ICAEW representation

ICAEW REP 45/06

AMENDING THE FRSSE: A BLUEPRINT FOR CHANGE

Memorandum of comment submitted in July 2006 by the Institute of Chartered Accountants in England and Wales, in response to the Accounting Standards Board's consultation paper 'Amendment to Financial Reporting Standard for Smaller Entities 2006' published in April 2006

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the ‘Institute’) welcomes the opportunity to comment on the consultation paper *Amendment to Financial Reporting Standard for Smaller Entities 2006* published by the Accounting Standards Board (the Board).

WHO WE ARE

2. The Institute is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

3. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry (DTI) through the Financial Reporting Council. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy.

MAJOR ISSUES

The Future of the FRSSE

4. As acknowledged by the Board, the future shape of the FRSSE depends on the pace of convergence between UK GAAP and IFRS and, crucially, on the outcome of the IASB project on SME accounting. This outcome is still far from clear, and it is thus too early to draw firm conclusions regarding the future of the FRSSE. Nonetheless, at present it seems unlikely we consider that - eight years after the first publication of the FRSSE and at a time of rapid change in the financial reporting landscape generally - now is the time for a through going review of the impact of the FRSSE and the future of differential reporting in the UK. We have set out some views below as an initial contribution to this important debate.

5. The FRSSE is widely used in the UK, and its success has established internationally the credibility of simplified financial reporting for smaller entities. The admirable qualities of the FRSSE - including the concept of a ‘one stop shop’, reflected in the importation of the relevant requirements of company law - should not be underestimated. Nonetheless, despite these qualities, a not inconsiderable number of eligible companies continue to apply full GAAP. Why should this be, despite widespread awareness of the FRSSE and the availability of software that purports to apply its requirements?

6. We have identified two key factors that may underlie the less than universal appeal of the FRSSE: firstly, the quite limited measurement simplification it provides of Big GAAP, and secondly, uncertainty over the degree to which FRSSE users are required to refer to other standards and UITF pronouncements. The impact of these two factors - which may lead some practitioners to doubt whether the cost of operating a two tier GAAP is worthwhile - is only likely to increase as convergence with IFRS gathers pace.

7. We recommend below fundamental changes to the FRSSE we believe are necessary to address these twin concerns.

The Relevance of Other Standards

8. The final paragraph of the 'General' section of the 'Status of the FRSSE' states:

'*Financial Statements will generally be prepared using accepted practice and, accordingly, for transactions or events not dealt with in the FRSSE, smaller entities should have regard to other accounting standards and UITF Abstracts, not as mandatory documents, but as a means of establishing current practice*'.

Further guidance to this effect is provided in paragraphs 32 and 33 of Appendix IV to the standard. Paragraph 32 explains that, although FRSSE users are exempt from other standards, where the FRSSE does not provide guidance on certain types of transaction the accounts should be prepared in accordance with '*accepted practice… unless there were good reasons to depart from it*'. Paragraph 33 appears to qualify this statement by indicating that new standards that amend existing practice may be disregarded by FRSSE users if – but only if - the FRSSE itself already deals with the issue, at least until the date that the FRSSE is next updated.

9. There is a significant level of uncertainty amongst users of the FRSSE over the interpretation of these references to other standards within the FRSSE and to references to the FRSSE within other standards. Although in the majority of cases the routine nature of the transactions involved means that the question of referring to the full standards does not arise, this lack of clarity brings with it a risk of poor accounting on the one hand and excessive cross-referral to Big GAAP requirements excluded from the FRSSE on the other. Considerable emphasis is attached by some practitioners to the statement in the second paragraph of the FRSSE (and in the corresponding paragraph found in other standards and Abstracts) that reporting entities that apply the FRSSE are 'exempt' from complying with those other documents. However, many others seeking to understand the true intentions of the Board find that the words of the FRSSE referred to in paragraph 8 above lead them to conclude that the standard is not really a 'one stop shop' at all.

10. The suggestion in paragraph 2.5 of the FRSSE that 'adequate explanation' should be given where 'there is doubt whether applying provisions of the

FRSSE would be sufficient to give a true and fair view' does nothing to remedy the lack of clarity that lies at the heart of the FRSSE, and has done so since its inception. This state of affairs always was unsatisfactory. The need for a more radical approach to simplification means that this degree of ambiguity can no longer be tolerated.

11. We have long believed that there is a pressing need for - as a minimum - a clearer and more prominent explanation in the main body of the FRSSE of the relevance of other accounting literature. It might be appropriate to include expanded guidance immediately after paragraph 2.2 of the main body of the standard. This should clarify the approach to be adopted where (a) the FRSSE is silent on a topic addressed by a new or revised standard, and (b) where the FRSSE contains explicit, older guidance on that topic.

12. We would go further than this. We believe that the debates at the IASB on the question of 'mandatory fallback' have highlighted the need for a clear line to be drawn between SME standards and the main body of standards. We would support an approach of requiring reference to specific paragraphs of other standards dealing with complex transactions not encountered by the generality of FRSSE users (along the lines of the cross-reference in paragraph 10.4 of the FRSSE in the context of defined benefit pension schemes). However, there should be no general requirement to 'fallback' to full GAAP and an explicit recognition that the different needs of the users of SME accounts and cost:benefit considerations may mean that applying professional judgement in circumstances where the FRSSE does not address a particular accounting recognition or measurement issue might lead to different accounting than that prescribed under full GAAP. Ideally it would be possible for the Board to assure readers in the introduction to the FRSSE that "the FRSSE encompasses all of the accounting requirements applicable to qualifying reporting entities".

A More Radical Approach to Simplification

13. To date, the FRSSE has been very closely aligned with the contents of full UK accounting standards, especially in relation to measurement requirements. There were sound reasons at the outset for this cautious approach. The introduction of the FRSSE in 1997 was a bold move, and it was important to ensure that the credibility of small company financial reporting was not undermined.

14. The advent of IFRS, and the trend in the UK and around the world towards the convergence of accounting standards, means that this degree of caution is no longer sustainable. Greater use of IFRS or IFRS-based standards in the UK would lead inexorably to more complex accounting for small companies. This tendency should be resisted. IFRS have been developed primarily for use in international capital markets, and so are aimed at investors without specific reference to the very different users - and uses - of the financial statements of privately-owned businesses – a fundamental feature of financial reporting that remains poorly-understood both in the UK and

internationally. Nonetheless, it is generally accepted that information of importance to investors and others seeking to forecast future cash flows and assess whether a business is capable of sustainable growth in economic value differs markedly from the information of relevance to users of SME financial statements - who will often be more interested in indications of solvency rather than value, in reliable numbers rather than relevant valuations and will tend to place more emphasis on the stewardship objective of financial reporting.

15. In view of these differences in user needs, unless the IASB delivers a radical simplification of IFRS for smaller entities – one focused on the objective of simplicity in SME financial reporting - the use by smaller UK companies of IFRS or a standard or standards substantially aligned with IFRS is likely to result in a reduction in the usefulness of their financial reporting. It would also entail significant extra costs for small companies - which often have limited access to accounting expertise - and perhaps less rigorous compliance with the detailed requirements of the standard.

16. While the outcome of the IASB project is in doubt, the Board should bide its time, monitoring international developments, commissioning appropriate research and continuing to consult closely with UK constituents before making decisions that could alter fundamentally - and perhaps irreversibly - the UK SME accounting landscape. The ultimate objective should be an SME standard fit for purpose, providing high quality and cost-effective financial reporting for a major segment of UK companies; in pursuing this objective, the Board should not shrink from calling for appropriate changes to the legal framework and from revising as necessary the existing content and scope of the FRSSE.

17. We comment further on some of these issues in our response to the Board's separate request for comments on the future of UK financial reporting. We also note there that it not clear whether the Board has considered the implications of the proposed removal of the current exemption in company law for the parents of medium-sized groups from the requirement to prepare group accounts. We suggest that the Board should discuss this matter with the DTI as soon as practicable.

FRS 25: Guidance

18. The recent application to private companies, including FRSSE companies, of the requirements of IAS 32 on presentation (reflected in FRS 25 *Financial Instruments: Presentation*) is a case in point. It has resulted in few benefits to users, at the price of numerous unforeseen practical difficulties and some counter-intuitive accounting outcomes. The Board is mistaken in its assumption, set out in paragraph 8 of the exposure draft (page 27), that 'few smaller entities' encounter the transactions covered by FRS 25. We propose that relevant practical guidance be provided to alleviate this situation.

FRS 20: Simplification

19. Following from our call above for greater simplification, we strongly disagree that the FRSSE should reflect the requirements of FRS 20 *Share-Based Payment* without major simplification. In our view, the application of the accounting requirements of FRS 20 - which, in relation to equity-settled awards, do not impact on shareholder equity – will not provide information of value to most users of SME financial statements. At the same time, many SMEs will encounter serious practical difficulties when seeking to determine reliable valuation numbers and may eschew potential compensation arrangements simply on the grounds of accounting complexity.

20. We recommend that the FRSSE reflects the recognition and measurement requirements of FRS 20 in relation to cash-settled payments only, and permits the intrinsic value method in those cases. For equity-settled awards, the FRSSE should mandate a set of disclosures sufficient to allow users to understand the arrangements in force, the number of shares likely to be issued and the exercise price. In our view, disclosure alone will meet the needs of the great majority of the users of SME financial statements and not put in jeopardy the credibility of small company financial reporting. Companies that feel differently would of course have the option of applying the full rigours of FRS 20.

RESPONSES TO SPECIFIC QUESTIONS

Question 1

Do you agree that the FRSSE should reflect the requirements of FRS 20 with no simplifications for smaller entities (see paragraphs 18 to 20 of Appendix I)? If not, why not and what requirements would you propose?

21. As explained above in paragraphs 19 and 20, we strongly disagree with this proposal.

Question 2

Would you wish to include in the revised FRSSE any of the requirements from FRSs 22 to 29, amendments to FRS 2 and FRS 26 and UITF Abstract 39 (see paragraphs 4 to 17 in Appendix I)? If so, what would you include?

22. We are content with the proposals in the exposure draft, although we would point out that the inclusion of only the consensus section of UITF 40 means that the requirement (stated in UITF 40, paragraph 19) that a 'critical event' must be outside of the control of the reporting entity to justify the postponement of revenue recognition is not highlighted. We suggest that this omission be remedied in the interests of consistency.

Question 3

Would you like Appendix III "Illustrative Examples and Practical Examples to include guidance on FRS 25, in particular the presentation requirements for classification of capital instruments between debt and equity?

23. We strongly agree that Appendix III should include guidance on FRS 25, in particular on the presentation requirements relating to the classification of capital instruments between debt and equity (which are already included in the FRSSE). In our view, these requirements are unclear and, as explained above, have led to many practical difficulties. Whilst mindful of the need to avoid increasing the length of the FRSSE without good reason, we suggest that three or four worked examples should be added to Appendix III, dealing for example with fixed coupon preference shares, the distinction between a 'standard' preference share and one with a participatory entitlement, and how a share that is recognised as a liability might be presented in the financial statements.

24. In general, we believe that users of the FRSSE would welcome additional illustrative examples regarding a number of more difficult accounting issues, provided these are succinct and particularly relevant to the circumstances of less sophisticated entities.

25. It is not clear to us to what extent the FRSSE intends that the bold-type principles in FRS 25 are to be reflected. Paragraphs 12.1 and 12.6 are derived from FRS 25, but the Exposure Draft is coy about the extent of convergence, referring to the "basic presentation requirements of FRS 25" as being reflected in the FRSSE "to maintain consistency with underpinning legal requirements". However, the consequence of applying FRSSE 12.1 to a compound instrument (which are quite common in small companies due to detailed share rights) is the need to allocate the consideration between liability and equity. UK GAAP users apply FRS 25.31 to fair value the liability element first, with the equity element as a residual. As a consequence of the lack of clarity referred to in paragraph 7 above, it is not clear whether this is what FRSSE users should also do.

Question 4

Do you have any specific comments on the proposals to reflect recent changes to company law in the FRSSE (paragraphs 22 to 24 in Appendix I)?

26. We are content with the proposed changes.

Question 5

Do you agree that small companies wishing to adopt the option to fair value financial instruments and certain other assets should be precluded from adopting the FRSSE (as explained in paragraph 21 of Appendix I)?

27. On balance we agree that small companies wishing to make use of the option to fair value certain assets should be precluded from adopting the FRSSE. In our view, measurement methods and principles centred on the use of historical cost rather than fair value are appropriate for most small entities, and in practice the fair value option is likely to be used only by more sophisticated reporting entities.

Question 6

Do you agree with the proposals for these minor presentational changes to the FRSSE (see paragraphs 26 to 27 in Appendix I)?

28. We are content with the proposed changes.

Question 7

Are there any further changes that you think should be made to the FRSSE (effective 2005)?

29. We have no further comments of substance except to observe that:

(a) if the derivation tables are in future only published on the ASB website, (a proposal with which we agree) it will be important to keep them up to date and aligned with the current version of the FRSSE at all times;

(b) the sub-title preceding the definition of grant date on page 17 of the exposure draft should for clarity be '*Grant date for share-based payment arrangements*' rather than simply '*Grant date*'; and

(c) a more appropriate subtitle to precede paragraph 4.10 might be '*contracts for services*', rather than '*revenue recognition and service contracts*' (page 14 of the exposure draft).

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