ASB's Convergence Strategy

FOR DISCUSSION AT ASB PUBLIC MEETING ON 19 JANUARY 2006 AND/OR FOR WRITTEN COMMENT

This paper sets out a revised proposed convergence strategy for the ASB. It has been prepared to provide a basis for discussion at our public meeting on 19th January 2006. Comments may also be submitted by e-mail to strategy@frc-asb.org.uk.

Background

1 The Accounting Standards Board's (ASB's) Policy Statement Exposure Draft "Accounting Standard-Setting in a Changing Environment: The Role of the Accounting Standards Board", issued in March 2005, included proposals for achieving convergence of UK accounting standards with IFRS.

2 In the exposure draft the ASB stated that it *"believes that there can be no case for maintaining differences between the principles underlying UK accounting standards and IFRS"*. The ASB still believes that is an appropriate aim because consistency is important for the credibility and understanding of financial reporting; in addition UK financial reporting cannot simply stand still, whilst internationally financial reporting evolves and solutions to new and emerging issues are found.

3 To achieve that aim, the ASB had proposed to:

(i) bring about convergence between UK standards and IFRS; that is setting UK accounting standards which are standards based on IFRS with no changes other than those that are necessary or are justifiable;

(ii) seek to issue accounting standards that are appropriate for the entities that have to apply them; and in particular that the burden of the requirements of accounting standards is proportionate to the benefits they provide;

(iii) use a phased approach under which a number of standards on related topics are brought into effect each year, with the aim of bringing UK standards fully into line within a period of 3-4 years.

4 The ASB proposes that it should continue to pursue the proposals in 3(i) and (ii) above but 3(iii) is being reconsidered.

5 Many respondents to the Policy Statement Exposure Draft commented on the ASB's convergence plans and suggested ways in which the ASB should improve them. In particular, many respondents believed that the time was right for the ASB to reconsider its phased approach to convergence and favoured a pause in convergence efforts before a 'big bang' implementation. It appeared that the development of exposure drafts related to IASB's proposals on business combinations had been particularly influential on these comments. Those exposure drafts demonstrated that the phased approach could be complex because of the interrelationship between standards in each group that is being converged and other standards that await convergence.

6 After considering the views of respondents and other practical issues relating to convergence, including other uncertainties about the direction of IASB standards the ASB now proposes that it should not continue to follow the phased approach. It proposes to issue new IFRS-based UK accounting standards, but these will not be mandatory before a single date, which is currently estimated to be financial years beginning on or after 1 January 2009. In most cases, it is expected that the interrelationships between standards will preclude early adoption of IFRS-based standards that are issued before the effective date, although early adoption may be permitted in specific cases. Proposals for the process of convergence of UK standards and IFRS are discussed in more detail in paragraphs 23-28 below.

Questions

Q1 Do you support the aim of the ASB as set out in paragraph 2 and the proposals for achieving the aim set out in paragraphs 3(i) and (ii)? If you do not support the aim and proposals, what factors have lead to your decision?

Q2 Should the ASB move from a phased approach to a 'big bang' approach to convergence with IFRS?

Which accounting standards should apply to which entities?

IASB standards

7 IASB presently envisages the possibility of two tiers of accounting standards, based on whether or not a reporting entity has 'public accountability':

(i) full IFRSs, which would be applicable to entities that have public accountability (but any other entities that do not have public accountability could also choose to apply them)

(ii) IASB Standards for SMEs[1], which would be suitable for entities that do not have public accountability.

8 The IASB plans to issue an exposure draft of accounting standards for SMEs in the second quarter of 2006. At present, the outcome of the SME project is uncertain and the content of IASB Standards for SMEs is not known. The IASB has indicated that these standards should not be expected to be suitable for entities with public accountability, although it has not set quantitative criteria for determining those entities the standards should be suitable for. However, the advice of the IASB's working group is that for the purposes of developing its Standards for SMEs the IASB should aim for a document of approximately 200 pages in length having in mind an entity with 50 employees and turnover of €10 million. The size criteria would not be included in the standards but each jurisdiction would be free to determine the standards' applicability. Therefore for the purposes of this paper the ASB has assumed that the IASB's Standards for SMEs will, broadly, be aimed at companies that are similar to those currently meeting the Companies Act definition of a small entity (and therefore usually entitled to prepare financial statements in accordance with the Financial Reporting Standard for Smaller Entities (FRSSE)).

9 The ASB does not wish to significantly extend the reporting requirements for smaller entities and if the IASB's Standards for SMEs appear more suitable for entities that are significantly larger than small companies the ASB will

[1] These entities have been labelled as 'non-publicly accountable entities' (NPAEs), but are still often referred to as Small and Medium-sized Entities (SMEs).

consider developing its own replacement for the FRSSE, in due course, which will be founded on the principles of IFRS.

Current UK accounting standards

10 At present entities reporting under UK accounting standards are subject to different requirements:

(a) Some companies are required to follow all the requirements of UK standards;

(b) Some are afforded some exemptions from those requirements—for example in respect of segmental reporting, and earnings per share. There are also some specific exemptions that are available to entities that are subsidiaries.

(c) Most smaller entities may choose to adopt the FRSSE; if so, they are not generally required to observe the requirements of other accounting standards.

Thus, present UK standards are not based on a 'one size fits all' philosophy.

UK accounting standards based on IFRS – utilising IASB's tiers of standards

11 In issuing UK accounting standards that are based on IFRS the ASB needs to determine how best the two tiers of IFRS can be utilised in aiming for appropriate financial reporting by entities under UK accounting standards:

(a) The ASB believes that, in addition to the consolidated financial statements of listed entities, full IFRS (or EU-adopted IFRS) is also appropriate for certain other UK reporting entities, including other listed entities, those of similar size to listed entities and those where there is a significant public interest.

(b) On the current assumption about the outcome of the IASB's SME project, the ASB believes that the IASB's Standards for SMEs should form a suitable basis for reporting by smaller entities.

12 The ASB recognises that many would consider the ideal solution would be a 'two sizes fits all' regime, and is minded to pursue this objective. However, there are a significant number of entities that fall in between those that are, or are comparable to, listed companies and the smaller entities for which the

FRSSE is appropriate. A 'two sizes fits all regime' could only be achieved if a satisfactory dividing line between those entities applying full IFRS and those permitted to use the IASB's Standards for SMEs could be found that resulted in appropriate financial reporting for all entities.

13 It seems likely, however, that some modifications to full IFRS may be appropriate for entities that are neither smaller entities nor comparable to listed entities. For example[2], there is a case that a detailed standard on segmental reporting would be excessively burdensome for a company with 80 employees—and unnecessary in the case of a subsidiary. As another example, the ASB has recently consulted on whether the impairment approach to purchased goodwill is suitable for all entities, or whether the option to amortise purchased goodwill over its useful life should be retained.

14 The ASB therefore proposes that, for all entities other than those entitled to use the FRSSE, UK standards should mirror the requirements of IFRS, with modifications restricted to those that that are necessary (eg for legal reasons) or justifiable (for example, on grounds of cost benefit).

15 Another solution would be to extend the applicability of the IASB's Standards for SMEs to larger entities. This alternative would need to be considered after the IASB has produced its Standard for SMEs.

16 As at present, any entity will continue to be able to choose to prepare its financial statements in accordance with the requirements of full UK accounting standards.

UK accounting standards based on IFRS – which entities the standards apply to

17 As noted above in paragraph 11(a) the ASB believes it might be appropriate to extend the application of full IFRS beyond those entities required to prepare their consolidated financial statements in accordance with EU-adopted IFRS. The following types of entities are being considered for possible suitability for full IFRS:

- listed companies that do not have subsidiaries and other companies accessing public markets;

[2] These examples are illustrative only and are not intended to signify conclusions about whether or not the accounting requirements mentioned are suitable for these entities, but only to demonstrate that there is a case that they may not be.

- parent entities that use full IFRS, or EU adopted IFRS, to prepare their consolidated accounts (ie in their individual accounts); and
- certain large unlisted entities (to be determined by reference to nature and / or size).

18 If the application of full IFRS were to be extended on the basis of the size of an entity, a suitable clear and unambiguous cut-off point would need to be determined. Inevitably the choice of a cut-off point will be arbitrary to a certain extent, but the objective should be to include those entities where it seems reasonable to require the same level of reporting as that required by listed groups and where the cost of complying with IFRS is not a burden greater than the benefits. For example, one would generally expect that de-listing should not lead to significant differences in the financial statements of the entity. One option might be to include those entities with a balance sheet total greater than [£50m] or turnover greater than [£100m][3].

19 A large number of UK entities fall in between the small and the largest entities (however defined). For those entities, alternatively, exemptions from certain requirements of full IFRS may be more appropriate than full IFRS or the IASB's Standards for SMEs, which could be based on either:

(i) full IFRSs (an 'IFRS minus' approach), or

(ii) IASB Standards for SMEs (an 'SME plus' approach).

20 The final standards should be same whichever route is adopted, but, taking into account the practical issue that the IASB's Standards for SMEs are not yet available and the idea that the nearer IFRS comparator for current UK accounting standards is full IFRS, it is likely that the base standards for these entities will be full IFRS (an 'IFRS minus' approach). Necessary amendments would for example include those that enable a standard to be applied within the framework of UK law. Justifiable amendments would include changes to IFRS that the ASB believes, after taking into account costs and benefits, make the standards more appropriate to the entities applying them.

21 However, the ASB believes it should defer making a final decision on whether to base convergence on full IFRS or IASB Standards for SMEs until a

[3] The Appendix provides an estimate of a stratification of UK companies based on size of turnover.

clearer picture of the latter standards emerge. Consequently, the ASB does not expect to make a decision until later in 2006, when it has had an opportunity to reflect on the results of the current consultation, and IASB's proposals for its SME standard may be clearer.

Public-benefit entities

22 In addition to profit-oriented companies, there are a wide variety of other entities that are required to prepare their financial statements in accordance with UK accounting standards (or other requirements that are based on UK accounting standards). Further consideration will be given to how the proposals should apply to these entities, in particular public-benefit entities. For example, by their very nature public-benefit entities should be publicly accountable, but taking into account their size it may not meet the cost/benefit test to require all public-benefit entities to comply with full IFRS.

Questions

Q3 Is it desirable for there to be a single suitable boundary such that all entities would apply either full IFRS or the IASB's Standards for SMEs; what are the specific factors that might influence the achievability of this?

Q4 Is it appropriate to extend full IFRS beyond those entities currently required to prepare their group financial statements in accordance with EU-adopted IFRS?

Q5 If so, which entities full IFRS might be applied to (bearing in mind those entities under consideration as noted above)?

Q6 If it is not possible to achieve a single boundary between full IFRS and the IASB's Standards for SMEs whether, for those entities that fall between the largest and the smallest entities;

- ***(i) the solution might be limiting disclosure requirements for certain entities; or***
- ***(ii) whether a suite of UK accounting standards based on IFRS (and possibly incorporating some recognition and measurement amendments from full IFRS) might be a suitable option?***

Implementation strategy

23 The ASB has already issued a number of UK accounting standards that are based on IFRS, which are applicable to some or all UK reporting entities. This will need to be added to in order to achieve a full suite of UK accounting standards based on IFRS. The ASB proposes that the additional standards should be implemented in a single step to be effective from the same date (this approach is often referred to as a 'big bang' approach). The ASB currently believes that it would be reasonable to specify an effective date of accounting periods beginning on or after 1 January 2009: in addition to allowing time for the due process involved in issuing the standards to take place, the ASB wishes to provide its constituents (particularly preparers) with time to plan for an orderly transition.

Converged standards already in issue

24 Although the ASB proposes that no new UK accounting standards based on IFRS should be effective before 1 January 2009, it is possible that the IASB will make amendments to standards that are already converged (for example, by issuing amendments to standards or IFRIC Interpretations). Given that the goal is convergence it seems unhelpful to create differences between IFRS and UK standards that have already been converged and therefore the ASB may propose (after appropriate due process) to implement amendments to converged standards broadly in line with the IASB's timetable.

New UK accounting standards based on IFRS

25 As far as is practicable, the suite of UK standards that will be in issue at the effective date should be based on IFRS in issue at the same date; however, this needs to be balanced with the need to provide a 'stable platform' to enable constituents to prepare for the effective date. The ASB aims to issue as soon as practicable a suite of exposure drafts of standards that will be applicable from the effective date. It is likely that this will be achieved by issuing exposure drafts based on IFRS as at 1 January 2006. The only exceptions to this might be IFRS where it is known that revisions will be made in the short term when a UK exposure draft may be delayed in order that it can be based on the proposed revised IFRS.

26 In issuing each exposure draft the ASB intends to review the IFRS to determine whether there are any amendments that are necessary or justifiable in aiming to issue a standard that is both principally converged with IFRS, but also appropriate to the entities that will be applying it.

27 In order that, as far as possible, the standards in issue at the effective date are based on IFRS at that date, the ASB will need to consider any changes made to IFRS during the period 1 January 2006 to 1 January 2009. In general the ASB will aim to issue consistent amendments to UK accounting standards. In some cases, the ASB might consider deferring the mandatory implementation date of an amendment in order to endeavour to allow adequate time for preparers to implement the changes.

28 After the effective date, the ASB will aim to keep UK standards converged with IFRS by issuing new UK IFRS-based standards in tandem with new IFRS.

Questions

Q7 Is 1 January 2009 a suitable effective date for the 'big bang'? If not, what are the key constraints?

Q8 In principle, should existing converged standards be kept up to date with IFRS in the mean time?

Appendix

Estimated stratification of companies

The following stratification of companies is an estimate based on information on the FAME database and information taken from a DTI consultation in 1999. It does not include other entities that are required to prepare their financial statements in accordance with UK accounting standards.

All figures are approximate.

Turnover	Total no. companies	Of which unlisted and not part of a listed group[4]
< £5.6m (ie small)	1,080,000	n/a
£5.6m < turnover < £22.8m (ie medium)	30,000	n/a
£22.8m < turnover < £50m	9,000	n/a
£50m < turnover < £100m	5,000	n/a
£100m <turnover < £250m	3,500	n/a
£250m < turnover < £500m	1,500	700
> £500m	1,700	300

Basing the stratification on another variable, such as total shareholders' funds would, of course, provide different results.

[4] The burden of preparing financial statements in accordance with full IFRS would be greater for these companies than subsidiaries of listed groups, which are already preparing IFRS information for group reporting purposes.