

ICAEW REP 46/06

THE FUTURE OF UK FINANCIAL REPORTING

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 invitation to comment on the future application of reporting requirements for UK companies

Contents	Paragraphs
Introduction	1
Who we are	2 - 3
Major issues	4 - 9
Responses to specific questions	10 - 19

INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales ('the Institute') welcomes the opportunity to respond to the invitation to comment on the future application of reporting requirements for UK companies issued by the Accounting Standards Board ('the Board') on 10 May 2006.

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 POINTS

The Consultative Process

4. We welcome the Board's continued commitment to public consultation on the question of convergence between UK GAAP and IFRS. The Board has consulted publicly on this question a number of times, but it is entirely appropriate to continue to seek the views of constituents, which are unlikely to have stood still in the wake of international developments and the early experience of the listed sector in applying IFRS.
5. We understand that the Board intends to consult more formally with constituents on this topic later in the year. This is to be welcomed. Even so, there are likely to be compelling reasons at that time for refraining from taking any final decisions on the future shape of the UK financial reporting regime. Firstly, it is important to ensure that the experiences of listed companies in applying IFRS in 2005/2006 are understood fully by standard setters, preparers and their advisors. Secondly, no firm proposals are possible until a clear picture has emerged of the probable outcome of the IASB project on SME accounting.
6. The Board should monitor closely all relevant developments and should not shrink from further extensive consultation with constituents before finalising its plans, probably in 2008 or 2009. Decisions made in the next few years will

alter fundamentally the UK accounting landscape, and the public interest demands that they should not be taken with any undue haste.

A UK GAAP FIT FOR PURPOSE

7. We have a number of serious reservations regarding the tentative proposals set out in the Board's invitation to comment. At present, although we understand the costs and difficulties involved, we anticipate that the interests of users of companies and other entities that are not publicly quoted may be best served by the maintenance for the foreseeable future of a UK GAAP fit for purpose. 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 other publicly accountable entities and privately-owned businesses. 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 the financial statements of other types of entity - who may be more interested in indications of solvency rather than value, in reliable numbers rather than relevant valuations and may tend to place more emphasis on the stewardship objective of financial reporting. Cost:benefit considerations will, moreover, be very different in the context of entities that are not publicly listed.
8. We envisage unlisted entities continuing to apply UK GAAP, updated and fit for purpose – and, if implemented successfully, a model for national GAAPs around the IFRS world. The requirements - and the words - of UK GAAP in these circumstances are likely to be aligned with IFRS, but with disclosure reductions and - depending on a rigorous assessment in each case of users' needs - some significant measurement differences. Taken as a whole, IFRS are principles-based. However, this is not the case, for example, with IAS 12 *Income Taxes*, one of a number of IASB standards which have their origins in US literature. Such standards tend to be relatively long and detailed, with many scope exemptions, resulting in difficulties of interpretation (despite extensive 'guidance') and, in some cases, counter-intuitive accounting. Until such standards have been rewritten, at which stage they should be re-assessed, the requirements of UK GAAP should remain different from the corresponding international standards.
9. In the meantime, the Board should develop and update as necessary a strategy for developing, implementing and maintaining the new-style UK GAAP, for execution should a decision be taken against a wholesale move in the foreseeable future to standards very closely aligned with IFRS. The Board should also consider changes to existing UK GAAP where (a) there are practical difficulties or shortcomings that could be addressed by the Board in the near term or (b) key aspects of UK GAAP may be improved conceptually by reference to widely-accepted and principles-based IFRS requirements.

DETAILED COMMENTS ON ASB CURRENT THINKING

The extension of IFRS to more companies

All UK Public Quoted and other publicly accountable companies would be required to apply full IFRS, irrespective of turnover and whether they present group accounts or not. This would mean that approximately another 1,000 to 1,500 companies would be required to report under IFRS.

The ASB's current thinking is that this will include AIM, OFEX and Investment Trust companies.

10. IFRS have been developed for the capital markets. We therefore agree in principle that financial information produced on a consistent basis should be available for all quoted companies, including investment trusts and other companies listed on the main market that do not produce consolidated accounts, together with AIM and OFEX companies. We assume that the Board does not intend to remove the right of parent companies that produce IFRS consolidated accounts to present their single entity accounts under UK GAAP.
11. The London Stock Exchange has already decided that AIM companies should apply IFRS with effect from 1 January 2007 (i.e. financial statements commencing on or after that date). The timetable for the migration of other publicly quoted companies to IFRS should reflect the need for the lessons of application by the first wave of IFRS reporters to be digested fully and for issues relating to distributable profits to be resolved satisfactorily. It might be appropriate to mandate the application of IFRS by such companies with effect from 1 January 2009 or - given the recent IASB announcement regarding the implementation date of new standards - 2010.
12. We do not agree with the proposed extension of IFRS to other publicly accountable companies. IFRS are not necessarily suitable for such entities: the information needs of users of such entities tend to centre on issues of stewardship rather than decision usefulness. They will often be regulated, ensuring that appropriate financial information is provided to the key user of their financial statements - the regulators themselves. We also assume - although the Board's paper is silent on this point - that small friendly societies, building societies, industrial and provident societies, charities, housing associations and similar entities would fall within the definition and would thus be required to apply IFRS: this would be inappropriate, both in terms of user needs and cost: benefit considerations. As indicated above, we envisage unlisted entities deemed to be publicly accountable continuing to apply UK GAAP.

The proposal that medium sized companies be allowed to use FRSSE

The use of the FRSSE would be extended beyond small companies to include medium-sized entities. This would mean that approximately another 30,000 companies would be able to use the FRSSE.

13. We have reservations over the suggested extension of the scope of the FRSSE to medium-sized companies. It is very possible that permitting medium-sized entities to apply the FRSSE will lead to a more complex and less accessible standard without any corresponding benefit for the users of the accounts of over one million small companies in the UK. This would be a highly unwelcome development. However, the key factor here is the behavioural response of the Board and stakeholders asked to comment on future updates of the more accessible FRSSE. On balance we believe that this deregulatory measure can be implemented successfully, provided the Board adopts a clear and unambiguous policy for the future updating of the standard and maintains a steady focus on the needs of users of the accounts of the generality of FRSSE companies. This task might be less challenging if the Board applied a public accountability test (rather than a size-based test) as the boundary between entities eligible to use the FRSSE and entities required to use full UK GAAP.
14. It not clear whether the Board has considered the implications in this context 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. The Board should discuss this matter with the DTI at soon as practicable.

Reduced disclosure requirements for subsidiaries using IFRS

UK subsidiaries of group companies that apply full IFRS would also be required to apply full IFRS in respect of measurement and recognition, but with reduced disclosure requirements (yet to be defined). This would affect approximately 14,000 companies.

15. We assume that this policy would involve a prohibition on subsidiaries of IFRS reporters reporting under new style UK GAAP, as is currently permitted by the Companies Act 1985. We do not agree with this proposal. Parent companies should retain the right to choose the most appropriate accounting regime for their individual accounts and for accounts of their UK subsidiaries, in accordance with the commercial interests of the group and the provisions of company law. A switch to UK-modified IFRS by subsidiaries is unlikely to provide more useful information for users of their financial statements. We envisage such subsidiaries continuing to have the right to apply the new-style UK GAAP, as discussed in outline above.

16. If the Board proceeds with this proposal, it should consider carefully the extent to which disclosure reductions are appropriate for subsidiaries which are less than wholly-owned.

The best financial reporting for companies in the “gap”

There has not yet been a decision on companies that do not fall within 1, 2 or 3 above. There are approximately 7,000 companies in this “gap”. The alternatives seem to be (i) extend the application of the FRSSE further, (ii) apply IFRS to more companies, (iii) maintain UK GAAP for them, or (iv) some combination of these three alternatives.

17. In our view the Board is right to withhold judgement in relation to these companies in view of the uncertainties referred to above in paragraph 5. We anticipate that such entities would continue to apply the new-style UK GAAP referred to above (unless they choose to move to full IFRS as permitted by UK law).

The operationalisation of the IASB definition of “publicly accountable companies”

The ASB is also minded to adopt the same definition of public accountability as that used by the IASB.

18. We agree that in principle the Board should plan to adopt the definition of public accountability that is finally agreed on by the IASB. However, the Board should continue to press for improvements to the proposed definition. For example, we welcome the IASB’s reconsideration of the proposal that the definition should encompass all entities that have an essential public service responsibility. If necessary, the Board should in due course consider providing further elaboration of the definition in a UK context.

The costs and benefits of the proposals

In making any of these changes the ASB needs to consider the costs and benefits involved. The ASB will prepare a Regulatory Impact Assessment (RIA) when it issues firm proposals. To inform this exercise, the ASB would be grateful for constituents’ (particularly preparers and users) views on these costs and benefits.

19. We welcome the Board’s commitment to publish an RIA alongside firm proposals on the future UK financial reporting regime. Cost: benefit considerations underpin our views on the future of UK GAAP, as outlined above.