Choosing your GAAP
Planning for the proposed removal of UK GAAP

Contents

What’s changing?

Since 2005 listed groups in the UK have been required to prepare their consolidated financial statements in accordance with International Financial Reporting Standards (IFRS). Almost all other groups and companies have a choice. They can choose to follow IFRS or UK GAAP. If they are small, they have a further option to use the Financial Reporting Standard for Smaller Entities (FRSSE). But, from 2012, the options will change. UK GAAP is expected to be replaced with something new, the IFRS for Small and Medium-sized Entities (IFRS for SMEs).

What is IFRS for SMEs?

Until now, the International Accounting Standards Board (IASB) has focussed on developing standards suitable for entities trading on public capital markets. The resulting standards are relatively complex and contain many disclosure requirements.

Over a hundred countries make use of IFRS but there has been a growing demand for the IASB to produce a regime more suited to entities without public accountability. The IASB has taken six years to develop this and the IFRS for SMEs was issued on 9 July 2009 (www.iasb.org or www.iasb.org/IFRS+for+SMEs/IFRS+for+SMEs.htm). Despite the title, the standard is applicable not only to SMEs but to all entities which do not have public accountability. This means that it will be suitable for most subsidiaries of listed companies as well as large private entities, as long as they are not publicly accountable.

IFRS for SMEs is a much simplified version of full IFRS. It takes into account the needs of users of financial statements of non publicly accountable entities and the costs and benefits of compliance. It is small, at 230 pages, in comparison to the full bound text of IFRS and has a tenth of the 3000 disclosure requirements contained in full IFRS. To make it easier to follow, it is set out by topic, as used in the current FRSSE. The following table illustrates the main format differences.

Full IFRS	IFRS for SMEs
Standards numbered as they are published	Organised by topics, following an order very similar to the UK’s FRSSE
Almost 3000 pages	Under 300 pages
Around 3000 disclosure points	About 300 disclosure points
Updated almost monthly	Updated once every two or three years

Notes

While its detailed accounting provisions are broadly consistent with full IFRS, there are key differences and simplifications. The following are the key simplifications made:

- some topics in full IFRS are omitted because they are not relevant to typical SMEs e.g. segmental reporting, assets held for sale and earnings per share;
- some accounting policy treatments in full IFRS are not allowed because a simplified method is available to SMEs e.g. the revaluation model for property, plant and equipment and intangible assets is not allowed; and
- easing of recognition and measurement principles that are in full IFRS e.g. simplified calculation of defined benefit pension plan obligations in some circumstances.

The detailed provisions are discussed further on pages 7 to 10.

When will UK accounting standards die?

In recent years, the UK Accounting Standards Board (ASB) has consulted with its constituents over the future of UK GAAP. The ASB believes only one accounting framework is needed in the UK and it should be based on IFRS. To date, commentators have broadly supported the ASB's view.

The ASB is expected to issue in August 2009 its Paper seeking views on its proposal to replace current UK GAAP by adopting the IFRS for SMEs. The Paper is expected to propose that the new regime takes effect for accounting periods beginning on or after 1 January 2012, an ambitious target. The IFRS for SMEs will then be available for use by all UK companies except those with public accountability who will use full IFRS.

What does 'public accountability' mean?
An entity has public accountability if:

- 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; or
- it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses. This is typically the case for banks, building societies, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks.

Notes

A major selling point of the ASB's plans is that the FRSSE will continue to be available to the two million or more small companies and businesses in the UK. They are therefore not facing any significant changes over the next three years. The entities directly affected by these plans are the 50,000 or so larger companies currently using full UK GAAP. These entities include:

- companies which are listed and have not adopted IFRS in their individual financial statements;

- subsidiaries in listed groups who have not adopted IFRS throughout the group;

Where consolidated accounts are prepared using IFRS, company law allows a free choice of using UK GAAP or IFRS for the company's individual financial statements. Deloitte research shows that half of UK listed companies still use UK GAAP in their parent company only accounts and thus use UK GAAP for their UK subsidiaries. Many others use IFRS for the parent company only accounts but continue to use UK GAAP for subsidiaries.

- all public limited companies which are not publicly accountable; and

- all private groups and companies, except those which may qualify as small by having two out of three of:
  – turnover less than £6.5m (£7.8m gross in groups);
  – balance sheet total less than £3.26m (£3.9m gross in groups); and
  – not more than 50 employees.

Why will the ASB drop UK accounting standards?

Maintaining UK GAAP and IFRS frameworks, which are partly converged, is not desirable in the long term and is challenging for those who have to keep up to date with the two sets of accounting requirements. The number of entities within the scope of full UK GAAP has been decreasing in recent years as groups traded on AIM and public sector entities move to IFRS. The ASB has not sought to develop UK GAAP since 2004 and so it has become a patchwork of very old SSAPs, FRSs issued by the ASB as an independent standard setter in the 1990s/early 2000s and FRSs based on their international equivalents and issued from 2004. IFRS is seen as the global language of accounting. With the IFRS for SMEs being available, it is now time to drop UK accounting standards.

Notes

What are the choices?

The 'middle tier' face a choice of whether to leap to full IFRS or to step to the new IFRS for SMEs. The following chart shows the options expected to be available to companies and groups.

	FRSSE	IFRS for SMEs	Full IFRS
Listed companies*			✔
Companies traded on AIM*			✔
Companies traded on other stock exchanges*			✔
Unlisted private companies with public accountability			✔
Unlisted companies without public accountability		✔	✔
Subsidiary within a listed group currently applying IFRS		**	✔
Medium-sized companies		✔	✔
Small companies	✔	✔	✔

* Also applies to their consolidated accounts which may already have to use full IFRS.
** See first question opposite.

Consideration of new regimes inevitably gives rise to many questions. Answers to some of the expected questions in relation to this transition are noted opposite.

Notes

1. Can companies, such as subsidiaries of listed groups that have already made the move to full IFRS change to use the IFRS for SMEs?

Under current UK law, an entity which opts to produce financial statements in accordance with IFRS cannot switch back to preparing UK GAAP accounts unless there is a 'relevant change of circumstance' e.g. the company becomes a subsidiary of another undertaking that does not prepare its accounts under IFRS. The IASB allows entities to move from full IFRS to IFRS for SMEs. On the assumption that IFRS for SMEs would become UK GAAP (see question 4 below) it would be necessary to clarify that the introduction of IFRS for SMEs is a 'relevant change in circumstance', so entities could switch from full IFRS to IFRS for SMEs.

2. Full IFRS or IFRS for SMEs?

Those companies faced with the choice will need to weigh up the pros and cons of both regimes for their particular circumstances. As well as the accounting differences in recognition and measurement and the differences in disclosure requirements between the two regimes, there are a number of other factors to consider. Is the company considering listing in the near future? What are competitors doing? How complex is the company? Does the company currently adopt FRS 26 on financial instruments? Pages 11 and 12 set out further matters for consideration.

3. Same regime for all entities in a group?

Currently many listed groups choose to prepare their parent company individual accounts and subsidiary accounts in accordance with UK GAAP. As the parent company is publicly accountable it will not be eligible to use IFRS for SMEs and will have to use full IFRS. Similarly if there were vehicles in the group with listed debt or holding assets in a fiduciary capacity, they would have to use full IFRS. Current UK law states that a parent company and its subsidiary undertakings must prepare their accounts using the same accounting framework unless there are good reasons not to do so. The Department for Business, Innovation and Skills (BIS) set out, in a note on its website, what might constitute 'good reasons'. Clarification will be welcomed from the ASB or BIS on whether groups will have the free choice of IFRS for SMEs or full IFRS for their non publicly accountable subsidiaries.

4. Why does IFRS for SMEs have to be adopted by the ASB and not used directly?

The ideal position would be for the European Commission to recognise IFRS for SMEs as part of the IAS Regulation. This would have direct effect in the UK and would mean that UK companies would not be required to consider the detailed accounting provisions in company law emanating from the EU's Fourth and Seventh Company Law Directives. While many are asking for this, the battles over IFRS in Europe appear to have left some war-weary to initiate another fight to have IFRS for SMEs directly recognised in European legislation.

Notes

What happens to tax?

The tax impacts of transitioning to IFRS for SMEs or full IFRS are complex and will need careful evaluation by entities. The immediate impact of transition to a new GAAP is the taxation of transitional adjustments. The tax rules on a change of accounting framework were established by HMRC in anticipation of the transition to full IFRS in 2005. These rules will now have a much wider application as the adoption of a new accounting framework will mean that many UK companies will be changing their accounting policies. Some transitional adjustments are taxed in the year of change, some adjustments are spread over 10 years and some will have no immediate tax effect. Entities will need to consider the impact of these adjustments on cash tax payments and incorporate them into their budgeting and planning activities.

The longer term significance of changing GAAP will arise from its ongoing impact on tax calculations and tax planning. Entities will need to consider areas where tax follows the accounting and where adjustments are required to move from the accounting treatment to the tax treatment. In many cases the starting point for taxable income is profit or loss per the entity accounts. Where a change of accounting policy affects the recognition of income or expenses, this will have a tax effect. This will affect both UK entities (as shown in the table below) and overseas entities which are classified as a 'Controlled Foreign Company' (CFC) as defined by tax legislation. Some groups rely on certain aspects of UK GAAP to get to an appropriate tax treatment. For example where entities rely on SSAP 20 *Foreign currency translation* to avoid taxable gains or losses on loans to overseas affiliates, the more stringent functional currency requirements in the IFRS for SMEs are likely to be unwelcome as this flexibility will be removed.

Where tax does not follow the underlying accounting treatment, additional compliance costs may be incurred to move from the accounting balances to the tax position. For example, the current legislation for financial instruments (known as the Disregard Regulations) allows entities to choose whether to follow the accounting or move to an effective hedging regime for tax purposes where the accounting regime does not permit this. The law is extremely complex and it is likely that more companies will be required to consider the rules when adopting the IFRS for SMEs or full IFRS. However, the current rules do not address all scenarios and cash tax volatility will be unavoidable in some situations where tax is left in the default position of following the accounting.

Transfer Pricing (TP) may also be affected by a change of GAAP where the setting of arm's length prices is by reference to results in the statutory financial statements. As a result transfer pricing and thin capitalisation positions may be different under the IFRS for SMEs unless further adjustments and calculations are carried out.

Entities should assess the impacts of transition early to avoid unexpected liabilities and cash tax volatility in future years and consider lobbying for change to the tax legislation to mitigate the accounting changes where appropriate. The impact of the change of GAAP on tax planning should also be analysed, particularly in areas where tax treatment is dependent on current UK GAAP accounting.

Notes

Key areas of accounting and tax impact

Transitioning to IFRS for SMEs or full IFRS is likely to mean a change in the recognition and measurement of a number of items in the financial statements. The list that follows is by no means exhaustive. It indicates the more significant accounting differences between UK GAAP and the IFRS for SMEs. Where the IFRS for SMEs differs significantly to full IFRS this is noted in italics. The impact of changing GAAP is not restricted to accounting. The implications for tax can be significant. An indication of the possible consequences for cash tax and on the effective tax rate of moving to a new regime is also given below.

Topic	Comparison of **IFRS for SMEs**, **UK GAAP** and *Full IFRS*	Tax impact of IFRS for SMEs	
		Cash tax impact	**Effective tax rate (ETR)/deferred tax**
Goodwill and intangibles	All internally developed intangibles, including development costs, must be expensed.	Expensing all internal costs may allow an upfront deduction of all revenue development costs rather than just qualifying research and development.	No impact on ETR where deferred tax is provided under UK GAAP.
	Capitalisation of development costs permitted if conditions met.		
	Capitalisation of development costs mandatory.		
	Acquired intangibles (including goodwill) must be amortised. Default useful life 10 years.	Use of shorter useful life may accelerate tax deduction.	
	Mandatory amortisation. Assumed maximum useful life 20 years.	May need to consider transfer pricing.	
	Goodwill and indefinite life intangibles are not amortised.		
Investment property	Use cost unless fair value can be measured reliably without undue cost or effort in which case use 'fair value through profit and loss' (FVTPL).	No effect since investment properties are taxed on a chargeable gains basis.	Deferred tax will be required on all temporary differences including revaluations.
	Mandatory revaluation to 'open market value' through the STRGL.		
	Option to use cost or FVTPL.		

Notes

Topic	Comparison of IFRS for SMEs, UK GAAP and *Full IFRS*	Tax impact of IFRS for SMEs	
		Cash tax impact	Effective tax rate (ETR)/deferred tax
Property, plant and equipment	Mandatory cost model, no option to revalue. Option to revalue through STRGL. *Option to revalue through comprehensive income.*	No obvious impact.	No revaluations. Will simplify deferred tax calculations.
Borrowing costs	Must be expensed as incurred. Option to capitalise or expense. *Mandatory capitalisation.*	No effect since UK tax law allows a deduction for the expense regardless of the accounting in relation to fixed assets or projects.	No deferred tax liability as costs will be expensed as incurred.
Financial instruments	Only two classifications: cost and FVTPL. • 'Basic' financial instruments (e.g. cash, trade receivables and 'vanilla' loans) are measured at cost or amortised cost using the effective interest method. Equity investments with a quoted price at FVTPL. • 'Complex' financial instruments (e.g. derivatives such as options and forward contracts) are measured at FVTPL. • No separation of embedded derivatives. • Simplified hedging requirements. • Option to use full IFRS for recognition and measurement (but retaining reduced disclosure). 'Old' UK GAAP follows a cost model but with little guidance. Some use full IFRS accounting (FRS 26). *Complex mixed cost/fair value model involving four asset categories, recycling of gains from equity, separation of embedded derivatives and restrictive hedging rules.*	Significant effect – amounts taken to profit or loss will generally be prima facie taxable unless the Disregard Regulations apply. Where entities are required to use FVTPL for the first time, there will be an additional compliance burden as they will need to consider the application of the Disregard Regulations (and whether to make the annual opt out election). If a taxable restatement arises in the year of transition, entities will need to consider the impact on certain types of financial instruments where the transition amount is required to be spread over 10 years. Entities which previously matched foreign exchange movements may have to apply the Disregard Regulations for tax purposes as a result of the simplified hedging requirements.	The ETR is likely to be more volatile where the Disregard Regulations apply if any resulting deferred tax assets are not recognised. Otherwise, the ETR will be 'normalised' through deferred tax provisions.

Notes

Topic	Comparison of **IFRS for SMEs**, **UK GAAP** and *Full IFRS*	Tax impact of IFRS for SMEs	
		Cash tax impact	**Effective tax rate (ETR)/deferred tax**
Defined benefit pension schemes	Net liability approach based on present value of future obligations. Simplification of the calculation allowed by omitting certain variables e.g. future salary increases. No spreading of actuarial gains/losses. Net liability approach using projected salaries. *Net liability approach using projected salaries. Spreading of actuarial gains/losses permitted.*	No effect since the tax deductions available for pensions are driven by cash payments rather than the expenses taken to profit or loss.	ETR should not be impacted if any deferred tax assets are fully recognised.
Multi employer pension schemes	No exemption from recording a pension surplus or deficit in individual accounts where entities in the scheme are under common control. Wider exemption as available to group schemes. *Same as for IFRS for SMEs.*	As above	As above
Income tax	Temporary difference approach. Specific rules on tax uncertainties. Timing difference approach. *Temporary difference approach. Limited rules on tax uncertainties.*		Temporary difference approach gives rise to more deferred tax. The specific inclusion of rules relating to provisions for tax uncertainties and a prescribed method of calculation will result in significant additional rigour for entities in the accounting process, especially around transfer pricing.

Notes

Topic	Comparison of **IFRS for SMEs**, **UK GAAP** and *Full IFRS*	Tax impact of IFRS for SMEs	
		Cash tax impact	**Effective tax rate (ETR)/deferred tax**
Foreign currency	Transactions recorded in functional currency. Option: • SSAP 20 permits use of a 'local' currency. • FRS 23 same as IFRS for SMEs. *Same as IFRS for SMEs.*	Significant effect where entities have used the 'local' currency approach in SSAP 20. The resulting FX movements taken to profit or loss as a result of the functional currency approach will be taxable causing significant volatility in cash tax payable on an annual basis.	No ETR impact where any deferred tax is fully provided.
Business combinations	Acquisition method using a cost approach – attributable costs capitalised, and adjustments to contingent consideration against goodwill. Acquisition accounting using a cost approach. Merger accounting permitted if conditions met. *Acquisition method using a fair value exchange approach – attributable costs are expensed, and adjustments to contingent consideration generally to profit or loss.*	Possible effect where negative goodwill is written off to profit or loss. No effect for transaction costs as they are generally disallowed for tax purposes.	Deferred tax will arise on business combinations where fair values allocated to assets and liabilities are different to the underlying tax base due to use of temporary difference approach. Where disallowable costs are capitalised the ETR will reduce.
Cash flow statements	Cash flow statement is required in every set of financial statements, including subsidiaries. Exemptions for 90% owned subsidiaries and other entities. *Same as IFRS for SMEs.*	No tax impact.	

Notes

More than accounting

Converting to a new accounting regime is not just an accounting issue. As well as identifying all accounting and tax differences, companies will consider the impact of moving to a new accounting regime on other areas of the business, the most common of which are listed below. While some considerations will have to await the final outcomes from the ASB, companies may wish to initiate certain work over the remainder of 2009 to ensure that the foundations for a smooth transition are in place. Work may be around group reorganisations, dividend planning and identifying whether there are any potential 'blocks' in groups, reviewing tax arrangements and updating computer systems.

Tax	• Will a change in GAAP impact on tax housekeeping, planning arrangements or cash payments?
Systems and reporting	• Can the accounting systems support a revised chart of accounts? • Will management reporting and forecasting need to be revised? • Are there accounting differences which require budgets and forecasts to be reworked? • Will a different accounting regime impact key performance indicators? Will targets need to be revisited?
Remuneration schemes	• Are any bonuses linked to financial measures? If so will these schemes need to be revisited in light of a new accounting regime?
Distributable profits	• Will the use of a different GAAP impact on the ability of group companies to pay dividends up through the group structure? • Will a pension deficit be recognised in the books and affect the ability to pay up profits (see 'Pensions' below)?

Notes

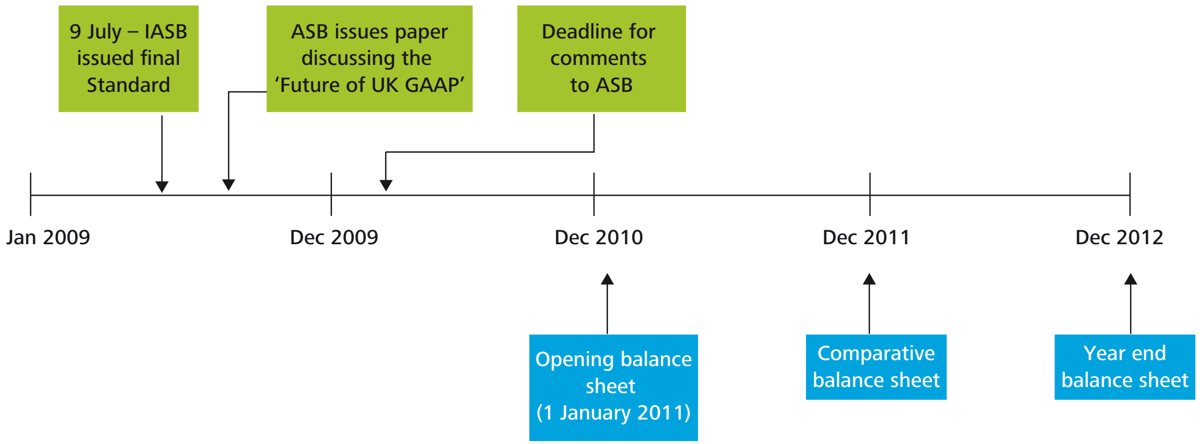
Staff	• Do directors and staff have sufficient knowledge of the content of IFRS for SMEs and full IFRS to be able to make an informed decision as to which accounting regime to follow? • Is there sufficient staff resource and expertise to manage the transition?
Group structure	• Which accounting regime do overseas entities follow? Would a consistent reporting framework improve efficiencies in group reporting? • Are there opportunities to centralise processes and reporting? • Are there too many subsidiaries at present? Can the group structure be tidied up?
Pensions	• Is there a multi employer pension scheme? If yes and the exemption in FRS 17 from recording the surplus or deficit in individual entity books is used, which entities in the group will recognise their share of the defined benefit liability or asset in their individual books under the new accounting regime?
Banking covenants and finance	• Does a change in GAAP affect the terms within any banking or other legal agreements (e.g. covenants or earn outs)? • How will hedging strategies be affected under a new accounting regime?
Regulatory impact	• Will assessment of capital adequacy/monitoring requirements need to be carried out in light of anticipated changes to the income statement, balance sheet and cash flow?
Lobbying for change	• Has preliminary analysis identified any particular issues for the company that should be taken up with the ASB, HMRC or BIS? • Should the company respond to the ASB Discussion Paper by the expected comments deadline early in 2010?

Notes

When will this happen?

The date that the IFRS for SMEs can be adopted by UK companies is uncertain at present. Current indications are that it could be effective for financial periods ending on or after 31 December 2012. This is an ambitious timetable. It is debatable whether this gives sufficient time for entities to become familiarised with the IFRS for SMEs, particularly as comparative figures would need to be collected from 1 January 2011. The ASB's consultation will run to early 2010 and so no final decision will be made until some time into 2010.

The timeline below indicates what a transition date of 1 January 2011 would mean:



The IFRS for SMEs has been issued in its final form so this gives companies a period of stability in the lead up to transition. The IASB will carry out an initial comprehensive review after two years' implementation experience. Thereafter the IFRS for SMEs is expected to be updated once every three years.

Notes

Preparing for the change

The concept of changing GAAP will be new to many. For listed groups, the experience of transitioning to full IFRS in 2005 has not faded from memory. Indeed many UK listed groups continue to use UK GAAP in their subsidiaries' financial statements and in the parent company individual financial statements, with IFRS being used on consolidation only. The ending of UK GAAP will now force such groups to change their accounting to full IFRS or IFRS for SMEs. Companies have the benefit of learning from those which transitioned in 2005. The main lesson from 2005 is that forward planning is vital for a successful transition. Planning in advance means that the transition can be paced, with costs being kept under control and unwelcome last minute surprises being kept to a minimum. 2012 may sound like a long way off, but remember that an opening balance sheet would be required in 2011.

That planning may involve a number of stages as set out below:

Advance planning/ action 2009/10	• What in broad terms will be the impact of the change? • Determine if any group reorganisations should be actioned in response to issues around tax arrangements, dividend streams or pension schemes. • Can the number of companies in the group be rationalised? • Will the change of GAAP create major issues e.g. computer systems which are XBRL compliant (tax filing purposes), reward packages, earn outs or covenants which require considerable time and effort to organise?
Detailed planning/ actions 2010/11	• Arrange detailed training for project leaders. • Determine the choice of accounting framework available for each entity. • Identify key accounting differences. • Evaluate which regime is most appropriate for each entity. • Assess impact on tax strategy and compliance. • Communicate the change with key stakeholders in the business. • Assess impact and opportunities of full IFRS or IFRS for SMEs adoption in functional areas (e.g. treasury, human resources, investor relations and tax). • Make systems enhancements.
Implementation 2011/12	• Prepare opening balance sheet. • Organise broader staff training.

Notes

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom.
Tel: +44 (0) 20 7936 3000 Fax: +44 (0) 20 7583 1198.

Designed and produced by The Creative Studio at Deloitte, London. 31660

Member of Deloitte Touche Tohmatsu