

THE FUTURE OF  
FINANCIAL REPORTING  
IN THE UK AND REPUBLIC OF IRELAND

REVISED FINANCIAL  
REPORTING EXPOSURE  
DRAFTS

PART THREE:  
DEVELOPMENT OF THE  
FINANCIAL REPORTING  
EXPOSURE DRAFTS  
& IMPACT ASSESSMENT

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 to:*

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*Comments should be despatched so as to be received no later than 30 April 2012. All replies will be regarded as on the public record, unless confidentiality is requested by the commentator.*

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*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.*

**REVISED FINANCIAL REPORTING  
EXPOSURE DRAFTS**

**Part Three:  
Development of the Financial Reporting  
Exposure Drafts  
&  
Impact Assessment**



**ACCOUNTING  
STANDARDS  
BOARD**



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**DEVELOPMENT OF THE REVISED FINANCIAL  
REPORTING EXPOSURE DRAFTS**



## **SECTION I: DEVELOPMENT OF THE REVISED FINANCIAL REPORTING EXPOSURE DRAFTS**

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### **1 INTRODUCTION**

- 1.1 This section of the revised financial reporting exposure draft (revised FRED) summarises the Accounting Standards Board's (ASB) decisions in its consideration of responses to the FRED 'The Future of Financial Reporting in the UK and Republic of Ireland: FRED 43 Application of Financial Reporting Standards & FRED 44 Financial Reporting Standard for Medium-sized Entities' (the FRED) and to its supplementary FRED 45 'Financial Reporting Standard for Public Benefit Entities' (FRED 45).
- 1.2 FREDs 43 to 45 were issued following previous consultations by the ASB, a history of the ASB's consultations on the Future of Financial Reporting in the UK and Republic of Ireland can be found in Appendix to this section of revised FRED.
- 1.3 FREDs 43 and 44 set out the draft text for two new accounting standards that would replace the majority of extant Financial Reporting Standards (current FRS) in the UK and Republic of Ireland. The FREDs therefore proposed radical changes to current FRS.
- 1.4 FRED 45 was issued in March 2011 and set out specific financial reporting requirements to be applied to public benefit entities (PBEs). This FRED supplemented FRED 44 addressing transactions and circumstances that are common to PBEs.
- 1.5 The revised proposals are set out in three draft Financial Reporting Standards:
  - FRED 46 'Application of Financial Reporting Requirements';
  - FRED 47 'Reduced Disclosure Framework'; and
  - FRED 48 'The Financial Reporting Standard applicable in the UK and Republic of Ireland'.

### **2 FEEDBACK TO FREDS 43 AND 44**

- 2.1 In response to the invitation to comment 293 responses have been received; of these responses approximately 44 per cent were from Providers of Social Housing (also known as housing associations) and 19 per cent were from credit unions. The ASB evaluated responses to decide if there was sufficient evidence to support continuation of the project and whether the invitation to comment and the outreach programme had solicited sufficient evidence from which the ASB could formulate future decisions.
- 2.2 The respondents broadly agreed with the ASB's proposals including its reason for proposing change, namely that current FRS lack cohesive principles as a consequence of developments in financial reporting in recent years and change is necessary. The responses were also supportive of the ASB's approach in developing the FRED from the August 2009 Consultation Document, Policy Proposal 'The Future of UK GAAP' ('Policy Proposal').
- 2.3 During the development and throughout the consultation period of FREDs 43 and 44 the ASB undertook an extensive programme of outreach aimed at raising awareness of the proposals and to address the view (held by some) that previous consultations had not gathered sufficient evidence to support and test its assumptions.
- 2.4 As part of the outreach programme a series of meetings and events took place with lenders to small and medium-sized entities. Lenders noted that financial statements are an important part of their decision-making process when considering providing finance and whilst a decision to provide finance is not based on financial statements alone, they provide useful information and verification to the lender.

- 2.5 In addition a review was made of academic research that addressed the users of small and medium-sized entities financial statements. The conclusion drawn from the research was that many entities requested financial statements from Companies House when considering whether to trade with another entity. The European Federation of Accountants and Auditors (EFAA) issued in May 2011 a statement that identified the users of financial statements noting who the users of SME's financial statements are and that information on the public record assists all users of financial statements of SME's by providing, in an efficient manner, basic information that protects their rights.
- 2.6 The ASB considered that the outreach programme had gleaned information from people who would not normally submit formal responses to a consultation and provided very useful information that could be used in developing the next stage of the project. The ASB noted that whilst this information was not part of the public record, as are formal consultation responses, it could use the information to assist in developing the revised FREDs, supplementing information contained in responses and will seek further comment in the next stage of its deliberations.
- 2.7 The ASB therefore concluded that the information gained as part of the outreach programme together with the formal responses to FREDs 43 and 44 provided sufficient evidence on which it could base future decisions. In reaching this conclusion the ASB noted that its outreach would continue during the next phase of the project and that it would continue to test its assumptions and elicit informal views of constituents as it developed its future proposals. In view of this it was decided to continue with the project but noted the responses highlighted some significant issues that would require careful consideration in the next stage of deliberations.

### 3 PROJECT OBJECTIVE

- 3.1 FREDs 43 and 44 outlined the following objective and its intended effects:

***Objectives for these proposals and the intended effects***

*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 users' information needs;*
- (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.*

- 3.2 In considering responses to FREDs 43 and 44 the ASB evaluated whether its decisions were aligned with the above project objective. This evaluation was undertaken because the proposals in FREDs 43 and 44 have been significantly amended. The ASB decided it should revise its project objective to align more closely with the feedback received that led to the alterations. The revised objective also needs to be consistent with the aim of the ASB and the Financial Reporting Council (FRC) "to contribute to high-quality corporate reporting by setting standards for accounting ...".

3.3 The ASB revised its project objective to:

***Overriding objective***

*To enable users of accounts to receive high-quality understandable financial reporting proportionate to the size and complexity of the entity and the users' information needs.*

3.4 In achieving the revised objective, the ASB decided it should provide succinct financial reporting standards that:

- have consistency with global accounting standards through the application of an IFRS-based solution unless an alternative clearly better meets the overriding objective;
- reflect up-to-date thinking and developments in the way businesses operate and the transactions they undertake;
- balance consistent principles for accounting by all UK and Republic of Ireland entities with pragmatic solutions, based on size, complexity, public interest and users' information needs;
- promote efficiency within groups; and
- are cost-effective to apply.

3.5 In defining its objective the ASB noted that the IFRS for SMEs:

- (a) is a way of achieving a consistent accounting framework, as it is a simplification of IFRS;
- (b) was developed by the IASB and published in 2009, it reflects more up-to-date thinking and developments than current FRS, especially for financial instruments;
- (c) is a single book setting out clear accounting requirements; and
- (d) is a cost effective way of updating current FRS.

3.6 The ASB noted that one of the most significant changes being introduced in its proposals is the changes to the recognition, measurement and disclosures related to financial instruments. Current FRSs contain limited requirements on accounting for financial instruments for unlisted entities or those that do not apply the fair value accounting rules. Entities use derivatives to manage risk and it is important that financial statements recognise and provide disclosures about the effect of those instruments on the entity's performance and position. The ASB believes that the approach under current FRSs, where derivatives are not recognised, does not adequately reflect the risks arising from financial instruments. Consistent with FREDs 43 and 44 the proposals in FREDs 47 and 48 will lead to an improvement in accounting for financial instruments.

#### **4 THE TIER SYSTEM – ELIMINATION OF 'PUBLIC ACCOUNTABILITY'**

4.1 Consistent with the Policy Proposal, FRED 43 set out proposals for a differential financial reporting system based on three tiers of entities using public accountability as a differentiator. Whilst respondents were broadly supportive of the proposed tier system those entities that would be required to apply EU-adopted IFRS did not support it. Several concerns were noted; the more significant include:

- (a) the costs for those entities that would be required to apply EU-adopted IFRS could not be justified in relation to the benefit to users of those entities financial statements;
- (b) inconsistencies in the recognition and measurement requirements between EU-adopted IFRS and FRED 44 would reduce comparability between entities; and

- (c) the application guidance addressing the definition of public accountability remained unclear despite the guidance being developed further from the Policy Proposal.
- 4.2 The ASB noted that it had received over 50 responses from credit unions that questioned the costs and benefits arising from the proposals set out in FRED 43. Although FRED 43 set out proposals to exempt small credit unions from the requirement to apply EU-adopted IFRS it was not clear how effective the proposed exemption would be to credit unions.
- 4.3 The ASB decided to commence its consideration of the responses to FREDs 43 and 44 by addressing the tier system. Specifically it wanted to address the concerns from respondents that the costs for those entities that would be required to apply EU-adopted IFRS could not be justified in relation to the benefit to users of those entities' financial statements.
- 4.4 FRED 43 proposed that publicly accountable entities apply EU-adopted IFRS; removing the definition of public accountability would require an alternative accounting standard for such entities. The most likely alternative was FRED 44; however, FRED 44 was based on the IFRS for SMEs and did not address certain areas that might be relevant to a broader group of entities.
- 4.5 In considering the areas that might be relevant for a broader group of entities the ASB considered the users' needs for entities that are listed but not on a regulated market, i.e. those entities that were in part (a) of the definition of public accountability but were not required by EU Regulation to apply EU-adopted IFRS. This identified (see paragraph 5.52 to 5.56) that earnings per share; operating segments, accounting for insurance contracts and interim reporting were not addressed in FRED 44 and accounting requirements would need to be set in these areas.
- 4.6 The ASB, however, noted that in addressing the needs of this broader group of entities it should not lose sight of its objective to provide succinct financial reporting standards. Consequently, consideration was given to whether entities listed on a non-regulated market could apply EU-adopted IFRS for the areas identified by including cross references to EU-adopted IFRS in a revised FRED 44 rather than setting out the requirements in the FRS itself.
- 4.7 Those entities that in accordance with FRED 43 were in the scope of part (b) of the definition of public accountability, i.e. entities that hold assets in a fiduciary capacity or take deposits, including credit unions, building societies, investment entities, the ASB broadly termed financial institutions. In considering the users' needs for financial institutions the ASB noted FRED 44 set out improvements, from current FRSs, for the recognition and measurement of financial instruments, however, it had limited disclosure requirements for financial instruments. The ASB decided that if it were to eliminate the definition of public accountability it would need to address the disclosure requirements for financial institutions, noting financial instruments are central to the business model of these entities and how such entities generate wealth.
- 4.8 Having identified that it would need to improve the disclosure requirements for financial institutions, if it were to remove the definition of public accountability, the ASB sought to find a clear definition of a financial institution. Various options were considered including whether to retain part (b) of the definition of publicly accountable, however this approach was rejected because it did not address the application difficulties raised by respondents to FRED 43.
- 4.9 The second option considered was to use the definition in section 467(1) of the Companies Act 2006; one advantage was that this was in part basing the definition on whether the entity was regulated or not.
- 4.10 The third option was simply to list the types of entity which should provide additional disclosures for financial instruments. In this regard the ASB gave consideration to its previous accounting standard FRS 13 'Derivatives and Financial Instrument: Disclosures', which applied a differential disclosure regime depending on the category of entity. On balance the ASB

decided that a list of entities provided the clearest approach to determine which entities should be defined as financial institutions.

- 4.11 Having undertaken the analysis above, it was concluded that public accountability could be eliminated and FRED 44 amended to apply to a broader group of entities. To address the users' needs of entities listed on a non-regulated market FRED 44 would need to be expanded by cross referencing to EU-adopted IFRS and additional disclosure requirements would be inserted for financial instruments held by financial institutions.
- 4.12 The ASB observed that if it were to require a financial institution, eligible to apply a revised FRED 44, to disclose additional information regarding its financial instruments, it also needed to consider its proposals for a reduced disclosure framework. Just as it had previously prohibited a subsidiary with public accountability from applying FRED 44 or to take advantage of the reduced disclosure framework; congruence would be required between a financial institution required to provide additional disclosures in accordance with the revised FRED 44 and the reduced disclosures available to financial institutions which are themselves subsidiaries.
- 4.13 The ASB considered how the reduced disclosure proposals could be applied to financial institutions. Given the support expressed by respondents to the proposals for a reduced disclosure framework, restricting financial institutions from applying the reduced disclosure framework was not desirable. An alternative was to permit financial institutions all disclosure exemptions except for the disclosures exemptions for IFRS 7 'Financial Instruments: Disclosures'.
- 4.14 The ASB took into consideration whether broadening the application of entities eligible to apply a revised FRED 44 (that is FRED 48) would increase the pressure to change a future FRS (in line with changes being made to full IFRS) more frequently than on a three-year cycle. The ASB agreed that there may be circumstances where a future FRS would require updating in an interim period between the three-year cycles.
- 4.15 The ASB also considered whether the Government's response to the House of Lords recent enquiry\* should influence its decision regarding the extension of EU-adopted IFRS. The ASB, however, decided that whilst it should work closely with the Department for Business Innovation and Skills (BIS) its role was that of an independent accounting standard setter and therefore it should not be influenced by the response but that it should be able to clearly articulate its decisions and reasoning leading to those decisions. It also noted the need to update the draft impact assessment for any changes that significantly amended the proposals set out in the FREDs 43 and 44.
- 4.16 The ASB recognised eliminating the definition of public accountability was a fundamental change from the proposals in FRED 43 and careful communication and evaluation of the effects was needed.

## **5 THE FINANCIAL REPORTING STANDARD FOR MEDIUM-SIZED ENTITIES (FRSME) – FRED 44**

- 5.1 Respondents to FRED 44 supported, in general, the use of the IFRS for SMEs as a base for a future financial reporting standard in the UK and Republic of Ireland. There were, however, concerns raised that would require careful consideration, most notably the removal of certain accounting treatments (options) that are available in current FRSs and EU-adopted IFRS but were not proposed in FRED 44.
- 5.2 Responses from the housing associations particularly focused on how the removal of options might have behavioural implications that the ASB should take into consideration. The housing associations noted that:

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\* House of Lords Economic Affairs Committee report 'Auditors: Market Concentration and their role', published 30 March 2011.

- (a) removal of the options would reduce comparability between entities that apply EU-adopted IFRS and those applying FRED 44 for entities operating in the same market, for example entities applying FRED 44 would not be permitted to revalue property, plant and equipment whereas entities applying EU-adopted IFRS could revalue; and
  - (b) the inability to include borrowing costs as part of the costs of property, plant and equipment may cause some housing associations to breach terms and conditions of current financing arrangements; this gave potential for banks and other lenders to renegotiate existing financing arrangements but at a higher cost of capital.
- 5.3 Other respondents noted that removal of the accounting options was potentially an over-simplification for the United Kingdom and Republic of Ireland (UK & ROI). These respondents noted the IFRS for SMEs had been developed by the IASB for countries that had a less developed financial reporting framework than the UK & ROI. They considered that as options existed in current FRSs the simplification had not been justified by the ASB.
- 5.4 A further view put forward by respondents was that retaining the options that existed in current FRSs would reduce transition costs and ease transition between tiers.
- 5.5 In addition to the concerns regarding the removal of accounting options respondents to the proposals raised specific areas in FRED 44, including:
- (a) the relationship between the company law formats and FRED 44;
  - (b) the inclusion of IAS 12 'Income Tax';
  - (c) the accounting for government grants; and
  - (d) the removal of the exemption for wholly owned group undertakings to disclose related party transactions.
- 5.6 Whilst the ASB expressed sympathy for the matters raised, and particularly the issues in relation to tax, it decided to first consider the guidelines applied in deciding whether to amend the IFRS for SME. The ASB had sought comment on its guidelines for changing the IFRS for SMEs.

***Guidelines for amending the IFRS for SMEs***

- 5.7 In considering respondents comments on the guidelines for amending the IFRS for SMEs it was agreed that the guidelines need to be consistent with the project objective of high-quality understandable financial reporting. The ASB noted that its project objective included an underlying principle of consistency with EU-adopted IFRS and diverging from this objective could lead to the creation of a new set of UK & ROI FRSs and reduce comparability.
- 5.8 In considering potential change to the guidelines for amending the IFRS for SMEs it was recognised that whilst there is a need for flexibility in application of the guidelines choosing to remove elements of IFRS or to retain elements of current FRS ran the risk of *cherry picking* and lay the process open to the individual preferences of different people or interests. It also noted that there is a framework underpinning IFRS and *cherry picking* also ran the risk of eroding the cohesiveness of a future FRS based on the IFRS for SMEs. The ASB agreed that it should be seeking to influence the IFRS debate to ensure high quality financial reporting and should not engage in a twin process of developing a new UK and Republic of Ireland FRSs.
- 5.9 The ASB agreed that in considering amending the guidelines pragmatism was required. Whilst its project objective was high-quality understandable financial reporting this objective needed to work within the legal framework that required the use of EU-adopted IFRS in certain circumstances and enable the provisions of company law to be adhered to. The guidelines needed to ensure the ASB could provide financial reporting standards that work within the

legal framework, to balance high-quality understandable financial reporting and are cost effective to apply. The high degree of support for the strategic thrust of the ASB's approach to the FRED suggested that respondents were prepared to balance high-quality financial reporting and costs/benefits.

- 5.10 In view of this the ASB decided that whilst it should have guidelines for when to amend the IFRS for SMEs it should identify its objective that underpinned the guidelines. An objective would enable the ASB to evaluate proposed changes consistently. The ASB therefore concluded that its objective and guidelines for making changes to the IFRS for SMEs should be:

In amending the IFRS for SMEs for application in the UK & ROI the ASB maintains its commitment to:

- (a) ensuring high-quality financial reporting by UK & ROI entities applying the revised draft FRS;
- (b) to operate under an international accounting framework; and
- (c) to acknowledge that users' preference for consistent financial reporting must be balanced with costs to preparers.

The ASB guidelines when considering amendments to the IFRS for SMEs are:

- (a) changes should be made to permit accounting treatments that exist in FRSs at the transition date that align with EU-adopted IFRS;
- (b) changes should be consistent with EU-adopted IFRS;
- (c) use should be made, where possible, of existing exemptions in company law to avoid gold-plating; and
- (d) changes should be made to provide clarification, by reference to EU-adopted IFRS, that will avoid unnecessary diversity in practice.

- 5.11 The ASB considered the revised guidelines should address respondents' concerns regarding inconsistencies between the recognition and measurement requirements in EU-adopted IFRS and the IFRS for SMEs. Further they should address the concerns that the IFRS for SMEs had been developed for environments with a lesser developed set of accounting standards than the UK or ROI.
- 5.12 It also noted that by providing clarification this should avoid unnecessary diversity in practice; maintaining its commitment to high quality financial reporting. In providing clarification the ASB decided that, as it is seeking to influence the IASB, it should amend the IFRS for SMEs by reference to EU-adopted IFRS.

#### ***Introducing options into FRED 44***

- 5.13 Application of the revised guidelines permitted the introduction of accounting options that exist in current FRS and EU-adopted IFRS that respondents had highlighted as reducing comparability. FRED 48 therefore includes accounting options for:
- (a) capitalisation of borrowing costs;
  - (b) revaluation of property, plant and equipment and intangible assets;

- (c) capitalisation of development costs, in certain circumstances; and
  - (d) hedge accounting of a net investment in a foreign operation in consolidated financial statements.
- 5.14 The ASB also decided that it should retain the current accounting permitted in accordance with FRS 6 'Acquisitions and Mergers' for group reorganisations. The ASB noted that whilst EU-adopted IFRS does not provide accounting requirements for the accounting for business combinations under common control the accounting provided by FRS 6 is well understood and provides useful requirements. It therefore decided to carry forward these requirements into the revised draft FRED (FRED 48).

***Providing clarifications in the revised FRED 44***

- 5.15 Having revised its guidelines to provide clarifications the ASB considered respondents requests for clarification. The ASB is proposing a number of clarifications in FRED 48, including:
- (a) disclosure requirements for discontinued operations;
  - (b) treatment of loan covenants, so that the treatment is consistent with IFRS 9 'Financial Instruments';
  - (c) financial instruments that would be equity under IAS 32 'Financial Instruments: Presentation' are not liabilities in accordance with the proposals set out in FRED 48, when an entity is required to prepare consolidated financial statements;
  - (d) an employee benefit trust, ESOP or similar arrangement is a special purpose entity and should be consolidated, where the entity is a parent and prepares consolidated financial statements, an entity applies paragraphs 2.53 to 2.55 in its individual accounts;
  - (e) when an investor that is not a parent but has an investment in one or more associates and/or jointly controlled entities shall account for its investments and/or jointly controlled entities using either cost or fair value;
  - (f) the presumed life for goodwill, in particular when an entity is otherwise unable to make a reliable estimate is 5 years and thereby consistent with company law. Intangible assets presumed useful life was also amended to 5 years to be consistent;
  - (g) accounting treatment for group share-based payments where the award is granted by the parent or another group entity; and
  - (h) that option pricing models are not required for the valuation of shared-based payments, particularly for unquoted shares or share options.
- 5.16 In clarifying the requirements for consolidation, the ASB noted that the accounting treatment for employee benefit trusts ESOP or similar arrangement would give rise to a change in accounting from current FRS. The removal of UITF 38 'Accounting for ESOP trusts' would mean that such arrangements would no longer be included in individual financial statements but only at consolidation level. However, the ASB decided to retain the accounting from UITF Abstract 32 'Employee benefit trusts and other intermediate payment arrangements'. As a consequence where an entity is not a parent it will apply these requirements, now included in Section 2 of FRED 48.
- 5.17 The ASB considered whether to provide guidance of the term used in FRED 48 'undue cost or effort' where respondents had sought clarification. The ASB noted that FRED 48 discussed in section 2 the balance between benefit and cost and that no further clarification was required.

- 5.18 The ASB also decided not to specify additional requirements for discontinued operations as it had clarified and amended the requirements for presentation to comply with company law.

***Share-based payments***

- 5.19 As part of its objective to provide proportionate financial reports the ASB reviewed the accounting requirements for share-based payments as previously proposed. The ASB noted that FRED 48 would predominantly apply to unquoted entities and consequently most schemes were likely to be cash-settled rather than equity-settled.
- 5.20 The ASB gave consideration to whether an entity should be required to recognise the costs of share-based payments; it decided that there is an economic cost to the entity of providing share-based payments which should be recognised. The ASB, however, noted that for many unquoted entities measuring this economic cost using option pricing models may incur disproportionate costs in comparison to the benefit to users of financial statements. It therefore decided to clarify that option pricing models are not required in all circumstances and that an entity could measure share-based payments using models that were appropriate to the entity's circumstances.

***Post-employment benefit plans***

- 5.21 Respondents also noted that the presentation requirements for post-employment benefit plans were not clear in FRED 44. Specifically a request was made to clarify where the difference between the return on plan assets and expected return on plan assets should be presented. The ASB, in considering this clarification, noted that the presentation requirements in IAS 19 'Employee Benefits' had been amended in 2011. The amendments to IAS 19 were consistent with the ASB's recommendations in its report following the consultation document 'The Financial Reporting of Pensions'. In view of this it decided to update its proposals to be consistent with the revised IAS 19. FRED 48 proposes that an entity recognises the net change in the defined benefit liability as follows:
- (a) the change in the defined benefit liability arising from employee service rendered during the reporting period in profit or loss;
  - (b) net interest on the defined benefit liability in profit or loss; and
  - (c) remeasurement of the defined benefit liability in other comprehensive income.
- 5.22 Remeasurement of the defined benefit liability includes actuarial gains and losses and the return on plan assets excluding amounts included in net interest on the defined benefit liability.
- 5.23 In making this amendment the ASB also noted that the accounting requirements in FRED 44 for group pension plan arrangements were actually more stringent than those set out in IAS 19 revised. The ASB therefore decided also to update these requirements to be consistent with the revised IAS 19.

***Distribution of non-cash assets to owners***

- 5.24 The ASB had also been asked to clarify that distribution of non-cash assets to owners did not apply to distributions within groups. In considering this requirement the ASB noted a distinction between the disposal of an asset at fair value followed by a distribution to shareholders of the profit and making a distribution of the asset to shareholders. In its view a distribution to shareholders does not generate a profit, whereas a disposal does generate a profit that may then be distributed to shareholders. The ASB decided, given it did not support the accounting requirement, to remove the requirement in FRED 44 to recognise a liability to pay a dividend for a non-cash asset at fair value and to require disclosure of the fair value of the assets distributed to shareholders.

*Company law formats*

- 5.25 The ASB considered feedback to FRED 44 and to the draft case studies prepared by its staff and posted on its website that addressed the interaction between FRED 44 and the presentation formats required by company law. The ASB noted that there were specific conflicts between FRED 44 and the formats, specifically the definition of current assets differed between the two sets of requirements.
- 5.26 The ASB considered whether to replicate in FRED 48 the requirements set out in company law for the information to be presented in the statement of financial position and the income statement, but were concerned that this would add clutter to FRED 48 and this was not consistent with its objectives. The ASB, however, agreed that it needed to work within company law and whilst it had encouraged changes to simplify the Accounting Directives it was unlikely such change would take place in the near future.
- 5.27 The ASB decided that it should promote only one set of formats and since these were already determined in company law the presentation requirements set out in FRED 44 should be removed. This would have the consequence of all entities being required to comply with the company law formats, promoting consistency amongst all those preparing financial statements intended to give a true and fair view.
- 5.28 In amending FRED 44 for inclusion of the Companies Act formats it was noted that the ASB had a long-standing policy that company law formats on their own were not sufficient and should be supplemented to highlight a range of important components of financial performance, to aid users' understanding of the performance of the entity. Therefore some requirements from FRS 3 'Reporting Financial Performance', notably covering acquisitions, exceptional items and discontinued operations would need to be factored in. The ASB decided to propose in FRED 48:
- (a) the disclosure of post-acquisition revenue and profit or loss of an acquiree in a business combination in the notes to the financial statements;
  - (b) not to mandate an operating profit line but to provide guidance, based on IAS 1 'Presentation of Financial Statements', on matters to consider where entities choose to present operating profit;
  - (c) the inclusion of an explicit requirement to disclose material items; and
  - (d) not to include the existing FRS 3 paragraph 20 requirement to show separately on the face of the profit and loss account profits or losses on sale or termination of an operation, costs of a fundamental reorganisation materially affecting the operation and profits and losses on disposal of fixed assets (all of which would still have to be disclosed where material).
- 5.29 The ASB decided, in view of the company law requirement that turnover includes the turnover from discontinued operations, a practical way of presenting this and the post-tax profit or loss on discontinued operations would be for the information about discontinued operations to be presented via a columnar approach. An example illustrating this is set out in FRED 48.

*Accounting for income tax*

- 5.30 The ASB had proposed in FRED 44 using the text of IAS 12 'Income Taxes' in place of the IFRS for SMEs section on income tax. The ASB had amended the tax section because it had been based on proposals subsequently abandoned by the IASB and not supported by respondents to the Policy Proposal. Respondents to FRED 44 had accepted that the IFRS for SMEs treatment could not be used, but did not support the ASB's proposal to replace the tax section with IAS 12.

- 5.31 In view of the lack of support for the proposals, an alternative was identified that bases the recognition requirements on timing differences, with additional recognition requirements where there were temporary differences that were not clearly timing differences, which was being referred to as a ‘timing differences plus’ approach. The ASB decided that this approach would:
- (a) provide useful information to users of financial statements;
  - (b) be consistent with its objective of convergence to an IFRS-based framework; and
  - (c) provide the simple solution preparers were looking for that was close to current FRS and that would give the same answers as IFRSs in most cases.
- 5.32 The most significant change to the requirements in current FRS is that the proposed approach requires the recognition of the deferred tax implications of the revaluation of assets. In the ASB’s view gains and losses recognised on a revaluation are timing differences the effects of which should be recognised. Such a requirement is consistent with that of IAS 12 and the IFRS for SMEs.
- 5.33 Under IAS 12 deferred tax is not generally recognised on the initial recognition of an asset, except that of assets and liabilities arising from a business combination. No specific exception for this is necessary under the ‘timing differences plus’ approach as no timing difference arises. The proposed treatment is therefore consistent in this respect with IAS 12.
- 5.34 The ‘timing difference plus’ approach does not, however, ensure complete consistency with the requirements of IAS 12. For example, the proposals do not specifically require the recognition of deferred tax arising from an intra group transfer of assets. The ASB considered, however, that such differences from IAS 12 were likely to be relatively rare and that in most such cases the relevance of the information produced in accordance with IAS 12 was unclear.
- 5.35 The ASB also gave consideration to the disclosures required to support the ‘timing difference plus’ approach. Consideration was particularly given as to whether the disclosures should be on a ‘net basis’ or a ‘gross basis’. A ‘net basis’ would require entities to schedule when timing differences would reverse (and therefore forecast future timing differences), consequently such an approach could be more burdensome to prepare. However, the ASB noted that a ‘net basis’ provided information about the entities potential future cash flows and that users focused on cash flow information.
- 5.36 The ASB noted that whilst a ‘gross basis’ might be easier to prepare and could be supplemented with an explanation of likely reversals, net disclosures more closely aligned with users’ needs and therefore decided to propose disclosure on a ‘net basis’ in the financial statements.
- 5.37 When considering the disclosures to support its proposals for income tax the ASB considered whether it should stipulate that disclosure is only required when the information is material. However, the ASB noted that it had already clarified in paragraph 3.16A of FRED 48 that an entity need only provide specific disclosures if the information is material. It decided to include a specific reference to materiality in Section 29 and considered further clarification was unnecessary.

### *The accounting for grants*

- 5.38 A number of respondents, particularly from the PBE sector, raised concerns about the proposed changes to the recognition requirements for grants received from government and other bodies. The proposals in FRED 44 used a criterion for the recognition of grants based on when an entity fulfilled the performance criteria stipulated in the grant. This is a change from both current FRSs and EU-adopted IFRSs that attempts to match grant income with the related expenditure. The ASB observed that similar to the situation for income tax the IFRS for SMEs used an approach not in current EU-adopted IFRSs.

- 5.39 The ASB reviewed the concerns of entities noting that it could amend the performance criterion approach to provide application guidance on performance outcome. This approach would require a research project to be undertaken and cause delay to the publication of a revised FRED. An alternative was to amend the requirements in FRED 44 so that they were consistent with EU-adopted IFRS and defer a research project on the accounting for grants until after publication of the FRED. However, respondents also noted that some entities, mainly in the PBE sector, recognised grant income based on performance criteria and that reverting to IFRS (which is similar to current FRS) would introduce a change for these entities. The ASB did not wish to implement change for entities that might be reversed when it undertook a research project on grant accounting. It therefore concluded it should allow entities a choice between the proposals in FRED 44 and those in EU-adopted IFRS. It consequently amended FRED 44 to permit a choice in the recognition of grant income.
- 5.40 The ASB recognised that the respondents to FRED 44 highlighted inconsistency in current practice and that it should recognise that the solution in FRED 48 is an interim solution until completion of a research project.

***Investment entities exemption from consolidation***

- 5.41 In September 2011 the International Accounting Standards Board (IASB) issued an exposure draft proposing to exempt qualifying investment entities from consolidating their investments. The ASB noted that without a similar exemption in FRED 48 investment entities, eligible to apply FRED 48, would need to elect to prepare EU-adopted IFRS in order to take advantage of the exemption. The ASB did not consider this to be a logical or meaningful outcome and therefore sought to find a solution.
- 5.42 The Companies Act, section 405(3) sets out the circumstances in which a subsidiary may be excluded from consolidation and the ASB must work within these requirements. Section 405(3) permits a subsidiary to be excluded from consolidation on the following grounds:
- (a) severe long-term restrictions substantially hinder the exercise of the rights of the parent company over the assets or management of that subsidiary; or
  - (b) the information necessary for the preparation of group accounts cannot be obtained without disproportion expense or undue delay; or
  - (c) the interest of the parent company is held exclusively with a view to subsequent resale.
- 5.43 On examination of these circumstances the ASB decided it could not provide an overriding exemption from consolidation for subsidiaries of qualifying investment entities. It did, however, note that FRS 2 ‘Subsidiary Undertakings’ currently defines those subsidiaries held exclusively for resale and that this definition had been inserted into FRED 48 for use in Section 9. The ASB decided that it could amend the definition of subsidiaries held exclusively for resale to include subsidiaries that are held as part of an investment portfolio. This would widen the definition of subsidiaries held for subsequent resale and permit subsidiaries held exclusively for resale as part of an investment portfolio to be excluded from consolidation.
- 5.44 FRED 48 proposes that a subsidiary should be excluded from consolidation where the interest in the subsidiary is held exclusively for resale and is held as part of an investment portfolio. Investments are held as part of an investment portfolio if their value to the investor is through their fair value as part of a directly or indirectly held basket of investments rather than as media through which the investor carries out business. A basket of investments is indirectly held if an investment fund holds a single investment in a second investment fund which, in turn, holds a basket of investments.

***Accounting for financial instruments***

- 5.45 In FREDs 43 and 44 the ASB noted that current FRSs were in need of updating and that they permitted certain transactions not to be recorded. Sections 11 and 12 of FRED 44 proposed to address these weaknesses in current FRS. The ASB carefully considered the view of respondents to FRED 44 concerning the proposed accounting for financial instruments set out in the FRED.
- 5.46 The ASB noted the concern, primarily from the social housing sector, that recognition of derivatives used for hedging purposes at fair value may result in volatility in profit and loss.
- 5.47 The ASB considered carefully the requirement to recognise derivatives at fair value but noted that any changes to the financial instrument proposals should be consistent with the principles for amending the IFRS for SMEs and thereby consistent with the objective of providing high quality information, including the risks an entity has in relation to its financial instruments.
- 5.48 The ASB observed that the requirements for hedge accounting in FRED 44 are based on the requirements in IAS 39 'Financial Instruments: Recognition and Measurement'. These requirements are currently being updated and whilst it was not able to resolve this issue at this stage it could return to it once the IASB completed its replacement financial instruments standard, IFRS 9 'Financial Instruments'.
- 5.49 The ASB decided it was reluctant to propose alternative hedge accounting requirements before IFRS 9 was finalised. Doing so could risk financial instruments requirements in FRED 48 being out of line with IFRS. Simultaneously, it was considered that the next scheduled amendment date for FRED 48 was too far away in relation to this particular issue. Consequently, it was decided that an exceptional amendment to that part of FRED 48 would be issued as IFRS 9 was updated. The ASB agreed it would issue FRED 48 highlighting those parts of Sections 11 and 12 that may be subject to change in a subsequent FRED to bring them into line with IFRS 9.

***Developing the definition of a financial institution and related disclosures***

- 5.50 Having decided to develop the disclosure requirements in FRED 48 for financial institutions and to define financial institutions by way of a list, the ASB gave consideration to entities that should be included in the list. The ASB noted that FRS 13 'Derivatives and Other Financial Instruments' made a distinction between an entity that used financial instruments to manage risk and entities that generated wealth from financial instruments. It therefore developed its list of entities based on the requirements in FRS 13.
- 5.51 In developing the list of entities to be defined as financial institutions, discussions were held with groups of entities that would be affected by the revised proposals. The ASB received strong support from the groups for the removal of the definition of public accountability and the development of additional disclosures in FRED 48 based on the principles of IFRS 7.

***Developing FRED 44 for a broader group of entities***

- 5.52 The elimination of public accountability requires FRED 48 to apply to a broader group of entities. The alternative view to FRED 44 had sought views on widening its use, therefore the responses to the alternative view were considered when considering the needs of the broader group. The responses highlighted few additional requirements; the ASB took these items into consideration and also undertook an analysis of FRED 44 to identify further areas that might require amendment. The following areas were identified as areas that FRED 44 did not address that might be relevant to a broader group of entities:
- (a) Earnings per share;
  - (b) Interim reporting;

- (c) Segmental information;
  - (d) Insurance accounting;
  - (e) Discontinued operations;
  - (f) Retirement benefit plans.
- 5.53 In considering the above requirements the ASB addressed which entities (the scope) should be required to apply the additional requirements. The ASB gave consideration to whether it should provide the relevant accounting requirements but allow regulatory authorities to stipulate which entities should apply the requirements. The ASB also noted that the scope of entities required to provide segmental information, earnings per share and interim reports varied in current FRSs and EU-adopted IFRSs. The ASB decided to propose in FRED 48 a scope in accordance with EU-adopted IFRSs and to request respondents' views as to which entities should be required to comply with the requirements.
- 5.54 In considering how to provide the accounting requirements in FRED 48 the ASB decided that, in view of the limited scope of entities that would apply the revised requirements, it would cross-refer to the relevant IFRSs, for example, an entity required to prepare interim financial statements would look to IAS 34 'Interim Reports'. This approach had the benefit that FRED 48 and any future FRS is not cluttered with requirements that apply to few entities.
- 5.55 The ASB agreed that for entities that undertake insurance business it could, similarly, refer the entity to IFRS 4 'Insurance Contracts', and that it would issue a further consultation document on insurance accounting.
- 5.56 The ASB, having clarified the requirement for discontinued operations disclosures in FRED 48 decided that supplementary guidance was not required.

***Specialised activities - Retirement benefit plans financial statements***

- 5.57 The ASB was asked to confirm how its tentative decision would affect the financial statements of retirement benefit plans. FRED 43 proposed that retirement benefit plans were publicly accountable and thereby should apply EU-adopted IFRS; having decided to eliminate the definition of publicly accountable retirement benefit plans would now apply the requirements proposed in FRED 48. However, as noted above, FRED 48 contains no specific provisions for retirement benefit plans.
- 5.58 The ASB considered whether to direct retirement benefit plans to IAS 26 'Accounting & Reporting by Retirement Benefit Plans' and request that the Statement of Recommended Practice (SORP) 'Financial Reports of Pension Schemes' be updated to be consistent with IAS 26. This approach would be consistent with how the ASB had addressed other areas of accounting for a broader group of entities that were not included in FRED 44. This option was, however, rejected based on feedback which suggested that the application of IAS 26 would be difficult for two reasons: (i) legal accounting and reporting requirements in the UK are different to those in IAS 26 and (ii) IAS 26 itself makes references to other IFRSs and the interaction between these references and those proposed in FRED 48 would be complicated. A further complication would arise as the SORP would also provide application guidance for retirement benefit plans.
- 5.59 Following this feedback the ASB decided to develop, as part of the specialised activities section, accounting requirements for retirement benefit plans financial statements that could be supplemented by the SORP.
- 5.60 In developing the proposals the ASB noted that the financial statements of retirement benefit plans need to provide disclosure regarding the pension liabilities and the related funding of the plan. The ASB noted that much of the information that should be contained in the financial

statements was included either in the Summary Funding Statement or the Schedule of Contributions for UK retirement benefit plans, consequently significant additional costs should not be incurred.

- 5.61 Section 34 of FRED 48 proposes that retirement benefit plans financial statements should include a statement of financial position excluding the liability to pay pensions benefits; however, disclosure is required regarding the liability to pay pension benefits.

### *Agriculture*

- 5.62 FRED 44 includes guidance for specialised activities including agriculture. The proposed requirements for agriculture are based on IAS 41 'Agriculture'. Respondents to FRED 44 questioned the proposed requirements noting that current FRSs do not set out accounting requirements and that the proposals are unduly arduous and would not benefit the users of financial statements.
- 5.63 The ASB evaluated the comments raised and noted that the proposed requirements in section 34 did not make a distinction between biological assets and agriculture produce, however, it was not clear from respondents if this was the concern. The ASB decided that respondents had not explained *why* the proposals are considered unduly arduous and that it should seek further explanation as to the reasons the proposals are considered arduous.

### *The retention of Urgent Issue Task Force (UITF) Abstracts*

- 5.64 FREDs 43 and 44 proposed to withdraw all UITF Abstracts except UITF Abstract 43 'The Interpretation of equivalence for the purposes of section 228A of the Companies Act'. Respondents to the FRED proposed that in addition to Abstract 43 other UITF Abstracts should be retained. The ASB gave consideration to this request and noted that rather than retain UITF Abstracts, consistent with its objective to provide succinct financial reporting standards, it should develop any guidance into its revised proposals.
- 5.65 Based on feedback the ASB is proposing the following accounting requirements of UITF Abstracts are retained:

<b>UITF Abstract</b>	<b>Action</b>
Abstract 4 Presentation of long-term debtors in current assets	Incorporated into the legal appendix of FRED 48.
Abstract 31 Exchange of business or other non-monetary assets for an interest in a subsidiary, joint venture or associate	Additional paragraphs 9.31 and 9.32 are inserted into FRED 48.
Abstract 32 Employee benefit trusts and other intermediate payment arrangements	Additional paragraphs 2.53 and 2.56 are inserted into FRED 48.
Abstract 43 The interpretation of equivalence for the purposes of section 228A of the Companies Act 1985	The guidance has been updated and included as application guidance to FRED 46.

- 5.66 Although requests were made to retain UITF Abstract 38 'Accounting for ESOP trusts' the ASB decided the matter could be addressed by stating in section 9 of FRED 48 that ESOPs and EBTs are an example of SPEs.
- 5.67 The ASB decided to withdraw Abstract 48 'Accounting implications of the replacement of the retail prices index with the consumer prices index for retirement benefits' as the circumstance it addressed were related to a one time period which has now expired.

## **6 INTERACTION WITH COMPANY LAW**

- 6.1 The ASB gave careful consideration to the comments received to its draft legal appendix set out in the FRED. The ASB agreed with respondents' views that the appendix should address entities that are not companies.
- 6.2 The ASB also considered whether it should retain, as proposed in the FRED, accounting options that had been removed because the option conflicted with company law, where an entity would not be restricted in the same way as a company. For example SSAP 4 'Government Grants' contained an option that was not permitted by the company law.
- 6.3 The ASB confirmed the position it had taken in developing FRED 44 that options that existed in the IFRS for SME's but not permitted by company law should be removed. This would promote consistency between reporting entities regardless of the legal framework under which they operate.

## **7 THE FINANCIAL REPORTING STANDARD FOR SMALLER ENTITIES (FRSSE)**

- 7.1 The proposal in FRED 43 and 44, consistent with the Policy Proposal, was to retain the FRSSE for a period after FRS 102 (FRED 48) was introduced and to consult again on the FRSSE's future. Whilst respondents to the Policy Proposal had supported this recommendation some respondents to FRED 44 called for the FRSSE to be removed and for the ASB to consult immediately on its future.
- 7.2 The ASB considered whether to consult immediately, and what the implications of the European Commission proposals on its review of the EU Accounting Directives issued in October 2011, and currently intended to be effective by 1 July 2014, might be for the FRSSE. The ASB decided that a FRSSE should be retained, but that the existing FRSSE (effective April 2008) will require significant revision to maintain consistency with company law, once it has been revised. This will also provide an opportunity to update it for consistency with FRS 102, where relevant.
- 7.3 The ASB will consult on the options for the revision of the FRSSE, including the extent to which consistency with draft FRS 102 should be achieved, once changes to the Directives are clear; this is expected to be during the first half of 2012.

## **8 REDUCED DISCLOSURES FOR SUBSIDIARY UNDERTAKINGS**

- 8.1 In response to concerns raised by respondents to the Policy Proposal, FRED 43 set out proposals to permit a qualifying subsidiary certain disclosure exemptions. This framework would benefit subsidiary undertakings where group financial statements provided disclosures that were equivalent to disclosures in EU-adopted IFRS. A limited reduced disclosure framework (RDF) was also proposed for qualifying subsidiaries where group financial statements were prepared in accordance with FRED 44.
- 8.2 Respondents to FRED 43 and 44 were supportive of the proposals, with calls for it to be available as soon as possible.
- 8.3 Following the ASB's decision to broaden the scope of entities eligible to apply FRED 44, and its decision to amend the recognition and measurement requirements in FRED 44 to be closer

to EU-adopted IFRS, careful consideration was given to whether there remained a need for the reduced disclosure framework.

- 8.4 In considering whether to continue to develop a reduced disclosure framework it was noted that the framework had been developed in response to the ASB's August 2009 Policy Proposal where respondents had argued the Policy Proposal did not address the needs of subsidiaries. The Policy Proposal required subsidiaries either to apply EU-adopted IFRS or to apply the IFRS for SMEs. Respondents argued that application of EU-adopted IFRS would not be cost effective due to the volume of disclosures required and simultaneously the application of the IFRS for SMEs, with recognition and measurement differences to EU-adopted IFRS would incur internal administration costs in recording and monitoring differences between group accounts (prepared in accordance with EU-adopted IFRS) and the IFRS for SMEs.
- 8.5 It was agreed that, given the level of support for the framework and the fact that it addressed the concerns raised to the August 2009 Policy Proposal the ASB should continue with its development of the framework.
- 8.6 Consideration was given to whether the framework should be made mandatory for subsidiary entities. Discussions held with constituents noted that there was little justification for mandating the framework. Any accounting arbitrage between the reduced disclosure framework and the proposals in FRED 48 would need to outweigh the benefits of the reduced disclosure framework. The ASB therefore retained its view set out in the FRED 43 that the framework should remain optional.
- 8.7 Respondents questioned whether the reduced disclosure framework could be applied to voluntarily prepared group accounts, in particular whether subsidiaries that were also intermediate parent companies should:
- (a) be permitted to apply the RDF to their group accounts if they voluntarily chose or were required to prepare group accounts;
  - (b) be permitted to apply the RDF to their group accounts if they voluntarily prepared group accounts but not if they were required to produce group accounts; or
  - (c) not be permitted to apply the RDF to their group accounts.
- 8.8 It was noted that the requirement for some entities to produce consolidated accounts is based on a view that the sort of information that these consolidated accounts provides is useful to users and that those who voluntarily produce consolidated accounts would be doing so for a purpose. The ASB therefore decided to proceed on the basis that FRED 47 would propose not permitting intermediate parents who prepared group accounts (for whatever reason) to apply the RDF to their group accounts.
- 8.9 The ASB did, however, reconsider the application of the RDF to parent entities financial statements that are presented as part of the consolidated financial statements. In accordance with FRED 43 parent entities with public accountability were prohibited from applying the RDF. However, now the ASB had decided to eliminate the definition of public accountability the question arose as to whether parent entities should be eligible to apply the RDF.
- 8.10 The ASB considered whether parent entities financial statements provided useful information to users but decided that users focus on the consolidated financial statements, not that of the parent entity and that publication of parent entity financial statements alongside consolidated financial statements are prescribed in company law and specific to the UK. Consequently the ASB decided to propose in FRED 48, an extension of the reduced disclosure framework to parent entities individual financial statements.
- 8.11 The ASB noted that in identifying the proposed disclosure exemptions when developing FRED 43, it had done so based on existing disclosure exemptions in current FRS and from

outreach activities, rather than developing a set of principles that could be applied in the future. The principles are set out in the development section of FRED 47.

- 8.12 The ASB also considered carefully respondents' proposals for amending the reduced disclosure framework and details are also set out in the development section of FRED 47.

## 9 RELATED PARTY DISCLOSURES

- 9.1 In FRED 44 the ASB proposed not to retain the exemption from disclosure of related party transactions currently permitted by company law, although it sought views on whether the exemption should be retained. The responses from preparers and auditors called for retention of the exemption on cost benefit grounds whilst the outreach from users was that related party information was important and it was particularly important in the case of small and medium sized entities (where, for example, a director might have a subsidiary company or might be trading with a relative) to have related party information in the individual accounts.
- 9.2 It was therefore recognised that whilst removing the exemption might be seen as gold-plating it might be justified in terms of providing useful information to users.
- 9.3 The ASB noted that the exemption is available only to transactions between wholly-owned members of a group and that it was unclear from the outreach if this related party information is useful to users. The ASB decided, not wishing to ignore user input, that the current exemption for related parties should remain in FREDs 47 and 48 and to invite respondents to make the case for removal of the exemption and what information regarding related parties would be useful.

## 10 APPLICATION OF THE PROPOSALS TO PUBLIC BENEFIT ENTITIES

- 10.1 The Policy Proposal set out ten issues that could be included in a PBE specific standard. However, following discussion with the ASB these 10 issues were refined to six which were deemed to be those most significant and relevant to the PBE sectors that were not satisfactorily addressed by FRED 44. These six issues were:
- (a) Concessionary loans;
  - (b) Property held for the provision of social benefits;
  - (c) Entity combinations;
  - (d) Impairment of assets: public benefit considerations;
  - (e) Funding commitments; and
  - (f) Incoming resources from non-exchange transactions.

### ***Concessionary loans***

- 10.2 No significant changes have been made to the proposed accounting treatment for concessionary loans from FRED 45 to FRED 48. As proposed in FRED 45 paragraphs have been inserted in to Section 34 *Specialised Activities* to address the accounting requirements for PBEs making and receiving concessionary loans.
- 10.3 There are two main accounting treatments to consider when determining the basis for the measurement of concessionary loans: the amount paid or received; or fair value. This has been the subject of significant discussion and debate by the ASB, taking into account the information that users of PBE accounts may consider useful and the difficulties that may arise for smaller organisations in measuring concessionary loans at fair value.

- 10.4 Accounting for concessionary loans at the amount paid or received rather than fair value is not consistent with the accounting requirements set out in either Section 11 of FRED 48, EU-adopted IFRS or IPSAS 29 'Financial Instruments: Recognition and Measurement' (which require that such arrangements are measured and recognised in the financial statements at their fair value).
- 10.5 The ASB is proposing that due to the difficulties that smaller PBEs may face with using fair value, PBEs that make or receive concessionary loans may have the option of measuring such loans at either the amount paid or received or at fair value. However, PBEs that make and receive concessionary loans must apply the same measurement method to both.
- 10.6 The requirement to disclose the terms and conditions of the concessionary loan will enable users of PBE financial statements to assess the 'income foregone' in issuing this type of loan and will provide them with the information they need to understand the impact of this transaction.
- 10.7 Presentation and disclosure of concessionary loan arrangements are an important part of the proposals for concessionary loans and the ASB concluded that the disclosure requirements in FRED 48 will provide sufficient information to understand and interpret the impact of this type of transaction on the financial statements.

***Property held for the provision of social benefits***

- 10.8 Subsequent to FRED 45, the ASB decided that the requirements for property held for the provision of social benefits should apply to all entities applying FRED 48 and should not be restricted to PBEs.
- 10.9 Consideration was given as to whether properties that are held for the provision of social benefits meet the definition of an investment property. The definition of investment property in FRED 48 paragraph 16.2, excludes properties held for use in the production or supply of goods and services or for administrative purposes. A property held to earn rentals and/or capital appreciation, but not used in the production or supply of goods or services, meets this definition. The ASB noted that although many PBEs that engage in the provision of social housing receive rental income, their primary purpose is to provide social benefits. Such entities hold properties in order to provide that service.
- 10.10 Provision of social housing is akin to supplying a service and therefore, property held for the primary purpose of providing social benefits should be excluded from the scope of investment property and be accounted for as property, plant and equipment.
- 10.11 The ASB acknowledges that PBEs may hold 'investment properties' which are not held primarily to provide social benefits and will return market value rentals and/or are held for their capital appreciation. FRED 48 does not exclude those properties from being accounted for as investment properties.

***Entity combinations***

- 10.12 In considering the issue of entity combinations in the PBE sectors there is some debate over whether the use of acquisition accounting for all combinations would be appropriate and in particular whether it reflects the substance of a transaction if there is a gift of one entity to another in a combination at nil or nominal consideration, or where two or more organisations genuinely merge to form a new entity.
- 10.13 Where there is a combination of entities at nil or nominal consideration which is in substance a gift, it is appropriate to follow the same accounting principles as donations of assets (as set out in 'Incoming resources from non-exchange transactions') by recognising the fair value of the assets received and liabilities assumed as a gain or loss in income and expenditure.

- 10.14 Accounting for combinations that meet the definition of a merger requires a different methodology to acquisition accounting in order to reflect the true substance of the transaction. Whilst it is not anticipated that all combinations in the PBE sectors are mergers or that merger accounting will generally be applicable to combinations in the PBE sectors it is considered appropriate to retain merger accounting in certain circumstances. In considering this matter it was noted that the accounting requirements for PBEs in some jurisdictions, for example, the US and Australia have recently been reviewed and noted that merger accounting has been retained for the public and not-for-profit sectors.
- 10.15 In retaining merger accounting, the ASB has considered the criteria to be met for a merger. The criteria set out in FRS 6 'Acquisitions and Mergers' provide a starting point, but are framed in the context of the commercial sector and therefore the criteria have been adapted to make them more appropriate for the PBE sectors. In particular, a criterion has been added to include consideration of the impact of the combination on beneficiaries and the benefits to which they are entitled.
- 10.16 One specific concern highlighted in relation to the current FRS 6, is the need to restate comparatives by adding together the previous periods' reported figures of each of the combining entities. This does not reflect the substance of the transaction as the historical parties which formed the entity did not exist in the previous accounting period and therefore the FRS requires that comparatives are marked as 'combined' to make it clear that they are a combination of previously reported figures for the combining entities.

#### ***Impairment of assets***

- 10.17 FRED 48 proposes impaired assets are measured at the lower of an asset's fair value less costs to sell and its value in use. In a for-profit context, value in use is determined by measuring the present value of the cash flows derived from the asset. However, often PBE assets are held for their service potential rather than their ability to generate cash flows. In such a case it is sometimes impossible to determine value in use by reference to cash flows and it is more appropriate to regard value in use as the present value of future service potential rather than cash flows.
- 10.18 International Public Sector Accounting Standard (IPSAS) 21 *Impairment of Non-Cash Generating Assets* permits value in use to be determined by any of three approaches: depreciated replacement cost (DRC); restoration cost and the service units approach. Restoration cost and the service units approach are applications of DRC as DRC is used as the starting point. DRC reflects the cash outflows that are saved through ownership of an asset. It is therefore likely to be widely applicable and appropriate for PBEs. Therefore FRED 48 permits a service potential driven valuation to be used for assets held for their service potential.
- 10.19 The use of DCR is not mandated; other methods that value service potential rather than cash flows may be used if those methods are more appropriate in those particular circumstances.
- 10.20 FRED 45 only allowed this alternative valuation method for PBEs, however subsequent to that consultation the ASB has decided that any entity that holds an asset for service potential can use a service potential valuation method.
- 10.21 The ASB also discussed whether a restriction on the use of an asset would affect its fair value. Because an asset's fair value is based on the amount that an entity could obtain, it was understood that restrictions might impact on the fair value obtainable where they prevented a purchaser from using the asset for another purpose that would be more valuable than that required by the restriction. In addition, the cost to sell should include the costs of breaking the restriction.
- 10.22 Another issue for discussion was indicators of impairment. Although the indicators provided in FRED 48 are mainly linked to the expected cash flow of an asset and as such may not

necessarily be relevant to some PBE assets, the ASB considered that they must, as a minimum, be considered by PBEs as possible indicators of impairment.

- 10.23 In addition, the ASB noted that other accounting literature (IPSAS 21 and SORPs) identified other indicators of impairment including:
- (a) Cessation, or near cessation of the demand or need for services provided by the asset;
  - (b) Social, demographic or environmental changes resulting in a reduction of beneficiaries; and
  - (c) A major loss of key employees associated with particular activities.
- 10.24 The ASB concluded that it would not be appropriate to include these indicators in FRED 48, as they are not exclusively specific to PBEs and because the indicators given in FRED 48 will continue to apply to PBEs. Therefore, their inclusion would make such entities subject to a confusing list of overlapping indicators. The indicators given in FRED 48 are merely minimum requirements, and recognition of an impairment loss is required irrespective of whether any of the given indicators are met.
- 10.25 It was also considered whether to specify that an indicator of impairment was present where an asset's service potential was not fully utilised. It was noted that an entity may require standby or surplus capacity to ensure that it has adequate capacity to provide services at all times. For example, a building that provides accommodation for the homeless may not be used to full capacity during the summer months but is used fully during winter. In this circumstance, the surplus capacity is part of the required service potential of the asset and the asset is not impaired. For this reason, it was concluded that it would be inappropriate to specify that the unutilised capacity should be treated as an indicator of impairment.

#### ***Funding commitments***

- 10.26 The ASB also discussed when to recognise a commitment to provide funding in a non-exchange transaction. The 'Statement of Principles – Interpretation for Public Benefit Entities' previously addressed this issue, however, it was considered necessary to incorporate these details into FRED 48 to be used in conjunction with Sections 2 and 21.
- 10.27 The issue was identified as being particularly important because many PBEs provide funding on an on-going basis and there is little guidance on how such multi-year obligations should be recognised.
- 10.28 The ASB considered when a liability for such a commitment should be recognised, and determined that an entity would only recognise a liability if that commitment to provide funding was made unconditionally, and the grantor could not realistically withdraw from the commitment. In this situation, an entity would recognise a liability for the present value of the total funding promised.
- 10.29 Subsequent to the issuance of FRED 45, the ASB decided that the requirements for funding commitments should apply to all entities and not just PBEs.

#### ***Incoming resources from non-exchange transactions***

- 10.30 The receipt of non-exchange resources by an entity represents an inflow of resources which is highly significant for many PBEs, the receipt of donations, grants, and legacies from non-exchange transactions are a major source of their funding and this issue is not addressed in FRED 48 apart from Section 24 'Grants'.
- 10.31 The ASB considered that for PBE financial statements to be complete, they should reflect the benefit that the inflow of these resources had on the entity. FRED 48 proposes, in principle,

that PBEs value the resources they receive from non-exchange transactions at their fair value. The ASB discussed whether using a fair value would overstate the value of a donation where the entity is unable to exploit fully an asset and the equivalent service potential could be derived from a lower value asset. Being able to achieve the same service potential from a lower value asset might suggest that the value of the donated asset should be at the lower value. However, FRED 48 requires donated assets to be valued at their fair value. This reflects that the circumstances described above would rarely occur. In many cases, an entity would be able to sell the donated asset and if appropriate, purchase a cheaper asset with the equivalent service potential.

- 10.32 Incorporating an exception for donated assets which may not be fully exploited would make the application of FRED 48 more onerous, as it would require all entities in receipt of donated assets (except those intended for resale) to consider whether they would be able to exploit fully the asset. This would be subjective and may incur the risk of understatement of the value of donated assets.
- 10.33 The ASB noted that where goods are donated for subsequent sale (for example donations to charity shops), it could be argued that the donated goods should be valued only when they are sold. The proposals in FRED 45 did not allow this as it is not consistent with the accruals concept which requires the financial statements to recognise goods when they are received and therefore proposed that goods be accounted for at their fair value if any, when received. However, for individual items such value may be immaterial in which case they may be recognised on a portfolio basis.
- 10.34 This proposal was not well received by constituents and the ASB subsequently specified that donated goods would only be recognised as income on receipt, when the item is material, can be measured reliably and if the benefits of recognising the item outweigh the costs.
- 10.35 FRED 48 proposes that donated services that can be reasonably quantified are accounted for at their estimated value to the recipient. FRED 48 therefore recognises that there are potential issues in determining a value for volunteer services and their contribution to the organisation and notes that quantifying this type of service may not be practicable. There is an argument to suggest that valuing volunteer services could be measured by reference to a metric such as the minimum wage, however this measure does not take into consideration an organisation's requirements for volunteers. In addition, this would be attributing an arbitrary value onto a volunteer's time which may not be reflective of their skills, experience or role and to determine a different method of valuation would be very subjective.
- 10.36 However, when a service is provided voluntarily for which the entity would otherwise have to pay (e.g. legal or financial advice) the value of that service should be recognised in the financial statements where, as will usually be the case, its value can be reasonably quantified.

#### ***Other PBE issues***

- 10.37 Prior to the issuance of FRED 45, the ASB did discuss the issue of reporting entity control and the indicators of control that may be specific to the PBE sectors. The indicators of control set out in Section 9 *Consolidated and Separate Financial Statements* of FRED 44 focus on benefits, and in the PBE sectors benefit can be in the form of indirect benefit through a PBE's beneficiaries or benefit which furthers a PBE's activities. Following discussion of these issues the ASB believed that FRED 44 could be interpreted and applied to PBEs and therefore no separate guidance for PBEs is considered necessary.
- 10.38 A number of additional topics were identified through the development of FRED 45, which may be considered in the future and as possible future updates to FRED 48. The following table summarises these subjects.

Narrative reporting	To consider narrative reporting requirements for public benefit entities and any specific matters.
Fresh start accounting	To consider the concept of fresh start accounting as an alternative accounting treatment for entity combinations where the effect of a combination is to create a new entity that cannot be reasonably portrayed as the enlargement of a pre-existing party.
Associates	To consider the definition of associates under the revisions to UK Financial Reporting Standards and international standards and the potential impact on the PBE sectors.
Social Benefit Obligations	To consider if and how social benefit obligations should be recognised and measured in the financial statements. The International Public Sector Accounting Standards Board currently have a project addressing this issue and it is likely to be most productive to await the outcome of that work.
Fund Accounting	To consider how fund accounting would be applied in accordance with FRED 48 in regards to segmental reporting.

## 11 THE ROLE OF THE STATEMENTS OF RECOMMENDED PRACTICE (SORPS)

- 11.1 FREDs 43 and 44 proposed to streamline the number of SORPs in existence. In its 2009 Policy Proposal the ASB's recommendation was to remove almost all of the SORPs. Respondents to the Policy Proposal questioned this recommendation and many noted that the ASB's process for providing negative assurance statements to the SORP played an important part in developing high quality SORPs that contributed to improving the quality of financial reporting in the UK.
- 11.2 Whilst respondents to FREDs 43 and 44 supported the revised recommendation for the SORPs the decision to eliminate the definition of public accountability and thereby broaden the scope of entities eligible to apply FRED 44 would have a consequential impact on the SORPs, for example pension funds would no longer be required to apply EU-adopted IFRS. Consequently, the ASB is proposing the following actions for the SORPs:

SORP	Implication of ASB decision
Financial reports of pension funds	All pension funds now in scope of FRED 48.
	Update the SORP to provide guidance on FRED 48 supplementing that in Section 34.
Accounting for insurance business	Entities applying a future FRS based on FRED 48 may now undertake insurance activities.
	A separate consultation is being undertaken on this SORP.
Accounting for oil & gas	None.
	Propose to retain SORP and update it for application to entities applying a future FRS based on FRED 48.

<b>SORP</b>	<b>Implication of ASB decision</b>
Leasing	None.
	No change to proposal - withdraw when a future FRS based on FRED 48 is effective.
Limited liability partnerships	None.
	Update for a future FRS based on FRED 48.
Investment companies	Will now fall in scope of FRED 48.
	Update for a future FRS based on FRED 48.
Authorised funds	Will now fall in scope of FRED 48.
	Update for a future FRS based on FRED 48.
Banking segments	Will now fall in scope of FRED 48.
	Withdraw as FRED 48 proposes disclosures for financial institutions.

- 11.3 In response to a request for clarification as to the role of the SORPs the ASB has provided clarification by including a reference to the SORPs in section 10 as a source of guidance on accounting policies.

## 12 EFFECTIVE DATE

- 12.1 FRED 43 and 44 proposed an effective date for accounting periods beginning on or after 1 July 2013, with early application being permitted. Respondents' views regarding the proposals were very mixed with some calling for earlier adoption and others for deferral of the proposals.
- 12.2 The ASB took into consideration its decision to amend FRED 44 to cover a broader scope of entities and its revised guidelines for amending the IFRS for SMEs in relation to the effective date. The ASB noted:
- although the revisions to its original proposals should ease the transition an 18 month period between the publication of the final standard and effective date should be retained as there are significant changes to the accounting requirements for financial instruments;
  - the IASB's decision to revise the effective date of IFRS 9 'Financial Instruments' to 2015. The ASB noted that entities that apply current FRS without FRS 26, who wished to move to the proposed reduced disclosure framework would not be able to apply IFRS 9 until it was adopted by the EU. Consequently such entities would need to apply IAS 39 'Financial Instruments: Recognition and Measurement' for an interim period. The costs associated with these changes were not justifiable;
  - the effective date needed to take into consideration the updating of the SORPs that is required.
- 12.3 The ASB decided based on the above that it should defer application and amended the proposed effective date to 1 January 2015.

- 12.4 The ASB also considered whether to permit early application. In considering early application the ASB noted that there was strong support for the reduced disclosure regime and respondents had requested early application be permitted. As regards FRED 48 the ASB noted that if unlimited early application is permitted this would allow entities that have not filed their financial statements in accordance with imposed deadlines to adopt the proposals in the draft FRS early. The ASB therefore decided it should permit early adoption only from the date on which the final standards were issued.

## APPENDIX TO SECTION I – DEVELOPMENT OF THE FINANCIAL REPORTING EXPOSURE DRAFT

### HISTORY OF PREVIOUS CONSULTATIONS

- A1 The ASB (and BIS under its previous names) has consulted on aspects of its strategy for UK accounting standards many times over a nine-year period. The current proposals reflect the evolution of its strategy taking into account feedback from respondents.
- A2 Lengthy and extensive consultation has determined the proposals set out in the revised FREDs.

**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 Policy Proposal on future of UK GAAP
2010	Request for responses to aid development of the Impact Assessment
2010	Financial Reporting Exposure Drafts 43 and 44
2011	Financial Reporting Exposure Draft 45

- A3 In 2004 the Discussion Paper contained two key elements underpinning the proposals: firstly that UK and Republic of Ireland (ROI) accounting standards should be based on IFRS and secondly that a phased approach to the introduction of the standards should be adopted.
- A4 The majority of respondents agreed with a framework based on IFRS, and although supportive overall, the response to the phased approach was mixed.
- A5 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 IFRSs, but recognised there was little case for being more prescriptive than IFRS.
- A6 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 standard on Business Combinations be adopted in the UK and ROI. These exposure drafts highlighted the complexity of a mixed set of UK accounting standards, with some based on IFRSs 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.

- A7 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 IFRS, and it noted that introducing them piecemeal created complications and anomalies within the body of current FRSs. This arose because IFRS-based standards were not an exact replacement for current FRSs and many consequential amendments were required to *fit* each replacement IFRS-based standard into the existing body of UK FRS.
- A8 The ASB agreed to continue with its convergence programme, but decided to re-examine how to achieve this.
- A9 The ASB published revised proposals to be discussed at the 2006 Public Meeting. By this time 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.
- A10 Those attending the public meeting supported the aim of basing UK and ROI accounting standards on IFRS and adapting them to ensure they were appropriate for the entities applying them.
- A11 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.
- A12 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.
- A13 The IASB published an 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.
- A14 Feedback on the IFRS for SMEs was largely positive: it would be suitable for the middle tier; it was international; it was compatible with IFRSs; 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.
- A15 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 would 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.
- A16 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 was subsequently incorporated into FRED 43 and is now set out in FRED 46.
- A17 The request for responses to aid development of the Impact Assessment 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.
- A18 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.
- A19 FRED 43 and 44 issued in October 2010 set out the draft suggested text for two new accounting standards that would replace the majority of extant Financial Reporting Standards (current FRS) in the UK and Republic of Ireland. The ASB issued a supplementary FRED addressing specific needs of public benefit entities (FRED 45) in March 2011.

#### **HOW HAVE THE PROPOSALS BEEN DEVELOPED?**

- A20 As set out above, the ASB has continued to consult regularly on the future of financial reporting in the UK & ROI. Over the consultations the ASB's thinking has evolved based on careful consideration of the feedback to each of its consultations. Whilst responses were sometimes mixed there has been agreement that:
- (a) current FRS, which are a mixture of Statements of Standard Accounting Practice (SSAP) issued by the Consultative Committee of Accounting Bodies, FRSs 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 principle; and
  - (b) whatever the solution, it should be based on IFRS and there should be different reporting tiers to ensure proportionality.
- A21 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 UK and Irish law will deliver financial statements that are suited to the needs of its primary users. The ASB has kept in close contact 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 UK 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 2006 are driven to a great extent by the European Accounting Directives, which are being revised.\*
- (d) The framework must be future-proofed, where possible. The ASB will continue to monitor the situation and retains sovereignty over UK accounting standards (subject to the law). Changes to the Accounting Directives may lead to further developments, for example the European Council and European Parliament decision to permit Member States an option to treat micro-entities as a separate category of Company and exempt them from certain accounting requirements.

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\* 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](http://ec.europa.eu/internal_market/accounting/sme_accounting/review_directives_en.htm)



**FEEDBACK STATEMENT  
ON THE DRAFT IMPACT ASSESSMENT**



**SECTION II: FEEDBACK STATEMENT – CONSULTATION STAGE  
IMPACT ASSESSMENT IN THE OCTOBER 2010 EXPOSURE DRAFT  
'THE FUTURE OF FINANCIAL REPORTING IN THE UK AND  
REPUBLIC OF IRELAND'**

**1 INTRODUCTION**

- 1.1 In October 2010 the Accounting Standards Board (ASB) of the Financial Reporting Council (FRC) issued a Financial Reporting Exposure Draft (FRED) 'The Future of Financial Reporting in the UK and Republic of Ireland'. The FRED was issued in two parts FRED 43 'Application of Financial Reporting Requirements' and FRED 44 'Financial Reporting Standard for Medium-sized Entities'. The FREDs were accompanied by explanatory material and a Consultation Stage Impact Assessment.
- 1.2 The ASB is now issuing draft Financial Reporting Standards setting out its revised proposals for financial reporting in the UK and Republic of Ireland. The draft FRSs are:
- FRED 46 'Application of Financial Reporting Requirements';
- FRED 47 'Reduced Disclosure Framework'; and
- FRED 48 'The Financial Reporting Standard applicable in the UK and Republic of Ireland'.
- 1.3 The purpose of this feedback statement is to:
- (a) Summarise the comments received in relation to the Consultation Stage Impact Assessment;
- (b) Explain how the comments received have been taken into account in drafting the Consultation Stage Impact Assessment accompanying FREDs 46, 47 and 48.

**2 COMMENTS RECEIVED**

- 2.1 The ASB received 293 comment letters from the following stakeholder groups:

<b>Category</b>	<b>No. of responses</b>
Preparer	213
Accountants	20
Accounting bodies	14
Preparer representative bodies	25
User representative bodies	6
Academics	1
Regulators & Government bodies	10
Individuals	4
<b>Total</b>	<b>293</b>

- 2.2 The comment letters, other than any specifically requesting confidentiality, have been placed on the public record on the ASB's website.
- 2.3 Not all respondents commented on every aspect of the FRED, including the Consultation Stage Impact Assessment. In addition, the ASB received a substantial number of responses from two particular groups of preparers, Registered Providers of Social Housing and Financial Institutions not currently reporting under EU-adopted IFRS (notably building societies and credit unions, in the context of the impact assessment). These two groups were treated separately for the purposes of analysing the comments received in order that the main points from other respondents are not obscured.
- 2.4 The ASB concluded, on the basis of the responses to the FREDs as a whole (including the Consultation Stage Impact Assessment), that there was sufficient evidence for its proposals for it to proceed with updating financial reporting in the UK and Republic of Ireland, although its proposals would require further development in some areas.
- 2.5 The FRED posed five questions relevant to the Consultation Stage Impact Assessment. A summary of the responses to those questions is set out below.

### 3 FEEDBACK FROM GENERAL RESPONDENTS AND ASB'S RESPONSE

*The views of Registered Providers of Social Housing and Financial institutions not currently reporting in accordance with EU-adopted IFRS are summarised by sector. Their views are summarised in paragraph 4.1 to 5.12 below. The following analysis therefore excludes their comments, and the ASB notes that fewer than half of these respondents commented on the Consultation Stage Impact Assessment.*

#### ***Benefits of the proposed financial reporting framework***

Question 16

Do you agree with the benefits that have been identified as arising after adoption of the proposed UK 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.

Table 1: Agreement with identified benefits

	<b>Percentage</b>
Agreed	27%
Disagreed	13%
Did not comment	56%
Other	4%

*Comments:*

- 3.1 A number of respondents generally agreed with the benefits that were identified, and considered that it could result in a standard that was simpler and easier to apply than current UK FRSSs, and as such should reduce compliance and training costs.
- 3.2 Most of those disagreeing with the benefits felt they were overstated (for example because of limitations imposed by current legal requirements, or entities continuing to use the FRSSE), or unlikely to be realised in practice.

*ASB response:*

- 3.3 The ASB agrees that quantification of the benefits is challenging. In revising its proposals in FREDs 46, 47 and 48, the ASB has been conscious of the impact on the costs and benefits of the changes it is now proposing. It believes that the draft FRS 102 will provide a succinct financial reporting standard for UK and Republic of Ireland entities, in particular delivering improvements in the accounting and reporting for financial instruments, and that the draft Reduced Disclosure Framework will provide cost benefits to qualifying entities, without a loss of information for users.
- 3.4 During the consultation period the ASB undertook a programme of activities designed to elicit the views of users of small and medium-sized entities financial statements. As explained in paragraph 2.4 of the Development Section of this FRED lenders (including banks and other providers of finance) noted that financial statements are an important part of their decision-making process when considering providing finance and whilst a decision to provide finance is not based on financial statements alone they provided useful information and verification to the lender. The ASB continues to believe, based on this evidence, that the proposals for financial instruments improve transparency and will provide greater benefit to users of financial statements.
- 3.5 The ASB believes its proposals in FRED 48 will, in addition to delivering improvements in transparency of accounting and reporting for financial instruments, facilitate better understanding of accounting requirements and therefore enable them to be applied more easily and cost-effectively.
- 3.6 The ASB agrees that it is unfortunate that in some cases it has had to tailor its proposals to fit within existing company law requirements. However, where possible it has aligned its proposals with EU-adopted IFRS, and specifically the introduction of greater accounting policy choice, consistent with EU-adopted IFRS, brings the draft FRS 102 closer to EU-adopted IFRS reducing costs for those entities that switch between Companies Act accounts and IAS accounts.
- 3.7 Overall the ASB continues to believe that its proposals will deliver benefits for UK and Republic of Ireland entities.

***Case study scenarios identifying nature and range of costs***

Question 17

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.

Table 2: Nature and range of costs

	<b>Percentage</b>
Agreed	5%
Disagreed	33%
Did not comment	62%

*Comments:*

- 3.8 Although there was very limited support for the estimate of the costs that had been identified in the draft Impact Assessment, few alternatives were suggested and a number of respondents did agree with the nature of the costs. Grant Thornton (CL151) said:

“We broadly agree with the nature and range of the costs identified in the case study scenarios.  
...

We consider that it is very difficult, if not impossible, to make any reliable estimate of the costs likely to be incurred. Each variable has a wide range of possible values, therefore whatever methodology or approach is used, the result will never provide more than a rough indication of the magnitude of costs.

However, we consider that there are some additional costs which will be incurred by the accounting profession and which have not been taken into account. These include the incremental costs for training all accounting professionals (except those who only have clients which use the FRSSE) in the new UK GAAP framework.”

*ASB response:*

- 3.9 The use of the case study scenarios to illustrate the possible impact on entities of applying the ASB’s proposals was well received as a concept and clearly illustrated the nature of the costs involved. The problem is, as many respondents noted, accurately identifying the range of those costs. The difficulty in estimating the range of costs is a function of the size and scope of the project. Unlike a project to amend a specific accounting standard, which perhaps impacts on a specific group of entities, or accounting for a specific type of transaction, this project is much broader and the impact on an individual entity could be quite varied.
- 3.10 The ASB in its Consultation Stage Impact Assessment has continued with, and refined, the case studies, but has decided against providing a possible range of costs because the range is so wide it is unlikely to be useful to individual entities. This includes the addition of further scenarios, as well as updating the nature of the changes to reflect the proposals in the draft FRSs 100 to 102.
- 3.11 The ASB notes that its Reduced Disclosure Framework continues to offer cost savings to entities, which have been increased from those originally proposed by extending the scope of qualifying entities to include parent entities and entities that were previously deemed to have public accountability\*.
- 3.12 The ASB further notes that the draft FRS 102, is a more concise, clear and understandable standard than current FRSs and believes that this has the potential to reduce costs for all preparers of financial statements through better understanding of the requirements and therefore the ability to apply them more easily and cost-effectively.
- 3.13 Other than from Registered Providers of Social Housing and Financial institutions not currently reporting in accordance with EU-adopted IFRS (see below) the ASB received little specific feedback on the costs that might be incurred, and these proposals significantly reduce the implications for these entities. However, as explained in the Consultation Stage Impact Assessment, ‘do nothing’ is not a realistic option for the Future of Financial Reporting and there will be some costs for entities whatever the form of the ASB’s proposals.

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\* For financial institutions qualifying for the Reduced Disclosure Framework there are some restrictions to the disclosure exemptions available, reflecting the nature of their business and users’ information needs.

***Impact on the ‘main affected groups’***

Question 18

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?

Table 3: Entities affected by the proposals

	<b>Percentage</b>
Agreed	8%
Disagreed	18%
Did not comment	74%

*Comments:*

- 3.14 In addition to Registered Providers of Social Housing, those disagreeing identified additional ‘main affected groups’ that in their view warranted a separate mention in the impact assessment, such as public benefit entities, small listed and PLUS-quoted companies, unincorporated entities, publicly accountable insurance subsidiaries and accounting firms. A number of these entities are those that, under the proposals, would have had to apply EU-adopted IFRS, and support for the ASB’s proposals did not extend to this aspect of the proposals, which was effectively extending the requirements of the IAS Regulation.
- 3.15 Some of the respondents disagreed because they felt the impact on a particular group was underestimated, such as pension schemes and credit unions.

*ASB response:*

- 3.16 The ASB has updated its case study scenarios, with the addition of further affected groups.
- 3.17 Further, in revising its proposals the ASB has decided not to extend the application of EU-adopted IFRS beyond those entities required to apply it by company law. As a result those entities that would previously have been required to apply EU-adopted IFRS will apply the draft FRS 102.
- 3.18 The most significant change in accounting requirements between current UK accounting standards and the draft FRS 102 relates to improvements in accounting for and reporting of financial instruments. The case study scenarios consider the impact of these proposals on a variety of different entities.

**Balance of costs and benefits**

## Question 19

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?

Table 4: Do the benefits outweigh the costs?

	<b>Percentage</b>
Agreed	23%
Disagreed	10%
Did not comment	60%
Other	7%

*Comments:*

- 3.19 A majority of those responding agreed that the benefits of the proposals do outweigh the costs. This is summed up, for example, by Kingston Smith (CL3):

“In the long run we would agree that the benefits of transition are likely to outweigh the costs and as stated previously we do believe that transition to an IFRS based financial reporting framework is the right thing to do given that UK GAAP is no longer being properly maintained. ... however, we believe that the costs of transition have been significantly underestimated although they are in the nature of a ‘one-off’ event.”

- 3.20 Those disagreeing believe the costs outweigh the benefits (which are hard to quantify and will not necessarily accrue directly to each individual reporting entity), and those with other comments mainly centre on ensuring that costs are minimised.

*ASB response:*

- 3.21 The ASB also wishes to ensure the costs associated with transition to the new draft FRSs 100 to 102 are minimised and believes that many of the costs are one-off in nature. The ASB is pleased that respondents agreed that overall the benefits of the proposals outweigh the costs, and has proceeded with the project on that basis. With the revised proposals in the draft FRSs 100 to 102 the ASB believes it has further improved the cost/benefit balance of its proposals.
- 3.22 In particular the ASB, in response to the comments received, has included a number of accounting policy options in the draft FRS 102 and provided a number of transitional provisions, which will limit the circumstances in which retrospective application of new accounting policies will be required. These provisions are both expected to reduce the costs of transition for entities.
- 3.23 The ASB also notes that the effective date of the draft FRS 102 is now 1 January 2015, some 18 months later than that proposed in FREDs 43 and 44. This will allow entities time to prepare for the implementation of the new standards and give them some choice within the period before mandatory application of the standards to phase the work (and costs) as is most convenient to them.

Question 21

Please provide any other comments you may have on the draft Impact Assessment.

Table 21: Other comments on the draft impact assessment

	<b>Percentage</b>
Commented	15%
Did not comment	85%

*Other comments on the Consultation Stage Impact Assessment*

- 3.24 The other comments made could often have been relevant to one of the preceding questions often relating to identifying the impact on other affected groups. The ASB has had regard to these comments in the further development of its proposals and the Consultation Stage Impact Assessment.

**4 FEEDBACK FROM FINANCIAL INSTITUTIONS NOT CURRENTLY REPORTING UNDER EU-ADOPTED IFRS**

- 4.1 FRED 43 proposed that entities applied EU-adopted IFRS if they were publicly accountable. An entity that took deposits from a broad group of outsiders was within this definition, and consequently many financial institutions would be required to apply EU-adopted IFRS.
- 4.2 In reviewing the feedback from respondents and reconsidering its proposals, in response to concerns about the costs and benefits of this aspect, the ASB has decided not to extend the requirements of the IAS Regulation regarding those reporting entities that are required to apply EU-adopted IFRS. Therefore the proposals in the draft FRSs 100 to 102 are significantly different to those on which respondents comments were based.

*Building societies*

- 4.3 The Building Societies Association (BSA) responded (CL44) representing the sector, in addition to individual responses from a number of building societies.
- 4.4 The BSA did not agree with the benefits identified in the draft Consultation Stage Impact Assessment to FREDS 43 and 44:

“We see limited benefits to users to adopting the proposed financial reporting framework. ... building society users are generally speaking ordinary members of the public whose interest in their society focuses on access to, and security of, funds. They do not care on which basis the accounts have been prepared, only that they show a true and fair view.”

- 4.5 Further, the BSA did not agree with the assessment of the costs that might be incurred by a building society in applying EU-adopted IFRS:

“The ASB puts implementation costs for a building society at £54,980. It does acknowledge that they are ‘likely to be more than minimal for financial institutions that have not previously recognised various financial instruments in their financial statements’. It also adds there may be extra costs in terms of audit effort. We think that the estimate is too low, omits substantial indirect costs and ignores ongoing costs.”

- 4.6 In weighing up the benefits and the costs BSA says:

“We agree in general with the analysis. Where we diverge is the scale of the impact.”

*ASB response:*

- 4.7 The ASB has revised its proposals for financial institutions that are not currently reporting under EU-adopted IFRS. It has decided not to extend the use of EU-adopted IFRS beyond those entities required to apply EU-adopted IFRS by the IAS Regulation. As a result FRED 46 proposes that financial institutions that are not currently reporting under EU-adopted IFRS should apply the draft FRS 102 set out in FRED 48. This will enable these financial institutions to apply the succinct requirements of the draft FRS 102, plus additional principles based disclosure requirements suitable for financial institutions. The ASB believes additional disclosures are necessary for financial institutions within the scope of the draft FRS 102 because financial instruments are central to the business model of financial institutions and there has been increased emphasis on risk disclosures for those entities following the financial crisis.
- 4.8 The additional disclosures are designed to provide users, including depositors, with information about the key risks arising from the financial instruments held by these financial institutions and based on principles, allowing preparers greater flexibility in how they provide the disclosures. The extent of disclosure made by an individual financial institution will depend on the complexity of the transactions it undertakes. However, the disclosures are not expected to be as extensive as those that would have been required by IFRS 7, if EU-adopted IFRS had been applied. As a result the ASB believes it has balanced the information needs of users with the costs of preparing the financial statements. The ASB notes that its proposals aim to improve the financial reporting for financial instruments by all entities, including financial institutions not currently reporting under EU-adopted IFRS, or currently applying FRS 26 (IAS 39) ‘Financial instruments: Recognition and measurement’ and FRS 29 (IFRS 7) ‘Financial instruments: Disclosure’. The ASB recognises that currently entities are not required to recognise all financial instruments, and may provide more limited disclosures, and as such there will be costs associated with the adoption of the draft FRSs 100 to 102.

#### ***Credit unions***

- 4.9 The Association of British Credit Unions Limited (ABCUL) responded (CL116) on behalf of its members. A template response was also received from members of ABCUL.
- 4.10 The key point made by, and on behalf of the credit unions, is that the expected cost of applying the proposals are estimated to be in the order of between £6.0 and £7.5 million for the entire sector (over 450 credit unions in England, Scotland and Wales).
- 4.11 In addition, ABCUL expands on its views regarding benefits:

“... we foresee no material benefit to their primary users, the credit union sector’s membership. In fact, it is likely that the accounts produced under IFRS will be more difficult for lay-members to understand and, therefore, less transparent than at present. Furthermore, we have been informed by the Financial Services Authority that they see no benefit in the extra disclosures under IFRS as they obtain their information primarily from a standardised return designed to provide information relating specifically to their prudential regulatory rules.”

*ASB response:*

- 4.12 The proposals in FRED 43 recognised that many credit unions are smaller entities and proposed that, subject to meeting certain criteria, those smaller prudentially regulated entities could apply the requirements set out in FRED 44, rather than EU-adopted IFRS. The ASB’s current proposals extend this, as no entities will now be required to apply EU-adopted IFRS unless required to do so by the IAS Regulation. As a result FRED 46 proposes that financial institutions that are not currently reporting under EU-adopted IFRS should apply the draft

FRS 102. This will enable these financial institutions to apply the succinct requirements of the draft FRS 102, plus additional principles based disclosure requirements suitable for financial institutions. The ASB believes additional disclosures are necessary for financial institutions within the scope of the draft FRS 102 because financial instruments are central to the business model of financial institutions and there has been increased emphasis on risk disclosures for those entities following the financial crisis.

- 4.13 The additional disclosures are designed to provide users, including members, with information about the key risks arising from the financial instruments held by these financial institutions. The extent of disclosure made by an individual financial institution will depend on its size and complexity of the transactions it undertakes. As very many credit unions are smaller entities with only basic financial instruments, although the ASB notes that its proposals are intended to improve the financial reporting for financial instruments by all entities, the extent of change is likely to be limited. In addition, the ASB intends to publish educational material for credit unions that will promote consistency between credit unions and reduce the costs of transition.
- 4.14 As a result the ASB believes it has balanced the information needs of users with the costs of preparing the financial statements.

## 5 FEEDBACK FROM REGISTERED PROVIDERS OF SOCIAL HOUSING

- 5.1 Responses were received from over 120 housing associations, plus the National Housing Federation (CL97), the Social Housing Regulator (CL184), the Scottish Housing Regulator (CL192) and the G15 group of housing associations (CL262). The proposals set out in FRED 43 would have required those Registered Providers of Social Housing that have listed debt to apply EU-adopted IFRS (approximately 10 at present, although a number of respondents commented that this number may increase in the future), whilst the remainder would have applied the proposals in FRED 44.

- 5.2 The responses considered the proposals to involve excessive costs.

- 5.3 The NHF disagrees with the benefits identified in the draft Consultation Stage Impact Assessment to FREDs 43 and 44:

“We do not agree with the benefits identified for the following reasons:

- (a) Housing associations currently typically source their own funding from the UK. Where funding has been sourced from foreign markets the fact that the housing association has accounted under UK GAAP has not been a barrier;
- (b) The accounting implications of FRSME, particularly the non-capitalisation of interest, are likely to lead to some loan covenant breaches. In some of these cases the housing association will be able to mitigate the covenant breach through renegotiating with its lenders. This gives rise to a clear risk of re-pricing. Accounting for financial instruments will also introduce huge volatility to the sector’s financial statements and this is likely to lead to a rise in the cost of funding.”
- 5.4 The NHF “... believe[s] the range of costs to be much higher both to implement the changes required and then on an ongoing basis.” It has estimated the transition costs to be approximately £500,000 for a large housing association and approximately £120,000 for a smaller housing association.
- 5.5 Registered Providers of Social Housing also noted that if, as a result of changing their accounting policies, they were required to renegotiate with their lenders, they would be likely to incur increased loan interest costs, that are not reflected in the above estimates. The NHF notes that an increase in lending margins of 1% would cost the sector £600 million annually.

- 5.6 The NHF acknowledges that there may be some benefits, but that these are not outweighed by the costs for housing associations:

“We accept that the benefits are hard to identify and are supportive of the ASBs overall aim to converge with International Accounting Standards. However it is important that this convergence is achieved whilst minimising costs. We can see that there will be some long term benefits in that both users and preparers of financial statements will be trained to apply the new financial reporting framework, however, we do not see any immediate benefits to the housing sector and these will certainly be significantly less than the incremental costs.”

*ASB response:*

- 5.7 The ASB has made a number of revisions to its proposals that will change the likely impact on Registered Providers of Social Housing. In particular:
- (a) As the application of EU-adopted IFRS will not be extended beyond those required to apply EU-adopted IFRS by the IAS Regulation, there will not be inconsistency in financial reporting within the sector (unless Registered Providers of Social Housing voluntarily chose to apply EU-adopted IFRS).
  - (b) Accounting policy options have been introduced into the draft FRS 102 that are available in current FRSSs, reducing the likelihood that Registered Providers of Social Housing will need to change accounting policies on its application.
- 5.8 The ASB believes these changes to its proposals will eliminate almost half of the costs of transition estimated by the NHF (loan renegotiation costs of £225,000 for a large association and £56,250 for a smaller one). In addition, the ASB notes that the estimates of the costs for Registered Providers of Social Housing appear higher than other sectors were forecasting. It was suggested that a change in accounting policy would trigger Registered Providers of Social Housing to require renegotiation of their borrowings, as a result of contractual provisions. The ASB notes that it has consistently said, since 2002, that it intended to amend UK FRSSs; a factor that could have been taken into account where relevant in the intervening time.
- 5.9 The ASB has included Registered Providers of Social Housing as one of the ‘main affected groups’ in the Consultation Stage Impact Assessment.
- 5.10 The ASB believes it has balanced the information needs of users with the costs of preparing the financial statements, however the ASB notes that its proposals are intended to improve the financial reporting for financial instruments by all entities not currently applying FRS 26 (IAS 39) ‘Financial instruments: Recognition and measurement’ and FRS 29 (IFRS 7) ‘Financial instruments: Disclosure’ and as such there will be costs associated with the adoption of the draft FRSSs 100 to 102. For a basic financial instrument there is unlikely to be significant change in accounting or reporting, but the proposals will require recognition of non-basic financial instruments (such as interest rate swaps) and provide greater transparency over risk management policies relating to financial instruments.
- 5.11 As at 31 March 2010 it was estimated that there was in excess of £42 billion\* of borrowing by Registered Providers of Social Housing; the proposals will enable this to be accounted for based on up-to-date accounting thinking.
- 5.12 In addition the draft FRS 102 will require Registered Providers of Social Housing to review their accounting for grants. The outcome of the changes is largely expected to be improved presentation of the effects on the business of receiving grants and will bring this into line with company law requirements that grants must not be netted off the cost of the assets acquired.

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\* 2010 global accounts of housing providers published by the Tenant Services Authority.

## **REVISED DRAFT IMPACT ASSESSMENT**



## **SECTION III: [REVISED DRAFT] IMPACT ASSESSMENT**

### **[Draft] Financial Reporting Standard 100: Application of Financial Reporting Requirements**

### **[Draft] Financial Reporting Standard 101: Reduced Disclosure Framework**

### **[Draft] Financial Reporting Standard 102: The Financial Reporting Standard Applicable in the United Kingdom and the Republic of Ireland**

#### **1 INTRODUCTION**

- 1.1 As published in its Regulatory Strategy,<sup>\*</sup> the FRC is committed to a proportionate approach to the use of its powers, making effective use of impact assessments and having regard to the impact of regulation on small enterprises.
- 1.2 The FRC follows three guiding principles in producing impact assessments:
  - The work that goes into the production of an impact assessment should be proportionate to the importance of the proposal that it covers.
  - Where a standard is being introduced as a direct response to legislation or regulation, or as part of an agreed policy commitment to adopt international standards of accounting or auditing, the impact assessment should explain the rationale for introducing the standard and should focus on any aspects of the proposed standard which augment the relevant legislation or augment or diverge from the relevant international standard.
  - Where appropriate, we are particularly alert to the impact of proposals on small businesses.

#### **2 BACKGROUND TO THE IMPACT ASSESSMENT**

- 2.1 The ASB is proposing FREDs 46 to 48 as part of a fully consulted process to move current Financial Reporting Standards (current FRS) towards a framework based on IFRS. The FRC guiding principles require the impact assessment to explain the rationale for introducing the FRSs (4 below) and focus on aspects of the proposed FRSs that augment relevant legislation or augment or diverge from the relevant framework (5 below). Small businesses are unaffected by these proposals; there are no changes<sup>†</sup> to the FRSSE that may be applied by entities eligible for the small companies' regime.
- 2.2 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 and ROI.
- 2.3 As a result there are three main components to the [draft] impact assessment:
  - (a) rationale for introducing the [draft] FRSs, including problem definition;
  - (b) aspects of the [draft] FRSs that augment relevant legislation or augment or diverge from the relevant IFRS; and
  - (c) evidence of costs and benefits of the proposals.

<sup>\*</sup> [www.frc.org.uk/documents/pagemanager/frc/Draft\\_plan\\_200910\\_December\\_2008/Our%20approach%20to%20setting%20our%20priorities%20final.pdf](http://www.frc.org.uk/documents/pagemanager/frc/Draft_plan_200910_December_2008/Our%20approach%20to%20setting%20our%20priorities%20final.pdf)

<sup>†</sup> There are minor consequential amendments to the FRSSE as a result of the proposed withdrawal of current UK FRS. These are designed so as not to affect the accounting by small entities for transactions they currently undertake.

### 3 EXECUTIVE SUMMARY

#### *Why intervention is necessary*

- 3.1 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.

#### *Options considered*

- 3.2 The ASB's proposals have evolved and been consulted on over a number of years; each time the ASB reconsidering and adapting its proposals taking into account the feedback received. It believes, and respondents broadly agree, that current FRSs 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.
- 3.3 Accepting a need for revision of UK accounting standards, there are two main routes to achieving this: an IFRS-based framework, which is the option pursued, or the maintenance and updating of UK accounting standards that are not based on IFRS. Appendix One provides more details of the alternative options considered.

#### *Overall assessment*

- 3.4 Overall the ASB believes that the introduction of its [draft] FRS 101 'Reduced Disclosure Framework' and [draft] FRS 102 'The Financial Reporting Standard Applicable in the UK and Republic of Ireland', both based on EU-adopted IFRS, will have a positive impact on financial reporting.
- 3.5 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. There will also be cost savings for those entities applying the [draft] reduced disclosure framework.
- 3.6 In the ASB's view, the benefits of more consistent, transparent information for decision-making (and the possible reduced risk of business failure) outweigh the transition costs of implementing the [draft] FRSs 100 to 102.

### 4 RATIONALE FOR INTRODUCING THE [DRAFT] STANDARDS

#### *The problem under consideration*

- 4.1 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:

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

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

### 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 and medium-sized 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.

- 4.2 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 providing a framework for the preparation and presentation of financial statements, which directors refer to when preparing financial statements.
- 4.3 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'). Entities in the UK and ROI operating under other legal frameworks that require the preparation of financial statements showing a true and fair view of the entities' financial performance and financial position also apply UK accounting standards; they may not be prohibited from applying EU-adopted IFRS if they chose to.
- 4.4 These proposals do not relate to financial statements required by the Regulation to apply EU-adopted IFRS.

#### ***The present need to revise UK accounting standards***

- 4.5 Accounting standards evolve over time to ensure that an entity'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 the phased approach to an IFRS-based framework that it began in 2003 is that UK accounting standards have not evolved sufficiently in the last decade, in particular with regard to accounting for financial instruments by entities without listed debt or equity.
- 4.6 In the ASB's view, based on evidence from previous consultations, current FRSs are not tenable in the longer term:
- (a) They are an incoherent mixture of standards developed 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.

- 4.7 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), current FRSs 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) Inconsistencies can arise between standards based on IFRS and those that are 'old' 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.
  - (c) 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. This can have a detrimental impact on intellectual mobility and training needs and associated costs, and create a disconnect for some accountancy students between their professional studies and their practical experience.
  - (d) It is not easy to compare the financial position and performance of large private companies with quoted or foreign competitors. As a result of UK accounting standards and IFRS not being derived from the same framework, the barriers to switching\* between the two are greater than need be.
- 4.8 The ASB believes these issues will be addressed by the adoption of a suite of UK accounting solutions based on IFRS. The ASB also identified the issue of the IFRS for SMEs by the IASB in 2009 as a potential opportunity to simplify UK accounting standards now that the very largest entities are no longer applying them.

***The objectives and intended effects***

- 4.9 The overriding objectives and intended effects are:

Overriding objective

To enable users of accounts to receive high-quality understandable financial reporting proportionate to the size and complexity of the entity and the users' information needs.

- 4.10 The ASB will achieve this by providing succinct financial reporting standards that:
- (a) have consistency with global accounting standards through the application of an IFRS-based solution unless an alternative clearly better meets the overriding objective;
  - (b) reflect up-to-date thinking and developments in the way businesses operate and the transactions they undertake;
  - (c) balance consistent principles for accounting by all UK and Republic of Ireland entities with pragmatic solutions, based on size, complexity, public interest and users' information needs;
  - (d) promote efficiency within groups; and
  - (e) are cost-effective to apply.

\* BIS proposes to reduce the legal barriers to switching between IAS accounts and Companies Act accounts in its 'Consultation on Audit Exemptions and Change of Accounting Framework' published on 6 October 2011.

***The key proposals***

- 4.11 There are two key components to the ASB's proposals:
- (a) The [draft] FRS 101, which provides a reduced disclosure framework for qualifying entities; in particular allows subsidiaries of groups preparing consolidated financial statements in accordance with EU-adopted IFRS to apply accounting policies consistent with the group accounts, but to take advantage of disclosure exemptions to reduce the cost of preparing financial statements.
  - (b) The [draft] FRS 102, which updates UK accounting standards for recent developments, adopts an IFRS-based framework with proportionate disclosure requirements and improves the accounting and reporting for financial instruments.

**5 ASPECTS OF THE [DRAFT] STANDARDS THAT AUGMENT RELEVANT LEGISLATION OR AUGMENT OR DIVERGE FROM THE RELEVANT IFRS*****Aspects that augment relevant legislation***

- 5.1 The proposals do not augment relevant legislation.

***Aspects that augment or diverge from the relevant IFRS****The [draft] FRS 101 'Reduced Disclosure Framework'*

- 5.2 The [draft] reduced disclosure framework permits qualifying entities to apply accounting policies that are consistent with EU-adopted IFRS, but allows exemption from certain disclosure requirements of EU-adopted IFRS. As a result it diverges from IFRS by permitting reduced disclosures.
- 5.3 This has been proposed to promote efficiency within groups, and takes into account the often limited use for subsidiary entity financial statements, or the individual financial statements of the parent entity when presented with consolidated accounts.

*The [draft] FRS 102 'The FRS Applicable in the UK and Republic of Ireland'*

- 5.4 The ASB used the IFRS for SMEs as a starting point in developing the [draft] FRS 102 for use in the UK and Republic of Ireland, but made amendments to result in a standard that is suitable for business practices and information needs in the UK and Republic of Ireland. In making amendments the ASB incorporated aspects of EU-adopted IFRS wherever possible so that the [draft] FRS 102 as a whole is an IFRS-based standard.
- 5.5 Nevertheless the ASB identified certain circumstances in which consistency with IFRS might not be appropriate or achievable. These include amendments essential for compliance with the law or areas where an alternative approach clearly better meets the ASB's overriding objective of high-quality understandable financial reporting proportionate to the size and complexity of the entity and users' information needs.

*Compliance with EU Accounting Directives*

- 5.6 Divergence from an IFRS-based solution (generally the IFRS for SMEs) to ensure companies reporting in accordance with the [draft] FRS 102 comply with the law fall into two categories. Firstly amendments to ensure that the [draft] FRS 102 is not incompatible with the company law, and secondly amendments to restrict the ability of reporting entities to choose options that are compatible with company law. The ASB considers these amendments essential.

*Income Tax*

- 6.7 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. Initially the ASB proposed replacing the Income Tax section of the IFRS for SMEs with IAS 12, however, respondents felt this was over-complicated for the entities within the scope of the [draft] FRS 102. As a result the ASB has developed its own solution, although it is still based on the principles of IAS 12.

**6 EVIDENCE***Cost of proposals**Business as usual*

- 6.1 In order to consider the incremental costs of the ASB’s proposals, it is necessary first to consider what constitutes ‘business as usual’ for preparers and their advisers.
- 6.2 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.
- 6.3 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.
- 6.4 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.
- 6.5 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.

*Costs*

- 6.6 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 companies that do not undertake complex transactions will incur minimal costs.
- 6.7 For groups, there will be cost savings as a result of the reduced disclosure framework.
- 6.8 The most significant costs of applying the proposed framework are likely to be incurred by entities that have a significant number of complex transactions (particularly financial instruments), but had previously applied neither EU-adopted IFRS, nor FRS 26.
- 6.9 The ASB believes the [draft] FRSs are a cost-effective solution for financial reporting in the UK and Republic of Ireland. The cost to any individual entity, or group, of applying the proposals will depend on a variety of factors, such as:

- (a) the current financial reporting applied (i.e. EU-adopted IFRS, UK accounting standards, FRSSE);
  - (b) whether the entity is a financial institution;
  - (c) its size; and
  - (d) the volume and complexity of its transactions.
- 6.10 As a result it is not possible to determine with any accuracy an average cost or even a meaningful range for entities implementing the proposal. In its previous Consultation Stage Impact Assessment, for FREDs 43 and 44, the ASB estimated the cost of implementing the proposals at approximately £80 million. Other than from Registered Providers of Social Housing and Financial institutions not currently reporting in accordance with EU-adopted IFRS (see below) the ASB received little specific feedback on the costs that might be incurred, and these proposals significantly reduce the implications for these entities. The ASB believes the revisions to its proposals will reduce the overall costs of implementation. In addition to the specific feedback from Registered Providers of Social Housing and Financial institutions not currently reporting in accordance with EU-adopted IFRS, other respondents felt the costs might be overstated, but the changes to the proposals should have reduced the costs of implementation, therefore taken together the ASB continues to believe the costs of implementing its proposals will be approximately £80 million. Those entities applying [draft] FRS 101 should see a reduction in the costs and the [draft] FRS 102, as a more concise, clear and understandable standard than current FRSs has the potential to reduce costs for all preparers of financial statements through better understanding of the requirements and therefore the ability to apply them more easily and cost-effectively. Therefore over time the ASB believes the costs of implementation will be recovered.
- 6.11 Set out in Appendix Two are a number of case studies, representing typical scenarios of requirements before and after the proposed changes. The majority of the costs identified are one-off and will be incurred in the year of transition.
- 6.12 In addition to the case study scenarios, other entities may be applying current FRS and in future the [draft] FRS 102. Although they may take a different legal form to those in the case study scenarios, the case studies illustrate the most significant changes that might arise on application of the [draft] FRSs 101 and 102 and therefore other entities should be able to draw an analogy with one of the case study scenarios.

### ***Benefits of proposals***

#### *The [draft] FRS 101 'Reduced Disclosure Framework'*

- 6.13 The [draft] reduced disclosure framework allows group entities to take advantage of disclosure exemptions in their individual accounts. In particular it allows entities within listed groups to apply the recognition and measurement requirements of EU-adopted IFRS, giving consistency within groups, whilst reducing disclosure requirements and therefore costs of preparing accounts.
- 6.14 At present where entities within listed groups prepare individual accounts in accordance with UK accounting standards they must also prepare financial information for group consolidation purposes that is consistent with EU-adopted IFRS. The [draft] reduced disclosure framework will eliminate the need to prepare financial information on two different accounting bases (albeit that there is a degree of commonality). Feedback from listed groups supported the introduction of the [draft] reduced disclosure framework, highlighting the benefits of consistent reporting across the group, and noting that the cost of producing full EU-adopted IFRS disclosure for individual group entities would be disproportionate to the use made of subsidiary financial statements, which often have few users that are external to the group.

- 6.15 For those groups that have chosen to prepare individual accounts in accordance with EU-adopted IFRS, the [draft] reduced disclosure framework offers a cost saving.
- 6.16 For those groups that have chosen to prepare individual accounts in accordance with the [draft] FRS 101 the [draft] reduced disclosure framework set out in that [draft] FRS allows efficiencies in applying a single set of recognition and measurement criteria to all financial reporting.
- 6.17 The ASB believes that the [draft] reduced disclosure framework provides proportionate disclosures for group entities, and generates opportunities for cost savings, particularly for those entities required to prepare accounts in accordance with EU-adopted IFRS.

*The [draft] FRS 102 'The FRS Applicable in the UK and Republic of Ireland'*

- 6.18 The [draft] FRS 102 brings an IFRS-based framework to all UK entities other than those adopting the FRSSE and incorporates relevant legal requirements. The [draft] FRS 102 is a proportional solution, in particular in using a principles-based approach to certain disclosure requirements, requiring information that enables users to evaluate the significance of transactions without mandatory prescriptive detail. The [draft] FRS 102 will improve accounting for and reporting of financial instruments.
- 6.19 The [draft] FRS 102 will ease the reporting burden for entities applying it because:
- (a) UK accounting standards (and associated literature) currently run to more than 2,400 pages. Virtually all of these requirements will be withdrawn and replaced with the [draft] FRS 102 which is set out in less than 250 pages providing a succinct framework. 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 IASB intends to update the IFRS for SMEs approximately every three years. Subsequently, the ASB will consider whether to make corresponding changes to the [draft] FRS 102 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.
- 6.20 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. The adoption of a framework based on the EU-adopted IFRS will allow better benchmarking and comparison between all entities. The enhanced transparency may also lead to a reduction in the cost of borrowing because users have easy access to understandable, comparable information.

*High-quality financial reporting*

- 6.21 High-quality accounting standards deliver relevant, useful information, which informed users need for making investment decisions. They enhance comparability, transparency and disclosure. High-quality standards produce financial information that reports events when they occur (not before or after) and as a result actual volatility is not smoothed.
- 6.22 The [draft] FRSs 101 and 102 update current FRSs using an IFRS framework as its base. In doing so accounting standards have also been streamlined into a single succinct standard, using up-to-date accounting language consistent with that taught to accountancy students, and reflecting developments in the way businesses operate; in particular with significant improvements in the requirements relating to financial instruments.

- 6.23 Other than for those entities applying FRS 26 (IAS 39) ‘Financial instruments: Recognition and measurement’ accounting for financial instruments in the UK has not changed much in nearly 20 years\*. Yet during this time we have seen the development of financial instruments and greater appreciation of the risks that might be associated with complex financial instruments. When the ASB issued FRS 26, it intended its requirements would be extended to a broader group. Subsequently, it decided FRS 26 was not a proportionate solution for all entities, and further developments in this area were expected as part of any future convergence with EU-adopted IFRS. The ASB has now decided to issue the [draft] FRS 102, which brings in significant improvements in the transparency of accounting for and reporting of financial instruments by those entities not preparing IAS accounts, or applying FRS 26.
- 6.24 The ASB believes that its proposals significantly improve transparency relating to financial instruments. At present, other than for those entities applying FRS 26, many financial instruments are not recognised. This means that financial statements are not providing sufficient information about the risks. The [draft] FRS 102 requires an entity to determine which of its financial instruments are basic, and which are not basic. It then applies different measurement and disclosure requirements to financial instruments in each category. Basic financial instruments are generally measured initially at transaction price, and subsequently at amortised cost using the effective interest rate method; disclosure requirements are based on entities applying a principle of enabling users to evaluate the significance of financial instruments and will therefore depend on the instruments held by an entity.
- 6.25 Non-basic financial instruments will be measured at fair value. Much has been said about the extent to which the use of fair value, in aiming to reflect conditions existing at the reporting date, creates volatility in financial reporting. The ASB believes that [draft] FRS 102 is a proportionate solution for non-basic financial instruments in order for users to understand their effects, but this should not lead to artificial volatility.
- 6.26 The disclosure required by the [draft] FRS 102 for financial instruments should give lenders more information about borrowings, and the extent to which financial instruments are used in the business and contribute to risk management.

*Intellectual mobility, education and training*

- 6.27 In the UK, as part of their professional qualification, accountants are trained in IFRS. However, those not qualifying recently were trained in UK FRSs. This has led to two streams of accountants:
- (a) those who trained in UK FRSs and therefore 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, and therefore require additional training on UK FRSs.
- 6.28 Implementation of the ASB’s proposals 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 current FRSs, which will generate ongoing savings for their employers, or allow training budgets to be allocated to other development areas.
- 6.29 Those more familiar with current FRSs will need to become fluent in IFRS terminology, but this should be regarded as a part of ongoing CPD.

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\* FRS 4 ‘Capital instruments’ was issued in 1993.

- 6.30 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*

- 6.31 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 proposals 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.
- 6.32 For UK entities 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*

- 6.33 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.
- 6.34 Inevitably if entities report a different 'profit' figure after implementing the ASB's proposals than they would have if there had been no change to current FRSSs, 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.
- 6.35 Similarly distributable reserves are determined by reference to company law, which is supplemented by guidance from the ICAEW. This is not a matter for the ASB, although it should be noted that some of the early issues relating to dividend traps were resolved through amendments to IFRS. The ASB will encourage BIS to review the law in this area, when a suitable opportunity arises.

*Regulated industries – reporting to regulators*

- 6.36 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.
- 6.37 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**

- A1.1 Current FRSs are a mixture of ‘old’ FRSs 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.
- A1.2 This position is not sustainable; accounting standards need to keep pace with business developments, and incorporate the best of modern thinking on accounting.
- A1.3 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 quoted groups, through the [draft] FRS 101, reduced disclosure framework. These savings will not be realised unless the ASB proceeds with its proposals.
- A1.4 The ASB does not consider ‘do nothing’ a viable option. There are cost savings associated with the [draft] FRS 101 reduced disclosure framework, and FRSs (unless FRS 26 has been applied) require insufficient information on financial instruments. If the ASB were not making these proposals, based on IFRS, it would need to undertake a comprehensive review and update to FRSs, 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 FRSs.

**OPTION 2 – UK ACCOUNTING STANDARDS NOT BASED ON IFRS**

- A1.5 Throughout the ASB's consideration of its plans for the future of FRSs there has been majority support from respondents for the proposed move to an IFRS-based framework.
- A1.6 The advantage of maintaining FRSs not based on IFRS would be:
- (a) those already familiar with current FRSs would not need to become familiar with IFRS language;
  - (b) standards drafted within the UK legal framework.
- A1.7 The disadvantages of having FRSs not based on IFRS include:
- (a) greater difficulty for entities in switching between FRSs and EU-adopted IFRS, including reduced efficiency for groups in preparing 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 FRSs to remain uninfluenced by IFRS. An IFRS solution is available, accountants will be used to IFRS and inevitably the FRSs will be influenced by IFRS, such that it will implicitly become an IFRS-based framework; and
  - (d) additional standard-setting resources would be needed to develop and maintain FRSs to sit alongside EU-adopted IFRS for quoted groups, diverting resources away from the ASB's role in influencing the IASB.
- A1.8 This option was not supported by respondents and has not been pursued by the ASB.

### **OPTION 3 – UK ACCOUNTING STANDARDS BASED ON IFRS WITH MINIMAL AMENDMENTS**

A1.9 The majority of respondents have been continually supportive of the UK adopting accounting standards based on IFRS. In its October 2010 FREDs the ASB proposed a framework for financial reporting based on entities applying either EU-adopted IFRS or the FRMSE (which was the IFRS for SMEs with minimal amendments). Although respondents continued to support UK accounting standards being based on EU-adopted IFRS, a number of detailed aspects of the proposals were opposed. As a result the ASB has revised its proposals, tailoring the [draft] FRS 102 more to UK entities.

## APPENDIX TWO – CASE STUDY SCENARIOS

Scenario		Approximate Number of UK entities*
Company A	FRSSE	1,959,000
Company B	Medium, no complex transactions	10,000
Company C	Medium, some complexity	30,000
Company D.1 Company D.2	Large unquoted group	10,000 100
Company E.1 Company E.2	Quoted group (parent company) Subsidiaries applying EU-adopted IFRS	1,700 5,500
Entity F	Building Society	38 <sup>†</sup>
Entity G	Credit union	1,200 <sup>‡</sup>
Entity H	Registered Provider of Social Housing	1,500 <sup>§</sup>
Entity I	Charity	185,202 <sup>  </sup>
Entity J	Pension fund	9,406 <sup>¶</sup>

\* Data on companies has been taken from the BIS consultation 'Amendment of restrictions for companies moving between IFRS and UK GAAP' Impact Assessment, which in turn uses data from the FAME database. The split of the 50,000 companies applying UK FRSs between B, C and D.1 is an assumption.

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

‡ The Financial Services Authority regulates nearly 500 credit unions in the UK ([www.fsa.gov.uk/smallfirms/your\\_firm\\_type/credit/](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 ([www.creditunion.ie/whoweare/#d.en.127](http://www.creditunion.ie/whoweare/#d.en.127)).

§ Taken from National Housing Federation response to FREDs 43 and 44 (CL 97).

|| 161,840 charities registered in England and Wales (Charity Commission website 5 October 2011), 23,362 charities registered in Scotland (OSCR website 5 October 2011). The Charity Commission notes that 1.1% of the charities it regulates have turnover in excess of £5,000,000. Therefore it has been assumed that 99% of charities will apply the FRSSE and only 1% will apply the FRS.

¶ Based on data from the Pensions Regulator there are 8,099 schemes in the UK. [www.thepensionsregulator.gov.uk/docs/annual-report-and-accounts-2009-2010.pdf](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](http://www.pensionsboard.ie/en/Publications/Annual_Report/Annual_Report_and_Accounts_2009.pdf).

**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.

*Applicable accounting standards:* Company A will continue to apply the FRSSE.

*Costs of implementing the applicable accounting standards:* As there are only consequential changes to the requirements of the FRSSE, unless an entity enters into new transactions, there are unlikely to be additional 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.

**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 loans from a bank without complex terms and conditions.

Company B employs a small finance team, but takes advice from its auditors regarding the presentation of its financial statements.

*Applicable accounting standards:* Company B will apply the [draft] FRS 102. As Company B only has basic financial instruments it is not required to adopt fair value accounting.

Changes to the financial statements will be minimal.

*Costs of implementing the applicable accounting standards:* 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.

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.

## 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 team, 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.

*Applicable accounting standards:* Company C will apply the [draft] FRS 102. However, the forward foreign exchange contracts are not basic financial instruments and Company C must apply the requirements of Section 12 of the [draft] FRS 102. 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 fall within the permitted effectiveness limits.

*Costs of implementing the applicable accounting standards:* 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, particularly relating to financial instruments, 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.

## Company D

*Scenario:* Company D is a large unquoted parent company. It has a number of subsidiaries and is the ultimate parent company within its group. Company D's business is based in the UK, although it may have a small number of transactions in foreign currency for which it takes out forward foreign exchange contracts. 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 (current FRS).

*Applicable accounting standards:* Company D will apply the [draft] FRS 102. However, the forward foreign exchange contracts are not basic financial instruments and Company D must apply the requirements of Section 12 of the [draft] FRS 102. 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 by accounting for transactions in foreign currency at contract rate. To achieve an element of matching gains and losses on contracts in foreign currency Company D will need to apply hedge accounting, but this is unlikely to achieve the same outcome as applying SSAP 20. 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 [draft] FRS 102 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 its financial statements. It will need to 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 could be different under the [draft] FRS 102, when compared with current FRSs, for example, deferred tax.

All Company D's significant subsidiaries will also apply the [draft] FRS 102. 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 or have acquired assets and liabilities constituting a business. In their published financial statements all subsidiaries will take advantage of the [draft] reduced disclosure framework set out in [draft] FRS 102, 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 applicable accounting standards:* 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.

Company D's auditors are likely to be a top 20 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; the [draft] FRS 102 is an IFRS-based standard. In addition, they will have well established annual processes for updating staff and resources. 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 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.

*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', proposed changes to company law will permit Company D to revert to 'Companies Act group accounts'.

*Applicable accounting standards (group accounts):* Company D has two choices available to it: either continue preparing 'IAS group accounts' or revert to 'Companies Act group accounts' and apply the [draft] FRS 102. Given that Company D:

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

it will not obtain significant benefits from applying the [draft] FRS 102 and chooses to continue to prepare 'IAS group accounts'.

*Applicable accounting standards (individual 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 current FRSS, with adjustments made as part of the consolidation process to address differences between EU-adopted IFRS and current FRSS. All entities, including the parent, will now voluntarily apply EU-adopted IFRS, for consistency, but take advantage of the reduced disclosure framework, such that the level of disclosure in their financial statements will be comparable to or less than that previously prepared under current FRSS.

*Costs of implementing the applicable accounting standards:* There are no changes to Company D's group reporting 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 revising for compliance with EU-adopted IFRS and the reduced disclosure framework ([draft] FRS 101), but this will be based on information already prepared for the group financial statements and therefore be relatively straightforward to implement and will not outweigh the saving from no longer preparing financial information on two different bases.

## 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 (because EU-adopted IFRS has been revised).

*Applicable accounting standards (individual accounts):* Company E has two choices, apply the FRS 102 or apply EU-adopted IFRS and the reduced disclosure framework. As all the information for applying EU-adopted IFRS in its individual financial statements, and those of its subsidiaries will already be available from the group consolidation, Company E decides that all group entities will apply EU-adopted IFRS with reduced disclosures in their individual accounts. As a result the cost of transition should be minor. The on-going savings available for Company E itself will depend partly upon the amount of business and transactions undertaken by Company E (i.e. holding company or operating company).

Company E's subsidiaries will be affected consistently with Scenario D.2.

*Costs of implementing the applicable accounting standards:* The same as Scenario D.2.

*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.

*Applicable accounting standards:* 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 ([draft] FRS 101) or applying the [draft] FRS 102. As Company E had previously decided that it was beneficial for it to apply EU-adopted IFRS, all group entities will apply EU-adopted IFRS with the reduced disclosure framework.

*Costs of implementing the applicable accounting standards:* Taking advantage of the reduced disclosures will reduce the cost of preparing (and auditing) the financial statements of the Company E and its subsidiaries.

**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 current FRSs. It has not adopted FRS 26, but has provided certain disclosures about financial instruments in accordance with FRS 13.

*Applicable accounting standards:* Entity F will apply the [draft] FRS 102, with the additional disclosures for financial institutions.

The most fundamental change in financial reporting for Entity F will be changes to financial instruments accounting and disclosure, although some of 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 where 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 disclosures about its financial instruments proportionate to the risks as set out in Section 34 of the [draft] FRS 102.

*Costs of implementing the applicable accounting standards:* The costs of applying the [draft] FRS 102 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.

**Entity G**

*Scenario:* Entity G is operating as a credit union within the meaning of the Credit Unions Act 1979. It is also registered with the FSA under the Financial Services and Markets Act 2000. It has been preparing its financial statements in accordance with the Industrial and Provident Societies Acts, and UK accounting standards. It has not adopted FRS 26.

*Applicable accounting standards:* Entity G will apply the [draft] FRS 102, with the additional disclosures for financial institutions.

The most fundamental change in financial reporting for Entity G will be changes to financial instruments accounting and disclosure. Entity G only has basic financial instruments and it is not required to adopt fair value accounting, although it will need to consider whether there are differences between its current accounting and amortised cost using the effective interest method.

In preparing its financial statements Entity G will need to prepare additional disclosures about its financial instruments proportionate to the risks as set out in Section 34 of the [draft] FRS 102.

*Costs of implementing the applicable accounting standards:* The costs of applying the [draft] FRS 102 for the first time will be minimised by making use of disclosure aids, but should be based on information currently available. There may also be additional costs in terms of audit effort.

## Entity H

*Scenario:* Entity H is a Registered Provider of Social Housing. It has been preparing its financial statements in accordance with the Industrial and Provident Societies Acts, and UK accounting standards. It has not adopted FRS 26.

Entity H has a significant amount of borrowings from financial institutions. Some of these loans may have terms that mean that they are non-basic financial instruments. In addition, Entity H has taken out interest rate swaps that in accordance with the [draft] FRS 102 are non-basic financial instruments. Entity H has dedicated treasury staff.

Entity H has also received significant amounts of grants to provide social housing.

*Applicable accounting standards:* Entity H will apply the FRS including any relevant requirements for public benefit entities.

The most fundamental changes in financial reporting will relate to financial instruments. It will be necessary to determine whether any loans have features meaning that they are complex financial instruments and within the scope of Section 12. Any loans that are not basic must be measured at fair value. In addition the interest rate swaps must be recognised at fair value and disclosures provided about the valuation methodology. Entity H will want to consider whether to apply hedge accounting to the interest rate swaps. Whether or not hedge accounting is available will depend partly on whether it meets the effectiveness test. Entity H will incur the administrative burden of maintaining the relevant documentation if it applies hedge accounting.

In addition to any other minor changes in accounting, Entity H will need to review its accounting for grants. Grants will no longer be permitted to be offset against the cost of housing property on the balance sheet, a presentational change. In addition, the full depreciable amount of the housing properties will be depreciated, and grants recognised in income over the life of the housing property; there should be no impact on reported surplus.

*Costs of implementing the applicable accounting standards:* Entity H's treasurer will need some training in the new accounting requirements, procedures and documentation, and will need to consider whether Entity H's treasury policies should be revised.

Entity H may need to consider whether its fixed asset register (or property database) can provide the required information on the amortisation of grants.

Entity H will be assisted by using the sector's SORP in revising its presentation and disclosure in its financial statements.

Entity H's financial statements will contain new information about the risks arising from financial instruments, as well as changes relating to housing property and grants. Users will need to familiarise themselves with this new information, and determine how it affects their view of the prospects of Entity H. 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.

**Entity I**

*Scenario:* Entity I is a large charity. It prepares its financial statements in accordance with its legal framework and the relevant sector specific SORP.

*Applicable accounting standards:* Entity I will apply the [draft] FRS 102 (including any relevant requirements applicable to public benefit entities). It will also continue to use its sector specific SORP, which is expected to be updated for consistency with the [draft] FRS 102.

If Entity I receives grants it will need to confirm that its previous accounting practice is consistent with the [draft] FRS 102.

If Entity I receives donations of goods or services it will need to confirm that its previous accounting practice is consistent with the [draft] FRS 102, in particular that it is recognising income at the right time, taking into account the nature and materiality of the goods or services.

Entity I will need to review the format of its primary financial statements to ensure that they are compliant with one of the formats required by the [draft] FRS 102 (the formats specified in Company Law).

*Costs of implementing the applicable accounting standards:* The entity'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.

Although Entity I will need to review its accounting for grants and donations it is considered relatively unlikely that significant changes in accounting will be required.

Some revision to the format of the primary financial statements may be required, but as this will be relevant to the sector as a whole it is expected to be addressed in the SORP minimising the implementation costs for each individual entity. In any event this involves representation of existing information, rather than preparing new information.

**Entity J**

*Scenario:* Entity J is a pension scheme. It prepares its financial statements in accordance with current FRSs and the SORP for pension schemes.

*Applicable accounting standards:* Entity J will apply the [draft] FRS 102; specifically Section 34 requirements for retirement benefit plans financial statements and the additional disclosures for financial institutions.

The most fundamental change in financial reporting for Entity J will be changes to financial instruments accounting and disclosure. Entity J will need to determine whether it has any financial assets that are non-basic, in accordance with the [draft] FRS 102. In which case, it will need to measure them at fair value and provide disclosures about the valuation methodology.

In preparing its financial statements Entity J will need to prepare additional disclosures about its financial instruments proportionate to the risks as set out in Section 34 of the [draft] FRS 102.

It will also need to provide information in its financial statements about the actuarial present value of the promised retirement benefits.

*Costs of implementing the applicable accounting standards:* The costs of applying the [draft] FRS 102 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, but will be less for those only affected by disclosure changes. 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.



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UP/ASBD-BI12525

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