



Article topic: Financial Reporting

The Great IFRS Debate

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International Financial Reporting Standards (IFRS) is, once again, causing quite a stir within the profession at present with certain critics urging the UK Government to repeal the requirement to apply IFRS to UK financial statements – though I am not sure how entirely successful this would actually be.

This article will look at why IFRS was brought in to the UK, where current developments are up to in relation to the proposed IFRS for SMEs and look at how the ASB could possibly save the much-loved FRSSE.

Currently in the UK quoted companies (and those on AIM) are required to adopt IFRS as their financial reporting framework. Companies which are not obligated to report under IFRS can choose to do so if they wish (though in reality very few companies voluntarily adopt IFRS as their financial reporting framework.) If a company chooses to voluntarily adopt IFRS, the switch is a 'one-way' switch only – companies cannot switch back to current UK GAAP if things do not go according to plan.

Current Developments

In July 2009, the International Accounting Standards Board (IASB) issued their 'IFRS for SMEs'. This standard was issued after a 5 year development process. The IASB estimate that companies who fall under the scope of a 'SME' account for 95% of all companies and an extensive consultation took place with companies in the SME sector worldwide.

The UK Accounting Standards Board issued a policy proposal 'The Future of UK GAAP' in August 2009 and comments on this proposal closed on 1 February 2010. The ASB received in excess of 150 comments and is currently in the process of sifting through the responses. An Exposure Draft is due to be issued by the ASB containing their proposals for the future of UK GAAP.

IFRS Criticisms

The primary objective of the IASB is to produce a set of accounting standards which are intended to be adopted on a worldwide level. IFRS was introduced in 2005 by the European Union and has been criticised quite heavily, particularly with regards to the use of the fair value model of accounting as opposed to depreciated historic cost. Critics have blamed the fair value model for disproportionately overstating banks profitability and in turn overstating profit enabling excessive dividends to be paid. The upshot of all this led to the financial crisis resulting in banks having to be bailed out by the taxpayer. Well known financial institutions such as Lehman Brothers collapsed and the accounting profession was in the spotlight, once again, for all the wrong reasons. Indeed the adoption of full IFRS by larger listed companies has caused problems with its implementation.

One of the objectives of the Coalition Government is to reduce burdensome regulation. Some high profile critics have written a letter to *The Times* suggesting that a good place to start would be to repeal the legal requirements of IFRS reporting in the UK. The critics believe that the IFRS regime is 'flawed' and makes financial statements difficult to understand because of the concepts in some of the IFRS. Most notably, the critics believe that auditors of institutions who report under IFRS have been required to audit the financial statements in compliance with 'a flawed accounting model'.

True and Fair

Under the UK Companies Act, financial statements must give a 'true and fair' view of the state of an entity's affairs at its balance sheet date (reporting date). Critics believe that IFRS conflicts with the UK's true and fair principle.

In developing and revising accounting standards, the IASB refer to the 'Framework for the Preparation and Presentation of Financial Statements' (otherwise known as the 'Framework Document'). The IASB's 'Framework' does not address the 'true and fair' principle. Indeed, the Framework document itself does not have the force of an accounting standard and as a consequence its contents are not mandatory (except in relation to IAS 8 '*Accounting Policies, Changes in Accounting Estimate and Error*'). The Framework document instead states that where accounting standards (IFRS) are followed and the qualitative characteristics are applied within the financial statements, this will result in the financial statements giving a true and fair view (or presenting fairly such information).

IFRS for SMEs

IFRS for SMEs is based on the principles in full IFRS. Full IFRS spans some 3,500 pages and is clearly inappropriate for use by a SME. IFRS for SMEs has been heavily condensed and is designed as a 'standalone' standard. In contrast to IFRS for SMEs, the Financial Reporting Standard for Smaller Entities (FRSSE) is not a standalone standard – FRSSE runs in conjunction with the mainstream standards.

The IASB have commented that IFRS were primarily designed to meet the needs of equity investors in companies in public capital markets. It is for this reason the IFRS are so vast; they cover a wide variety of issues, contain a lot of implementation information and the disclosure requirements are appropriate for listed companies. In developing the IFRS for SMEs, the IASB recognised that the users of financial statements prepared for SMEs do not have the same needs as those users of the financial statements of listed companies and are more focussed on shorter term cash flows, liquidity and solvency. In addition the IASB acknowledged that many SMEs say that full IFRS would place an unnecessary burden on them so in their attempts to 'kill two birds with one stone' the IASB's objectives in developing IFRS for SMEs were to meet user needs whilst balancing costs and benefits from the perspective of the preparer.

The IASB want global convergence – in other words they want all financial statements to essentially 'sing from the same hymn sheet'. In this respect, if we are to assume that the UK will fully report under the IFRS regime then clearly the proposed IFRS for SMEs is much more appropriate than full IFRS.

Complexities in IFRS for SMEs versus FRSSE

The ASB stated in their consultation paper that current UK GAAP has become 'overly complicated' and that 'it did not make sense to maintain UK GAAP in its existing form'. However, IFRS for SMEs is quite complex in certain areas – and I am of the opinion that some areas of the proposed standard may be over-complicated for preparers of SME financial statements. For example, deferred tax under current UK GAAP is recognised on 'timing differences' which recognise the mismatch between the accounting periods in which gains or losses are reported in the financial statements compared to when the tax effects arise. Deferred tax under the IFRS (SME) regime is recognised on 'temporary' differences which recognise deferred tax on the differences between assets and liabilities in the financial statements compared to the effect on taxable profit if the associated assets or liabilities had been sold or settled at the balance sheet date. This is far

more complicated than current FRS 19 and FRSSE requirements and would result in more deferred tax provisions being recognised than under current UK GAAP. In addition, other areas that are likely to be over-complicated for clients in the SME sector are in relation to pensions and leases.

I think UK GAAP has become established by preparers of financial statements and in the main is generally well understood. There are some particular areas which cause difficulties, such as financial instruments and IFRS derived standards (such as FRS 20: 'Share-Based Payments'). In deciding the way forward for UK GAAP, the ASB is likely to take account of the complexities in the proposed standard in comparison to FRSSE.

FRSSE

Without a doubt, FRSSE is a much-loved standard and one proposal by the ASB is to retain FRSSE for 'very small' companies or to align FRSSE with IFRS for SMEs. A large number of practitioners who work with FRSSE are praying the ASB will keep the standard.

There are problems inherent with FRSSE when you consider the standard in context with the proposed IFRS for SMEs (in its current form). The main problem with FRSSE is that it is a cut-down version of full FRS/SSAP. If FRSSE is retained and IFRS for SMEs (in its current form) is adopted in the UK, FRSSE will be based on a financial reporting framework which no longer exists. There are also various accounting treatments which FRSSE allows that are not permitted under IFRS for SMEs, for example revaluation of fixed assets, valuation of stock under LIFO and the discounting of deferred tax.

Additionally, because of the fact that FRSSE is not a standalone standard, and where particular issues are not covered in FRSSE, fall back to the full standards is required to decipher an appropriate accounting treatment. As IFRS for SMEs is a standalone standard no fall back to full IFRS is required – management must develop a policy having regard to the IASB 'Framework'.

In terms of FRSSE (in its current form) compared to IFRS for SMEs (in its current form) there are many inconsistencies which clearly the ASB will have to address. The main issue being the lack of comparability between the financial statements of an entity adopted FRSSE and those of a large company. If the idea of bringing IFRS for SMEs in is to enable consistency in financial reporting, my view is that if FRSSE is going to be retained, then it should be aligned with IFRS for SMEs – particularly with regards to the differing accounting treatments.

In light of the fact that FRSSE would (in its current form) be based on a financial reporting framework which would essentially be redundant, it would seem plausible for the ASB to dispense with FRSSE (in its current form) and produce an alternative FRSSE based on IFRS for SMEs. Who would be able to adopt such an alternative FRSSE would be subject to eligibility criteria as we currently have in the UK. In producing the revised FRSSE, certain aspects of IFRS for SMEs could be dispensed with – particularly the requirement to produce a cash flow statement and enable a disclosure-only approach to dealing with share-based payments. Users of FRSSE (in its current form) like it so much because of the reduced disclosure requirements and therefore it would make sense to have a FRSSE based on IFRS for SMEs also to allow reduced disclosure requirements.

The Way Forward

The UK ASB is still deliberating on the proposals for UK GAAP and indeed there are some genuine concerns about IFRS in terms of its appropriateness in certain areas – particularly in the controversial area of fair value accounting.

Most professional bodies are now examining students on IFRS, with many UK based papers having already been withdrawn from syllabuses or plans to withdraw UK based corporate reporting papers which is resulting in the newly qualified accountants having undertaken their training under IFRS.

An Exposure Draft is due out shortly from the ASB outlining their plans for UK GAAP. FRSSE is a bit of a 'problem child' in that if the ASB keep the FRSSE then a company who is currently borderline small would be required to report under IFRS for SMEs and would not be eligible to apply FRSSE. If the same company in the succeeding year were to suffer a bad year and the numbers meant the company was subsequently classified as small, the ASB would need to consider how such companies would deal with this – particularly in terms of comparability within the financial statements.

Interesting times lie ahead in the area of financial reporting, though I suspect the complete withdrawal of IFRS in the UK might be a little over-optimistic given that it has always been the intention of adopting an IFRS based reporting framework in the UK. If readers feel strongly about the whole issue then why not fill in the questionnaire on the ASB's website which will help them develop their proposals.

Steve Collings FMAAT FCCA DipIFRS is the audit and technical director at Leavitt Walmsley Associates Ltd and a partner in AccountancyStudents.co.uk. He is also the author of 'The Core Aspects of IFRS and IAS' and lectures on financial reporting and auditing issues.