

IPSASB Consultation Paper
Measurement

**Response from the Chartered Institute of
Public Finance and Accountancy (CIPFA)**

10 October 2019

CIPFA, the Chartered Institute of Public Finance and Accountancy, is the professional body for people in public finance. CIPFA shows the way in public finance globally, standing up for sound public financial management and good governance around the world as the leading commentator on managing and accounting for public money.

Further information about CIPFA can be obtained at www.cipfa.org

Any questions arising from this submission should be directed to:

Don Peebles

Head of CIPFA Policy & Technical UK
CIPFA
Level 3 Suite D
160 Dundee Street
Edinburgh
EH11 1DQ
Tel: +44 (0)131 221 8653
Email: don.peebles@cipfa.org

Steven Cain

Technical Manager
CIPFA
77 Mansell Street
London
E1 8AN
Tel: +44 (0)20 543 5794
Email: steven.cain@cipfa.org

Our ref: Responses/ 191010 SC0259

IPSASB Consultation Paper *Measurement*

CIPFA is pleased to present its comments on this consultation paper which has been reviewed by CIPFA's Accounting and Auditing Standards Panel.

The issue of measurement is a key matter for financial reporting, and CIPFA was conscious that the discussion of this matter in the development of the IPSAS Conceptual Framework left some matters unresolved. In our response to IPSASB Conceptual Framework Exposure Draft Phase 3 - *Measurement of Assets and Liabilities in Financial Statements* we suggested that it would be appropriate to set out more detailed requirements for specific measurement bases in standards.

Since then, the IASB has completed its rationalisation of approaches in IFRS and developed a standard for consistent application of fair value reporting in IFRS 13 *Fair Value Measurement*. Against this more stable backdrop IPSASB is better placed to consider how to provide standards and guidance which best supports the alignment between IFRS and IPSAS, having regard to issues around understandability, and minimising confusion due to overlaps in terminology. The approach proposed in the Consultation Paper is structurally similar to that taken in IFRS through the combination of its conceptual framework, IFRS 13, and standards on specific topics. CIPFA supports this approach.

Responses to the Preliminary Views and Specific Matters for Comment in the Consultation Paper are attached as an Annex.

These relate primarily to the content of a proposed IPSAS *Measurement*. However, in our comments on SMC 1, we reflect on other amendments which the Board will be progressing, including in the Conceptual Framework. We suggest it would be helpful to review the handling of Market Value, and to refer to and explain the concept of Value in Use. In our view Value in Use is a key concept affecting the valuation of many public sector assets, even where the final calculation is on a different (generally more objectively measurable) basis.

In general, CIPFA supports the proposals. However, we found it much more difficult to come to a view in respect of the proposals on borrowing costs. Unlike the majority of the proposals which are mainly rationalising or clarifying existing IPSAS, Preliminary View 7 is proposing a substantive change to extant IPSAS 5, *Borrowing Costs* by requiring that borrowing costs relating to qualifying assets are not capitalized. The core of the reasoning is that

- it is impractical to capitalize all borrowing costs
- there are also some assets whose construction is not funded by borrowing
- if a capitalization approach is taken for some assets, comparability issues arise both with those assets which are not funded by borrowing, and any assets where capitalization is not carried out

While we agree with the majority of this analysis, we are not fully convinced by the arguments to adopt Option 4 (and thus to prohibit the capitalization of borrowing costs) on the basis that this straightforwardly provides more useful information. In CIPFA's view there is a much more difficult balance of arguments for and against capitalization, and it may be more relevant to frame this discussion more explicitly in terms of practicality and cost-benefit issues.

We hope this is a helpful contribution to IPSASB's work in this area.

RESPONSES TO PRELIMINARY VIEWS AND SPECIFIC MATTERS FOR COMMENT

Preliminary View 1: the fair value, fulfilment value, historical cost and replacement cost measurement bases require application guidance.

Preliminary View 2: the application guidance for the most commonly used measurement bases should be generic in nature in order to be applied across the IPSAS suite of standards. Transaction specific measurement guidance will be included in the individual standards providing accounting requirements and guidance for assets and liabilities.

Preliminary View 3: guidance on historical cost should be derived from existing text in IPSAS. The IPSASB has incorporated all existing text and considers Appendix C: Historical Cost– Application Guidance for Assets, to be complete.

Preliminary View 4: fair value guidance should be aligned with IFRS 13, taking into account public sector financial reporting needs and the special characteristics of the public sector. The IPSASB considers Appendix A: Fair Value–Application Guidance, to be complete.

Preliminary View 5: fulfilment value guidance should be based on the concepts developed in the Conceptual Framework, expanded for application in IPSAS. The IPSASB considers Appendix B: Fulfilment Value–Application Guidance, to be complete.

Preliminary View 6: replacement cost guidance should be based on the concepts developed in the Conceptual Framework, expanded for application in IPSAS. The IPSASB considers Appendix D: Replacement Cost–Application Guidance, to be complete.

CIPFA agrees with Preliminary Views 1 to 6. In particular, we agree:

- that the fair value, fulfilment value, historical cost and replacement cost measurement bases require application guidance.
- that this should be provided through application guidance for the most commonly used measurement bases which is generic in nature, with transaction specific measurement guidance being included in individual standards.

We are also content with the approach to developing this guidance, and the specific proposals in Appendices A, B, C and D

Preliminary View 7

The IPSASB's Preliminary View is that all borrowing costs should be expensed rather than capitalized, with no exception for borrowing costs that are directly attributable to the acquisition, construction, or production of a qualifying asset.

Do you agree with the IPSASB's Preliminary View?

If not, please state which option you support and provide your reasons for supporting that option.

The IPSASB has identified four options for treatment of borrowing costs for a qualifying asset during the period between the start of acquisition/construction/production and active use. Each of these has advantages and disadvantages. In the commentary below we will focus mainly on Option 2 and Option 4.

CIPFA agrees with the reasoning in paragraph 3.20 that conceptually (and specifically having regard to the economic substance of transactions) the cost of creating, constructing or developing a usable asset should include all costs necessarily incurred in the creation/construction/development process. This may involve purchases of goods and services, related consumption of assets already owned by the entity, employee costs allocated to asset creation, and finance costs.

We would note that asset creation is generally conducted through a series of exchange transactions, each of which is designed to achieve equal or greater value for the entity. While there may be inefficiencies or waste, the overall effect should be to obtain an asset of commensurate value with the total cost, including finance costs.

In line with the above, CIPFA considers that (in contrast to Option 4) applying Option 2 to a qualifying asset in respect of which borrowing was incurred:

- more faithfully represents the cost of the asset
- is likely to better reflect the underlying operational capacity of the asset or its service potential
- is likely to provide a value which is more comparable to similar assets purchased from third parties, which implicitly include financing costs in the price.

CIPFA also agrees with paragraph 3.22 which explains that Option 2 potentially has disadvantages in terms of comparability between qualifying assets where attributable borrowing was incurred with assets with no attributable borrowing.

However, while we agree that this may lead to users incorrectly attributing greater operational capacity to asset measurements which include borrowing costs, we suggest that this is not because those assets are overvalued. The main implication is that the other assets are undervalued because no account has been taken of explicit or implicit costs of capital. Adopting Option 4 therefore means that total asset values are reduced, and are likely to become less aligned with economic substance.

CIPFA agrees that as a benefit of Option 4, greater comparability may be achieved between different assets constructed by the entity, and between different entities which have constructed assets. We would note however that this is somewhat balanced by

reduced comparability between assets which are constructed by the entity and assets which the entity purchases from third party constructors, and between entities which have different balances of self-constructed assets and purchased constructed assets.

CIPFA agrees that there may be public sector differences as set out in 3.24 in that borrowing is often centralised and funding is often not specifically allocated to specific assets, although we are by no means certain that the first of these issues is unique to the public sector.

In the light of the above factors, without consideration of other matters we would find it difficult to unreservedly support the views at 3.27 that allowing any form of capitalizing borrowing cost will diminish comparability, and that excluding borrowing costs from the cost of assets will provide more useful information. In CIPFA's view, the position is much more balanced:

- Option 2 is potentially problematic due to issues with arbitrariness, practicality and cost, and does raise some issues in connection with comparability.
- Option 4 seeks to maximise comparability (while not altogether avoiding comparability issues), but does so by reducing alignment with economic substance.

In seeking to resolve the above issues, it may be helpful to separately consider the issues having regard to the fact that preparers of public sector financial statements may already follow two different approaches to the balance between faithful representation and the other qualitative characteristics of useful information, and these approaches are both legitimately supported by the IPSAS canon.

- Approach 1 - adopting the revaluation model for subsequent measurement of assets, and more generally adopting current value bases which seek to maintain close alignment with economic substance.
- Approach 2 - adopting the cost model for subsequent measurement, reflecting on the practical and resource difficulties that may be faced in maintaining close alignment with economic substance, and the arbitrary factors that may be addressed if these cannot be resolved. While there is less emphasis on economic substance, the information produced still acts as a useful benchmark, and may in some ways be more objective and understandable.

Having regard to the above, it seems likely that the concerns we have expressed in connection with alignment with economic substance impact substantially on those following Approach 1. However, while this misalignment may be problematic for initial recognition at cost, we would note that the effect is temporary due to the application of the revaluation model.

By way of contrast, we suggest that those following Approach 2 and mainly applying the cost model have already accepted that over time there will be a degree of misalignment with economic substance, and the primary emphasis is on maintaining a workable benchmark.

Preliminary View 8

The IPSASB's Preliminary View is that transaction costs in the public sector should be defined as follows:

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of an asset or liability and would not have been incurred if the entity had not acquired, issued or disposed of the asset or liability.

Preliminary View 9

The IPSASB's Preliminary View is that transaction costs should be addressed in the IPSAS, *Measurement* standard for all IPSAS.

Preliminary View 10

The IPSASB's Preliminary View is that transaction costs incurred when entering a transaction should be:

- Excluded in the valuation of liabilities measured at fulfilment value;
- Excluded from the valuation of assets and liabilities measured at fair value; and
- Included in the valuation of assets measured at historical cost and replacement cost.

Preliminary View 11

The IPSASB's Preliminary View is that transaction costs incurred when exiting a transaction should be:

- Included in the valuation of liabilities measured at fulfillment value;
- Excluded from the valuation of assets and liabilities measured at fair value; and
- Excluded in the valuation of assets measured at historical cost and replacement cost.

CIPFA agrees with Preliminary views 8 to 11.

The definition is appropriate, and we support addressing the treatment in the overarching measurement standard.

We agree with the treatments for the valuation bases, which are consistent with the rationale underlying the use of each basis when entering or exiting a transaction.

Specific Matter for Comment 1

Definitions relating to measurement have been consolidated in the core text of the Illustrative ED.

Do you agree that the list of definitions is exhaustive?

CIPFA agrees that the list of definitions proposed for the IPSAS *Measurement* is exhaustive.

However, having regard to further amendments which the Board will be progressing, including in the Measurement chapter in the Conceptual Framework it would be appropriate to review the handling of Market Value, and to refer to and explain the concept of Value in Use (ViU).

We note that that the CP proposals align IPSAS fair value with fair value in IFRS, and so reflect exit based market value with no confusion over terminology. The proposals in respect of replacement cost also incorporate consideration of entry based market value where this is appropriate. It may therefore no longer be necessary for the Conceptual Framework to include a Market Value basis which encompasses both exit and entry values.

Value in Use seeks to capture the (present) value of an asset to the entity in terms of the benefits it will gain from using the asset. This seems particularly relevant for financial reporting on public sector assets, where the distinguishing features of measurement are grounded in the use of assets to provide public services rather than for cash generating purposes. This basis is not used for general purpose measurement because it is relatively difficult to operationalise, both for cash generating assets and non-cash generating assets. However, it remains important conceptually, even though it is only used in standards as part of impairment testing.

Specific Matter for Comment 2

Guidance in International Valuation Standards (IVS) and Government Financial Statistics (GFS) has been considered as part of the Measurement project with the aim of reducing differences where possible; apparent similarities between IPSAS, IVS and GFS have been noted. Do you have any views on whether the IPSASB’s conclusions on the apparent similarities are correct?

Do you agree that, in developing an Exposure Draft, the IPSASB should consider whether the concepts of Equitable Value and Synergistic Value should be reviewed for relevance to measuring public sector assets (see Addendum B)?

CIPFA agrees that a review of the relevance of these measurement bases should be considered.

Specific Matter for Comment 3

Do you agree that the measurement flow charts (Diagrams 4.1 and 4.2) provide a helpful starting point for the IPSASB to review measurement requirements in existing IPSAS, and to develop new IPSAS, acknowledging that other matters need to be considered, including:

- The Conceptual Framework Measurement Objective;
- Reducing unnecessary differences with GFS;
- Reducing unnecessary differences with IFRS Standards; and
- Improving consistency across IPSAS.

CIPFA agrees that Diagrams 4.1 and 4.2 provide a helpful starting point for the IPSASB to review measurement requirements in existing IPSAS.