20 August 2010

Our ref: ICAEW Rep 79/10

Your ref:

Jenny Carter
Accounting Standards Board
5th Floor, Aldwych House
71-91 Aldwych
London
WC2B 4HN

Dear Jenny

THE FUTURE OF UK AND IRISH FINANCIAL REPORTING

ICAEW is pleased to respond to the request for responses to aid development of the *Impact Assessment on the Proposed UK Financial Reporting Framework.*

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

Dr Nigel Sleigh-Johnson

T +44 (0)20 7920 8793
F +44 (0)20 7638 6009
E nigel.sleigh-johnson@icaew.com

ICAEW REP 79/10

ICAEW REPRESENTATION

ASSESSING THE IMPACT OF THE ACCOUNTING STANDARDS BOARD PROPOSALS FOR THE FUTURE OF UK AND IRISH FINANCIAL REPORTING

Memorandum of comment submitted in August 2010 by the ICAEW, in response to the ASB's request for responses to aid development of the *Impact Assessment on the Proposed UK Financial Reporting Framework* published in July 2010.

Contents **Paragraph**

INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultation paper *Impact Assessment on the Proposed UK Financial Reporting Framework* published by the Accounting Standards Board (the Board).

WHO WE ARE

2. The ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance, which has over 775,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. We ensure that these skills are constantly developed, recognised and valued.

MAJOR POINTS

4. In our response to the Board's August 2009 consultation on the future of UK GAAP (ICAEW rep 16/10), we expressed our broad support for the three tier system as described in the consultation document. We are pleased to advise that we remain supportive of the Board's proposals, particularly in the light of the developments explained in the Impact Assessment concerning reduced disclosures for subsidiaries. Nonetheless, we strongly recommend that the Board continues in coming months to make every effort to ensure that constituents are aware of the proposals, understand the implications for their sectors, and support the direction of travel.

5. We note that the ASB Chairman has explained other more detailed proposed developments during various outreach events, particularly at presentation at Chartered Accountants' Hall in July 2010. We are likewise supportive of the more detailed suggestions explained then, for example regarding how to deal with incompatibilities with EU Directives and current UK company law.

6. We understand that it is necessary for the Board to consult on the overall impact of the proposed Framework, but we believe it is very difficult to quantify this impact in financial terms at this stage. Once the detail of the UK requirements based on the IFRS for SMEs is finalised and HMRC have made it clear how they will deal with any tax impact, it might be possible to calculate an approximate cost of first time conversion for an average company. At this stage, even this is not possible, while so many of the detailed requirements are not final.

7. However, we can say that we believe that on balance, the introduction of the new regime will be positive from an economic perspective. This is because we believe that any one-off cost to companies of conversion to the IFRS for SMEs will be more than off-set by the long term benefit of applying a simplified regime which changes only once every three years, by comparison with complying with current UK GAAP which could potentially change at any time and is inherently more complex than the IFRS for SMEs from a practical perspective. In making this broad brush assessment, we have taken into account the fact that most companies will either use software in order to assist with

the conversion of their financial statements or otherwise will employ the assistance of professional accountants, who will themselves use appropriate software.

8. The UK has prior experience of the application of a simplified differential financial reporting framework, in over 14 years of use of the FRSSE. The high take up of the FRSSE, wherever it is permitted, is largely as a direct result of the fact that companies applying the standard do not have to change accounting treatments and disclosures on a frequent and piecemeal basis, but instead can make one set of changes every two years or so, when the FRSSE is updated. The same benefit will apply to tier 2 companies applying the IFRS for SMEs and must surely, over time, more than compensate for the one-off cost for converting to the new regime.

9. In our detailed responses below, we comment specifically on the items mentioned in 2a to 2e, but we would particularly like to draw attention to our support for the proposed reduced disclosure framework for subsidiaries, which is an intelligent and pragmatic solution to one of our greatest concerns about the August 2009 consultation document.

10. Finally, we would not consider it appropriate to increase the scope of the FRSSE to include larger entities. As we explained in our response to the Board's August 2009 consultation, we believe the retention of the FRSSE should be a temporary measure, designed to ease transition for smaller companies, and that the FRSSE should be replaced with a cut-down version of the IFRS for SMEs in due course. Increasing the range of companies able to use the FRSSE would make the eventual transition for these companies to the IFRS for SMEs harder by causing a double transition for those medium-sized companies who might change from current full UK GAAP to the FRSSE and then eventually to a cut-down IFRS for SMEs. It will also create confusion about what simplifications can be made in the cut-down IFRS for SMEs. This can only increase transition costs and would not improve the quality of financial reporting in the UK.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Do you have any comments on the overall direction of travel for the UK Financial Reporting Framework as described above?

11. We are broadly supportive of the direction the Board is taking, from what we have seen to date, including a fairly full description of tentative decisions as described in various presentations and meetings.

12. The extent to which the regime will work well in the future will depend on how the IFRS for SMEs develops (which is why the Board must retain sovereignty over UK accounting standards), changes to company law (which we hope will be amended at both EU and UK level to give a broad framework to the accounting rules instead of the current overly-detailed Accounting Directives); and what the Board decide to do eventually with the FRSSE (which itself may depend on what the EU decides in relation to micro entities). In spite of these uncertainties, we believe the Board is in a position to push ahead now with its proposals, subject to the results of its continuing outreach activities; the system is capable of being flexed and adjusted for future developments.

13. We are pleased that the Board is suggesting reduced disclosures for subsidiaries under both IFRS as adopted in the EU and IFRS for SMEs. It will also be important to ensure this regime continues to operate in a sensible fashion going forward, and has regard for the justifiable needs of users.

14. We also believe that proposing a category of small publicly accountable entity is an acceptable way of allowing such entities to use the IFRS for SMEs instead of full IFRS as adopted in the EU, but we would not support less stringent requirements or enhanced size criteria. We note that the regulators of such entities would generally retain the right to require full IFRS if they though that that was appropriate.

15. Although the overall accounting regime is more complex than originally envisaged, it appears to fit together well enough and, once an entity has determined which tier it is in, that complexity should not affect that particular entity. Some complexity in the overall regime is perhaps inevitable given the sophistication of the UK economy.

Q2: What do you think the overall impact of the proposed UK Financial Reporting Framework will be in terms of its likely costs and benefits – quantified where possible? In framing your answer you might like to consider the following:

a) the impact on the economy as a whole, efficient functioning of markets and enterprise, fostering investment;

16. The IFRS for SMEs is a coherent and workable standard for at least some elements of the UK unlisted sector. It will eliminate 2,000-3,000 pages of UK GAAP (depending on whether the fair value rules were being followed or not), leaving only about 230 pages of requirements in the IFRS for SMEs. The IFRS for SMEs in general strikes a fair balance between rigorous reporting on the one hand and practicability and simplifications (through reductions in options) on the other.

17. Companies that are growing will face a much more cohesive range of requirements to be tackled as they move from tier to tier. Although they will still need to make changes, these will be limited to more complex areas. Users should also benefit from the similarities between each regime.

18. For many accountants working in or advising non-publicly accountable businesses, we anticipate that it is likely to reduce their workload significantly just to have to cover the FRSSE and the IFRS for SMEs.

19. Users should also appreciate the similarities between the regimes. The IFRS for SMEs is a generally clear standard that will lead to the production of stable, readable financial statements which should aid economic development and investment.

b) transition to the new framework, noting that for entities currently applying the FRSSE there will effectively be no change;

20. One-off costs are likely to be limited in companies that use off-the-shelf software packages (or their advisers do). The one-off cost of transition to the IFRS for SMEs is likely to be more than offset by the reduced compliance burden going forward, underpinned by the relative stability of the IFRS for SME regime, with a regular cycle of updates and changes.

c) the impact on groups of the proposed reduced disclosure framework for subsidiaries;

21. There will be one-off costs incurred in conversion to IFRS for SMEs or IFRS as adopted in the EU, mitigated by the reduced disclosures.

22. For companies with group accounts already on IFRS as adopted in the EU, this should be more than outweighed by the reduction in cost from alignment of recognition and measurement across the group, which will feed straight through the consolidation pack with no need for adjustment from UK GAAP.

23. The same is likely to apply for companies with group accounts under the IFRS for SMEs. Their added conversion costs for the group accounts (as well as individual entity accounts) are likely to be reduced and even fairly minimal as it will be more cost efficient to convert both the group and all individual entity accounts at the same time than to do them separately.

d) requirements for education and training of account preparers and users, and the impact on their intellectual mobility;

24. Many accountants are now trained only in IFRS. The IFRS for SMEs is comparatively new, so will require additional training. However, this will not be substantial compared to the cost of training accountants in UK GAAP, which is often required to supplement IFRS training. The reduction in volume of the requirements is pronounced, so it should make training new recruits much more manageable.

25. Another important advantage of the IFRS for SMEs is its relative stability; it is expected to change only every 3 years (with the first review 2 years after implementation). This will provide a stable platform for users in the non-publicly-accountable sector, which is likely to be beneficial. By contrast, users of the accounts of publicly accountable entities have far more resources to deal with frequent changes to accounting standards. The users of the IFRS for SMEs will thus be put on a regular cycle of updating that has proved beneficial to the FRSSE sector.

e) whether the information available to users will be more useful for investment decisions, and by owner-managers in managing their businesses, than the existing framework.

26. As noted by the Board and others, current UK GAAP is an unhappy mix of old UK standards and new standards converged to IFRS, with no unifying principle. This is not helpful to users. The IFRS for SMEs is a more straightforward standard, with unifying underlying principles and a simpler approach than full IFRS.

27. Although there will be a cost of compliance with the IFRS for SMEs in relation to financial instruments at fair value, we believe these rules are proportionate and should better help users understand the financial position of the entity than is currently the case if that entity has not opted into the fair value rules under UK GAAP.

Q3: What do you think would be the impact if the ASB were to propose increasing the scope of the FRSSE to include larger entities (for example, to include all medium-sized entities, or to use an alternative size criteria)?

28. We are not sure that there will be any additional benefit in extending the scope beyond small companies as defined in the law, if only because of the legal requirement to produce group accounts above that level. There might be arguments for allowing more entities to be categorised as small, but this will probably need to be tied to the relevant legal provisions. In any case, medium-sized companies are quite large businesses, which can have a significant impact on local economies and can certainly incur substantial debts. Creditors in particular may not be happy with a FRSSE-style regime.

Q4: What do you think the impact of the proposed UK Financial Reporting Framework will be on taxation and distributable profits?

29. Past experience of conversion to full IFRS suggests that the tax effect of transition will differ from company to company; some may receive a tax benefit while others experience the opposite. To assess the overall tax impact therefore, each individual change would need to be examined from a variety of perspectives. The Board may wish to consider focussing such an exercise on an assessment of whether any specific industry group is likely to be especially advantaged or disadvantaged by each particular change. One example of how this may apply are the provisions of paragraphs 34.2 to 34.10 *Agriculture*, these require biological assets to be held at fair value and are therefore likely to result in accelerated profit recognition (and hence tax) for those adopting them. However, fair value does not need to be applied in this case if the fair value cannot be reliably determined without undue cost or effort and therefore whether or not there is a change in practice is likely to vary between industry segments or even individual companies.

30. Prior period adjustments when the new UK GAAP is first adopted are likely to present a particular problem. Where these have a significant profit or loss effect the tax impact could be considerable. It may be beneficial to give further thought to how this issue should be approached.

31. In addition, as the proposals are to create three tiers with subsets within those tiers, the Board may also wish to bear in mind that taxation issues may differ between tiers. For example, those entities moving onto tier 1 will benefit from the experience of those UK companies who have already adopted full IFRS, but there may be significant taxation effects across a segment of companies adopting EU-IFRS, or the subsidiaries' reduced disclosure version – as well as with entities in tier 2.

32. We are aware that on the adoption of full IFRS, HMRC put transitional rules in place which spread the effects of transitional adjustments over an extended time period. It will need to be assessed whether it would be desirable to establish similar provisions in this instance. In addition, disregard regulations were put into place for certain financial assets or liabilities, which allowed the change in accounting treatment to be disregarded for tax purposes. The Board may wish to further explore the relevance of these provisions to the current proposals. Nevertheless, whatever the impact, tax considerations should not drive high quality financial reporting where the primary users are investors and creditors.

33. The issues affecting distributable profits, relating as they do to profit recognition, are likely to be broadly similar to those affecting taxation set out above. For example, if one of the changes is to defer revenue recognition this will result in both a lower tax liability and a reduction in distributable profits.

E : nigel.sleigh-johnson@icaew.com

icaew.com