CIPFA The Chartered Institute of Public Finance & Accountancy

3 Robert Street, London WC2N 6RL
T: 020 7543 5600 F: 020 7543 5700
cipfa.org.uk

Our ref: Responses/110505 SC0158

Michelle Sansom
Accounting Standards Board
5th Floor, Aldwych House
71-91 Aldwych
London
WC2B 4HN

By email to: asbcommentletters@frc-asb.org.uk

Dear Michelle Sansom

THE FUTURE OF FINANCIAL REPORTING IN THE UK AND REPUBLIC OF IRELAND

FRED 43, *APPLICATION OF FINANCIAL REPORTING STANDARDS*

FRED 44, *FINANCIAL REPORTING STANDARD FOR MEDIUM-SIZED ENTITIES*

CIPFA is pleased to provide comments on the proposals in these exposure drafts.

In making this response we have considered the full scope of the proposed FRSME, but have focused particularly on the implications for public benefit entity financial reporting, which are an area where CIPFA has particular knowledge and expertise. In commenting on FRED 43 and FRED 44, we have therefore also had regard to the recent publication of FRED 45, *Financial Reporting Standard For Public Benefit Entities and Consequential Amendments to Proposals in FRED 44 Financial Reporting Standard For Medium-Sized Entities*. We will provide a full and separate response to that consultation in due course.

The ASB proposals have been reviewed by CIPFA's Accounting and Auditing Standards Panel, and members of specialist panels for the Charity, Further and Higher Education, and Social Housing sectors.

Background

The ASB has been developing its thinking for several years on how UK GAAP might become IFRS based or grounded in IASB derived standards and guidance, or otherwise based on high quality standards developed internationally rather than purely reflecting a UK perspective. The Board's views have evolved against a background of

- the experience of UK company sector users of EU adopted IFRS (principally EU listed groups and linked companies)
- the adoption of EU adopted IFRS by the UK government sector, with some adaptation for sector specific issues
- the development of the IFRS for SMEs by the IASB, setting out a more compact and simplified basis of financial reporting available for use by entities which are not required to use full IFRS

- further development by the IASB of its IFRS standards and Conceptual Framework for Financial Reporting, much of which has been carried out in conjunction with the US Financial Accounting Standards Board (FASB), with a view to converging or minimising disparities in treatment between
- other IFRS standards development, including initiatives progressed in response to the economic crisis, including work on simplifying and improving accounting for financial instruments
- ASB consultation and outreach seeking to engage UK stakeholders in the IASB development process, including consultation on individual IFRS (for example, Business Combinations) and the IFRS for SMEs.
- ASB consultation and outreach on how standards might be applied to various 'tiers' and other sub-sectors within UK GAAP preparers

CIPFA has responded at various stages of the ASB's consideration on these matters, including most recently the Board's 2009 Consultation Paper. On 29 November 2009 we were very pleased to hold a discussion event which was attended by CIPFA panel members, auditors, regulators and preparers from the sector, at which the ASB chair made a presentation on the ASB proposals and other speakers reviewed the implications for each of these three areas of the public benefit sector. CIPFA technical staff and members have also attended ASB and other outreach events relating to the current exposure drafts.

CIPFA strongly supports the ASB work in this area, and we recognise the efforts which the Board is making to support proportionate reporting by different types of entity, by basing some reporting on the simpler IFRS for SMEs, and at least in the short term providing smaller entity support through the FRSSE.

Comments on the proposals as they impact on Public Benefit Entities

The IFRS for SMEs is well drafted and well regarded, but neither it nor 'full' IFRS are designed with significant consideration of public benefit entities. To adequately encompass the economic characteristics of most public benefit entities it is necessary to broaden the scope of recognition of economic activity. Non-exchange transactions need to be considered, and assets recognised which have not been obtained through conventional contractual exchanges, or which are used to provide services without recompense through exchanges. We appreciate that the ASB proposes to address this aspect of public benefit reporting by supplementing the FRSME with the FRSPBE, which defines and discusses 'non-exchange transactions' and 'service potential'.

As noted above, CIPFA will provide a full and separate response to the FRSPBE consultation in due course. However, the FRSPBE, and any SORP guidance based on the FRSPBE will ultimately be based on the FRSME, which is primarily drawn from the IFRS for SMEs. As we understand it, the FRSPBE will augment, rather than substantially modify, the material in the FRSME.

In making comments on the FRSME, we are therefore concerned with both

- the quality of that standard, as applied to the various public benefit sectors in conjunction with the FRS for Public Benefit Entities and SORPs; and

- the coherence of UK GAAP as a whole, in providing a basis for measuring the performance of entities in different tiers and sectors in a broadly comparable way.

Underlying these comments is our view that ideally, all financial reporting would follow a single conceptual framework, even if the detail of standards application differs between entities. The apparent differences between sectors mainly relate to wider views of economic activity. The differential reporting applied to entities of different sizes and accountability status should thus mainly reflect proportionality, with simpler reporting for entities with simpler operations and less detailed reporting for entities with lower accountability requirements, while also providing additional reporting on matters of particular sector interest. In line with this, CIPFA has been very pleased to support the ASB and its Committee on Public Benefit Entities in their development of an Interpretation of the UK GAAP Statement of Principles and other guidance. CIPFA was also correspondingly disappointed that the IASB has been unable to adopt a similar broad view in developing its Conceptual Framework, although we accept that this would be difficult in the light of their current organisation and pressures from world regulators and markets. In the absence of an overarching framework, CIPFA does of course strongly support the work of the International Public Sector Accounting Standards Board in developing a conceptual framework for public sector reporting.

Against this backdrop, we would note that while the IASB has very helpfully developed the IFRS for SMEs in response to requests from stakeholders, this work differs from that which the Board has traditionally seen as its primary role. The requirement to consider the needs of small and medium entities as part of the objectives of the IASB is a relatively new addition to the constitution of the IASCF (now renamed as the IFRS Foundation). The IFRS for SMEs does not yet, in CIPFA's view, form part of as coherent a vision of financial reporting as the one which UK GAAP aspired to. In particular, the IFRS for SMEs applies a simplified model of financial reporting to all entities which are, in its terms, not publicly accountable, without regard to whether the operations of those entities are correspondingly simple.

Of particular note is the approach taken to asset valuation which focuses on historic cost as a measurement method, while also disallowing recognition of certain assets. We can see that for many entities with less complex operations this simplified accounting will not be problematic. However, many entities currently report under UK GAAP on a revaluation basis or capitalise interest to produce a more relevant value than the historical cost directly attached to asset purchase transactions. They do this despite additional information requirements and costs, because this information is relevant to their operations and enhances comparability.

Given this, we are concerned that

- some of the simplifying approaches which the IASB has used in developing the IFRS for SMEs would result in both higher costs and less useful financial information when applied to some public benefit entities;

- these approaches are embedded in the draft FRSME, and when applied to more complex entities will require more work in transition from UK GAAP; and

- the subsequent accounting may also result in more fragmented accounting guidance, and require more work in moving between tiers 1 and 2. Alternatively, it may discourage the use of higher quality asset accounting options by bodies in Tier 1 and Tier 3.

While we appreciate that the ASB wishes to remain as close as possible to the IFRS for SMEs, the decision as to whether to modify the requirements should be informed by consideration of the usefulness of the information provided, and the way which the new proposals align with current practice under UK GAAP and future practice under EU adopted IFRS and the FRSSE.

Other General Comments

In the light of the above, we would emphasise that in our view it is very desirable that the ASB maintain a body of UK GAAP which is coherent as a whole. If the FRSME is reframed to reduce differences between the tiers, this will ease transition and improve comparability between entities in the same SORP sector.

There is a need to keep the FRSME updated. As noted at 11.22c of the FRED, the IASB schedule for revision of the IFRS for SMEs will provide a natural trigger for ASB review of the FRSME. We would however suggest that the Board may need to take a broader view of the factors which should trigger update, including relevant developments in UK legislation and regulations, and, for example, developments in full IFRS. A particularly pertinent example is the work which the IASB is carrying out on IFRS 9 in simplifying the accounting for financial instruments. If this work is successful, it would make sense to cascade the improved guidance to other tiers without undue delay.

Answers to Specific Questions

Answers to the specific questions in the Invitation To Comment are set out in the attached Annex.

If you have any questions on the material in this response, please contact Steven Cain (t:020 7543 5794 e:steven.cain@cipfa.org.uk).

I hope these comments will assist the Board in its development of this significant and important revision of UK GAAP.

Yours sincerely

Paul Mason
Assistant Director
Professional Standards and Central Government
CIPFA
3 Robert Street
London WC2N 6RL
t: 020 7543 5691
e:paul.mason@cipfa.org.uk
www.cipfa.org.uk

THE FUTURE OF FINANCIAL REPORTING IN THE UK AND REPUBLIC OF IRELAND

- FRED 43 APPLICATION OF FINANCIAL REPORTING STANDARDS
- FRED 44 FINANCIAL REPORTING STANDARD FOR MEDIUM-SIZED ENTITIES

RESPONSES TO SPECIFIC QUESTIONS

The tier system Q1 Do you agree that a differential financial reporting framework, based on public accountability, provides a targeted approach to relevant and understandable financial information that contributes to discharging stewardship obligations? Q2 Do you have any further comments on the proposed application of the tier system? Q3 Appendix 1 'Note on the Legal Requirements in the United Kingdom and Republic of Ireland' to this FRED sets out a note on legal matters that are applicable to the tier system. Do you have any comments or queries on the scope or content of this Appendix?
Q1: As we noted in our response to the Consultation Paper, the definition of public accountability focuses on accountability to capital markets or fiduciary accountability to investors or depositors. Many public benefit entities are subject to stringent reporting requirements under relevant UK law or regulation, and in this sense are also publicly accountable, but we again do not suggest that the ASB should move to a wider definition. Nor do we suggest that the ASB should use different terminology to that used by the IASB which within its specific context is fit for purpose. CIPFA supports the proposed approach, setting out a differential framework based on principles rather than purely on size grounds. Having said this, it would be helpful if the approaches applicable to the different tiers and sectors were designed to provide a coherent framework and avoid fragmentation of guidance, while also reducing the one-off transition overheads in moving from UK GAAP, and supporting orderly transition between tiers. Q2: We have no further comments at this stage. However, while we appreciate that FRED 45 is principally framed in terms of application to tier 2 public benefit entities, CIPFA may wish to comment on the application of the tier system after more thoroughly considering the FRED 45 proposals. Q3: As well as reviewing company law, it may be necessary to carry out a review of relevant law relating to other sectors (principally charities) to which the FRSME will be applied. The Board may be pursuing this question in relation to its work on a proposed FRS for Public Benefit Entities.

Entities with public accountability (Tier 1) Q4 Should entities that have public accountability, satisfy all three of the size conditions of a small company or small group, and are prudentially regulated, be permitted to apply the FRSME? Q5 Are the definition of public accountability and the accompanying application guidance sufficiently clear to enable an entity to determine if it has public accountability? If not, why not?
Q4: We support the proposals. Q5: Notwithstanding our comments on terminology, we agree that the definitions of public accountability are clear.

Entities without public accountability (Tier 2)

Q6 The ASB is proposing to amend the IFRS for SMEs to comply with Company law. Do you agree with the amendments? If not, please explain your reason for disagreement and, if appropriate, suggest an alternative.

Q7 The ASB decided to evaluate possible amendments to the IFRS for SMEs using three guidelines:

(a) changes should be minimal;

(b) changes should be consistent with EU-adopted IFRS; and

(c) use should be made, where possible, of existing exemptions in Company law to avoid gold-plating.

Do you agree with these guidelines? If not, please explain why.

Q8 The ASB has amended the IFRS for SMEs to:

(a) replace section 29 Income Tax with IAS 12 ‘Income Taxes’;

(b) provide transitional relief for dormant entities with intra-group balances;

(c) exempt an entity preparing consolidated financial statements from including a parent company cash flow statement; and

(d) revise the scope of section 9 such that an entity is required to prepare consolidated financial statements only when required to do so by Company law.

Do you agree with the amendments? If not, please explain your reason for disagreement and, if appropriate, your proposed alternative.

Q6: CIPFA has not considered the detail, but we agree with the rationale for these amendments. As noted in our answer to Q3, further consideration may need to be given to the legal requirements of other entities which will report under the proposed FRSME.

Q7: CIPFA agrees substantially with the guidelines for evaluating possible amendments to the IFRS for SMEs.

However, we consider that the ‘minimal change’ guideline is too simplistic, or has been applied too rigorously without sufficient regard to other relevant factors. We support the idea that change should be minimised, without which there would be a question as to whether the resulting guidance is in any meaningful sense based on IFRS for SMEs. However, in our view insufficient weight has been given to whether the resulting FRSME package

- transitions well from UK GAAP on first adoption;
- transitions well on an ongoing basis, to or from the FRSSE, and to or from IFRS;
- works as a basis for wider application to non-profit public benefit entities; and

- provides sufficiently high quality and relevant financial reporting

In particular, we are concerned about the effect of adopting the IFRS for SME approach to recognition and measurement of certain assets. Specifically that *subsequent remeasurement* of property, plant and equipment is required to be on the basis of historical cost without recourse to the revaluation approaches available under full IFRS, the FRSSE or indeed current UK GAAP.

Historical cost often provides relevant and useful information at the time of the transaction. <u>However, for some assets historical cost approaches become progressively less relevant over time and provide significantly less useful information.</u>

In CIPFA discussions and consultations on this FRED and earlier consultations we have received considerable feedback setting out concerns over the lack of a revaluation option in the IFRS for SMEs, and most recently the proposed FRSME. Many UK GAAP preparers, including both public benefit entities and for-profit companies, have opted to use revaluation approaches under UK GAAP because this better reflects their business: the effect of the FRSME proposals would be that these entities would need to incur additional expenditure to produce less useful information. We note that the FRED allows the use of current valuations on transition, and that revaluation based information can be provided in notes. This may be very helpful to preparers who have profit-sharing, loan covenants or other contractual arrangements based on UK GAAP accounting, but we suggest that this has the effect of putting the 'real' accounts information into the notes.

Furthermore, in addition to providing less useful information and additional costs in transition, there may also be adverse effects for entities moving between tiers. This may also have the effect of reducing the quality of reporting in Tier 1 and Tier 3 in order to minimise changes on transition between FRSSE and FRSME, and between FRSME and EU adopted IFRS.

Similar issues arise in connection with Capitalisation of Borrowing Costs. The IFRS for SMEs proposes a simplified regime in which these need not, and for comparability's sake <u>must not</u>, be capitalised. While we appreciate that this has the effect of reducing the accounting burden for some entities for which this information is less useful or material, it produces less useful information and may reduce comparability for other entities such as housing associations, for which loan financed properties are a significant aspect of their public benefit operations.

In similar vein, some sector stakeholders particularly in the social housing sector are concerned over the change to the SSAP 4 approach to capital grants, requiring recognition when grant conditions are fulfilled. This contrasts with the position for Tier 1 entities where the relevant SSAP 4 options are retained in the FRSSE, and Tier 3 entities using full EU-IFRS which adopt a deferred income treatment under IAS 20.

CIPFA agrees that this is anomalous, although we consider that this may be less problematic for UK GAAP than the revaluation and capitalisation issues. Both SSAP 4 and IAS 20 are old standards, neither of which fit well with the UK and IASB conceptual frameworks. The IASB has noted that it considers IAS 20 to be deficient, but work on a revision has been deferred in the light of other priorities. In contrast we would note that

the proposal in the draft FRSME is in line with the more recently developed IPSAS 23, and in CIPFA's view this treatment works well for public sector entities. Q8: CIPFA has not considered the detail, but we agree with the rationale for these amendments, including the decision not to incorporate the IFRS for SMEs guidance on taxation. It might also be helpful if the FRSME provided signposting to similar requirements from other regulators, perhaps by referencing the FRSPBE or relevant SORP guidance.
Small entities (Tier 3) Q9 Do you agree with the proposed consequential amendments to the FRSSE? If not, why not? Please state your reason for disagreement and, if appropriate, suggest an alternative.
Q9: We have no comments to make on the FRSSE.
Reduced disclosures for subsidiaries Q10 – Q14
Q10-Q14: We have no comments to make on these disclosure proposals.
SORPs for profit-seeking entities Q15 Do you agree with the detail of the ASB's proposal to streamline the number of SORPs for profit-seeking entities? If not, why not?
Q15: We have no comments to make on these proposals.

Draft impact assessment

Q16 Do you agree with the benefits that have been identified as arising after adoption of the proposed Financial Reporting Framework? If not, why not? Please provide examples, including quantification where possible, of any benefits you believe have not been taken into account.

Q17 In relation to the case study scenarios identifying the likely costs of transition for certain entities, do you agree with the nature and range of costs identified? If not, please provide details of any alternatives you would propose, including any comments on the assumptions underlying the calculation of the costs.

Q18 The [draft] Impact Assessment also gives an indication of the impact on the 'main affected groups'. Do you agree with this analysis? If not, why not?

Q19 The benefits are hard to quantify; do you agree that they outweigh the costs of transition and any ongoing incremental costs? Do you have any comments on the estimates used?

Q20 The ASB is proposing an effective date of July 2013, with early adoption permitted, which assumes an 18 month transition period. The ASB's rationale for this date is set out in paragraphs 11.121 to 11.126. Early adoption will permit entities to secure benefits as soon as possible, however other entities may wish to defer the effective date to permit businesses more time to prepare for transition. Do you agree with the proposed effective date and early adoption? If not, what would be your preferred date, and why?

Q21 Please provide any other comments you may have on the [draft] Impact Assessment.

Q16 – Q19. We agree in broad terms with the Draft impact assessment, although we are not sure that it encompasses all of the costs. We have had feedback from some accounts preparers suggesting that some of the changes may have adverse effects for both formal contracts and informal arrangements with third parties which are based upon consideration of headline figures in financial statements. We have some hopes that this will be minimised by the FRSME allowing the use of existing carrying values as deemed cost, and disclosure of 'old style' revaluation based information in the notes.

We hope that it will be possible to pursue any additional requirements from the FRSPBE and derived SORPs without significant additional expenditure.

Q20 The effective date will be quite an ambitious one for public benefit preparers, not least because the FRSPBE consultation will also need to be completed, and this will be the starting point for the development of SORP guidance, which will need to be subject to a further round of consultation and refinement.

Alternative view *Boundary between Tier 1 and Tier 2* Q22 - Q23 *Accounting requirement for entities falling into Tier 2 (FRSME)* Q24 - Q25 *Boundary between Tier 2 and Tier 3* Q26 - Q27
Q22-Q27 We have no comments to make on the Alternative View.