be permitted to present its financial statements in any currency (or currencies) that it chooses?*

A Agree. CIPFA believes that reporting in the functional currency best portrays the financial performance and position of the entity, and therefore considers that it would be reasonable to include a rebuttable presumption that the functional and presentational currencies should be identical. However CIPFA accepts that there may be valid reasons for a specific presentation currency (e.g. listing rules). Given the disclosure requirements in paragraphs 51 and 53 – 55 CIPFA supports the approach in the ED.

Q3 *Do you agree that all entities should translate their financial statements into the presentation currency (or currencies) using the same method as is required for translating a foreign operation for inclusion in the reporting entity's financial statements (see paragraphs 37 and 40)?*

A Agree.

Q4 *Do you agree that the allowed alternative to capitalise certain exchange differences in paragraph 21 of IAS 21 should be removed?*

A Agree

Q5 *Do you agree that*

(a) goodwill and
(b) fair value adjustments to assets and liabilities

that arise on the acquisition of a foreign operation should be treated as assets and liabilities of the foreign operation and translated at the closing rate (see paragraph 45)?

A *(a) Goodwill*

Agree. CIPFA acknowledges that goodwill arising on an acquisition is, as a matter of fact, recognised an asset of the acquiring entity only. However it is CIPFA's view that goodwill is part of the value of the acquired entity and that it is therefore more consistent to treat goodwill in the same way as the other assets of the entity.

(b) Fair value adjustment to assets and liabilities.

Agree. In this context fair value adjustments should be treated identically to the assets to which they relate.

IAS 24 – RELATED PARTY DISCLOSURES

General Comments

CIPFA notes with concern the intention to remove paragraph 4(d), which exempted financial statements of state controlled enterprise from disclosing transactions with other state controlled enterprises. It is CIPFA's view that, with particular regard to local authorities, central government influence is such that the nature of the relationship will be a prominent feature of the statement of accounts.

Answers to Specific Questions

Q 1 *Do you agree that the Standard should not require disclosure of management compensation, expense allowances and similar items paid in the ordinary course of an entity's operations?*

A CIPFA agrees and would consider that it is desirable for an accounting standard to define generic terminology such as 'management' and 'compensation'.

Q 2 *Do you agree that the Standard should not require disclosure of related party transactions and outstanding balances in the separate financial statements of a parent or a wholly owned subsidiary that are made available or a wholly-owned subsidiary that are made available or published with consolidated financial statements for the group to which that entity belongs?*

A Agree.

IAS 27 – CONSOLIDATED AND SEPARATE FINANCIAL STATEMENTS

No specific comments.

IAS 28 – ACCOUNTING FOR INVESTMENTS IN ASSOCIATES

No specific comments.

IAS 30 – EARNINGS PER SHARE

No specific comments.

IAS 40 – INVESTMENT PROPERTY

Answers to Specific Questions

Q1 – Q2 No comments

Q3 *Do you agree that the board should not eliminate the choice between the cost model and the fair value model in the Improvements project, but should keep the matter under review with a view to reconsidering the option to use the cost model in due course?*

A Agree. The Board's rationale for retaining the choice between the cost model and the fair value model is acknowledged. However, in the context of investment properties, depreciated historical cost is of highly limited use in providing a proper understanding of an entity as it does not provide a reflection of the value of the asset to the entity. It is therefore important that the cost model is eliminated at the earliest appropriate point in the future.