Accounting Standards Board October 2010

Part One

The Future of Financial Reporting in the UK and Republic of Ireland

43
Application of Financial Reporting Standards

44
Financial Reporting Standard for Medium-sized Entities

Part One: Explanation

FINANCIAL REPORTING EXPOSURE DRAFT

ACCOUNTING STANDARDS BOARD

This draft is issued by the Accounting Standards Board for comment. It should be noted that the draft may be modified in the light of comments received before being issued in final form.

For ease of handling, we prefer comments to be sent by email (in Word format) to

asbcommentletters@frc-asb.org.uk

Comments may also be sent in hard copy form to:

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Comments should be despatched so as to be received no later than 30 April 2011. All replies will be regarded as on the public record, unless confidentiality is requested by the commentator.

The FRC's policy is to publish on its website all responses to formal consultations issued by the FRC and/or any of its operating bodies unless the respondent explicitly requests otherwise. A standard confidentiality statement in an email message will not be regarded as a request for non-disclosure. We do not edit personal information (such as telephone numbers or email addresses) from submissions; therefore only information that you wish to be published should be submitted.

We aim to publish responses within 10 working days of receipt.

We will publish a summary of the consultation responses, either as part of, or alongside, our final decision.

Financial Reporting Exposure Draft

43

Application of Financial Reporting Requirements

44

Financial Reporting Standard for Medium-sized Entities

Part One: Explanation

FINANCIAL REPORTING EXPOSURE DRAFT

ACCOUNTING
STANDARDS
BOARD

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The Financial Reporting Standard for Medium-sized Entities is adapted from the approved text of the International Financial Reporting Standard for Small and Medium-sized Entities. The authoritative text of the International Financial Reporting Standard for Small and Medium-sized Entities and other IASB publications is that issued by the IASB in the English language. Copies may be obtained from the IFRS Foundation Publications Department. Please address publication and copyright matters to:

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See separate booklet

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PREFACE

i The Accounting Standards Board (ASB) is issuing this Financial Reporting Exposure Draft (FRED) outlining a proposed future for UK and Republic of Ireland* financial reporting. The proposals in this FRED could as a consequence have far-reaching effects.

ii This FRED is part of the ASB's due process for setting new accounting standards, and sets out the draft suggested text for two new accounting standards, together with the Board's reasoning. Comments from respondents are invited in section 2. All comments will be considered in detail and used in determining how, and if, the proposals should developed. Comments will also be used to assist in developing an impact assessment, a draft of which is set out in section 11.

iii Respondents are encouraged to consider whether the proposals will provide the optimal outcome or whether different proposals would be better. Details of alternative proposals and why they are considered better are welcome.

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* *The ASB's Standards are issued by Chartered Accountants Ireland in respect of the application in the Republic of Ireland. References to 'UK' in terms of the Financial Reporting Standards and Generally Accepted Accounting Practice should be read as also being applicable to the Republic of Ireland. Specific references to Irish Company Law are set out in Appendix 1 'Note on the Legal Requirements in the UK and Republic of Ireland'.*

iv The proposals in this FRED recognise that one size of accounting standard does not fit all entities. It proposes a tier system for financial reporting that requires entities to prepare financial statements in one of the following three tiers (an entity may voluntarily elect to adopt a higher tier):

	Nature of Entity	**Accounting Regime***	**Reduced disclosures for …**
Tier 1	Entities that have public accountability.	EU-adopted IFRS	Qualifying subsidiaries
Tier 2	Entities without public accountability; and Small publicly accountable entities that are prudentially regulated.	Financial Reporting Standard for Medium-sized Entities	Qualifying subsidiaries
Tier 3	Small entities without public accountability.	Financial Reporting Standard for Smaller Entities	

v The ASB is proposing these changes in response to the evolution of financial reporting requirements. The ASB considers that its Financial Reporting Standards now lack cohesive principles as a consequence of developments in financial reporting in recent years.

vi The ASB believes its proposals will have significant benefits for both preparers and users. Preparers will benefit from the replacement of current Financial Reporting Standards with the Financial Reporting Standard for Medium-sized Entities (FRSME), which

* *All entities will prepare 'Companies Act accounts' except for those applying EU-adopted IFRS without the reduced disclosure framework, who will prepare 'IAS accounts'.*

is substantially less complex and easier to use than current UK accounting standards. The ASB considers the FRSME will reduce the costs of accounts preparation whilst maintaining the quality of information to users.

vii The ASB is proposing an effective date of accounting periods beginning on or after 1 July 2013, with earlier application permitted.

viii The ASB is seeking comments on its proposals, by 30 April 2011.

SECTION 1: OVERVIEW OF THE PROPOSALS IN THIS FRED

INTRODUCTION

1.1 This FRED sets out draft versions of:

(a) FRS ● 'Application of Financial Reporting Requirements' (Application FRS) which sets out a framework for financial reporting based on three tiers of entities; and

(b) FRS for Medium-sized Entities (FRSME) which the ASB is proposing as part of the new framework and which would replace the current Financial Reporting Standards.

WHY IS THE ASB PROPOSING THESE CHANGES?

1.2 The ASB is proposing these changes because it recognises that its current Financial Reporting Standards now lack cohesive principles as a consequence of developments in financial reporting in recent years.

Benefits

1.3 The ASB considers that:

(a) the proposals will provide a proportionate framework targeted to meet users' and preparers' needs;

(b) replacement of its current Financial Reporting Standards with the FRSME will have the following benefits:

(i) it is easy to apply – it replaces current voluminous UK accounting standards with a single book that is much more concise and easy to navigate;

(ii) it allows simplified accounting in some areas, and fewer disclosures;

(iii) it will reduce compliance and training costs – the ASB envisages only updating the FRSME at intervals of three years; and

(iv) it introduces a common framework. A common framework should reduce education and training costs to accountants and increase intellectual mobility. It will also assist users in the interpretation of financial statements;

(c) the reduced disclosure framework will generate cost savings in the preparation of financial statements for subsidiaries.

1.4 The ASB believes that current Financial Reporting Standards are not tenable in the longer term:

(a) they are an incoherent mixture of standards developed in the UK over a long period of time and standards that have been converged with IFRS; there is no consistent framework;

(b) they permit certain transactions to remain unrecognised that are relevant to an assessment of the financial position of an entity; and

(c) they have not kept pace with evolving business transactions and in some areas are out of date. As business transactions change, accounting requirements must evolve to ensure that financial statements continue to show a true and fair view of an entity's financial performance and position at the balance sheet date.

WHAT ARE THE MAIN PROPOSALS?

The Tier System

1.5 The draft Application FRS sets out a differential reporting framework based on three tiers of entities. The framework uses public accountability as the differentiator. An entity has public accountability if:

(a) as at the reporting date, its debt or equity instruments are traded in a public market, or it is in the process of issuing such instruments for trading in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets); or

(b) as one of its primary businesses, it holds assets in a fiduciary capacity for a broad group of outsiders and/or is a deposit-taking entity for a broad group of outsiders. This is typically the case for banks, credit unions, insurance companies, securities brokers/dealers, mutual funds or investment banks.

	Nature of Entity	**Accounting Regime***	**Reduced disclosures for …**
Tier 1	Entities that have public accountability.	EU-adopted IFRS	Qualifying subsidiaries
Tier 2	Entities without public accountability; and Small publicly accountable entities that are prudentially regulated.	Financial Reporting Standard for Medium-sized Entities	Qualifying subsidiaries
Tier 3	Small entities without public accountability.	Financial Reporting Standard for Smaller Entities	

* *All entities will prepare 'Companies Act accounts' except for those applying EU-adopted IFRS without the reduced disclosure framework, who will prepare 'IAS accounts'.*

1.6 In accordance with the draft Application FRS:

(a) entities that have public accountability prepare financial statements in accordance with EU-adopted IFRS;

(b) entities without public accountability and which are not small may prepare financial statements in accordance with the FRSME or EU-adopted IFRS; and

(c) small entities without public accountability and which are permitted in accordance with the Companies Act 2006 (the Act) to apply the small companies regime may apply the FRSSE; alternatively they may apply the FRSME or EU-adopted IFRS.

1.7 In addition, the draft Application FRS proposes that relief be provided for small publicly accountable entities that are prudentially regulated.

Reduced disclosures for subsidiaries

1.8 In response to concerns expressed by respondents to the ASB Consultation Paper 'Policy Proposal: The Future of UK GAAP' (policy proposal), the draft Application FRS also sets out a reduced disclosure framework for qualifying subsidiary undertakings. The framework gives exemptions from certain disclosure requirements to qualifying subsidiaries that prepare financial statements either in accordance with EU-adopted IFRS or the FRSME.

Legal requirements

1.9 The draft Application FRS proposes a framework that complies with Company law. Entities that apply EU-adopted IFRS are in the scope of section 395(1)(b) or section 403(1) or (2)(b) of The Companies Act 2006 (the Act). All other entities, including those applying EU-adopted IFRS with the reduced disclosure

framework, prepare Companies Act accounts in accordance with section 396 or section 404.

The FRSME

1.10 The draft FRSME is based on the IASB's IFRS for SMEs but adapted to comply with UK and European legal requirements. The significant changes required to the IFRS for SMEs to comply with legal requirements include:

(a) adjusting the requirement for the preparation of consolidated financial statements, so that this is only required when stipulated by the Companies Act 2006;

(b) removing certain options permitted by the IFRS for SMEs but not available in accordance with the Companies Act 2006; and

(c) inserting disclosure requirements for certain financial liabilities held at fair value.

1.11 The ASB carefully considered suggestions to amend the IFRS for SMEs for application in the UK but ultimately decided to make only the following amendments:

(a) to replace the chapter on tax with IAS 12 'Income Taxes', based on feedback from respondents to the policy proposal;

(b) to provide transitional relief for dormant companies; and

(c) to introduce a parent company cash flow statement exemption.

The FRSSE

1.12 The ASB is not proposing to change the Financial Reporting Standard for Smaller Entities (FRSSE) except for consequential amendments to reflect the removal of the existing body of UK FRSs.

The SORPs

1.13 The ASB is also proposing to reduce the number of Statements of Recommended Practice (SORPs) in issue and will retain SORPs only where there is a clear and demonstrable need.

WHAT WILL BE THE EFFECT?

Draft impact assessment

1.14 In developing the proposals, the ASB has been mindful of the approach to regulation adopted by the UK Government, including the introduction of the 'One-in, One-out' regulatory management system.

1.15 The ASB has carried out a consultation stage Impact Assessment, which is set out in Section 11. Overall, the ASB believes the proposals will have a positive impact on financial reporting. In its view, the benefits of a more proportionate, transparent financial reporting regime, targeted to meet users' and preparers' needs, will in the long term generate cost savings.

WHO WILL BE AFFECTED BY THE PROPOSALS?

1.16 The proposals are intended to apply to all entities that are required to prepare financial statements that give a 'true and fair' view. This includes companies and other corporate structures in both the for-profit and public benefit entity (also known as not-for-profit) sectors.

1.17 The proposals therefore encompass all entities that are currently required to apply UK FRS, including those that presently apply the industry-specific guidance contained in the SORPs.

1.18 The financial reporting framework for the public sector is determined by the Relevant Authority*. This includes those companies classified in the public sector by the Office for National Statistics. As these companies will be operating in the public interest it is likely that they will be required to prepare financial statements in accordance with EU-adopted IFRS and any additional financial reporting requirements of the Relevant Authority.

1.19 The ASB is proposing that as a supplement to the proposals in this FRED it will develop a public benefit entity (PBE) financial reporting standard. The PBE FRS will aim to address the needs of PBEs by setting out financial reporting requirements where the FRSME does not contain adequate guidance for such entities. As a consequence it is proposed that PBEs will follow this PBE FRS as a supplement to, rather than substitute for, the FRSME. Where a PBE has public accountability, as defined in the draft Application FRS, it should comply with the PBE standard to the extent the standard does not conflict with EU-adopted IFRS.

HOW HAVE THE PROPOSALS DEVELOPED?

1.20 The ASB first consulted on the future of UK financial reporting standards in March 2004 in its Discussion Paper: 'UK Accounting Standards: A strategy for convergence with IFRS'. This consultation followed the EU decision that all quoted groups should prepare consolidated financial statements in accordance with EU-adopted IFRS. This led the ASB to question the role of UK FRS when quoted groups were no longer required to apply these standards.

1.21 Since then, the ASB has continued to consult regularly on the future of UK FRS.

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* *The relevant authorities are determined by the UK government and the devolved administrations. At present they are HM Treasury, the Welsh Assembly Government, the Scottish Government, the Northern Ireland Assembly, CIPFA/LASAAC, the Department of Health and Monitor. In the Republic of Ireland, the relevant authority is the Irish government.*

1.22 Initially, the ASB adopted a number of IFRSs to fill acknowledged gaps in UK standards and converge with IFRS; for example, the UK had no comprehensive standard on the recognition and measurement of financial instruments. Although the UK has been a leader in many areas of accounting, pervasive and highly complex standards, such as those on financial instruments, have rightly been developed internationally, with significant input from the UK.

1.23 As time proceeded, the ASB formed the view that convergence by adopting certain IFRSs was not meeting the needs of its constituents, which no longer included quoted groups. The ASB was concerned about the complexity of certain IFRSs, and it noted that introducing them piecemeal created complications and anomalies within the body of UK FRS. This arose because IFRS-based standards were not an exact replacement for UK FRS and many consequential amendments were required to "fit" each replacement IFRS-based standard into the existing body of UK FRS. This prompted some respondents to the policy proposal to note that UK FRS were an uncomfortable mismatch, lacking strong underlying cohesion or principles.

1.24 In seeking an alternative to full convergence with IFRS the ASB consulted on whether the IASB's standard, then in development, for small and medium-sized entities, should be part of a new framework for financial reporting. This alternative would permit UK FRS to converge under the IASB framework but offered more proportionate financial reporting requirements for constituents.

1.25 This FRED is the outcome of the ASB's consideration of responses to its policy proposal issued in August 2009 and previous consultations. The ASB believes that the proposals in this FRED will place the UK at the forefront of financial reporting. The tier system will enable UK entities to have a suite of financial reporting standards available to them that are high-quality and fit-for-purpose. The tier system aims

to address comprehensively the needs of both preparers and users.

1.26 During the consultation process to date, and in plans to develop the proposed approach going forward, the ASB has been guided by the following principles:

(a) The framework must be fit for purpose, so that each entity required to produce true and fair financial statements under Company law will deliver financial statements that are suited to the needs of its primary users. The ASB has kept in close touch with constituent users on this point, including investors, creditor institutions and the tax authorities.

(b) The framework must be proportionate, so that preparing entities are not unduly burdened by costs that outweigh the benefit to them and to the primary users of information in their financial statements. The ASB believes that the proposals will produce a lower-cost regime, while enhancing user benefits. It has carried out a consultation stage impact assessment with input from interested parties, and will continue to assess cost-benefit issues.

(c) The framework must be in line with Company law. This determines which entities must produce true and fair financial statements. Exemptions within the law have generally been retained. The detailed requirements of the Companies Act are driven to a great extent by the European Accounting Directives, which are now generally perceived to be out-of-date.* This has meant that some aspects of the ASB's desired approach cannot be implemented at this stage and it has also made the outcome more complex than it might have been. The ASB nevertheless believes that its

* *The EU's consultation process on review of the Accounting Directives is summarised at http://ec.europa.eu/internal_market/accounting/sme_accounting/review_directives_en.htm*

proposals represent a significant improvement to the current regime.

(d) The framework must be future-proofed, where possible. The ASB will continue to monitor the situation and retains sovereignty over UK Financial Reporting Standards (subject to the law). Legal changes may lead to further developments, for example if the EU decides to give member states an option to exempt micro-entities from the Accounting Directives* or if the Accounting Directives themselves are revised. But one advantage of the approach advocated by the ASB is that the FRSME will be much more stable, as the IFRS for SMEs will be revised only every three years, in line with the ASB's approach to the FRSSE.

MAJOR CHANGES SINCE THE CONSULTATION DOCUMENT

1.27 In August 2009, the ASB issued a consultation document: 'Policy Proposal: The Future of UK GAAP'. In this document, the ASB set out its proposed strategy for the future of UK Generally Accepted Accounting Practice. It proposed that UK FRS would operate under the IASB framework to the fullest extent possible, consistent with the needs of UK entities.

1.28 The ASB has considered carefully the responses to its policy proposal and adapted it to address concerns where appropriate. Areas where the FRED differs significantly from the policy proposal include:

(a) application guidance on the definition of public accountability;

(b) allowing publicly accountable entities that are prudentially regulated and meet all three of the size

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* *http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0083:FIN:EN:HTML*

conditions of the small companies regime to apply the FRSME;

(c) a reduced disclosure framework for subsidiary undertakings which gives relief for subsidiaries;

(d) replacing the tax section of the IFRS for SMEs with IAS 12 'Income Taxes'; and

(e) amendments to the IFRS for SMEs so that it complies with EU and UK legal requirements.

ALTERNATIVE VIEW

1.29 Section 12 of this FRED outlines the view of one member of the ASB who does not support all of the proposals in the FRED. The member notes that the ASB's outreach activities have not managed to generate adequate responses from the users of financial statements prepared under UK GAAP.

1.30 As a result, the ASB does not have sufficient evidence to test the assumptions underlying the main structure of these proposals, and the member holding the alternative view believes that:

(a) more publicly accountable entities should fall into Tier 2;

(b) the accounting requirements for Tier 2 should be further simplified particularly in respect of:

  (i) financial instruments and leases,

  (ii) other uses of fair value, and

  (iii) deferred tax.

(c) the upper limit for use of the FRSSE should be raised.

1.31 He considers that such an approach would better meet the FRC's objective of reducing complexity, and the government's objective of reducing burdens upon UK business.

1.32 He further believes that, due to the low level of input from users of financial statements, the proposals in the FRED, while they may, or may not, be an improvement on existing requirements, cannot be presented as the best possible trade-off between costs and benefits for UK companies, and cannot be determined to be proportionate or targeted.

DATE FROM WHICH EFFECTIVE AND TRANSITION

1.33 The proposals in this FRED shall apply for accounting periods beginning on or after 1 July 2013. Early application is permitted.

1.34 The ASB has set out draft transitional provisions in the Application FRS.

SECTION 2: INVITATION TO COMMENT

2.1 The ASB is requesting comments by 30 April 2011. The ASB is committed to developing standards based on evidence from consultation with users, preparers and others. Sections 3 to 12 of this document provide an overview of the proposals in the FRED including details of an alternative view. Comments are invited on all aspects of the proposals (including the alternative view). In particular, comments are sought on the questions below.

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?

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?

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.

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.

Reduced disclosures for subsidiaries

Q10 The ASB is proposing that subsidiary undertakings which apply the reduced disclosure framework should:

(a) disclose the disclosure exemptions taken;

(b) state in the notes the name of the parent undertaking in whose consolidated financial statements the subsidiary's results and relevant disclosures are included; and

(c) only be permitted to take the disclosure exemptions where the consolidated financial statements of the parent are publicly available.

Are these requirements necessary and sufficient to protect users of subsidiary financial statements?

Q11 The ASB proposes that disclosure exemptions should be permitted for all subsidiary undertakings: do you agree, or do you consider that there should be a minimum percentage ownership requirement?

Q12 Do you consider that a disclosure exemption should or should not be provided for transactions between wholly-owned group undertakings? Please explain your reasoning.

Q13 The reduced disclosure framework was developed in response to the feedback on the ASB's policy proposal issued in August 2009. Qualifying subsidiaries applying the reduced disclosure framework look to EU-adopted IFRS and the Appendix to the draft Application FRS to prepare their financial statements. Does this proposal adequately address preparers' needs?

Q14 Do you have any further suggestions for disclosure exemptions for qualifying subsidiaries? If so, please explain why you consider the disclosure is not required in the subsidiary financial statements.

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?

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.

Alternative view

Boundary between Tier 1 and Tier 2

Q22 Do you agree that all the entities that the ASB has identified as falling within Tier 1 should be in Tier 1, or do you agree with the Alternative View that some could move to other tiers? If you do think some entities could be moved– which entities and to which tier?

Q23 Are you aware of any information that users of financial statements of publicly accountable entities require which would not be disclosed in financial statements prepared using the FRSME (the IFRS for SMEs adapted for use in the UK)? If so, please identify such information and explain why it is required.

Accounting requirement for entities falling into Tier 2 (FRSME)

Q24 Do you believe that the ASB's proposals for the FRSME should be changed to reduce complexity? If so, what changes would you suggest? Please explain how such changes would improve the balance between costs and benefits.

Q25 If the FRSME was changed in accordance with your response to Q24, would it still be suitable for use by some publicly accountable entities? If not, why not?

Boundary between Tier 2 and Tier 3

Q26 The current cut-off point for the FRSSE is the small company threshold (Turnover £5.6m, Balance Sheet £2.8m, Employees 50). Do you think the cut-off could be raised to permit all companies defined as medium-sized (Turnover £22.8m, Balance Sheet £11.4m, Employees 250) under the Companies Act to use the FRSSE without any additions to the FRSSE? If not, can you identify an intermediate level for the cut-off, and what would it be?

Q27 If you consider that the upper limit of the FRSSE could not be raised without amendment, what additional topics would the FRSSE need to cover if it was extended to include medium-sized entities, and why?

SECTION 3: THE TIER SYSTEM

3.1 Part two, section I of this FRED sets out a draft FRS for the application of a differential framework for financial reporting based on three tiers of entities: 'Application of Financial Reporting Requirements'.

3.2 The ASB also took into consideration the findings from previous consultations on the future of UK financial reporting. It has consulted six times on this subject over a period of six years and the majority of responses to all of these consultations favoured a system using an IFRS-based conceptual framework.

3.3 The ASB considers that presenting the framework for financial reporting in a financial reporting standard rather than Company law allows for more flexibility and makes it easier to respond to change. It also retains the ASB's role in setting accounting standards. Respondents to the policy proposal noted the ASB should not give up its sovereignty over setting accounting standards.

3.4 The decision as to which tier an entity reports under is based on the status of the reporting entity and not that of its parent undertaking. Consequently, subsidiary undertakings of parents that have public accountability may be eligible to apply the FRSME.

Public accountability or size

3.5 In its policy proposal, the ASB set out two alternatives for a differential reporting framework: one based on whether an entity has public accountability and the alternative based on its size. Whilst the majority of respondents agreed with the proposal to base the reporting framework on public accountability, some did question its application.

3.6 The ASB gave consideration to the views of those that supported a differential reporting framework based on size,

but noted the majority of respondents suggested that the increase in costs for larger entities to apply EU-adopted IFRS might outweigh the benefits to users. Others commented that size was an arbitrary criterion.

3.7 The ASB considers that publicly accountable entities have stewardship obligations that arise from their decision to enter a public capital market or because they act in a public fiduciary capacity, such as banks. Investors in these entities are typically not involved in their management and do not have the power to demand the financial information necessary for making investment decisions. They rely on the financial statements, and those financial statements must provide a broader range of financial information than those of entities that do not raise finance on a public capital market or act in a public fiduciary capacity.

3.8 The ASB decided to retain public accountability as the differentiator because it considers that classification of entities on this basis addresses the need to provide proportionate information. In its view, a financial reporting framework based on public accountability represents a targeted approach to providing relevant and understandable financial information that contributes to discharging stewardship obligations.

Thresholds for the tiers

3.9 In response to a suggestion that simplification of financial reporting could be achieved by raising the threshold for application of the FRSSE, the ASB reviewed responses to an earlier consultation.

3.10 In May 2006, the ASB issued PN 289, consulting on whether the scope of the FRSSE should be extended to include medium-sized entities. The outcome of this consultation did not provide a clear constituent view in favour of the extension of the FRSSE. Those who supported it did so mainly on efficiency grounds (for preparers, and for the process of maintaining accounting

standards), while those who disagreed suggested that more complex accounting and disclosures were needed for companies that are not small, and that if the scope of the FRSSE became too broad it would lose its fitness for purpose for the entities for which it was originally written. Examples of this more complex accounting include share-based payments (at present dealt with in the FRSSE only through disclosure) and financial instruments.

3.11 The ASB also consulted with its Committee on Accounting for Smaller Entities as to whether the use of the FRSSE could be extended. The Committee noted that the FRSSE was originally designed for smaller entities and since its development in 1997 the turnover threshold in the UK had been increased from £2.8 million to £6.5 million. The Committee expressed a concern that a move to increase the threshold further could result in smaller entities no longer having available to them an accounting standard that is fit for purpose.

3.12 The majority of ASB members agreed that were the threshold for application of the FRSSE to be revised, it would be necessary to amend the FRSSE to address more complex transactions and that the conditions for using the FRSSE should therefore remain unchanged.

3.13 The ASB also noted the ongoing EU debates on whether "micro" entities* may be exempted from the requirement to prepare financial statements. If member state permission to allow this exemption were to be added to EU law and enacted in UK law, it would reduce the number and diversity of entities using the FRSSE and the ASB could consider how this change would affect the proposed tier structure. Further, the UK Financial Reporting Council (FRC) is currently carrying out a study on how reporting

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* *An entity is a "micro entity" if it meets two of the following three conditions: a. Less than average of 10 employees during the financial year; b. A balance sheet total below €500.000; c. A net turnover below €1.000.000*

by micro entities might be simplified. The results of this study may also affect the ASB's future consideration of the FRSSE.

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 a tier system. Do you have any comments or queries on the scope or content of this Appendix?

SECTION 4: FINANCIAL REPORTING FOR ENTITIES WITH PUBLIC ACCOUNTABILITY (TIER 1)

4.1 The draft Application FRS proposes that entities that have public accountability are required to elect to prepare their financial statements in accordance with EU-adopted IFRS, unless they are already required to do so by law.

4.2 It is proposed that an entity has public accountability if:

(a) at its reporting date, its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets); or

(b) as one of its primary businesses, it holds assets in a fiduciary capacity for a broad group of outsiders and/or it is a deposit-taking entity for a broad group of outsiders. This is typically the case for banks, credit unions, insurance companies, securities brokers/dealers, mutual funds or investment banks.

4.3 Whilst the majority of respondents agreed that the differential reporting framework should be based on public accountability, the ASB carefully considered the concern expressed by small entities that have public accountability that the costs of applying EU-adopted IFRS might outweigh the benefits. The ASB has sought to provide a relief to address this concern by using a combination of size and regulation, agreeing that this would be an exception to the public accountability requirements.

4.4 It is proposed that a reporting entity that has public accountability in accordance with the definition in the draft Application FRS, and which satisfies **all three** of the size

conditions of a small company or small group as defined by section 382 or section 383 of the Companies Act 2006 (the Act), and is prudentially regulated, may apply the FRSME. The ASB decided it was necessary to require small publicly accountable entities to meet all three of the size conditions because the requirement to achieve only two of the three conditions would allow entities responsible for a high value of assets to report under the FRSME, which was not considered appropriate due to the risk involved. The three size conditions as set out in the Act are*:

Turnover £6,500,000

Balance sheet total £3,260,000

Average number of employees 50

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?

4.5 Respondents to the policy proposal also requested further clarification and guidance in relation to the definition of public accountability.

4.6 The ASB has amended the definition of public accountability to clarify that an entity has public accountability when, as one of its primary businesses, it 'holds assets in a fiduciary capacity for a broad group of outsiders' or is 'a deposit-taking entity for a broad group of outsiders'.

4.7 In addition, the draft Application FRS sets out guidance to assist an entity in determining if it has public accountability. The application guidance provides that:

* *There is no equivalent to the small companies regime in Irish law. Exemptions for Irish companies from presenting consolidated accounts are described in Table III of Appendix 1 'Note on the Legal Requirements in the UK and Republic of Ireland'.*

(a) the definition of public markets is consistent with IFRS 8 'Operating Segments';

(b) where, for reasons incidental to its primary business, an entity 'holds assets in a fiduciary capacity for a broad group of outsiders' or is a 'deposit-taking entity for a broad group of outsiders' this does not result in the entity's having public accountability;

(c) the extension in the definition by the ASB to include entities that take deposits from a broad group of outsiders is consistent with paragraph BC59 of the IFRS for SMEs, which includes the primary business of banks and providers of credit where the deposits are held in a public fiduciary capacity;

(d) an entity 'holds assets in a fiduciary capacity for a broad group of outsiders' or 'is a deposit-taking entity for a broad group of outsiders' where the outsiders are not involved in the management of the entity and rely on general purpose financial statements because they do not have the power to demand additional financial information; and

(e) certain specified types of entities are considered to have public accountability (although the definition is not limited to these specified types).

4.8 The indicative list of entities considered to have public accountability includes, but is not limited to, the following entities:

(a) quoted companies;

(b) pension schemes;

(c) insurance entities;

(d) credit unions;

(e) building societies;

(f) incorporated friendly societies or registered friendly societies;

(g) banks;

(h) employee benefit trusts;

(i) investment trusts including an Investment Company*, venture capital trust, mutual fund, exchange traded fund, unit trust, open-ended investment company (OEIC), custodian bank and stockbrokers; and

(j) entities which have debt or equity instruments traded in the following UK or Irish markets (this list is not intended to be exhaustive):

    (a) London Stock Exchange;

    (b) Irish Stock Exchange;

    (c) Alternative Investment Market;

    (d) Irish Enterprise Exchange;

    (e) Plus-listed; and

    (f) Plus-quoted.

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?

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* *An investment company is a corporate vehicle formed under the Irish Companies Act and regulated by the Irish Financial Regulator.*

SECTION 5: FINANCIAL REPORTING FOR ENTITIES WITHOUT PUBLIC ACCOUNTABILITY (TIER 2)

5.1 Part two, Section II of this FRED sets out a draft FRSME which the ASB is proposing in replacement of current FRS. Entities that do not have public accountability and are not permitted to apply the small companies regime may apply the FRSME or voluntarily adopt the requirements for Tier 1 entities.

5.2 The FRSME is based on the IFRS for SMEs as developed by the IASB, adapted for specific UK circumstances. In its policy proposal the ASB proposed not to change the IFRS for SMEs except for amendments needed to comply with legislation.

5.3 The European Financial Reporting Advisory Group (EFRAG) has recently completed a review of the compatibility of the IFRS for SMEs with the EU Accounting Directives*. EFRAG identified six areas of incompatibility. The draft FRSME has been amended to comply with legislation for these six areas as follows:

(a) amending the definition of extraordinary items to retain the definition in FRS 3 'Reporting Financial Performance';

(b) adding disclosure requirements for certain financial liabilities held at fair value;

(c) shortening the presumed life of goodwill from 10 to 5 years;

* *http://www.efrag.org/news/detail.asp?id=548*

(d) providing guidance that negative goodwill may be recognised in profit only when this meets the definition of a realised profit;

(e) replacing the prohibition on reversal of goodwill impairment losses with a requirement to reverse the loss if, and only if, the reasons for the impairment cease to apply; and

(f) removing the requirement for unpaid called-up share capital to be recognised as an offset to equity.

5.4 In addition to the areas of incompatibility, certain options permitted by the IFRS for SMEs but not permitted by the Directives have been removed. Details of the amendments to the IFRS for SMEs in the FRSME are set out in part two, section III of this FRED.

5.5 The ASB also considered carefully whether modifications to the FRSME were required in respect of financial instruments. In rare circumstances, an entity applying the FRSME may be required to account for a financial liability at fair value in accordance with section 12 where this is not permitted by Company law, which restricts the types of instrument that may be held at fair value. This issue is described in detail within Appendix 1 (Note on Legal Requirements in the UK and Republic of Ireland) of this FRED. The ASB's conclusion was that such circumstances would be sufficiently rare that an amendment was not necessary, although disclosure requirements have been added to section 11 for liabilities at fair value which are not derivatives or held as part of a trading portfolio, again for compliance with Company law.

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.

5.6 As noted above, the ASB initially proposed not to change the IFRS for SMEs except for amendments needed to comply with legislation. Whilst respondents agreed with this principle, many of them nevertheless proposed amendments.

5.7 In view of the responses, 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.

5.8 The ASB gave careful consideration to the respondents' proposed amendments (details of the ASB's considerations are provided in section 10 of this FRED 'Development of the FRED') but decided that, aside from changes for legislation, it should propose only four changes to the IFRS for SMEs:

(a) the replacement of section 29 with IAS 12 'Income Taxes';

(b) the provision of transitional relief for dormant companies;

(c) the introduction of a parent company cash flow statement exemption; and

(d) an adjustment to the requirement for preparation of consolidated financial statements (the scope of section 9 of the IFRS for SMEs).

5.9 The proposal to replace section 29 of the IFRS for SMEs is based on feedback from respondents who raised concerns

that section 29 was based on an IASB exposure draft that did not proceed to an IFRS, therefore the requirements in section 29 were not consistent with IFRS.

5.10 The decision to provide transitional relief for dormant companies arose because of the large number of dormant companies which, without such relief, would be required to re-measure intercompany balances and consequently lose their dormant company status. The relief protects this position.

5.11 The decision to introduce an exemption from presenting a parent company cash flow statement for a parent preparing consolidated accounts was a pragmatic one based on user needs and current UK practice.

5.12 The amendment to the scope of section 9 of the IFRS for SMEs ensures that an entity is required to prepare consolidated financial statements only when required to do so by Company law. This amendment was necessary to ensure that application of an IFRS for SMEs based standard in the UK would not extend the current consolidation requirements set out in Company law.

5.13 The International Accounting Standards Board (IASB) has undertaken to review the IFRS for SMEs when two years of financial statements using the IFRS for SMEs have been published by a broad range of entities. The ASB undertakes to consider any amendments proposed to the IFRS for SMEs and to consult on those proposed amendments.

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.

SECTION 6: FINANCIAL REPORTING FOR SMALL ENTITIES WITHOUT PUBLIC ACCOUNTABILITY (TIER 3)

6.1 Consistent with the policy proposal, this FRED is proposing that the FRSSE should remain in force until a further consultation is undertaken (meaning that there is no change in accounting practice for small entities).

6.2 Entities that do not have public accountability and are permitted, in accordance with the Act, to apply the small companies regime or to take advantage of the size exemption set out in Irish law may apply the FRSSE or voluntarily adopt the requirements for Tier 1 or Tier 2 entities.

6.3 In developing this FRED, the ASB took into consideration the views of the majority of respondents to the policy proposal favouring retention of the FRSSE for a period after the introduction of the FRSME, followed by a further consultation on the FRSSE's future role. The ASB agrees with the views of respondents and, at this stage in the development of the FRED, has decided not to commit itself to any particular options for the FRSSE but to consult on all options at a later date.

6.4 The ASB considers that the timing of the review is dependent on the progress and feedback on implementation of the FRSME, on progress within the European Council of proposals for Member States to be permitted to exempt micro entities from the provisions of the Accounting Directives, and on the outcome of a current FRC study on the financial reporting of micro entities.

6.5 This FRED is proposing consequential amendments to the FRSSE (Appendix 3). The consequential amendments address how the FRSSE will operate once existing FRS are withdrawn.

6.6 Under the proposals, entities applying the FRSSE would not be required to make any adjustments to their existing accounting policies when the FRSME becomes effective. Only when such an entity enters into a new transaction that is not addressed by the FRSSE or by its existing accounting policies would it need to develop a new accounting policy having regard to other sources of guidance such as the FRSME.

6.7 The consequential amendments also propose to remove the exemption from providing details of related party transactions between subsidiaries. This is consistent with the ASB's decision to seek views on the disclosure of related party transactions (see paragraphs 7.10 – 7.13).

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.

SECTION 7: PROPOSED REDUCED DISCLOSURES FOR SUBSIDIARY UNDERTAKINGS

7.1 This section addresses the proposed financial reporting requirements and disclosure exemptions for subsidiary undertakings. The proposed disclosure exemptions are set out in the draft Application FRS.

7.2 In developing the proposed disclosure exemptions, the ASB took into consideration concerns about the original suggestion in its policy proposal that there should be no disclosure exemptions for subsidiary undertakings. It agreed that, by proposing certain disclosure exemptions, cost savings could be made in the preparation of financial statements for subsidiary undertakings without impeding the quality of financial reporting.

7.3 The ASB considers that where an entity takes advantage of the reduced disclosure exemptions it should state in the notes to the financial statements the areas in which exemptions are taken and the name of the parent undertaking in whose consolidated financial statements the subsidiary's results and the relevant disclosures are included.

7.4 The exemptions set out in the draft Application FRS are available to all subsidiaries regardless of the reporting framework adopted by the parent undertaking or in the group financial statements. The exemptions apply whenever the consolidated financial statements of the parent undertaking are publicly available and, in certain instances, make equivalent disclosure.

Q10 The ASB is proposing that subsidiary undertakings which apply the reduced disclosure framework should:

(a) disclose the disclosure exemptions taken;

(b) state in the notes the name of the parent undertaking in whose consolidated financial statements the subsidiary's results and relevant disclosures are included; and

(c) only be permitted to take the disclosure exemptions where the consolidated financial statements of the parent are publicly available.

Are these requirements necessary and sufficient to protect users of subsidiary financial statements?

7.5 In developing the disclosure exemptions, the ASB also needed to decide which subsidiary undertakings should be permitted to apply the reduced disclosure framework. The ASB gave consideration to whether the exemptions should be available for all subsidiary undertakings, only for wholly-owned subsidiaries, or at a specified percentage of ownership. After consideration, the ASB decided that the reduced disclosure framework should be permitted for all subsidiary undertakings where there was no objection from any shareholders.

Q11 The ASB proposes that disclosure exemptions should be permitted for all subsidiary undertakings: do you agree, or do you consider that there should be a minimum percentage ownership requirement?

Subsidiaries using EU-adopted IFRS

7.6 The ASB developed the proposed disclosure exemptions by evaluation of proposals from three sources:

(a) disclosure exemptions permitted in accordance with current FRS;

(b) areas that are managed on a group basis; and

(c) other proposals.

Disclosure exemptions permitted in accordance with current FRS

7.7 Current FRS provide disclosure exemptions for subsidiary undertakings from the requirements of:

(a) FRS 1 'Cash flow statements (revised 1996)' in respect of producing a cash flow statement;

(b) FRS 29 (IFRS 7) 'Financial instruments: disclosures'; and

(c) FRS 8 'Related party disclosures' where the transactions are between group undertakings.

7.8 The draft Application FRS proposes mirroring the current exemption allowing subsidiary undertakings not to prepare a cash flow statement.

7.9 The ASB notes that currently FRS 29 permits an exemption for 90 per cent subsidiaries from disclosures on financial instruments. However, this is not in accordance with paragraph 36(4) of Schedule 1 to the Regulations, which requires that disclosures are made in accordance with International Accounting Standards for financial liabilities measured at fair value that are not held as part of a trading portfolio and are not derivatives. As a consequence, the ASB has amended the disclosure exemption to reflect the requirements of the Regulations.

7.10 The FRED does not include an exemption from disclosure of related party transactions between wholly-owned group undertakings.

7.11 FRS 8 has always exempted disclosure of transactions with certain subsidiary undertakings. The ASB notes, however, that IAS 24 'Related party disclosures' does not contain a similar exemption. The IASB removed a similar disclosure exemption based on feedback that disclosure of related party transactions and outstanding balances provides essential information for external users who need to be aware of the level of support provided by related parties.

7.12 The ASB also considered the outcome of the report published by BIS following the results of an independent inquiry into the collapse of the MG Rover Group*. In the press release issued by BIS it was noted that the Inspectors suggested that improvements could be made to auditing and reporting standards that would increase transparency in financial statements, and the ASB undertook to review whether changes were needed, particularly in respect of related party disclosures.

7.13 In view of the above, the ASB is seeking views as to whether it should retain the exemption for disclosure of transactions between wholly-owned group undertakings or should require disclosure of related party transactions on the basis that external users need to be aware of the level of support provided by related parties. At present, an exemption exists not only in FRS 8 but also in Company law, in paragraph 72(4) of the Regulations.

Q12 Do you consider that a disclosure exemption should or should not be provided for transactions between wholly-owned group undertakings? Please explain your reasoning.

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* *Report on the Affairs of Phoenix Venture Holdings Limited MG Rover Group Limited and 33 Other Companies*

Areas that are managed on a group basis

7.14 In relation to areas managed on a group basis, the draft Application FRS proposes reduced disclosures in respect of:

(a) share-based payments;

(b) acquisitions of assets that constitute a business;

(c) discontinued operations;

(d) employee benefits; and

(e) impairment of assets.

Other proposals

7.15 The CBI Financial Reporting Panel Working Party identified further disclosure reductions which the ASB considered. The outcome of this work gave rise to a proposed exemption in the draft Application FRS from the requirements:

(a) in paragraph 38 of IAS 1 'Presentation of Financial Statements' to present certain comparative information;

(b) in paragraph 134 to 136 of IAS 1 'Presentation of Financial Statements';

(c) in paragraphs 30 and 31 of IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'; and

(d) in paragraph 37 of IAS 28 'Investments in Associates'.

Q13 The reduced disclosure framework was developed in response to the feedback on the ASB's policy proposal issued in August 2009. Qualifying subsidiaries applying the reduced disclosure framework look to EU-adopted IFRS and the Appendix to the draft Application FRS to prepare their financial statements. Does this proposal adequately address preparers' needs?

SUBSIDIARIES USING THE FRSME

7.16 Having identified disclosure exemptions for subsidiary undertakings preparing financial statements in accordance with EU-adopted IFRS, the ASB then evaluated which exemptions should similarly be available for subsidiary undertakings preparing financial statements in accordance with the FRSME. The ASB is proposing disclosure exemptions for:

(a) financial instruments, where permitted by the Regulations;

(b) share-based payments; and

(c) employee benefits.

Q14 Do you have any further suggestions for disclosure exemptions for qualifying subsidiaries? If so, please explain why you consider the disclosure is not required in the subsidiary financial statements.

SECTION 8: STATEMENTS OF RECOMMENDED PRACTICE (SORPS) FOR PROFIT-SEEKING ENTITIES

8.1 In its consultation paper the ASB proposed that SORPs should only remain where there is a clear and demonstrable need arising from sector specific issues not covered by guidance in accounting standards.

8.2 Respondents to the consultation paper noted that SORPs had contributed to improvements in financial reporting and promoted consistency. Particular support was expressed for retaining the Association of Investment Companies SORP, the Authorised Funds SORP and, to a lesser extent, the Limited Liability Partnerships SORP.

8.3 The ASB also received feedback that it was its oversight role in the development of the SORPs, rather than the negative assurance statement itself, that gave the greatest value to the development of the SORPs.

8.4 The ASB considers that over time the number of SORPs can be reduced but that it will retain the SORPs where there is a clear and demonstrable need. The following table summarises the ASB's proposals for SORPs:

SORP	ASB proposal
Financial Reports of Pension Schemes	The SORP should be developed to provide application guidance for IFRS, namely IAS 26 'Accounting and Reporting by Retirement Benefit Plans'.
Accounting for Insurance Business	The SORP should remain in issue until the IASB completes phase II of its project on accounting for insurance contracts.

SORP	ASB proposal
Accounting for oil and gas exploration, development, production and decommissioning activities	The SORP should remain in issue until the IASB issues a new IFRS for the oil and gas industry.
Accounting issues in the asset finance and leasing industry	The SORP should be withdrawn when the FRSME becomes effective.
Limited Liability Partnerships	The SORP could continue but will need to be amended to provide guidance based on the tier system.
Association of Investment Companies	The SORP could continue but will need to be amended to provide guidance based on the tier system.
Financial Statements of Authorised funds	The SORP could continue but will need to be amended to provide guidance based on the tier system.
Banking segmental reporting	The SORP should be withdrawn.

Q15 Do you agree with the detail of the ASB's proposal to streamline the number of SORPs for profit-seeking entities as set out above? If not, why not?

SECTION 9: APPLICATION OF PROPOSALS TO PUBLIC BENEFIT ENTITIES

9.1 This section sets out the ASB's intentions regarding financial reporting by public benefit entities (PBEs).

9.2 In commencing its consideration of the comments made by respondents regarding the financial reporting for PBEs, the ASB noted that separate proposals were included in the policy proposal for these entities because they have different objectives, funding and ownership from for-profit entities, and that IFRS were not framed with PBEs in mind.

9.3 As a consequence, the policy proposal noted the ASB was minded to develop a public benefit entity standard, and suggested there may be a need to retain the PBE SORPs. The ASB took into consideration the large number of responses to the policy proposal from entities operating in the public benefit sector and the overwhelming support for the development of a PBE standard. The ASB decided to commission its Committee on Accounting for Public Benefit Entities to commence the development of such a standard.

9.4 The ASB is proposing:

(a) that the PBE standard should be a 'differences only' standard – identifying where there are omissions in UK financial reporting standards that need addressing for PBEs;

(b) that a consequence of having a specific standard would be that a PBE not falling within the scope of any of the SORPs would have to follow the PBE standard. The ASB therefore proposes that the standard would apply to all PBEs not just those addressed by the current SORPs; and

(c) that the PBE standard should be drafted in compliance with the FRSME and that PBEs falling in Tier 1 should adopt it to the extent that it does not conflict with EU-adopted IFRS. The ASB noted that PBEs generally did not apply the FRSSE because of charity limits. The ASB also decided to permit PBEs the option to adopt a higher tier voluntarily.

9.5 The ASB acknowledges that the task of developing the PBE standard is significant and could not be done to the same time line as this FRED. The ASB anticipates that a PBE FRED will be completed in 2011.

9.6 Having decided to work towards a PBE standard, the ASB addressed the future role of PBE SORPs. Responses to the consultation were very supportive of these. There was clear evidence that the SORPs were highly regarded and had improved the quality of financial reporting in this sector. The ASB agreed that the development of a PBE standard would still leave space for supplementary guidance to be developed by the PBE sectors in the form of SORPs.

9.7 The ASB agreed that existing SORPs would need to be updated but that this could not commence until the PBE standard was developed.

9.8 The ASB will consult further on the reporting requirements for public benefit entities when it issues the exposure draft of the PBE standard.

SECTION 10: THE DEVELOPMENT OF THE FINANCIAL REPORTING EXPOSURE DRAFT

INTRODUCTION

10.1 This section of the FRED summarises the ASB's decisions in its consideration of responses to its Consultation Paper 'Policy Proposal: The Future of UK GAAP'.

10.2 The ASB issued the policy proposal in August 2009 setting out its strategy for the future of Financial Reporting Standards (FRS) in the United Kingdom and Republic of Ireland*. In this document, the ASB noted its intention was to work under the International Accounting Standards Board's (IASB) framework. As a consequence of the proposed approach the ASB would withdraw extant FRSs and Urgent Issues Task Force (UITF) Abstracts. That said, the ASB did not propose to relinquish its right to set UK accounting standards.

10.3 The policy proposal was developed following previous consultations by the ASB:

(a) March 2004, Discussion Paper: 'UK Accounting Standards: A strategy for convergence with IFRS';

(b) March 2005, Exposure Draft: 'Accounting Standard-Setting in a Changing Environment: The Role of the Accounting Standards Board';

(c) January 2006, Public Meeting: 'Convergence Strategy';

* *The ASB's Standards are issued by Chartered Accountants Ireland in respect of application in the Republic of Ireland. References to 'UK' in terms of the Financial Reporting Standards and Generally Accepted Accounting Practice should be read as also being applicable to the Republic of Ireland.*

(d) May 2006, Press Notice: 'Tentative Proposal for Convergence'; and

(e) April 2007, Consultation Paper: 'IASB exposure draft of a proposed IFRS for small and medium-sized entities'.

RESPONSES TO THE POLICY PROPOSAL

10.4 The ASB received 155 responses to the policy proposal, of which approximately 30 per cent were from public benefit entities, including representative bodies of that sector. On 15 February 2010 the ASB issued a press notice which noted that the responses demonstrated a divergence of views on many important issues and that the ASB would have a challenging task in analysing them and coming to firm recommendations.

10.5 The responses highlighted an overall consensus that current UK FRS are in need of significant review. It was noted that current FRS, which are a mixture of Statements of Standard Accounting Practice (SSAP) issued by the Consultative Committee of Accounting Bodies, FRS developed and issued by the ASB and IFRS-based standards issued by the ASB to converge with international standards, are an uncomfortable mismatch that lack strong underlying cohesion or principles. Only a minority of respondents considered that existing UK FRS should be retained. In view of the level of consensus, the ASB decided to develop the policy proposal taking into consideration the detailed comments, with the aim of developing a FRED that would set out detailed financial reporting requirements for the future.

10.6 The ASB noted that to develop detailed requirements to include in a FRED it needed to work closely with the Department for Business, Innovation and Skills (BIS); to take into consideration EU proposals and an FRC study on micro entities; and to consider the outcome of the work being undertaken by the European Financial Reporting

Advisory Group (EFRAG) on behalf of the European Commission, on incompatibilities between the IFRS for Small and Medium-sized Entities and the EU Accounting Directives.

10.7 The ASB also noted that, given the detailed responses to the policy proposal, it should seek to work with constituents in developing the FRED. It noted that relatively few responses had been received from the users of small and medium-sized entities' financial statements. After consideration of whether further consultation was required, the ASB decided to ensure that public meetings were held in advance of publication of the FRED as one way of continuing to seek feedback from the users of these entities' financial statements.

10.8 The ASB also instructed staff to identify users and, if possible, to discuss its proposals in relation to their needs. ASB staff identified and held discussions with users who had not responded to the policy proposal. This process found that most of the users were aware of the ASB's proposals but had not responded to the policy proposal because it was not their usual custom to do so and because there was nothing in the proposals that had sufficiently concerned them.

THE FUTURE FRAMEWORK FOR FINANCIAL REPORTING

10.9 The first stage in the redeliberation was to consider respondents' comments on what the principle for the differential reporting framework should be, which would determine the future framework for financial reporting.

10.10 The policy proposal suggested a differential reporting framework based on public accountability. It proposed that entities that have public accountability would report in accordance with EU-adopted IFRS, and entities able to apply the FRSSE would continue to prepare financial statements in accordance with that standard. All other

entities (i.e. those that do not have public accountability and are not permitted to use the FRSSE) would be required to prepare financial statements in accordance with a standard based on the IFRS for SMEs. This would give rise to the following financial reporting framework:

	Nature of Entity	**Accounting Regime**
Tier 1	Entities that have public accountability	EU-adopted IFRS
Tier 2	Entities that do not have public accountability and are not small	IFRS for SMEs
Tier 3	Small entities	FRSSE

10.11 In considering responses to the proposal that the differential reporting framework should be based on whether an entity has public accountability, the ASB noted that whilst respondents raised specific concerns regarding the definition of 'public accountability' and its application to specific classes of entity, few actually disputed that it is an appropriate differentiator.

10.12 The ASB did consider two alternatives: the first sought to amend the IFRS for SMEs in a fundamental manner and the second suggested an alternative framework for financial reporting that focused on extending the use of the FRSSE.

10.13 The proposal for a more fundamental reconsideration of the IFRS for SMEs considered that the relevant users of the financial statements of Tier 2 entities are mainly shareholders (who are not involved in management of the entity), suppliers and customers, and credit insurers. Consequently, it was suggested that the IFRS for SMEs should be amended to focus on the information needs of these users. As highlighted above, there was a lack of responses from users of Tier 2 entity financial statements, and so little evidence is available about the needs of these

users and hence whether those needs would be met by the ASB's proposals.

10.14 This alternative view considered users of Tier 2 entities' financial statements to be interested in the state of affairs at the end of the period, the results from that period and, most importantly, wanted to be able to identify future cash flows from the entity. A reconsideration of the IFRS for SMEs catering to the needs of these users would aim to simplify the IFRS for SMEs, focusing on future cash flows and removing what are perceived to be the complexities that arise from a desire to make accounting comparable to that produced under IFRS.

10.15 In discussing this view the ASB noted that in simplifying the IFRS for SMEs, a distinction needed to be made between changes for the sake of simplicity and changes to achieve other accounting goals such as the reduction of volatility. The example of derivatives was considered. The majority of ASB members considered that it would not, in the current age, be acceptable for a company with derivatives, such as forward foreign exchange contracts or interest rate swaps, to avoid accounting for these at fair value.

10.16 This majority expressed a concern that were transactions to remain unrecognised in the primary statements, an entity might not fully appreciate all the ramifications of a transaction entered into. For example, an entity may believe itself to be simply fixing its cash flows when entering into a derivative, when it is in fact taking on substantial risks. Without adequate financial reporting standards, such risks may not be reported. The need to fair value derivatives can be the trigger event that informs management of the risk they have taken on. These ASB members consider that financial reporting standards should be effective in ensuring transactions are reported fully and transparently.

10.17 In contrast, the alternative view considered that if a derivative is being used to fix future cash flows, its market value at a single point in time should not be reflected in the balance sheet.

10.18 A majority of ASB members did not agree with the alternative view's proposal to amend the IFRS for SMEs, noting that it was not consistent with a move to an IFRS-based framework and did not address the need to ensure that financial statements reported transactions appropriately.

10.19 The second alternative view considered by the ASB focused on the opportunity to make a substantial simplification to the requirements applying to smaller entities. This view noted that the distribution of entities in Tier 2 was thought to be heavily weighted towards the smaller end. In this circumstance, it was suggested, both the lowest and highest tiers could be expanded to include more entities. At its most extreme, this could lead to a two-tier system offering only the choice between EU-adopted IFRS and the FRSSE.

10.20 The ASB decided to review the responses to an earlier consultation on the possibility of raising the FRSSE threshold. In May 2006, the ASB had issued PN 289, consulting on whether the scope of the FRSSE should be extended to include medium-sized companies. Of 43 respondents, 18 agreed with the proposal, 11 disagreed, and 14 did not answer the specific question. There did not, therefore, appear to be a clear constituent view in favour of the extension of the FRSSE. Those who supported it did so mainly on efficiency grounds (for preparers, and for the maintenance of accounting standards), while those who disagreed suggested that more complex accounting and disclosure were needed for companies that are not small, and that if the scope of the FRSSE became too broad it would lose its fitness for purpose for the entities for which it was originally written.

10.21 ASB members expressed a concern that extending the scope of the FRSSE without amending it to include accounting for more complex transactions would run the risk of reducing the quality of financial reporting for larger entities, which are more likely to engage in transactions not currently addressed in the FRSSE. Conversely, amending the FRSSE to include the accounting for more complex accounting would risk over-complicating matters for smaller entities. The majority of ASB members noted it was necessary to balance these two competing positions in developing a proportionate financial reporting framework.

10.22 The ASB decided not to extend the scope of the FRSSE, noting that it wished to retain the FRSSE in its current form so that those smaller entities, where complex transactions are less likely, can produce quality financial statements based on a single, simplified financial reporting standard relevant to their activities.

10.23 In forming its view the ASB consulted its Committee on Accounting for Smaller Entities. The Committee noted that the FRSSE was originally designed for smaller entities and, since its development in 1997, the turnover threshold had been increased from £2.8 million to £6.5 million. It expressed a concern that a move to increase the scope further would lead to small entities not having an accounting standard available to them that was fit for purpose.

10.24 Following consideration of the two alternative lines of thought, and as a consequence of the general support for the proposed move to a differential reporting regime based on public accountability, the ASB decided to proceed with its proposals.

SCOPE OF ACCOUNTING STANDARDS

10.25 As outlined in its policy proposal, the ASB acknowledged the need to work closely with BIS in developing its proposals into a FRED. One question that arose regarded

the role of the ASB and the interaction of accounting standards with Company law. A view was expressed that it was a matter for the government (BIS in the UK, and DETI in the Republic of Ireland), not the ASB, to set the scope of accounting standards and thereby to decide the financial reporting framework. The ASB expressed the view that it had in the past determined the scope of accounting standards and that this should continue. The ASB agreed it must, however, continue to work with BIS to attain maximum agreement on the proposals to be included in the FRED. In the absence of agreement the government has the right to set Company law that augments or overrides accounting standards.

10.26 In developing the FRED, consideration was given to the route by which entities should be required to apply EU-adopted IFRS. Two options were evaluated: amending Company law, or including the requirements within financial reporting standards. The first option would require that either a list of entities that have public accountability, or the definition of public accountability, would have to be included in the Companies Act 2006.

10.27 The alternative, of including the requirements within financial reporting standards, continues existing practice whereby the scope section of accounting standards sets out the application of the standard. The ASB decided this approach would maintain a greater level of flexibility for possible future changes than enshrining requirements in Company law. This option also retains the ASB's sovereignty over the setting of accounting standards.

PUBLIC ACCOUNTABILITY AS THE DIFFERENTIATOR FOR TIER 1 ENTITIES

10.28 Consistent with the policy proposal, the FRED proposes that entities that have public accountability apply EU-adopted IFRS. Entities in this tier will, under the proposal, be required to elect under section 395(1)(b) of the Companies Act 2006 to prepare financial statements in

accordance with international accounting standards ("IAS individual accounts") or in the case of a group, section 403(2)(b)("IAS group accounts"), unless they are already required by law to prepare IAS accounts.

10.29 In developing this proposal the ASB took into consideration the concerns raised regarding the use of public accountability as the differentiator for the financial reporting framework and regarding the definition of public accountability, as well as the additional clarification sought on whether specific entities would fall within the definition or not.

DIFFERENTIAL REPORTING REGIME BASED ON PUBLIC ACCOUNTABILITY

10.30 The concerns of respondents that did not support public accountability as the differentiator broadly related to:

(a) small entities that have public accountability;

(b) entities that have a wider importance in society, such as charities and service providers; and

(c) large private entities.

Small entities that have public accountability

10.31 The suggestion that small entities that have public accountability should not be included in Tier 1 arose from considering the costs in comparison to the benefits in the application of EU-adopted IFRS. A particular concern was noted in relation to some smaller financial institutions, such as small building societies and credit unions.

10.32 The ASB agreed it was important to balance the costs and benefits of financial reporting. In relation to the benefits of quality financial reporting it noted that a small financial institution fulfilled the definition of having public

accountability and that the role of such institutions in wider society needed to be taken into account.

10.33 The ASB did not, however, wish to overburden these small entities, and accordingly undertook a review of a sample of the financial statements of smaller credit unions. The review noted that the assets and liabilities of credit unions were made up of deposits from members which were lent back to members. Consequently it seemed unlikely that smaller credit unions would engage in the use of complex financial instruments (including interest rate management) because they did not have expert employees. In this scenario, financial instruments would meet the basic instruments requirements in the FRSME. The ASB concluded that, in these circumstances, the accounting under EU-adopted IFRS would actually be little different from that under the FRSME.

10.34 Having determined that the accounting would not differ significantly between EU-adopted IFRS and the FRSME for small credit unions, the ASB sought to identify how these institutions could be permitted, given the definition of public accountability, to apply the FRSME. The ASB decided it could use a combination of size and regulation, agreeing this would be an exception to the public accountability requirements.

10.35 The FRED proposes that financial entities that have public accountability and are prudentially regulated and small enough to meet the definition of a small entity should use the FRSME. The ASB, however, decided it was necessary to require these small financial entities to meet all three of the qualifying conditions of a small company because the legal requirement to achieve only two of the three criteria did not address the fact that such entities might have a low turnover and number of employees while still being responsible for a high value of assets.

10.36 The eligibility conditions in respect of being prudentially regulated are those in section 384(1)(b) or 384(2)(c), (d) and (e) of the Companies Act 2006.

Entities that have a wider importance in society and large private entities

10.37 In relation to entities that have a wider importance to society and large private entities, which some respondents suggested should be included in Tier 1, the ASB considered the application of the differential financial reporting framework in developing its proposals and sought comments on this issue. Respondents to the policy proposal noted that the increased cost of applying EU-adopted IFRS outweighed the benefits to users whilst others commented that size could be an arbitrary criterion.

10.38 The ASB agreed that it was important to identify what benefit a user of the financial statements would gain from the increased disclosures that a large entity would have to make if it were to apply EU-adopted IFRS.

10.39 The users of large privately owned entities' accounts are predominantly lenders and shareholders (who may be owner/managers). Feedback from lenders noted that if additional information were required, it would be requested from management; financial statements were a starting point for further discussion.

10.40 Whilst the ASB took into consideration concerns about size, it noted it was highly unlikely that full agreement on a differentiator for a tier system would ever be achieved. A good level of agreement had been received, however, to the policy proposal's recommendation to use public accountability. As a consequence, the Board decided to retain a differentiator based on public accountability.

THE DEFINITION OF PUBLIC ACCOUNTABILITY (TIER 1)

10.41 A significant number of respondents to the policy proposal sought clarification of the key elements of the definition of public accountability. The ASB decided that it would provide some guidance; however, the guidance would only supplement the information already contained in paragraphs BC55 to BC77 of the IFRS for SMEs.

10.42 The elements of the definition on which respondents sought guidance included:

(i) traded on a public market;

(ii) deposit-taking entity;

(iii) holds assets in a fiduciary capacity;

(iv) broad group of outsiders; and

(v) primary business.

Traded on a public market

10.43 The ASB did not consider that it needed to provide further guidance on the definition of traded on a public market because paragraph BC57 of the IFRS for SMEs states:

The exposure draft referred to, but did not define, public markets. The IFRS for SMEs includes a definition consistent with the definition in IFRS 8.

Deposit-taking entity and holds assets in a fiduciary capacity

10.44 In the consultation document, the ASB extended the definition of public accountability to include 'deposit-taking entities' because, in its view, banks and other credit institutions do not hold funds in a fiduciary capacity. The holding of monies in a fiduciary relationship implies a

relationship whereby funds are held by one party in trust for another party. The entity holding the funds is expected to act at all times in good faith and with due regard to the other party's best interests.

10.45 The ASB noted that by extending the definition in this way it was referring to deposits taken by a money-lending entity and/or regulated entity; that is banks and providers of credit. The ASB noted that BC59 of the IFRS for SMEs provides that:

"*a primary business of banks, insurance companies, securities brokers/dealers, pension funds, mutual funds and investment banks is to hold and manage financial resources entrusted to them by a broad group of clients, customers or members who are not involved in the management of the entities. Because such an entity acts in a public fiduciary capacity, it is publicly accountable.*"

10.46 The ASB decided that including 'deposit-taking entity' in the definition was consistent with the IASB reference to acting in a 'public fiduciary capacity'.

Broad group of outsiders

10.47 Respondents to the policy proposal questioned the meaning of the term 'a broad group of outsiders'. Did 'a broad group' relate to diversity of membership or to the number of members? Some respondents, for example, suggested that small credit unions might not have public accountability because they did not meet the 'broad group of outsiders' test within the definition.

10.48 The ASB noted that the definition of a broad group of outsiders was linked with 'holding assets in a fiduciary capacity' or 'is a deposit-taking entity' – hence a charity, for example, that was involved with a broad group of outsiders would not have public accountability as it failed the first part of the definition, i.e. it is not a 'deposit-taking entity for a broad group of outsiders' nor does it 'hold assets in a fiduciary capacity for a broad group of outsiders'.

10.49 In considering whether to provide guidance as to what constitutes a broad group of outsiders the ASB noted that BC58 of the IFRS for SMEs states that an entity's decision to enter a capital market makes it publicly accountable. It was further noted that public investors often provide longer-term risk capital, and do not have the power to demand the financial information they might find useful for investment decision-making. The ASB saw a link between this statement and the holding of assets in a fiduciary capacity for a broad group of outsiders. The outsider is not involved in the management of the entity and relies on general purpose financial statements and publicly available information such as regulatory returns.

Primary business

10.50 In relation to concerns regarding the meaning of 'primary business', BC57 of the IFRS for SMEs states:

The exposure draft had proposed that any entity that holds assets in a fiduciary capacity for a broad group of outsiders should not be eligible to use the IFRS for SMEs. Respondents noted that entities often hold assets in a fiduciary capacity for reasons incidental to their primary business (as, for example, may be the case for travel or real estate agents, schools, charitable organisations, co-operative enterprises and utility companies). The IFRS for SMEs clarifies that those circumstances do not result in an entity having public accountability.

10.51 In view of the explanation provided in the basis for conclusions to the IFRS for SMEs, the ASB decided further guidance was not necessary.

Public benefit entities

10.52 Some respondents to the policy proposal representing those engaged in charitable activities expressed concern that the use of the phrase 'publicly accountable' in this context might be misleading, as charitable organisations also consider themselves to be accountable to the public in

their activities and use of funds. The ASB considers that 'publicly accountable' is understood in the context of the FRED to relate to markets, and that the term 'public benefit entities', as discussed in section 9 of this FRED, appropriately describes charitable organisations.

Application of the definition to certain entities

10.53 Respondents to the policy proposal had sought clarification on the application of public accountability to specific types of entities. The ASB considered whether to address this concern by providing a list of entities that it considers to have public accountability. The ASB did not wish, however, to restrict the application of Tier 1 to such a list. It therefore developed application guidance, as outlined above, and part of the draft application guidance set out in the FRED provides an indicative list of entities that it considers have public accountability. In this way the list provides clarification but does not restrict the application of public accountability to entities included on the list.

Pension schemes[*]

10.54 The ASB agreed with BC59 of the IFRS for SMEs that pension schemes' primary business is to hold and manage financial resources entrusted to them by a broad group of members and that they therefore have public accountability. The ASB noted that a pension scheme holds assets in a fiduciary capacity. Having made this decision, it agreed that pension schemes would apply IAS 26 'Accounting and Reporting by Retirement Benefit Plans' and that a decision needed to be reached on what role the SORP for the Financial Reports of Pension Schemes should take. The ASB considers that the SORP can fulfil a useful role in providing application guidance on IAS 26.

[*] *Also referred to as pension plans and pension funds.*

10.55 The FRED therefore proposes that pension plans have public accountability and should prepare financial statements in accordance with EU-adopted IFRS, and that the SORP for pensions should be updated to provide guidance on the application of IAS 26.

Co-operatives

10.56 Respondents to the policy proposal also sought guidance on whether co-operative entities have public accountability. The ASB considered that where the co-operative was not traded on a public market and did not hold assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses, it did not have public accountability.

Entities undertaking insurance business

10.57 The ASB considered the application of public accountability to entities that undertake insurance business. It noted that the IFRS for SMEs does not provide guidance on accounting for insurance contracts. Therefore, an entity applying the FRSME would need to refer to IFRS 4 'Insurance Contracts' and, where appropriate, FRS 27 'Life Assurance' in the UK. The Board agreed that it would retain FRS 27 until the IASB completed phase II of its insurance project and a comprehensive accounting standard for insurance contracts was available.

10.58 The ASB noted that the risks associated with insurance contracts are different from other contracts, such as construction contracts or contracts to supply goods, because the amount of any individual claim on an insurance contract could be in excess of any individual premium paid as consideration for the contract. The nature of an entity undertaking insurance business is that it pools risks from many individuals in anticipation of paying claims to only a few.

10.59 The ASB agreed with the IASB's reasoning in BC59 of the IFRS for SMEs that such entities act in a public fiduciary capacity and as such have public accountability.

Mutual and investment funds

10.60 The ASB gave consideration to whether certain Irish funds had public accountability due to a complication whereby the Irish funds are listed but not, technically, traded because although asset values are published, those wishing to trade in them have to go through the fund administrator and not a broker.

10.61 The ASB, whilst acknowledging the position, noted that these funds acted in a public fiduciary capacity and gained access to funds from the general public.

10.62 The ASB concluded that mutual funds, along with investment trusts, venture capital trusts and exchange traded funds, all had public accountability.

FINANCIAL REPORTING BY QUALIFYING SUBSIDIARY ENTITIES

10.63 One of the most significant concerns highlighted in responses to the consultation document was the financial reporting by subsidiary entities. Many respondents considered that the policy proposal did not adequately address the needs of subsidiaries.

10.64 They identified that, for subsidiary undertakings of entities that have public accountability, a move to the IFRS for SMEs would require recognition and measurement differences to be monitored and maintained at group level, and the alternative of a move to EU-adopted IFRS would increase disclosure in comparison to current FRS.

10.65 Respondents who commented on the recognition and measurement differences between subsidiary and group accounts highlighted that these differences could require

significant time to identify, quantify and monitor. As a consequence additional costs would be incurred (both internally and in external audit fees). A move to the IFRS for SMEs was not therefore supported by these respondents.

10.66 The ASB agreed with respondents' views that a move to EU-adopted IFRS would increase disclosure requirements.

10.67 Accordingly it decided to consider exemptions from disclosure requirements for subsidiary undertakings. This would enable qualifying subsidiaries to prepare financial statements with reduced disclosures where the disclosures or their equivalent are included in group financial statements that are publicly available.

10.68 The ASB developed the proposed disclosure exemptions by evaluating three sources of information:

(a) disclosure exemptions currently permitted in UK FRS;

(b) areas that are managed on a group basis; and

(c) other areas.

10.69 Current UK FRS permits subsidiaries exemptions from the requirement to prepare a cash flow statement and from making disclosures in respect of intra-group related party transactions and certain financial instruments.

Cash flow statements

10.70 The FRED retains the current exemption available in FRS allowing qualifying subsidiary undertakings not to prepare a cash flow statement.

Related party transactions

10.71 The FRED does not, however, include an exemption from disclosure of related party transactions between group undertakings. The exemption currently permitted by

FRS 8 'Related party disclosures' is taken from the Regulations. In considering whether to retain the exemption, the Board noted that IAS 24 'Related party disclosures' does not contain a similar exemption. It also took into consideration the outcome of the report published by BIS following the results of an independent inquiry into the collapse of the MG Rover Group.

10.72 In the press release issued by BIS, it was noted that the Inspectors suggested that improvements could be made to auditing and reporting standards that would increase transparency in financial statements. In view of the Inspectors' comments, rather than include the exemption the Board decided to seek views on whether it should allow the exemption permitted by the Regulations.

Financial Instrument Disclosures and Classification

10.73 The ASB has considered the recognition and measurement requirements of EU-adopted IFRS and possible conflicts with the Accounting Directives. In doing so it noted that where an entity includes financial liabilities at fair value in accordance with section 36(4) of Schedule 1 of the Regulations (i.e. where the financial liability is not held as part of a trading portfolio and is not a derivative), it must provide relevant disclosures for those instruments. To assist preparers and auditors, the relevant disclosures have been added to Section 11 of the FRSME.

10.74 The ASB also considered the effect of the existence of features such as loan covenants for the purposes of determining whether a debt instrument meets the criteria for a basic financial instrument in accordance with section 11 of the FRSME. Management judgement should be applied where no specific guidance is included in the FRSME: in this case, it might be noted that the wording in paragraph 11.9 is based on IFRS 9. By analogy to paragraph B4.10 of IFRS 9, terms that protect the lender from credit deterioration of the borrower are not contingent on future events. Therefore, a debt instrument

with such a condition would meet the criteria for a basic financial instrument measured at amortised cost.

Areas managed on a group basis

10.75 In examining disclosure requirements the ASB considered areas that are managed on a group basis, such as share-based payments and employee benefits. In these areas the Board considered that more meaningful disclosures could be obtained from making the appropriate disclosures in the consolidated financial statements rather than in the subsidiary undertakings' financial statements. The FRED proposes reduced disclosures for:

(a) share-based payments;

(b) acquisitions of assets that constitute a business;

(c) discontinued operations; and

(d) employee benefits.

Other proposals

10.76 In identifying other areas where reduced disclosures might be permitted, the ASB reviewed the proposals made by the Australian Accounting Standards Board (AASB). The AASB approach, however, focuses on reducing disclosure in general and is not specific to the financial reporting of subsidiary entities. The ASB, nonetheless, reviewed the AASB proposals and also sought guidance from the CBI Financial Reporting Panel Working Party on identifying further disclosure reductions. The outcome of this work gave rise to the FRED proposing an exemption from the requirements:

(a) in paragraph 38 of IAS 1 'Presentation of Financial Statements' to present certain comparative information;

(b) in paragraphs 134 to 136 of IAS 1 'Presentation of Financial Statements';

(c) in paragraph 30 and 31 of IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'; and

(d) in paragraph 37 of IAS 24 'Investments in Associates'.

Definition of a qualifying subsidiary

10.77 The ASB considered whether the reduced disclosures should be restricted to 100% subsidiaries. It was agreed that specifying any percentage majority ownership below 100% would be arbitrary, but that if there were no ownership threshold, protection should nonetheless be afforded to minority shareholders. The ASB considered achieving this through:

(a) using wording comparable to the formulation in IAS 27 'Consolidated and Separate Financial Statements' allowing minority shareholders to insist on consolidated financial statements; or

(b) amending the Companies Act to give minority interests the right to vote on whether they were satisfied with reduced disclosures.

The ASB decided:

(a) not to specify a qualifying ownership percentage for subsidiaries allowed disclosure exemptions, and

(b) to give any shareholders (therefore a minority shareholder) the right to require full disclosures.

The FRED therefore proposes that an entity informs its shareholders of its decision to apply the reduced disclosure framework.

10.78 The ASB also discussed the case of subsidiary companies that are intermediate parent companies. The Act allows parent companies an exemption from preparing group accounts in certain circumstances, but if those circumstances do not apply then the intermediate parent must prepare group accounts. The ASB concluded that where an entity that is a qualifying subsidiary must prepare group accounts because it has no exemption under the Act, it may not take advantage of the reduced disclosure framework in those group accounts.

Reduced disclosures and Company law

10.79 In developing disclosure requirements for subsidiary entities, the ASB considered the fact that the Act permits financial statements to be prepared either in accordance with international accounting standards or in accordance with section 396 of the Act. Any amendment to the disclosure requirements of EU-adopted IFRS would mean that the financial statements would no longer be in accordance with international accounting standards and, as a result, the financial statements of a subsidiary choosing to apply EU-adopted IFRS and the reduced disclosure framework must be prepared in accordance with section 396 of the Act.

10.80 As a consequence of the above, financial statements that take advantage of the reduced disclosures also need to comply with the Accounting Directives, so, for instance, their primary statements must be presented in accordance with one of the Companies Act formats.

Publicly accountable subsidiaries

10.81 In its policy proposal the ASB proposed that publicly accountable subsidiary entities should report under full EU-adopted IFRS. A majority of respondents to the policy proposal agreed with the ASB. Consequently the ASB confirmed its view that subsidiaries that have public

accountability should report under EU-adopted IFRS and should not be permitted any disclosure exemptions.

Consistency within groups

10.82 The ASB noted that section 407 of the Act permitted exceptions to the requirement for consistent accounting policies across a group in certain instances. The ASB agreed that the 'good reasons' to have inconsistent accounting within a group should include the existence of a publicly accountable subsidiary, rather than just, as is currently required, a publicly traded subsidiary, meaning that it would be acceptable for some subsidiaries within a group to prepare financial statements in accordance with Tier 1 while other subsidiaries in the same group applied the requirements of Tier 2.

Aggregated and abbreviated disclosure

10.83 The Board agreed that disclosure exemptions for subsidiaries should be permitted where the relevant disclosure requirements were met in the group accounts, even where the disclosures were made in aggregate or in an abbreviated form.

Requirement to prepare group accounts

10.84 The Board considered whether qualifying subsidiaries applying the reduced disclosure framework would need an alteration to IAS 27 in respect of the requirement to prepare group accounts, to align this with Company law. However, as discussed in paragraph 10.95 below, EU guidance exists recommending IFRS preparers to look to local law in this regard. As such, it was not seen as necessary to make additional amendments to IAS 27 for qualifying subsidiaries using the reduced disclosure framework.

AMENDMENTS TO THE IFRS FOR SMEs (TIER 2)

10.85 In its policy proposal the ASB proposed to adopt the IFRS for SMEs wholesale without amendment. Whilst respondents to the policy proposal supported the adoption of the IFRS for SMEs, many suggested amendments. In order for the ASB to evaluate the suggestions, it agreed the following guidelines:

(a) changes to the IFRS for SME should be minimal;

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

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

10.86 The ASB also considered whether the guidelines for evaluating proposed amendments to the IFRS for SMEs should include the IASB framework. It was noted that as part of the move to an IFRS-based framework, the current ASB framework would be withdrawn. It was agreed that guideline (b) would adequately address compliance with the IASB framework.

10.87 It was also agreed that the guidelines should be working guidelines. Costs and benefits related to the proposals would also be considered.

10.88 The ASB undertook a detailed review of all suggested amendments put forward by respondents. A considerable number of the suggestions did not adhere to the core guidelines agreed by the ASB and were not considered to provide a significant cost reduction or to have a significant impact on the value of the information provided to users, therefore these were not considered further.

10.89 The ASB considered three categories of amendments:

(a) wording clarifications, where respondents considered the IFRS for SMEs needed further clarification;

(b) significant areas in the IFRS for SMEs that needed amendment; and

(c) areas where the IFRS for SMEs conflicts with legal requirements

10.90 The areas that the ASB considered regarding wording clarifications included:

(a) Respondents had suggested clarification of the meaning of actuarial gains and losses – although the IFRS for SMEs refers to actuarial gains and losses in respect of defined benefit pension schemes, it does not explain what these are. The Board observed that entities could refer to EU-adopted IFRS for clarification and so decided that no amendment was necessary.

(b) Respondents had highlighted a concern regarding the measurement of distributions in kind. The IFRS for SMEs has incorporated part of IFRIC 17, so that an obligation to distribute a non-cash asset gives rise to a liability measured initially at the fair value of the asset, and this liability is remeasured at the end of each reporting period until the distribution is made. However, the IFRIC 17 exemption for dividends between companies under common control has not been included. The ASB decided that this was unlikely to create issues in practice as intercompany distributions are rarely declared before being made.

(c) The next clarification issue was in relation to key management personnel, where there were requirements in both the IFRS for SMEs and the Companies Act. The ASB decided to adhere to the

principle of minimal changes and so did not amend the definition of key management personnel.

(d) The ASB did, however, agree to amend the definition of related parties, where the definition in the IFRS for SMEs was not synchronised with that in the Act. The ASB considered this was a change to ensure consistency with the Accounting Directives.

Significant changes requested

10.91 The second category of change related to respondents' more significant concerns, where change to the IFRS for SMEs would be more fundamental.

Income tax

10.92 The ASB noted that a number of respondents had suggested amending the income tax requirements. Respondents to the policy proposal had identified a number of reasons for making the change, including the fact that the IFRS for SMEs anticipated a change to IAS 12 that was never made, and the general lack of clarity on what the requirements mean in practice.

10.93 Section 29 of the IFRS for SMEs was based on the IASB proposals to amend IAS 12 that were at exposure draft stage when the IFRS for SMEs was published. The IASB subsequently decided not to proceed with the exposure draft; consequently the IFRS for SMEs does not take its principles from existing IFRSs. Further, respondents to the policy proposal had argued strongly that the chapter was difficult to understand and lacked relevant guidance.

10.94 The draft FRED proposes to remove section 29 'Income Tax' and replace it with IAS 12 'Income Taxes'. The ASB acknowledges that this amendment is not consistent with its policy of minimal changes, but accepted the validity of the concerns raised by respondents to the policy proposal.

Consolidation

10.95 A further matter raised by respondents related to the requirement to prepare consolidated financial statements. Respondents questioned whether the exemption from preparing consolidated accounts for intermediate parent companies, currently available under the Act and FRS 2, would continue to be available under the IFRS for SMEs. The ASB noted that the EU had issued guidance in respect of EU-adopted IFRS stating that preparers should look first to the requirements of the law to establish whether consolidated accounts were needed, and then use IAS 27 for guidance on how to prepare group accounts if these are required. The ASB decided to amend the IFRS for SMEs to clarify that section 9 applies only when an entity is required to prepare consolidated financial statements in accordance with the Act.

Dormant entities

10.96 In response to the policy proposal, a question had been raised regarding dormant entities. Respondents were concerned that dormant entities with intra-group balances would be required to discount long-term liabilities and that performing this remeasurement on first-time adoption would give rise to an accounting adjustment. By recording a transaction in its financial statements, such an entity would no longer be dormant.

10.97 The ASB noted that dormant entities could choose whether to apply the FRSSE or the FRSME. The ASB, taking into consideration the costs and benefits of its proposals, agreed to provide entities applying the FRSME with transitional relief whereby on transition an entity may elect to retain its accounting policies for measurement of reported assets, liabilities and equity at the date of transition to the FRSME until there is any change to those balances or the company undertakes any new transactions.

Other suggestions

10.98 The ASB considered and decided not to amend the IFRS for SMEs for the following suggestions:

(a) Removal of the prohibition from revaluing fixed assets.

(b) Insertion of guidance to address group reconstructions. FRS 6 and the Act permit, in certain instances, the use of merger accounting. The ASB noted that this is also an issue under EU-adopted IFRS and it should not seek to resolve the issue for entities reporting in accordance with the FRSME.

10.99 The ASB also noted the suggestions made by some respondents that, in general, accounting policy choices (such as the option to revalue fixed assets) should be reintroduced, on the grounds that this would put the cost/benefit decision in the hands of preparers rather than of standard-setters. It was noted, however, that the IASB's consultations led to a conclusion that most small and medium-sized entities would choose the simplest of any set of options, and that (in BC91) "if a private entity feels strongly about using one or more of the complex options, it could elect to follow full IFRS, rather than the IFRS for SMEs". Accordingly, the ASB decided not to reintroduce any accounting policy options.

10.100 The ASB was asked to reconsider its tentative decision on the prohibition of the revaluation of fixed assets. It considered these concerns further but noted that the amendment did not adhere to the guidelines for amendments that it had set itself. The ASB decided, however, that it should consult explicitly on its principles for minimal modifications to the IFRS for SMEs.

Conflicts with legal requirements

10.101 The third category related to conflicts between the Act or the Directives and the IFRS for SMEs. To identify the areas

where the IFRS for SMEs allowed only one accounting treatment and that treatment was in conflict with the Directives, the ASB referred to the detailed work undertaken by EFRAG on these incompatibilities and noted the need to ensure that all of the requirements were properly in compliance with the Directives.

10.102 The ASB decided on the following actions for the six areas identified by EFRAG as incompatibilities between the IFRS for SMEs and the Directives:

(a) amending the definition of extraordinary items to retain the definition in FRS 3 'Reporting Financial Performance';

(b) requiring additional disclosures for financial liabilities that were held at fair value but were not held as part of a trading portfolio or a derivative;

(c) shortening the presumed life of goodwill from 10 to 5 years;

(d) providing guidance that negative goodwill may be recognised in the income statement only when it meets the definition of a realised profit;

(e) replacing the prohibition on reversal of impairment losses of goodwill with a requirement to reverse the loss if, and only if, the reasons for the impairment cease to apply; and

(f) removing the requirement for unpaid called-up share capital to be recognised as an offset to equity.

10.103 In addition to the areas of incompatibility noted by EFRAG, the ASB decided it should also remove options that were available in the IFRS for SMEs but not permitted by the Accounting Directives. By removing these options, a set of financial statements under the FRSME cannot breach the requirements of the Directives or UK Company law,

although it may not fully meet the disclosure requirements thereof.

10.104 As part of this review, the ASB spent some time considering the disclosure requirements in the Directives (and thereby transposed into the Regulations) for financial instruments. Paragraph 36(4) of Schedule 1 to the Regulations requires that disclosures are made in accordance with International Accounting Standards for certain financial liabilities. The ASB decided to include the relevant disclosures within section 11 of the FRSME so that they would be applied when entities had this type of instrument. These disclosures also apply when an entity takes the option within section 11 to apply the requirements of EU-adopted IAS 39.

FINANCIAL REPORTING BY SUBSIDIARY ENTITIES (TIER 2)

10.105 Following its proposal to allow reduced disclosures for subsidiary entities that apply EU-adopted IFRS, the ASB considered whether it should permit similar reductions for subsidiary undertakings that apply the FRSME, and agreed to permit similar disclosure reductions.

THE FINANCIAL REPORTING STANDARD FOR SMALLER ENTITIES (TIER 3)

10.106 The policy proposal suggested that the existing FRSSE should remain for the foreseeable future, so there would be no change in accounting practice for small entities. In reviewing matters raised by respondents to the policy proposal, the ASB gave consideration to (i) the longer term role of the FRSSE and (ii) how the FRSSE would operate once existing FRS are withdrawn.

10.107 Respondents had mixed views on the suitability of the IFRS for SMEs for those entities currently applying the FRSSE. The majority favoured retaining the FRSSE for a period after the transition of UK financial reporting

standards to an IFRS-based framework, and then consulting on the FRSSE's future role.

10.108 The ASB decided that, at this stage, it would not commit itself to any particular options for the FRSSE but that it would consult on all options at a later stage.

10.109 The ASB also decided not to specify when it would consult but to consider the timing of the review once the FRSME was implemented. The timing of the review would also depend on the progress of the European Council's proposals for micro entities, the experience of entities applying the FRSME, the IASB's plans for updating the IFRS for SMEs and the FRC study of financial reporting by micro entities.

10.110 In considering how the FRSSE would operate once existing FRS are withdrawn, the ASB decided to propose amendments to the FRSSE that would confirm that on transition to an IFRS-based framework, entities applying the FRSSE would not be required to make any adjustments to their existing accounting policies.

10.111 It was agreed that where an entity (reporting in accordance with the FRSSE) entered into a new transaction that was not addressed by the FRSSE, and for which it did not have an existing accounting policy, it would have regard to the FRSME.

10.112 The ASB noted that the FRSSE provided at paragraph 16.2 an exemption from the requirements of FRS 8 where an entity prepared consolidated financial statements. The FRED proposes to remove this exemption consistent with the decision to consult on the exemption for Tier 1 and Tier 2 entities, and consults specifically on this question.

THE FUTURE ROLE OF THE STATEMENTS OF RECOMMENDED PRACTICE IN THE FOR-PROFIT SECTOR

10.113 In its policy proposal the ASB proposed that SORPs should only remain in place where there was a clear and demonstrable need arising from sector specific issues not covered by guidance in accounting standards.

10.114 Respondents to the policy proposal noted that SORPs in the for-profit sector had contributed to the improvement of financial reporting and promoted consistency. Particular support was expressed for retaining the Association of Investment Companies SORP, the Authorised Funds SORP and, to a lesser extent, the Limited Liability Partnerships SORP.

10.115 The ASB conclusions set out in section 8 of part 1 of the FRED are based on consultation with interested parties, and propose retaining any SORP for which there is a clear and demonstrable need.

10.116 The ASB took into consideration the views of respondents to the consultation paper that the process of developing the SORPs brought a body of people together to achieve consistent reporting in the industry, and the ASB's oversight role gave weight to that process. It was the involvement in the process of developing the SORPs rather than the negative assurance itself that gave value. Consequently the ASB decided to retain several SORPs.

10.117 In developing the proposals for SORPs the ASB noted that it would need to update its Statement on its Policy and Code of Practice in relation to SORPs. The ASB decided that this matter could be addressed after the FRED had been published.

10.118 The ASB also noted that it would need to include in the FRED the words from FRS 18 'Accounting Policies' which had the effect of requiring SORPs to be applied.

FINANCIAL REPORTING FOR PUBLIC BENEFIT ENTITIES

10.119 In considering respondents' comments regarding the financial reporting for public benefit entities (PBEs), the ASB noted that separate proposals were included in the policy proposal for PBEs because these entities have different objectives, funding and ownership from for-profit entities, and that IFRSs were not framed with PBEs in mind.

10.120 In the policy proposal the ASB had said it was minded to develop a PBE standard, and suggested there may be a need to retain the PBE SORPs. It took into account the large number of responses to the policy proposal from this sector and the overwhelming support for the development of a PBE standard. The ASB decided to commission its Committee on Accounting for Public Benefit Entities to commence the development of the standard.

10.121 The ASB addressed whether the PBE standard should:

(a) be comprehensive or just address the differences between profit-seeking and not-for-profit entities;

(b) apply to all PBE entities, or just those covered by SORPs; and

(c) should apply to PBEs in all tiers.

10.122 The ASB also noted that, although the existing SORPs were all compliant with current financial reporting standards, there were inconsistencies between them (for example in relation to capital grants). In response, the ASB decided:

(a) the PBE standard should be a 'differences only' standard – identifying where there are areas of silence in financial reporting standards that need to be addressed for PBEs.

(b) that a PBE not applying any of the SORPs would still have to follow the PBE standard.

(c) that the PBE standard should be drafted in compliance with the FRSME and that PBEs falling in Tier 1 should adopt it to the extent that it does not conflict with full EU-adopted IFRS. The ASB noted that many PBEs did not apply the FRSSE because of restrictions within the Charities SORP. The ASB also decided to allow PBEs the option to adopt a higher tier voluntarily.

10.123 The ASB agreed that the task of developing the PBE standard would be significant and noted that other countries (including Australia, Singapore and Canada) were working on this, but had not reached a conclusion. As a consequence, the ASB decided the PBE standard could follow a different timeline from the FRED.

10.124 Having decided to develop a PBE standard, the ASB addressed the future role of PBE SORPs. Responses to the consultation were very supportive of these SORPs and there was clear evidence, for example from extensive research by the Charity Commission, that the SORPs were highly regarded and had improved the quality of financial reporting in this sector. The ASB agreed that the development of a PBE standard would not preclude the need for SORPs in the sector.

10.125 The ASB also addressed the question of whether the SORPs should go through the Board's review process and have the Board's negative assurance statement, or not. It was clear that it was very important to the SORP-making bodies to have this process of challenge and oversight by the ASB. There was strong support for the Board's Code of Practice for SORPs and its statement of negative assurance.

10.126 The ASB considered the costs and benefits of the retention of SORPs. In relation to the benefits, respondents had noted that the ASB's role in challenging the SORP-making bodies and overview of the process was highly valuable.

The sectors felt that if the ASB were not involved, value and credibility of the SORPs could be lost.

EFFECTIVE DATE AND TRANSITION

10.127 The policy proposal had proposed a transition date effective for accounting periods commencing on or after 1 January 2012. A considerable number of respondents argued that 2012 was too soon.

10.128 The ASB tentatively agreed with respondents that 2012 was too soon but did not want to defer for too long, noting a degree of impatience in some comment letters. However, the ASB needed to balance this sense of impatience with providing adequate time for respondents to consider the proposals in the FRED and for it to redeliberate the comments received. Consequently, the ASB decided it should have a comment period of six months. This would result in the Board considering comments in the second half of 2011, with the aim of issuing the FRSs in the latter part of 2011. The effective date could not, with a minimum transition period of eighteen months, be before July 2013.

10.129 The ASB noted that a situation might arise where the IASB was consulting on amendments to the IFRS for SMEs (issued in July 2009) before the FRSME became effective, but decided it would have to address this if and when it arose.

10.130 In relation to early adoption, whilst the ASB noted concerns about several streams of financial reporting standards running alongside each other if early adoption were permitted, it decided to permit early adoption. In this way, qualifying subsidiaries applying EU-adopted IFRS, and other entities, could transition early.

10.131 The ASB also agreed to make minimal changes to current FRS until 2013.

SECTION 11: IMPACT ASSESSMENT

[Draft] Impact assessment

[Draft] Financial Reporting Standard • Application of Financial Reporting Requirements and the Financial Reporting Standard for Medium-sized Entities (FRSME)

As published in its Regulatory Strategy,* the FRC is committed to a proportionate approach to the use of its powers and making effective use of Impact Assessments.

BACKGROUND TO THE IMPACT ASSESSMENT

The ASB is proposing the [Draft] Application FRS and the FRSME as part of a fully consulted process to move UK accounting standards towards a framework based on IFRS. The FRC guiding principles require the impact assessment to explain the rationale for introducing the standard (1. below) and to focus on aspects of the proposed standard that augment relevant legislation or augment or diverge from the relevant framework (2. below).

The ASB is satisfied that the overarching case for change has been repeatedly considered. The majority of constituents have continually supported the adoption of IFRS-based accounting requirements for the UK. However, when any changes to accounting standards are implemented, the impact on preparers, auditors and users will not only relate to the decisions the ASB has taken to vary the standards, but also to changes inherent in moving to an IFRS-based framework. Therefore, this impact assessment will also set out the case that has been made

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* *http://www.frc.org.uk/documents/pagemanager/frc/Draft_plan_200910_December_2008/Our%20approach%20to%20setting%20our%20priorities%20final.pdf*

for moving to an IFRS-based financial reporting framework (3. below).

As a result there are three main components to the [draft] impact assessment:

1. rationale for introducing the [Draft] Standards, including problem definition;

2. aspects of the [Draft] Standards that augment relevant legislation or augment or diverge from the relevant IFRS; and

3. evidence of costs and benefits of the proposals and respondents' views on previous consultations.

EXECUTIVE SUMMARY

PROBLEM DEFINITION

11.1 Accounting standards provide a framework for the preparation and presentation of financial statements. The aim is to give a true and fair view of the financial performance and position of the reporting entity. 'True and fair' is a dynamic concept, evolving over time so that financial statements continue to reflect the economic substance of businesses and transactions.

11.2 In 2002 the ASB began a phased approach to converging UK accounting standards with IFRS. However it became clear that this was not the optimal solution. Integrating IFRS into UK accounting standards on a piecemeal basis proved to be extremely complex, and the standards themselves, developed with global capital markets in mind, were not always best suited to an ASB constituency that now excluded quoted groups. During this time the development of new UK standards, reflecting emerging business issues and practices, has largely been 'on hold' awaiting clarity on the future financial reporting standards and framework.

11.3 The ASB believes that this means UK accounting standards are not tenable in the longer term:

(a) They are an incoherent mixture of standards developed in the UK over a long period of time, and standards that have been converged with IFRS; there is no consistent framework.

(b) They permit certain transactions to remain unrecognised that are relevant to an assessment of the financial position of an entity.

(c) They have not kept pace with evolving business transactions and in some areas are out of date. As

business transactions change, accounting requirements must evolve to ensure that financial statements continue to show a true and fair view of an entity's financial performance and position at the balance sheet date.

11.4 Examples of problems the ASB aims to address in the proposed financial reporting framework include:

(a) Other than for quoted companies and groups (and those entities choosing to adopt the fair value accounting rules in Company law), UK accounting standards provide inadequate guidance on accounting for financial instruments. In particular, derivatives (including interest rate swaps and foreign exchange forwards) remain off balance sheet. This results in a balance sheet that does not reflect all relevant information about an entity's financial position.

(b) The scope of individual standards or requirements is not always based on a coherent framework (for example, SSAP 25 contains provisions applying to entities exceeding 10 times the medium-sized company criteria).

(c) Inconsistencies can arise between standards based on IFRS and those based on 'old' UK accounting standards. An additional amendment to FRS 3 'Reporting financial performance' was needed to clarify the treatment of fair value gains and losses on financial instruments in the performance statement.

(d) Many accountants and users need to maintain knowledge of both UK accounting standards and IFRS (and the differences), but accountancy students are only being taught IFRS, which has a detrimental impact on intellectual mobility and training needs, and creates a disconnect for some accountancy students between their professional studies and their practical experience.

(e) It is not easy to compare the financial position and performance of large private companies with quoted or foreign competitors, and because UK accounting standards and IFRS are not derived from the same framework, the barriers to switching between the two (subject to the Company law restrictions) are greater than they need to be.

11.5 The ASB believes these issues will be addressed by the adoption of a suite of UK accounting solutions based on IFRS.

WHY INTERVENTION IS NECESSARY

11.6 The over-arching requirement of the Companies Act is that entities must prepare financial statements that present a true and fair view of their financial performance and position. Accounting standards provide guidance on the accounting and reporting necessary to achieve a true and fair view. As businesses evolve and transactions change, relevant information about an entity's financial performance or position may not be recognised in the financial statements. Accounting standards need to be revised to address this.

POLICY OBJECTIVES AND INTENDED EFFECTS

Aims and objectives of the ASB

11.7 The FRC is an independent regulator for corporate reporting and governance. Its aim is to foster, in the public interest, high-quality financial reporting and corporate governance for stewardship purposes. In doing so, it supports investor, market and public confidence. The FRC has entered into a Memorandum of Understanding with the Department for Business, Innovation and Skills (BIS)*, acknowledging the complementary nature of their

* *http://www.frc.org.uk/documents/pagemanager/frc/About_the_FRC/MoUbetweenFRCandBIS.pdf*

objectives. However, the FRC and its operating bodies are independent and pursue their own aims and objectives.

Aims of the Accounting Standards Board*

The Accounting Standards Board contributes to the achievement of the Financial Reporting Council's fundamental aim of supporting investor, market and public confidence in the financial and governance stewardship of listed and other entities by pursuing **its own aims of establishing and improving standards of financial accounting and reporting**, for the benefit of users, preparers, and auditors of financial information.

Objectives

The Board intends to achieve its aims by:

- Developing principles to guide it in establishing standards and to provide a framework within which others can exercise judgement in resolving accounting issues.

- **Issuing new accounting standards, or amending existing ones, in response to evolving business practices, new economic developments and deficiencies being identified in current practice**.

- Addressing urgent issues promptly.

- Working with the International Accounting Standards Board (IASB), with national standard-setters and relevant European Union (EU) institutions to **encourage high quality in the IASB's standards and their adoption in the EU**.

(Emphasis added)

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* *http://www.frc.org.uk/asb/about/aims.cfm*

Objectives for these proposals and the intended effects

11.8 The overriding objectives and intended effects are to:

(a) ensure high-quality financial reporting by UK entities at all levels, which is proportionate to the business, the risks faced and the users' needs for information.

(b) provide a financial reporting framework that:

(i) demonstrates a commitment to high-quality global accounting standards that are cost-effective to develop, apply and maintain;

(ii) has the potential to reduce the cost of capital for UK entities;

(iii) applies consistent principles to accounting for all UK entities, promoting efficiency within groups and ease of transfer between the various tiers of the framework.

OPTIONS CONSIDERED

11.9 The ASB's proposals have evolved and been consulted on over a number of years. It believes, and respondents broadly agree, that the current set of UK accounting standards require revision if they are to remain 'fit for purpose' in supporting high-quality financial reporting. As a result the ASB does not consider 'do nothing' a viable option in the medium or long term.

11.10 Accepting a need for revision of UK accounting standards, there are two main routes to achieving this: an IFRS-based framework or the maintenance of a separate UK framework (whether derived as an evolution of current UK accounting standards, or based on the IFRS for SMEs with significant amendments). The ASB believes that many of the advantages of an IFRS-based framework will be lost or

diluted the further UK requirements move away from 'pure' IFRS.

11.11 Appendix One provides more details of the alternative options considered.

OVERALL ASSESSMENT OF THE COSTS AND BENEFITS OF THE PREFERRED OPTION

11.12 Current UK accounting standards were initially developed for all UK reporting entities, including quoted companies and other large, medium-sized and small entities. In 1997 the ASB published the first FRSSE, differentiating between accounting and reporting requirements relevant to small companies, and others.

11.13 The EU Regulation requiring quoted companies to use EU-adopted IFRS in their consolidated financial statements created a further differentiation, and arguably removed from UK accounting standards those companies at which the standards had been primarily aimed.

Costs

11.14 Any change in accounting requirements leads to some costs of transition. However, the ASB's proportional approach to UK accounting standards means that companies applying the FRSSE will not be affected by these changes. In addition, those private, non-publicly accountable companies that do not undertake complex transactions will incur minimal costs, mainly in revising the format of their financial statements.

11.15 For groups, there will be cost savings as a result of the reduced disclosure options.

11.16 The most significant costs of applying the proposed framework are likely to be incurred by entities that are publicly accountable, but had previously applied neither EU-adopted IFRS, nor UK accounting standards applicable

to listed entities. The ASB believes that public accountability brings with it a responsibility to demonstrate the highest standards of financial reporting and transparency, but the proposals do offer some relief to the smallest publicly accountable entities. The potential impact on certain 'main affected groups' is set out below:

11.17 ***Pension funds*** – the application of EU-adopted IFRS by pension funds will require pension funds to account in accordance with IAS 26 'Accounting and Reporting by Retirement Benefit Plans'. This standard applies in preference to all other IFRS where items fall within the scope of more than one standard. As a result it is anticipated that a SORP for pension funds will continue to exist, supplementing the guidance in IAS 26, and that there will be minimal changes in reporting by pension funds.

11.18 ***Building societies*** – those building societies with permanent interest bearing shares (PIBS) are already required to apply EU-adopted IFRS. For the remaining building societies there will be costs associated with conversion (see Building Society F in Section 3) counterbalanced by the benefits of increased transparency.

11.19 ***Credit unions*** – the types of financial instruments credit unions may hold are restricted by law. As a result, the ASB believes that most credit unions do not hold financial instruments that will be required to be accounted for at fair value. Therefore, the costs of transition to EU-adopted IFRS are unlikely to be substantial because there will be little change in the underlying accounting.

11.20 ***Insurance entities*** – insurers are typically publicly accountable and therefore IFRS 4 'Insurance Contracts' is relevant to them. As an interim standard (a stepping stone to phase II of the IASB's insurance project) it exempts insurers from some requirements of other IFRS and permits the maintenance of existing accounting policies. As a result the ASB will retain FRS 27 'Life assurance' until the IASB completes phase II of its work, and those UK insurers not

already applying EU-adopted IFRS will not be significantly affected by the move.

Benefits

11.21 The ASB sees its proposals for the UK's financial reporting framework as an extension of its pioneering work in developing the FRSSE. The FRSME brings an IFRS-based framework to all UK entities other than those adopting the FRSSE and incorporates relevant legal requirements. The IFRS for SMEs, and therefore the FRSME, is a proportional solution striking a balance between simplification and recognition principles. The ASB is also mindful of the Coalition Government's commitment to reducing the regulatory burden on businesses; the 'one-in, one-out' rule whereby no new regulation is brought in without other regulation being cut by a greater amount.

11.22 The FRSME will ease the reporting burden for entities applying it because:

(a) UK accounting standards (and associated literature) currently run to more than 2,000 pages. Virtually all of these requirements will be withdrawn and replaced with the FRSME which, being based on the IFRS for SMEs, is set out in less than 400 pages. This reduction in the volume of literature will make it easier for preparers, auditors, advisers and users to maintain familiarity with all the requirements.

(b) The FRSME allows simplified accounting in some areas and generally fewer disclosures than full EU-adopted IFRS. In addition, the FRSME proposes reduced disclosures for subsidiaries, reducing the burden of compliance further.

(c) The IASB intends to update the IFRS for SMEs approximately every three years. Subsequently the ASB will consider whether to make corresponding changes to the FRSME and consult accordingly. This will lead

to periods of stability between each potential revision, rather than the possibility of multiple annual changes. Education and training costs will be reduced.

11.23 The benefits of the proposals go wider than their impact on the regulatory burden on entities. Maintaining and improving the quality of financial reporting is important for maintaining confidence in financial markets and the wider economy. Increased comparability assists the efficient functioning of markets: following the application of EU-adopted IFRS by quoted companies in 2005, a reduction in the cost of equity capital for UK companies has been observed. The adoption, by private companies, of a framework based on the same underlying principles will allow better benchmarking and comparison between companies. The enhanced transparency may also lead to a reduction in the cost of borrowing because users have easy access to understandable, comparable information.

OVERALL ASSESSMENT

11.24 Overall the ASB believes that the introduction of its proposed IFRS-based financial reporting framework for the UK and Ireland will have a positive impact on financial reporting.

11.25 The benefits are impossible to quantify in a realistic way. The main quantifiable costs are the transition costs incurred by those entities* that will need to change aspects of their accounting and reporting. There will be huge variation in the transition costs for individual entities. The estimated total transition costs are £78.9 million. The Board notes that even a very small reduction in the cost of borrowing would outweigh these costs. (Based on an assumed £100 billion lent to large and medium-sized entities, a reduction of 0.08% would yield £80 million in savings.)

* *Accounting and auditing firms' costs are ultimately assumed to be borne by the reporting entities.*

11.26 In the Board's view, the benefits of more consistent, transparent information for decision-making (and possible reductions in the cost of borrowing and reduced risk of business failure) outweigh the transition costs of implementing the proposed Financial Reporting Framework.

QUESTIONS FOR RESPONDENTS ON THE [DRAFT] IMPACT ASSESSMENT

11.27 This is a consultation stage impact assessment, and respondents' views are requested on the following questions.

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? It 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.

1. RATIONALE FOR INTRODUCING THE [DRAFT] STANDARDS

Background – development of EU-adopted IFRS

In 2001 the IASB was formed to succeed the IASC (International Accounting Standards Committee), with objectives including:

- developing, in the public interest, a single set of high-quality, understandable and enforceable global accounting standards that require high-quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions; and
- bringing about convergence of national accounting standards and International Accounting Standards to high-quality solutions.

In 2002 the EU passed a Regulation requiring quoted companies to prepare their consolidated financial statements in accordance with EU-adopted International Financial Reporting Standards (IFRS) from 2005 onwards.

Department of Trade and Industry Consultation Document, August 2002

Following the adoption of the EU Regulation on the application of International Accounting Standards in June 2002, the Department of Trade and Industry published a Consultation Document on the possible extension of the EU Regulation in August 2002.

The Government strongly supported the European move to use IFRS. For publicly traded companies, the move to global standards would lead to reduced costs of capital, make it easier for users of accounts to compare the performance of different

companies on a consistent basis, and promote financial stability.

At the time the ASB already had a policy of pursuing convergence* between IFRS and UK accounting standards, although the timetable was dependent on the IASB's progress. The ASB had indicated [to the DTI] that it would be mindful of the implications for non-publicly traded companies of using the international framework, with a view to avoiding unnecessarily onerous requirements.

The DTI noted that ASB standards intended to be used by non-publicly traded companies might sometimes regulate with a lighter touch than IFRS, but would be based on the same principles and would not prevent those wishing to follow EU-adopted IFRS from doing so (provided they also complied with the Directives)†.

The issue

11.28 Company law sets out the requirements for the preparation of a company's report and accounts.

The Companies Act 2006 ('the Act') section 380(2) notes that different provisions apply to different kinds of company. Section 380(3) of the Act gives the main distinctions as being:

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* *ASB Press Notice 203 issued in June 2002 to announce publication of FRED 30 on financial instruments, noted:*
"During discussions with interested parties, the ASB has been urged to pursue a programme of work (a) to ease the transition for listed entities from existing UK standards to international standards, and (b) to enable unlisted entities to use broadly the same standards as listed entities. The ASB has decided to respond to these requests by publishing a series of proposals to replace, prior to 2005, certain existing UK standards with new UK standards based on international standards. FRED 30 is an example of such a proposal."
† *Paragraph 4.7 of the Consultation Document.*

- between companies subject to the small companies regime and those that are not; and
- between quoted companies and those that are not quoted.

Requirement to prepare financial statements – True and fair

The directors of a company are required to prepare financial statements for each year that give a true and fair view of the assets, liabilities, financial position and profit or loss of the company (the small companies regime permits abbreviated accounts to be *filed*, but this does not override the obligation to *prepare* full financial statements). In doing so, companies (other than small companies) must state that they have complied with applicable accounting standards and all companies must have regard to the substance of transactions and generally accepted accounting principles or practice. The ASB is the body responsible for issuing accounting standards, and in all but extremely rare cases compliance with them should result in a true and fair view.

The ASB's Statement of Principles for Financial Reporting notes that the concept of true and fair is at the heart of financial reporting in the UK, but it is a dynamic concept, constantly evolving in response to changes in accounting and business practices. The ASB issues new and revised accounting standards to ensure that financial reporting keeps pace with these changes.

11.29 These proposals do not change the legal requirements for directors to prepare financial statements that present a true and fair view of the assets, liabilities, financial position and profit or loss of the company. The proposals are to revise the accounting standards that directors refer to when preparing financial statements.

The present need to revise UK accounting standards

11.30 Currently, UK companies, other than those required by the Regulation to prepare 'IAS accounts' (and charitable companies, which must follow UK accounting standards) have a choice between preparing IAS accounts and following UK accounting standards ('Companies Act accounts').

11.31 As noted above, accounting standards evolve to ensure that a company's financial information continues to reflect the substance of the transactions entered into, as business practices change and new circumstances come to light. However, a consequence of the ASB pausing in its phased approach to an IFRS-based framework is that UK accounting standards have not evolved to the extent that might have been expected in recent years.

11.32 In the ASB's view, this has left current UK accounting standards in an untenable position:

(a) They are an incoherent mixture of standards developed in the UK over a long period of time, and standards that have converged with IFRS; there is no consistent framework.

(b) They permit certain transactions to remain unrecognised that are relevant to an assessment of the financial position of an entity.

(c) They have not kept pace with evolving business transactions and in some areas are out of date. As business practices change, so too must accounting requirements, to ensure that financial statements continue to show a true and fair view of the financial performance and position of an entity.

11.33 Examples of problems the proposed financial reporting framework aims to address include:

(a) Other than for quoted companies and groups (and those entities choosing to adopt the fair value accounting rules in Company law), UK accounting standards provide inadequate guidance on accounting for financial instruments. In particular, derivatives (including interest rate swaps and foreign exchange forwards) remain off balance sheet. This results in a balance sheet that does not reflect all the relevant information about an entity's financial position.

(b) The scope of individual standards or requirements is not always based on a coherent framework (for example, SSAP 25 contains provisions applying to entities exceeding 10 times the medium-sized company criteria).

(c) Inconsistencies can arise between standards based on IFRS and those based on 'old' UK accounting standards. An additional amendment to FRS 3 'Reporting financial performance' was needed to clarify the treatment of fair value gains and losses on financial instruments in the performance statement.

(d) Many accountants and users need to maintain knowledge of both UK accounting standards and IFRS (and the differences), but accountancy students are only being taught IFRS. The double requirements have a detrimental impact on intellectual mobility and training needs, and create a disconnect for some accountancy students between their professional studies and their practical experience.

(e) It is not easy to compare the financial position and performance of large private companies with quoted or foreign competitors. Because UK accounting standards and IFRS are not derived from the same framework, the barriers to switching between the two (subject to

Company law restrictions) are greater than they need to be.

11.34 The ASB believes these issues will be addressed by the adoption of a suite of UK accounting solutions based on IFRS.

The key decisions

11.35 The proposed Financial Reporting Framework for the UK and the Republic of Ireland reflects the following key decisions:

(a) The time is now right to proceed with convergence:

(i) quoted companies (and their auditors and users) have several years of experience in IFRS;

(ii) the IASB has issued the IFRS for SMEs, which the ASB considers a key building block in its financial reporting strategy;

(iii) UK accounting standards are becoming increasingly out of date and do not require recognition of certain financial instruments by many companies.

(b) The framework will be based on EU-adopted IFRS and the IFRS for SMEs, subject only to minimal essential changes, for example to ensure compliance with the law. For those entities permitted to use the FRSSE there will be no fundamental changes at this time, but this will be reviewed after the implementation of the remaining framework.

(c) A three-tier approach will be adopted, based first on public accountability and then on size, with disclosure exemptions available for qualifying subsidiaries. This allows different entities to apply accounting standards that are proportional to the size and complexity of their

business and the risks they face. It is consistent with the Company law distinction between categories of companies to which differential reporting requirements might apply.

11.36 Appendix One of this [draft] impact assessment discusses, in more detail, other options that were not pursued.

The intended effects

11.37 The overriding intended effects are to:

(a) Ensure high-quality financial reporting by UK entities at all levels. The reporting will be proportionate to the business, the risks it faces and the users' needs for information. The ASB believes that the proposed Financial Reporting Framework will improve the understandability and usefulness of financial statements.

(b) Provide a financial reporting framework that:

(i) demonstrates a commitment to high-quality global accounting standards and is cost-effective to develop, apply and maintain;

(ii) potentially reduces the cost of capital for UK companies;

(iii) applies consistent accounting principles to accounting for all UK companies, promoting efficiency within groups and ease of transfer between the various tiers of the framework; and

(iv) reduces costs for preparers, auditors, users and others in remaining fluent in both UK accounting standards and IFRS.

2. Aspects of the [Draft] Standard that augment relevant legislation or augment or diverge from the relevant IFRS

ASPECTS THAT AUGMENT RELEVANT LEGISLATION

Entities that have public accountability should apply EU-adopted IFRS

11.38 When the EU Regulation was brought into Company law the then Department of Trade and Industry consulted on whether or not to extend the application of the Regulation beyond the consolidated accounts of publicly traded companies. After consultation the government decided not to take the Member State option to extend the application of the Regulation beyond the minimum required. A similar decision was made by the Irish Government. Therefore Company law* only requires quoted companies to apply EU-adopted IFRS in their consolidated financial statements.

11.39 Subsequently individual regulators have taken decisions about whether or not to require their regulated bodies to apply EU-adopted IFRS. For example, the AIM rules for companies require those AIM companies incorporated in an EEA country to prepare their group financial statements in accordance with IFRS.

11.40 In developing the IFRS for SMEs, the IASB considered how to describe the entities at which the standard would be aimed. They would be different from companies participating in capital markets, for which its standards are generally developed. The IASB decided to use the absence of 'public accountability' as the principle for identifying those entities for which the IFRS for SMEs was intended.

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* *The equivalent legislation in the Republic of Ireland is the Companies Acts 1963 to 2009.*

11.41 The ASB agrees with the IASB that those entities that have public accountability should use IFRS (or EU-adopted IFRS) because their broad range of investors and/or the broad group of clients for whom they manage financial resources need a wide range of financial information for economic decision-making. This is discussed in paragraphs BC58 and BC59 of the IFRS for SMEs Basis for Conclusions.

"**Entities whose securities are traded in a public market have public accountability**

BC58 Public securities markets, by their nature, bring together entities that seek capital and investors who are not involved in managing the entity and who are considering whether to provide capital, and at what price. Although those public investors often provide longer-term risk capital, they do not have the power to demand the financial information they might find useful for investment decision-making. An entity's decision to enter a public capital market makes it publicly accountable – and it must provide the outside debt and equity investors with a broader range of financial information than may be needed by users of financial statements of entities that obtain capital only from private sources. Governments recognise this public accountability by establishing laws, regulations and regulatory agencies that deal with market regulation and disclosures to investors in public securities markets. The Board concluded that, regardless of size, entities whose securities are traded in a public market should follow full IFRSs.

Financial institutions have public accountability

BC59 Similarly, a primary business of banks, insurance companies, securities brokers/dealers, pension funds, mutual funds and investment banks is to hold and manage financial resources entrusted to them by a broad group of clients, customers or

members who are not involved in the management of the entities. Because such an entity acts in a public fiduciary capacity, it is publicly accountable. In most cases, these institutions are regulated by laws and government agencies."

11.42 The ASB's decision to use public accountability to determine which entities should apply EU-adopted IFRS has the effect of extending the use of those standards beyond the entities described in the Regulation (and Company law), and will include:

(a) quoted single entities – it might be argued that the Regulation is anomalous in only requiring quoted groups to apply EU-adopted IFRS;

(b) entities listed on smaller markets – but, for example, AIM companies are already required to apply IFRS; and

(c) certain financial institutions.

ASPECTS THAT AUGMENT OR DIVERGE FROM THE RELEVANT IFRS – CHANGES MADE TO THE IFRS FOR SMEs IN DEVELOPING THE FRSME

11.43 The ASB decided that as a principle it should make minimal changes to the IFRS for SMEs in developing the FRSME for use in the UK and Ireland, because:

- any amendments dilute the consistency between UK accounting standards and IFRS; and
- without rigorous criteria for making changes* the resulting standard would no longer resemble the introduction of an IFRS-based framework.

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* *Many constituents suggested amendments that could be made to the IFRS for SMEs, and indeed individual members of the ASB can identify elements of the IFRS for SMEs they would target for change.*

11.44 Nevertheless the ASB identified certain circumstances in which amendments might be appropriate. These include amendments essential for compliance with the law.

Compliance with EU Accounting Directives

11.45 Amendments proposed to the IFRS for SMEs to ensure companies reporting in accordance with the FRSME comply with the law fall into two categories. Firstly amendments to ensure that the FRSME is not incompatible with the law, and secondly amendments to restrict the ability of reporting entities to choose options that are incompatible with the law. The ASB considers these amendments essential. However, if the EU Accounting Directives are updated so that the IFRS for SMEs is no longer incompatible with the law the ASB intends to remove these, subject to consultation.

Income Tax

11.46 In developing the IFRS for SMEs, the IASB aimed to simplify the IAS 12 requirements on deferred taxation, recognising that not all reporting entities routinely maintain 'tax balance sheets'. In doing so, the IASB incorporated proposals from an exposure draft of proposed amendments to IAS 12. However, subsequently the IASB decided not to pursue the ideas from the exposure draft and, as a result, the IFRS for SMEs is not based on extant IFRS in this area. Taking into account comments from respondents the ASB has decided to replace the Income Tax section of the IFRS for SMEs with IAS 12.

Reduced disclosures for subsidiary undertakings

11.47 The ASB is proposing that non-publicly accountable subsidiaries may take advantage of reduced disclosures in certain areas, as compared with the requirements of either EU-adopted IFRS, or the FRSME. This will provide cost savings for preparers.

Other proposed divergences from the IFRS for SMEs

11.48 The other proposed divergences are intended to provide cost-effective solutions for entities and do not augment Company law requirements. They provide transitional relief for dormant companies, introduce an exemption from parent company cash flow statements and adjust the requirement for preparation of consolidated financial statements.

3. Evidence

Consultation history

11.49 The ASB (and BIS under its previous names) has consulted on aspects of its strategy for UK accounting standards many times over an eight-year period. The current proposals reflect the evolution of its strategy taking into account feedback from respondents.

11.50 Key messages from the consultation responses include:

(a) continuing underlying support for a financial reporting framework for the UK based on IFRS;

(b) constant support for a tiered framework (as used in current UK accounting standards), which provides a proportional approach. As the IASB developed its IFRS for SMEs, both respondents and the ASB did change their views on which tier this might be most suitable for.

Lengthy and extensive consultation shapes current proposals

Table 1 – Consultations conducted

Year	Consultation
2002	DTI consults on adoption of IAS Regulation
2004	Discussion Paper
2005	Policy Statement: Exposure Draft
2006	Public Meeting and Proposals for comment
2006	Press Notice seeks views
2007	Consultation Paper on proposed IFRS for SMEs
2009	Consultation Paper on future of UK GAAP
2010	Request for responses to aid development of the Impact Assessment
2010	Financial Reporting Exposure Drafts 43 and 44

In **2004** the **Discussion Paper** contained two key elements underpinning the proposals: firstly that UK accounting standards should be based on IFRS*, and secondly that a phased approach to the introduction of the standards should be adopted.

The majority of respondents agreed with a framework based on IFRS, and although supportive overall, the response to the phased approach was mixed.

The ASB embarked on the phased approach and issued a number of standards based on IFRS. In its **2005 Exposure Draft** of a **Policy Statement** 'Accounting standard-setting in a changing environment: The role of the Accounting Standards Board', amongst other aspects of its role, the ASB intended to converge with IFRS by implementing new IFRS in the UK as soon as possible. It also proposed to continue the phased approach to adopting UK accounting standards based on older IFRS, but recognised there was little case for being more prescriptive than IFRS.

Although the ASB had wanted to move the debate on to how it would seek to influence the IASB's agenda, respondents' main concern remained convergence. The ASB had issued Exposure Drafts proposing the IASB's standards on Business Combinations be adopted in the UK. These Exposure Drafts highlighted the possible complexity of a mixed set of UK accounting standards, with some based on IFRS and others developed independently by the ASB. The majority of respondents continued to agree with the aim of basing UK accounting standards on IFRS, but a broader set of views on how to achieve this was emerging. The ASB agreed to continue with its convergence programme, but decided to re-examine how to achieve this.

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* *Indeed the proposals went further than this, that UK standards based on IFRS should be expressed in the same words with few substantive differences which are restricted to those that are clearly necessary.*

The ASB published revised proposals to be discussed at the **2006 Public Meeting**. By now the IASB had started its IFRS for SMEs project, and the ASB decided this might have a role as one of the tiers in the UK financial reporting framework. The ASB proposed a 'big bang' with new IFRS-based UK accounting standards mandatory from a single date, 1 January 2009. The ASB's proposal was for a three-tier system, with Tier 1 being EU-adopted IFRS; and the other two tiers being developed as the IASB progressed with its projects.

Those attending the public meeting supported the aim of basing UK accounting standards on IFRS and adapting them to ensure they were appropriate for the entities applying them.

Taking this feedback into account, later in **2006** the ASB issued a **Press Notice (PN 289)** seeking views on its current thinking:

(a) All quoted and publicly accountable companies should apply EU-adopted IFRS.

(b) The FRSSE should be retained and extended to include medium-sized entities.

(c) UK subsidiaries of groups applying full IFRS should apply EU-adopted IFRS, but with reduced disclosure requirements.

(d) No firm decision on the remainder, but options included extending the FRSSE, extending full IFRS, maintaining separate UK accounting standards or some combination of these.

The responses were mixed, but there was agreement that whatever the solution, it should be based on IFRS and there should be different reporting tiers to ensure proportionality.

The IASB published the Exposure Draft of its IFRS for SMEs in early **2007**; shortly afterwards the ASB published its own **Consultation Paper.** This sought views on how the IFRS for SMEs might fit into the future UK financial reporting framework, for example whether it might be appropriate for Tier 2, with the FRSSE continuing for those eligible for the small companies regime.

Feedback on the IFRS for SMEs was largely positive: it would be suitable for the middle tier; it was international; it was compatible with IFRS; it represented a significant simplification. Overall it was seen as a workable alternative to full IFRS. In addition, respondents wanted to retain the FRSSE (it reduces the regulatory burden on smaller entities) and to give subsidiaries the option of applying the IFRS for SMEs as well as a reduced disclosure regime if applying full IFRS.

The IFRS for SMEs was published in **2009**, allowing the ASB to further develop its proposals in the **Consultation Paper** 'Policy Proposal: The future of UK GAAP'. The proposals were largely consistent with the cumulative results of the preceding consultations, and included:

(a) a move to an IFRS-based framework;

(b) a three-tier approach;

(c) publicly accountable entities are Tier 1 and should apply EU-adopted IFRS;

(d) small companies are Tier 3 and continue to apply the FRSSE; and

(e) other entities are Tier 2 and should apply a UK accounting standard based on the IFRS for SMEs.

> The only significant proposal that was inconsistent with respondents' comments was that subsidiaries should simply apply the requirement of the tier they individually met – respondents had wanted subsidiaries to be able to take advantage of disclosure exemptions. This has subsequently been incorporated into the FRED.

Request for responses to aid development of the Impact Assessment

11.51 This consultation was focused on the costs, benefits and impact of the proposals, rather than on the principles. Thirty two responses were received, and although no specific question was asked on this point, only 12.5% of respondents did not agree with the introduction of an IFRS-based framework.

11.52 In addition to many useful, detailed points, some common themes included general agreement that change was needed to UK accounting standards and support for many of the changes proposed in the Consultation Paper.

TECHNICAL MERITS

11.53 Businesses, and therefore accounting requirements, are constantly evolving, although the pace of change is more rapid or radical in some periods than others. As businesses and transactions change, and more information comes to light about the economics or drivers of transactions, accounting requirements need to be revised. This ensures that financial statements continue to show the economic substance of the transactions and financial position of reporting entities, and provide users with relevant disclosures.

Standard-setting process

11.54 Standard-setters may become aware of 'gaps' in the accounting literature, where no specific requirements

apply to a particular type of transaction. This can lead to divergent accounting treatments being adopted by different entities, some of which may not fully reflect the substance of the transactions entered into. Standard-setters then aim to fill the 'gap' and improve financial reporting, encouraging consistency and appropriate disclosures. As a result, users get better information about the existence and nature of transactions entered into and their likely impact on future cash flows.

11.55 The standard-setting process seeks to balance a number of factors in developing, or revising, accounting standards that are fit for purpose. These include:

(a) the underlying principles, currently set out in the ASB's 'Statement of Principles for Financial Reporting'. The IASB has a similar document, its *Framework for the Preparation and Presentation of Financial Statements*, which is currently the subject of the IASB's Conceptual Framework project;

(b) legal requirements;

(c) cost/benefit considerations;

(d) industry-specific issues;

(e) the desirability of evolutionary change; and

(f) implementation issues.

11.56 The ASB takes all of these factors into account in developing accounting standards, although their relative importance will vary on a case-by-case basis. As an operating board of the FRC, the ASB works within the FRC's aims and objectives, and follows its approach to regulation including its commitment to the Better Regulation Commission principles of proportionality, targeting, consistency, transparency and accountability.

11.57 In assessing accounting proposals for improving financial reporting, the ASB first considers the technical merits of the proposal, followed by the other factors listed above to arrive at a proportional solution.

Proposals meet the ASB's objectives

11.58 The ASB considers the proposals meet its objectives because the adoption of the proposed UK Financial Reporting Framework will:

(a) reflect business practices and economic developments in recent years by being based on IFRS. Current UK accounting standards remain largely unchanged since 2005, or earlier for most non-financial instruments standards, and therefore do not reflect up-to-date accounting thinking;

(b) address deficiencies in current UK accounting standards that permit many entities to recognise the impact of certain financial instruments only on settlement; and

(c) increase the adoption of IFRS-based accounting standards in the EU.

COSTS OF PROPOSALS

Business as usual

11.59 In order to consider the incremental costs of the ASB's proposals, it is necessary first to consider what constitutes 'business as usual' for companies and accountants.

11.60 All companies are required, by Company law, to prepare annual financial statements that give a true and fair view of the assets, liabilities, profit or loss and financial position of the company. This requirement is not changed by these proposals.

11.61 However, the concept of true and fair is a dynamic and evolving one. These proposals represent the latest in a long line of new, or revised, accounting standards aimed at ensuring that financial statements continue to provide a true and fair view of the financial performance and position of companies, in the context of the business environment of the day.

11.62 A review of extant UK accounting standards demonstrates that in the period from 1990 to 2005, new accounting requirements became effective almost every year. Inevitably some changes would affect some entities more than others, but all reporting entities would need to consider whether the changes were applicable to them. Similarly the FRSSE has generally been updated every other year to keep pace with changes to the other UK accounting standards.

11.63 Those preparers, auditors and users of financial statements who are qualified accountants are required by their professional bodies to undertake appropriate continuing professional development (CPD) each year. Each professional body has its own requirements, but CPD is generally focused on identifying current and future development needs and the right solution. For accountants involved in preparing, auditing or using financial statements, one might expect annual CPD activities to include ensuring that their knowledge of relevant accounting and reporting requirements is up to date.

11.64 Therefore, the costs of a 'normal' level of change should be regarded as 'business as usual' and the impact assessment will focus on the extent to which the ASB's proposals are in excess of this.

Feedback from constituents on costs and benefits

11.65 In a number of its consultations, the ASB requested feedback on the anticipated costs and benefits of its proposals. However, this was rarely the focus of respondents' concerns. This limited response rate implies

that respondents broadly feel the cost/benefit considerations are not imbalanced.

Costs

11.66 The ASB believes the proposed Financial Reporting Framework is a proportionate one, with different requirements applicable to different entities, meaning that each will incur different levels of cost. This will depend on such factors as:

(a) the current financial reporting framework (i.e. EU-adopted IFRS, UK accounting standards, FRSSE);

(b) whether the entity is publicly accountable;

(c) its size; and

(d) the volume and complexity of its transactions.

11.67 As a result it is not possible to determine with any accuracy an average cost for entities implementing the proposal. Set out below are a number of case studies, representing typical scenarios of requirements before and after the proposed changes. These have been prepared taking into account the areas where changes to financial reporting have been identified by UK entities that have already applied EU-adopted IFRS. The majority of the costs identified are one-off and will be incurred in the year of transition.

11.68 Analysis has been prepared on the possible costs that will be incurred in each scenario, and the proportion of companies that each scenario may apply to, providing a weighted estimate of the relevant costs of implementation.

11.69 General assumptions include:

(a) Incremental training costs for the FRSME over the IFRS for SMEs are likely to be minimal because training providers will be preparing materials for the IFRS for SMEs anyway.

(b) Standard cost assumptions are set out below:

Table 2 – Cost assumptions

Cost of training course for an individual	£175 Based on the cost of the ICAEW IFRS for SMEs learning and assessment programme of £175.
Cost of staff time per day	£130 Based on ONS wage survey data.
Cost of partner time per day	£520 Based on four times the staff costs, which is consistent with the ratio used by the then DTI in previous impact assessments.

Company A

Scenario: Company A is a small family run company, eligible to apply the small companies regime. It has engaged accountants to prepare its financial statements, which are in accordance with the FRSSE, and it is not required to, nor does it choose to, have an audit.

Application of the proposed Financial Reporting Framework: Company A will continue to apply the FRSSE.

Costs of implementing the proposed Financial Reporting Framework: As there are no changes to the requirements of the FRSSE, unless an entity enters into new transactions, there are no changes to costs of preparing financial statements for Company A.

Company A does not incur any 'business as usual' costs in keeping up to date with accounting developments – a saving.

If Company A were to enter into a new type of transaction, and therefore needed to determine its accounting policy for these transactions for the first time, the proposed amendments to the FRSSE may require it to have regard to different guidance to that which existed previously. However, this is a consequence of a business decision to enter into new transactions and the costs associated with determining the accounting for them arise directly from the transactions and are not affected by these proposals.

Summary:

Estimated costs of implementation £0

Company B

Scenario: Company B is a medium-sized company, with annual turnover of approximately £20 million. Its business operates solely in the UK and it is not directly exposed to changes in foreign exchange rates. Any borrowings are standard operating leases of equipment or basic loans from a bank.

Company B employs some finance staff, but takes advice from its auditors regarding the presentation of its financial statements.

Application of the proposed Financial Reporting Framework: Company B will be in Tier 2 and eligible to apply the FRSME. As Company B only has basic financial instruments it is not required to adopt fair value accounting for these instruments.

Presentation and disclosure in the financial statements will change, but changes to recognition and measurement will be minimal.

Costs of implementing the proposed Financial Reporting Framework: The company's finance staff will need to make some small adjustments to the way transactions and/or other financial data are recorded, for example in order to disclose the total future minimum lease payments rather than payments due next year.

Company B will be assisted by its auditors in ensuring that all relevant presentation and disclosure changes are reflected in the financial statements. It will, therefore, benefit from the economies of scale of the auditor training its staff, but there are likely to be increased fees from the auditor in the implementation year. There are not expected to be any ongoing incremental costs.

As the recognition and measurement of items in the financial statements are not expected to be significantly different, although the notes to the financial statements may provide additional transparency on certain items, users are not expected to incur any incremental costs in understanding the financial statements.

Summary:

Estimated costs of implementation £540

Estimated costs charged to Company B by its auditors £600

Estimated costs incurred by users ....£negligible

Company C

Scenario: Company C is a medium-sized company. It is an importer and exporter, conducting many transactions in currencies other than £sterling. As a result Company C enters into forward foreign exchange contracts for a proportion of its cash flows (both inflows and outflows).

Like Company B, Company C has a small finance staff, but also an experienced treasurer. It takes advice from its auditors on presentation in its financial statements. Company C has not voluntarily adopted FRS 26 in the past.

Application of the proposed Financial Reporting Framework: Company C will be in Tier 2 and eligible to apply the FRSME. However, the forward foreign exchange contracts are not basic financial instruments and Company C must apply the requirements of Section 12 of the FRSME. This will include recognising these derivatives at fair value and providing disclosure about the valuation methodology.

Although Company C enters into the forward foreign exchange contracts as cash flow hedges, it does not propose to adopt hedge accounting because it considers the administrative burden of maintaining the relevant documentation to outweigh the benefits of the accounting treatment permitted, particularly if its hedges may not be classified as 'effective'.

Costs of implementing the proposed Financial Reporting Framework: In addition to other small adjustments to the way transactions are recorded, the most significant change in accounting will be the need to recognise forward foreign exchange contracts when they are taken out, maintain the value based on fair value, and recognise gains and losses on an ongoing basis, rather than just on settlement. Depending on how Company C manages its treasury operations, the ease with which its Treasury Management System (TMS) is/can be integrated with the accounting system to produce the required

accounting entries, and the remaining useful life of the TMS, the cost of any system changes could be minimal.

Company C's treasurer will need some training in the new accounting requirements and procedures, and will need to consider whether Company C's treasury policies should be revised.

Company C will be assisted by its auditors in ensuring all relevant presentation and disclosure changes are reflected in the financial statements. It will, therefore, benefit from the economies of scale of the auditor training its staff, but there are likely to be increased fees from the auditor.

The financial statements will contain new information on Company C's exposure to foreign exchange risk and how it manages that risk. Users will need to familiarise themselves with this new information, and determine how it affects their view of the prospects of Company C. However, those users considering the financial statements for the purposes of making lending decisions should already be familiar with fair value accounting for derivatives and this will minimise their additional costs. The additional information may change the lending and investing decisions users might make, which may have further costs and benefits.

Summary:

Estimated costs of implementation £920

Estimated costs charged to Company C by its auditors £670

Estimated costs incurred by users £175

Note: this does not include any costs for upgrading the TMS, should that prove necessary. The benefits of an upgrade should not be confined to the ease of implementing the FRSME.

Company D

Scenario: Company D is a large unquoted parent company. It has a number of subsidiaries and is the ultimate parent undertaking within its group. Company D's business is based in the UK, although it may have a small number of transactions in foreign currency. It has basic borrowings and leases.

Company D has a well-resourced finance department.

Scenario D.1: Company D previously prepared its financial statements in accordance with UK accounting standards.

Application of the proposed Financial Reporting Framework: Company D will be in Tier 2 and eligible to apply the FRSME. However, the forward foreign exchange contracts are not basic financial instruments and Company D must apply the requirements of Section 12 of the FRSME. This will include recognising the derivatives at fair value and providing disclosure about the valuation methodology. For its basic borrowings Company D will apply Section 11 and recognise its loans at amortised cost based on the effective interest method. This may require some adjustment to the book value brought forward under UK accounting standards. Disclosures may also be more extensive than previously, but should be based on information already to hand.

By applying SSAP 20 Company D reduced its exposure to volatility in the profit and loss account. To achieve similar results using the FRSME Company D will need to apply hedge accounting. Company D decides to adopt a policy of hedge accounting where it has designated a hedging relationship. It will then decide on a case-by-case basis whether to designate a hedging relationship for individual transactions.

Company D has decided not to apply Section 19 of the FRSME to business combinations prior to the transition date.

Going forward the goodwill balance brought forward will continue to be amortised, although Company D should reassess its useful life.

Company D has a number of leases. It will need to determine whether there will be any change in their classification as either operating or finance leases and, if so, determine the accounting on transition. Changes in classification are most likely to occur if Company D has medium-term operating leases of property (based on the term at inception). In addition, any lease incentives will be reconsidered to ensure they are accounted for over the correct period.

Company D will need to review the presentation in its financial statements. It will need to reformat some statements and notes, revise the drafting in some areas, for example accounting policies, and add additional notes, including explaining the transition (only in the year of transition).

There are likely to be other areas where the recognition or measurement of items is different under the FRSME, when compared with current UK accounting standards, for example, deferred tax.

All Company D's significant subsidiaries are not publicly accountable themselves and they will also be in Tier 2. Any minor subsidiaries that are eligible to apply the small companies regime will continue to apply the FRSSE, and any differences in recognition/measurement will not be material to the group financial statements. The impact for the subsidiaries will be the same as for Company D but will depend on the extent to which each subsidiary has the transactions that lead to changes in accounting. In particular, accounting for business combinations (and goodwill) will only be relevant to those subsidiaries that are also parent entities if they prepare group financial statements. In their published financial statements all subsidiaries will take advantage of the reduced disclosure options, which will mean that the overall

level of disclosure will be similar to previous financial statements prepared under UK accounting standards.

Costs of implementing the proposed Financial Reporting Framework: The costs of implementing many of the adjustments are likely to be minimal, or fall within the costs that would be incurred each year in preparing the financial statements.

The costs of a more extensive review of the presentation in the financial statements than might otherwise have been undertaken are likely to be absorbed within the finance function, making use of illustrative financial statements (for example, those issued by the IASB to accompany the IFRS for SMEs or other commercial products). Costs and activities that are absorbed by a business do not result in additional cash flows, but may limit the ability of the business to undertake other projects.

Company D's auditors are likely to be a larger firm of Chartered Accountants and Registered Auditors and, as such, will already have clients that have adopted EU-adopted IFRS, and have incurred the initial costs of training and developing resources for EU-adopted IFRS. In addition, they will have well established annual processes for updating staff and resources, such that any costs associated with the FRSME will be absorbed within existing budgets. However, in the year of transition it is likely that some additional audit fees will be incurred by Company D, associated with any restatements and review of work demonstrating that areas of possible differences have been considered adequately.

External users of Company D's financial statements are likely to include customers and suppliers, possibly competitors, lenders (banks and leasing companies) and credit rating agencies. Depending on the way they want to use the information, and whether they are already familiar with the financial statements of quoted companies, there may or may not be some costs for users in understanding the new

information presented. This should be offset by the benefits of decision-making based on more transparent information.

Summary:

Estimated costs of implementation £2,500

Estimated costs charged to Company D by its auditors £870

Estimated costs incurred by users ....£negligible

Scenario D.2: Company D previously chose to prepare its group financial statements in accordance with EU-adopted IFRS (about 20% of the largest private companies have chosen EU-adopted IFRS) in order for its financial reporting to be comparable to its quoted competitors. In terms of Company law, Company D has been producing 'IAS group accounts' and may only revert to 'Companies Act group accounts' following a relevant change of circumstances. The ASB has asked BIS to confirm that the implementation of these proposals is a relevant change.

Application of the proposed UK Financial Reporting Framework: Company D will be in Tier 2 and has two choices available to it: either continue preparing 'IAS group accounts' or take advantage of the relevant change in circumstances to revert to 'Companies Act group accounts' and apply the FRSME. Given that Company D:

- voluntarily prepared 'IAS group accounts' in order to publish information comparable to its competitors; and
- has already incurred any costs of first time adoption of IFRS,

it will not obtain significant benefits from applying the FRSME and chooses to continue to prepare 'IAS group accounts'.

Although Company D's group financial statements were prepared in accordance with EU-adopted IFRS, its subsidiaries (and Company D's individual financial statements) had continued to be prepared in accordance with UK accounting standards, with adjustments made as part of the consolidation process to address differences between EU-adopted IFRS and UK accounting standards. All entities will now voluntarily apply EU-adopted IFRS, for consistency, but take advantage of the reduced disclosure options, such that the level of disclosure in their financial statements will be comparable to that under UK accounting standards.

Costs of implementing the proposed Financial Reporting Framework: There are no changes to Company D's group reporting as a result of the proposed UK Financial Reporting Framework and therefore no costs will be incurred.

However, Company D itself and its subsidiaries will no longer need to prepare two sets of financial information, therefore saving time and cost in the subsidiaries, the group finance function and the audit process. All group entities' individual accounts will need revision for compliance with EU-adopted IFRS and the reduced disclosure regime, but this will be based on information already prepared for the group financial statements and therefore be relatively straightforward to implement.

Summary:

Estimated costs of implementation, group financial statements .... £(325)

Estimated costs of implementation, individual entities £1,125

Estimated costs charged to Company D by its auditors £300

Company E

Scenario: Company E is a quoted company that has been preparing its group financial statements in accordance with EU-adopted IFRS since 2005. It has a well-resourced finance department.

Scenario E.1: At the time of transition to EU-adopted IFRS for its group financial statements Company E decided that its individual financial statements, and those of its subsidiaries, would continue to be prepared in accordance with UK accounting standards. Company E has not revisited this decision despite some of the original deciding factors ceasing to be relevant.

Application of the proposed Financial Reporting Framework: Company E must now prepare its individual financial statements in accordance with EU-adopted IFRS, but may take advantage of an exemption from preparing a cash flow statement. All the information for its individual financial statements will already be available from the group consolidation, and the annual report could be streamlined by once again showing the parent company alongside the group, rather than separate parent company financial statements in the same document. As a result the cost of preparing the initial draft should be minor.

Its subsidiaries will be affected consistent with Scenario D.2.

Costs of implementing the proposed UK Financial Reporting Framework: The same as Scenario D.2.

Summary:

Estimated costs of implementation, group financial statements .... £(325)

Estimated costs of implementation, individual entities £1,125

Estimated costs charged to Company E by its auditors £300

Scenario E.2: At the time of transition to EU-adopted IFRS for its group financial statements Company E decided that its individual financial statements, and those of its subsidiaries, would also be prepared in accordance with EU-adopted IFRS.

Application of the proposed Financial Reporting Framework: As in Scenario D.2 Company E and its subsidiaries will have the option of reverting back to 'Companies Act accounts', and therefore making use of either the reduced disclosure options or, in the case of the subsidiaries, applying the FRSME. As Company E had previously decided that it was beneficial for it to apply EU-adopted IFRS, all group entities will voluntarily be in Tier 1, but take advantage of the reduced disclosures available.

Costs of implementing the proposed Financial Reporting Framework: Taking advantage of the reduced disclosures will cut the cost of preparing (and auditing) the financial statements of the subsidiaries.

Summary:

Estimated costs of implementation, group financial statements £0

Estimated costs of implementation, individual entities .. £70

Estimated costs charged to Company E by its auditors £200

Entity F

Scenario: Entity F is a building society. It has been preparing its financial statements in accordance with the Building Societies Act 1986 and UK accounting standards. It has not adopted FRS 26, but has provided certain disclosures about financial instruments in accordance with FRS 13.

Application of the proposed Financial Reporting Framework: Entity F has public accountability by virtue of being a deposit taker for a broad group of outsiders as one of its primary businesses, and therefore will be in Tier 1 and required to apply EU-adopted IFRS.

The most fundamental change in financial reporting for Entity F will be the adoption of IAS 39 (if still applicable), IFRS 7 and IFRS 9 (when endorsed), although this will build on data already held and disclosed for FRS 13. As with Company C, the extent of the changes required to the financial data will depend on the data already captured by Entity F's Treasury Management System for monitoring and managing its financial instruments, and the extent to which Entity F decides to incorporate the new financial data/ presentation into its internal reporting.

However, costs will be incurred in maintaining fair value accounting records for financial instruments currently recognised at cost, training staff on the new process and understanding new information.

Entity F is likely to seek to apply hedge accounting wherever possible. This is also likely to result in additional requirements to prepare and maintain information about the hedges and their effectiveness.

In preparing its financial statements Entity F will need to prepare additional disclosures about its financial instruments including sensitivity analyses.

Depending on the financial performance and position Entity F reports under EU-adopted IFRS, it may need to invest additional time and resources in its narrative reporting and other communication with members and other users of its financial statements.

Costs of implementing the proposed UK Financial Reporting Framework: The costs of applying EU-adopted IFRS for the first time are likely to be more than minimal for financial institutions that have not previously recognised various financial instruments in their financial statements. There may also be additional costs in terms of audit effort and, as noted above, in ensuring effective communication with members and other users about the new financial information.

Summary:

Estimated costs of implementation, based on undiscounted ICAEW estimate of costs to quoted companies and average total income for building societies not currently applying EU-adopted IFRS £54,980

Table 3 – Summary of estimated costs of implementation

Scenario		Approximate Number of UK companies*	Proportion of UK companies %†	Estimated costs £	Total estimated costs £million
Company A	**FRSSE**	1.7million	96.7%	–	–
Company B	**Medium, no complex transactions**	20,000	1.1%	1,140	22.8
Company C	**Medium, some complexity**	15,000	0.9%	1,765	26.5
Company D.1 **Company D.2**	**Large unquoted group**	5,250 750	0.3% –	3,370 1,100	17.7 0.8
Company E.1 **Company E.2**	**Quoted group**	1,000 100‡	0.1% –	1,100 610	1.1 0.1
Entity F	**Building Society**	38§	–	54,980	2.1
Other • **co-operatives (see below)**		4,400	0.2%	1,765	7.8
Total			99.3%‖		**78.9**
Other (business as usual) • **ongoing annual savings for subsidiaries** • **ongoing costs**					(0.9) 7.6

* *These approximate numbers of companies are taken from analysis of the FAME database by BIS.*

† *Based on 1.76million companies. This data is limited in that it does not take into account entities that are not companies.*

‡ *This is an assumption.*

§ *This excludes those Building Societies that already apply EU-adopted IFRS.*

‖ *The use of estimates and approximations in the numbers of companies in each category, and inclusion of entities that are not companies, will have contributed to a total other than 100%.*

11.70 In addition to the scenarios listed above, other main affected groups include pension funds and credit unions.

Pension funds (9,406* defined benefit and hybrid schemes)
Pension funds are publicly accountable and will apply EU-adopted IFRS. This will require them to account in accordance with IAS 26 'Accounting and Reporting by Retirement Benefit Plans'. IAS 26 applies in preference to all other IFRS where items fall within the scope of more than one standard. As a result it is anticipated that a SORP for pension funds will continue to exist, to supplement IAS 26. Therefore there are likely to be minimal changes in reporting by pension funds and minimal costs of implementation.

Credit unions (about 1,200†)
Credit unions are publicly accountable and, unless they qualify for Tier 2 because they are small and prudentially regulated, they will be in Tier 1 and apply EU-adopted IFRS. However, the types of financial instrument that credit unions may hold are restricted by law and the ASB believes that these financial instruments are not usually required to be accounted for at fair value. Therefore the costs of transition to EU-adopted IFRS are unlikely to be substantial because there will be little change in the underlying accounting.

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* *Based on data from the Pensions Regulator there are 8,099 schemes in the UK. http://www.thepensionsregulator.gov.uk/docs/annual-report-and-accounts-2009-2010.pdf. Based on data from The Pensions Board there are 1,307 schemes in the Republic of Ireland. http://www.pensionsboard.ie/en/Publications/Annual_Report/Annual_Report_and_Accounts_2009.pdf.*

† *The Financial Services Authority regulates nearly 500 credit unions in the UK (http://www.fsa.gov.uk/smallfirms/your_firm_type/credit/), although Co-operatives UK reports 716 credit unions (see link below), and the Irish League of Credit Unions represents the interests of over 508 credit unions in Ireland (http://www.creditunion.ie/whoweare/#d.en.127).*

Co-operatives (about 4,400*)

Co-operatives are not generally publicly accountable. Depending on their size co-operatives will be either in Tier 2 or Tier 3. No reporting entity in Tier 3 will need to change its accounting and reporting as a result of these proposals. The impact of the proposals on Co-operatives in Tier 2 will depend on the nature of the transactions they undertake and the accounting policies adopted in the past. Possible areas of difference include financial instruments that are not basic, and agriculture. For agricultural activity the FRSME will require entities to determine an accounting policy for each class of biological assets based on a fair value model (if fair value is readily determinable) or a cost model. Co-operatives may recognise an analogy with Company C above.

ACCA field testing

11.71 The above analysis of the costs is borne out by the results of field testing carried out by ACCA† in early 2008 on what was at the time the proposed IFRS for SMEs. The IFRS for SMEs was subsequently amended in some areas before final publication. The sample was 25 entities, all but two of which were eligible for the small companies regime, and therefore would not be required to apply the FRSME under the ASB's proposals. Differences in recognition and measurement observed at the time were:

- 20% of entities recognised additional deferred tax balances.

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* *Co-operatives UK reports over 4,992 co-operatives in the UK (http://www.uk.coop/sites/default/files/Co-operative%20economy%202010%20web%20version_0.pdf) and over 150 co-operatives affiliated to the Irish Co-operative Organisation Society. However the UK figure includes 716 credit unions and other co-operatives that fall into other categories of reporting entity (eg John Lewis Partnership plc, which already applies EU-adopted IFRS).*

† *International Financial Reporting Standard for Small and Medium Sized Entities: Review of field testing results carried out by ACCA in UK in early 2008 (TECH-TP-SFT)*

- 8% of entities no longer amortised goodwill (the proposed IFRS for SMEs used for the field testing required entities to measure goodwill at cost less impairment, and therefore cease amortisation of existing goodwill. The proposals were subsequently amended to require amortisation, and impairment tests only where there are indicators of impairment. This means there is no longer a difference between UK accounting standards and the IFRS for SMEs).

- 4% of entities re-measured fixed asset investments, previously valued at cost (depending on whether or not fair value can be easily measured, the IFRS for SMEs may or may not require re-measurement).

11.72 In addition 40% of companies were affected by balance sheet presentation changes, generally reclassifications within the same general category, of which 4% of companies adopted a net presentation for government grants for property, plant and equipment (the IFRS for SMEs does not specify the accounting for government grants for property, plant and equipment, but any accounting treatment adopted under the FRSME would need to be consistent with the law).

11.73 ACCA attributed the low impact to:

(a) the similarity in recognition and measurement criteria between existing UK accounting standards (including the FRSSE) and the IFRS for SMEs; and

(b) where there were more significant differences between UK accounting standards and IFRS, they related to more complex areas of accounting/transactions, which were either simplified by the IFRS for SMEs, or the companies subject to the field testing did not have activities giving rise to accounting complexities.

11.74 The main presentational difference related to the requirement to present a cash flow statement, but the

FRSME will not extend the need for a cash flow statement beyond current requirements/practice.

11.75 The main additional disclosure requirement was in relation to lease commitments, where often the full value of commitments was not readily to hand. It is possible that in a 'live' scenario more differences would emerge.

11.76 ACCA concludes that "... this study would support replacing UK GAAP with [IFRS for SMEs] for all companies and not just medium-sized and above. However when it comes to small companies a continuation of the existing derogations in the law for consolidation and for cash flow statements would be appropriate ..."

ICAEW report for the European Commission: EU implementation of IFRS and the Fair Value Directive

11.77 The ICAEW carried out work in 2007 on the implementation of EU-adopted IFRS, based on 2005 financial statements. The methodology included the use of questionnaires/surveys and round tables to gather data and test preliminary findings. The ICAEW's report includes a broad estimate of the typical costs of preparing the first IFRS consolidated financial statements and a broad estimate of the typical recurring costs of preparing IFRS financial statements in subsequent years. These estimates only relate to the consolidated financial statements of quoted groups.

Table 4 – ICAEW estimate of costs to quoted companies

First time adoption of EU-adopted IFRS

Companies with turnover below €500m	0.31% of turnover
Companies with turnover from €500m to €5,000m	0.05% of turnover
Companies with turnover above €5,000m	0.05% of turnover

Annual recurring costs

Companies with turnover below €500m	0.06% of turnover
Companies with turnover from €500m to €5,000m	0.01% of turnover
Companies with turnover above €5,000m	0.008% of turnover

11.78 The ICAEW noted that:

(a) by reference to the extremes of the turnover band sizes the relationship between IFRS transition costs and turnover might be more variable than the percentages quoted.

(b) respondents were asked for incremental costs, but there are some doubts over whether all the reported costs are truly incremental.

(c) the data suggested that smaller quoted groups bore a proportionally higher cost, implying that economies of scale were realised within bigger companies with a larger number of complex transactions requiring sophisticated accounting and reporting, whereas smaller companies relied more heavily on external advice/support.

11.79 Whilst this is interesting information about the transition to EU-adopted IFRS by quoted groups in 2005, the ASB believes there is limited scope to extrapolate this to companies applying new accounting requirements under its proposals for the following reasons:

(a) as noted elsewhere, entities adopting the FRSSE will not be required to make any changes to their accounting at this time;

(b) as a result of these proposals most companies (other than those eligible for the small companies regime) will

be required to adopt the FRSME, which by definition is less complex than EU-adopted IFRS;

(c) many companies adopting the FRSME will have few, if any, significant complex transactions. This means that although they will not benefit from internal economies of scale, they will simply not incur costs in relation to the sophisticated accounting required for complex transactions, which was cited as one of the reasons the costs were proportionately higher for smaller quoted groups;

(d) in contrast to the first-time adoption of EU-adopted IFRS in 2005, many more UK accountants now have much greater knowledge and experience of IFRS generally. Therefore, one would anticipate the costs of external advice to be lower as the supply/demand ratio has changed;

(e) a number of new UK accounting standards were also applicable from 2005, and would have been applied by quoted groups even without the transition to EU-adopted IFRS. This includes share-based payments, financial instruments standards and retirement benefits. It is not clear to what extent these costs have been included or excluded from the ICAEW's analysis. Although the present UK accounting standards with detailed requirements for financial instruments are only mandatory for quoted companies, UK companies adopting an IFRS-based framework now, will incur no incremental costs relating to share-based payments and retirement benefits.

11.80 As a result the ASB believes a significant discount can be applied to the ICAEW's observed percentage in order to apply it to companies adopting the FRSME.

Danielle Stewart, Partner Baker Tilly, quoted in Accountancy Age 19 August 2010.

Commentators have suggested a cost nearer £1,000* per company might be appropriate for adoption of the FRSME. One respondent to the ASB suggested an estimate of £3,000† per company for conversion to either EU-adopted IFRS or the IFRS for SMEs.

Table 5 – Estimated upper limit of costs of implementation

Upper limit for first time adoption of FRSME	ICAEW %	After 75% discount
Company/group with turnover of £100m	£310,000	£77,500
Company/group with turnover of £30m	£93,000	£23,250
Company/group with turnover of £10m	£31,000	£7,750

11.81 The discount factor of 75% is an assumption, but is designed to reflect less complexity, greater availability of IFRS expertise and the fact that to the extent UK accounting standards are already based on IFRS, there should be no further costs of adopting the FRSME.

BENEFITS OF PROPOSALS

High quality financial reporting

11.82 High-quality accounting standards deliver relevant, useful information, which educated users need for making investment decisions. They enhance comparability, transparency and disclosure.

11.83 High quality standards produce financial information that reports events when they occur (not before or after) and as a

* *Danielle Stewart, Partner Baker Tilly, quoted in Accountancy Age 19 August 2010.*

† *BDO 'The Future of UK GAAP' 17 August 2010.*

result actual volatility is not smoothed to create an artificial picture of steady and consistent growth.*

11.84 Much has been said about the extent to which IFRS increases volatility in financial reporting, through the use of fair values, in aiming to reflect conditions existing at the reporting date. The IFRS for SMEs makes more limited use of fair values for measuring assets and liabilities, for example all basic financial instruments are measured at amortised cost, and it is only the more complex financial instruments that are measured at fair value. The ASB believes that this is a proportionate solution for the FRSME, with complex transactions requiring more than basic accounting and disclosure in order for users to understand their effects, but this should not lead to artificial volatility.

11.85 In the paper 'Incentives or standards: What determines accounting quality changes around IFRS adoption?'† reference is made to the situation in Germany, where companies were permitted to adopt IFRS from 1998, with mandatory adoption from 2005. After voluntary adoption of IFRS, companies' financial reporting showed evidence of reduced earnings management and increases in the timely recognition of losses. However, following mandatory adoption of IFRS, those companies that did not voluntarily adopt IFRS showed fewer improvements in accounting quality. The hypothesis was that they were less externally focused and therefore lacked incentives to improve their accounting.

11.86 In developing the IFRS for SMEs, the IASB considered that it would be suitable for entities producing reports for external users. The implication from the above research, therefore, is that adoption of an IFRS-based framework will improve the quality of accounting by those entities applying it.

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* *From remarks made by Arthur Levitt, Chairman, SEC in September 1997.*

11.87 The ASB believes that its proposed IFRS-based framework for UK accounting standards, including the FRSME, will lead to an increase in the quality of financial reporting by UK companies and proportionate disclosures.

Reduction in the cost of debt and equity investment

11.88 The ACCA Research report 105 'Mandating IFRS: its impact on the cost of equity capital in Europe'*, put the UK as the only country with a maximum score for its financial reporting environment. At the other end of the scale various other countries scored zero. The conclusion of the ACCA's research is that:

"We find no evidence of a reduction in the cost of equity capital among countries where there are relatively low financial reporting incentives and enforcement. Instead, we find a significant reduction in the high incentive group, mainly companies based in the UK. **... improved cross-border comparability could have benefited such companies."**

"... companies in countries such as the UK, where equity-based financing and higher disclosure quality are common, benefited more from IFRS. ... irrespective of accounting standards companies will commit to higher disclosure should they see the need to do so."

11.89 BIS has carried out economic analysis on the benefits and costs of the transition to EU-adopted IFRS by quoted companies. An extract of the preliminary results is attached as Appendix Two. The analysis shows that the most likely outcome is a recurring net annual benefit of £4.6 billion, with transition costs of £0.8 billion.

11.90 It is difficult to extrapolate these results directly to non-publicly accountable entities, not financed from external

* *http://www.accaglobal.com/general/activities/research/reports/global_integration/rr_105*

equity markets, but which may access debt financing. There do not appear to be any studies examining the impact of IFRS on costs of debt. However, the adoption of IFRS and the IFRS for SMEs will increase the transparency of information about debt and similar commitments, for example by requiring disclosure by lessees of the gross future cash flows for both operating and finance lease commitments. This will enable potential lenders to be better informed in their lending decisions. In turn this should result in lower costs of lending because the risk of default can be more accurately predicted.

11.91 Indeed, anecdotal evidence from rating agencies suggests that when AIM companies applied EU-adopted IFRS for the first time, the additional information in their financial statements made the process of rating easier.

11.92 Although not all companies have complex financial instruments, and many will be able to recognise their indebtedness on the basis of amortised cost, the FRSME will require all entities to evaluate the significance of financial instruments to their financial position and performance and disclose to users information relevant to an understanding of the financial statements. Again, this should give lenders more information about borrowings, and the extent to which financial instruments are used in the business and contribute to risk management (or increased risk). This additional transparency should enhance lending decisions.

Assumptions about the lending market

11.93 Data:

(a) The British Bankers' Association (BBA) reports total lending to non-financial companies of £330 billion*. Of this £46 billion is to small companies.

* *BBA statistics 24 August 2010.*

(b) The Bank of England gives indicative median interest rates on new variable rate facilities for SMEs as 3.25% over base rates for medium-sized entities*.

(c) ACCA research report 105 says UK companies observed an average 1.17 point drop in the cost of equity capital after the introduction of EU-adopted IFRS†.

11.94 Assumption:

Lending to unquoted medium and large entities is £100 billion (ie approximately twice the total lending to small companies).

11.95 Based on the above data and assumption, if unquoted companies adopting the FRSME, which is based on the IFRS for SMEs, experienced a reduction of only 0.25% in the cost of borrowings, benefits of £250 million would accrue in terms of interest saved. A cut of less than a tenth of a percentage point would cover the £78.9 million estimated cost of implementing the ASB's proposals.

Intellectual mobility, education and training

11.96 In the UK, as part of their professional qualification, accountants are trained in IFRS. However, those not qualifying recently were trained in UK accounting standards. This has led to two streams of accountants:

(a) those who trained in UK accounting standards and need to undertake additional CPD training where their role now requires them to apply IFRS; and

(b) those who trained in IFRS, but prepare or audit financial statements based on UK accounting standards,

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* *Trends in Lending, August 2010.*

† *Note, this is an absolute drop in the interest rate, not a proportion of the initial interest rate.*

and therefore require additional training on UK accounting standards.

11.97 Implementation of the ASB's proposed Financial Reporting Framework will mean that all companies, other than those permitted to use the small companies regime, will report in accordance with a framework based on IFRS. As a result newly trained accountants will no longer need retraining on UK accounting standards, which will generate ongoing savings for their employers, or allow training budgets to be allocated to other development areas.

11.98 Those more familiar with UK accounting standards will need to become fluent in IFRS and/or the FRSME, but this should be regarded as a part of ongoing CPD.

11.99 In addition, all accounting will be based on a common framework, promoting consistency, but also reducing scope for confusion and the risk of unintentionally applying one framework through the perspective of the other.

Comparison with competitors

11.100 At present some large private companies have decided to apply EU-adopted IFRS voluntarily, so that their reported results and financial statements are presented in a manner consistent with their quoted competitors. Implementation of the ASB's proposed Financial Reporting Framework will improve consistency for all reporting entities with quoted competitors, and also with quoted companies from other parts of the EU with whom they may be competing for contracts.

11.101 For UK companies evaluating tenders from EU companies, there will also be savings/benefits from all tenderers reporting financial information based on a consistent framework.

Other potential consequences

Tax and distributable reserves

11.102 Many quoted companies required to apply EU-adopted IFRS in their group financial statements have chosen to continue with UK accounting standards in the individual financial statements of the parent company and subsidiaries. The reasons often cited for this include the potential for changes in the timing of tax payments and a possible inability to pay dividends because of a 'dividend trap' or other impacts on distributable reserves, such as the removal of discounting in measuring deferred tax liabilities.

11.103 Inevitably if entities report a different 'profit' figure after implementing the ASB's proposals than they would have if there had been no change in UK accounting standards, there is a risk that taxable profits (and hence current tax payable) will vary. However, this is a matter for the tax authorities. The ASB has been working closely with HMRC to ensure it is aware of the changes and the potential implications for its work.

11.104 The determination of profits available for distribution is a complex area where accounting and Company law interface. In determining profits available for distribution a company may refer to 'Guidance on realised and distributable profits under the Companies Act 2006' issued by the ICAEW and the Institute of Chartered Accountants in Scotland.

Regulated industries – reporting to regulators

11.105 Some reporting entities, both quoted and unquoted, operate in regulated industries, where financial information is required as part of the regulatory regime. This financial information may, or may not, be based on an entity's statutory financial reporting. It is the responsibility of the regulator to determine the information it needs and,

if necessary, how profits/(losses) are defined for regulatory purposes.

11.106 As noted above, good accounting recognises the impact of transactions when they occur. If regulators wish to smooth the impact of some transactions or events over a longer period, this does not negate the need for good accounting in statutory financial statements. In such circumstances regulators may determine that a separate calculation of regulatory profit should be made.

APPENDIX ONE – OTHER SOLUTIONS CONSIDERED BUT REJECTED

OPTION 1 – DO NOTHING

11.107 Current UK accounting standards are a mixture of 'old' UK accounting standards and 'new' standards that are converged with IFRS. This leads to the possibility of unintended consequences where standards were not developed from a consistent framework, and 'gaps' in the literature, for example, where currently only quoted companies are required to account for financial instruments.

11.108 This position is not sustainable; accounting standards need to keep pace with business developments, and incorporate the best of modern thinking on accounting.

11.109 There are costs associated with doing nothing:

(a) Additional risks arise from failing to strive continually to improve standards of financial accounting and reporting; for example, the risk of reduced availability of finance/investment and of corporate failure increases if users do not have access to suitable financial information.

(b) The ASB believes its proposals offer significant savings to subsidiaries of quoted groups, through the option to apply EU-adopted IFRS with reduced disclosures. A number of responses to the development of the impact assessment support this view. These savings will not be realised unless the ASB proceeds with its proposals.

11.110 The ASB does not consider 'do nothing' a viable option. There are costs associated with not providing the option of reduced disclosures for subsidiaries, and UK accounting standards now lack cohesive principles as a consequence of developments in financial reporting in recent years. If the

ASB were not proposing a Financial Reporting Framework based on IFRS, it would need to undertake a comprehensive review and update to UK accounting standards, with the same objective of improving the quality of financial reporting, whilst providing a cost-effective solution. This would result in changes being proposed to existing UK accounting standards.

OPTION 2 – UK FINANCIAL REPORTING FRAMEWORK NOT BASED ON IFRS

11.111 Throughout the ASB's consideration of its plans for the future of UK accounting standards there has been majority support from respondents for the proposed move to an IFRS-based framework. Indeed there has been continual support for Tier 1 to apply EU-adopted IFRS.

11.112 There has been more debate about the appropriate accounting for Tier 2 (those entities that are neither publicly accountable nor eligible for the small companies regime). One of the options for Tier 2 was to maintain separate UK accounting standards, which was raised by the ASB in its 2006 Press Notice seeking views. The ASB asked for respondents' views on the best financial reporting for Tier 2.

11.113 The advantages of maintaining separate UK accounting standards for Tier 2 would include:

(a) a more evolutionary pace of change;

(b) standards drafted within the UK legal framework;

(c) increased ability to respond to UK specific issues.

11.114 The disadvantages to having separate UK accounting standards for Tier 2 include:

(a) greater difficulty for entities in moving between tiers because there is less comparability in financial reporting, and in preparing group consolidations;

(b) increased costs and intellectual difficulty for accountants, auditors and users in remaining fluent in two different accounting frameworks, and justifying different accounting for the same transactions, particularly in a group situation;

(c) it will not be possible for separate UK accounting standards to remain uninfluenced by IFRS. An IFRS solution is available, accountants will be used to IFRS and inevitably the UK accounting standards will be influenced by IFRS, such that it will implicitly be an IFRS-based framework. The question would be, how closely it was based on IFRS; and

(d) additional standard-setting resources would be needed to develop separate accounting requirements for UK companies, to sit alongside IFRS for publicly accountable entities, diverting resources away from the ASB's role in influencing the IASB.

11.115 This option was not supported by respondents and has not been pursued by the ASB. In fact, as noted above, it seems likely that this option is, in practice, not significantly different from Option 3.

11.116 The ASB notes that commentators have suggested that this approach has been adopted by some other European countries. Different European countries have different local accounting standards and, as noted in Section 3, the UK's financial reporting framework was considered by ACCA to be the highest quality in Europe. It is also based on principles that are not dissimilar to those in the IASB's Framework, which is not the case for all other European countries. As a result it is more understandable that countries other than the UK would want to maintain separate accounting standards; in the UK the similarity of the principles, the fact that some standards (eg FRS 12) were developed jointly with the IASC and the adoption of converged standards (eg financial instruments) imply that if the UK attempted to maintain separate accounting standards, as noted above, they would inevitably tend towards consistency with IFRS.

OPTION 3 – UK FINANCIAL REPORTING FRAMEWORK BASED ON IFRS, BUT SUBSTANTIALLY AMENDED WHERE THERE IS A 'BETTER ANSWER' FOR THE UK

11.117 The majority of respondents have been continually supportive of the UK adopting a Financial Reporting Framework based on IFRS, and as the IASB's solution for non-publicly accountable entities developed consensus grew around using the IFRS for SMEs as the starting point for Tier 2.

11.118 Responses to the 2009 Consultation Paper agreed with this, but many respondents suggested amendments to the IFRS for SMEs for use in the UK. Inevitably there were only a small number of potential amendments that respondents agreed on, with many other suggestions only raised by one respondent.

11.119 The ASB carefully considered its approach to the possibility of making amendments to the IFRS for SMEs for application in the UK and Ireland. It decided that maintaining genuine consistency with an IFRS-based framework was important in having accounting standards that are cohesive (one of the problems with the current UK accounting standards is that they have not been developed from a consistent framework). Therefore, the ASB decided that it would make minimal changes to the IFRS for SMEs, and that any changes would be consistent with IFRS, thus maintaining the FRSME as an IFRS-based standard. This consistency will have benefits in terms of education and training, and ease of moving between tiers.

11.120 Having determined the basis on which amendments would be made to the IFRS for SMEs, the ASB then evaluated all suggested amendments against the criteria. The changes that are proposed are set out in Section III of part 2 of this FRED.

Note: Options 2 and 3 contain almost limitless permutations of changes that could be made, singly or in combination. These are not considered separately here.

OPTION 4 – DELAY IMPLEMENTATION FOR A NUMBER OF YEARS

11.121 During the various consultations, the first date suggested for full implementation of an IFRS-based suite of accounting standards in the UK was 1 January 2009. Some respondents felt this might not be attainable, and that the ASB should be prepared to delay if it resulted in a better product. As the ASB continued to work on its proposals, it became clear that 2009 was too ambitious a target.

11.122 The 2009 Consultation Paper proposed an effective date of 1 January 2012, and the [draft] standard proposes delaying this to 1 July 2013 to ensure entities have adequate time to plan for any changes in their financial reporting.

11.123 Some comments received as a result of the 2010 request for responses suggested that implementation be delayed further, often suggesting 1 January 2015, because:

(a) businesses may need additional time to prepare for transition; and

(b) businesses that are regulated should be able to apply the standards at the time most convenient to their regulatory regime.

11.124 However, the ASB has also received responses over the years requesting a quicker adoption of an IFRS-based framework.

11.125 The ASB does not want to delay implementation further:

(a) UK accounting standards have not significantly evolved since 2005, and further delays to implementation could only mean that UK accounting standards move further away from current thinking;

(b) in the light of the current economic climate, the ASB considers that the adoption of the FRSME will

contribute to financial stability in the UK and Ireland by ensuring appropriate relevant, understandable information is provided on entities' financial instruments, and other obligations;

(c) although the amount of effort involved in adopting the FRSME, and other elements of the IFRS-based framework, will vary from entity to entity, and for some will be minimal, the ASB is not convinced that more than 18 months is needed between publication of the standard and its implementation date; it is not clear that a delayed implementation date would not simply delay the point at which entities started to prepare for it.

11.126 For those that prefer a quicker pace of change, early adoption will be permitted.

APPENDIX TWO – EXTRACT FROM BIS PRELIMINARY ANALYSIS OF THE BENEFITS AND COSTS OF IFRS IMPLEMENTATION IN THE UK BY QUOTED COMPANIES

11.127 We have carried out some preliminary analysis of the benefits and costs to companies that have implemented the International Financial Reporting Standard (IFRS) in the UK. At present only listed companies are required to use this standard. This analysis is based on data for 1,130 UK listed companies. Subsidiaries and companies in the financial service sector have been excluded from this analysis.

Benefits and Costs

11.128 Our assumptions are drawn from background literature, academics and practitioners to present the consensus view. We have adopted the findings of an ACCA report on mandating IFRS to inform our assumptions of the benefits. Our assumptions include*:

(a) Costs of adopting IFRS by UK listed companies are based on the findings of the ICAEW report on the EU implementation of IFRS. The cost estimates are based on an on-line survey of EU investors, preparers and auditors of IFRS financial statements.

(b) FAME analysis: 1) Listed, active, UK Companies reporting under IFRS as of July 2010 were selected. Subsidiaries and companies in the financial service sector (including insurance) have been excluded. This totalled 1,240 Companies. Those that did not have figures for either market capitalisation or turnover were excluded as well taking the total sample down to 1,130.

* *Further detail on assumptions is available if required.*

11.129 The table overleaf summarises the range of costs and benefits, the benefits being a reduction in the cost of equity capital, based upon our sensitivity analysis of the assumptions employed.

Table 6 – BIS benefits and costs summary table

Benefits and Costs Summary Table				
	Annual recurring costs £billion	**Annual recurring benefits £billion**	**Net annual benefits £billion**	**Transition cost £billion**
Best Case	0.1	23.9	23.8	0.8
Worst Case	0.7	4.7	4.0	3.9
Mid Point	0.4	14.3	13.9	2.3
Most Likely	0.1	4.7	4.6	0.8

11.130 The positive message is that UK listed companies have overall benefited from switching to IFRS. However, the main beneficiaries have been the largest corporations.

11.131 Most unlisted UK companies have few shareholders and we believe a further analysis is needed to assess what the likely impacts would be of extending reporting under IFRS to unlisted companies.

APPENDIX THREE – TIME ASSUMPTIONS UNDERLYING COSTS

Table 7 – Approximate incremental time spent on implementing the ASB's proposals

	Internal costs	Costs incurred by advisors
Company B	2½ days, plus a training course.	2½ days of staff time, plus ½ a day of partner time.
Company C	4½ days, a training course and additional valuation fees.	3 days of staff time, plus ½ a day of partner time.
Company D.1	15 days, 2 training courses and additional valuation fees.	4 days of staff time, plus 5 hours of partner time.
Company D.2	8½ days.	1½ days of staff time, plus 1 hour of partner time.
Company E.1	8½ days.	1½ days of staff time, plus 1 hour of partner time.
Company E.2	½ day.	½ day of staff time, plus 2 hours of partner time.

SECTION 12: ALTERNATIVE VIEW

12.1 The member holding the alternative view considers that the purpose of financial statements is to provide users with useful information in a useable format. Users are therefore the key constituency when assessing proposed changes to UK GAAP. While preparers and auditors can provide input on the cost of proposals, only users can provide meaningful input on benefits. The ASB's outreach activities, although extensive, have not managed to generate adequate responses from the users of financial statements prepared under UK GAAP to support the current proposal.

12.2 As a result, the alternative view asserts the ASB does not have sufficient evidence to test the assumptions underlying the main structure of these proposals, and the member holding the alternative view believes that:

(a) more publicly accountable entities should fall into Tier 2.

(b) the accounting requirements for Tier 2 should be further simplified particularly in respect of:

(i) financial instruments and leases,

(ii) other uses of fair value, and

(iii) deferred tax.

(c) the upper limit for use of the FRSSE should be raised.

12.3 He considers that such an approach would better meet the FRC's objective of reducing complexity*, and the

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* *The FRC recently consulted on the causes of complexity in financial reporting and its report "Louder than Words" included the following statement: "There is a tendency to focus on the technical merit or theory behind each regulation and accounting standard. While this is clearly*

government's objective of reducing burdens upon UK business.

12.4 He further believes that , due to the low level of input from users of financial statements, the proposals in the FRED, while they may, or may not, be an improvement on existing requirements, cannot be presented as the best possible trade off between costs and benefits for UK companies, and cannot be determined to be proportionate or targeted.

THREE MAJOR STRUCTURAL ISSUES WITHIN THE ASB PROPOSAL

12.5 Set out below are three (of the four[†]) key assumptions on which the ASB's proposals are based:

(a) In paragraph BC56 of the Basis for Conclusions published with the IFRS for SMEs, the IASB made a statement to the effect that the IFRS for SMEs was not a suitable accounting standard for entities with public accountability. The IASB provided no reasoning to support this statement, but the ASB has accepted that this assumption is valid for the UK.

(b) The ASB has assumed that the information requirements of users of financial statements of

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important, there needs to be more emphasis on understanding the problem being addressed, determining the most efficient regulatory solution for the problem and delivering this solution in an understandable way. We believe that if regulators use a framework for considering these issues, then over time complexity in corporate reporting will be reduced." The report also highlighted the risk of "*accounting becoming too theoretical*" and went on to say "*it is not sensible for regulators to make disclosure requests that require companies to reformat existing information in a slightly different way. And regulators should consider whether information that management doesn't need is actually useful*". The member holding an alternative view believes that the current ASB proposals do not pay sufficient regard to these issues

† *The fourth assumption is that users of financial statements do not need a full set of disclosures in the accounts of subsidiaries when their parent company prepares consolidated accounts. The member holding the alternative view is similarly concerned about the lack of user input to support this assumption, but in his experience this assumption is valid.*

entities currently prepared using UK GAAP will best be met by financial statements prepared using accounting treatments that are, as far as practicable, consistent with the IFRS for SMEs as issued by the IASB. The ASB, despite many outreach activities, has not succeeded in testing this assumption with that key group of users.

(c) The ASB has assumed that increases in the upper size limit for application of the FRSSE would require changes to the FRSSE, and that the result of the changes would be that the FRSSE ceases to be appropriate for the smaller entities for which it was originally designed. The ASB has not specified the changes to the FRSSE that it believes might be required nor explained the reasons why, or at what size points, such changes might be appropriate.

12.6 The implications of these assumptions on the structure of the ASB's proposals are set out below:

Boundary between Tier 1 and Tier 2

12.7 When determining where to set the boundary between Tier 1 and Tier 2 the ASB considered using size criteria, or public accountability, or a combination of both criteria. Its decision is founded on the premise that the IFRS for SMEs is not a suitable accounting standard for entities with public accountability. This premise is based on an unsupported statement to that effect by the IASB in paragraph BC56 of the Basis for Conclusions published with the IFRS for SMEs.

12.8 The ASB identifies a list of entities that it believes are publicly accountable, i.e. Tier 1, and which should use EU-adopted IFRS. The ASB's proposals do permit some smaller publicly accountable entities to use the UK variant of the IFRS for SMEs, the FRSME, provided they meet certain size criteria and are prudentially regulated. This exemption has been devised for small credit unions but

extends to all prudentially regulated private companies that meet the size criteria. The rationale for this exception is that the financial statements for small credit unions when prepared under the FRSME will not differ significantly from financial statements prepared using EU-adopted IFRS. However the ASB fails to identify how the size and regulation conditions are either necessary or sufficient, i.e. why the exemption should be either restricted to, or allowed for, such entities.

12.9 The member holding the alternative view believes that an adjusted version of the IFRS for SMEs could be suitable for some or all of the entities identified as publicly accountable, i.e. Tier 1, and that the ASB should identify the information which is lacking from accounts prepared using the IFRS for SMEs, and which makes this standard unsuitable for these entities. Only then will the ASB be in a position to determine whether an unadjusted, or adjusted, version of the IFRS for SMEs might be a more proportionate solution for some or all of those entities.

Accounting requirement for entities falling into Tier 2 (FRSME)

12.10 When determining the accounting requirements for entities falling into Tier 2, the ASB's primary concern was to maintain consistency with EU-adopted IFRS. As a result, changes were only made to the IFRS for SMEs to the extent necessary to comply with EU Accounting Directives and Company law, to bring the tax requirements into line with IFRS and in the other limited circumstances set out in paragraph 5.8.

12.11 The ASB accepts that the IFRS for SMEs may not be perfect, but is of the view that responsibility for improvements lies with the IASB in its triennial reviews of the standard.

12.12 The relative brevity of the IFRS for SMEs has been achieved in the main by omitting those paragraphs in full

IFRS that expand upon the accounting principles and rules, and, to a lesser extent, the elimination of options and limited changes to accounting treatments. The circumstances in which the IFRS for SMEs would mandate a recognition or measurement principle that is different from the requirements under full IFRSs are limited*. Preparers of financial statements may well find themselves reverting to explanations and guidance in full IFRS.

12.13 The member holding the alternative view considers that in drawing up these proposals, the ASB has focused on reducing the size of the "rule book" and maximising consistency with IFRS. It has not considered in detail whether limited changes to the more complex accounting treatments required under the IFRS for SMEs could result in a net reduction in complexity, despite reducing consistency with IFRS.

12.14 The member holding the alternative view proposes that the ASB should have adopted the following working assumptions:

(a) Tier 2 may be suitable for some publicly accountable entities other than those small entities regulated by the FSA.

(b) The main categories of relevant† Tier 2 users are the external shareholders not involved in management, plus customers, suppliers and credit insurers.

(c) Financial statements meeting the information needs of such users about an entity's financial position, performance and cash flows will also meet those

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* *Differences are set out in paragraph BC68 of the Basis for Conclusions for the IFRS for SMEs.*

† *For the purposes of setting accounting standards, the information requirements of management, government, regulatory bodies and banks are usually excluded because they have ability to require access to information that is not generally available.*

users' needs for information about the quality of stewardship displayed by directors.

(d) Absolute measures clearly identifying the implications on cash flows are more relevant to such users than relative measures which enhance comparability between different entities.

12.15 On the basis of these assumptions, the FRSME could be further adjusted, for example by:

(a) further simplification of accounting for financial instruments and leases;

(b) restriction of the use of fair value to situations where it provides meaningful and useful information to Tier 2 users; and

(c) eliminating deferred tax or only requiring a partial provision.

12.16 The Alternative View is that some targeted simplification of the IFRS for SMEs by the ASB before implementation in the UK and Republic of Ireland, would enable constituents to apply accounting standards that are better fit for purpose.

Boundary between Tier 2 and Tier 3

12.17 The ASB has left the upper limit for application of the FRSSE unchanged because of concerns that increases in the size limit would require changes to the FRSSE, and that as a result the FRSSE would cease to be appropriate for the smaller entities for which it was originally designed.

12.18 The ASB has not clearly identified in this FRED, or in previous consultation papers, the changes that it considers would be necessary if the FRSSE was extended to cover larger entities. Only if such changes are identified will respondents be in a position to identify where the cut-off point can be best positioned, so that the necessary changes

to the FRSSE are minimised, and the FRSSE remains appropriate for the smallest companies.

12.19 The Alternative View is that the FRSSE could be extended upwards without amendment. However, further investigation by the ASB of the information requirements of users of the financial statements of entities either side of the Tier 2/Tier 3 boundary would enable the ASB to make more informed decisions about the need for or extent of any changes to the FRSSE if the size threshold were to be increased.

Boundary between Tier 1 and Tier 2

Q22 Do you agree that all the entities that the ASB has identified as falling within Tier 1 should be in Tier 1, or do you agree with the Alternative View that some could move to other tiers? If you do think some entities could be moved – which entities and to which tier?

Q23 Are you aware of any information that users of financial statements of publicly accountable entities require which would not be disclosed in financial statements prepared using the FRSME (the IFRS for SMEs adapted for use in the UK)? If so please identify such information and explain why it is required.

Accounting requirement for entities falling into Tier 2 (FRSME)

Q24 Do you believe that the ASB's proposals for the FRSME should be changed to reduce complexity? If so, what changes would you suggest? Please explain how such changes would improve the balance between costs and benefits.

Q25 If the FRSME was changed in accordance with your response to Q24, would it still be suitable for use by some publicly accountable entities? If not, why not?

Boundary between Tier 2 and Tier 3

Q26 The current cut-off point for the FRSSE is the small company threshold (Turnover £5.6m, Balance Sheet £2.8m, Employees 50). Do you think the cut-off could be raised to permit all companies defined as medium-sized (Turnover £22.8m, Balance Sheet £11.4m, Employees 250) under the Companies Act to use the FRSSE without any additions to the FRSSE? If not, can you identify an intermediate level for the cut-off, and what would it be?

Q27 If you consider that the upper limit of the FRSSE could not be raised without amendment, what additional topics would the FRSSE need to cover if it was extended to include medium-sized entities, and why?

GLOSSARY

The following terms and abbreviations are used throughout this Financial Reporting Exposure Draft.

Accounting Directives
Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54(3)(g) of the Treaty in the annual accounts of certain types of companies, and Seventh Council Directive 83/349/EEC of 13 June 1983 based on the Article 54(3)(g) of the Treaty on consolidated accounts.

The Act
Companies Act 2006.

ASB
Accounting Standards Board.

BIS
The Department for Business, Innovation and Skills.

Company law
The Act, The Regulations, and other relevant legislation.

EU-adopted IFRS
Accounting Standards adopted by the European Union in the form of regulations and published in the Official Journal of the European Union.

FRED
Financial Reporting Exposure Draft.

FRS
Financial Reporting Standards.

FRSME
Financial Reporting Standard for Medium-sized Entities, being the International Financial Reporting Standard for

Small and Medium-sized Entities published July 2009, as amended by the Accounting Standards Board for application in the UK and Republic of Ireland.

FRSPBE
Financial Reporting Standard for Public Benefit Entities.

FRSSE
Financial Reporting Standard for Smaller Entities.

IASB
International Accounting Standards Board.

IFRS
International Financial Reporting Standards.

IFRS for SMEs
The International Financial Reporting Standard for Small and Medium-sized Entities published in July 2009 by the International Accounting Standards Board.

Qualifying Subsidiary
A subsidiary undertaking that does not have public accountability and whose parent undertaking prepares publicly available consolidated financial statements in which the subsidiary undertaking is included.

Quoted Company
A quoted company as defined by section 385 of the Companies Act 2006.

The Regulations
Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008.

Small Company
A small company as defined in section 382 of the Companies Act 2006.

Small Company Regulations
Small Companies and Groups (Accounts and Directors' Report) Regulations 2008.

SORP
An extant Statement of Recommended Practice (SORP) developed in accordance with the Board's policy on SORPs, and including a statement by the Board.

SORPs recommend accounting practices for specialised industries or sectors. They supplement accounting standards and other legal and regulatory requirements in the light of the special factors prevailing or transactions undertaken in a particular industry or sector.

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