

# A FRED Letter Day Reforming UK and Irish GAAP

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Not for the first time, a revolution in financial reporting standards may be on the cards, as Irene O’Keeffe and Fiona Hackett outline in this review of the ASB’s recent proposals.

The Financial Reporting Exposure Drafts, FRED 43 and FRED 44 published by the Accounting Standards Board (ASB) at the end of October 2010 mark the beginning of the end of Irish and UK Generally Accepted Accounting Practice (GAAP). The FREDs propose withdrawing the current suite of Financial Reporting Standards used by Irish and UK entities that currently don’t apply EU-adopted international financial reporting standards (IFRS) and requiring all but the smallest Irish and UK entities to prepare financial statements under a version of IFRS. The FREDs are the result of several years of deliberation and consultation by the ASB, aimed at developing a cohesive IFRS-based framework for financial reporting in Ireland and the United Kingdom.

## Would the ASB’s proposals have a significant impact?

Yes. The proposals represent a radical reform of financial reporting in Ireland and the UK. All entities that currently prepare their financial statements in accordance with Irish or UK GAAP are impacted by the proposals. Revolution is not a one-time event. In 2005 and 2006 we had the first revolution when Irish and UK quoted groups adopted IFRS. The recent proposals would have a much wider impact on business throughout Ireland and the UK than the

introduction of IFRS due to the far-reaching scope of the proposals.

## What do the proposals mean?

At the heart of the proposals is a three-tier reporting framework that would determine the accounting by all Irish and UK entities (illustrated opposite). The three-tier framework works around the concept of ‘publicly accountable’ entities. ‘Publicly accountable’ entities are in tier 1 and the proposals require tier 1 entities to report using IFRS.

Small entities, that are not publicly accountable, may elect to report under FRSSE – so-called tier 3.

All other entities would be required, at a minimum, to prepare their financial statements under the ASB’s version of the IASB’s *IFRS for SMEs* known as the *FRSME (Financial Reporting Standard for Medium-sized Entities)*.

Entities in tiers 2 and 3 would be permitted to elect to report under the requirements of a higher tier.

The ASB’s initial proposals and concept of a three-tier framework were originally put forward in a 2009 discussion paper. A number of responses to the ASB’s 2009 discussion paper urged the ASB to incorporate a reduced disclosure regime for subsidiaries of IFRS reporters, as the original proposals did not contain any concessions for

subsidiaries of IFRS reporters. The ASB has addressed this request and has actually gone one step further in the FREDs by proposing a reduced disclosure regime within tiers 1 and 2 (tiers 1S and 2S) for all ‘qualifying subsidiaries’.

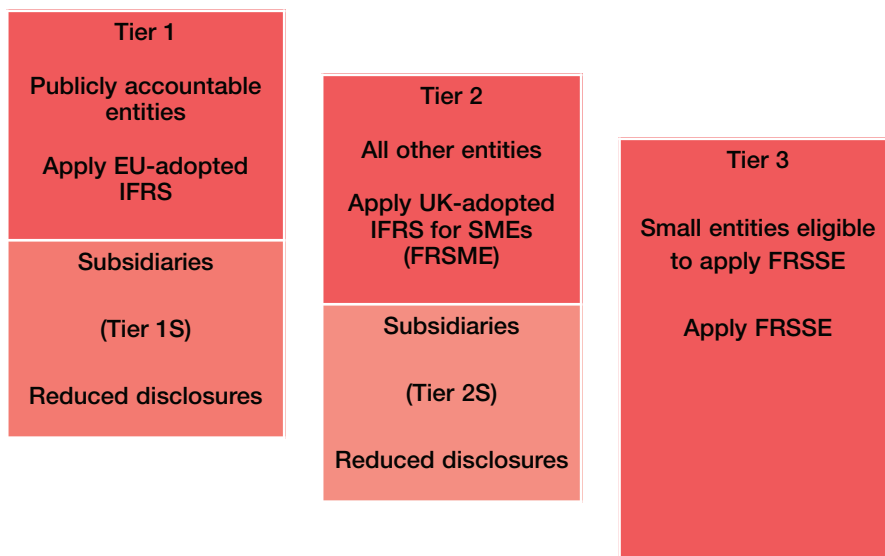
This major change from the discussion paper is welcome and is an attractive option for Irish subsidiaries of IFRS reporters. Such subsidiaries would be able to use their IFRS group reporting numbers in their statutory accounts without needing to include all IFRS disclosures; for example, such subsidiaries would not have to disclose information about financial instruments under IFRS 7.

## What does ‘publicly accountable’ mean?

The ASB is proposing to largely adopt the public accountability definition developed by the IASB for its standard, *IFRS for SMEs*, with amendment to include a reference to deposit-taking entities. Therefore “An entity has public accountability if:

- a) its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets), or
- b) at its reporting date, as one of its primary businesses, it holds assets

## ASB's Proposed Three-Tier Structure



in a fiduciary capacity for a broad group of outsiders and/or is a deposit-taking entity for a broad group of outsiders. This is typically the case for banks, credit unions, insurance companies, securities brokers/dealers, mutual funds or investment banks.”

### Is there more guidance on 'publicly accountable'?

A number of responses to the discussion paper expressed concern that the definition of 'publicly accountable' without explanatory guidance might be difficult to

interpret in practice. The ASB has addressed these concerns and a second major change from the discussion paper is the inclusion in the FREDs of application guidance on the meaning of 'publicly accountable'.

The FREDs also include the following indicative, but not exhaustive, list of entities considered to have public accountability:

- ▶ Quoted companies;
- ▶ Pension schemes;
- ▶ Insurance entities;
- ▶ Credit unions;
- ▶ Building societies;
- ▶ Friendly societies;
- ▶ Banks;
- ▶ Employee benefit trusts; and
- ▶ Investment trusts.

### What is the FRSME?

The proposals require all tier 2 entities to prepare financial statements under the FRSME or IFRS. The FRSME is the

## Timeline for adoption of the FRSME Introduction of Tiered Approach

October 2010	ASB released FRED on the proposed mandatory adoption of IFRS for all UK/Irish entities (excluding those that qualify for reporting under the FRSSE).
April 2011	Deadline for comments on the FRED.
Mid 2011	Final standard expected.
July 2013	Effective date for the proposals.
June 2014	First balance sheet that would be required to be prepared under the new framework.

ASB's version of the IASB's *IFRS for SMEs*, which has been amended for some UK- and Irish-specific circumstances.

### What are the differences between the FRSME and the IFRS for SMEs?

The *IFRS for SMEs*, as issued by the IASB, is currently not fully compliant with Irish and UK company law. The FRSME reflects necessary amendments to the *IFRS for SMEs* to achieve company law compliance.

Other than the necessary legal changes the ASB has made the following four pragmatic changes to the *IFRS for SMEs*:

- ▶ Replaced the *IFRS for SMEs* section on income tax accounting with the IASB's standard on Income Tax, *IAS 12*;
- ▶ Provided an exemption to parent entities from presenting a parent company cash flow statement when the parent is preparing consolidated accounts;
- ▶ Aligned the requirements to prepare consolidated accounts in accounting standards with the requirements in Company Law; and
- ▶ Provided transitional relief to

dormant companies in the UK.

### What are some of the advantages of using FRSME?

The advantages of using the FRSME standard include:

- ▶ Simpler accounting – there are fewer options in relation to accounting treatments; for example, land and buildings are never measured at valuation under the FRSME, easing the burden on preparers of financial statements.
- ▶ Fewer disclosure requirements than IFRS – notably in the area of financial instrument disclosures.

### What are some of the disadvantages of using FRSME?

FRSME is different from IFRS, it is not just a simplified version of IFRS. The disadvantages of using the FRSME include:

- ▶ The simplified accounting may result in accounting policies that companies do not find attractive; for example, immediate expensing of development and borrowing costs and amortisation of goodwill.
- ▶ FRSME financial statements would not be accepted for use in a listing document or subsequent filings,

impacting companies contemplating an IPO.

### What else should tier 2 entities consider?

FRSME would not be suitable for all tier 2 entities. When deciding whether to use IFRS or the FRSME management should consider the broader business implications of adopting IFRS over FRSME, such as the consequences on tax, distributable reserves, systems and data requirements and corporate structures. For example:

#### ▶ Tax

There may be tax advantages for companies that move to full IFRS. Depending on their structure and other factors, companies could enjoy a cash tax advantage, where IFRS would either slow down the rate at which income is recognised or speed up recognition of cost.

#### ▶ Distributable reserves

A change in accounting framework may reduce distributable reserves – for example, due to the impact of recognising derivatives at fair value.

#### ▶ Systems and data requirements

Information requirements for measurement and disclosure would be more onerous under both full IFRS and the FRSME. Where the capture of additional data may require more than a simple system modification, this may not be straightforward.

#### ▶ Corporate structures

Large groups with many subsidiaries may wish to take the opportunity to simplify their structure to reduce the time and cost of converting to IFRS or FRSME.

For most Irish entities the future of financial reporting looks likely to be the FRSME. Adequate planning will be critical to a successful implementation.

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