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**COMMON APPENDIX
STOCK EXCHANGE AND PROFESSIONAL ACCOUNTING
REQUIREMENTS APPLYING IN BOTH
THE REPUBLIC OF IRELAND AND THE UNITED KINGDOM**

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This appendix is common to the separate chapters on the Republic of Ireland (ROI) and the United Kingdom (U.K.). Stock exchange regulations and professional accounting pronouncements are largely the same in both jurisdictions - consequently, the material in this appendix applies to both chapters.

This appendix is organized into six parts:

- Part 1: General items (Sections 1 and 2)
- Part 2: Profit and loss account items (Sections 3 to 5)
- Part 3: Balance sheet items (Sections 6 to 11)
- Part 4: Cash flow (Section 12)
- Part 5: Groups (Section 13) and
- Part 6: Smaller entities (Section 14).

The appendix ends with a summary of the professional accounting pronouncements at July 2002 applicable in both the Republic of Ireland and the United Kingdom which is shown in Appendix 1.

PART 1: GENERAL ITEMS

1. Conceptual Framework and Accounting Policies

The principles underlying the preparation and presentation of general purpose financial statements in the United Kingdom and Republic of Ireland are contained in the Accounting Standards Board's (ASB's) *Statement of principles for financial reporting*, published in December 1999. Development of the statement of principles took almost the whole of the 1990s, but the statement is comprehensive and has benefited from a protracted consultation and refinement process and from previously developed frameworks. It is based on the International Accounting Standard's (IASC's) *Framework for the preparation and presentation of financial statements* which, in turn, was based on the *Statements of financial accounting concepts* developed in the USA by the Financial Accounting Standards Board (FASB) in the 1980s. In addition, it is also similar in content to framework documents issued by standard setters in Australia, Canada and New Zealand. The ASB believes that the statement of principles will contribute to international harmonization of accounting

practices because the use of language created by shared principles will contribute to consistent accounting approaches internationally.

Application of the general principle of substance over form is required in the United Kingdom and Republic of Ireland by Financial Reporting Standard (FRS) 5 *Reporting the substance of transactions* which was issued in 1994. Requirements for disclosure of accounting policies are set out in Statement of Standard Accounting Practice (SSAP) 2 *Disclosure of accounting policies*, published in 1971. FRS 18 *Accounting policies* issued in December 2000.

1.1 Statement of Principles

The statement of principles is primarily intended to be a tool to help guide the ASB when developing and reviewing accounting standards for specific transactions and events. It also provides a framework against which questions not covered by specific standards can be answered by preparers and users of financial statement. The ASB intends to use the statement of principles to ensure that its proposals are rigorous and consistent. The statement of principles contains eight chapters covering the following topics:

- Objective of financial statements
- Reporting entity
- Qualitative characteristics of financial information
- Elements of financial statements
- Recognition in financial statements
- Measurement in financial statements
- Presentation of financial information
- Accounting for interests in other entities.

The stated objective of financial statements is to provide information that is useful to those for whom they are prepared. This objective is elaborated upon in Chapter 1. Chapter 2 focuses on defining the reporting entity. It emphasizes that entities that ought to prepare and publish financial statements do, in fact, do so and that those financial statements report on all relevant activities and resources. FRS 2 *Accounting for subsidiary undertakings* already uses the reporting entity concept described in the statement of principles. In chapter 3 the qualities of financial information that make it useful are identified and discussed. The four characteristics of relevance, reliability, comparability and understandability are given priority, although the potential for conflict between them is recognized. Subsidiary qualities for all four are identified and discussed. The elements of financial statements are identified in chapter 4 as assets, liabilities, ownership interest, gains, losses, contributions from owners and distributions to owners. These elements are then defined and explained. To date, FRSs 4 *Capital instruments*, 5 *Reporting the substance of transactions*, 7 *Fair values in acquisition accounting*) and 12 *Provisions, contingent liabilities and contingent assets* are already based on definitions set out in this chapter.

When the reporting entity undertakes a transaction, or when some other relevant event occurs, the effect of that transaction or event on the elements of financial statements will need to be recognized in the financial statements if certain criteria set out in chapter 5 are met. Where a transaction or other event has created a new asset or liability or added to an existing asset or liability, that effect is recognized if sufficient

evidence exists and the new asset or liability can be measured with sufficient reliability. Measuring an asset or liability entails deciding on the measurement basis and determining the monetary amount that is appropriate for that basis. Chapter 6 describes the measurement process and explains how to choose between the measurement bases available. FRS 11 *Impairment of fixed assets and goodwill* already uses the recoverable amount notion described in this chapter. The statement of principles deals with the principles underlying presentation of financial information in addition to those underlying their preparation. The principles underlying presentation included in chapter 7 are based on the philosophy that good presentation ensures that the essential messages of the financial statements are communicated clearly and effectively and in as simple and straightforward a manner as possible. Included among the principles on presentation is a statement that disclosure of information in notes is not a substitute for recognition and does not correct or justify any misrepresentation or omission in the primary financial statements. FRS 3 *Reporting financial performance* already draws on the principles of good presentation described in this chapter. The final chapter focuses on accounting for interests in other entities. Although this involves various measurement and presentation issues dealt with in earlier chapters of the statement of principles, those relating to interests in other entities are dealt with together in the final chapter. It acknowledges that single entity financial statements and consolidated financial statements present the interests of the reporting entity from different perspectives.

1.2 Disclosure of Accounting Policies

FRS 18, *Accounting policies* was issued in December 2000. It sets out the principles to be followed in selecting accounting policies and disclosures required to facilitate understanding of the accounting methods adopted in the financial statements. The FRS aims to ensure that an entity adopts the most appropriate policies for its circumstances for the purpose of giving a true and fair view. It also requires that the policies adopted are regularly reviewed to ensure they remain appropriate, and are changed when a new policy becomes more appropriate. A change of accounting policy is generally treated as a prior period adjustment under FRS 3 (see Section 4.1.3 below).

Accounting policies are defined as:

Those principles, bases, conventions, rules and practices applied by an entity that specify how the effects of transactions and other events are to be reflected in its financial statements through (i) recognizing, (ii) selecting measurement bases for, and (iii) presenting assets, liabilities, gains, losses and changes to shareholders' funds.

FRS 18 requires that accounting policies adopted should be consistent with accounting standards, UITF Abstracts and companies' legislation. The appropriateness of accounting policies should be judged against the objectives of relevance, reliability, comparability and understandability. A description of each of the accounting policies that is material in the context of the entity's financial statements must be disclosed, as must details of any changes to the accounting policies that were followed in preparing financial statements for the preceding period. This must include an explanation of why the new policy is more appropriate, the effect of any prior period adjustment on the results of the preceding period and an indication of its effect on the current period.

The FRS also defines estimation techniques. They are defined as:

Methods adopted by an entity to arrive at estimated monetary amounts, corresponding to the measurement bases selected, for assets, liabilities, gains, losses and changes to shareholders' funds.

Estimation techniques include, for example, depreciation methods and methods used to quantify bad debts provisions. Changes in estimation techniques should not be given retrospective effect by restatement of prior periods. Where their effect is material, the effect on the current year should be disclosed.

1.3 Reporting the Substance of Transactions

FRS 5 *Reporting the Substance of Transactions* was issued in April 1994 after a lengthy process which spanned nine years of proposals. FRS 5 is unusual in that it prescribes accounting practice in general terms based on the ASB's *Statement of Principles* with the aim that the standard will have continued and lasting relevance. The standard's fundamental principle is that the substance of an entity's transactions should be reflected in its accounts.

The general approach adopted by FRS 5 involves analysing the effects of transaction on assets and liabilities to establish if new assets (and related liabilities) have been acquired and if previously recognised assets and liabilities should continue to be included in the reporting entity's accounts. Where there is a series of connected transactions, it is necessary to identify and account for the series of transactions as a whole, rather than addressing each transaction individually. The application of the general principles is illustrated in detailed Application Notes, which consider specific kinds of off-balance sheet finance

Although FRS 5 applies to all transactions, the accounting treatment and disclosure of the vast majority of items in the financial statements are unaffected by the standard. It is particularly relevant to transactions whose substance is not readily apparent and whose true commercial effect may not be fully indicated by their legal form. FRS 5 sets out general principles covering:

- Determination of the substance of a transaction
- Whether any resulting assets and liabilities should be included in the balance sheet
- Reporting these transactions in the profit and loss account
- Disclosures necessary
- Whether any special 'vehicle' companies incorporated into a transaction should be consolidated

A key step in determining the substance of a transaction is to identify whether the transaction has given rise to new assets or liabilities, or whether it has increased or decreased existing assets or liabilities. Central to this judgment are the FRS 5 definitions of assets and liabilities. Assets are defined as:

rights or other access to future economic benefits controlled by an entity as a result of past transactions or events.

Liabilities are defined as:

an entity's obligations to transfer economic benefits as a result of past transactions or events.

FRS 5 extends the legal consolidation requirement to cover all entities that are in essence subsidiaries (referred to in the standard as 'quasi-subsidiaries'). There is also guidance on offset of related debit and credit balances. In certain circumstances, a transaction may qualify to be shown by a 'linked presentation'.

2. Corporate Governance

Corporate governance deals with the way in which businesses are run. Stock exchange regulations on corporate governance have increased substantially in recent years in response to major corporate scandals and deliberations of dedicated committees throughout the 1990s. Under stock exchange regulations, directors' reports must deal with issues of corporate governance following recommendations of the Cadbury, Greenbury and Hampel committees.

The Committee on the financial aspects of corporate governance (Cadbury Committee) published its report in 1992. The report contained a voluntary code of best practice covering the activities of the Board, the roles of non-executive and executive directors, and directors' responsibilities for financial reporting and internal controls.

In 1995 the Greenbury Committee report on directors' remuneration identified good practice in relation to remuneration committees, developing and disclosure of company policy on directors' remuneration and service contracts.

The Hampel Committee report *Principles of Good Governance and Code of Best Practices* ('the Combined Code') was published in August 1998 and it replaced the Cadbury and Greenbury codes. The principles set out in the Combined Code are summarized in Table 1.

The Combined Code is included in paragraph 12.43A of the Listing Rules and requires certain matters to be disclosed in the annual report as follows:

- How the principles of the Combined Code are applied
- Whether or not detailed provisions of the Combined Code are complied with (exceptions should be explained)
- Remuneration policy and details of the remuneration of each director
- Justification for combining the posts of chairman and chief executive
- The following must be named:
 - chairman, chief executive, senior independent director, other independent directors
 - chairman and members of the nomination committee
 - members of the remuneration committee
 - members of the audit committee
 - directors for election/re-election (with biographies)
- Directors' responsibility for preparing the accounts
- Going concern status of business, with supporting assumptions or qualifications
- Directors have reviewed effectiveness of the internal controls.

The Combined Code requires the board to review the effectiveness of all controls, not just financial controls. This requires the board and audit committee to consider the company's approach to evaluating risk.

Table 1: Principles of Good Corporate Governance

Directors and the Board

- 1 Effective board to lead and control the company
- 2 Running the board and running the company are separate tasks
Clear division of responsibilities at the head of the company
No individual has unfettered powers
- 3 Balance of executive and non-executive directors
No individual or group to dominate the board
- 4 Timely and quality information to the board
- 5 Formal and transparent procedures for appointments to the board (nomination committee)
- 6 Directors re-elected at least every three years

Directors' remuneration

- 1 Remuneration to attract and retain but no more than necessary
Executive remuneration partly linked to corporate and individual performance
- 2 Formal, transparent procedure for developing policy and individual packages (remuneration committee)
Directors not involved in deciding their own remuneration
- 3 Statement of remuneration policy and details of remuneration of each director to be disclosed

Relations with shareholders

- 1 Encourage dialogue on objectives with institutional shareholders
- 2 Annual general meeting to communicate with private investors and encourage their participation

Accountability and audit

- 1 Balanced and understandable assessment of the company's position and prospects
- 2 Sound system of internal control
- 3 Formal transparent system to apply above two principles and maintain relationship with auditors (audit committee, with at least three non-executive directors)

Institutional investors

- 1 Responsibility to make considered use of their votes
- 2 Preparedness to enter dialogue on objectives with the company
- 3 Evaluation of companies' governance arrangements, particularly board structure and composition

Source: *Principles of Good Governance and Code of Best Practices*

The final piece of the corporate governance jigsaw, guidance on internal control, *Internal control: Guidance for Directors on the Combined Code* (Turnbull Report), was issued in September 1999. This guidance is to assist directors in the review of internal controls as required in the Combined Code.

2.1 Directors' Remuneration

One area of major concern is directors' remuneration - both the amounts and the availability of information on remuneration packages. Legal disclosure requirements require disclosure of fees, salaries, pensions and compensation for loss of offices. Modern compensation packages are infinitely more complex. They may include substantial non-cash elements whose disclosure is not covered by legislation.

Paragraph 12.43 (d) of the listing rules requires disclosure of any arrangements by directors to waive emoluments and of any arrangements to waive future emoluments.

Remuneration committees' reports on the Combined Code provisions on directors' remuneration must contain:

- Policy statement on executive directors' remuneration
- Amount for each director and former director for the current and previous period in tabular form for:
 - basic salary and fees
 - estimated monetary value of benefits in kind
 - annual bonuses
 - deferred bonuses
 - compensation for loss of office/breach of contract/termination payments,
 - total
- Information in tabular form on share options for each director in accordance with UITF Abstract 10
- Details of long-term incentive schemes
- Explanation and justification for elements of remuneration other than basic salary which are pensionable
- Details of directors' service contracts with notice period greater than one year or with provisions for pre-determined compensation on termination exceeding one year's salary and benefits in kind, giving reasons for such a notice period
- Unexpired term of any service contract of a director being proposed for election/re-election or a statement that such a director does not have a service contract
- Statement of company policy on granting of options and any changes therein from the previous year
- Details under defined benefit pension schemes.

The auditors are required to express an opinion on whether details of directors' remuneration have been disclosed in accordance with the Combined Code. In cases of non-compliance the auditors are required to disclose the information in their report.

2.1.1 Directors' Share Options

UITF Abstract 10 '*Disclosure of directors' share options*' was issued by ASB in September 1994. The abstract suggests the following disclosures in the notes to the accounts for each director:

- Number of shares under option at beginning and end of year (or date of appointment if later)
- Number of options during the year - lapsed, exercised and lapsed unexercised;
- Exercise prices
- Dates from which options may be exercised
- Expiry dates
- Cost of the options (if any)
- Market price of shares on date any options were exercised during the year (giving separate information on options exercised at different dates and at different prices)
- Concise summary of performance criteria attached to options
- Market price of shares, together with range (high/low) during the year.

2.2 Going Concern

A statement by the directors that the business is a going concern, supported by assumptions and qualifications as necessary, is required by paragraph 12.43 (v) of the Stock Exchange listing rules. This statement must be audited.

2.3 Internal Control

The Combined Code states

“The board should maintain a sound system of internal control to safeguard shareholders’ investment and the company’s assets.”

The Turnbull Report issued in September 1999 articulates three objectives to ensure that:

- Internal controls are firmly embedded in the business to ensure effective management of significant risks
- Guidance remains relevant over time
- Companies are able to tailor the guidance to their unique circumstances.

Particular emphasis is placed on adopting a risk-based approach to internal control systems and effectiveness. Clarification is provided on the role of the board, its committees and management in maintaining effective internal controls.

2.4 Statement of Directors’ Responsibilities

Under Statement of Auditing Standard 600 *Auditors’ reports on financial statements* a brief description of directors’ responsibilities is included in audit reports. This should refer to disclosure elsewhere, where relevant, of a more detailed statement of directors’ responsibilities.

2.5 Operating and Financial Review

ASB’s statement on *Operating and Financial Review* (OFR) was published in July 1993. This statement is unusual in that it is not mandatory. The OFR gives management an opportunity to discuss some of the main factors underlying the performance and financial position shown by the financial statements, with a view to enhancing the financial reporting of companies. The statement recommends essential features for OFR. It should:

- Be clear and succinct
- Include only matters that are significant to investors
- Be balanced and objective, dealing even-handedly with both good and bad news
- Refer to previous commentary not borne out by events
- Contain analytical discussion, not merely numerical analysis
- Follow a ‘top down’ structure, discussing individual aspects of the business in the context of the business as a whole
- Explain reason for and effect of changes in accounting policies
- Be clear how ratios/numerical information relates to financial statements
- Emphasize trends, unusual factors, and uncertainties

- Assist users in understanding the factors that are most significant to future performance
- Not mislead users by omission of confidential information.

There are two sections to the review: the operating section and the financial section. Detailed guidance is given in the ASB's statement on the information to be included under each of the headings. The sub-headings suggested include:

Operating section

- Operating results for the period
- Dynamics of the business
- Investment for the future
- Returns attributable to shareholders
- Comparison of profit and dividends in total and per share

Financial section

- Capital structure and treasury policy
- Taxation
- Cash flow
- Current liquidity
- Going concern
- Balance sheet value

Directors are not required to include in the annual report any formal confirmation that they have followed the principles set out in the ASB's statement. However, the statement suggests that where such adherence is implied, e.g., through using the words *operating and financial review*, the directors should signal any fundamental departures from the principles laid down in the statement.

2.6 Related Party Transactions

A fundamental assumption underlying the preparation of financial statements is that enterprises are distinct entities separate from their owners and other entities. Company accounts are therefore assumed to reflect transactions that have been effected on an arm's-length basis between independent entities. However, where parties to transactions are related this assumption may not be valid. Related parties may arrange transactions to produce particular desired results rather than those which would obtain if transactions were conducted on normal commercial terms.

A proper understanding of company financial statements requires transactions between companies and related parties to be disclosed. In practice, directors, holding companies, subsidiaries, and associated undertakings are assumed to be related parties to a company. Related party disclosures are governed by stock exchange requirements and by FRS 8.

2.6.1 Stock Exchange Requirements

The stock exchange requires disclosure of particulars of any contract of significance subsisting during, or at the end of, the financial year, in which a director of the company is or was materially interested, or if there was no such contract, a statement of that fact. In addition, it requires listed companies to disclose:

- Interests of each director (including their spouse and children under 18) in shares and options up to one month before the annual general meeting
- Options granted to directors in respect of share capital
- Names of individuals or companies holding substantial shareholdings
- Particulars of any arrangement under which a director has waived or agreed to waive any emoluments

- Particulars of any arrangement under which a shareholder has waived or agreed to waive any dividends
- The unexpired period of any service contract of more than one year's duration of any director proposed for re-election or a statement that no such contract exists.

2.6.2 FRS 8

FRS 8 *Related party disclosures* was issued in October 1995. Its objective is to ensure that financial statements contain disclosures necessary to draw attention to the possibility that the reported financial position and results may have been affected by the existence of related parties and by material transactions with them. These disclosures complement statutory and stock exchange disclosure requirements.

FRS 8 defines related party transactions as:

“the transfer of assets or liabilities or the performance of services by, or for a related party irrespective of whether a price is charged”.

A related party relationship will arise where there is control or influence affecting the independence of action of either party. The following are identified in FRS 8 as related parties of the reporting entity:

- Ultimate and intermediate parent, subsidiary and fellow subsidiary undertakings
- Associates and joint ventures
- Investor or venturer in respect of which the reporting entity is an associate or a joint venture
- Directors, including shadow directors, of the reporting entity
- Directors of the ultimate and intermediate parent undertakings
- Pension funds for the benefit of employees of the reporting entity or of any entity that is its related party.

Other parties are presumed to be related parties unless it can be demonstrated that neither party has influenced the financial nor operating policies of the other in such a way as to inhibit the pursuit of separate interests. Examples of these are:

- Key management of the reporting entity and its parent undertaking
- Shareholder controlling over 20% of the voting rights
- Entity managing or managed by the reporting entity under a management contract
- Members of the close family of any individual qualifying as a related party
- Partnerships, companies or trusts in which any individual qualifying as a related party or in which a close family member has a controlling interest.

The standard requires financial statements to disclose material related party transactions, and, in addition the following details:

- Names of the related parties and their relationship to the reporting entity
- Description of the transactions
- Amounts involved
- Amounts due to or from related parties and provisions for doubtful debts at the balance sheet date
- Amounts written off in the period in respect of debts due from related parties

The name of any controlling party, and if different, the name of the ultimate controlling party must also be disclosed.

2.6.3 FRED 25

FRED 25 proposes to replace FRS 8 with IAS 24 which has recently been revised by IASB. However, FRED 25 proposes retaining the requirement that an entity's controlling party should be named; this is not included in the revised IAS 24. Implementation of FRED 25 would mean changes in disclosure requirements, the definitions of related parties and the exemptions from disclosure. For example, FRED 25 does not propose that the names of transacting related parties be disclosed. The proposed exemption for subsidiaries' disclosures extends only to wholly-owned subsidiaries (FRS 8 exempts 90%-owned subsidiaries), though the proposed exemption will cover all related party transactions and balances.

2.7 Interim Reporting

Since 1964 the stock exchange has required listed companies or groups to produce interim reports on their activities and profit or loss for the first six months of each financial year. The Listing Rules detail the amount and type of information that must be included in the half-yearly report. The report must be published within 90 days after the end of the six-month period (effective for accounting periods beginning on or after 23 December 1999). The stock exchange does not require the half-yearly report to be audited. However, if it has been audited then the report of the auditors must be included in full, including any qualifications. If the interim statement has not been audited, then this must be stated.

Interim reports must contain the following amounts in tabular form:

- Turnover
- Operating profit / loss
- Interest payable less interest receivable (net)
- Profit / loss before taxation and extraordinary items
- Taxation, with overseas tax and share of associates' tax separately disclosed, where material
- Profit / loss on ordinary activities after tax
- Minority interests
- Profit attributable to shareholders before extraordinary items
- Extraordinary items (net of tax)
- Profit / loss attributable to shareholders
- Rates of dividend paid and proposed and the amount absorbed
- Earnings per share
- Balance sheet
- Cash flow statement
- Comparative figures for the corresponding six-month period in the preceding year.

Interim reports must also contain an explanatory statement relating to company or group activities and profit or loss during the six months. This statement must include:

- Any significant information which enables investors to make an informed assessment of the trend of the activities and results
- Indication of any special factor influencing activities and results
- Sufficient information to enable a comparison to be made with the corresponding period of the preceding financial year
- Reference to the prospects in the current financial year, so far as possible.

The Cadbury Committee report recommended changes to existing regulations on interim reporting. In response, in September 1997 the ASB published a non-mandatory statement *Interim Reports* providing guidelines on the amount of information to be included in interim reports and on their underlying accounting principles.

Among its key recommendations are that interim reports should:

- Be issued within 60 days of the period end
- Be drawn up using the same measurement and recognition bases and accounting policies as used in the annual financial statements
- Contain a management commentary, summarized profit and loss account, statement of total recognized gains and losses, summarized balance sheet and summarized cash flow statement

In addition, a known accounting policy or presentation change for the full year should be implemented in the interim accounts to ensure that they are presented on the same basis. If a known policy change is not implemented in the interim report, then an estimate of its effect should be shown.

2.8 Preliminary Announcements

The stock exchange requires listed companies to publish preliminary statements within 120 days of the end of the financial period to which it relates (effective for accounting periods beginning on or after 23 December 1999). The statement must include at a minimum a balance sheet, profit and loss account and a cash flow statement and must contain the items required for a half-yearly report (see 2.4 above). Details of dividends must also be disclosed.

In August 1998, the ASB issued another non-mandatory statement *Preliminary Announcements*. This statement recommends that these announcements should:

- Contain a narrative commentary, summarized profit and loss account, statement of total recognized gains and losses, summarized balance sheet, summarized cash flow statement, segmental information, an analysis of discontinued and continuing activities and earnings per share figures
- Be based on draft financial statements on which the audit is at least at an advanced stage.

Companies are encouraged to comment specifically on the second half results and to issue the announcements within 60 days of the year-end. They are also advised to explore electronic means for dissemination of preliminary announcements.

PART 2: PROFIT AND LOSS ACCOUNT ITEMS

3. Statement of Total Recognized Gains and Losses

Because certain gains and losses are required or permitted by law and accounting standards to be taken directly to reserves, focusing on the profit and loss account provides an incomplete picture of financial performance. In October 1992 FRS 3 *Reporting financial performance* was issued. In this standard the ASB introduced a new primary statement, the statement of total recognized gains and losses, to bring together all gains and losses recognized in the accounts and to give it equal prominence with those included in the profit and loss account.

The most common gains and losses to by-pass the profit and loss account are fixed asset revaluation surpluses and deficits, and foreign currency differences permitted by SSAP 20 to go directly to reserves. Movements between reserves, and realization of previously recognized unrealized gains are not included in the statement because they represent reclassification rather than initial recognition of gains and losses.

The revaluation gains and losses included in the statement of total recognized gains and losses are those *recognized* in the period, and not necessarily those *arising* in the period. While the profit and loss account *only* includes realized profits and losses, it does not include *all* realized profits and losses. Under FRS 3 gains and losses are recognized only once in the primary statements. The realization of previously recognized unrealized gains and losses will not feature in the profit and loss account or in the statement of total recognized gains and losses in the period of realization. Realization gives rise to a reserve movement in the period of disposal of the asset.

4. Reporting Profits and Earnings

As described in the United Kingdom/Irish chapters, the incorporation of the requirements of the EC Fourth Directive into law impacted on the presentation of the profit and loss account, prescribing formats and extensive disclosure requirements. The publication in 1992 of FRS 3 further expanded disclosures relating to profits and losses.

4.1 Profit and Loss Account

FRS 3 was introduced in 1992 and replaced the somewhat discredited SSAP 6 which dealt with presentation in the accounts of unusual or non-recurring transactions and with prior year adjustments.

In addition to expanding disclosure in the profit and loss account, FRS 3 defines exceptional items more broadly than SSAP 6, virtually eliminates extraordinary items, and redefines earnings per share. The computation of profit on disposal of revalued fixed assets is also prescribed in FRS 3. In addition to the statement of total recognized gains and losses, FRS 3 introduced the following additional reconciling disclosures:

- Reported profits reconciled with profit calculated on a purely historic cost basis
- Movements on total shareholders' funds reconciled with profits retained, other recognized gains and losses, new capital subscribed and other adjustments.

4.1.1 Analysis of Operating Profit

Under FRS 3 turnover, operating profit, and all statutory disclosure headings between these two headings in the profit and loss account must be analyzed to show separately the amounts from continuing activities, from acquisitions (within continuing activities), and from discontinued activities. The breakdown of turnover and operating profit must be shown on the face of the profit and loss account, while the analysis of cost of sales, distribution costs and administrative expenses may be shown in the notes.

Discontinued operations are strictly defined in FRS 3 to ensure consistency of presentation and to prevent abuse, e.g., by classifying losses as discontinued and profits as continuing. They are defined as:

“Operations of the reporting entity that are sold or terminated and that satisfy all of the following conditions:

- a. The sale or termination is completed either in the period or before the earlier of three months after the commencement of the subsequent period and the date on which the financial statements are approved.*
- b. If a termination, the former activities have ceased permanently.*
- c. The sale or termination has a material effect on the nature and focus of the reporting entity's operations and represents a material reduction in its operating facilities resulting either from its withdrawal from a particular market (whether class of business or geographical) or from a material reduction in turnover in the reporting entity's continuing markets.*
- d. The assets, liabilities, results of operations and activities are clearly distinguishable, physically, operationally and for financial reporting purposes.*

Operations not satisfying all these conditions are classified as continuing”.

Only income and costs directly related to discontinued operations should be included in the discontinued category. Any reorganization or reconstruction costs arising from sale or termination of part of the business must be treated as costs of continuing activities. Guidance is provided in the standard on the extent to which provisions should be made for costs incurred in terminating a business. It also addresses how these costs should be classified between continuing and discontinued activities and how provisions can be used to offset losses arising on discontinued activities and the disposal of related assets.

4.1.2 Exceptional and Extraordinary Items

FRS 3 defines exceptional items as:

“Material items which derive from events or transactions that fall within the ordinary activities of the reporting entity and which individually or, if of a similar type, in aggregate, need to be disclosed by virtue of their size or incidence if the financial statements are to give a true and fair view”.

Exceptional items should be included in the statutory headings to which they relate. They should be separately disclosed in the notes, or if greater prominence is required

to give a true and fair view, they should be shown on the face of the profit and loss account.

Paragraph 20 of FRS 3 states that the following specified exceptional items must be shown on the face of the profit and loss account after operating profit and before interest:

- Profits or losses on sale or termination of an operation
- Costs of a fundamental reorganization or restructuring having a material effect on the nature and focus of the reporting entity's operations
- Profits or losses on disposal of fixed assets.

Extraordinary items are defined as:

“Material items possessing a high degree of abnormality which arise from events or transactions that fall outside the ordinary activities of the reporting entity and which are not expected to recur. They do not include exceptional items nor do they include prior period items merely because they relate to a prior period”.

Ordinary activities are very broadly defined in FRS 3. ASB has made it clear that it does not expect to see extraordinary items in practice. To encourage their extinction, earnings per share now includes the effect of any profit or loss treated as extraordinary. In the unlikely event that an item is classified as extraordinary it must be shown separately on the face of the profit and loss account, net of taxation, after profit or loss on ordinary activities after tax, and before appropriations. Individual extraordinary items must be disclosed, as must the attributable taxation on the extraordinary profit or loss. The portion of extraordinary items attributable to minority interests must be shown separately.

4.1.3 Prior Period Adjustments

FRS 3 defines prior period adjustments as:

“Material adjustments applicable to prior periods from changes in accounting policies or from the correction of fundamental errors. They do not include normal recurring adjustments or correction of accounting estimates made in prior periods”.

The FRS explains fundamental errors as follows:

“In exceptional cases ... financial statements of prior periods may have been issued containing errors which are of such significance as to destroy the true and fair view and hence the validity of those financial statements”.

The standard requires prior period adjustments to be accounted for by restating the prior period's profit and loss account and retained earnings brought forward. The cumulative effects of the adjustments should also be noted at the foot of the statement of total recognized gains and losses of the current period.

4.1.4 Reconciliation of Historic Cost Profits

Where there is a material difference between results as disclosed in the profit and loss account and results on a historic cost basis, a note of the historic cost profit or loss for the period should be presented. This provides a consistent benchmark for inter-company comparison. The note should appear immediately after the profit and loss account and the statement of total recognized gains and losses. The historic cost retained profit for financial year must also be shown.

Reconciliation of movements in reserves is dealt with in Section 11.1.1.

4.1.5 Foreign Currency Translation

In individual company accounts, assets, liabilities, revenues and expenses from transactions denominated in foreign currencies should be translated at the rate of exchange ruling on the date of the transaction (or at an average rate, if it is a reasonable approximation of the actual rate). If the transaction is to be settled at a contracted rate or is covered by a forward rate, then the contract or forward rate should be used.

Normally non-monetary assets (e.g. fixed assets, stock) should not be retranslated. Monetary assets and liabilities should be retranslated at the balance sheet date using the rate of exchange ruling on that date.

Exchange differences which have arisen on settled transactions during the period, and those arising on unsettled retranslated items at the balance sheet date, should be included in the profit or loss of the period. Their categorization as normal, exceptional and their inclusion in continuing or discontinued is determined in accordance with the criteria of FRS 3.

SSAP 20 suggests that unrealized gains on long term monetary items may require special consideration, but that normally they should be included in the results of the period. Equally, where there are doubts as to the marketability or convertibility of the currency in question, it may be necessary to restrict the amount of gains (or the amount by which exchange gains exceed past losses on the same item) recognized in the profit and loss account.

There is one exception to the rule that all exchange differences arising in the individual company should be brought to the profit and loss account and that non-monetary items should not be retranslated. The exception arises where a company uses foreign currency borrowings to finance or provide a hedge against foreign equity investments. In this situation, the foreign equity investments *may* be denominated in foreign currency and retranslated at each balance sheet date. Any differences arising should be transferred to reserves. Foreign currency differences on retranslating the borrowings can then be offset in reserves against, and up to a maximum of, differences in that period relating to foreign equity investments.

FRED 24 *The Effects of Changes in Foreign Exchange Rates & Financial Reporting in Hyperinflationary Economies* was published in May 2002 as a proposed replacement to SSAP 20 and to harmonise UK/Irish regulations on foreign currency

accounting. Relatively few changes to SSAP 20 are proposed in this FRED. The most significant change proposed is that the forward rate would not continue to be permitted for transactions which are settled at a contract rate. Rather they would be measured initially at the spot exchange rate on the date of the transaction, unless hedge accounting as proposed under FRED 23 *Financial Instruments: Hedge Accounting* is applied.

4.2 Segmental Reporting

Enactment of the EC Fourth Directive introduced a legal requirement in the United Kingdom and Republic of Ireland to analyze turnover segmentally by type of business activity and geographically. SSAP 25 *Segmental reporting* added to these requirements by requiring segmental analysis of profitability and net assets in addition to turnover.

SSAP 25 also provides guidance on how reportable segments should be determined and it specifies the segmental information to be disclosed. The statutory provisions contained in the standard apply to all companies. The non-statutory provisions apply to plcs, to holding companies that have a plc as a subsidiary, to banking and insurance companies or groups and to private companies that exceed by a multiple of 10 the size criteria for medium companies (as defined by legislation).

A separate class of business is defined by SSAP 25 as a distinguishable component of an entity that provides a separate product or service or a separate group of related products or services. A geographical segment is defined as a geographical area comprising an individual country or group of countries in which an entity operates, or to which it supplies products or services.

For each class of business and geographical segment the company must disclose:

- Turnover analyzed between sales to external customers and sales between segments (in the first instance by origin and then by destination except where this is not materially different)
- Results before taxation and minority interests
- Net assets.

If associate undertakings account for 20% or more of an entity's total result or 20% of its total assets, under the standard it is considered to be significant. The following should be segmentally disclosed in respect of significant associates:

- Share of results before tax and minority interests
- Share of net assets, including goodwill to the extent not written off, stated after attributing fair values to the net assets at the date of acquisition.

SSAP 25 restates the legal provision that where, in the opinion of the directors, the disclosure of segmental information would be seriously prejudicial to the interests of the reporting entity, the information need not be disclosed. The fact of non-disclosure must be stated.

4.3 Earnings per Share

All companies whose ordinary shares are publicly traded should disclose earnings per share (EPS). FRS 14 *Earnings per share* aims to standardize the computation and disclosure of basic and diluted EPS.

Basic EPS should be calculated by dividing profit/loss for the period attributable to ordinary shareholders by the weighted average (i.e. time weighted) number of ordinary shares outstanding during the period. Earnings are those available to ordinary shareholders and are based on profits after taxation, minority interests and non-equity dividends (i.e. preference dividends). The number of shares is a weighted average amount taking into account new shares issued during the year.

Companies may have obligations or financial instruments that could dilute EPS in the future. Such obligations include:

- Convertible debt or equity instruments
- Share warrants or options
- Rights granted under employee or other share purchase plans
- Rights to ordinary shares contingent on satisfaction of contractual conditions.

Since investors are concerned with forecasting future EPS it is important to disclose the effect of any future dilution. Diluted EPS is calculated assuming exercise of the dilutive instruments. Only instruments that are dilutive, i.e., leading to a decrease in net profit per share (increase in net loss per share) should be included in the calculation of diluted EPS. Accordingly, guidance is given in FRS 14 on the order (from most dilutive) in which to include each potentially dilutive instrument in the calculation.

Basic and diluted EPS should be disclosed on the face of the profit and loss account, even if amounts are negative, and given equal prominence. The amounts used for earnings and number of shares in the calculations must be disclosed.

FRS 14 permits additional EPS calculations to be disclosed. Where EPS is presented on an alternative basis, it must be presented on a consistent basis over time, and reconciled in detail to the FRS 14 EPS amount.

FRED 26 proposes changes to FRS 14 to bring that standard into line with the revised IAS 33 *Earnings per Share*. The changes to FRS 14 proposed by FRED 26 are limited and largely restricted to disclosure. The proposals are that basic and diluted earnings per share (EPS) be disclosed on the face of the profit and loss account both for net profit or loss for the period and for profit or loss from continuing operations. Basic and diluted EPS for discontinued operations (if reported) may be shown either on the face of the statement or in a note. Additional per share amounts can only be disclosed by way of note.

5. Reporting Taxation

Under company legislation, financial statements must disclose the tax charge on the ordinary profit or loss of the company, as well as the tax effects of extraordinary items and items taken direct to reserves. Amounts owed to tax authorities are included in the

balance sheet as current liabilities, amounts recoverable are included as current assets or disclosed separately if recoverable in more than one year, and deferred tax liabilities are disclosed as part of provisions and liabilities. FRS 16 deals with current tax on profits; SSAP 5 outlines the accounting treatment for value added tax (VAT) and other indirect taxes paid by companies; and SSAP 15 currently governs the recognition and presentation of deferred tax. FRS 19, issued in December 2000, proposes reforms of deferred tax accounting.

5.1 Current Tax Charge

FRS 16 *Current Tax* was issued in December 1999 to define the accounting treatment for “current tax”:

“The amount of tax estimated to be payable or recoverable in respect of the taxable profit or loss for a period, along with adjustments to estimates in respect of previous periods”.

It comes into force for accounting periods ending on or after 23 March 2000, but earlier adoption has been encouraged. The FRS replaces SSAP 8 *The treatment of taxation under the imputation system in the accounts of companies* and UITF Abstract 16 *Income and expenses subject to non-standard rates of tax*.

SSAP 8 became out of date with changes in the United Kingdom and Republic of Ireland tax systems. The most significant change for current tax accounting was the abolition of advance corporation tax (ACT) in April 1999 in both countries. Although the United Kingdom continues to operate an imputation system of dividend taxation, the Republic of Ireland has ceased to have an imputation system and operates a system of withholding taxes on dividends instead (a classical system). An appendix to the standard deals with transitional arrangements for United Kingdom accounting for “shadow ACT” rules that continue to apply.

FRS 16 requires that dividends, interest and other amounts payable or receivable should be recognized at an amount that:

- Includes withholding taxes payable to the tax authorities wholly on behalf of the recipient
- Excludes any other taxes, such as attributable tax credits, not payable wholly on behalf of the recipient.

The treatment of United Kingdom dividends is derived from the definition of “tax credit”:

“The tax credit given under UK tax legislation to the recipient of a dividend from a UK company. The credit is given to acknowledge that the income out of which the dividend has been paid has already been charged to tax, rather than because any withholding tax has been deducted at source. The tax credit may discharge or reduce the recipient’s liability to tax on the dividend”.

FRS 16 alters the way that SSAP 8 dealt with dividend tax credits in financial statements. Dividends received from United Kingdom companies are no longer reported “gross” (*i.e.* the cash dividend payable plus the attributable tax credit), but are instead reported “net” (*i.e.* the cash dividend only). Under FRS 16, as under SSAP

8, dividends paid and payable are reported net of any attributable tax credit, but before any withholding tax.

Under the standard and existing United Kingdom and Irish tax law, only dividends paid by United Kingdom companies may have a tax credit attached. Other dividends paid by non-United Kingdom companies may suffer deduction, as they do in the Republic of Ireland, of a withholding tax. Such dividends are reported inclusive of the withholding tax. For the purposes of the FRS, dividends from overseas companies attracting an enhanced form of double tax relief for “underlying tax” will be treated as having suffered extra withholding tax.

Other requirements of FRS 16:

- Income and expenses subject to non-standard rates of tax (or exempt from tax) should be included in pre-tax results on the basis of amounts actually receivable or payable, without any adjustment to reflect a notional amount of tax that would have been paid or relieved in respect of the transaction if it had been taxable, or allowable for tax purposes, on a different basis
- Current tax should be measured using tax rates and laws that have been enacted or substantively enacted by the balance sheet date. This is a change from SSAP 8, which used the latest known rate.

FRS 16 requires the following disclosures for current tax in the profit and loss account and, as relevant, the statement of total recognized gains and losses:

- Domestic tax (United Kingdom or Republic of Ireland tax according to which companies legislation applies to the reporting company)
- Foreign tax
- Domestic tax and foreign tax analyzed before and after double taxation relief
- Domestic tax and foreign tax analyzed between the current accounting period and any adjustments recognized in respect of prior periods.

FRS 1 and FRS 3, as outlined in Sections 12 and 4.1 respectively, require additional current tax disclosures.

5.2 Accounting for Deferred Tax

SSAP 15 *Deferred tax* is one of the most controversial, most amended and most internationally idiosyncratic of existing United Kingdom and Irish accounting standards. The deferred tax balance recognized under the “partial provision” basis of the SSAP includes any payment of tax that:

“will be temporarily deferred or accelerated by the operation of timing differences which will reverse in the foreseeable future without being replaced”.

The SSAP was introduced in 1978 and represented a pragmatic compromise between advocates of a full provision basis and companies and their advisors who argued that, given the economic circumstances and tax system of the 1970s, partial provision better reflected the economic costs of deferred taxation. SSAP 15 was revised in May 1985 and has been amended on four occasions since then. United Kingdom and Irish retention of the partial provision basis for deferred tax, rather than a full provision basis, is inconsistent with international practice. Partial provision is not an acceptable

basis for deferred tax under IAS 12. In August 1999 FRED 19 *Deferred tax* proposed a full provision basis for the United Kingdom and Republic of Ireland.

Deferred tax is a measure that reflects the fact that there is often a difference between the profits recognized in a company's profit and loss account for a period and the taxable profits recognized by the tax authorities for the same period. The different basis for the calculation of profits has two main causes. First, certain types of income are not taxed and certain types of expense attract no tax relief. Taxable income or allowable expenses may or may not be recognized in a company's financial statements. These features of the tax treatment cause "permanent differences" between taxable and accounting profits. Second, certain types of income are taxed and certain types of expenditure attract tax relief in a different accounting period than the one in which the amount is recognized in the company's profit and loss account. Such treatment generates "timing differences" between taxable and accounting profits. Tax recognition may occur earlier or later than the accounting recognition. When timing differences arise, the current tax assessed by the tax authorities for the accounting period is not regarded as the full tax liability for the period. Deferred tax is recorded to adjust the tax charge for the period to the amount that will be payable over time on the profits shown in the financial statements.

SSAP 15 requires that deferred tax should be calculated under the "liability method", i.e., calculated at the rate of tax that it is estimated will apply when the timing differences reverse. The "partial provision" basis of SSAP 15 is justified on the basis that, if the company expects to generate the same timing differences in the future, the additional tax represented by the timing differences will never crystallize and therefore should not be provided for as a liability.

Management's assessment of whether deferred tax liabilities or assets will or will not crystallize should be based upon "reasonable assumptions". These assumptions should take into account "*all relevant information available up to the date on which the financial statements are approved by the board of directors, and also the intentions of management*", e.g., financial plans or projections into the foreseeable future. Then, management should take a "prudent view".

A problem with the standard is the inconsistency of its treatment of timing differences. In 1992 SSAP 15 was amended to give a unique treatment to timing differences attributable to pensions and other post-retirement benefits obligations recognized in accordance with SSAP 24 and UITF Abstract 6. Companies had the option of adopting a full provision basis for such timing differences, notwithstanding the general rules in SSAP 15 to the contrary. In practice, the exception meant that on adoption of SSAP 24 companies were required to recognize only the net-of-tax cost of very large future pension obligations in their financial statements, even though most tax effects would be realized a very long time in the future.

Other requirements of the SSAP include:

- Tax effects should be shown in financial statements separately from the items or transactions to which they relate
- The provision for deferred tax liabilities should be reduced by any deferred tax debit balances

- Deferred tax net debit balances should not be carried forward as assets, except to the extent that they are expected to be recoverable without replacement by equivalent debit balances.

SSAP 15 requires the following disclosures:

- Separately, on the face of the financial statements or in a note to them:
 - deferred tax relating to the ordinary activities of the company as part of tax on profit or loss on ordinary activities
 - deferred tax relating to any extraordinary items as part of the tax on extraordinary items
 - the deferred tax liability and its major components
 - adjustments to deferred tax arising from changes in tax rates and tax allowances as part of the tax charge for the period
- In a note to the financial statements:
 - unprovided deferred tax in respect of the period, analyzed into its major components
 - total amount of any unprovided deferred tax, analyzed into its major components.
 - transfers to and from deferred tax
 - where amounts of deferred tax arise which relate to movements on reserves, the amounts transferred to or from deferred tax should be shown separately as part of such movements
 - where the potential amount of deferred tax on a revalued asset is not shown because the revaluation does not constitute a timing difference, a statement to this effect
 - where disclosure of material differences between an asset's value and its book amount is made, the note should also disclose any tax effects assuming realization at the balance sheet date
 - where deferred tax is not provided on earnings retained overseas, a statement to this effect.

SSAP 15 has been criticized for its subjectivity (relying heavily on management expectations about future events) and its inconsistency with other standards. FRS 19 will require deferred tax to be provided on a full provision that is similar to, but not identical to, IAS 12. There are two significant differences between FRS 19 and IAS 12:

- Deferred tax will not be, in general, required to be provided for when assets are revalued or adjusted to their fair values on the acquisition of a business.
- Deferred tax balances may be discounted where the effect is material.

5.3 Accounting for Value Added Tax

SSAP 5 *Accounting for value added tax* was issued in 1974 shortly after the United Kingdom and Republic of Ireland joined the EU and introduced VAT, an indirect sales tax defined by EU directives. The tax is in principle a tax on the supply of goods and services to be borne by the final consumer, but it is collected at each stage of the production and distribution chain. The standard requires companies to exclude VAT from reported income and expenditure. This treatment reflects a general principle that the treatment of VAT in accounts should reflect the role of the businesses as a tax collector. Companies may, if they wish, show gross sales turnover, the related VAT as

a deduction and the turnover exclusive of VAT. In certain circumstances, businesses bear the cost of VAT, i.e., they cannot reclaim the VAT incurred on some inputs against the VAT they are required by law to charge on sales. Such irrecoverable VAT should be included in the cost of the related items reported in the financial statements.

Other requirements of SSAP 5:

- The net amount due to or from the revenue authorities in respect of VAT should be included as part of debtors or creditors and will not normally require separate disclosure
- The estimated amount of capital commitments should include the appropriate amount, if any, of irrecoverable VAT.

PART 3: BALANCE SHEET ITEMS

6. Tangible Fixed Assets

There is no one accounting standard dealing comprehensively with tangible fixed assets. They are incompletely dealt with in FRS 15 *Tangible fixed assets* and in SSAP 19 *Accounting for investment properties*. FRS 3 *Reporting financial performance* deals with profits and losses on disposal of tangible fixed assets, and SSAP 4 *Accounting for government grants* deals with government grants.

FRS 15 defines tangible fixed assets as:

“Assets that have physical substance and are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes on a continuing basis in the reporting entity’s activities.”

The standard addresses three areas: initial measurement, valuation and depreciation. Its objectives are to ensure that:

- Consistent principles are applied to initial measurement
- Valuation is performed on a consistent basis and kept up-to-date
- Gains/losses are recognized on a consistent basis
- Depreciation is calculated in a consistent manner
- Sufficient information is disclosed.

6.1 Initial Measurement

Tangible fixed assets should initially be measured at cost, which includes purchase price and any costs directly attributable to bringing them into working condition. FRS 15 also sets out guidelines on capitalization of indirectly attributable costs including:

- Commissioning costs
- Borrowing costs
- Enhancement expenditure.

Companies which incur borrowing costs financing acquisition of assets, which take a substantial period to bring into use, should adopt a policy of either consistently capitalizing borrowing costs or not capitalizing them. Where borrowing costs are capitalized, the amount to be capitalized should be the proportion of total borrowing costs for the period which the borrowings for capital expenditure purposes bears to

total borrowings. Notional borrowing costs may not be capitalized. Where borrowing costs are capitalized, the following should be disclosed:

- Aggregate amount of finance costs included in tangible fixed assets
- Amount of finance costs capitalized in the period
- Amount of finance costs in the profit and loss account in period
- Capitalization rate used to determine borrowing costs

Subsequent expenditure to ensure a fixed asset maintains its standard of performance should be written off in the profit and loss account. Subsequent expenditure may only be capitalized in three circumstances, i.e., if it:

- Enhances economic benefits in excess of that previously assessed
- Relates to replacement or restoration of a component with a shorter life
- Restores economic benefits previously depreciated.

6.2 Revaluations

Revaluation of assets has long been justified in the United Kingdom and Republic of Ireland on the grounds that such values provide useful information to users of accounts. Furthermore, the use of valuations in the balance sheet enables more satisfactory calculation of performance ratios measuring the effectiveness with which capital has been employed. A certain degree of reliability is sacrificed for an increase in relevance.

Although revaluation is not mandatory, FRS 15 clearly supports the view that modified historic cost accounting is preferable to pure historic cost accounting. Companies can adopt a policy of valuation for a particular class of fixed assets and need not apply it to all classes. A class of fixed assets is defined as a category of assets appearing in the financial statements as a single item. Where a policy of revaluation is adopted, valuations should be kept up-to-date. Under the standard, full valuation should be carried out every five years. There should also be interim year three valuations and valuations in between where it is likely there has been a material change in value.

Valuations of non-specialized properties should normally be based on the existing use basis of valuation with additional disclosures if open market value is materially different. For specialized properties, valuations may be based on depreciated replacement cost (the current cost of acquiring the assets less an allowance for their present condition). Open market value should be used to value tangible fixed assets other than properties.

Valuations have to be carried out by qualified external valuers except where a company has an internal property department with a substantial staff of qualified valuers. Their valuations should, however, be subject to external review. Disclosure is required of:

- Name and qualifications of the valuer
- Whether the valuer is internal/external to the entity
- Basis, date and amounts of valuation
- Historic cost carrying amount of the revalued asset less depreciation
- Where a valuation has not been updated

- statement by directors that they are not aware of any material change in value
- date of last full valuation
- Where properties have been valued as trading entities, a statement to that effect and the carrying amount of such properties (including the amount of any notional directly attributable acquisition costs included).

6.2.1 Surpluses and Deficits on Revaluation

Surpluses and deficits on revaluation are the difference between the revalued amount of an asset and its net book value at the date of valuation. Revaluations surpluses (gains) should be recognized in the statement of total recognized gains and losses except those that reverse previous deficits included in a prior period profit and loss account, in which case such gain should also be recognized in the profit and loss account. The gain is reduced by any depreciation that would have been charged had the deficit not been recognized in the first place.

Revaluation deficits (losses) should be recognized in the profit and loss account if they represent consumption of economic benefit (e.g., physical damage or deterioration in the quality of service provided by asset). Other revaluation losses should be recognized in the statement of total recognized gains and losses to the extent of reducing the asset's carrying amount to its depreciated historic cost. Any remaining loss should be charged in the profit and loss account. However, where the recoverable amount is greater than the revalued amount, the loss may be recognized in the statement of total recognized gains and losses.

6.2.2 Reporting Financial Performance

FRS 3 requires publication of supplementary information in a more structured form where revaluations are incorporated in accounts. The statement of total recognized gains and losses and note of historic cost profits and losses attempt to clarify the effects of modifying the traditional historic cost approach. Statements of total recognized gains and losses give revaluation surpluses a higher profile than previously when they could get lost in a haze of reserve movements.

FRS 3 requires gains and losses on disposal of revalued fixed assets to be based on depreciated revalued amount. Any unrealized and unamortized revaluation surplus remaining in reserves relating to the asset disposed is transferred to retained earnings as a movement on reserves.

6.2.3 FRED 29

FRED 29, *Property, Plant and Equipment; Borrowing Costs* includes the text of a revised IAS 16, *Property, Plant and Equipment* and IAS 23, *Borrowing Costs*. The revised IAS 16 and FRS 15 are similar in terms of principles for initial measurement and depreciation of fixed assets. Both standards allow the option of revaluing assets or keeping them at depreciated cost. However, in accounting for revalued assets, IAS 16 uses a 'fair value' model rather than the FRS 15's 'value to the business' model. IAS 23 and FRS 15 both permit a choice between capitalising certain borrowing costs and treating all such costs as an expense.

6.3 Depreciation

Depreciation is defined in FRS 15 as:

“The measure of the cost or revalued amount of the economic benefits of the tangible fixed asset that have been consumed during the period.

Consumption includes the wearing out, using up or other reduction in the useful economic life of a tangible fixed asset whether arising from use, effluxion of time or obsolescence through either changes in technology or demand for the goods and services produced by the asset.”

The depreciable amount of the asset should be allocated on a systematic basis over its useful economic life. *Depreciable amount* is the cost of a fixed asset (or, where a fixed asset is revalued, the revalued amount) less its residual value. The *useful economic life* is the period over which the entity expects to derive economic benefit from the asset. *Residual value* is the net realizable value of an asset at the end of its useful economic life. The depreciation method used should reflect as fairly as possible the pattern in which the asset’s economic benefits are consumed. The depreciation charge should be recognized as an expense in the profit and loss account unless permitted to be included in the carrying value of another asset

Components of tangible fixed assets with substantially different useful economic lives should be depreciated separately over their respective useful lives. Depreciation must continue to be charged on an asset even after subsequent expenditure that maintains or enhances the previously assessed standard of performance of the asset.

A change in method of depreciation is allowed only if the new method gives a fairer presentation of results. Such a change is not a change of accounting policy. The net book amount of the asset at the date of the change should be written off prospectively using the new method.

Useful economic lives of assets must be regularly reviewed and revised, if necessary. When the useful economic life of an asset is revised, its book amount, less revised residual value, should be depreciated prospectively over the revised life. Residual values that are material should also be reviewed at the end of each reporting period and any change in residual value should be accounted for prospectively.

For each category of depreciable asset, there must be disclosed:

- Depreciation methods used
- Useful economic lives or depreciation rates used
- Total depreciation charged in the period
- Where material, financial effect of:
 - change in estimate of useful economic lives
 - change in estimate of residual values
- Opening and closing gross amount of assets, related accumulated depreciation and net carrying amounts
- Reconciliation of movements in above
- Disclose effect of change of method in year of change (if material) and reason for change.

6.4 Impairment

In July 1998 FRS 11 *Impairment of fixed assets and goodwill* was issued to increase consistency in the treatment of fixed assets and goodwill whose values have fallen below the amounts at which they are recorded in the balance sheet. Impairment is a reduction in recoverable amount below carrying value. The FRS sets out the method to be used for measuring the extent of any impairment. Impaired assets must be written down, irrespective of whether the impairment is viewed as permanent or temporary. The objective of the standard is to ensure that fixed assets are recorded at no more than their recoverable amount. Recoverable amount is the higher of net realizable value and value in use. Value in use is measured by forecasting the future cash flows that will be generated by using the asset, and discounting these cash flows to their present value.

Impairment of assets should be recognized when it occurs. Nonetheless, impairment reviews are only required when there is some indication that impairment has occurred and the carrying amount may not be recoverable (except that annual impairment reviews are required for goodwill being treated as having a very long or indefinite useful life). Examples of indications of impairment are provided in the standard, e.g., operating losses, significant decline in market value, significant adverse change in market of operation (e.g., entrance of major competitor or change in the regulatory environment).

Much of the detail of FRS 11 is concerned with the methods to be applied in measuring value in use. The methods incorporate constraints to make the forecasts as reliable as possible, e.g., restrictions are placed on long-term growth assumptions to discourage unwarranted optimism. There is also a requirement to monitor forecasts in subsequent years and to recalculate recoverable amount if inaccurate forecasting has caused a past impairment to be overlooked.

FRS 11 requires disclosure of impairment losses charged in the profit and loss account and in the statement of total recognized gains and losses. For assets included at historic cost such losses should be included in accumulated depreciation. For assets at market value losses should be shown as a reduction in the revalued amount. The reversal of past impairment losses should be recognized when the recoverable amount of the asset has increased because of a change in economic conditions or in the expected use of the asset.

6.5 Investment Properties

SSAP 19 *Accounting for investment properties* was developed in response to arguments by the property industry that it was inappropriate to depreciate properties the value of which was of critical importance in evaluating their performance. The standard is a compromise justified on the grounds that a different treatment is required for fixed assets which are not held for 'consumption' but as investments. In such cases, changes in value rather than systematic depreciation are of prime importance.

Investment properties are defined as interests in land and buildings (not occupied by the company itself or other group companies) in respect of which construction and

development has been completed, which are held for investment purposes and the rent for which is negotiated at arm's length.

Except in the case of leases with twenty years or less to run, such properties should not be depreciated but should be stated in the balance sheet at open market valuation. This conflicts with legislation requiring depreciation to be provided on all assets with limited useful economic lives. However, property companies argue that the overriding requirement of the legislation for financial statements to give a true and fair view justifies applying SSAP 19. Reference to this departure from the statutory requirement should be made in the financial statements.

Changes in the value of investment properties are not taken to the profit and loss account but are disclosed as movements on an investment property revaluation reserve except to the extent that any deficit on revaluation exceeds the balance on that reserve. In such a case, the excess of the deficit over the balance on the investment property revaluation reserve should be charged in the profit and loss account.

Disclosure is required of the names and qualifications of valuers and of the valuation bases used. Where the valuer is an employee, this fact must be disclosed. The carrying value of investment properties and the investment property revaluation reserve must be displayed prominently in the financial statements.

Where investment properties represent a substantial proportion of total assets of a company, it is recommended that valuations be carried out annually by experienced, professionally qualified persons and at least every five years by external valuers.

IASC is at present reviewing its standard, IAS 25 *Accounting for investments*, which includes the treatment of investment properties. The ASB is following and contributing to the international debate on investment properties and may review SSAP 19 in due course in light of the outcome of the IASC project.

6.6 Government Grants

SSAP 4 *Accounting for government grants* was issued in 1974 and revised in 1990. Under SSAP 4 capital grants should be recognized when conditions for their receipt have been complied with and their receipt is reasonably assured. They should be credited to revenue over the expected useful lives of the related assets. This is achieved by treating the grant as a deferred credit, a portion of which is amortized to revenue annually on the same basis as the related asset is depreciated.

The unamortized part of the grant should be included in the balance sheet either in creditors under the heading '*deferred income*' and separately disclosed, or as a separate item. Most capital grants are repayable if certain conditions are not complied with. FRS 12 *Provisions, contingent assets and contingent liabilities* requires disclosure of the amount and nature of this contingent liability.

7. Leases and Hire Purchase

The acquisition of fixed assets by hire purchase has long been treated for accounting purposes in accordance with the commercial substance of the transaction rather than

its strict legal form. The asset being acquired is treated as a fixed asset in the balance sheet of the purchaser from the commencement of the contract. Legally, however, the asset remains the property of the hire purchase company until the final payment is made. Outstanding payments, net of deferred interest, are included in the balance sheet as a liability.

In the past, lease payments were treated as an expense in the books of lessees. The asset and its financing were accounted for *off balance sheet*. Concern that the balance sheet did not properly reflect the impact of leasing transactions gathered momentum culminating in the publication of SSAP 21 *Accounting for leases and hire purchase contracts* in July 1984.

SSAP 21 defines a lease as:

“ .. a contract between a lessor and a lessee for the hire of a specific asset. The lessor retains ownership of the asset but conveys the right to the use of the asset to the lessee for an agreed period of time in return for the payment of specified rentals”.

The standard categorizes leases into finance leases and operating leases. A finance lease is one which transfers substantially all the risks and rewards of ownership of an asset to the lessee. Such a transfer of risks and rewards is presumed to occur if, at the inception of the lease, the present value of the minimum lease payments amounts to 90% or more of the fair value of the leased asset (the ‘90% rule’). This ‘90% rule’ has been applied somewhat mechanistically in practice. Leases are often arranged so that the minimum lease payments are fractionally below 90% of the fair value, yet in reality the risks and rewards of ownership have passed to the lessee. The requirement of FRS 5 to report the substance of transactions reinforces the principle on which SSAP 21 is based – that commercial substance takes precedence over legal form.

An operating lease is any lease other than a finance lease. Hire purchase contracts are classified similarly to leases, notwithstanding that their legal status is different. SSAP 21 distinguishes between accounting practices by lessees and by lessors.

7.1 Lessees

Operating lease rentals are charged in the profit and loss account on a straight-line basis, over the lease term. SSAP 21 requires disclosure of:

- Accounting policy adopted
- Total operating lease rentals charged in the profit and loss account, distinguishing between those in respect of plant and machinery and other leases
- Obligations under operating leases, analyzed into commitments in respect of land and buildings and other leases, and analyzed between those in which the commitment expires:
 - within one year of the balance sheet date
 - between the second to fifth year
 - after five years from the balance sheet date.

For finance leases SSAP 21 requires capitalization of the rights acquired and recognition of obligations to make future payments. This treatment may be summarized as follows:

- Fixed assets are brought into the balance sheet at fair value, usually purchase cost of the equivalent assets
- Liabilities for obligations under finance leases are simultaneously recorded at the same amount
- Fixed assets are depreciated in the usual way over their useful economic lives, which should not exceed the lease term
- Lease rentals are divided between amounts to reduce lease obligations and finance charges which should be charged in the profit and loss account of the period
- Total finance charge over the period of the lease is the excess of the total lease rentals over the cost of the asset
- This finance charge should be allocated to the periods benefiting from the use of the capital so as to produce a constant periodic rate of return on the capital outstanding.

The following disclosures by lessees are required in relation to finance leases:

- Accounting policy
- Gross amount of assets held under finance leases, together with the accumulated depreciation, analyzed by each major class of asset and the depreciation charge for the period in respect of these assets, similarly analyzed. Alternatively, if leased assets are integrated with owned fixed assets of a similar type, then the net book value of the assets held under finance leases and the depreciation charge for the period included in the overall totals should be disclosed
- Net obligations under finance leases should be disclosed separately and analyzed between amounts payable in the next year, in the second to fifth year, and after five years from the balance sheet date. Alternatively, the gross rentals can be analyzed by repayment dates, as above, and the total deferred finance charges deducted. Where obligations under finance leases are combined with other obligations, the total liability can be analyzed by time as a further alternative
- Total finance charges allocated to the period
- Amount of any commitments existing at the balance sheet date in respect of finance leases which have been entered into, but whose inception occurs after the year end.

7.2 Lessors

Lessors should treat assets leased under operating leases as fixed assets and depreciate them in the normal way. Rental income should be recognized on a straight-line basis over the period of the lease unless another systematic and rational basis is more representative of the time pattern in which the lessor receives the benefit from the leased asset. The lessor is required to disclose:

- Accounting policy
- Gross amount of assets held for use in operating leases and related accumulated depreciation
- Aggregate rentals receivable in respect of the period.

The accounting treatment of finance leases by lessors should be complementary to that of lessees, although amounts may differ due to taxation and cash flow considerations. It is summarized thus:

- The asset *net investment in finance leases* represents the capital portion of the leasing rentals receivable by lessors
- Finance charges should be allocated to income over the lease term, to give a constant periodic rate of return on lessors' net investment in leases in each period.

Lessors must disclose:

- Accounting policy adopted for finance leases and finance lease income
- Net investment at each balance sheet date in:
 - finance leases
 - hire purchase contracts
- Aggregate rentals receivable in respect of an accounting period in relation to finance leases and hire purchase contracts
- Cost of assets acquired for the purpose of letting under finance leases and hire purchase contracts.

8. Reporting Intangible Fixed Assets

FRS 10 outlines standard accounting requirements for most intangible assets, but does not deal with oil and gas exploration and development costs or expenditure dealt with in another standard. SSAP 13 deals with the intangible assets recognized in connection with research and development projects. The SORP *Accounting for oil and gas exploration and development activities* tailors the principles of intangible asset accounting to this industry.

8.1 Accounting for Goodwill and Similar Intangibles

FRS 10 *Goodwill and intangible assets* was issued in December 1997 and seeks to ensure that purchased goodwill and intangible assets are charged to the profit and loss account in the periods in which they are depleted. The FRS treats goodwill arising on an acquisition as neither an asset like other assets nor an immediate loss in value. Instead, it links the cost of an investment shown as an asset in the acquirer's own financial statements to the values attributed to the acquired assets and liabilities in consolidated accounts. Section 13.5 below discusses goodwill accounting in group accounts in more detail.

During the late 1980s and early 1990s recognition of intangible assets, most particularly brands, became a popular way of bringing current values of proprietary assets, whether purchased or home grown, into balance sheets without any requirement to amortize them. Such practices were widely regarded as a form of creative accounting and practices varied considerably between companies, even in the same industry. In 1990 the ASC proposed the amortization of intangibles in ED 52 *Accounting for intangible assets*, a project continued by the ASB. FRS 10 was preceded by FRED 12, in which the ASB proposed to treat purchased brands as part of the goodwill arising on the related acquisition. In the face of protest, the ASB offered the possibility of separate recognition in FRS 10, but only if expenditure on brands met the definition of intangible asset and, even then, only on accounting rules similar to goodwill.

The FRS defines intangible assets as:

“Non-financial fixed assets that do not have physical substance but are identifiable and are controlled by the entity through custody or legal rights”.

If control cannot be demonstrated through custody or legal rights, then the expected future benefits cannot be recognized as an asset. For this reason, a company would not normally exercise sufficient control over a team of skilled staff for their recognition as a company asset.

Under United Kingdom and Irish company law, an asset is “identifiable” if it is capable of being disposed of separately from a business of the reporting entity. An asset that can be sold only as part of a particular profit-making activity is accounted for as part of goodwill. Software development costs are a special case. *“If they are directly attributable to bringing a computer system or other computer-operated machinery into working condition for its intended use within the business”*, they are treated as part of the related tangible fixed asset cost, e.g. the hardware or computer-operated machinery.

The FRS adopts the principle that intangible assets that are similar in nature to goodwill should be accounted for in a very similar manner. The costs of most internally generated intangible assets should be written off in the accounting periods of the expenditure. The exception is an internally generated intangible asset that has a readily ascertainable market value.

The standard requires purchased intangible assets to be capitalized and, in most circumstances, to be amortized systematically through the profit and loss account (usually over 20 years or less). Useful economic lives must be regularly reviewed and impairment reviews must be undertaken, particularly if the intangible asset is regarded as having an infinite life and is therefore not being amortized. The guidelines on impairment reviews are those set out in FRS 11 *Impairment of fixed assets and goodwill*, which were discussed in Section 6.4 above, subject to extra provisions concerning the first year review.

8.1.1 Initial Recognition

- An intangible asset purchased separately from a business should be capitalized at its cost
- If an intangible acquired with a business is identifiable separately from its goodwill then it should be recorded at fair value, assuming such a value can be reliably measured and assuming such allocation of purchase consideration does not generate negative goodwill. “Fair values” ascertained according to FRS 7 are discussed in Section 13.3. Any intangible for which no value can be measured reliably must be subsumed into goodwill
- An internally developed intangible asset may be capitalized only if it has a readily ascertainable market value
- Developed techniques for the valuation of unique intangibles, such as brands and publishing titles, may be used in certain circumstances, as an alternative to the market value.

The UITF has recently (March 2000) proposed that start-up costs that do not meet the recognition criteria of fixed assets in this standard or in SSAP 13 (see Section 8.2 below) should be written off as expenses when they are incurred.

8.1.2 Revaluation

Where an intangible asset has a readily ascertainable market value, the asset may be revalued to its market value. All capitalized intangible assets of the same class should be revalued as well. Once an intangible asset has been revalued, the valuations should be reviewed at regular intervals.

8.1.3 Amortization

- Intangible assets are regarded as having limited useful economic lives, and their cost or valuation should be amortized on a systematic basis over those lives
- There is a rebuttable presumption that the useful economic lives of intangible assets are limited to periods of 20 years or less. This presumption may be rebutted and a useful economic life regarded as a longer period or indefinite only if:
 - the durability of the intangible asset can be demonstrated and justifies estimating the useful economic life to exceed 20 years; and
 - the intangible asset is capable of continued measurement (so that annual impairment reviews will be feasible)
- A residual value may be assigned to that asset only if such residual value can be measured reliably
- The method of amortization should reflect the expected pattern of depletion of the intangible asset, and straight-line method will usually be chosen.

8.2 Accounting for Other Intangible Assets

SSAP 13 *Accounting for research and development*, issued in 1977 and last amended in 1998, outlines the circumstances in which development expenditure may be recognized as an intangible fixed asset. The SSAP also gives guidance on the accounting policies to be followed in respect of research and development expenditure.

The term “research and development” covers a wide range of activities and classification of expenditure as “research” or “development” may depend on the nature and organization of the business. Research and development activity is distinguished from non-research activity, according to the SSAP, “*by the presence or absence of an appreciable element of innovation*”. Three broad categories of activity are distinguished: pure research, applied research and development. The standard notes that “*The dividing line between these categories of expenditure is often indistinct and particular expenditure may have characteristics of more than one category*”. Classification has to pay careful attention to the principle of prudence, which is emphasized in the SSAP.

“Pure research” is defined as:

“experimental or theoretical work undertaken primarily to acquire new scientific or technical knowledge for its own sake rather than directed towards any specific aim or application”.

“Applied research” is:

“original or critical investigation undertaken in order to gain new scientific or technical knowledge and directed towards a specific practical aim or objective”.

Expenditure on pure and applied research should be written off to profit and loss account in the year of expenditure. The only exception is expenditure on fixed assets, which should be accounted for under FRS 15 and other relevant standards already discussed in Section 6 above.

“Development” involves the:

“use of scientific or technical knowledge in order to produce new or substantially improved materials, devices, products or services, to install new processes or systems prior to the commencement of commercial production or commercial applications, or to improving substantially those already produced or installed”.

Development expenditure should also be written off in the year of expenditure except when all of the following criteria are met in connection with a development project:

- The project is clearly defined
- Its expenditure is separately identifiable
- Its outcome has been assessed with reasonable certainty as to:
 - its technical feasibility, and
 - its ultimate commercial viability
- Future revenues associated with the project are reasonably expected to exceed aggregate deferred development costs, any further development costs, and related production, selling and administration costs
- Adequate resources exist, or are reasonably expected to be available, to meet the direct and indirect costs to complete the project.

Development expenditure meeting these criteria may be recognized as an intangible asset to the extent that its recovery can reasonably be regarded as assured. Such deferred development costs must be amortized in future years, commencing when the development is applied in commercial practice. Deferred development costs should be amortized on a systematic basis to each accounting period *“by reference to either the sale or use of the product, service, process or system or the period over which these are expected to be sold or used”*. At the end of each accounting period, deferred development expenditure should be reviewed project by project. If the circumstances justifying deferral no longer apply, or are judged to be doubtful, any irrecoverable expenditure should be immediately written off to profit and loss account.

SSAP 13 requires disclosure of the

- Accounting policy on research and development expenditure
- Total amount of such expenditure charged to profit and loss account, analyzed between current year expenditure written off and deferred development expenditure amortized
- Movements on the deferred development expenditure presented as an intangible fixed asset in the balance sheet.

9. Reporting Stocks and Work-In-Progress

Under United Kingdom and Irish historical cost accounting rules, company legislation requires that “*the amount to be included in respect of any current asset shall be its purchase price or production cost*”; if lower, net realizable value is substituted for the cost amount. The rule is relatively straight-forward applied to debtors, prepayments and liquid assets that comprise current assets, but it is less straight-forward when applied to stocks (inventory).

SSAP 9 *Stocks and long-term contracts*, issued in 1975 and revised in 1988, outlines the accounting treatment of stocks and long-term contracts. Six categories of stock are identified: goods or other assets purchased for resale; consumable stores; raw materials and components purchased for incorporation into products for sale; product and services work-in-progress; long-term contract balances; and finished goods. Profit recognition for a reporting period involves the allocation of relevant costs to the period. Recognition of the value of unsold and unconsumed stocks forms an important and sensitive part of this process, and normally stocks are stated at the lower of cost or net realizable value. SSAP 9 provides guidelines for the recognition of relevant costs, the assessment of cost recoverability, and the presentation of accounting information. The comparison of cost and net realizable value needs to be made for each item of stock or group of similar items separately. Owing to the length of time taken to complete long-term contracts, separate consideration of them is required. The SSAP outlines the circumstances in which attributable turnover and profits should be recognized for long-term contracts, in preference to a completed contract method of accounting.

9.1 Cost Recognition

The “cost” of stocks consists of only that expenditure which has been incurred in the normal course of business in bringing the product or service to its present location and condition. Such costs will include purchase costs plus all costs of conversion. Cost allocation methods must provide the fairest possible approximation to the relevant expenditure actually incurred.

Purchase costs include basic purchase price plus import duties, transport and handling costs and any other directly attributable costs, less trade discounts, rebates and subsidies. Recognizable “costs of conversion” include:

- Costs specifically attributable to units of production, *e.g.* direct labour, direct expenses and sub-contracted work
- Production overheads
- Any other overheads attributable in the particular circumstances of the business to bringing the product or service to its present location and condition.

The SSAP defines production overheads as those incurred in respect of materials, labour or services for production, “*based on the normal level of activity, taking one year with another*”. Classification according to function (*e.g.* production, selling or administration), says the SSAP, will ensure the inclusion, in cost of conversion, of those overheads (including depreciation) which relate to production, notwithstanding that these may accrue wholly or partly on a time basis. Abnormal conversion costs

that are avoidable under normal operating conditions should be excluded. The SSAP cites losses due to exceptional spoilage and idle capacity as examples.

9.2 Valuation of Stocks

In valuing stock, company law required directors to adopt the most appropriate costing method for the circumstances of the company. They may adopt one of the following methods:

- “First in, first out” (FIFO)
- “Last in, first out” (LIFO)
- Weighted average price
- Any other method similar to one of the others.

SSAP 9 requires the use of a method which provides a fair approximation to the expenditure actually incurred. Therefore, the use of base cost or LIFO methods, in most circumstances, will be regarded as inappropriate and inconsistent with the SSAP.

Stocks must be valued under company legislation at the lower of cost or net realizable value. The SSAP defines net realizable value as *“the actual or estimated selling price (net of trade but before settlement discounts) less: (a) all further costs to completion; and (b) all costs to be incurred in marketing, selling and distributing”*. The SSAP requires that net realizable value calculations should take account of such criteria as age, movements in the past, expected future movements and estimated scrap values of the stock under review, as well as any special circumstances, such as changes in the state of the order book. If a net realizable value provision is required in relation to finished stock, then stocks of related parts, sub-assemblies, and stocks on order need to be reviewed critically.

The SSAP states that events occurring between the balance sheet date and the date of completion of the financial statements need to be considered in arriving at balance sheet net realizable values, *e.g.* a subsequent reduction in selling prices. However, no reduction is necessary when the realizable value of material stocks is less than the purchase price, but the goods into which the materials will be incorporated can be sold at a profit after incorporating the materials at cost price.

9.3 Long-term Contracts

A “long-term contract” is defined by the SSAP as:

“a contract entered into for the design, manufacture or construction of a single substantial asset or the provision of a service (or of a combination of assets or services which together constitute a single project) where the time taken substantially to complete the contract is such that the contract activity falls into different accounting periods”.

The SSAP makes clear that a long-term contract will usually last longer than one year, but that material shorter contracts may fall within the long-term contract accounting treatment.

The general, SSAP 9 cost recognition rules apply to long-term contracts. In addition, interest payable on borrowed money may be included if the sums borrowed can be

identified as financing specific long-term contracts. If interest is included in long-term contract stock values, then this fact and the amounts of interest involved must be disclosed in a note to the financial statements.

Long-term contracts should be accounted for on a contract by contract basis and reflected in the profit and loss account by recording turnover and related costs as contract activity progresses. Where the outcomes of long-term contracts can be assessed with “reasonable certainty” before their completion, the SSAP says that the “attributable profit” should be calculated on a prudent basis and taken to profit and loss account in the relevant period. Such profit is defined as:

“That part of the total profit currently estimated to arise over the duration of the contract, after allowing for estimated remedial and maintenance costs and increases in costs so far as not recoverable under the terms of the contract, that fairly reflects the profit attributable to that part of the work performed at the accounting date”.

Attributable profit is calculated using a variety of methods, but the SSAP requires that:

“The profit taken up needs to reflect the proportion of the work carried out at the accounting date and to take into account any known inequalities of profitability in the various stages of a contract”.

An appropriate proportion of total contract value is reflected as turnover in the profit and loss account as the contract activity progresses. Companies should ascertain turnover in a manner appropriate to the stage of completion of the long-term contracts, the businesses and the industries in which they operate. Relevant costs incurred are matched with this turnover. The difference between the turnover and related costs recognized in the profit and loss account should equal the attributable profits calculated for the particular accounting period. Cumulative turnover recognized, less cumulative costs recognized as part of cost of sales, equals cumulative profits recognized to date on the contract. Turnover, costs and profit may be attributed to contracts on the basis of costs incurred to date, percentage of completion as assessed by architects or surveyors, or another appropriate method.

Where the outcomes of long-term contracts cannot be assessed with “reasonable certainty” before their completion, it is inappropriate to take any attributable profit to the profit and loss account in respect of those contracts. If no loss is expected, however, an appropriate proportion of contract value may be reflected in the turnover of the period but associated with a zero estimate of profit.

If a loss is expected on a long-term contract, then the principle of prudence requires that it should be recognized as soon as it is foreseen. If such a loss is less than the costs incurred to date on the contract, it is treated as a net realizable value adjustment to stock. If the loss exceeds the value of the work-in-progress figure, the net amount is classified as an accrual within “Creditors” or under “Provisions for liabilities and charges” depending upon the circumstances. Where unprofitable contracts represent a very large proportion of a company’s economic capacity for a substantial period, administrative overheads related to the contract may have to be included in estimates of the loss.

9.3.1 Additional Disclosures

- In the balance sheet:
 - under “stocks” long-term contract balances are stated:
 - at total costs incurred,
 - net of amounts transferred to the profit and loss account in respect of work carried out to date,
 - less foreseeable losses and applicable payments on account.
 - cumulative total turnover recorded in respect of the contract in the profit and loss accounts is compared with cumulative total payments on account.
 - if turnover exceeds payments on account, an “amount recoverable on contracts” is separately disclosed within debtors.
 - if payments on account are greater than turnover to date, the excess is classified as a deduction from any balance on that contract in stocks, with any residual balance in excess of cost being classified with creditors.
- The accounting policy notes should clarify where differing bases have been adopted for different types of stocks and long-term contracts.

10. Reporting Liabilities and Provisions

Liabilities and provisions can have a substantial impact on an entity’s financial position and performance. They cover a wide range of circumstances, *e.g.* warranties, onerous contracts, restructuring costs, environmental liabilities and decommissioning costs. Prior to the early 1990s, United Kingdom and Irish standards tended to focus on particular forms of provision rather than the general principles underlying all provisions. It was often the case that companies aggregated present liabilities with expected future liabilities in one large provision, often reported as an exceptional item. Sometimes expected expenditures related to ongoing operations were included. As the ASB explained, “*The effect of such ‘big bath’ provisions has been not only to report excessive liabilities at the outset but also to boost profitability during the subsequent years, when the liabilities are in fact being incurred*”. Such practices were often associated with acquisition accounting in groups.

The ASB has attempted to tackle these problems in its work programme. Concurrently with the development of the statement of principles, the ASB has issued three new FRSs relating to accounting for liabilities (FRSs 4, 12, 13). Proposals to replace SSAP 24 concerning accounting for pension obligations (FRED 20) and SSAP 15 concerning deferred tax provisions (FRED 19) are under consideration. ASB is working on a further project concerned with the measurement of financial instruments. In this section, we consider how United Kingdom and Irish accounting regulation deals with the recognition and measurement of liabilities and provisions. We will consider separately accounting for financial instruments (Section 10.3), capital instruments (Section 10.4) and pension obligations (Section 10.5).

10.1 Recognition of Liabilities, Provisions and Contingencies

10.1.1 Definitions

In September 1998 FRS 12 *Provisions, contingent liabilities and contingent assets* was issued. It was developed as a joint IASC/ASB project that also led to IAS 37. It

defines “liabilities”, “provisions” and “contingencies”, and recognizes that difficulties in accounting for provisions revolve around the uncertainty of present obligations and problems of measurement.

The FRS distinguishes a “liability” from a “provision”. The definition of liability is the same as in the statement of principles: “*the obligations of an entity to transfer economic benefits as a result of past transactions or events*”. A “provision” is defined in FRS 12 as “*a liability that is of uncertain timing or amount, to be settled by the transfer of economic benefits*”. The objective of the FRS is to ensure that a provision is recognized only when it actually exists at the balance sheet date.

FRS 12 applies to all financial statements that are intended to give a true and fair view in accounting for all provisions, contingent liabilities and contingent assets except those:

- Related to financial instruments, executory contracts, and insurance contracts with policy-holders, and
- Covered by more specific requirements in another FRS or a SSAP *i.e.* long-term contracts, deferred tax, pension provisions, finance leasing provisions, acquisition provisions.

Financial instruments and pension provisions are dealt with in Sections 10.3 and 10.5 below. Long-term contracts, deferred tax, and finance leasing provisions were dealt with in Sections 9.3, 5.2 and 7 respectively above, and acquisition provisions are dealt with in Section 13.3 below.

10.1.2 Recognition of provisions

FRS 12 requires a provision to be recognized when a legal or constructive *present obligation exists* that is a result of a *past event*. It must be *probable* that a transfer of economic benefits will be required to settle the obligation; and it must be possible to make a *reliable estimate* of the amount of the obligation. If these conditions are not met, then no provision should be recognized.

“Present obligation” can be difficult to recognize in practice. For example, the UITF recently (February 2000) confirmed how the principles of FRS 12 should be applied to regulated industries. Many regulators will impose a price reduction or similar regulatory correction in a future period based on the profitability of the current accounting period. The UITF agreed with ASB guidance in FRS 12 that liabilities for such items should not be included in financial statements unless the company had a binding obligation actually to repay amounts to customers at the balance sheet date rather than adjusting prices in the following year. The UITF noted that “the mere making of book entries would not result in such an obligation”. The requirement for a binding obligation at the balance sheet date applies whether the liability is classified as a provision, creditor or other class of liability.

In cases of uncertainty, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is *more likely than not* that a present obligation exists at the balance sheet date. A past event that leads to a present obligation is called an *obligating event*. For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created

by the event, *e.g.* when settlement of the obligation is enforceable by law, or where constructive obligation exists, an event having created the valid expectation in other parties that the company will discharge the obligation.

A transfer of economic benefits is regarded as probable if the probability that the transfer will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, the company would treat the obligation as a contingent liability, unless the possibility of a transfer of economic resources is remote.

10.1.3 Contingencies

In contrast to the treatment of liabilities and provisions, “contingent liabilities” and “contingent assets” are not recognized in financial statements. A contingent liability is defined by FRS 12 as:

“either

(i) a possible obligation arising from past events whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the entity’s control; or

(ii) a present obligation that arises from past events but is not recognised because it is not probable that a transfer of economic benefits will be required to settle the obligation or because the amount of the obligation cannot be measured with sufficient reliability”.

A contingent asset is “*a possible asset arising from past events whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the entity’s control*”. The FRS notes that contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the entity.

Contingent liabilities are *disclosed* in a note to the accounts, unless the possibility of transfer of economic benefits is remote. Contingent assets are *disclosed* where inflows of economic benefits are probable. Such contingencies must be assessed continually to determine whether a transfer of economic benefits has become probable.

FRS 12 superseded SSAP 18 *Accounting for contingencies*.

10.1.4 Post-Balance Sheet Events

SSAP 17 *Accounting for post balance sheet events*, issued in 1980, provides guidelines on how post-balance sheet events may affect the recognition of provisions and disclosure of contingencies. “Post balance sheet events” are defined as “*those events, both favourable and unfavourable, which occur between the balance sheet date and the date on which the financial statements are approved by the board of directors*”. They are “adjusting events” if they provide additional evidence of conditions existing at the balance sheet date. Adjusting events would include renegotiation of amounts owing by debtors; the insolvency of a debtor; amounts received or receivable in respect of claims which were in the course of negotiation at the balance sheet date; and the discovery of errors or frauds which show that the financial statements were incorrect. Post-balance sheet events that statute or

convention (e.g. dividends proposed for the accounting period) require to be reflected in financial statements are also treated as adjusting events.

“Non-adjusting events” are post-balance sheet events which concern conditions which did not exist at the balance sheet date, e.g. mergers and acquisitions; share issues; purchases of fixed assets; losses of assets as a result of a catastrophe; commencing or extending trading activities; closing a significant part of the trading activities if this was not anticipated at the year end; decline in the value of property and investments held as fixed assets, if it can be demonstrated that the decline occurred after the year end; changes in rates of foreign exchange; and labour disputes.

Any material post-balance sheet events should be reflected in the amounts included in financial statements where it is an adjusting event, or it indicates that it is inappropriate to apply the going concern concept to the whole or a material part of the company. A material post balance sheet event should be disclosed where:

- *“It is a non-adjusting event of such materiality that its non-disclosure would affect the ability of the users of financial statements to reach a proper understanding of the financial position”* or
- *“It is the reversal or maturity after the year end of a transaction entered into before the year end, the substance of which was primarily to alter the appearance of the company’s balance sheet”.*

10.2 Measurement of Liabilities and Provisions

FRS 12 requires provisions to be measured by establishing the “best estimate” of the expenditure (before taxation) required to settle the present obligation that exists at the balance sheet date. All future events that may affect the amounts required to settle present obligations should be reflected in the amount of the provision, provided there is “sufficient objective evidence that they will occur”. This includes future legislation that is “virtually certain to be enacted”. The risks and uncertainties surrounding these events should be taken into account in determining the best estimate. Gains on future disposals of assets must not be anticipated when calculating provisions. (However, expected reimbursements should be taken into account, if it is virtually certain, but recognized as a separate asset.) If the effects of the time value of money are material, then the value of the provision should be discounted. Discount rates should be pre-tax rates that reflect current market assessments of the time value of money and the risks specific to the liability.

The ASB notes that the use of estimates is *“an essential part of the preparation of financial statements and does not undermine their reliability”*. In the case of provisions, which are by nature more uncertain than other balance sheet elements, measurement relies upon estimation. The ASB is confident that companies will usually be able to determine a range of possible outcomes and make an estimate of the obligation that is sufficiently reliable to use in recognizing a provision. But, in *“the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised”*. In such circumstances, the liability must be disclosed as a contingent liability.

Provisions should be reviewed at each balance sheet date and adjusted to reflect current best estimates. If it is no longer probable that a transfer of economic benefits

will be required to settle the obligation, the provision should be reversed. A provision should be used only for expenditures for which the provision was originally recognized.

10.3 Accounting for Financial Instruments

In a Discussion Paper *Derivatives and other Financial Instruments* issued in July 1996, the ASB raised a number of issues and reached several conclusions about financial instruments. One was that disclosures about financial instruments needed to be improved urgently. The production of a disclosure FRS was made a priority. FRED 13 *Derivatives and other Financial Instruments: Disclosures* was issued in April 1997 and a final version, FRS 13, was issued in September 1998. FRS 13 applies to accounting periods ending on or after 23 March 1999.

10.3.1 Definition

FRS 13 defines a “financial instrument” as “any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity”. The term includes both “primary financial instruments”, e.g. bonds, debtors, creditors and shares, and “derivative financial instruments” that derive their value from the price or rate of some underlying item. Derivatives include futures, options, forward contracts, interest rate and currency swaps, interest rate caps, collars and floors, forward interest rate agreements, commitments to purchase shares or bonds, note issuance facilities and letters of credit.

Some of these instruments tend to be highly visible within financial statements regulated by company legislation and accounting standards. The ASB noted that certain other instruments are less visible, e.g. swaps, forwards, caps and collars, and other derivatives that are entered into by companies to manage the risks arising from their operating and financing activities. The purpose of FRS 13 is to improve the disclosures about all financial instruments by focusing on the way in which they are used by the reporting entity. The disclosures should provide information about:

- Impact of the financial instruments on the company’s risk profile
- How the risks arising from financial instruments might affect the company’s performance and financial condition
- How these risks are being managed.

FRS 13 applies to all listed companies, other than insurance companies and groups, and all banks and similar institutions. It is narrower in scope than IAS 32, which applies to the financial statements of all entities.

10.3.2 Disclosure

The ASB took the view that a structured mixture of narrative and numerical disclosures would provide users with the most meaningful form of information and the approach would avoid requirements for a mass of detail. The narrative disclosures explain the company's chosen risk profile and the numerical disclosures show how these policies were implemented and provide information to enable exposures to be evaluated. Taken together, the disclosures give a broad overview of the risks arising on financial instruments, emphasizing the most significant instruments and risks.

The main focus of the FRS is on financial instruments that are complex or play a significant medium- to long-term role in the financial risk profile of the entity. Therefore, a company has the option of excluding all or none of its short-term debtors and creditors (other than the currency disclosures) from the disclosures outlined below. This option distinguishes the FRS from IAS 32. These disclosures apply to financial instruments that are treated as equity, non-equity share capital and liabilities.

The narrative disclosures required by FRS 13 include an explanation of the role that financial instruments play in creating or changing the risks a company faces in its activities. The directors' approach to managing each of those risks should also be explained, and this should include a description of the objectives, policies and strategies for holding and issuing financial instruments.

The numerical disclosures required are intended to show how these objectives and policies were implemented in the period. They focus on: interest rate risk; currency risk; liquidity risk; fair values; and hedging activities. Different disclosures are required for companies that are not financial institutions, banks and similar institutions, and other financial institutions. For example, the disclosure of liquidity risk of banks and similar institutions is regulated by other provisions.

In general, the FRS's disclosures are more specific than those of IAS 32, and the narrative disclosures are a distinctive feature of the United Kingdom and Irish standard.

10.3.3 Recognition and Measurement

The ASB has expressed concern that existing accounting practices do not cope with the rapid growth in the use of financial instruments and the increasingly complex types of instruments that are used. The issues and its proposals were aired in a Discussion Paper *Derivatives and other Financial Instruments*, issued in 1996, that made recommendations on the recognition and measurement of financial instruments and the use of hedge accounting. The paper tentatively proposed that:

- All financial instruments should be measured in the financial statements at current value
- Use of hedge accounting techniques should be regulated more closely and its use should probably be restricted in some way.

Since the paper was issued, the ASB has joined eight other national standard-setters and the IASC in a joint working group on financial instruments and the IASC has issued IAS 39 *Financial Instruments: Recognition and Measurement*. The ASB has

confirmed that it will not adopt IAS 39 as the United Kingdom and Irish standard, but will follow harmonized joint working group proposals. These proposals will be exposed for discussion in the United Kingdom and Republic of Ireland.

The principal features of the joint working group approach are that all:

- Financial instruments will be carried at fair value
- Gains and losses arising from changes in those fair values will be recognized immediately in the profit and loss account.

It is not yet resolved if “fair value” in this context means the same thing as “current value” in the statement of principles (the lower of current replacement cost and recoverable amount), or something different. FASB views on fair value are likely to influence the joint working group proposals - these were expressed recently in preliminary form in a paper *Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value*. FASB currently regards fair value as an estimated net market exit price.

10.4 Accounting for Capital Instruments

Immediately after its creation in 1990, the ASB began to develop an FRS to distinguish debt from equity instruments because it was concerned about the increasing number and variety of capital instruments in use. Accounting in this area lacked uniformity and new practices challenged conventional analyses. A Discussion Paper *Accounting for Capital Instruments* (December 1991) and FRED 3 *Accounting for Capital Instruments* (December 1992) preceded FRS 4 *Capital Instruments* (issued in November 1993).

“Capital instruments” are defined in the FRS as

“all instruments that are issued by reporting entities as a means of raising finance, including shares, debentures, loans and debt instruments, options and warrants that give the holder the right to subscribe for or obtain capital instruments”.

FRS 4 deals with accounting for capital instruments by the companies that issue them, and its objectives are to ensure that:

- Financial statements provide a clear, coherent and consistent treatment of capital instruments, especially for the classification of instruments as debt, non-equity shares or equity shares
- Costs associated with capital instruments are dealt with in a manner consistent with their classification, and, for redeemable instruments, allocated to accounting periods on a fair basis over the period that the instrument is in issue
- Financial statements provide relevant information concerning the nature and amount of a company’s sources of finance and the associated costs, commitments and potential commitments
- Treatment of capital instruments reflects the obligations of the issuer.

Capital instruments that are accounted for as part of shareholders’ funds or minority interests are dealt with in Sections 11.1.1 and 13.1.5 below. Debt instruments are liabilities, not shares, and contain an obligation to transfer economic benefits.

The principal requirements of FRS 4 are:

- Balance sheets should disclose the fair value of the capital instruments
- Capital instruments other than shares should be classified as liabilities if they contain an obligation to transfer economic benefits (including a contingent obligation to transfer economic benefits)
- Convertible debt should be reported separately within liabilities and the finance cost should be calculated on the assumption that the debt will never be converted. This is justified on the basis that the balance sheet is a record of the financial position of the company at a point in time, rather than a forecast of future events. When convertible debt is converted, no gain or loss should be recognized
- Amounts to be initially attributed to these instruments are the net amounts of the issue proceeds
- Capital instruments that are issued at the same time in a composite transaction should be considered together. They should be accounted for as a single instrument unless they are capable of being transferred, cancelled or redeemed independently of each other
- Costs incurred that can be demonstrated to related directly to the issue of capital instruments should be deducted from the proceeds of the issue. Other costs are to be charged as expenses when incurred
- Associated finance costs should be allocated to periods for the term of the debt at a constant rate based on the carrying amount
- Finance cost for a period is added to the carrying amount and payments deducted from it. In the case of a redeemable instrument this will result in the carrying amount at the time it is redeemed being equal to the amount payable at that time.

“Finance costs” are measured as the difference between the net proceeds of an instrument and the total transfers of economic benefits that the issuer may be required to make in respect of the instrument.

FRS 4 superseded UITF Abstract 1 and Abstract 8.

10.5 Accounting for Pensions and Similar Obligations

SSAP 24 *Accounting for pension costs* was issued in 1988. It deals with the accounting for, and the disclosure of, pension costs and commitments in the financial statements of companies with pension arrangements for the provision of retirement benefits for their employees. It treats a pension as the deferred remuneration of employees and, therefore, as an employer’s cost incurred in obtaining the employee’s services. The accounting objective of the SSAP is to require the employer to recognize the cost of providing pensions on a systematic and rational basis over the period benefiting from the employees’ services. This is achieved by recognizing a regular cost for the pension every year. Variations from the regular cost are allocated over the expected remaining service lives of the current employees.

The SSAP applies to “defined contribution” (money purchase) and “defined benefit” pension schemes. In a defined contribution scheme, the employer makes agreed contributions to a pension scheme and the benefits paid will depend upon the size of the accumulated contributions and investment returns of the funds. The cost to the employer is linked to the contributions and can be measured with reasonable certainty.

In a defined benefit scheme, however, employer costs are much more uncertain. Pension benefits depend upon either the average pay for a number of years or, more typically, the final pay of the employee. It is impossible to be certain in advance that accumulated employers' contributions, plus the investment return on such funds, will cover future pension obligations. Usually, the employer has obligations to meet any shortfall in funds. If a surplus arises, the employer may be entitled to a refund of, or reduction in, contributions paid into the pension scheme. The provisions of the SSAP apply equally to funded and unfunded schemes (schemes where the benefits are paid directly by the employer).

10.5.1 Accounting for Employers' Pension Obligations

In a *defined contribution scheme*, the employer's obligation at the balance sheet date is limited to the contributions payable to date. The pension cost is, therefore, the amount of the contributions payable in respect of the particular accounting period.

Assets and liabilities in a *defined benefit pension scheme* are valued on an actuarial basis with the objective of arriving at a regular pension cost each year that is a substantially level percentage of the pensionable payroll. Any variations from the regular cost are spread forward and recognized gradually over the average remaining service lives of the employees.

The SSAP requires that the pension cost should be calculated using actuarial valuation methods that ensure full provision may be made over the employees' service lives for the expected costs of their pensions. In connection with the actuarial valuation, the following must be taken into account and disclosed:

- Effect of expected future increases in earnings, including merit increases, up to the assumed retirement date or earlier date of withdrawal or death in service
- Expected future increases in deferred pensions and pensions in payment where the employer has an express or implied commitment to grant such increases
- Calculation of benefit levels should be based on the situation most likely to be experienced and not on a contingent event not likely to occur
- Actuarial methods selected should be used consistently and should be disclosed.
- If there is a change of method this fact should be disclosed and the effect quantified
- Actuarial assumptions and the actuarial method taken as a whole should be compatible and should lead to the actuary's best estimate of the cost of providing the pension benefits promised.

When there is a significant change in the normal level of contributions, cost recognition under the SSAP may alter. Where a significant reduction in the number of employees is related to the sale or termination of an operation, the associated pension cost or credit should be recognized immediately to the extent necessary to comply with the requirement of FRS 3. In all other cases the reduction of contributions should be recognized as it occurs. The full effect of a contribution holiday should not be recognized at the outset of the holiday, but rather spread over its duration. A material deficit may be recognized over a period shorter than the expected remaining service lives of current employees in the scheme only if a major event or transaction has occurred which:

- Has not been allowed for in the actuarial assumptions

- Is outside the normal scope of those assumptions
- Has necessitated the payment of significant additional contributions to the pension scheme.

If the cumulative pension cost recognized in the profit and loss account has not been completely discharged by payment of contributions or directly paid pensions, the excess should be shown as a *net pension provision*. If there is an excess of contributions paid or directly paid pensions over the cumulative pension cost, the excess should be shown as a *pension prepayment*.

UITF Abstract 6 *Accounting for post-retirement benefits other than pensions* was issued in 1992. It adopts similar principles to those of SSAP 24 for post-retirement benefits other than pensions, *e.g.* health care.

10.5.2 New Requirements for Accounting for Defined Benefit Pension Obligations

The accounting treatment of defined benefit pension obligations has been criticized in the United Kingdom for the number of different valuation methods and ways of accounting for the resulting gains and losses that it allows, its poor disclosure requirements and the lack of transparency in the figures it produces. It is also inconsistent with international standards on the subject: IAS 19, as revised in 1998.

FRS 17 *Retirement Benefits* was published in November 2000 and is proposed as a substitute for SSAP 24 and UITF Abstract 6. It follows two Discussion Papers: *Pension costs in the employer's financial statements* (1995) and *Aspects of accounting for pension costs* (July 1998). It would change the way in which defined benefit schemes are treated, by moving away from the use of actuarial values for assets in a pension scheme to a market value based approach. This is consistent with international practice (*i.e.* IAS 19) and the increasing use of market values by the United Kingdom and Irish actuarial profession. One consequence would be to move away from the practice of using the expected rate of return on pension scheme assets to discount scheme liabilities toward the use of a discount rate that reflects the characteristics of the liabilities. Another would be to require actuarial valuations to be updated at each balance sheet date.

The ASB has noted that the use of market values at the balance sheet date introduces volatility into the measurement of the surplus or deficit in the pension scheme. It proposes a distinctive approach to cope with such volatility. The profit and loss account would show the relatively stable ongoing service cost, interest cost and expected return on assets measured on a basis consistent with international standards. The effects of market value fluctuations would not be recognized as part of the operating results of the business and would be treated like revaluations of fixed assets by being taken direct to the statement of total recognized gains and losses. The ASB argues that their approach has two advantages over the IAS 19 approach. First, the balance sheet would show the deficit or recoverable surplus in the scheme, and second, the total profit and loss charge is more stable than it would be if the market value fluctuations were spread forward.

11. Share Capital and Reserves

Owners' equity consists of company share capital and reserves. Much of the regulations dealing with owners' equity derives from legal requirements and which are dealt with in the two chapters supporting this appendix.

11.1 FRS 4 *Capital Instruments*

11.1.1 *Shareholders' Funds*

Capital instruments comprise debt and shareholders' funds. Shareholders' funds include called up share capital and all reserves and excludes minority interests. It comprises capital instruments that are not debt and includes warrants.

FRS 4, issued in 1993, requires shareholders' funds to be divided into equity and non-equity components so that shares with more of the character of debt are distinguishable from pure equity shares. Shares should be regarded as non-equity if they have restrictions on the rights attaching to them or are redeemable. They are defined as shares possessing any of the following characteristics:

- Rights to receive payments of limited amount, not calculated by reference to the company's assets, profits or dividends
- Rights to participate in a surplus on winding up limited to a specific amount, not calculated by reference to the company's assets or profits
- Shares are redeemable according to their terms or because the holder can require their redemption.

FRS 3 requires companies to include a single statement of all movements on reserves: the *reconciliation of movements in shareholders' funds*. This reconciliation brings together the performance of the period as shown in the statement of total recognized gains and losses and all other changes in shareholders' funds in the period including capital contributed/repaid. The standard suggests that '*a note be presented*' of the reconciliation but goes on to say that if the reconciliation is presented as a primary statement it should not be part of the statement of total recognized gains and losses.

Finance costs relating to non-equity shares are to be measured in the same way as for debt instruments, except that they are shown as an appropriation in the profit and loss account rather than as an expense. FRS 4 requires finance costs to be allocated over the life of the instrument at a constant rate on the carrying amount. The standard contains a number of disclosure requirements. Those relating to shareholders' funds are summarized in Table 2.

Table 2: FRS 4 disclosure requirements for shareholders' funds

Total shareholders' funds

- Show total amount of shareholders' funds on face of balance sheet
- Analyze shareholders' funds between equity and non-equity interests

Summary of rights attaching to each class of share

- Rights to dividends
- Dates at which shares are redeemable
- Amounts payable in respect of redemption
- Priority and amounts receivable in a winding up
- Voting rights.

Aggregate dividends on each class of share

- Dividends on equity shares
- Participating dividends
- Dividends on non-equity shares
- Other appropriations of profit in respect of non-equity shares.

11.1.2 Reserves

There is no accounting standard dealing specifically with reserves. However, SSAPs 19, 20 and FRSs 3 and 15 refer to the effect on reserves of the accounting treatments dealt with in those standards. In certain circumstances, accounting adjustments to reserves arise which are not included in calculating profit for the year. Adjustments to reserves provided for in other accounting standards are:

- Under SSAP 19 and FRS 15, changes to the valuation of tangible fixed assets should be accounted for in revaluation reserves and under FRS 3, they should be reported in the statement of total recognized gains and losses
- Under SSAP 20, certain exchange differences should be accounted for as reserve movements.

Tangible fixed assets (Section 6) and foreign exchange translations (Sections 4.1.5 and 13.6) are dealt with in other parts of this appendix.

PART 4: CASH FLOW

12. Reporting Cash Flows

A cash flow statement reports actual inflows and outflows of cash during a period, classified according to specified business activities. Transactions are only included if they result in a change in cash. Detailed reporting of cash flow information is required by FRS 1, published in 1991 and revised in 1996. The original FRS required movements on 'cash and cash equivalents' to be reported. The notion of cash equivalents was controversial. It provided scope for manipulation and the criteria defining the concept were somewhat arbitrary. The current requirement is to report movements of cash in the accounting period under prescribed headings. Inflows and outflows of cash are grouped together in headings indicating the type of activity giving rise to them. Cash is defined as cash in hand or deposits with qualifying financial institutions repayable on demand, less overdrafts with qualifying financial institutions repayable on demand. Qualifying financial institutions are those receiving

deposits and granting credits as part of their business. Cash includes deposits denominated in foreign currency. Cash flows are reported under the following standard headings:

- Operating activities
- Dividends from associates and joint ventures
- Returns on investments and servicing of finance
- Taxation
- Capital expenditure and financial investments
- Acquisitions and disposals
- Equity dividends paid
- Management of liquid resources
- Financing.

The ASB increased the number of prescribed standard headings when it revised FRS 1 in 1996 to distinguish between cash flows over which the entity has control, e.g., equity dividends paid and those where less discretion is exercisable, e.g., interest payments. It also wanted to eliminate allocations across headings that might reduce the value of the information provided. The change to a pure cash statement introduced the heading '*management of liquid resources*' which deals with flows in respect of current asset investments.

Cash flows from operating activities can be calculated either directly, or indirectly by adjusting operating profit for non-cash items reflected in profit. Under the direct method they are presented on the face of the cash flow statement described as follows:

- Cash receipts from sales
- Cash payments to suppliers
- Cash payments to and on behalf of employees
- VAT paid or received
- Other cash payments.

The more common approach to calculating operating cash flows is the indirect one where cash flows from operations are presented as a single item on the cash flow statement. The reconciliation of operating profit to operating cash flows required by FRS 1 reports the indirect calculation of operating cash flows.

Returns from investments and servicing of finance include interest and dividends received (except dividends received from associates and joint ventures), the interest element of finance lease repayments, dividends paid to non-equity shareholders and dividends paid to minority interest shareholders. Taxation cash flows only include tax paid on income and capital gains. It does not include indirect taxes, such as VAT or PAYE which are included in operating activities.

Capital investments and financial investments include cash flows relating to purchase and disposal of fixed assets and any current asset investment not included in the definition of liquid resources. However, it does not include flows in respect of acquisition and disposal of interests in subsidiaries, associates or joint ventures. These are included in '*acquisitions and disposals*'. Cash flows of companies acquired in the period are included for the same period as profits of the acquisition are included in the profit and loss account.

Liquid resources are defined as current asset investments which are readily disposable without curtailing the reporting entity's business. Financing cash flows represent amounts received from or paid to providers of both debt and equity finance. Within each of the standard headings detailed disclosures are required which may be provided in the notes to the accounts.

Because of the importance of movements in net debt in determining the solvency of the reporting entity, the standard requires cash flows and net debt to be reconciled. Net debt is defined as borrowings less liquid resources and cash.

PART 5: GROUPS

13. Accounting for Groups

Both the stock exchange and company law requires listed companies to publish consolidated or group financial statements if they have subsidiaries. Group financial statements show the financial position and results of a group of companies consisting of a holding company and its subsidiaries as if the group was a single entity. They may also include investments in associated companies and other investments such as joint ventures using equity accounting principles. Group financial statements are prepared by the holding company in addition to its own company financial statements. Company law exempts the holding company from publishing its own individual company profit and loss account provided the consolidated accounts show how much of the consolidated profit or loss is dealt with in the individual accounts of the parent.

In addition to the legal requirement to disclose country of incorporation of subsidiaries, the stock exchange listing rules require country of operation to be disclosed. Where the number of subsidiaries is large, details concerning those of less importance may be omitted.

A number of accounting standards cover different aspects of group accounts. They include:

FRS 2	1992	<i>Subsidiary undertakings</i>
FRS 6	1994	<i>Mergers and acquisitions</i>
FRS 7	1994	<i>Fair value in acquisition accounting</i>
FRS 9	1998	<i>Associates and joint ventures</i>
FRS 10	1998	<i>Goodwill and intangible assets</i>
SSAP 20	1980	<i>Foreign currency translation</i>

13.1 FRS 2 Subsidiary Undertakings

This standard was introduced to clarify the legal requirements relating to group accounts introduced when the seventh EU Directive was implemented in the United Kingdom. The later introduction of this Directive in Republic of Ireland is accommodated with a dedicated paragraph in FRS 2 cross-referencing United Kingdom legal references in the standard to the provisions of the relevant Republic of Ireland legislation. The objective of FRS 2 is to indicate the way parent undertakings should provide financial information about economic activities of groups by preparing consolidated financial statements. FRS 2 emphasizes the requirements of legislation

that parent undertakings should consolidate all subsidiary undertakings over which the group exercises ‘dominant influence’, subject only to certain specified exclusions. It reduces the possibility of circumventing legal definitions of subsidiary undertakings using quasi-subsidiaries to move assets and liabilities off balance sheet. It also extends the legal requirement for limited companies with subsidiaries to prepare group financial statements to all parent undertakings (including partnerships and other unincorporated businesses).

The standard requires parent undertakings to prepare group accounts incorporating their own results and financial position and that of all their subsidiaries. It defines the process of consolidation as:

“the process of adjusting and combining financial information from the individual financial statements of a parent undertaking and its subsidiary undertakings to prepare consolidated financial statements that present financial information for the group as a single economic entity.”

FRS 2 deals primarily with:

- Defining parent and subsidiary undertakings
- Circumstances where group accounts are required
- Exemptions from the requirement to prepare group accounts
- Exclusions from consolidation
- Accounting for excluded subsidiaries
- Consistency of accounting policies, periods and dates
- Disclosures in consolidated accounts.

13.1.1 Definitions

FRS 2 definitions are based on United Kingdom legislation, which is slightly different from the Republic of Ireland equivalent.

13.1.2 Exemptions

Under legislation implementing the seventh Directive, parent companies need not prepare consolidated financial statements if they fall within specified size criteria. FRS 2 points out that there could be cases where a company is exempt from preparing group financial statements but the individual financial statements do not give a true and fair view of its results and financial position. Sufficient disclosures should be made to enable the parent company’s financial statements to give a true and fair view. FRS 2 also requires a note referring to the legal exemption taken and a note that the financial statements present information about an individual undertaking.

13.1.3 Exclusions

FRS 2 discusses exclusions required and permitted under legislation, i.e. exclusion on the grounds of:

- Immaterial subsidiaries
- Disproportionate expense or undue delay
- Severe long term restrictions

Under legislation

} may exclude

- Interest held exclusively with a view to subsequent resale
- Dissimilar activities such that inclusion would be incompatible with true and fair view. } must exclude

As standards only apply to material items, exclusion on the grounds of immateriality is not covered by, and need not be referred to, under FRS 2. The standard is more definitive about the other exclusions *permitted* under the legislation:

- Under FRS 2, neither disproportionate expense or undue delay in obtaining necessary information can justify excluding from consolidation a subsidiary that is material in the context of the group
- Where severe long-term restrictions hinder the exercise of the rights of the parent over the assets or management of a subsidiary, that subsidiary must be excluded from consolidation under FRS 2
- Subsidiaries held with an immediate intention to sell within one year (and which have not previously been included in consolidated accounts) must be excluded from consolidation under FRS 2.

FRS 2 accepts the legally required exclusion of dissimilar activities on the grounds of incompatibility but states that it would be exceptional for such circumstances to occur. It instances the contrast between banking or insurance companies or between profit and not for profit undertakings as not being sufficient to justify exclusion.

The standard specifies accounting treatment and additional disclosure requirements for excluded subsidiaries which vary with the reason for exclusion.

<i>Reason for exclusion</i>	<i>Accounting treatment</i>
• Severe long-term restrictions	Fixed asset investment: the carrying amount should be cost (if restrictions were in place at the beginning) or amount under the equity method (if restrictions came into effect after acquisition)
• Held exclusively with a view to subsequent resale	Current assets: at lower of cost and net realizable value
• Dissimilar activities	Use equity method

Additional disclosure requirements for excluded subsidiaries include:

- Particulars of balances between excluded subsidiaries and the group
- Nature and extent of transactions of excluded subsidiaries with the group
- For subsidiaries excluded and not accounted for using the equity method:
 - dividends received/receivable
 - any write-downs during the period of investments in or amounts due from excluded subsidiary
- For subsidiaries excluded because of dissimilar activities, their separate financial statements (summarized financial information suffices in some cases).

13.1.4 Consistency of Accounting Policies, Periods and Dates

Similar to legal requirements, FRS 2 requires uniform group accounting policies to be used in consolidated financial statements, if necessary by adjusting amounts for

consolidation. In exceptional cases, different accounting policies may be used which under law should be disclosed, together with particulars of the differences.

The same accounting period should be used in subsidiaries' financial statements as for the parent. Group undertakings should have the same financial year-ends. Where the subsidiary's year-end differs, interim accounts to the group year-end should be prepared. If this is not practicable, subsidiary financial statements not more than three months before the group year-end should be used. Any material intervening events should be adjusted for in the consolidated financial statements.

For subsidiaries with different accounting periods or year-ends there should be disclosed:

- Name of subsidiary undertaking
- Accounting period or date
- Reason for using a different accounting period or date.

13.1.5 Minority Interests

FRS 2 requires the aggregate of capital and reserves attributable to minority shareholders to be disclosed in the balance sheet separately from shareholders' funds. The profit or loss attributable to the minority should be shown separately in the consolidated profit and loss account, after profit after tax. When a subsidiary undertaking is acquired, minority interest should be calculated by reference to assets and liabilities recorded at fair value or at adjusted carrying value. Goodwill arising on acquisition should not be attributed to minority interests. FRS 4 requires minority interests to be analyzed between amount attributable to equity interests and non-equity interests.

A minority interest debit balance (representing net liabilities in the subsidiary) should only be provided for to the extent the group has any commercial or legal obligation to provide finance that may not be recoverable in respect of the subsidiary's accumulated losses.

13.1.6 Consolidation Adjustments

Inter-company profits or losses included in assets in the group balance sheet should be eliminated in full under FRS 2 in respect of all subsidiaries (whether consolidated or not). The amount should be charged against the group and the minority interest in proportion to their holdings in the subsidiary that recorded the profit/loss.

13.2 FRS 6 Mergers and Acquisitions

This standard sets out criteria to be satisfied if merger accounting (pooling of interests) is to be adopted in preparing group accounts following a combination. The objectives of FRS 6 are to ensure that:

- Merger accounting is only used for those business combinations that are *not* acquisitions
- Acquisition accounting is used for all other business combinations
- Financial statements provide sufficient information for users concerning the effect of combinations.

Under FRS 6 merger accounting is restricted to very rare cases where the business combination cannot be properly viewed as a takeover of one company by another but arises from the formation of a new reporting entity as a substantially equal partnership where no party is dominant. Merger accounting should be used where:

- The use of merger accounting is not prohibited by legislation
- The combination meets *all* five criteria and thus falls within the definition of a merger in FRS 6.

Group reconstructions and some combinations effected by using a new parent company (depending on the substance of the transaction) may be accounted for using merger accounting.

FRS 6 defines a merger as:

“A business combination that results in the creation of a new reporting entity formed from the combining parties, in which the shareholders of the combining entities come together in a partnership for mutual sharing of risks and benefits of the combined entity and in which no party to the combination in substance obtains control over any other, or is otherwise seen to be dominant, whether by virtue of the proportion of the shareholders’ rights in the combined entity, the influence of its directors or otherwise”.

Where the following five criteria for merger accounting under FRS 6 are satisfied the combination *must* be accounted for as a merger.

- No party to the combination is portrayed either as acquirer or acquired
- All parties to the combination participate in establishing the management structure for the combined entity
- The relative sizes are not so disparate that one party dominates
- Consideration received comprises primarily equity shares, and any non-equity consideration or shares carrying reduced voting rights represent an immaterial proportion of the fair value of consideration
- No equity shareholders retain any material interest in the future performance of only a part of the combined entity.

The following details must be disclosed for both acquisitions and mergers:

- Names of combining entities
- Whether combination has been accounted for as acquisition or merger
- The date of the combination.

Other disclosure requirements relate specifically to acquisition or merger accounting.

13.2.1 For Mergers Only

- Analysis of principal components of the profit and loss account and of total recognized gains and losses into:
 - post merger period
 - period up to date of merger for each party to the merger
 - previous period for each party to the merger

The analysis should show at a minimum turnover, operating profit and exceptional items, split between continuing operations, discontinued operations and

acquisitions; profit before taxation, taxation, minority interests and extraordinary items

- Composition and fair value of consideration given
- Aggregate book value of net assets of each party at the date of the merger
- Nature and amount of significant accounting adjustments to net assets to achieve consistency of accounting policies, and explanation of any other adjustments to net assets made as a consequence of the merger
- Adjustments to reserves resulting from the merger.

13.2.2 For Acquisitions Only

- Post-acquisition profits should be shown separately in the profit and loss account as a component of continuing operations (in accordance with FRS 3)
- Costs incurred in reorganizing, restructuring and integrating the acquisition included in the profit and loss account after the acquisition
- Cash and cash equivalents paid on acquisition, net of cash balances taken over, should be disclosed in the cash flow statement.

FRS 6 disclosure requirements relating to fair values are summarized in Section 13.3.

FRS 6 also requires disclosure of amounts not included in consolidated accounts. In this context it distinguishes between *material* and *substantial* acquisitions. A substantial acquisition is a combination classified as a Class 1 or Super Class 1 transaction under stock exchange listing rules. Alternatively, where net assets or operating profits of the acquired entity exceed 15% of those of the acquiring entity, or where the fair value of the consideration exceeds 15% of the net assets of the acquiring entity, the combination is categorized as substantial. The following disclosures are required:

- For each material acquisitions: Profit after tax and minority interests for the current year up to the date of acquisition and for the previous financial year
- For substantial acquisitions: Summarized profit and loss account and statement of total recognized gains and losses for the current year to the date of acquisition and for the previous financial year, showing as a minimum turnover, operating profit, exceptional items requiring disclosure under FRS 3, profit before taxation, taxation, minority interests and extraordinary items.

13.3 FRS 7 Fair Values in Acquisition Accounting

References to fair value are found in legislation and accounting standards. Acquisition accounting is described in legislation as including identifiable assets and liabilities of the undertaking acquired in the consolidated balance sheet at their fair values at the date of acquisition. Purchased goodwill is defined in FRS 10 as:

“The difference between the cost of an acquired entity and the aggregate of the fair values of that entity’s identifiable assets and liabilities”.

Fair values were first mentioned in SSAP 22 *Accounting for goodwill* in 1984. Revision of SSAP 22 in 1989 attempted to discourage creative accounting practices, prevalent at that time in goodwill calculations, by requiring additional disclosures. The requirement to publish a fair value table was introduced, as was the requirement

to disclose detailed movements on provisions related to acquisitions. Nonetheless, there was no guidance on identifying fair values in accounting standards until 1994 when FRS 7 was issued, by which time manipulation of fair values was widespread.

The objectives of FRS 7 are:

- To ensure that all assets and liabilities that existed in the acquired entity at the date of acquisition are recorded at their fair values
- To ensure that all changes after acquisition to acquired assets and liabilities, and the resulting gains and losses, are reported as part of post acquisition financial performance.

Fair value is defined in FRS 7 as:

“The amount at which an asset or liability could be exchanged in an arm’s length transaction between informed and willing parties, other than in a forced or liquidation sale.”

13.3.1 Fair Values of Assets and Liabilities Acquired

The basic principle of FRS 7 is that fair value should reflect circumstances at the time of acquisition, and should not reflect either the acquirer’s intentions or events subsequent to acquisition. Thus, assets and liabilities recognized are restricted to those of the acquired entity that existed at the date of acquisition. Any provisions for reorganization costs to be carried out by the acquirer, and provisions for future losses, should be treated as part of the post-acquisition results of the acquired group. FRS 7 does not permit these to be included in the liabilities of the acquired entity at the date of acquisition.

Detailed rules in assigning fair values to assets and liabilities are laid down in the standard. The valuation rules are summarized in Table 3:

Table 3: Fair Values of Assets and Liabilities

Asset/liability	Fair value
Tangible fixed assets	Market value (if similar assets traded on open market) or Depreciated replacement cost
Intangible assets	Replacement cost – normally estimated market value
Stocks and work in progress	Lower of replacement cost and net realizable value (allows for subsequent realization of trading profit)
Commodity stocks	Current market price
Quoted investments	Market price
Monetary assets and liabilities	Market price or Current price to acquire similar asset/liability or Discounted future cash flows to present value
Contingencies	Fair value where calculable - use reasonable estimates of the expected outcome
Business sold or acquired exclusively with a view to subsequent resale	Estimated sale proceeds. If not sold within a year consolidate at fair values at date of acquisition
Pensions	Recognize fair value of deficiency or surplus in a funded pension (if expected to be realized)
Deferred taxation	Calculate deferred tax liabilities by considering group as a whole. Recognize benefit of any tax losses attributable to acquired entity

The fair value exercise should be completed by the date on which the directors approve the acquirer's first post-acquisition financial statements. If this is not possible, fair values may be revised as necessary in the following year's financial statements. Any adjustments subsequent to this must be included as part of post-acquisition results.

Disclosure requirements relating to fair values are included in FRS 6, which requires disclosure of:

- Table ('*fair value table*') showing the book values in the acquired company's books and the fair values of each major category of assets and liabilities acquired
- Differences between fair values and book values should be analyzed between:
 - revaluations
 - provisions for future trading losses
 - other provisions
 - adjustments to bring accounting policies into line
 - other significant adjustments, with explanations
- Fair values at the date of acquisition
- Purchased goodwill/negative goodwill arising on acquisition
- Details of provisions for the costs of reorganization and restructuring included in the liabilities of the acquired entity and related asset write-downs in the twelve months to the date of acquisition
- Movements on provisions relating to acquisitions; these should be analyzed between the amounts used for the specific purpose they were created and amounts released unused or applied for another purpose
- Where the fair value of the assets and liabilities or of the consideration, can only be determined on a provisional basis at the end of the accounting period, this should

be stated and reasons given. Subsequent material adjustments causing adjustment to goodwill should be disclosed and explained.

13.3.2 Fair Value of Consideration

Under FRS 7 the cost of acquisition includes:

- Cash and other monetary consideration
- Fair value of other purchase consideration given by the acquirer
- Expenses of acquisition.

If cash settlement is to be deferred, fair value can be calculated by discounting cash payments back to present value using a discount rate equivalent to the interest rate which the acquirer could obtain on similar borrowing.

Other purchase consideration (such as capital instruments) should be valued at market price on the date of acquisition or, where there is no reliable market, fair value will have to be estimated by other means (e.g. value of similar quoted securities).

Where the amount of purchase consideration is contingent on one or more future events (e.g. performance of the acquired entity) the cost of acquisition should include a reasonable estimate of the fair value amounts expected to be payable.

Professional fees and similar costs can be included in the cost of acquisition. Internal costs (e.g. cost of directors' time) and expenses that cannot be directly attributable to the acquisition cannot.

In relation to purchase consideration FRS 6 requires disclosure of:

- Composition and fair value of consideration given, including details of deferred or contingent consideration
- Where the fair value of the consideration, can only be determined on a provisional basis at the end of the accounting period, this should be stated and reasons given; subsequent material adjustments causing adjustment to goodwill should be disclosed and explained.

13.4 FRS 9 Associates and Joint Ventures

FRS 9 *Associates and joint ventures* was issued in November 1997, replacing SSAP 1 which had operated since 1971. The current standard continues the requirement that equity accounting principles should be used for associates. Equity accounting is defined in FRS 9 as:

“A method of accounting that brings an investment into its investor’s financial statements initially at its cost, identifying any goodwill arising. The carrying amount of the investment is adjusted in each period by the investor’s share of the results of its investee less any amortisation or write-off for goodwill, the investor’s share of any relevant gains or losses, and any other changes in the investee’s net assets including distributions to its owners, for example by dividend. The investor’s share of its investee’s results is recognised in its profit and loss account. The investor’s cash flow statement includes the cash flows between the investor and its investee, for example relating to dividends and loans. ”

The objective of FRS 9 is to reflect the effect on an investor's financial position and performance of its interests in two special kinds of investments, associates and joint ventures, for whose activities it is partly accountable. The FRS also deals with joint arrangements that do not qualify as associates or joint ventures because they are not entities. The requirements of FRS 9 are summarized as follows:

- Investments must be analyzed between associates, joint ventures and joint arrangements that are not entities
- Associates arise where the investor has a ‘participating interest’ and ‘exercises a significant influence’ (both terms are defined). Associates are accounted for using the equity approach (balance sheet amount is group share of investee’s net assets plus unamortized goodwill on acquisition while the profit and loss account includes the group share of operating profit and group share of associate’s tax charge)
- Joint ventures arise where the investor holds an interest on a long-term basis and jointly controls the venture under a contractual arrangement. The ‘gross equity’ method is required for joint ventures, i.e., equity method with expanded analysis in both the profit and loss account and balance sheet
- Joint arrangements that are not entities are defined as a contractual arrangement in which participants engage in joint activities that do not create an entity because it would not be carrying out a trade or business of its own. Participants in joint arrangements that are not entities should account directly for their own assets, liabilities and cash flows measured according to the terms of the agreement covering the arrangement in both the individual company and the group accounts
- Profit and loss account disclosure has been expanded as follows:
 - group share of joint ventures’ turnover must be separately disclosed
 - amounts for associates and joint ventures should be shown separately from each other and from those of the group
 - group share of their operating profit should be shown immediately after group operating profit
 - group share of non-operating items must be disclosed
- Additional disclosures are required where certain thresholds of 15% (aggregate associates and joint ventures) and 25% (individual associate or joint venture) have been breached.

13.5 FRS 10 Goodwill

Goodwill is dealt with in a number of professional pronouncements. In December 1997, FRS 10 *Goodwill and intangible assets* superseded SSAP 22 *Accounting for goodwill* which was published in December 1984. FRS 7 gives guidance on how fair values of assets and liabilities should be determined, which in turn determines amounts attributable to goodwill. UITF Abstract 3 *Treatment of goodwill on disposal of a business* specifies the appropriate accounting treatment of goodwill in calculating profit or loss on disposal of previously acquired businesses. FRS 6 contains disclosure requirements relating to goodwill.

United Kingdom and Irish accounting treatment of goodwill based on SSAP 22 was out of line with internationally acceptable accounting treatment. The debate surrounding replacement of SSAP 22 lasted years and finally culminated in the publication of FRS 10. SSAP 22 had permitted a choice of accounting treatment between immediate write off against reserves, and capitalization as an asset coupled with subsequent amortization. FRS 10 no longer permits the previously preferred treatment (of writing off goodwill on acquisition against reserves). Purchased goodwill must now be capitalized and amortized through the profit and loss account unless the directors can support the view that its useful life is indefinite, when it is carried as a permanent asset. As with its predecessor, FRS 10 prohibits recognition of internally generated goodwill.

As intangibles have already been dealt with in Section 8 of this appendix, this section concentrates on goodwill. The definition of purchased goodwill from FRS 10 was reproduced in Section 13.3 above.

FRS 7 provides guidance on quantifying goodwill recognized in financial statements, while FRS 10 sets out its required accounting treatment. FRS 7 regulates the measurement of goodwill in three ways by focusing on:

- Fair values of assets and liabilities acquired
- Fair value of purchase consideration, including deferred and contingent consideration
- Controlling, mainly by prohibiting, acquisition provisions.

The main provisions of the FRS 10 in relation to goodwill are as follows:

- Capitalized goodwill is to be written off over its useful economic life; there is a rebuttable presumption that useful life will not exceed 20 years
- A longer definite life or an indefinite life can be adopted if the durability of the asset can be demonstrated and if it is possible to re-measure its value each year to identify any reduction
- All goodwill must be reviewed for impairment at the end of the first full financial year after acquisition
- For goodwill being amortized over 20 years or less, further impairment reviews are only required where there is an indication of impairment
- Where goodwill is being amortized over a longer period than 20 years, or where an indefinite life is claimed, the carrying amount of the goodwill must be reviewed for impairment at each year-end
- Negative goodwill must be included within fixed assets and must be gradually released to profit and loss account

- Old goodwill remaining in reserves cannot be shown as a negative reserve - rather it must be written off against profit and loss account or other suitable reserve.

Companies were permitted, but not required, by FRS 10 to reinstate past goodwill written off against reserves under SSAP 22. Very few did so, preferring to enhance future earnings by ignoring the goodwill previously written off.

Legislation requires goodwill to be amortized over a limited period. Where goodwill is not amortized, the departure from legal requirements (for the overriding purpose of showing a true and fair view) should be explained, detailing the reasons for and effect of the departure.

Negative goodwill under FRS 10 is expected to arise infrequently. Where an acquisition appears to give rise to it, fair values of acquired assets should be tested for impairment and the fair values of acquired liabilities should be checked for completeness. Negative goodwill remaining should be separately disclosed on the balance sheet below positive goodwill. It should subsequently be written back to profit and loss account in the periods expected to benefit.

The requirements of FRS 10 rely upon impairment reviews being reliable and robust. FRS 11 *Impairment of fixed assets and goodwill* issued in July 1998 facilitated these aspirations.

13.6 Translation of Financial Statements Denominated in Foreign Currency

There are two methods of translating the accounts of foreign enterprises, prior to consolidation:

- Closing rate/net investment method
- Temporal method.

The method chosen depends on the relationship between the investing company and the investee.

13.6.1 Closing Rate / Net Investment Method

Normally investments are in the net worth of foreign enterprises as opposed to direct investment in individual assets and liabilities. The foreign enterprise is normally partly financed by local borrowings. Day to day operations are independent of the reporting currency of the investing company. The investing company may receive dividends, but the net investment remains until the investment is disposed of. In these circumstances the closing rate/net investment method should be used.

Under this method, balance sheet items are translated using the rate ruling at the balance sheet date (closing rate). Profit and loss account items are translated using either the closing rate or the average rate for the period. Differences arising on retranslating the opening net investment in the subsidiary, branch or associated undertaking are shown as a reserve movement, as are differences arising when the profit and loss account is translated using the average rate rather than the closing rate.

Similar to individual companies (see Section 4.1.5), exchange differences on foreign borrowings used to finance foreign equity investments may be offset through reserves in group accounts. The offset in group accounts is against differences arising on retranslating opening net investment. The offset is restricted to situations where the relationship between the entities justifies the use of the closing rate method (rather than the temporal method which is discussed later). Amounts offset in reserves in group accounts will not usually be the same as amounts offset in individual company accounts for various reasons.

Such offsetting is subject to the restriction that borrowings used in the offset procedure should not exceed the total cash expected from the investments.

13.6.2 Temporal Method

The temporal method of translation is permitted where the trade of the foreign enterprise is more dependent on the investing company's currency than on its own currency. SSAP 20 gives an example where the foreign enterprise acts as a selling agency receiving stocks of goods from the investing company and remitting the proceeds back to the company. The effect of using the temporal method is the same as adopting the individual company approach. It is as if the investor had a direct investment in the investee's individual assets and liabilities. In particular:

- All transactions should be translated at the rate of exchange ruling on the date of the transaction or at an average rate for the period if this is not materially different
- Non-monetary assets and related expenses (depreciation and cost of sales) should be translated at the rate of exchange ruling when the assets were acquired
- Monetary assets and liabilities should be translated using the closing rate
- All exchange gains and losses should be included in the profit and loss account as part of profit or loss on ordinary activities.

SSAP 20 requires the following items to be disclosed:

- Methods used in translating the financial statements of foreign enterprises and the treatment of exchange differences
- Net amount of exchange gains and losses on foreign currency borrowings less deposits, identifying separately:
 - amount offset in reserves
 - net amount credited/charged to the profit and loss account
- Net movement on reserves arising from exchange differences.

As already indicated under Section 4.1.5, FRED 24 was published in May 2002 as a proposed replacement to SSAP 20. Relatively few changes to SSAP 20 are proposed in this FRED. The most significant change from a group accounts perspective is that there would no longer be an option to translate the profit and loss account of a foreign subsidiary or equity-accounted entity using the closing rate.

PART 6: SMALLER ENTITIES

14. Reporting by Small and Medium-Sized Entities

Some private companies are exempt from certain legal provisions and professional accounting requirements on grounds of size alone. These exemptions are summarized in this section.

As a general rule accounting standards apply to financial statements of entities that are intended to give a true and fair view. Three standards provide specific exemptions from full disclosure:

- SSAP 25 *Segmental reporting*
- FRS 1 *Cash flow statements*
- FRS 14 *Earnings per share*

14.1 SSAP 25 Segmental Reporting

The requirements of SSAP 25 in excess of statutory segmental disclosure requirements apply only to plcs and to entities that exceed by ten times the legal criteria for medium-sized companies.

14.2 FRS 1 Cash Flow Statements

Small companies as defined in legislation are exempt from the requirement to prepare cash flow statements under FRS 1. Other specialised companies, and some wholly owned subsidiaries, are also exempt.

14.3 FRS 14 Earning per Share

This standard applies to listed companies only.

14.4 Financial Reporting Standard for Smaller Entities (FRSSE)

There is considerable debate on the financial reporting needs of smaller and owner-managed private companies. Principles of revenue recognition and measurement apply to all companies irrespective of size. However, there is some argument over the extent to which disclosure requirements should be applied to such companies. There is a widespread view that smaller companies are compelled to disclose information to their shareholders irrespective of its usefulness or relevance.

In response to this debate ASB developed a specific financial reporting standard for smaller entities which deals comprehensively with all their accounting requirements in one document. The definition of small is based on the legal definition. Small companies have the option of complying with full standards and UITF abstracts or simply the FRSSE. The FRSSE brings together the relevant accounting requirements and disclosures from other standards and UITF abstracts, modified and amended where appropriate for smaller entities. The FRSSE is amended, as needed, to take account of new accounting standards and UITF Abstracts issued since the previous version of the FRSSE. It has already been amended twice since it was first issued in November 1997.

The standard represents a major simplification of financial reporting for smaller entities. The FRSSE contains in a simplified form the requirements from existing standards that are relevant to the majority of smaller entities. Small companies would follow this standard and would be exempt from the requirements of other SSAPs, FRSs and UITF abstracts. The objective is to reduce the burden of preparing accounts for smaller entities.

The accounting requirements of more complex transactions are not included in the FRSSE. Measurement bases are the same as, or are a simplification of, existing accounting standards. The disclosure requirements of the FRSSE are considerably reduced by comparison with existing standards. The FRSSE does not require analysis of turnover and profits into continuing operations, acquisitions and discontinued operations.

Appendix 1: Professional Pronouncements as of July 1, 2002

Statements of Standard Accounting Practice (SSAPs)

- 4 Accounting for government grants
- 5 Accounting for value added tax
- 9 Stocks and long-term contracts
- 13 Accounting for research and development
- 17 Accounting for post-balance sheet events
- 19 Accounting for investment properties
- 20 Foreign currency translation
- 21 Accounting for leases and hire purchase contracts
- 25 Segmental reporting

Note: SSAPs not listed have been withdrawn

Financial Reporting Standards (FRSs)

- 1 Cash flow statements
 - 2 Accounting for subsidiary undertakings
 - 3 Reporting financial performance
 - 4 Capital instruments
 - 5 Reporting the substance of transactions
 - 6 Acquisitions and mergers
 - 7 Fair values in acquisition accounting
 - 8 Related party disclosures
 - 9 Associates and joint ventures
 - 10 Goodwill and intangible assets
 - 11 Impairment of fixed assets and goodwill
 - 12 Provisions, contingent liabilities and contingent assets
 - 13 Derivatives and other financial instruments: Disclosures
 - 14 Earnings per share
 - 15 Tangible fixed assets
 - 16 Current tax
 - 17 Retirement benefits
 - 18 Accounting policies
 - 19 Deferred tax
- Financial reporting standard for smaller entities

Financial Reporting Exposure Drafts (FREDs) in progress

- 22 Revision of FRS 3, Reporting Financial Performance
- 23 Financial instruments: Hedge Accounting
- 24 The effects of changes in foreign exchange rates; Financial reporting in hyperinflationary economies
- 25 Related party disclosures
- 26 Earnings per share
- 27 Events after the balance sheet date
- 28 Inventories; Construction and service contracts
- 29 Property, plant and equipment; Borrowing costs
- 30 Financial instruments: Disclosure and Presentation, Recognition and Measurement

Non-mandatory ASB Statements

- Foreword to accounting standards
- Foreword to UITF Abstracts
- Statement of principles for financial reporting
- Operating and financial review
- Interim reports
- Preliminary announcements

Appendix 1 (continued): Professional Pronouncements as of July 1, 2002

Urgent Issues Task Force (UITF) Abstracts

- 4 Presentation of long-term debtors in current assets
- 5 Transfers from current assets to fixed assets
- 7 True and fair view override disclosures (superseded by FRS 18)
- 9 Accounting for operations in hyper-inflationary economies
- 10 Disclosure of directors' share options
- 11 Capital instruments: issuer call options
- 13 Accounting for ESOP trusts
- 15 Disclosure of substantial acquisitions (revised)
- 17 Employee share schemes (revised in October 2000)
- 18 Pension costs following the 1997 tax changes in respect of dividend income (superseded by FRS 17)
- 19 Tax on gains and losses on foreign currency borrowings that hedge an investment in a foreign enterprise
- 21 Accounting issues arising from the proposed introduction of the Euro
- 22 The acquisition of a Lloyd's business
- 23 Application of the transitional rules in FRS 15
- 24 Accounting for start-up costs
- 25 National insurance contributions on share option schemes
- 26 Barter transactions for advertising
- 27 Revision to estimates of the useful economic life of goodwill and intangible assets
- 28 Operating lease incentives
- 29 Website development costs
- 30 Date of award to employees of shares or rights to shares
- 31 Exchanges of businesses or other non-monetary assets for an interest in a subsidiary, joint venture or associate
- 32 Employee benefit trusts and other intermediate payment arrangements
- 33 Obligations in capital instruments
- 34 Pre-contract costs
- 35 Death-in-service and incapacity benefits

(Note: UITF Statements not listed have been withdrawn and have no continuing relevance).
The up-to-date position on accounting standards in force can be obtained on the ASB's web site (<http://asb.org.uk>)

Appendix 2: Summary IAS Comparison Table		
IAS No.	IAS requirement	National requirement for <i>consolidated</i> accounts
1.	<p>Financial statements include a balance sheet, income statement, a statement of either all changes in equity or changes in equity excluding capital transactions with and distributions to owners, a cash flow statement, a statement of accounting policies and explanatory notes. Minimal disclosure items and formats are specified. A number of general principles should be followed in financial statements, which must give a fair presentation of financial position, financial performance and cash flows in compliance with IAS/IFRS. Compliance with IAS/IFRS should be disclosed. 100% compliance is required, but an 'override' may be used in very rare cases, when compliance with a Standard would fail to give a fair presentation.</p>	<p>Company law requires parent companies to prepare consolidated profit and loss accounts and balance sheets. These statements are required to give a true and fair view of financial performance and financial position. Reconciliation of movements in shareholders' funds is required by FRS 3. FRS 1 requires most groups to prepare a consolidated cash flow statement. The consolidated profit and loss account and balance sheet must comply with prescribed formats and layout of the Fourth Directive, as enacted. Company law specifies a number of fundamental accounting principles to be followed, while FRS 18 deals with accounting policies and estimation techniques. FRS 5 requires that the commercial substance of transactions should take precedence over legal form. Company law and FRS 18 both permit invocation of the true and fair view override, where compliance with legislation or the provisions of accounting standards would not result in the financial statements showing a true and fair view.</p>
2.	<p>Inventory is shown at lower of cost and net realizable value. FIFO, LIFO and weighted average accepted. Reversal is required for increases in value of inventory previously written down.</p>	<p>Stock should be shown at lower of cost and net realizable value, similar to IAS. However, LIFO is not permitted as a method of valuing stocks. SSAP 9 does not deal with reversals of stock previously written down.</p>
7.	<p>Cash flow statements are based on cash and cash equivalents; direct and indirect methods permitted; requires classification into operating, investing and financing activities.</p>	<p>FRS 1 focuses on movements of cash – cash equivalents are not mentioned in the standard. FRS 1 instead requires movements in liquid resources to be reported separately within the cash flow statement. FRS 1 is more prescriptive than IAS 7 in relation to the presentation of cash flows.</p>

Appendix 2 (continued): Summary IAS Comparison Table		
IAS No.	IAS requirement	National requirement for consolidated accounts
8.	Changes in accounting policy, and correction of fundamental errors, may be recognised in the income statement with proforma comparative information presented, or restate comparatives and adjust prior year opening retained earnings. Changes in accounting estimates are taken to the income statement when identified.	Changes in accounting policy and correction of fundamental errors must be treated as prior period adjustments under FRS 3, by restating comparative figures and adjusting opening retained profits brought forward. Under FRS 18, changes in accounting estimates should not give rise to prior period adjustments, but may require additional disclosure.
10.	Post balance sheet events which provide evidence of conditions existing at the balance sheet date are adjusting events, if material. Non-adjusting events are disclosed. The announcement of a dividend relating to the year just ended is a non-adjusting event.	Requirements similar to IAS. However, certain post balance sheet events are recognised including proposed dividends not declared at the balance sheet date, and dividends proposed by subsidiaries and associates but not declared by the balance sheet date.
11.	Construction contracts must use the percentage of completion method.	SSAP 9 also requires the percentage completion method for calculating revenues, expenses and profits on construction contracts. However, SSAP 9 is more conservative in requiring only “prudently calculated attributable profit” to be recognised.
12.	Deferred tax is generally provided using the full provision method, related to temporary balance sheet differences. Deferred tax assets are recognised if recovery is probable. Non-tax-deductible goodwill, and negative goodwill, do not give rise to temporary differences.	Under FRS 19 deferred tax is provided using the full provision method, based on timing differences (not temporary differences as for IAS 12). Deferred tax on some timing differences is not recognised (e.g. on revaluation gains). FRS 19 permits discounting of deferred tax liabilities.
14.	Public (listed) entities should report segmental information based on both business and geographical segments, one of which should normally be chosen for the primary disclosure format, and the other for the secondary format, based on internal reporting structure and using the group accounting policies. Extensive disclosures are specified for the primary format (including revenues, results, capex, total assets and liabilities), less for the secondary.	SSAP 25 applies to plcs, banking and insurance companies and large companies. Segmental analysis by class of business and geographically is required, but there is no distinction between primary and secondary markets. Disclosures required as less extensive than for primary segments under IAS, but are more extensive than those required for IAS secondary segments.

Appendix 2 (continued): Summary IAS Comparison Table		
IAS No.	IAS requirement	National requirement for <i>consolidated</i> accounts
16.	Property, plant and equipment should use either historical cost, or revalued amounts involving frequent revaluations of entire classes.	Tangible fixed assets may be valued at historic cost or may be revalued. Where a policy of revaluation is adopted, revaluations should take place regularly (generally at least every five years).
17.	Finance leases are leases which, in substance, transfer substantially all the risks and rewards of ownership. Lessors allocate gross earnings to give a constant rate of return based on the net (i.e. pre-tax) net investment method.	There are small differences in the definition of finance leases which may lead to differences in classification between finance and operating leases. Lessors' finance lease income should be credited to the profit and loss account, based on a method that reflects a constant periodic rate of return on the lessor's net cash investment in the lease.
18.	Revenue should be recognised when the risks and rewards have been transferred and revenue can be measured reliably.	There is no separate standard on revenue recognition.
19.	Defined benefit employee pension plans must measure obligations using the projected unit credit method. Other employee benefits are generally treated consistently with pensions.	FRS 17 requirements are similar to IAS 19. FRS 17 requires immediate recognition of actuarial gains and losses in the STRGL, whereas under IAS 19 these are recorded in the profit and loss account. The scope of IAS 19 is greater than FRS 17.
20.	Government grants are either recognised as deferred income and amortised, or offset against asset carrying values.	The preferred treatment of capital grants is to record the grant as a deferred credit which is amortised on the same basis of the related fixed asset. Netting the grant off against the related fixed asset is not prohibited by SSAP 4 but is effectively prohibited in law by the prohibition on netting off of assets and liabilities.

Appendix 2 (continued): Summary IAS Comparison Table		
IAS No.	IAS requirement	National requirement for consolidated accounts
21.	For individual companies, foreign currency transactions are translated at the transaction-date rate, monetary items at balance sheet date rate, non-monetary items at historic rate. For consolidated accounts, use closing rate for balance sheets and average rate for income statements taking exchange differences to equity.	Requirements similar except that transactions subject to forward currency contracts are translated at the contract rate of exchange. Gains and losses on translating foreign currency transactions are recognised in the profit and loss account. The closing rate/net investment method is the most commonly used method for translating subsidiary and equity-accounted entities prior to consolidation. Closing rate or average rate can be used to translate the profit and loss account. Exchange differences on translation of foreign currency financial statements are dealt with in the statement of total recognised gains and losses and as reserve movements. <i>FRED 24 The Effects of Changes in Foreign Exchange Rates & Financial Reporting in Hyperinflationary Economies</i> published in May 2002 proposes limited changes to current requirements, but most proposed changes are to bring the UK/Irish standard into line with IAS 21.
22.	Business combinations using uniting of interests method (pooling) are severely restricted. The purchase method requires the fair values of assets and liabilities acquired. Purchased goodwill should be capitalised, and amortized over its useful life, normally not exceeding 20 years. Restructuring provisions must meet criteria relating to a formal plan that involves terminating or reducing the activities of the acquiree, the main features of which must be announced to those affected.	The merger method of accounting to record business combinations is permitted provided five criteria of FRS 6 and the legal requirements arising from the Seventh Directive are met. Under acquisition accounting, goodwill is the difference between the fair value of the assets acquired and of the purchase consideration. Goodwill with a finite useful life should be amortised over 20 years or less. Goodwill that is amortised over a period exceeding 20 years is subject to an annual impairment review. Goodwill should not be amortised if its useful life is indefinite, provided durability can be demonstrated and it is capable of continuing measurement and impairment review.

Appendix 2 (continued): Summary IAS Comparison Table		
IAS No.	IAS requirement	National requirement for consolidated accounts
23.	Borrowing costs may be capitalised for “qualifying” assets related to the construction period.	FRS 15 permits capitalisation of borrowing costs, but only that part of the finance costs that relates to the capital expenditure incurred to date.
24.	Extensive disclosures are required for related parties, i.e. where control or significant influence exists.	FRS 8 is similar. However, related parties encompass parties under common control and common influence and parties that are under control or influence of persons acting in concert.
26.	Retirement benefit plans should carry investments at fair value, and follow extensive disclosure requirements.	Pension scheme accounts are covered by Statement of Recommended Practice (SORP) 1. Investments should be recorded at market value.
<u>IAS No.</u>	<u>IAS requirement</u>	<u>National requirement for consolidated accounts</u>
27.	A subsidiary involves voting control or power to exercise dominant influence. Dissimilar activities are not a justification for non-consolidation.	FRS 2 requirements are similar. However, a subsidiary relationship exists under FRS 2 where the parent has a participating interest in the undertaking and actually exercises a dominant influence or it and the undertaking are managed on a unified basis. In exceptional circumstances, subsidiaries with dissimilar activities should be excluded.
28.	An associate involves significant influence by the investor entity. Participation in policy determination, or a 20% investor interest, both lead to a presumption of significant influence. The equity method is required.	FRS 9 requirements are similar IAS 28, but FRS 9 requires that the investor <i>actually</i> exercises significant influence in order to create an associate relationship. FRS 9 requires investor’s share of operating profit, exceptional items and interest to be disclosed on the face of profit and loss account. IAS 28 does not give guidance on this.
29.	Local financial statements for foreign entities in hyper-inflationary economies (as defined) must be updated to current purchasing power before translation.	UITF 9 allows a choice of treatment in translating foreign entities in hyperinflationary economies (the current purchasing power method and the stable currency remeasurement method) whereas IAS only allows current purchasing power method.

Appendix 2 (continued): Summary IAS Comparison Table		
IAS No.	IAS requirement	National requirement for <i>consolidated</i> accounts
30.	Extensive disclosure requirements exist for the financial statements of banking institutions. Hidden reserves are not permitted.	No accounting standard on banks and financial institutions
31.	Investments in jointly controlled incorporated entities may be accounted for using either proportionate line-by-line consolidation or the equity method. For investments in jointly controlled unincorporated operations, the investor's share of assets, liabilities, income and expenses must be recognized in its financial statements. For any jointly controlled assets and liabilities, an investor must account for its share.	Proportional consolidation is not permitted under FRS 9. Joint ventures should be accounted for using the gross equity method. In the profit and loss account, gross (inclusive of joint venture) turnover should be separately disclosed, with deduction of joint venture turnover to present group turnover. In the balance sheet, gross assets and gross liabilities of joint venture should be separately disclosed. Where there are net liabilities, include investor's share, unless it can be demonstrated that investor has withdrawn from the relationship.
32.	Extensive disclosure requirements exist for financial instruments.	There are extensive disclosure requirements for financial instruments contained in FRS 4 and FRS 13. Some of these requirements differ from IAS requirements.
33.	Basic and diluted earnings per share must be disclosed, with equal prominence, on the fact of the income statement.	Requirements under FRS 14 are similar.
34.	Interim financial reports are not mandatory, but must follow IAS 34 in full if prepared. Interim reports should be consistent with full year statements, and include comparatives.	ASB's non-mandatory statement on Interim Reports requires these reports to be issued within 60 days. Guidance is given on the content of interim reports. A known accounting policy or presentation change should be implemented in the interim accounts.
35.	Extensive disclosure is required of discontinuing operations, defined as separate major components, and the effects.	Extensive disclosures are also required under FRS 3. Discontinued operations are defined as those that have a material effect on the nature and focus of operations. The operation must be discontinued by three months after the year-end, or the date of approval of the financial statements, if earlier.

Appendix 2 (continued): Summary IAS Comparison Table		
IAS No.	IAS requirement	National requirement for consolidated accounts
36.	If impaired, assets should be written down to the higher of net selling price and value in use based on discounted cash flows. Reversal of losses is permitted under certain conditions.	Under FRS 11 assets should be recorded at recoverable amount which is the higher of net realisable value and value in use. Reversal of impairment losses on intangible assets is restricted to those intangibles with readily ascertainable market values.
37.	Provisions should be recorded as liabilities if they meet the liabilities definition and the obligation is probable and can be reliably estimated. Unrecognised possible losses, and probable gains, are disclosed as contingencies.	Requirements under FRS 12 are similar to IAS 37.
38.	Acquired intangible assets are treated consistently with property, plant and equipment, if recognition criteria are met. Internally generated development costs are capitalized if stringent criteria are met.	Internally generated intangibles cannot be capitalised under FRS 10.
39.	There is a fourfold categorization of financial assets as either (a) held for trading, (b) held-to-maturity, (c) loans and receivables originated by the entity and (d) available-for-sale. Categories (b) and (c) are recognized and measured at amortized cost, (a) and (d) at fair value. Remeasurement gains/losses on (a) go to income; on (d) they may go either to income or directly to equity, but the chosen policy must be followed consistently. Financial liabilities are divided into trading and non-trading. Non-trading liabilities are recognized and measured at amortized cost. Trading liabilities are initially recognized at cost, but are subsequently measured at fair value with gains/losses taken to income. Hedge accounting is allowed when the hedged item is measured at cost and the hedging item at fair value, but only for well-documented and effective micro hedges.	There is currently no accounting standard on financial assets. FRED 23 Financial Instruments: Hedge Accounting was published in May 2002. This proposed standard deals with a limited category of investment. FRED 30 <i>Financial Instruments: Disclosure and Presentation & Recognition and Measurement</i> was published in June 2002. The draft sets out proposals for the partial implementation in the UK and Ireland (in 2004) of currently proposed (at the time of writing) revised versions of IAS 32 and IAS 39. This proposed implementation is dependent on changes in legislation to permit use of fair value accounting to measure certain financial assets and liabilities.

Appendix 2 (continued): Summary IAS Comparison Table		
IAS No.	IAS requirement	National requirement for <i>consolidated</i> accounts
40.	Investment properties are measured at fair value with all changes taken to the income statement, or at depreciated cost.	Under SSAP 19 investment properties should be revalued annually at open market value and should not be depreciated. A property held under an operating lease can be an investment property of the lessee under SSAP 19, but not under IAS 40.
41.	Biological assets are recorded at fair value less estimated point-of-sale costs, with movements in carrying value going to the income statement.	There is no equivalent accounting standard on accounting for agricultural activity and biological assets.