

## An Alternative View

Areas that will not be questioned:

3 Tiers

Disclosure derogations

IFRS for SMEs as basis for Tier 2

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Good morning ladies and gentlemen

I am here to present an alternative view, explaining how the ASB's proposals could be improved.

I am going to start this morning by being philosophical. There are two great questions in life: "What" and "Why". These are even more important than the three oriental gentlemen: "who", "how" and "when".

You have heard "what" these proposals are about. This morning I will give you an alternative view of "why" leading to different answers to the question "what". But not fundamentally different answers I agree with the main building blocks

First, should there be 3 main tiers – well yes, BUT...

If Tier 2 was not so complex, tier 3 would not be required.

Should there be disclosure derogations for subsidiaries, - yes, BUT...

We need confirmation from the users of these accounts that they are happy with these derogations. I like the idea that we could introduce this quickly, separately from changes to the rest of UK GAAP?

Should Tier 2 be based on the IFRS for SMEs?

In effect this question is whether we should abandon the old language of UK GAAP; a language that has not been taught for a number of years, and whether we should standardise on the language of IFRS.

I do not think that we can maintain 2 accounting languages. So Tier 2 needs to be written in the language of IFRS, and the IFRS for SMEs is therefore a good starting point.

Let's move on to the areas that I will be covering today:

Content of this Presentation

The role of the standard setter

The objective of accounts

The purpose of accounting standards

The future structure of UK GAAP

The content of IFRS for SMEs

Questions

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First I will address “why”

I will talk briefly about the role of the standard setter, the objective of accounts and the purpose of accounting standards.

Then I will move on to consider “what”

I will then build on this background to identify the key structural questions arising from the EDs and then consider what further changes need to be made to the IFRS for SME so that it is suitable for use in the UK and Ireland.

Finally I will highlight some questions arising from this presentation that you may want to develop in the panel session or your consultation responses.

## The Role of the Accounting Standards Board

Setting accounting standards for the UK

Influencing the development and endorsement of IFRS

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The role of the ASB is twofold: first setting accounting standards for the UK. I like to think that the ASB is a leading, if not the best, national standard setter. The current proposals damage that reputation.

If we are going to replace UK GAAP with IFRS based standards the ASB ought to have the ambition to review those IFRS based standards critically, and improve them where necessary. I do not accept the policy that changes should be minimal for the sake of convergence.

A limited number of improvements to the IFRS for SMEs is not impractical. Quality can be maintained

Those interested in cross border comparisons will be able to cope, since changes will be limited in number. Training providers and technical departments will all be able to cope, because differences will be limited.

The ASB should be putting in place the best possible standards for the UK. This will enhance the ASB's reputation and maximise the ASB's influence, and by association the UK's influence; not only with the IASB, but also in endorsement debates within Europe.

Amending the IFRS for SME will give the UK practical experience of different solutions. We can then draw on this experience in debates with the IASB. I am sure that most members of the IASB will accept that IFRS are not perfect. We should not be scared of trying to improve upon them.

## The objective of Accounts

To provide **users** with **useful information** in a **useable** format

The ASB does not know:

**who** uses UK GAAP accounts,

or what they use UK GAAP accounts for?

*“There is a tendency to focus on the technical merit or theory behind each regulation and accounting standard. While this is clearly important, there needs to be more emphasis on understanding the problem being addressed, determining the most efficient regulatory solution for the problem and delivering this solution in an understandable way.”*

*Louder than Words, FRC, 2009*

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Before I address accounting standards, I want to discuss the objective of accounts. This objective obviously influences the content of accounts and accounting standards.

I see the objective as being to provide **users** with **useful information** in a **useable** format

Accounts are all about communicating information. No more, no less. The big challenge is in identifying the relevant information to be communicated. Only then does the approach to presenting that information become an issue. Accounting theory is helpful in standardising the presentation of information, but it is users of accounts, and not accounting theory, that should drive the content of accounts

I am sure that many of you are wondering how all of this relates to today’s discussions. The ASB has two problems when it comes to the replacement of UK GAAP. First, In order to meet the objective of accounts it **needs to know who uses those accounts**.

The ASB knows who the main users are for accounts prepared under IFRS, and the ASB has developed good contacts with them. But, the ASB **does not know** who uses accounts prepared under UK GAAP. Throughout the consultation process on the Future of UK GAAP, there has been virtually no input from users of accounts **prepared under UK GAAP**. To be honest, there has been virtually no input from **any** users of accounts. Most of the outreach from the ASB to users has been to users of IFRS accounts. Only recently has the ASB been seeking out users of UK GAAP accounts.

Any users out there – WE NEED YOUR INPUT. Tell us what you use accounts for.

This is the second problem. What are UK GAAP accounts used for? The ASB needs a good understanding of who uses accounts **and** what they use accounts for, in order to determine the content of accounts.

When preparing these EDs the ASB did not have this crucial information. This is not of itself a disaster. Often proposals lack key facts. But in the absence of facts the recommended approach is to state your assumptions and present arguments to support those assumptions.

This the ASB has failed to do. There is no clear discussion in these proposals of who uses accounts or what they use accounts for. **Without a clear vision of who uses accounts, or what they use them for, the ASB cannot identify the benefits arising from its proposals.**

This is why the ASB is struggling to put together a coherent “impact assessment”. Only once we have a view on who uses accounts and what they use them for, can we determine the necessary content.

### **The objective of Accounts**

To provide **users** with **useful information** in a **useable** format

### **The purpose of Accounting Standards**

To guide **preparers** of accounts in:

**identifying relevant information** about their business which will be useful to users, and

**presenting this information in a standard format** that maximises its useability,

bearing in mind the better regulation principles (Transparent, Accountable, Proportionate, Consistent, and Targeted)

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Now that we have clarified the objective of accounts as being “to provide **users** with **useful information** in a **useable** format”, we can move on to the purpose of accounting standards.

Which is to help users access useful information in two ways:

First, by guiding preparers of accounts in identifying relevant information about their business. That is information that will be useful to users. We have just established the problem with this. The ASB doesn't know what information will be useful to users. But I have covered that already, so moving swiftly on,

the second role is to guide preparers in presenting this information in a standard format that maximises its useability. As mentioned previously, accounting theory is very useful in standardising presentation. Calling things by the same name: stocks or inventory, and putting information in a similar place, all these improve the users access to information.

And in preparing standards the ASB needs to bear in mind the 5 principles of better regulation: Transparent, Accountable, Proportionate, Consistent, and Targeted. Picking two of these, how can we justify proposals as being **Proportionate** or **Targeted** when we do not have a view on who uses accounts or what they use them for?

So now you know my answer to the question “why”? My answer is “**to improve users access to quality information**”. If we can make life easier for preparers and auditors at the same time that is an added benefit. Accounting theory should be used where it helps achieve this, not where it hinders. This is my first heresy

Our focus needs to be on the purpose of accounts: To provide **users** with **useful information** in a **useable** format

## Future Structure of UK GAAP

Cut off between Tiers 1 and 2 and Tiers 2 and 3

Should the ASB determine where to cut off? If so, how?

Should markets/regulators/management/shareholders?

No justification for the IASB statement "IFRS for SMEs is not suitable for publicly accountable entities"

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Moving on at last to "what" should UK GAAP look like?

Assuming for the time being that we need 3 Tiers, the next question is who falls into which Tier? First, we need to consider why the cut off points exist, *another "why" question*, and only then will we know whether the ASB should be determining the cut off points, and if so how?

Since accounts are all about supplying users with information, the reason we have 3 Tiers is because there are assumed to be 3 different sets of information that users need, depending on the nature of the company. These information requirements are assumed to be so materially different, that not all these information requirements can be sensibly be met with one set of rules. If there are not 3 sets of data we do not need 3 Tiers of rules.

So the cut off points reflect these assumed changes in information requirements of users. As with many things in life, this is not a question of black or white, rather shades of grey. There are no hard and fast transition points. For the ASB to set these cut off points properly, it needs to have a clear view of the different information requirements of users. As I have said before: this is not the situation at present.

In the same way that UK GAAP is at present, Tier 2 can be an option for all. There is no need for the ASB to extend its remit. It can be left to regulators, markets, management or shareholders to determine who uses which Tier.

For example the EU can say that Listed companies must use Tier 1 - EU adopted IFRS.

The London Stock Exchange can say, as they do at present, that AIM companies must use Tier 1.

Water, gas and electricity regulators could say that all the companies they regulate must supply returns using Tier 1.

But PLUS could say they think that investors in their market will be happy to accept accounts using either Tier 1 or Tier 2

Management could say that they want to use Tier 1 because it is appropriate for their strategy.

Alternatively shareholders could require the use of a specific tier.

I realise this could be called radical. But ask yourself: Does the ASB know best? I don't think that we do. And that is my second heresy. As Mr Rumsfeld would put it: this is a known unknown. For the ASB to be competent to set cut off points this needs to change to a known known

Let's look again at the ASB's proposals for the cut off points. The ASB has not been able to differentiate between the different sets of users. Its rationale for the cut off point between Tiers 1 and 2 is that the IASB has stated that the IFRS for SMEs is not suitable for publicly accountable entities. I have seen no evidence to support this statement, and so cannot agree with it.

Even if we accept that the IFRS for SMEs is not suitable for publicly accountable entities, then we need to consider whether adapting the IFRS for SMEs could be a more proportionate solution than requiring such companies to use Tier 1?

Similarly there is no justification based on differing user needs for the proposed cut off between Tiers 2 & 3

## Content of IFRS for SMEs (1)

### Drivers of complexity

“Comparability” between entities

only down to ebitda and associated items in the statement of financial position

not fixed assets, debt/equity financing, taxation

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Finally we come to a brief review of the content of the IFRS for SMEs and its suitability as a basis of Tier 2.

First off complexity. As the FRC says in *Louder than Words*, regulators should be looking to drive out complexity from corporate reporting. Some complexity is needed in accounting standards, but the challenge for standard setters is to minimise this complexity.

I think that there are 2 unnecessary drivers of complexity in the IFRS for SMEs. I should warn you that what comes next is my third heresy. Please let me finish before you start throwing stones.

The first unnecessary driver of complexity is the concept of Comparability. I must qualify that statement. Comparability is fully justified to the extent that it means consistency between accounting periods, **for the same entity**.

In my opinion, Comparability **between entities** is only of use down to the EBITDA line on the income statement and in related items in the statement of financial position. Let me repeat that, Comparability between entities is only of use down to the EBITDA line on the income statement and in related items in the statement of financial position.

Striving for comparability between entities in other areas such as fixed assets, debt and equity financing and taxation, introduces unnecessary complexity. It is Comparability that is the rationale behind much of the pressure to use Fair Value. Conversely, if you examine arguments against Fair Value, these are often arguments against Comparability.

Content of IFRS for SMEs (2)

“Reliability” and its implications on “Recognition” and “Disclosure”

Reliable	represents faithfully that which it... purports to represent
Recognition	inclusion of “reliable” point values in the statement of financial position what do changes in these values mean and where do they go?
Disclosure	explanation in the notes only

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The second avoidable cause of complexity, and my fourth and last heresy, is the view that we can obtain reliable information by for example marking to model and that this justifies recognition as opposed to disclosure.

The issue I have with this is that the definition of “reliability” revolves around a number being “replicable”, someone else doing the same calculation will get the same answer, even if the calculation is just marking to model.

But first for the non-techys out there I should clarify what the other bits of jargon mean.

Generalising, “recognition” requires a “reliable” point value to be attributed to assets and liabilities so that these assets or liabilities can be included in the balance sheet, no matter how uncertain their valuation. This has the consequence that changes in these values need, to be reflected in the other primary statements. Unnecessary complexity can not only arise from the mechanics of calculating the valuation, but also in how to present changes in these valuations.

“Disclosure”, putting information about some asset or liability in the notes, is not currently accepted as an adequate alternative to “recognition”.

Coming back to “reliability”, there is no requirement for a reliable number to provide the user with any relevant information. This inclusion in accounts of numbers that are not useful just generates clutter and makes accounts harder to use. If we accept that users are sensible people who read the notes to accounts, it is possible to convey all the information about selected items in the notes.

If we change the definition of “reliability” to include a sense of usefulness, then we can reduce complexity in areas such as Share Options, Pensions and Contingent Liabilities.

### Content of IFRS for SMEs (3)

Once accounting principles have been confirmed, we can then address:

How best to present relevant information about assets and liabilities of uncertain value e.g:

intangibles,	contingent liabilities
deferred tax,	pension assets/liabilities etc.
derivative financial instruments,	

Which valuation methods are appropriate e.g.:

fair value,	NPV,
historic cost,	management's best guess etc.
probability weighted averages,	

*“it is not sensible for regulators to make disclosure requests that require companies to reformat existing information in a slightly different way. And regulators should consider whether information that management doesn't need is actually useful.”*

*Louder than Words, FRC, 2009*

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We know that the purpose of accounts is to convey information to users of accounts. We know that some of the qualitative characteristics underlying the accounting standards can be improved. We can now move on to the rest of the content of the IFRS for SMEs.

In the jargon it comes down to questions of “recognition” and “measurement”. What needs to be “recognised” in the primary financial statements, and how do we “measure” those items, if we are to convey information effectively to users? Or to look at this in reverse: what items are “recognised” under IFRS for SMEs that we do not need to “recognise” in Tier 2? How do we treat items of uncertain value? I have my views, but the ASB needs your input!

Intangibles, deferred tax, derivative financial instruments, contingent liabilities, pension assets/liabilities, these are some of the possibilities. Share options are another

And, is there a better way to “measure” items recognised in Tier 2 than the measure used in IFRS for SMEs?

Fair value, historic cost, probability weighted averages, NPV, management's best guess.

The ASB needs to know what you think

Questions

- 1) Should the ASB seek to maintain its reputation as a first class national standard setter?
- 2) Is copying IFRS into UK GAAP the best way to increase influence with the IASB?
- 3) Who uses UK GAAP accounts, and what do they use UK GAAP accounts for?
- 4) Can the ASB justify its proposals as being “Proportionate” or “Targeted” when they do not have a view on who uses accounts or what they use them for?
- 5) Do we need Tier 3?
- 6) Can Tier 1A be introduced quickly without having to wait for Tier 2 to be finalised?
- 7) Should we base Tier 2 on the IFRS for SMEs or the FRSSSE?
- 8) Should the ASB determine where to cut off between Tiers 1 & 2 and Tiers 2 & 3? If so, how?
- 9) In what areas does “Comparability” between entities provide useful information to users?
- 10) In what areas can “disclosure” be a substitute for “recognition”?
- 11) Is there a better way to measure (value) items recognised in Tier 2 than the measure used in IFRS for SMEs?

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These EDs are a stage in the development of new Standards. The ASB needs your input.

There are some questions arising from this presentation that you may want to develop in the panel session or your consultation responses.

[You have these in your pack so I am not going to read them out.]/[Read out]

Conclusion

There are good reasons for the ASB to improve upon the IFRS for SMEs

IFRS for SMEs can easily be improved

But users need to tell the ASB what information they need

Especially users of accounts currently prepared under UK GAAP

**We have the time to do this, do we have the inclination?**

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To conclude

There are good reasons for the ASB to improve upon the IFRS for SMEs

There are areas of the IFRS for SMEs that are ripe for improvement

But users need to tell the ASB what information they need

especially users of accounts currently prepared under UK GAAP

I hope that most of you are aware of the FRC's publication "Louder than Words". "Louder than Words" challenges standard setters, and others, to reduce complexity and I think that the ASB should be rising to that challenge.

This is a once in a generation opportunity and it is up to all of us to take full advantage of it.

I do not think that we should be scared into doing the wrong thing by self imposed artificial deadlines

**We have the time to do this, do we have the inclination?**