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CIPFA RESPONSE TO FRED 30 'FINANCIAL INSTRUMENTS DISCLOSURE AND PRESENTATION & RECOGNITION AND MEASUREMENT'

October 2002

CIPFA

CIPFA is one of the leading professional accountancy bodies in the UK and the only one which specialises in the public sector. It is responsible for the education and training of professional accountants and for their regulations through the setting and monitoring of professional standards. Uniquely among the professional accountancy bodies in the UK, CIPFA has responsibility for setting accounting standards for a significant part of the economy, namely local government. CIPFA's members work (often at the most senior level) in public service bodies, in the national audit agencies and major accountancy firms. They are respected throughout for their high technical and ethical standards, and professional integrity. CIPFA also provides a range of high quality advisory, information and training and consultancy services to public service organisations. As such, CIPFA is the leading independent commentator on managing and accounting for public money.

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CIPFA RESPONSE TO FRED 30 FINANCIAL INSTRUMENTS DISCLOSURE AND PRESENTATION & RECOGNITION AND MEASUREMENT

GENERAL COMMENTS - FRED 30

1. CIPFA welcomes the opportunity to respond to FRED 30. This response has been prepared by CIPFA's Accounting and Auditing Standards Panel ('the Panel'), with additional input provided by CIPFA's Treasury Management Panel.

2. The main content of this response is CIPFA's response to the International Accounting Standards Board's consultation on the Exposure Draft of Improvements to IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement* (attached). Additional comment relevant to the UK context and responses to the ASB's specific questions are included in this preamble.

Application in the Public Sector

3. The Panel has had an initial consideration of how the proposals may be applied in the public sector. We understand that the Treasury is considering the possible impacts of FRED 30 in a central government context. The Panel cannot, of course, predict the decisions that will be taken by government or the CIPFAJLASAAC on the application of the standard. However the Panel hopes that the ideas set out below will be contemplated by the ASB in its further considerations.

4. Assets and liabilities arising from taxation are not contractual and do not meet the definition of financial assets and liabilities. Likewise debt transferred between authorities, or obligations in respect of debt held by another authority, in accordance with a statutory instrument on reorganisation are non-contractual.

5. Local authority accounts are based on a mixed measurement model and it is therefore unclear whether the proposed approach would include local authorities. At present the local authorities SORP requires that investments be carried at historical cost less provision for loss in value.

6. Local authorities are not permitted to use hedging, and thus much of the standard will not be applicable in this sector. However the prohibition on hedging may mean that other parts of the FRED have unforeseen consequences. For example, because of this law many local authorities manage their interest rate exposures through debt restructurings.

7. Where a local authority undertakes regular debt restructurings this may be seen as the authority holding 'a portfolio of identified financial instruments that are managed together for which there is evidence a recent actual pattern of short-term profit-taking.' This would result in local authority debt being classified as held for trading, in that the authority is actively seeking to manage its risks.

8. Were an authority to adopt a fair value approach to measuring its capital borrowing at fair value the Panel is of the view that it is difficult to describe Public Works Loan Board debt as available in an active market. The Panel considers that robust

estimation techniques would be required. However it is not clear at this stage what form these might take.

9. Local authorities invest and borrow in the money markets for cash flow management purposes. Such assets and liabilities will generally be classified as held for trading and in this case the Panel can see no reason in principle why the treatments applied to instruments held for trading should not apply to these financial assets and liabilities.

10. Concerns have been expressed that the description ‘held for trading’ may be inappropriate for the public sector as, generally, holding assets for the specific purpose of trading would be seen as improper. In many cases it may be *ultra vires*. Thus the Panel considers that different terminology may be required in the public sector, such as ‘held for treasury management’.

11. Many local authorities have portfolios of mortgage assets granted under housing legislation. The Panel would anticipate that these would be classified as loans and receivables originated by the entity as these are not granted with the intention of sale. However authorities are able to sell these portfolios and in certain circumstances it might be necessary to consider classification as ‘available for sale’.

12. The CIPFAI/LASAAC Joint Committee has on its work programme a reconsideration of the treatment of premiums and discounts on the redemption or rescheduling of local authority debt. It is our understanding that, as gains or losses on liabilities measured at amortised cost are recognised in profit and loss on derecognition, premiums and discounts would not be deferred. The Panel would expect the Joint Committee to give FRED 30 due weight in developing its proposals.

ANSWERS TO SPECIFIC QUESTIONS — FRED 30

Q(i) *Treating L4Ss 32 and 39 as a package (Appendix III, paragraph 15)—The ASB has concluded that it is best to view the requirements in L4Ss 32 and 39 as a single package of requirements that should, as far as is practicable, be implemented in the UK at a single point in time. Do you share this view?*

A Agree. The Panel believes that the usability of the standards could be improved by their integration, both in a single IAS and a single FRS.

Q(ii) *Implementation in 2004 (Appendix III, paragraphs 17-20)—Notwithstanding the general approach referred to in (i) above, the ASB is proposing to implement, at a single point in time, some parts of the standards in mandatory form, some in non-mandatory form and some not at all for the time being. At the same time, it is proposing to withdraw FRSs 4 and 13 (and related UITF Abstracts) and keep in place most parts of FRS 5. Do you believe that, in the circumstances, this represents the best possible approach of implementing in the UK the international requirements in this area?*

A Agree. The Panel recognises that (until the EU regulation mandating IAS comes into effect, thus overriding the relevant provisions of the Companies Act for listed groups) many of the proposed requirements can be adopted only using the fair value accounting rules in companies legislation. Nevertheless the Panel has concerns about allowing otherwise similar entities to adopt very different 'measurement models for similar transactions. Allowing a variety of alternative measurement bases may undermine comparability.

Hedge accounting is in any case optional — it is open to any preparer not to designate instruments as hedges. We presume that it is not proposed to allow forms of hedge accounting prohibited under the standard during the non-mandatory period. If this is the intention, this will seriously undermine comparability and call the credibility of UK standards in this area into question. The Panel would support an unambiguous requirement that any entity adopting hedge accounting during the non-mandatory period should be required to do so only by applying the standard.

The Panel has some concerns regarding the (de)recognition requirements of IAS 39. While these are not included in FRED 30 we would particularly thaw your attention to our views as expressed in paragraph 3 of our general comments to. the IASB and the response to IASB question 2.

Q(iii) *Recognition and derecognition (Appendix III paragraphs 23-29)-The FRED proposes that the proposed new IAS 39 approach to recognition and derecognition should not be implemented in the UK at the present time: Instead, when the direction of international convergence on this subject becomes clearer, a further consultation document will be issued. Do you agree with this approach?*

A Agreed. The Panel has misgivings about the approach proposed by the IASB, although it is superior to the current approach in IAS 39. It would be preferable to retain FRS *5* for UK use until the recognition elements of IAS 39 have been properly addressed.

Q(iv) Measurement (Appendix III, paragraphs 30-49)-The ASB is proposing that, prior to 2005, companies should be required to adopt IAS 39's measurement requirements 'only if they choose to adopt the fair value accounting rules that will be set out in companies legislation. Entities that do not choose to adopt those rules will not initially be required by UK standards to adopt the measurement requirements at all.

(a) *Do you agree with this approach?*

A See response to question 2

(b) *Do you agree that the recycling requirements of US 39 should not be implemented in the UK pending completion of the project on reporting financial performance and do you agree with the alternative treatment proposed in the FRED? (Appendix III paragraphs 50-52)*

A Agree

Q(v) *Hedge accounting—The ASB is proposing a similar approach to US 39 's hedge accounting requirements as to its measurement requirements. (Appendix III paragraphs 5 7-63, 69 and 70)*

(a) *Do you agree with this approach?*

A See response to question 2

(b) *Do you agree that the approach being proposed in place of recycling? (Appendix III paragraphs 64-68)*

A Agree

Q(vi) Unlisted entities and individual financial statements

(a) *The FRED proposes that, prior to 2005, entities should be required to comply with US 39 's measurement and hedge accounting provisions in certain circumstances only. That will change in 2005 for the consolidated financial statements of listed entities but, the FRED suggests, not for other entities or other types of financial statement Thus, from 2005 listed entities that do not prepare consolidated financial statements and unlisted entities will not be required to adopt US 39 's measurement and hedge accounting provisions unless they choose to adopt the fair value accounting rules set out in the Companies Act 1985. 'Similarly, listed entities that prepare consolidated financial statements will not be required to adopt US 39 '.s measurement and hedge accounting provisions in their individual financial statements unless they adopt the fair value accounting rules in those financial statements. Do you agree with this approach?*

A See response to question 2

(b) *FRS 13 's disclosure requirements apply only to entities, other than insurance entities, that are listed or have publicly-traded securities and all banks. The ASB is proposing to revise the disclosure requirements on 1 January 2004 and to apply those new requirements to all listed entities, all other entities that have publicly-traded securities and all banks (in other words, the exemption for listed insurance entities' will be removed, but otherwise the scope will be unchanged). Do you agree with this approach or do you believe that, from 2004, the requirements should apply to some other entities (for example, unlisted insurance companies) or, alternatively, to a narrower range of entities?*

A Agree

(c) *FRS 13 's disclosure requirements apply both to consolidated financial statements and to individual financial statements, except that they do not need to be applied in the individual financial statements of entities that are preparing FRS 13-compliant consolidated financial statements. The FRED proposes to retain a similar exemption. Do you agree with this approach?*

A Agree

CL 29

CIPFA RESPONSE TO IASB EXPOSURE DRAFT ‘AMENDMENTS TO IAS 32 FINANCIAL INSTRUMENTS: DISCLOSURE AND PRESENTATION, AND IAS 39 FINANCIAL INSTRUMENTS: RECOGNITION & MEASUREMENT

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CIPFA RESPONSE TO IASB EXPOSURE DRAFT 'AMENDMENTS TO IAS 32 FINANCIAL INSTRUMENTS: DISCLOSURE AND PRESENTATION, AND IAS 39 FINANCIAL INSTRUMENTS: RECOGNITION & MEASUREMENT

GENERAL COMMENTS – IAS 32/39

1. CIPFA welcomes the opportunity to respond to the consultation on the improvements to IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement.* This response has been prepared by CIPFA's Accounting and Auditing Standards Panel ('the Panel').

2. Overall the Panel supports the IASB's ('the Board') approach of seeking improvements to these standards while the longer-term project to develop a new framework of accounting for financial instruments is under development. However the Panel considers that the improvements proposed do not address the more fundamental concerns with these standards, particularly IAS 39. It is the Panel's view that these changes should not be allowed to substitute for a more fundamental review. We therefore applaud the Board's commitment to make this a priority project.

3. The recognition provisions of IAS 39 remain a concern. Detailed comments on this issue are set out in response to the consultation questions. However the Panel wishes to highlight its view that derecognition criteria are crucial to ensuring the credibility of financial reporting. This is particularly true because the Enron affair has focused public attention on off balance sheet treatments.

4. The Panel welcomes the emphasis in the 'continuing involvement' approach on treating separable elements individually. The Panel also acknowledges that this is clearly a principles based approach. Nevertheless concerns remain that the 'continuing involvement' approach might allow contracts to be structured that would allow derecognition criteria to be met even while an entity is in substance exposed to contractual risks.

5. With regard to hedge accounting, although the Panel does not disagree with paragraph 146 as such, this area does give grounds for concern. The threshold prescribed for high effectiveness seems arbitrary. (Why not 79.5% or 90%?). This approach may lead to a 'compliance culture' where this relationship is taken as conclusive proof of high effectiveness.

6. The threshold also seems incompatible with the statement in paragraph 151 that 'this standard does not specify a single method of assessing hedge effectiveness'. Hence the Panel concludes that the 80% test is meant to represent a minimum requirement for high effectiveness. The Panel would therefore prefer an approach that reworded these provisions to indicate unmistakably that the 80% test is a necessary, rather than a sufficient, condition of high effectiveness.

7. More generally, the Panel has substantial concerns about the 'user-friendliness' of these standards. It is accepted that the complexity of the transactions, and the mixed measurement model, make the requirements inherently complicated. However the structure and language of the standards are so complex and difficult as to make the already complicated requirements incomprehensible, even to many 'technical' accountants. The Panel therefore has grave concerns about the ability of many 'ordinary' practitioners to cope. Such impenetrability undermines compliance and brings the standards-setting process into disrepute.

8. These difficulties are particularly acute on first time application. Our concerns are therefore particularly timely as many European entities prepare to adopt IAS. In this context we note that experience shows that implementation can take some companies two years. The Panel therefore strongly advocates a 'usability' review of the revised standards prior to the publication. We would see two possible, and separable, elements to this review – a review to ensure the use of plain language and a degree of 'field-testing'. A small investment of time in this regard would pay significant dividends in improved comprehension and credibility for the standards.

ANSWERS TO SPECIFIC QUESTIONS – IAS 32

Q1 ***Probabilities of different manners of settlement (paragraphs 19, 22, and 22A)****—Do you agree that the classification of a financial instrument as a liability or as equity in accordance with the substance of the contractual arrangements should be made without regard to probabilities of different manners of settlement? The proposed amendments eliminate the notion in paragraph 22 that an instrument that the issuer is economically compelled to redeem because of a contractually accelerating dividend should be classified as a financial liability. In addition, the proposed amendments require a financial instrument that the issuer could be required to settle by delivering cash or other financial assets, depending on the occurrence or non-*

occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder of the instrument, to be classified as a financial liability, irrespective of the probability of those events or circumstances occurring (paragraph 22A).

A The Panel considers that, where a financial instrument gives rise to an obligation to deliver cash or other financial assets and it is not within the reporting entities control to avoid the obligation or to settle the obligation in another form, the obligation should be classified as a liability. The amendments proposed will reinforce this general principle and are therefore welcome.

The Panel notes that the definition of a financial liability (paragraph 5) on which this passage depends continues to refer to 'a contractual obligation.' The Panel accepts that, in the field of financial instruments, contractual commitments will predominate. However it is the Panel's view that the standard would be significantly improved by widening the definition to expressly include constructive obligations.

Q2 ***Separation of liability and equity elements (paragraphs 28 and 29)****—Do you agree that the options in IAS 32 for an issuer to measure the liability element of a compound financial instrument initially either as a residual amount after separating the equity element or based on a relative-fair-value method should be eliminated and, instead, any asset and liability elements should be separated and measured first and then the residual assigned to the equity element?*

A The equity element of any compound instrument should be the residual amount after deduction of all liability elements.

Q3 ***Classification of derivatives that relate to an entity's own shares (paragraphs 29C – 29G)****—Do you agree with the guidance proposed about the classification of derivatives that relate to an entity's own shares?*

A Agree.

Q4 ***Consolidation of the text in IAS 32 and IAS 39 into one comprehensive Standard****—Do you believe it would be useful to integrate the text in IAS 32 and IAS 39 into one comprehensive Standard on the accounting for financial instruments? (Although the IASB Board* *is not proposing such a change in this Exposure Draft, it may consider this possibility in finalising the revised Standards.)*

A The Panel would welcome the integration of IAS 32 and IAS 39 into one standard as part of a project to improve the usability of the standards advocated in paragraphs 7 – 8 of our general comments.

ANSWERS TO SPECIFIC QUESTIONS – IAS 39

Q1 ***Scope: loan commitments (paragraph 1(i))****— Do you agree that a loan commitment that cannot be settled net and the entity does not designate as held for trading should be excluded from the scope of IAS 39?*

A Agree

Q2 ***Derecognition: continuing involvement approach (Appendix I, paragraphs 35-57)****—Do you agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets under IAS 39? If not, what approach would you propose?*

A The Panel acknowledges that there is much in the 'continuing involvement' approach to be welcomed. The existing requirements of IAS 39 are, as the Board has recognised, an unsatisfactory compromise between the 'control components' approach and the 'risks and rewards' approach. As an approach to producing interim improvements to an existing standard the Panel is not opposed to a 'continuing involvement' approach.

In particular the Panel agrees that a components approach should be the basis of the derecognition model. The Panel also agrees that components in which the entity has no on-going involvement should be derecognised.

The fundamental weakness, however, in basing the derecognition model on 'continuing involvement' is that this only succeeds in recasting many of the problems around derecognition in terms of the question "what constitutes 'continuing involvement'?"

The Panel is concerned that the emphasis placed on contractual provisions in determining continuing involvement is unduly narrow. Contractual provisions should certainly be the basis of any analysis.

However in order to be sure of capturing the full economic substance of a transaction, the analysis should not be restricted to contractual terms alone. In particular the Panel is of the view that the quantum of the continuing involvement should reflect the reporting entity's full potential exposure to the retained elements. The Panel is also concerned that a reliance solely on contractual terms may present opportunities for 'creative finance' aimed only at avoiding financial reporting requirements.

The Panel therefore believes that the continuing involvement approach needs to be extended to capture the full economic effects of a transaction or its separable components. To validate derecognition of an asset it should be necessary to demonstrate that the reporting entity has in substance no continuing involvement in the asset.

Q3 ***Derecognition: pass-through arrangements (Appendix I, paragraph 41)****—Do you agree that assets transferred under pass-through arrangements where the cash flows are passed through from one entity to another (such as from a special purpose entity to an investor) should qualify for derecognition based on the conditions set out in paragraph 41 of the Exposure Draft?*

A Agree. The Panel compared the proposed treatment to the current treatment under UK GAAP. This would permit derecognition only when substantially all the risks and benefits in the asset had been transferred. The requirements of FRS 5 in relation to use of 'linked presentation' are similar to those in the draft revised IAS 39 for derecognition in the case of a pass-through transaction. The conditions outlined in paragraph 41 adequately describe the circumstances in which the entity has no continuing involvement, i.e. the risks and benefits of the asset (or relevant part of the asset) have transferred.

Q4 ***Measurement: fair value designation (paragraph 10)****—Do you agree that an entity should be permitted to designate any financial instrument irrevocably at initial recognition as an instrument that is measured at fair value with changes in fair value recognised in profit or loss?*

A The Panel agrees with the Board's analysis that permitting any asset to be designated as held-for-trading (and thus measured at fair value) greatly simplifies the requirements and structure of the standard. The basic approach is therefore welcomed.

As currently worded the definition of held-for-trading appears to allow entities the scope to designate individual instruments as held-for-trading without adopting a consistent policy. The Panel is concerned that this could be abused to allow entities to 'cherry pick' favourable instruments. Consideration should be given to permitting designation only as part of a consistent policy applied to classes of asset.

Q5 **Fair value measurement considerations (paragraphs 95 – 100D)**—*Do you agree with the requirements about how to determine fair values that have been included in paragraphs 95 – 100D of the Exposure Draft? Additional guidance is included in paragraphs A32 – A42 of Appendix A. Do you have any suggestions for additional requirements or guidance?*

A Agree.

Q6 ***Collective evaluation of impairment (paragraph 112 and 113(a)-113(d))****— Do you agree that a loan asset or other financial asset measured at amortised cost that has been individually assessed for impairment and found not to be individually impaired should be included in a group of assets with similar credit risk characteristics that are collectively evaluated for impairment? Do you agree with the methodology for measuring such impairment in paragraphs 113A-113D?*

A The Panel is concerned that collective impairment testing offers the opportunity for reporting entities to smooth results. It is acknowledged that, for many classes of asset, it is possible to predict with reasonable accuracy the overall level of impairment but more difficult to assess reliably for individual assets. However the Panel is of the view that the emphasis should be on individual impairment testing. It would be reasonable to restrict collective impairment testing to assets where there was reliable empirical evidence that a given level of impairment was predictable.

Q7 **Impairment of investments in available-for-sale financial assets (paragraphs 117 – 119)**—*Do you agree that impairment losses for investments in debt and equity instruments that are classified as available for sale should not be reversed?*

A Disagree. To the extent that impairments have been recognised in profit and loss they should be reversed out in the same way.

(The Panel notes that the treatment proposed in paragraphs 117 – 118 would require the recycling of gains recognised in equity to profit and loss on impairment. The Panel does not support the recycling of gains and losses. However we recognise that this is a pre-existing treatment not included within the scope of the improvements project. 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 welcome indications in the most recent project summary issued by the Board, which suggest that recycling of these gains and losses would be prohibited.)

Q8 ***Hedges of firm commitments (paragraphs 137 and 140)****—Do you agree that a hedge of an unrecognised firm commitment (a fair value exposure) should be accounted for as a fair value hedge instead of a cash flow hedge as it is at present?*

A Agree.

Q9 ***'Basis adjustments' (paragraph 160)****—Do you agree that when a hedged forecast transaction results in an asset or liability, the cumulative gain or loss that had previously been recognised directly in equity should remain in equity and be released from equity consistently with the reporting of gains or losses on the hedged asset or liability?*

A Agree.

Q10 ***Prior derecognition transactions (paragraph 171B)****—Do you agree that a financial asset that was derecognised under the previous derecognition requirements in IAS 39 should be recognised as a financial asset on transition to the revised Standard if the asset would not have been derecognised under the revised derecognition requirements (i.e. that prior derecognition transactions should not be grandfathered)? Alternatively, should prior derecognition transactions be grandfathered and disclosure be required of the balances that would have been recognised had the new requirements been applied?*

A The Panel accepts that this treatment is conceptually correct. The Panel is concerned that this may prove onerous in practice, but as the information requirements of disclosure are essentially the same that option cannot be considered superior.