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Response to the ASB's exposure draft
The Future of Financial Reporting in the UK and ROI

30 April 2012

Saffery Champness

CHARTERED ACCOUNTANTS

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1 INTRODUCTION

Saffery Champness is delighted to have this opportunity to comment on the exposure draft, *The Future of Financial Reporting in the UK and ROI*, published by the ASB on 30 January 2012.

Our main concern is with the impact of the proposals on businesses engaged in agriculture activities and accordingly we are submitting a detailed response to Question 5(a) which asks:

In relation to the proposals for specialist activities, the ASB would welcome views on whether and, if so, why the proposals for agriculture activities are considered unduly arduous? What alternatives should be proposed?

We set out below specific comments regarding the practicalities of compliance, the impact on a farming business, more general comments and proposed alternatives.

2 WHO WE ARE

2.1 Saffery Champness is an independent top 20 firm of chartered accountants with nine offices across the UK and offices in Guernsey and Geneva. We focus particularly on advising owner-managed businesses in a variety of commercial sectors, wealthy individuals, families and trusts, charities, other not-for-profit organisations and landed estates.

2.2 We are the leading accountancy, tax and business advisers to landowners and our Landed Estates Group specialises in advising landowners and rural businesses on financial and tax matters.

2.3 In particular, we prepare accounts and tax returns for a significant number of agricultural businesses which would be affected by the ASB's proposals. These businesses cover well over 3 million acres in the UK.

3 OVERVIEW

3.1 Fair value is an important accounting tool for recording the holdings and trading in complex financial instruments which are often traded for short term financial gain.

3.2 The businesses which engage in this activity tend to be large and with an international reach. The ownership structure is typically diverse, often through a listing. It is important that these businesses can present internationally understood financial data to shareholders who are likely to have very limited contact with the daily running of the business and who often need to make rapid investment decisions.

3.3 The farming sector in the UK is characterised by many small businesses, some incorporated but many not. Those engaged in the farming activity tend to be owners of the farming business and if not, they are usually closely linked with the owners. Owners of farming businesses tend to be there for the long term and are not generally concerned with short term investment decisions.

3.4 It is difficult to see how, in this context, imposing fair value as a measurement requirement on the agricultural sector is likely to provide useful information. Yet imposing it will mean farming businesses, typically not resourced by sophisticated accounting back offices, will be faced with a significantly increased compliance cost with unclear associated benefit.

3.5 Consequently we do consider the proposals for agriculture activities to be unduly arduous and set out below why we think this, with some suggested alternatives.

4 PRACTICALITIES OF COMPLIANCE

4.1 Livestock and harvested crops

Current practice is to value livestock and harvested crops stock at the lower of cost of production and net realisable value. If the cost of production information is not available, deemed cost is used. This method of calculation is in accordance with HMRC guidance - contained in Helpsheet IR232 - and is therefore also acceptable for tax purposes.

In accordance with proposed FRS 102, a farming entity would value its livestock and harvested crops stock (biological assets) at fair value less costs to sell.

For many biological assets there are readily available market prices, though cost to sell would be more difficult to ascertain.

It is worth bearing in mind however, that proposed FRS 102 will need to be applied not only by non-small farming businesses, but also effectively by small farming businesses.

Although the FRSSE is silent on the topic of agricultural activities., it states that '*Financial statements will generally be prepared using accepted practice and, accordingly, for transactions or events not dealt with in the FRSSE, smaller entities should have regard to other accounting standards ………, not as mandatory documents, but as a means of establishing current practice'*.

Accordingly, the specialised activities chapter of the proposed FRS 102 will represent current practice for the small agricultural business.

It is also likely that proposed FRS 102 will need to be applied by non-incorporated farming businesses in the preparation of their accounts for tax purposes, as these have to be prepared in accordance with UK Generally Accept Accounting Practice.

Many small farming businesses currently take advantage of the HMRC guidance for valuing harvested crops: sheep and pigs livestock can be carried at a deemed cost of 75% of market value and cattle at 60% of market value. HMRC has recognised that for some farming businesses it is not always possible to ascertain actual costs from the farmer's records and accordingly have made this concession.

It is unlikely that these businesses would have sufficiently sophisticated accounting systems to be able to ascertain the cost to sell.

If the tax treatment of stock remains unchanged, adopting proposed FRS 102 may lead to an anomaly between the tax and accounting treatments of livestock and harvested crop stocks, leading to further compliance costs for clients.

4.2 **Tillages – crops in the ground**

The valuation of growing crops at fair value presents particular problems as, until they have been harvested, the farmer does not know the weight or quality of the crop, and therefore neither quantity nor the market value per tonne is known.

The calculation of costs to sell is also difficult for crops still in the ground, as in addition to not knowing the final weight for preparing/transporting, other variables may affect the path to market eg weather.

Therefore under proposed FRS 102, crops in the ground would need to be measured using the cost model "cost less any accumulated depreciation and any accumulated impairment". For most small businesses this would need to be on a fairly simple basis. Many small businesses currently use the costs of seeds sown and any other such costs as fertilisers/chemicals added.

However, where a business is using the cost model proposed FRS 102 requires disclosure of the following information, which for a business applying FRSSE may be somewhat onerous:

34.10 An entity shall disclose the following with respect to its biological assets measured using the cost model:

a description of each class of its biological assets.
an explanation of why fair value cannot be measured reliably.
the depreciation method used.
the useful lives or the depreciation rates used.
the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period

Further, proposed FRS 102 does not define what constitutes a class of biological asset.

4.3 **Animals – the herd basis**

Many farms account for their animals on the herd basis where those animals are kept for the whole of their lives for their products or progeny, eg milk, eggs, calves, lambs, etc.

The herd basis involves attributing to the herd the characteristics of a single fixed asset rather than stock. This is on the basis that the herd is being held for what it can produce as a whole in the long term, rather than as individual items for resale purposes or being consumed within the business.

Even if farming businesses had to account for all their livestock within stock and value at fair value, they would still need to calculate the amounts for the herd basis for tax purposes. This would give farming businesses increased compliance cost, as they would need to value the herd livestock for accounting purposes under proposed FRS 102 and continue to maintain herd basis records for tax compliance purposes.

4.4 **Disclosures**

The disclosures required by paragraph 34.7 of proposed FRS 102 would be onerous for small businesses. Whilst they may be proportionate for larger businesses used to complying with full FRSs, this information would not be readily to hand for small businesses complying with the FRSSE, who generally have far less sophisticated accounting systems.

5 IMPACT ON A FARMING BUSINESS

5.1 Livestock and harvested crops

Using fair value less cost to sell as the basis of measurement rather than the current method (the lower of cost of production or net realisable value or deemed cost) will have a significant impact on balance sheet values for farming businesses

We have tested how proposed FRS 102 would affect a typical farming client's figures. The farm is a mixed farm with dairy and sheep herds.

Our test has revealed that the change in the method of valuation would cause an increase in stock values of between £370k and £510k over the three years tested – increases of between 82% and 122% over the current stock values.

For a business that is approaching the audit threshold, this increase in stock and therefore total assets could be enough to push them over the audit threshold.

The increase in stock values also gives rise to increased profits leading to increased tax liabilities.

5.2 Animals – the herd basis

As noted in 4.3 above, the herd basis of accounting lends a herd the characteristics of a fixed asset rather than stock.

As a fixed asset, the herd is included in fixed assets at the initial cost of purchase. Additions are only valued at a higher amount if they increase the actual size of the herd ie the fixed asset has undergone some inherent improvement. Therefore where a herd has been held for many years the value per animal as a fixed asset would be much lower than the current fair value less cost to sell which would be used by proposed FRS 102 for valuing it within stock.

For example a herd of dairy cattle numbering approximately 360 animals at 31 March 2011 is valued under the herd basis at £70k and included in fixed assets. Under proposed FRS 102 this same herd of dairy cattle would be included in current assets under stock at a value in the region of £415k. This would lead to an uplift in the balance sheet of £345k.

This would distort the accounts. The herd is in essence a fixed asset but other fixed assets are not re-valued each year, unless the business has a policy of revaluation. Most small businesses do not have such policies.

Where a business is sitting close to the audit threshold on the balance sheet criteria, the valuing of the herd at fair value, less cost to sell may push a business over the audit threshold, which would increase the business's compliance costs.

Valuing the herd at fair value will also cause greater volatility in the profit and loss account. Currently the only impact in the profit and loss account is the profit or loss on disposal of any animals from the herd. For our test client, over three years tested, the profit figure varied by between £120k above and £78k below, that which had been reported in the statutory accounts.

6 OTHER COMMENTS

6.1 Fair value and agricultural activities

At a single point in time fair value is a very arbitrary measure. Most commodity prices are very volatile. A farming business might, under proposed FRS 102, be valuing wheat at the year end at £190 per tonne, suffering the tax thereon straight away and be realising a loss at £120 per tonne only two months later for which the business won't receive relief until a year later.

Some commodities do not have an accurate price eg immature plants and some animals. For example a farmer may have a prize bull held for breeding and not for sale. If a special price has just been paid in the latest auction mart (as often happens), does the value of that prize bull have to be uplifted?

6.2 Agricultural activities versus other sectors

Why should biological assets be valued at fair value, when a manufacturer would value stock at the cost of production? We find it difficult to understand the rationale behind making the farming sector fair value stock and not other sectors; we can't see what the proposed treatment is trying to achieve in respect of biological assets as we don't believe it will give a more realistic picture of the performance of agricultural activity businesses which are essentially manufacturing businesses.

6.3 Unincorporated farming business

It would be useful to have some clarification for unincorporated businesses as to how they should account for agricultural activities for tax purposes should the proposed FRS 102 be adopted in its current form.

6.4 Stakeholders

6.4.1 Banks

As noted above fair valuing biological assets will generate greater fluctuations in balance sheet values. This is likely to pose problems for those farming businesses dependent on lending which in turn may be dependent on covenants based on balance sheet values.

As noted above we find it difficult to understand the rational of making the farming sector adopt a fair value approach when the fair value information produced is unlikely to be additional value to that already produced and in the case of lending agreements is likely to involve a significant amount of paperwork to work in different lending criteria for what will be an otherwise unchanged business sector.

Banks normally make lending decisions based on the ability to recover loans from the cashflow generated by a farming business and the land stock Fair value information is unlikely to be used – especially for the vast majority of the farming businesses who are likely to be affected by the proposed FRS 102.

6.4.2 Shareholders

The UK farming sector is characterised by family ownership and/or contract farming in local communities ie those doing the farming are closely linked to or are the owners. Therefore, fair value information is of little additional benefit in these scenarios as the stewards are in close communication with the owners and the owners have a long standing interest in the farming business ie they are not making short term investment decisions for which fair value can provide meaningful information.

7 PROPOSED ALTERNATIVES

7.1 Options not to fair value

There could be more options created in the proposed FRS 102 to accommodate current accounting practice for small farming businesses. This would be consistent with other changes to the IFRS for SMEs which have been made to accommodate current accounting options in UK GAAP, such as revaluation of tangible fixed assets.

7.2 Disclosure only

As with existing UK GAAP in respect of derivatives, perhaps useful information could be provided by directors disclosing their valuation of certain biological assets where such information would be meaningful.

7.3 Tax spreading adjustment

The uplift to fair value will be very expensive in tax for most farming clients. If the proposed FRS 102 is adopted as currently drafted, a spreading adjustment for tax (cf UITF 40) might help to limit the damage to farming cash flows.